Financial Monitoring Policy for 2014-2015

(Policy for Supervision and Inspection)

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Financial Services Agency

Contents

The Financial Services Agency (FSA) has been working to improve the quality of Japan's financial regulations ("Better Regulations") since program year 2007. In program year 2013, aiming for an in-depth understanding of the condition of financial institutions and the financial system, the FSA published its "Financial Monitoring Policy" and integrated the process of on-site monitoring (on-site inspections of financial institutions) and off-site monitoring (hearing and request to submit materials).

For 2014-2015, the FSA has decided to integrate its annual supervisory and financial monitoring policies into a single policy to further enhance the effectiveness and consistency of cooperation between the Supervisory Bureau and the Inspection Bureau.

Going forward, the Supervisory Bureau and the Inspection Bureau will work to enhance the effectiveness and efficiency of their financial supervision and inspection by discharging the responsibilities allocated to them, while working in close cooperation under the common policy.

It should be noted that the financial monitoring policy for 2014-2015 was drafted based on the economic and financial conditions that surrounded the financial system in September 2014, and is subject to review as necessary.

Ⅰ. Basic Concepts of Financial Supervision and Inspection for 2014-2015

1. Efforts to overcome deflation and build a positive economic cycle

The Japanese government is promoting initiatives to overcome deflation and achieve sustainable economic growth. To facilitate this, it is important to ensure that the necessary funds are readily available to the economy and industries.

Going forward, given the aging and decreasing population, it is important to ensure that the growth of the economy and industries is sustained over the long-term, contributing to improving employment and wages and ensuring that Japanese citizens' cash-concentrated assets are appropriately managed for a steady buildup of wealth, thereby generating risk monies necessary for economic growth.

Financial institutions should support the above view, and contribute to building a positive cycle whereby their support for economic growth and stable living of Japanese citizens would result in the generation of a stable income for the financial institutions themselves.

2. Maintaining safety and soundness of the financial system and financial institutions

To achieve effective financial intermediation as described above, it is essential that the financial system and financial institutions remain robust and sound. Financial institutions are largely susceptible to market and economic conditions both in Japan and abroad. Therefore, it is important to respond appropriately to changes in the environment surrounding the financial system in order to retain the soundness of the financial system and financial institutions.

Ⅱ. Focus of Monitoring

Grounded on the basic concepts described above, the FSA's monitoring will focus on the following points.

1. Effective response to the needs of customers

In order to induce the above-mentioned positive cycle successfully, the management of financial institutions must endeavor to develop financial products/services that are really beneficial for their customers.

However, in the business of offering financial products/services, there is a gap in the volume of information between the supplier (i.e. financial institutions) and the end user (i.e. customers). As such, financial institutions may operate their businesses focusing on short-term profits and business expansion, instead of in the interests of their customers.

In financial inspections, the FSA will review whether individual financial institutions align their businesses with the interests of their customers, really satisfying customer needs. For example, the FSA will review the adequacy of financial institutions' governance, including the prevention of abuse of a dominant position of institutions and conflicts of interest between institutions and customers. The FSA will also review whether financial institutions provide financial products/services that are really beneficial for their customers, regardless of the level of commission and fees and the customer's corporate group association. The result of the verification will be communicated to the financial institutions to enhance discussions.

2. Lending based on customers' business potentials

Under the ongoing globalization of financial transactions/corporate activities and the aging and decreasing population in Japan, Japanese companies and industries should maintain their economic dynamism and lead economic growth. For regional economies facing labor shortages, it is important to encourage companies/industries in the relevant regions to improve productivity.

Therefore, companies and industries operating in global competition should maintain and enhance their global competitiveness, while those based in regional economic zones should improve their efficiency and productivity through moderate business integration, thereby increasing employment and wages in the relevant region.

Considering the above, financial institutions should facilitate the growth of companies and industries based on an assessment of borrower companies' business profiles and growth potential (evaluation of customers' business potentials), providing financing and advice without overly relying on financial data, collateral and guarantees. In addition, financial institutions should continue supporting small and medium enterprises (SMEs) carefully and endeavor to smoothly facilitate access to finance.

In connection with the above, the FSA will review their management's policy, their attempt to incorporate Customers' business potential in the process of credit screening, and actual business practices towards customers.

3. Upgrading asset management capacity

It is important that the massive amount of funds and assets invested by households, pension funds and institutional investors should be managed appropriately in line with the characteristics of each fund and asset, and the needs of the asset owners.

As such, individual financial institutions are required to fulfill their roles and responsibilities in the given function, such as product origination, financial product sales, portfolio management and asset management (fiduciary duty[1]).

Financial institutions' efforts to improve their asset management capabilities, while fulfilling their fiduciary duties, will create a positive cycle facilitating steady asset formation for Japanese citizens, accelerating investment flows further, and contributing to the medium- to long-term growth of asset managers and relevant markets.

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1 A general term for the extensive and various roles and duties of a trustee who must fulfill certain obligations entrusted by the counterparty (entrustor)

The FSA will review financial institutions' policies towards their business operations and incentive mechanisms in relation to the above, and the financial products/services actually offered by financial institutions.

In addition, the FSA will review the effectiveness of internal control and risk management for proprietary investment by financial institutions in relation to the size, etc. of the invested funds keeping in mind the characteristics of asset management that vary among the types of their businesses.

4. Macro prudence

Soundness of financial institutions' business operations is affected by changes in the condition of the economy, finance, and capital markets both in Japan and overseas. Conversely, individual financial institutions' behavior may affect the overall economy, finance and capital markets. As such, it is important to understand the status of both sides at all times and analyze how they interact with each other.

The FSA will enhance its framework to analyze risks inherent to the overall financial sector with a forward looking perspective, and endeavor to grasp the actual condition of the global economy, flow of funds, trends in financial/capital markets, market participants, and financial institutions' businesses/strategies. This would include an analysis of the potential impacts of global market trends, such as changes in the ongoing global expansion of the credit market on the financial system in Japan, and the potential impact on financial institutions' business operations of changing interest rates and prices of various assets in line with the economy shifting away from the deflationary state.

Based on the analyses noted above, the FSA will review the risk management framework etc. of individual financial institutions. In addition, the FSA will analyze how the overall direction of financial institutions' business operations will impact the economy and financial/capital markets. In this connection, the FSA will re-examine what information to request from financial institutions.

Further, the FSA will strengthen information sharing and coordination with the Bank of Japan (BOJ) and self-regulatory organizations.

5. Enterprise risk management (ERM)

To date, the FSA has inspected the soundness of financial institutions mainly through individual asset reviews during on-site monitoring. However, in order to continuously ensure the soundness of overall business management in financial institutions, it is important to identify the principal risks to individual financial institutions, taking into account their business and financial condition in a comprehensive manner, and to analyze their vulnerability to such risks.

Therefore, the FSA will reinforce its monitoring to better identify and analyze business risks for individual financial institutions through off-site monitoring. The FSA will also perform targeted on-site inspections based on the results of off-site monitoring. Further, the FSA will look at financial institutions' risk management framework, including interest risk, credit concentration risk and enterprise risk management (including use of stress tests). The FSA will refine its approach to verification of the above by studying cases including those in overseas countries. Based on the results of verification, the FSA will encourage financial institutions to build a strong and secure financial base.

For on-site monitoring regarding individual assets review by financial institutions, the FSA will generally rely on the assessment of financial institutions in terms of small-sized assets, as long as the FSA considers that financial institutions' asset management, such as provisioning, is well established and effective. Further, on this basis, the FSA will respect, in principle, the decisions of financial institutions except those on large-lot credits with the potential to impact the safety and soundness of a financial institution.

6. Sustainability of business model and corporate governance

For financial institutions to continue providing appropriate financial intermediation into the future while maintaining soundness, their business model must be sustainable, with a capability to appropriately handle future changes in the environment.

The FSA will have in-depth discussions with individual financial institutions about how they recognize medium- to long-term economic and social trends, etc. and under what management policy financial institutions are attempting to ensure the sustainability of their business model.

In addition, the FSA will review the effectiveness of governance in individual financial institutions, which is necessary for developing a sustainable business model. Specifically, the FSA will confirm the status of information management/earnings management necessary for financial institutions to get a grasp of their business condition. The FSA will also confirm the functions of the Board of Directors (including outside directors), Board of Company Auditors, the internal audit department and external audit firm, the effectiveness of those functions and the coordination among them. Therefore, where necessary, the FSA will exchange views directly with individuals associated with the above Board of Directors etc., as well as the president of the financial institution.

Further, the FSA will enhance knowledge of business practices in other financial institutions and corporations both in Japan and abroad which can be used as good examples of business management.

7. Ensuring customers' trust/security

The financial system is at the core of the economic infrastructure. Thus, it is essential for economic growth and customers' daily life to ensure steady and appropriate offerings of financial services (including preventing illegal use) and fairness/transparency in the financial/capital markets.

In view of this, the FSA will review the status of the business continuity plan of financial institutions, as well as how they ensure information security and respond to fraudulent remittance through Internet banking and cyber-attacks. The FSA will also review initiatives taken by financial institutions against fraudulent use of financial services, including transactions with antisocial groups and money laundering.

8. Acceleration of recovery from the Great East Japan Earthquake

To accelerate recovery from the Great East Japan Earthquake and rebuild a sustainable economy and industries in disaster-affected areas, financial institutions should provide financial intermediation precisely, based on a thorough understanding and analysis of the conditions and needs of the disaster-affected areas.

Particularly, many disaster-affected areas are shifting away from the restoration stage, facing the start of full-blown reconstruction of industries and regional revitalization. It is important for financial institutions to facilitate the development of industries and companies that can become the driving force behind the recovery of disaster-affected areas and support the creation of new communities incorporating changes in the environment from financial institutions' view point.

The FSA will continue to deal with the so-called double loan problem, while confirming the appropriateness of finance facilitations' support for full-blown reconstruction of disaster-affected areas and reconstruction of businesses and livelihoods of disaster-affected people, as well as the utilization of the Corporation for Revitalizing Earthquake affected Business and the Individual Debtor Guidelines for Out-of-Court Workouts. At the same time, the FSA will encourage financial institutions to use the Reconstruction Finance Network.

9. Public finance and private finance

To ensure that Japan's financial system contributes to the economic growth and improvement of the living standard of Japanese citizens, it is important that the public and private finance sectors complement each other. The FSA will develop better understanding of the competing and complementary relations between public and private finance sectors through discussions with financial institutions and their customers, to be followed by discussions with relevant stakeholders on how better relations between the public and private financial systems could be established.

Ⅲ. Concrete measures for monitoring

1. Integration of on-site and off-site monitoring process

To date, the Supervisory Bureau has been in charge of conducting hearings, requesting financial institutions to submit materials (off-site monitoring), and taking specific supervisory measures, whereas the Inspection Bureau has conducted on-site inspections of financial institutions (on-site monitoring).

In program year 2013, a new financial monitoring policy was introduced, and the FSA changed to a new approach where the statuses of financial institutions are confirmed effectively and efficiently through a combined on-site and off-site monitoring process. However, the new monitoring of the Inspection Bureau overlapped with the off-site monitoring conducted by the Supervisory Bureau until the launch of the new monitoring policy. Therefore, for 2014-2015, the FSA has decided to combine the annual supervisory policy and financial monitoring policy and integrate the process of monitoring financial institutions; thereby the two bureaus are expected to conduct financial monitoring in close cooperation, fulfil their responsibilities under the common policy and ultimately reduce the administrative burden on the financial institutions that are subject to monitoring. The FSA will also strengthen cooperation between the Supervisory Bureau and the Securities and Exchange Surveillance Commission to minimize the administrative overlap between the two to improve financial monitoring.

2. Enhance constructive dialogues between FSA and the financial sector

Financial institutions should not only work towards achieving the standard set out in related laws and regulations (i.e., minimum standard) but also aim to improve their business operations further (i.e., best practices). Many financial institutions' efforts to achieve superior business operations and provide high quality financial products/services will ultimately strengthen Japan's financial capabilities.

In doing so, the best practices for which individual financial institutions aim should not be uniform across all institutions, but unique, developed through individual financial institutions' voluntary efforts. Through various opportunities for constructive dialogue with financial institutions, the FSA will encourage them to eliminate the herd-instinct and achieve a healthy state of competition where they try to improve the quality of their services to customers. Further, results of the FSA's monitoring and analyses will be published and fed-backed to financial institutions in the form of financial monitoring reports, etc. as a reference for future actions.

3. Enhanced international cooperation

The links between Japan's economy/markets and the global economy/markets have become stronger, and financial institutions continue to expand their business overseas, increasing cross-border transactions. As a result, Japanese financial institutions are becoming more susceptible to international regulatory trends and changes in the regulatory environment in other countries.

The FSA is committed to active participation in international discussions on financial regulations. At the same time, the FSA will strengthen its coordination with financial supervisory authorities in other countries to achieve more effective and efficient supervision of internationally active financial institutions, including Japanese financial institutions.

Further, in order to maintain high quality supervision (best practices) that is in line with the international level, the FSA will endeavor to obtain information regarding supervisory trends in overseas countries and continue its efforts to improve its supervisory approach in Japan.

4. Enhance dialogues with stakeholders and collection of information

The FSA will work towards an accurate understanding of the status of financial institutions' business operations by accelerating the collection of information and dialogue with shareholders, customers, outside directors, auditors, sales staff members, self-regulating organizations, and regional communities, and will consider measures for improvement.

IV. Supervision and Inspection for Major Banks[2]

1. Issues facing Major Banks and concepts for 2014-2015

Major Banks maintain large-scale assets and an extensive customer base. Thus, their activities may strongly affect Japan's economy and markets through the economic activities of corporate customers, industry sectors and individuals. In addition, the safety and soundness of Major Banks may affect the financial system not only in Japan but also globally.

In view of this influential position, Major Banks are expected to contribute to the sustainable growth of Japanese companies and industries, sophistication of wealth accumulation for individuals, the stability of Japanese citizens' daily lives, and market stability by performing effective financial intermediation. This in turn will enable Major Banks to ensure stable earnings and maintain soundness.

With the aim of creating a positive cycle as above, the FSA will monitor Major Banks focusing on the four important points below.

Firstly, due to the international and cross-sectional nature of their business operations, Major Banks are able to accumulate knowledge on global industries relatively easily and offer more sophisticated financial services. Leveraging on this, Major Banks are expected to facilitate companies and industries to enhance their competitiveness and achieve sustainable growth and renovation. Specifically, Major Banks should accurately assess not only the business profile of individual borrower companies but also the overall condition of relevant industries and growth potential (evaluation of customers business potentials), and make efforts to provide advice utilizing their above expertise and funds for growth including offshore financing in an efficient manner.

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[2] In this document, the term "Major Banks" refers to the banks commonly referred to as major banks, as well as Shinsei Bank, Aozora Bank, Citibank, and Japan Post Bank.

Secondly, amidst the government's efforts to shift away from the deflationary state, it is important for Major Banks to contribute to a stable accumulation of wealth for individuals and others. Major Banks should accurately capture the needs of individuals and others, and provide financial products/services that really meet their needs. Also, as a foundation for offering such products/services, it is important to nurture an environment in which customers can use financial services with a sense of security at any time. Thus, Major Banks should make efforts to provide financial services in a stable manner.

Thirdly, Major Banks manage securities investments in large volumes. In view of the government's efforts to overcome deflation, Major Banks are expected to work on upgrading their securities investment management further, including the refinement of their framework for collecting various information and managing the risk/return tradeoff.

Fourthly, it is important for Major Banks to improve their governance and risk management systems. In particular, responding to the global nature of their businesses, Major Banks should build a strong governance system, appropriately incorporating changes in the international regulatory environment and meeting the international level in a group-wide effort, as a viable governance system prevents activities that will reduce the enterprise value and improves competitiveness and profitability. Major Banks should also build an integrated risk management system, where material risks for the group as a whole are identified and managed, taking into account the potential impact of their own behavior on the economy and financial system.

Through the above actions, Major Banks will be able to develop a sustainable business model, secure and improve their competitive position in international markets, while contributing to the growth of financial and capital markets in Tokyo as a whole.

2 Key priority measures and the focus of supervision and inspection

2-1 Performing financial intermediation

(1) Providing funds to accelerate industrial restructuring and economic growth

(i) Accurate assessment of corporate customers, proposal of solutions and support for Implementation

Key characteristics of Major Banks are: (i) They can acquire extensive information on global industries as well as individual companies relatively easily, given a customer base encompassing from large companies to SMEs; and (ii) backed by the international and cross-sectional nature of their business operations, they have solid capabilities to provide sophisticated financial services such as assistance for overseas expansion, business support including the provision of equity etc., and encouragement for infrastructure development through project finance.

The FSA will review whether Major Banks, leveraging on the characteristics noted above, (i) accurately understand and analyze the needs of and issues facing corporate customers and relevant industries, and evaluate customers business potentials based on such an understanding and analysis; and (ii) proactively and appropriately take action to provide funds for growth that will support industrial restructuring and economic growth by proposing appropriate solutions for potential issues identified through customers' business potentials, before such issues materialize in corporate customers.

In view of invigorating regional economies and facilitating finance in the regions, the FSA will review whether Major Banks (i) provide funds smoothly and accept changes in the lending terms based on the borrowing corporates' condition; (ii) have established a framework for taking appropriate action including the provision of risk money utilizing the "Guidelines for Personal Guarantee Provided by Business Owners" and reflecting the purpose of the March 2014 revision to Ordinance for Enforcement of the Banking Act; (iii)coordinate with outside experts/organizations if necessary, actively perform an effective consulting function that is not just financial advice but will lead borrower SMEs to acknowledge issues and make self-help efforts to improve management and restructure businesses; and (iv) are actively involved in other initiatives for growth/reconstruction of SMEs, leveraging expertise acquired through international and cross-sectional business operations.

(ii) Acceleration of recovery from the Great East Japan Earthquake

To assist in the recovery from the Great East Japan Earthquake and rebuild sustainable economy/industries in the disaster-affected areas, financial institutions should systematically understand and analyze the condition and needs of the disaster-affected areas, propose best-suited solutions for people affected by the disaster and provide support for implementing solutions.

Especially, many disaster-affected areas are shifting away from the restoration stage, facing the start of full-blown reconstruction of industries and regional revitalization. It is important for financial institutions to provide support for facilitating the development of industries and companies that are likely to become the core of the disaster-affected areas and for building communities reflecting changes in the environment.

The FSA will continue dealing with the so-called double loan problem, while confirming whether Major Banks actively utilize Corporation for Revitalizing Earthquake affected Business, Industrial Recovery Consultation Center, Industry Reconstruction Corporation, and the Individual Debtor Guidelines for Out-of-Court Workouts. The FSA will also confirm the appropriateness of financial support for full-scale reconstruction of the disaster-affected areas and reconstruction of the livelihoods and businesses of people affected by the disaster, while promoting the use of the Reconstruction Finance Network.

(iii) Public finance and private finance

The FSA will develop a better understanding of the competing and complementary relations between public and private finance sectors through discussions with financial institutions and their customers, to be followed by discussions with relevant stakeholders on how better relations between the public and private financial sectors could be established.

(2) Provision of financial services in line with the needs of customers

(i) Provision of appropriate products/services reflecting customer needs

Major Banks are expected to offer effective and efficient asset management tools by accurately identifying the needs of various customers, developing and providing financial products/services that satisfy the identified customer needs, their levels of knowledge, experience and wealth.

Considering the above, the FSA will review the following points.

a. Whether Major Banks provide explanations on the products they offer and implement post-sale follow-ups appropriately in line with the levels of knowledge, experience and wealth of their customers;

b. In selecting products to offer to customers, whether Major Banks have established a procedure that ensures offerings of financial products that really match their customers' needs and interests, regardless of the commission/fee and the business relations; and

c. Whether Major Banks are considering or have introduced management targets and an incentive mechanism to promote sales activities focusing on customer interests.

The FSA will also review whether, in order to nurture an environment in which, regardless of the means of investment, customers obtain the financial products/services they really need, and where the interests of both customers and financial institutions are realized, Major Banks have solid internal control systems for (i) conflicts-of-interest management, prevention of abuse of a dominant position, and customer information management, in line with the degree of collaboration among banks, trust banks and securities companies; and (ii) providing explanations to customers and conducting credit screening appropriately so that housing loans, consumer loans and other loans are provided in line with the needs, economic conditions, etc. of individual customers.

The FSA will also check whether Major Banks maintain a structure whereby, with the involvement of top management, the causes of customer consultations/complaints are analyzed, information is shared institution-wide, and measures to prevent the recurrence of complaints are developed, disseminated and followed up, and where these are reflected in the future development of products/services and improvement of risk management systems.

The FSA will review whether Major Banks are taking appropriate action in connection with the financial Alternative Dispute Resolution (ADR) system, such as disclosure of required information for quick dispute resolution, explanations regarding the financial ADR system, and introduction of the system to customers upon consultation.

Taking into account the purpose of introducing NISA (Nippon Individual Savings Account), the FSA will encourage Major Banks to be actively involved in industry-wide/cross-sectorial efforts to improve the financial literacy of their investors.

The FSA will review whether there is a well-established framework to ensure appropriate provision of financial groups' custody services in view of their importance as an essential element of the asset management business in the group.

(ii) Measures to improve customer convenience

Major Banks should make constant efforts to improve customer convenience, including the enhancement of settlement systems, considering the fact that financial services are an essential element of the economy.

In this context, the FSA will encourage the Japanese Bankers Association and individual financial institutions to take action to improve their customer services, including the enhancement of settlement systems such as real-time bank transfers in view of the Japan Revitalization Strategy (Revised in 2014).

In addition, the FSA will strongly encourage Major Banks to develop facilities and systems that allow people with disabilities and elderly people to utilize financial services safely and easily over the counter and from ATMs at financial institutions.

(3) Ensuring customers' trust/security

To achieve customer-oriented business, it is important to ensure that customers are able to utilize financial services safely at any time. The financial system is a key element of the economy. Thus, ensuring the appropriate and steady offering of financial services (including prevention of illegal use) is essential to economic growth and customers' daily living. Also, stable provision of financial services will enhance customers' sense of security and loyalty, and ultimately contribute to establishing a sustainable business model.

As such, the FSA will monitor whether Major Banks are precisely implementing measures for business continuity and stable services under the leadership of the management, including the following.

(i) Ensuring business continuity

a. Stable IT system operation

In order to ensure the stability of IT systems, the FSA will review the status of operation and management of inter-bank systems, such as, the Zengin System, as well as individual banks' IT systems, including scheduled system updates.

b. Validation of business continuity system

The FSA will review whether Major Banks have set up their business continuity system to assume major risks sufficiently, and whether they review the business continuity plan in light of discussion results at Central Disaster Prevention Council, etc.

(ii) Comprehensive information security

The FSA will review whether Major Banks identify, understand and manage important customer information including cases that are contracted out/subcontracted, and whether they have solid internal control to deter and prevent fraudulent access and acquisition of customer information.

(iii) Preventing abuse of financial services

a. Illegal money transfer through internet banking

In connection with Internet banking services for individuals and corporate customers, the FSA will review whether Major Banks are (i) implementing measures to prevent the theft of funds: (ii) giving sufficient warning to customers by presenting examples of security measures required for customers; and (iii) setting out policies to indemnify customers for illegal transfers of funds in accordance with the agreement within the Japanese Bankers Association.

b. "Furikome" fraud (Bank Transfer Fraud in which the criminal tricks a person into transferring money to a designated fraudulent deposit account)

The FSA will review whether Major Banks are taking action to eliminate crime such as *Furikome* fraud and are continuing their assistance to enable fraud victims to obtain a prompt recovery in accordance with *Furikome* Fraud Relief Act.

c. Use of counterfeit/stolen cash cards and stolen passbooks

The FSA will review whether Major Banks are taking measures to prevent fraudulent withdrawals using counterfeit/stolen cash cards and stolen passbooks, and providing indemnification to victims in accordance with the Depositor Protection Law.

d. Cyber-attacks

The FSA will review whether Major Banks have taken appropriate security measures and developed a contingency plan in response to various cyber-attacks.

e. Money laundering and terrorism financing of transaction

The FSA will review whether there is a sophisticated system to appropriately execute tasks, including verification at the time of a transaction, preparation and preservation of verification and transaction record, monitoring of executed transactions, and reporting of suspicious transactions based on the revised Act on Prevention of the Transfer of Criminal

Proceeds, while keeping customer convenience in mind.

f. Cutting relationships with antisocial groups

In view of the June 2014 revision of guidelines for supervision, the FSA will review whether Major Banks are taking measures to cut relationships with antisocial groups appropriately at every stage of a transaction—at initiation, post-execution and termination, including pre-screening, ex post-review —and are taking measures to terminate transactions with antisocial groups.

(iv) Maintaining and improving credibility and transparency of financial benchmarks

Financial benchmarks, such as the TIBOR[3], are an important part of financial markets. Fraudulent activities in the calculation process will damage the credibility of the services provided using such benchmarks. Based on this, the FSA will review whether Major Banks have solid systems to prevent abusive conduct when submitting data for the benchmark calculations, such as measures to prevent conflicts-of-interest, etc.

Particularly for the TIBOR, the FSA will review whether JBA TIBOR Administration is acting appropriately to maintain and improve the credibility and transparency of the benchmark interest rates, incorporating the direction of international discussions including IOSCO Principles[4] and the revised Financial Instruments and Exchange Act.

2-1 Ensuring the soundness of financial institutions

(1) Forward looking risk management

For financial institutions to fully discharge their responsibilities as financial intermediary functions, such as supporting the real economy and corporate growth by providing financing steadily in a changing environment, it is essential that the FSA acts to ensure the financial soundness of individual financial institutions and the stability of the financial system.

In view of the international and cross-sectorial nature of business operations, Major Banks should (i) understand the effect of changes in domestic and global economy and financial/capital markets on each financial group and the financial system as a whole, and

[3] Tokyo Interbank Offered Rate. A reference rate used in the Tokyo interbank market.
[4] "Principles for Financial Benchmarks" was developed by IOSCO (International Organization of Securities Commissions) in July 2013. It sets out principles for improving the transparency of management and calculation methods for financial benchmarks by the financial benchmark administrators.

discuss/analyze countermeasures, (ii) keep in mind the effect of their own behavior on the overall financial system, economy, and financial/capital markets, (iii) establish an integrated risk management system in view of the complexity and diversity of risks associated with their businesses, and (iv) improve and strengthen equity capital, etc. to ascertain stable business operations, taking into account the trend in international financial regulations.

The FSA's review of Major Banks in this connection will cover the points provided below. Further, the FSA will confirm the progress of sophistication in risk management and MIS (Management Information Systems).[5]

(i) Supervision and Inspection Based on the Macro Prudential Point of View

Soundness of Major Banks' business operations is affected by changes in the condition of the economy, finance, and capital markets both in Japan and overseas. Conversely, the behavior of Major Banks as a whole may affect the overall economy, finance and capital markets. As such, it is important to understand the status of both sides at all times and analyze how they interact with each other.

The FSA will enhance its framework to analyze risks inherent to the overall financial sector with a forward looking perspective, and endeavor to grasp the actual condition of the global economy, flow of funds, trends in financial/capital markets, market participants, and Major Banks' businesses/strategies.

Then, the FSA will analyze how these conditions and trends may affect the financial system and Major Banks' business operations. At the same time, the FSA will review whether Major Banks' governance and risk management systems can respond forcefully to changes in the environment. The FSA will analyze the potential impact of changes in Major Banks' business operations as a whole on the economy and financial/capital markets.

In addition, the FSA will capture changes in global markets, and review Major Banks' investment management, including whether they develop and revise their asset management policies in a forward looking perspective (including the allocation of human resources to investment and investment management), together with their risk management

[5] "Management Information Systems" are systems that collect and analyze risks and market data, etc. from a centralized perspective.

systems.

Further, for derivative products that have relatively low liquidity in domestic and global markets, and products for which risk identification is difficult, the FSA will review whether Major Banks accurately understand the investment performance, profitability and potential impact on equity capital of these products, and appropriately manage the products from the aspect of financial resilience against changes in markets. The FSA will also review the status of Major Banks' investment and risk management regarding individual sectors and products, including housing loans and real estate financing.

(ii) Establishing and reinforcing the integrated risk management system

The FSA will identify various risks associated with Major Banks, including market risks, credit risks and operational risks, and understand the validity of the status of Major Banks' integrated risk management systems and methodologies.

For example, the FSA will review whether Major Banks (i) conduct stress testing incorporating the economic and financial conditions in Japan and other countries based on a solid understanding of the risks inherent to their business models; and (ii) discuss the results of stress testing involving management and utilize them for developing management policies and managing risks.

In reviewing Major Banks' self-assessment of individual assets, the FSA will generally rely on the assessment of financial institutions' small-sized assets, as long as the FSA considers such financial institutions' asset management as incorporating well-established and effective provisioning. Further, based on a review of asset management including the provisioning mechanism and integrated risk management, the FSA will respect, in principle, the decisions of each financial institution except those on large-lot credits with the potential to impact its safety and soundness.

Particularly for Japanese G-SIBs[6] and other relevant banks, the FSA will review whether there is a well-established system to analyze the results of stress testing on a group-wide basis, and improve the financial model and statistical approach constantly and consistently using the PDCA (plan-do-check-act) cycle. The FSA, as necessary, will also encourage them to refine their risk management further by requiring stress tests under common

[6] Global Systemically Important Banks

scenarios across G-SIBs.

The FSA will review whether G-SIBs and other relevant banks have developed a risk appetite framework (a group-wide framework where the management discuss, understand and evaluate the risk level which G-SIBs and other relevant banks are willing to accept in light of the group's management strategy), and utilize such framework for making decisions regarding management policy and the financial (B/S and P/L) management framework.

The FSA will request G-SIBs and other relevant banks to develop or revise their recovery plans and encourage them to enhance group risk management for times of crisis and normal situations. At the same time, the FSA will continue working to elaborate the resolution plans of these firms.

Further, the FSA will review whether G-SIBs have established appropriate group-wide management systems covering overseas operations for credit risk and liquidity risk associated with foreign currencies etc.

(iii) Enhancement of financial foundations

In order to improve the resilience and robustness for future stresses in real terms, the FSA will encourage Major Banks to strengthen their capital bases by securing a reliable stream of profits etc., taking into account the gradual implementation of the Basel III capital requirement.

(2) Developing governance in line with globalization

(i) Developing group-wide robust governance at the international level

Responding to the ongoing globalization of businesses, Major Banks should have their governance systems in line with international levels. In view of this, the FSA will review whether the management and executive departments of Major Banks are working to strengthen and improve their governance appropriately by developing and securing diverse human resources, assigning them to best suited positions, nurturing an environment where outside directors can discharge their responsibilities effectively, securing the effectiveness of corporate auditors, and refining the internal audit function.

In relation to IT governance, the FSA will review the appropriateness of the policy and actions taken to develop IT infrastructure considering global business expansion.
The FSA will endeavor to understand group-wide business operations of both domestic and foreign financial institutions by strengthening cooperation with financial supervisory authorities in other countries. The FSA will also endeavor to learn about best practices in G-SIFIs[7] based abroad, and encourage Major Banks to enhance their governance and risk management.

The FSA's verification in relation to the governance system will include the following.

a. Whether each listed bank or bank holding company has introduced at least one, and preferably two or more, independent outside directors in order to ensure and enhance the supervisory functions of the Board of Directors;

b. Whether the group which owns the bank holding company is making efforts to refine the group-wide governance system, including clarifying the holding company's roles and responsibilities, etc.; and

c. Whether the bank holding companies within Japanese financial groups specified as G-SIBs have more robust group-wide governance corresponding to the group's size, complexity, international nature and systemic inter-connectedness, for example, by placing committees as a governance structure, and for major banks owned by the above holding companies, by ensuring the selection of highly independent outside directors when approving the proposed appointment of directors, even if they are unlisted companies, and securing diverse human resources in line with businesses that are becoming increasingly diverse and complex.

(ii) Enhancing risk management systems to support overseas (cross-border) businesses

In view of the increasing number of overseas and cross-border businesses and the fact that there are a number of cases where financial institutions are charged large penalty payments by foreign supervisory authorities, the FSA will review whether Major Banks are taking action to improve operational risk and compliance risk management. The FSA will also encourage Major Banks to establish a legal and regulatory compliance structure, incorporating rapidly changing financial regulations in various countries as a result of

[7] Global Systemically Important Financial Institutions

international financial regulatory reform.

(iii) Business development of foreign financial institutions in Japan

The FSA will review whether foreign bank branches, etc. (“Foreign Bank Branches”), under appropriate supervision and support from their head offices, have implemented customer protection measures and established solid structures for governance, legal/regulatory compliance system, risk management, and internal control systems, in line with their business models and businesses operated in Japan.

Further, the FSA will review Foreign Bank Branches regarding the enhancement of measures to prevent money laundering and improvement of legal/regulatory compliance systems to be consistent with cross-border business operations. The FSA will also check whether they have developed an outsourcing management in line with diversifying outsourcing businesses, and an operational structure that does not overly rely on funding from other operational bases in the group.

3 Supervision and inspection approach

3-1 Three megabank groups

For monitoring the three megabank groups (“Megabank Groups”), the FSA will put emphasis on identifying best practices, industry-wide conditions and challenges facing them from a consistent point of view, by setting out issues that are common among these groups as verification items under the Horizontal Review (e.g. group-wide governance, overseas business operations, etc.).

In order to improve the efficiency of financial monitoring, the FSA’s Horizontal Review will be basically conducted through off-site monitoring, combined with on-site monitoring if necessary. When monitoring Megabank Groups, the FSA will focus on exchanging views with outside directors, company auditors and the internal audit department. In addition, the FSA will endeavor to capture any development in financial institutions and financial markets as quickly as possible through an analysis of management information and interviews with relevant business units about business trends if necessary, and improve the sensitivity to potential risks, thereby selecting monitoring items vigorously from a forward looking perspective. Further, it is necessary for the FSA as the supervisory authority to keep abreast of the latest trends in global best practices. As such, the FSA will strengthen cooperation with financial supervisory authorities in various countries, and study the practices of G-SIFIs that are taking an advanced approach to operating their businesses.

It should be noted that in the Horizontal Review, the FSA will avoid making decisions in a mechanical and uniform fashion, taking into account differences in the strategies taken by each financial group. Further, in off-site monitoring, the Supervisory Bureau and the Inspection Bureau will discharge their allocated administrative responsibilities in full cooperation.

3-2 Other Major Banks

In light of the various business models taken by individual financial institutions and under the integrated operation between the Supervisory Bureau and the Inspection Bureau, the FSA will conduct financial monitoring of other Major Banks effectively and efficiently corresponding with the risk profiles of each financial institution via off-site monitoring, targeted inspections[8], etc.

3-3 Foreign Bank Branches

The FSA will continue applying the PDCA cycle of financial monitoring consisting of off-site and on-site monitoring for Foreign Bank Branches. In doing so, the FSA will mainly monitor whether the risk management of individual Foreign Bank Branches in Japan is in line with their business profile and risk characteristics.

Specifically, the FSA's monitoring of Foreign Bank Branches will mostly rely on off-site monitoring. However, the FSA will conduct on-site monitoring (targeted inspection) if it is considered necessary. The FSA's monitoring of Foreign Bank Branches will also include the Horizontal Review, where individual branches in Japan are grouped based on their business model and risk characteristics, and are reviewed in terms of issues common within the group. In particular, the FSA will monitor G-SIFIs from the best practice point of view.

In monitoring Foreign Bank Branches, the FSA will also strengthen cooperation with the Securities Exchange Surveillance Committee, as well as the financial supervisory authorities in various countries.

V. Supervision and Inspection of Regional Financial Institutions[9]

[8] Targeted inspections are conducted for selected inspection items or individual business cases.

[9] In this document, regional financial institutions refer to regional banks, second-tier regional banks,

1. **<u>Issues facing regional financial institutions and concept for 2014-2015</u>**

Regional financial institutions operate in specific regions, with their customer base mainly consisting of SMEs and individuals. As such, regional financial institutions are required to enhance their efforts to build a positive cycle, in which they support the regional economy and industrial activities, grow and expand with regional communities.

Given the existence of labor shortages in some regional economies, it is important for companies and industries to improve efficiency and productivity through modest business integration and thereby improve employment and wages in the relevant region.

As such, regional financial institutions should recognize and analyze the economic/industrial conditions of and issues facing the region, based on which they should assess the business, growth potential, etc. (evaluation of customers' business potentials) of companies that are at various stages in the business life cycle, and provide the necessary support by considering and proposing solutions for issues identified through the customers' business potential.

Particularly, regional financial institutions should further enhance their efforts to provide financing based on the customers' business potentials, leveraging their capability to assess the business performance accurately, and provide support to sustainable companies (particularly, companies that can lead the regional economy and industries) to improve their business, productivity and quality of management, through an effective consulting function. Regional financial institutions should also support the termination of business for companies facing difficulties in continuing to operate.

Efforts such as the above on the part of regional financial institutions will encourage corporate customers to enhance their productivity, promote industrial renovation, while allowing regional financial institutions themselves to compete by offering value-added services instead of plunging into a race to cut interest rates and to generate a steady stream of earnings and improve/maintain the soundness of their business operations. Regional financial institutions should further strengthen the functions/systems necessary to fulfill the above role effectively and consistently and the risk management/financial soundness backing those functions and systems.

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shinkin banks, and credit cooperatives.

In doing so, regional financial institutions should re-acknowledge region-based finance as their business model, under which they aim to benefit users of financial services, and the economy and society in the relevant region, while improving their own financial soundness and profitability. Regional financial institutions should continue to further enhance institution-wide, innovative measures to establish the said business model from a medium- to long-term perspective.

Further, given the current business environment where the profitability of the lending business is declining and the likely shrinkage of future regional lending markets reflecting the aging population and declining working population, regional financial institutions should develop and execute sustainable management strategies not only for the short term, but also for the medium to long term, looking five to ten years ahead. To achieve this, regional financial institutions should get a grasp of the medium- to long-term outlook of their regional economy/industries and the issues they are facing, discharge the roles and functions required to vitalize the regional economy over the medium to long term, and follow through with their goals under their management/business plans.

In doing so, regional financial institutions should be fully aware of the fact that roles and management strategies vary among institutions depending on the scale, characteristics and other factors. In particular, regional banks who are the key player in financial activities in their targeted region are expected to take the leading role in vitalizing the economy of their region. Additionally, *shinkin* banks and credit cooperatives should recognize the basic characteristics of cooperative financial institutions and the underlying principle of mutual aid, and perform the roles expected of them by their members/cooperative members (and relevant regions) as providers of specialty finance in regional/SME financing.

Based on the above, the FSA will have in-depth discussions with the management of financial institutions regarding activities that will fulfill their expected roles and efforts to devise a business model, and encourage regional financial institutions to scrutinize these issues further.

2. Key priority measures and the focus of supervision and inspection

2-1 Effective financial intermediation

(1) Effective financial intermediation to support growth of regional economies and industries and renovation

(i) Accurate assessment of corporate customers, recommendation of solutions and support for implementation

As noted in Section 1, regional financial institutions should assess the business, growth potential, etc. (evaluation of customers' business potentials) of corporate customers who are at various stages of their business lifecycle using outside organizations and experts as necessary, and provide the necessary support by considering and proposing solutions to issues identified through the customers' business potential. It is important to note that regional financial institutions should take these actions appropriately and proactively before potential issues materialize.

With this in mind, the FSA will take the following actions.

a. The FSA will confirm the status of regional financial institutions' initiatives for accurate assessment of growth potential and sustainability of companies at various stages of the business lifecycle including the following.

   1) A specific approach to grasp and analyze the current conditions and medium- to long-term outlook regarding the economy and industries (including major industry sectors) in their main business areas, and specific use of this analysis in assessing the business potential of corporate customers;
   2) In particular, a specific approach to identifying the business conditions, management issues and needs of key corporate customers (companies leading the regional economy and industries, large customers, etc.) and main corporate customers (those for which the financial institution functions as the main bank) who expect their main bank to act as a principal advisor;
   3) A specific method to collect information on business conditions, etc. of other corporate customers;
   4) Regional financial institutions' specific efforts to obtain a clear view of the business value of customers including growth potential and sustainability, without excessively relying on customers' historical performance such as their financial profile and repayment history; and
   5) Specific initiatives to further enhance the employees' capability to assess business performance accurately and consultation skills, accumulation of expertise in the organization, etc.

b. The FSA will confirm the status of regional financial institutions' initiatives for recommending solutions that are consistent with the conditions of corporate customers and providing support for implementing the recommended solutions, including the following.

1) Whether regional financial institutions appropriately assess and analyze the sustainability and growth potential, in particular, of corporate customers leading the regional economy and large customers from a medium- to long-term view point, and provide necessary consulting services and financing on that basis;

2) Specific initiatives to actively provide support to region-based companies, etc. for starting and expanding businesses, including assistance in collaboration with the relevant industry, academia and government for start-up businesses and financing in cooperation with governmental financial institutions and funds;

3) Specific initiatives to promote lending based on the customers' business potential (including the use of Guidelines for Personal Guarantees Provided by Business Owners) without overly relying on collateral and guarantees;

4) Specific initiatives for effectively providing the appropriate consulting services to corporate customers not only from a financial aspect but also from the aspect of the various management issues such as revenue expansion and business succession, including the utilization of outside experts with the capability to support the main business of the corporate customer;

5) Whether regional financial institutions provide truly viable and drastic support for business reconstruction to their corporate customers in need of assistance, such as debt-debt swaps, forgiveness of debt and other financial support, without putting off problems (including active participation in the business reconstruction support led by other financial institutions); and

6) In restructuring guaranteed debt, whether regional financial institutions carefully respond to consultation requests from business owners, etc. based on individual situations, coordinate with outside organizations and experts if necessary, and utilize the Guidelines for Personal Guarantees Provided by Business Owners.

c. The FSA had requested regional financial institutions to continue facilitating financing for SMEs and accept modifications to lending terms even after the expiry of the Act concerning Temporary Measures to Facilitate Financing for SMEs, etc. (SME Financing Facilitation Act). The FSA will continue encouraging regional financial institutions to take appropriate action in terms of this.

d. Active utilization of the Regional Economy Vitalization Corporation of Japan (REVIC)

In proposing solutions for issues facing corporate customers and providing support for implementing those solutions, use of REVIC is considered effective, given its functions (secondment of experts, direct support for corporate turnarounds, capital contribution to the business reconstruction fund and the regional revitalization fund, operation of these funds, purchase of guaranteed debt, etc.). The FSA will encourage regional financial institutions to utilize REVIC actively.

Particularly, the FSA will encourage regional financial institutions to utilize REVIC's function of sending out experts, thereby enhancing the quality of their functions including customers' business potential and recommendation of necessary solutions.

e. Active transmission of information to regions and users

The FSA will encourage regional financial institutions to transmit information actively and clearly, so that the relevant region is well-informed of the available support, including recommendations of possible solutions and implementation thereof, and so that it is utilized by as many companies as possible.

Further, as the supervisory authority, the FSA will continue its efforts to identify highly advanced initiatives and those recommended to be practiced widely, and transmit information to share expertise and know-how among regional financial institutions.

(ii) Acceleration of recovery from the Great East Japan Earthquake

To assist in the recovery from the Great East Japan Earthquake and rebuild sustainable economy/industries in the disaster-affected areas, financial institutions should systematically understand and analyze the condition and needs of disaster-affected areas, propose best-suited solutions for affected by disaster and provide support for implementing solutions.

Especially, many disaster-affected areas are shifting away from the restoration stage, facing the start of full-blown reconstruction of industries and revitalization of regional revitalization. It is important for financial institutions to provide support for facilitating the development of industries and companies that are likely to become the core of the disaster-affected areas and for building communities reflecting changes in the environment.

As such, the FSA will encourage regional financial institutions to assist customers who are facing changes in the business environment as a result of the disaster and trying to resume, establish and transform their businesses by not only providing financial support but also proposing solutions for the development of their products using regional resources, technology and sales channels and support for implementation of the proposed solutions.

The FSA will continue to deal with the so-called double loan problem, while confirming whether regional financial institutions actively utilize Corporation for Revitalizing Earthquake affected Business, Industrial Recovery Consultation Center, Industry Reconstruction Corporation, and the Individual Debtor Guidelines for Out-of-Court Workouts. The FSA will also confirm the appropriateness of financial support for full-scale reconstruction of the disaster-affected areas and reconstruction of the livelihoods and businesses of people affected by the disaster, while promoting the use of the Reconstruction Finance Network.

Further, for financial institutions in which the FSA has implemented the government's capital participation under the Act on Special Measures for Strengthening Financial Functions (Special Disaster Measures), the FSA will appropriately follow up on the implementation of business-enhancing plans for continued contributions to the reconstruction of the businesses and livelihoods of people affected by the disaster and revitalization of the economy of the disaster-affected areas.

(iii) Public finance and private finance

Public financing works complement private financing in areas where associated risks cannot be taken entirely through private financing. Regional financial institutions and public finance sector should discharge their responsibilities, collaborate with each other and contribute to revitalizing the regional economy.

In view of this, the FSA will determine the status of the relationship between the public and private finance sectors, including the degree of competition and complementary relationships through interviews with the relevant financial institutions and their customers. Then the FSA will hold discussions with related parties on how to build a desirable relationship between the two sectors.

(2) Provision of financial services in line with the needs of customers

(i) Provision of appropriate products/services reflecting customer needs

Financial institutions are expected to offer effective and efficient asset management tools by accurately identifying the needs of various customers, and developing and providing financial products/services that satisfy the identified customer needs, their levels of knowledge, experience and wealth.

Considering the above, the FSA will confirm the following points.

a. Whether financial institutions provide explanations on the products that they offer and implement post-sale follow-ups appropriately in line with the levels of knowledge, experience and wealth of their customers;

b. In selecting products to offer to customers, whether financial institutions have established a procedure that ensures offerings of financial products that really match their customers' needs and interests, regardless of the commission/fee level and the business relations ; and

c. Whether financial institutions are contemplating or have introduced management targets and an incentive mechanism to promote sales activities focusing on customer interests

The FSA will also review whether, in order to nurture an environment where customers obtain the financial products/services they are really need and where the interests of both customers and financial institutions are realized, regional financial institutions have solid internal control systems for (i) providing explanations to customers and conducting credit screenings appropriately so that housing loans, consumer loans and other loans are provided in line with needs, the economic conditions, etc. of each customer, and (ii) conflict-of-interest management, prevention of abuse of a dominant position, customer information management, etc.

The FSA will also check whether regional financial institutions maintain a structure whereby, with the involvement of top management, the causes of customer consultations/complaints are analyzed, information is shared institution-wide, and measures to prevent the recurrence of complaints are developed, disseminated and followed up, and where these are reflected in the future development of products/services and improvement of risk management systems.

The FSA will review whether regional financial institutions are taking appropriate action in connection with the financial Alternative Dispute Resolution (ADR) system, such as disclosure of the information necessary for quick dispute resolution, explanations regarding the financial ADR system, and introduction of the system to customers upon consultation.

Taking into account the purpose of the NISA (Nippon Individual Savings Account), the FSA will encourage regional financial institutions to be actively involved in industry-wide/cross-sectorial efforts to improve the financial literacy of their investors.

(ii) Measures to improve customer convenience

Regional financial institutions should make constant efforts to improve customer convenience, considering the fact that financial services are an essential element of the economy.

In this context, in view of the Japan Revitalization Strategy (Revised in 2014), the FSA will encourage the financial industry and individual financial institutions to take action to improve customer services, including development of the settlement function by, for example, offering immediate fund transfer services.

In addition, the FSA will strongly encourage regional financial institutions to develop facilities and frameworks to allow people with disabilities and elderly people to utilize financial services easily and safely over the counter and through ATMs.

(3) Ensuring customers' trust and security

To realize customer-oriented business, it is important to ensure that customers are able to utilize financial services safely at any time. The financial system is a key element of the economy. Thus, ensuring the appropriate and steady offering of financial services (including prevention of illegal use) is essential to economic growth and customers' daily lives. Also, stable provision of financial services will enhance customers' sense of security and loyalty, and ultimately contribute to establishing a sustainable business model.

As such, the FSA will monitor whether regional financial institutions are precisely implementing appropriate measures for business continuity and stable services under the leadership of the management, including the following.

(i) Ensuring business continuity

a. Stable IT system operation

In order to ensure the stability of IT systems, the FSA will review the status of operation and management of inter-bank systems, such as the Zengin System, as well as individual banks' IT systems, including scheduled system updates.

b. Business continuity framework

The FSA will review whether regional financial institutions have set up their business continuity system to assume major risks sufficiently, and whether they review the business continuity plan in light of discussions at the Central Disaster Prevention Council, etc.

(ii) Comprehensive management of information security

The FSA will review whether regional financial institutions identify, understand and manage important customer information including cases in which information handling is contracted/subcontracted, and whether they have solid internal control to deter and prevent fraudulent access and acquisition of customer information.

(iii) Prevention of fraudulent use of financial services

a. Illegal money transfer through Internet banking

In connection with Internet banking services for individuals and corporate customers, the FSA will confirm whether regional financial institutions are (i) implementing measures to prevent the theft of funds: (ii) giving sufficient warning to customers by presenting examples of security measures required for customers; and (iii) setting out policies to indemnify customers against any fraudulent remittance of funds in accordance with the agreement within the Japanese Bankers Association.

b. "*Furikome*" fraud (Bank Transfer Fraud in which the criminal tricks a person into transferring money to a designated fraudulent deposit account)

The FSA will review whether regional financial institutions are taking action to eliminate crime such as *Furikome* fraud and are continuing their assistance to enable fraud victims to obtain a prompt recovery their money in accordance with *Furikome* Fraud Relief Act.

c. Use of counterfeit/stolen cash cards and stolen passbooks

The FSA will review whether regional financial institutions are taking measures to prevent fraudulent withdrawals using counterfeit/stolen cash cards and stolen passbooks, and are providing indemnification to victims in accordance with the Depositor Protection Law.

d. Cyber-attacks

The FSA will review whether regional financial institutions have taken appropriate security measures and developed contingency plans in response to various cyber-attacks.

e. Money laundering and financing terrorism of transaction

The FSA will review whether there is a sophisticated system to appropriately execute tasks, including verification at the time of a transaction, preparation and preservation of verification and transaction record, monitoring of executed transactions, and reporting of suspicious transactions based on the revised Act on Prevention of the Transfer of Criminal Proceeds, while keeping customer convenience in mind.

f. Cutting relationships with antisocial groups

In view of the June 2014 revision of guidelines for supervision, the FSA will review whether regional financial institutions are taking measures to cut relationships with antisocial groups appropriately at every stage of any transaction—at initiation, post-execution and termination, including pre-screening, ex post-review —and are taking measures to terminate transactions with antisocial groups.

2-2 Ensuring the soundness of financial institutions

(1) Forward looking risk management

It is important that the FSA implements robust and comprehensive risk management and ensures the financial soundness of individual financial institutions and the stability of the financial system, which is vital for financial institutions' effective financial intermediation including, for example, support for regional economies/industries and growth of corporate customers through a stable supply of funds, amidst a changing environment.

As such, the FSA will inspect regional financial institutions from a macro-prudential view point, and review their efforts to upgrade risk management to be level with their business models and strengthen financial bases.

(i) Supervision and inspection based on a macro-prudential point of view

The FSA will analyze risks associated with the financial system and implement financial supervision from a macro-prudential perspective, a viewpoint that says that sustainable and steady financial system can be developed by recognizing the strong correlation between the economic/financial/market trends and financial intermediation/soundness of financial institutions and focusing on the level of risk concentration and channel of risk propagation.

In doing so, the FSA will keep in mind the possibility of rational behavior by individual financial institutions, in aggregate, that can have a negative impact on the overall economy and financial/capital markets.

The FSA will also review regional financial institutions' investment management (including the human resources allocated to investment and management) and risk management, including whether regional financial institutions develop and revise their asset management policies taking into account the analysis of risk/return tradeoffs based on the level of the interest rate and volatility movement.

It should be noted that asset management by *shinkin* banks and credit cooperatives is monitored by their central organizations, which are providing support to these banks and cooperatives to enhance investment and risk management. As such, the FSA will monitor *shinkin* banks and credit cooperatives in close cooperation with their respective central organizations.

Further, for products including structured bonds that have relatively low liquidity in both

Japan and overseas and other products for which risk identification is difficult, the FSA will confirm whether regional financial institutions accurately understand investment performance, profitability and potential impacts on equity capital, and appropriately manage these products from the aspect of financial resilience against changes in the markets. The FSA will also review the status of regional financial institutions' investment and risk management for individual sectors and products such as housing loans and real estate financing.

(ii) Establishing an enterprise risk management framework and enhancing risk and earnings management corresponding to the business model

The FSA will identify various risks associated with regional financial institutions including market risk, credit risk and operational risk, determine the status of regional financial institutions' enterprise risk management and methodologies, and review their validity.
For example, the FSA will look to see whether regional financial institutions (i) conduct stress tests incorporating the economic and financial condition in Japan and other countries based on a solid understanding of the risks inherent to their business models; and (ii) discuss the results of stress tests involving the management and utilize such results to develop management policies and manage risks.

Regional financial institutions' accurate understanding of the profitability of their businesses is an essential precondition to developing a sustainable business model from a medium- to long-term perspective. Therefore, the FSA will confirm whether and how regional financial institutions have established appropriate earnings management frameworks incorporating profitability by business unit, segment and region, as well as the characteristics of their businesses.

Regional financial institutions' lending portfolios tend to concentrate in specific industry sectors, reflecting the economic and industrial structure of their main business areas. Thus, the FSA will confirm the status of credit concentration and frameworks for credit screening/management in light of the characteristics and growth potential of sectors in which regional financial institutions' portfolios are concentrated, and discuss portfolio management issues with the management.

In reviewing regional financial institutions' self-assessment of individual assets, the FSA will generally rely on the assessment by regional financial institutions in terms of small-sized assets, as long as the FSA considers that these regional financial institutions' asset management, including their provisioning mechanism, is well established and effective. Further, based on a review of the asset management including provisioning and enterprise risk management, the FSA will respect, in principle, the decisions of each financial institution except those on large-lot credits with the potential to impact its safety and soundness.

The FSA will confirm whether regional financial institutions have developed the capabilities to manage new businesses including overseas business expansion.

(iii) Strengthening the financial base

The FSA will encourage regional financial institutions to consider and implement far-sighted capital policies to improve and strengthen their financial base necessary for providing appropriate and consistent financial intermediation in the relevant regions, including support for a drastic business turnaround.

If regional financial institutions are contemplating capital injection to strengthen their equity capital, the FSA will promote utilization of the Act on Special Measures for Strengthening Financial Functions as one of the alternatives.

In terms of *shinkin* banks and credit cooperatives, their respective central organizations complement and support their businesses and play a key role in strengthening their financial base. Based on this, the FSA will confirm central organizations' status in relation to their support for *shinkin* banks and credit cooperatives. Additionally, the FSA will further strengthen cooperation with these central organizations, by, for example, discussions on enhancing the financial base of their affiliated financial institutions.

(2) Enhancement of governance

In order to prevent activities that will reduce the enterprise value including scandals by building a sustainable business model and handling management issues involving the entire organization and to ensure the steady implementation of management strategies and business expansion for upgrading its competitiveness and earnings capability, each financial institution should establish a viable framework for governance.

Thus, the FSA will review the governance system of each financial institution including the key points listed below, and discuss with the management.

a. Whether each listed bank or bank holding company has introduced at least one, and preferably two or more, independent outside directors in order to ensure and enhance the supervisory function of the Board of Directors and whether these banks and holding companies have developed frameworks where outside directors can discharge their duties effectively; and

b. Whether the group which owns the bank holding company is making efforts to refine the group-wide governance system, including clarifying the holding company's roles and responsibilities, etc.

While many regional financial institutions have been working on building shared banking system centers to reduce IT system costs, it is becoming increasingly important to use information technologies effectively in their management strategies for improving customer services, etc. Therefore, the FSA will encourage the management of regional financial institutions to lead discussions to develop management strategies that are consistent with their IT strategies from a medium- to long-term perspective, including the development and retention of professional human resources.

As *shinkin* banks and credit cooperatives take the form of cooperative financial institutions based on the principle of self-regulation by members/cooperative members, external discipline imposed on *shinkin* banks and credit cooperatives by the markets, large shareholders, etc. may not be as effective as it is for stock companies. In view of this, the FSA will review the action taken by *shinkin* banks and credit cooperatives to improve their governance, including, for example, efforts to enhance the quality of the Board of Directors' supervision and internal/external audits, and efforts to achieve business operations that meet the expectations of members/cooperative members (or regions), and discuss these matters with management.

3. <u>Supervision and inspection approach</u>

3-1 Regional banks

With the intention of monitoring regional banks under cooperation between the Inspection Bureau and the Supervisory Bureau (including Local Finance Bureaus) on a daily basis, the FSA reorganized the Inspection Bureau's organization for monitoring regional banks by setting up monitoring teams in accordance with the size and other attributes of the regional banks to be monitored. Each team in the Inspection Bureau will conduct off-site monitoring mainly through robust profiling involving periodic data collection, analysis and discussions.

The FSA will combine the above profiling with targeted inspections as necessary.

In addition, the FSA will make use of the approach under a Horizontal Review for cross-sectorial, important matters, such as regional banks' governance. For efficiency purposes, a Horizontal Review will generally be based on off-site monitoring, combined with on-site monitoring as necessary.

It should be noted that in a Horizontal Review, the FSA will avoid making decisions in a mechanical and uniform fashion, taking into account the differences in strategies taken by each bank.

3-2 Cooperative financial institutions (*shinkin* banks/credit cooperatives)

Monitoring of cooperative financial institutions (*shinkin* banks/credit cooperatives) will be conducted under cooperation between the inspection department and supervisory department in the relevant Local Financial Bureaus. The said monitoring teams in the Inspection Bureau, together with the Supervisory Bureau, will actively provide support for enhancing quality and consistency in the Local Financial Bureaus' monitoring of cooperative financial institutions.

Each Local Financial Bureau should enhance the quality of profiling, taking into account each financial institutions' scale, characteristics, etc. through periodic data collection, analysis and hearings, based on which they should conduct monitoring effectively and efficiently.

VI. Supervision and Inspection of Insurance Companies, etc.

1. Issues facing insurance companies, etc. and concept for 2014-2015

Insurance companies, etc. provide guarantee and compensation against various risks facing households and companies, offer effective financial intermediation through their investment management as the institutional investor, and play a key role in financial and capital markets. Through these functions, insurance companies, etc. provide a foundation for people's lives and economic activities, along with the important duty of facilitating Japanese citizens in moving towards new growth with confidence. Insurance companies, etc. will also contribute to the creation of a positive cycle, where fulfilling the functions described above will result in steady income generation for insurance companies, etc.

Amidst the changing business environment surrounding insurance companies, etc., including the aging and declining population and business/market expansion of companies, insurance companies, etc. should develop sustainable business models where they can ensure financial soundness and appropriateness of business operations and provide better value-added services reflecting customer needs.

It should be noted that to develop sustainable business models, it is essential that insurance companies, etc. remain customer-oriented.

Japan has become an aging society at a speed unprecedented in other countries. It is particularly important for insurance companies, etc. to deal with the aging of their customers at every step of the business process, including product development, solicitation, and insurance payments.

Investment activities by insurance companies, etc. as institutional investors will promote steady asset formation by Japanese citizens. Therefore, insurance companies, etc. should endeavor to improve their investment capabilities in alignment with their asset size and implement robust risk management practices.

From a governance viewpoint, it is also important for insurance companies, etc. to implement appropriate and forward looking risk management to address unforeseeable events, in view of the recent increase in natural disasters and changes in economic and financial condition in both Japan and overseas.

Hence, it is increasingly important for insurance companies, etc. to fully recognize their expected roles, and their management should make responsible and prompt management decisions to respond to sudden social and economic changes and international financial regulatory reforms. At the same time, insurance companies, etc. should consider creating medium to long-term business strategies, taking into account super-long term insurance contracts and structural changes in customer needs in the future, with an accurate understanding of the various risks.

The FSA will confirm whether insurance companies, etc., under the appropriate leadership of their management, have enhanced their governance and risk management, verified the sustainability of their business models appropriately, and devised short-term and medium- to long-term management strategies, including capital policies. The FSA will push this further through discussions with the management, where necessary.

2 Key priority measures and the focus of supervision and inspection

2-1 Fulfill guarantee and compensation function

(1) Fulfill guarantee/compensation function appropriately

Insurance companies, etc. are expected to function as the provider of extensive coverage and compensation to prepare for adverse events for customers, and implement these functions promptly and appropriately upon an insured event. As such, insurance companies, etc. should establish appropriate frameworks for insurance payments, etc. and offer a sense of security and trust for customers. The FSA's monitoring will focus on the following.

(i) Keeping in mind that the most important responsibility of insurance companies, etc. is to make insurance payments appropriately, the FSA will continue to monitor whether insurance payments are managed effectively, in a systematic and consistent manner.

(ii) In particular, the FSA will focus on whether a well-developed framework exists to provide guidance in relation to the submission of insurance claims, etc. (including giving advice on claiming for other available insurance in the process of reviewing the received insurance claims) to each customer promptly and appropriately from a customer protection and user convenience point of view, taking account of each policyholder's attributes and situation, including their age and any disability.

(iii) The FSA will encourage insurance companies, etc. to maintain the same mindset as taken for the 2011 Great East Japan Earthquake at normal times, including an active approach reflecting the position of insurance policyholders and their families and prompt and appropriate insurance payments. Specifically, the FSA will encourage insurance companies, etc. to take measures in view of the aging of their customers, including maintaining contact with policyholders and their family members and simplification/rationalization of paperwork.

(2) Improve customer protection and convenience for users

To achieve customer-oriented management policy, it is important for the management of insurance companies, etc. to fully provide leadership, establish a solid operational structure, strictly control customer information and other relevant information, protect customers thoroughly in the process of solicitation, and build a sense of security and trust with the customer. For customer protection, being compliant with laws and regulations just as a formality is insufficient; insurance companies, etc. should fully understand the intended effects and purposes of specific laws and regulations, identify compliance levels required by customers and society, and meet their expectations as highly public financial institutions that are expected to be reliable.

Insurance companies, etc. must also recognize that complaints and consultations from customers may provide opportunities to discover potential customer needs, and should respond to complaints and consultations appropriately and actively.

Considering the above, for 2014-2015, the FSA will review measures taken by insurance companies, etc. to improve customer protection and user convenience in light of the supervisory guidelines, focusing on the areas listed below. In doing so, the FSA will respect the self-improvement efforts of insurance companies, etc., and supervise them by putting emphasis on incentivizing them to continue making such efforts. The FSA will also pay attention to (i) what products/services are offered to what types of customers under what management policies, (ii) whether there are warped incentives arising from the pursuit of short-term profits and from conflicts of interest, (iii) whether there is an internal process to confirm, involving management, whether management policies are implemented thoroughly in actual business operations. The FSA will also cooperate with the Consumer Affairs Agency and other relevant organizations as necessary.

(i) Establishment of a framework for appropriately managing insurance solicitations

In distributing insurance products, it is very important for insurance companies, etc. to provide easy-to-understand explanations to their customers in accordance with their level of knowledge, experience, etc. taking into account the characteristics of the products offered. Therefore, the FSA intends to review the compliance status with the rules for insurance sales and solicitation, internal frameworks to provide explanations in line with customers' needs, knowledge and experience and manage insurance solicitors by utilizing various information acquired via reporting from insurance companies, etc., the results of the Inspection Bureau's inspections and information from the Counseling Office for Financial Services Users. The FSA will also confirm whether insurance solicitors have developed appropriate frameworks for managing insurance solicitations in line with their solicitation channels, scale and characteristics. In particular, the FSA will focus on the following.

a. Insurance solicitors, including insurance agents, should provide appropriate explanations and information to their customers from the viewpoint of protecting policyholders, given the ongoing diversification of distribution channels for insurance products such as direct channels and the emergence of large-scale insurance agents. In light of this, the FSA will review the status of governance over insurance agents by insurance companies, etc. and the status of independent agents' governance and their insurance solicitation management. It is noted that solicitation via the telephone is likely to result in receiving complaints from customers, as it takes place unexpectedly without face-to-face contact with the customer. Considering this, the FSA will review the insurance solicitation process of insurance companies, etc. and their management and supervision of insurance solicitors and confirm whether insurance companies, etc. are making sure that their customers are not confused.

Further, given the possibility of insurance agents involving their employees in soliciting customers without properly training, instructing and managing such employees, the FSA will review the status of insurance companies, etc. and insurance agents pursuant to the guidelines for supervision revised as of March 18, 2014 (clarification of definition of insurance agents' employees).

b. The FSA will also confirm whether insurance companies, etc. have established processes for providing appropriate explanations on products including premium payments, taking account of customers' level of knowledge, experience, etc. in order to make sure that customers' intentions are reflected in insurance contracts. Also, in light of the requirement under the guidelines for supervision to establish robust frameworks for providing adequate explanations to customers to avoid or terminate overlapping coverage that is not intended by customers, the FSA will confirm whether insurance companies, etc. have taken appropriate measures including *ex post* verification.

c. Regarding over-the-counter sales of insurance products at banks, etc., the FSA will confirm the compliance status with the rules for insurance solicitation including the implementation of measures to prevent internal collusion.

d. For elderly customers, considering the possibility that their ability to make judgments may deteriorate over a short period and that they may not fully understand the related contract due to deterioration in their hearing and/or vision, insurance companies, etc. should provide adequate and appropriate explanations to these customers. To this end, the FSA stipulated in its guidelines for supervision the requirement to treat elderly customers carefully and to implement measures for the early prevention and detection of potential problems. Going forward, the FSA will review whether insurance companies have properly implemented measures in connection with elderly customers, including follow-up processes such as *ex post* verification.

e. Given the implementation of the revised Insurance Act (Act No. 45 of 2014), the FSA will review the status of initiatives taken by insurance companies, etc. in connection with their duty to understand their customers' intentions, provide information to customers and establish operational systems for insurance solicitors, and start considering specific measures to take, such as revisions to the guidelines for supervision.

(ii) Accelerating and ensuring the effectiveness of product examinations

Insurance companies, etc. should meet the diversifying needs for insurance in light of social and economic changes including Japanese people's diversifying values/lifestyles and rapidly declining birthrate and aging population, and corporate customers' new business expansion and launch of new technologies. At the same time, it is also important to develop insurance products that are simple and easy-to-understand in view of protecting insurance policyholders. Based on the above, the FSA will conduct examination of insurance products offered by insurance companies, etc. appropriately.

In examining insurance products, the FSA intends to provide sufficient support to enable insurance companies, etc. to develop well-designed products through innovative ideas, by measures such as pre-examination meetings to exchange views. The FSA will also endeavor to improve the efficiency and speed of the examination process so that insurance companies, etc. can make prompt product revisions.

(iii) Enhancing the framework for processing consultations and complaints from customers

The FSA will review whether insurance companies, etc., with the management's involvement, handle consultations/complaints from customers appropriately and in a timely manner through well-developed consultation counters and call centers, that the causes of consultations/complaints are analyzed, that information is shared institution-wide, and that measures to prevent the recurrence of complaints are developed, disseminated and followed up, and that all of the above are reflected in the future development of products/services and enhancement of risk management.

The FSA will also review whether insurance companies, etc. are taking appropriate action in connection with the financial alternative dispute resolution (ADR) system, such as disclosure of the information necessary for quick dispute resolution, explanations and introduction of the system to customers.

(iv) Ensuring business continuity

a. Stable IT system operation

In order to ensure the stability of IT systems, the FSA will review the operation and management of IT systems of insurance companies, etc., including management of outsourcing contractors and the scheduled system updates.

b. Business continuity framework

The FSA will review whether insurance companies, etc. have set up their business continuity frameworks sufficiently assuming major risks, and whether they review the business continuity plan to reflect the discussions at the Central Disaster Prevention Council, etc.

(v) Comprehensive management of information security

The FSA will review whether insurance companies, etc. identify, understand and manage all important customer information including cases where information handling is contracted/subcontracted, and whether there is a forceful mechanism in place to deter and prevent fraudulent accesses and acquisition of customer information. For outsourced operations, the FSA will also confirm whether insurance companies, etc., as the outsourcer, periodically monitor outsourcing contractors to ensure that outsourced operations are carried out appropriately.

Further, the FSA will confirm whether insurance companies, etc. as the outsourcer are set up to monitor and track the status of outsourced customer data management by contractors, including cloud-service providers.

(vi) Prevention of abuse of insurance services

a. Prevention of false insurance claims

The FSA will confirm measures taken by insurance companies, etc. to prevent them from making payments against false insurance claims, focusing on the progress of enhancing the examination system at the stage of both contract and payment of insurance and the effectiveness of these measures (including the progress of database upgrades to prevent false claims) through utilizing the related system, such as “the registration system for information on insurance policies”, “the reference system for claim examination”, “the fraudulent claim prevention system”, and “the information exchange system concerning personal insurance events”.

b. Cyber-attacks

The FSA will review whether insurance companies, etc. have taken appropriate security measures to respond to various cyber-attacks and developed contingency plans.

c. Money laundering and financing terrorism

The FSA will review initiatives taken by insurance companies, etc. to enhance the framework for executing their tasks appropriately, such as verification of customers at the initiation of a transaction, preparation and safekeeping of the verification and transaction records, monitoring executed transactions, and reporting suspicious transactions pursuant to the revised Act on Prevention of the Transfer of Criminal Proceeds, while keeping in mind customer convenience.

d. Disconnecting from anti-social forces

In view of the June 2014 revision of the guidelines for supervision, the FSA will review whether insurance companies, etc. are taking measures to disconnect from anti-social forces appropriately at every stage of any such transaction. Namely, the FSA will confirm whether insurance companies, etc. implement pre-screening, *ex post*-verification and measures to terminate businesses with anti-social forces at the initiation, post-execution and termination stages respectively.

2-2 Soundness of insurance companies, etc.

(1) Upgrade risk management

Due to economic and social changes, including the rapidly declining birthrate and aging population, the recent increase in the number of natural disasters, and changes in the economic and financial conditions in both Japan and overseas countries, the earnings structure of insurance companies, etc. is becoming increasingly important in their business challenges to establish sustainable business models in the future.

For instance, some insurance companies (insurance groups) are actively seeking to expand earnings opportunities effectively on a group-wide basis by expanding their business overseas to regions such as Asia and diversifying their insurance business within Japan. At the same time, insurance companies, etc. are required to manage risks appropriately. Namely, it is necessary for them to consider risk management as a key element that substantially underpins and promotes various efforts to expand their earnings opportunities and manage risks together with their earnings, rather than managing risks in a preventive and defensive fashion. It is also important to develop and secure human resources that are capable of doing so, and assign them to their best-suited positions.

From this point of view, the FSA will ensure the financial soundness of insurance companies, etc. by encouraging them to upgrade their risk management and disclose information appropriately, taking into account the increasing variety and complexity of the risks surrounding them, market trends both in Japan and overseas and international regulatory trends. In order to promote the sophistication of the risk management approach, it is important to develop regulatory and supervisory frameworks that are consistent with these sophisticated risk management approaches. Thus, the FSA will consider introducing an economic value-based solvency regime.

(i) Promotion of enterprise risk management

a. Given the diversification and complex nature of the risks surrounding insurance companies, etc., the FSA will continue encouraging them not only to ensure the maintenance of their regulatory capital and disclose financial information appropriately, but also to develop enterprise risk management frameworks to control all associated risks in a comprehensive manner involving the entire business operations, under a risk return tradeoff consistent with their business strategies. In promoting the sophistication of risk management, the FSA will continue to consider formally introducing Own Risk and Solvency Assessment (ORSA[10]) reporting, which was implemented on a trial basis under the enterprise risk management hearing survey

[10] A process where insurance companies assess their capital adequacy, etc. by comparing the capital base and current/future risks and review the validity of risk taking strategies, etc. from a comprehensive perspective

for the program year 2013, given that ORSA reporting is considered useful for understanding each insurance company's enterprise risk management in a consistent manner across the industry, and supervisory authorities in various western countries are preparing to implement the ORSA reporting requirement.

b. Given the increasing number of natural disasters and new risks arising from technological innovation, it has become increasingly important to set up a framework to manage risks associated with underwriting insurances. In this regard, the FSA will review the status and effectiveness of insurers' efforts to retain the ability to make payments and a solid business foundation, including the progress of developing appropriate underwriting processes, efforts to identify and measure risks accurately, efforts for risk reduction and adjustments based on risk monitoring and stress testing, and risk mitigation measures such as reinsurance.

c. In reviewing the risk management of insurance companies, etc., the FSA will not just collect information and assess these companies' risk management uniformly, but will confirm their asset liability management (ALM) in light of the characteristics of their liabilities. For example, the FSA will check the adequacy of risk management, including whether insurance companies, etc. manage sales in line with the characteristics of their distribution channels and insurance products, and whether product parameters are reviewed appropriately in a timely manner. The FSA will also encourage insurance companies, etc. to take initiatives in accordance with their characteristics.

d. Insurance companies should endeavor to enhance their asset management capabilities under the appropriate risk management in order to retain sufficient funds for future insurance payments, etc., and facilitate steady asset formation for Japanese citizens. The FSA will review whether insurance companies, etc. understand risks/returns accurately through various risk measurement techniques, stress testing, and analysis of market trends, develop fund management policies, manage their assets in accordance with these policies, and monitor the status.

(ii) Review of solvency assessment

a. Economic value-based solvency regulations contribute to an accurate understanding of insurance companies' financial conditions and the sophistication of risk management for insurance companies, etc. through the mark-to-market valuation of assets and liabilities in their entirety. The FSA will continue to consider introducing an economic value-based solvency regime in cooperation with professional organizations, such as the Institute of Actuaries of Japan and the General Insurance Rating Organization of Japan, taking into account trends in international discussions and the results of the field test.

In considering the ideal framework for an economic value-based solvency regime, the FSA will review the use of internal risk models by insurance companies, etc. to measure associated risks, and start exploring possible supervisory measures, etc.

b. In view of the revision of the international accounting standards on insurance contracts by the International Accounting Standards Board (IASB), the FSA will continue to consider how the statutory insurance accounting should be over the medium term for Japan.

(2) Enhance governance

Effective governance is essential to corporate management, as it prevents activities that will reduce the enterprise value, such as scandals, and improve the competitiveness and earnings capability of companies. In view of this, in-depth monitoring is necessary covering the effectiveness of the Board of Directors, enhancement of audit functions, management strategies, etc. of insurance companies etc.

(i) Effectiveness of the board

The FSA will review the effectiveness of Board of Directors, including the status of discussions and decision-making at Board of Directors meetings involving outside directors.

Particularly for outside directors, the FSA will confirm whether a mechanism is in place to support outside directors in fulfilling their duties, by, for example, ensuring the independency of and providing the necessary information to outside directors.

In addition, for insurance companies with a mutual company structure, taking into account the organizational differences with the stock company, the FSA will review the progress of efforts to implement effective governance, including the effectiveness of outside directors' management checks.

(ii) Enhancement of audits

The FSA will review whether the audits by company auditors, the internal audits and external audits are well-coordinated, appropriate and effective.

Especially for major insurance companies, the FSA will interview the company auditors regarding the audit plan, thereby confirming the effectiveness of the company auditors and the Board of Company Auditors. Additionally, the FSA will confirm the effectiveness of internal audits through an exchange of views with the internal audit department regarding the audit plan, risk assessment, initiatives to enhance internal audits, etc., and promote the use of the internal audit function.

Further, the FSA will endeavor to understand the status of other insurance companies, etc. through discussions regarding audits conducted by company auditors and internal auditors as necessary, taking into account each company's business and risk characteristics.

(iii) Management strategies, etc.

In monitoring governance, the FSA will confirm the management's awareness regarding medium- to long-term business strategies, management issues and actual performance against business plans and targets (especially when there is a large gap between actual performance and plans/targets).

For insurance companies (groups), given their solid appetite for overseas business expansion, the FSA will confirm their internal control over business operations at overseas bases (subsidiaries, affiliates etc.), joint ventures with overseas business partners, business partnerships, etc. In addition, the FSA will review whether insurance companies (groups) have created IT infrastructure policies and developed their IT infrastructure in line with the level of their appetite for overseas business expansion.

The FSA will request new-entry insurance companies, etc. that are expanding rapidly or deviating from their originally intended business models and business execution plans to align their governance and risk management with their actual business size and business model.

For foreign insurance companies, depending on their size and business profile, it may make sense to convert and incorporate branches into subsidiaries. Subsidiaries and branches alike they should be given sufficient authority and responsibility to establish a governance and internal control system inside Japan with the appropriate instruction and support from their head offices, and thereby they should clarify the decision making process.

With this in mind, the FSA will implement in-depth supervision and inspection in terms of governance and risk management at Japanese subsidiaries and branches of foreign insurance companies.

3 Approach to supervision and inspection

3-1 Major insurance companies

Continuing from the program year 2013, in principle, the FSA will monitor major insurance companies through a Horizontal Review.

In order to increase the efficiency of financial monitoring, generally the FSA’s Horizontal Review will be based on off-site monitoring, combined with on-site monitoring as necessary. When monitoring major insurance companies, the FSA will focus on exchanging views with outside directors, company auditors and internal audit departments. In addition, the FSA will endeavor to understand the conditions in each insurance company as quickly as possible through an analysis of management information and interviews with the relevant business units where necessary, and improve the sensitivity to potential risks, thereby selecting monitoring items dynamically from a forward looking perspective.

It should be noted that in the Horizontal Review, the FSA will avoid making decisions in a mechanical and uniform fashion, taking into account differences in the strategies taken by each financial group. In off-site monitoring, the Supervisory Bureau and the Inspection Bureau will discharge their allocated administrative responsibilities in close cooperation with each other (same shall apply to section 3-2 through 3-5).

Further, as the supervisory authority, the FSA will take the necessary action to enhance cooperation with foreign financial supervisory authorities in view of the ongoing international discussions regarding the enhancement of insurance supervision by the Financial Stability Board (FSB) and the International Association of Insurance Supervisors (IAIS).

3-2 Other insurance companies

Given their diverse scales and business models, the FSA will monitor other insurance companies effectively and efficiently using off-site monitoring and targeted inspections in accordance with each insurance company’s risk profile.

As with the major insurance companies, the FSA will also conduct a Horizontal Review for other insurance companies in terms of significant issues common to them. Further, for subsidiaries and branches of foreign insurance companies, the FSA will exchange views with supervisory authorities in their home countries and management at the holding company/head office as necessary, taking into account the environment surrounding international insurance companies, etc.

3-3 Small amount and short term insurance providers

The FSA will endeavor to understand small amount and short term insurance providers' business conditions and business plans from the viewpoint of customer protection, in view of their size and the characteristics of their products and solicitation methods. The FSA will also monitor small amount and short term insurance providers' governance, financial soundness, adequacy of their business operations, etc. effectively and efficiently using off-site monitoring and targeted inspections in accordance with each provider's risk profile, in close cooperation with the relevant Local Financial Bureaus. It should be noted that the FSA will carefully monitor those insurance providers identified as facing issues regarding financial soundness, legal compliance status, etc. and also new market entrants.

3-4 Authorized specified insurance providers

The FSA will monitor authorized specified insurance providers effectively and efficiently using off-site monitoring and targeted inspections in accordance with each insurance provider's risk profile, in close cooperation with the relevant Local Financial Bureaus. In particular, the FSA will endeavor to understand whether their actual business deviates from what was originally intended, and carefully monitor providers who are facing issues regarding financial soundness and legal and regulatory compliance.

3-5 Insurance agents, etc.

The FSA will monitor insurance agents and other business operators engaged in insurance solicitation by combining on-site and off-site monitoring in an efficient manner, taking into account the size and business model of these business operators and in close cooperation with the relevant Local Financial Bureaus.

VII. Supervision of Financial Instruments Business Operators, etc.

1. <u>Issues facing Financial Instruments Business Operators, etc. and concept for</u>

2014-2015

Financial Instruments Business Operators, etc. are expected to play a key role in developing fair and transparent markets as providers of direct financing through financial intermediation between fund providers and seekers. To this end, financial business operators, etc. are expected to improve the credibility and reliability of Japan's financial and capital markets through their unremitting efforts to adequately demonstrate financial intermediary functions, contributing further to Japan's economic growth.

The Japanese government is promoting initiatives to overcome deflation and build a positive economic cycle. Going forward, given the aging and decreasing population, it is important that the massive amount of assets invested by households, pension funds and institutional investors is managed appropriately in line with the characteristics of each fund and asset and the needs of asset owners. Considering this, Financial Instrument Business Operators, etc. are expected to facilitate steady asset building for Japanese citizens by providing financial products and services that match the needs of Japanese citizens.

It is important to build a positive cycle in which Financial Instruments Business Operators, etc. discharge their responsibilities as noted above, which will further induce a flow of funds to investment, contribute to medium- to long-term market growth, and ultimately generate a steady stream of profits for the business operators themselves.

In order to achieve the positive cycle noted above, both asset management companies and sales companies should build frameworks that will provide products of a higher quality that really meet customer needs and continue making efforts to enhance customers' understanding regarding the necessity of asset formation.

At the same time, in order to provide financial intermediation appropriately, it is essential that Financial Instruments Business Operators, etc. maintain and improve their soundness. In particular, large-scale securities company groups, etc. (domestic and foreign major securities companies) should upgrade their governance and risk management to be level with their business models, in view of the economic and financial condition and the progress in international discussions regarding financial regulations.

Based on the above, financial instrument business operators, etc. should fully recognize their roles and the issues facing them, accurately understand the various risks and create/implement management strategies incorporating structural changes in the economy and markets. The FSA will encourage further efforts through discussions with the management of Financial

Instruments Business Operators, etc. where necessary, considering each operator's characteristics.

2 Key priority measures and the focus of supervision

2-1 Effective financial intermediation

(1) Effective response to the needs of customers (Upgrading asset management capacity

In order to develop the positive cycle mentioned previously, Financial Instrument Business Operators, etc. should endeavor to provide financial products/services that give top priority to customer needs and improve their asset management capabilities.

In view of this, the FSA will review these operators' policy towards business management, incentive mechanism, and the financial products/services actually provided by these operators. For investment trusts, for example, the FSA's monitoring will focus on the following.

(i) Whether fiduciary duties are incorporated in investment managers' product development and investments to provide products that really satisfy customer needs and interests, and whether their investment activities are sufficiently independent of group sales companies;

(ii) Whether securities companies, etc. offer products/services that really meet customer needs and interests, regardless of the level of commission/fees and the customer's corporate group association.

In addition, in the business of offering financial products/services, there is a gap in the volume of information between the supplier (i.e. Financial Instruments Business Operators, etc.) and the end user (i.e. customers). As such, Financial Instruments Business Operators, etc. should always sufficiently explain and maintain transparency of their financial products to ensure the suitability of a given product for customers. From this point of view, the FSA will take action as below.

(i) The FSA will encourage investment managers to actively take measures for the disclosure of easy-to-understand information to customers, including product parameters, risk characteristics and investment management, taking into consideration the "two-level performance-reporting requirement" to be implemented in December 2014 pursuant to the 2013 revision of the Act on Investment Trusts and Investment Corporations.

(ii) The FSA will confirm whether securities companies, etc. are prepared to provide clear explanations to customers, taking account of their suitability to invest in the products offered, so that customers can make investment decisions with an adequate understanding of the risks associated with the products offered and the costs charged to customers, including commission.

Taking into account the purpose of introducing NISAs, the FSA will encourage Financial Instruments Business Operators, etc. to be actively involved in industry-wide/cross-sectoral efforts to improve the financial literacy of investors. As the supervisory authority, the FSA will also take initiatives to promote financial and economic education. Further, the FSA will encourage business operators to build frameworks to support the offering of financial products, appropriate solicitation, and sales activities incorporating the purpose of the NISA.

The FSA will confirm whether Financial Instruments Business Operators, etc., in their underwriting businesses, fully consider issuers' funding needs and financial condition to ensure that they are providing services that meet customer needs.

Additionally, the FSA will review securities companies' own securities investment management; namely, whether their fund management and risk management are in line with their asset size, etc.

(2) Fulfill the functions towards providing funds for growth

Financial Instruments Business Operators, etc. are expected to contribute to expanding the supply of risk money required for economic growth by discharging their responsibilities to provide direct financing through financial intermediation. In view of this, the FSA will take the following action.

(i) The FSA will encourage securities companies, etc. to make active efforts to provide effective financial intermediation under appropriate internal control, including support for the business development and financing of companies with growth potential (identification of fund providers, matching fund providers and seekers, IPO support, etc.).

The FSA will also check whether Financial Instruments Business Operators, etc. are developing strategies for expanding their customer bases through offerings of NISAs, etc., thereby increasing the overall number of investors in financial and capital markets.

(ii) Based on the introduction of laws related to crowd funding service providers under the 2014 revision of the Financial Instruments and Exchange Act, the FSA will establish a supervisory framework to achieve robust dissemination and utilization of crowd funding, in cooperation with self-regulatory organizations.

(3) Ensure customers' trust/security

While ensuring user protection and legal/regulatory compliance, constant efforts by Financial Instruments Business Operators, etc. to operate their businesses appropriately will build a sense of trust and security with customers, enable operators to provide financial intermediation smoothly and effectively, and ensure the fairness and transparency of financial and capital markets. As such, Financial Instruments Business Operators, etc. should implement comprehensive user protection measures and maintain legal/regulatory compliance to avoid damaging customer trust.

(i) Comprehensive protection of users in the financial instruments business

a. Development of a management framework for processing consultations and complaints from customers

The FSA will confirm whether a framework is in place to analyze the causes of customer consultations/complaints, share information institution-wide, develop, disseminate and follow up measures to prevent recurrence of complaints with the involvement of top management, and reflect all of these in the future development of products/services and improvements to risk management.

The FSA will also check whether Financial Instruments Business Operators, etc. are taking appropriate action in connection with the financial alternative dispute resolution (ADR) system, such as disclosure of the information necessary for quick dispute resolution, explanations and introduction of the system to customers.

b. Development of an internal control framework regarding collaboration with banks within the group

The FSA will confirm whether conflict-of-interest management and customer information management of Financial Instruments Business Operators, etc. are in line with the degree of collaboration between banks within the group.

c. Ensuring business continuity

1) Stable IT system operation

In order to ensure the stability of IT systems, the FSA will review the status of operation and management of IT systems including outsourcing contractors and the scheduled system updates.

2) Business continuity framework

The FSA will confirm whether Financial Instruments Business Operators, etc. have set up their business continuity frameworks to sufficiently assume major risks, and whether they review their business continuity plans to reflect the discussions at the Central Disaster Prevention Council, etc.

(ii) Ensuring appropriate business operations of Financial Instruments Business Operators, etc.

a. Comprehensive management of information security

The FSA will review whether Financial Instruments Business Operators, etc. identify, understand and manage all important customer information including cases in which information handling is contracted/subcontracted, and whether there is a forceful mechanism to deter and prevent fraudulent access and acquisition of customer information.

The FSA will also confirm whether corporate information, including insider information, is managed appropriately and strictly in underwriting and sales departments.

b. Prevention of fraudulent use of services

1) Cyber-attacks

The FSA will confirm whether Financial Instruments Business Operators, etc. have taken appropriate security measures to respond to various cyber-attacks and have developed contingency plans.

2) Money laundering and terrorism financing

The FSA will confirm whether there is a sophisticated system to appropriately execute tasks, such as verification of customers upon the initiation of a transaction, preparation and safekeeping of the verification and transaction records, transaction monitoring, and reporting of suspicious transactions based on the revised the Act on Prevention of Transfer of Criminal Proceeds, while keeping in mind customer convenience.

3) Disconnecting from anti-social forces

In view of the June 2014 revision of the Comprehensive Guidelines for Supervision, the FSA will confirm whether Financial Instruments Business Operators, etc. are taking measures to disconnect from anti-social forces appropriately at every stage of every transaction. Namely, the FSA will confirm whether Financial Instruments Business Operators, etc. implement pre-screening, *ex post*-verification and measures to terminate business with anti-social forces at the initiation, post-execution and termination stages respectively

c. Maintaining and improving the credibility and transparency of financial benchmarks

Financial benchmarks are an important part of financial markets. Based on this, the FSA will confirm whether Financial Instruments Business Operators, etc. have solid systems to prevent fraudulent activities when submitting data for the benchmark calculation, such as measures to prevent conflicts-of-interest, etc.

d. Type II financial instruments firms

In view of the ongoing enhancement of business reports, the FSA will strengthen its monitoring process by developing systems to use obtained information efficiently. The FSA will also share information with the Securities and Exchange Surveillance Commission (SESC) and request the SESC to conduct inspections promptly if necessary.

The 2014 revision of the Financial Instrument and Exchange Act will require type II financial instruments firms (type II firms) that do not belong to the Type II Financial Instruments Firms Association to prepare company regulations equivalent to the regulations of the said association. In view of this, the FSA will monitor the type II firms to confirm that they take appropriate action before the implementation of the 2014 revision, such as participation in the association. The FSA will also encourage the Type II Financial Instruments Firms Association to protect investors adequately through stronger self-regulation, etc.

e. Qualified Institutional Investors, etc. operating specially permitted businesses

For funds sold and managed by qualified institutional investors, etc. who are operating specially permitted businesses (special business operators), the FSA will endeavor to confirm whether businesses notified by these special business operators actually meet the predetermined criteria for specially permitted businesses, understand the actual business profile of special business operators, and share information with the SESC. If malicious operators are discovered, the FSA will publicly disclose such facts, issue warning notices in coordination with the law enforcement authorities, publicly disclose the issuance of such warning notices and add the identified operators to the "List of notified business operator that have been detected as having problems."

f. Advisory and agency businesses operators

Given several cases of foreign investment securities offerings and private placements that have not been filed, the FSA will continue investigating similar cases in cooperation with the SESC.

g. Credit rating agencies

The FSA will further enhance its supervision by utilizing the information acquired through cooperation with supervisory authorities in various countries, in cooperation with the SESC.

h. Discretionary investment business operators

The FSA will continue its efforts to grasp the status of discretionary investment business operators in close cooperation with the SESC, and supervise them appropriately through a risk-based approach.

i. Foreign currency margin transactions (FX transactions) business operators

The FSA will continue to verify the adequacy of FX businesses' customer solicitation and explanation systems. The FSA will also confirm, in cooperation with the SESC, whether these operators are taking appropriate measures against the slippage associated with FX transactions pursuant to the guidelines for supervision and other relevant self-regulatory rules and against trades using software that allows automatic trading (system trading, etc.).

j. Financial crime

The FSA will handle malicious and fraudulent solicitations of investment products in cooperation with the law enforcement authorities, the Consumer Affairs Agency, etc. through information sharing. In addition, FSA will issue prompt warning notices to unregistered Financial Instruments Business Operators, etc. (including overseas business operators soliciting investors in Japan) and publicly disclose the fact that the warning notices were issued, thereby alerting investors. Further, the FSA will urge the related industry bodies and Financial Instruments Business Operators, etc. to take prevention measures against crime associated with financial transactions.

2-2 Ensuring the soundness of Financial Instruments Business Operators, etc.

(1) Forward looking risk management of large-scale securities company groups, etc.

(i) Supervision Based on the Macro-Prudential Point of View

The soundness of the business operations of large-scale securities company groups, etc. is susceptible to the economic and financial/capital markets trends in Japan and overseas. Therefore, it is important to keep track of the status of both the economy and financial/capital markets at all times and analyze how they interact with each other.

The FSA will strengthen its capabilities to analyze the risks inherent to the overall financial sector with a forward looking perspective, and thereby endeavor to determine the situation including global economic conditions, the flow of funds, trends in financial/capital markets and market participants, and trends in the business strategy of large-scale securities company groups.

Then the FSA will analyze how these conditions and trends may affect the financial system and the business operations of large-scale securities company groups. At the same time, the FSA will confirm whether governance and risk management frameworks in large-scale securities company groups, etc. can respond forcefully to changes in the environment.
In addition, the FSA will review the management control and risk management systems of large-scale securities company groups, including whether they develop and revise policies for liquidity and position management of foreign currency, etc. with a forward looking perspective, according to trends in global markets.

Further, for derivative and other products that have relatively low liquidity in both Japan and overseas and for which risk identification is difficult, the FSA will confirm whether large-scale securities company groups accurately understand these products’ sales and investment performance, profitability and potential impacts on equity capital, and appropriately manage these products from the aspect of financial resilience against changes in market conditions.

(ii) Establishing and Strengthening Comprehensive Risk Management

The FSA will identify various risks associated with large-scale securities company groups, etc. including market risk, credit risk and operational risk, determine the status of their group-wide comprehensive risk management and methodologies, and review the validity thereof.

For example, the FSA will review whether large-scale securities company groups (i) conduct stress testing incorporating the economic and financial conditions in Japan and other countries based on a solid understanding of the risks inherent in their business models; and (ii) discuss the results of stress testing involving the management and utilize them for developing management policies and manage risks.

(2) Supervision of large-scale securities company groups, etc. from a global perspective

1. Enhancing the group-wide governance and risk management considering the international standard

The FSA will try to timely and accurately grasp business conditions and business models of internationally active securities company group with large and complex operations. In doing so, the FSA will encourage them to enhance the quality of their governance and risk management to a level equivalent with that of the international standard, by referring to the progress in international discussions regarding financial regulations and best practices in G-SIFIs.

To that end, the FSA will encourage internationally active securities company groups with large and complex operations to implement the following initiatives:

(i) Reinforcement of internal control and group-wide business management backed by properly functioning business, risk management, finance and internal audits divisions

(ii) Development of internal systems for setting capital policy from a medium- to long-term perspective

(iii) Improvement of the skills and expertise of personnel in charge of risk management and internal auditing

(iv) Development of a framework for strengthening the IT infrastructure, including sophistication of group-wide Management Information Systems (MIS) to maintain appropriate data aggregation capabilities

(v) Implementation of a risk appetite framework (a group-wide framework to discuss, understand, and evaluate the risk level which the group is willing to take based on the group's management strategy) and use of such framework in formulating management strategies and decisions on the financial (B/S and P/L) management frameworks

(vi) Development or revision their recovery plans

At the same time, the FSA will continue working to develop the Resolution plans.

2. Enhancing risk management to support overseas (cross-border) business expansion

The FSA will enhance information sharing and cooperation for internationally active securities company groups with large and complex operations with the financial supervisory authorities in countries where these securities groups operate and encourage these groups to understand and review the sustainability of the business models of their overseas operation bases and make efforts to implement solid risk management.

It should be noted that in foreign countries, overseas operation bases are often governed by regulations concerning capital, liquidity, etc. that are unique to their host countries. Thus, the FSA will review the action taken by overseas subsidiaries to deal with new laws and regulations introduced overseas, including the soundness of their financial base and the status of their group-wide governance.

Further, in view of the increase in overseas and cross-border businesses and the fact that there are a number of cases where financial institutions are charged large penalty payments by foreign supervisory authorities, the FSA will review whether internationally active securities company groups with large and complex operations are taking appropriate action to improve their operational risk and compliance risk management. The FSA will also encourage these groups to establish legal and regulatory compliance structure, incorporating rapidly changing financial regulations in various countries as a result of international financial regulatory reform.

(3) Managing business risks in small and medium-sized securities companies, investment

companies, etc.

The FSA will encourage small and medium-sized securities companies, investment companies, etc. to comprehensively implement higher-quality risk management in view of sudden changes in the economic and financial environment. In connection with this, the FSA will review FX business operators' foreign exchange risk management.

It should be noted that if these companies show signs of deterioration in financial profile and liquidity, the FSA will promptly check whether they are taking measures, such as implementation of achievable reforms in their management/earnings structure and activities to improve liquidity.

Further, the FSA will conduct thorough examination through segregation management. The FSA will also watch out for the possibility of anti-social forces or individuals who lack either the intention or the ability to conduct sound business operations engaging in business management as fund providers, etc.

3. Supervisory approach

In implementing the supervisory approach outlined below, the FSA will closely cooperate with the SESC as necessary. In doing so, the FSA will endeavor to minimize overlaps with the SESC's supervision and reduce the burden on financial institutions subject to the FSA's supervision.

3-1 Effective financial intermediation

(i) Significant issues common across the industry

The FSA will conduct a Horizontal Review for significant issues common across the industry (business operations that serve customer needs, sophistication of asset management, etc.), and have in-depth discussions with Financial Instruments Business Operators, etc. on how to achieve better business operations, taking into account their sizes and characteristics.

(ii) Ensuring appropriate business operations

In terms of legal/regulatory compliance and the appropriateness of business operations, the FSA will endeavor to identify risks at an early stage through the analysis of various kinds of information and promote risk-based, effective and efficient supervision. For cross-border cases, the FSA will work to coordinate with financial supervisory authorities in relevant countries as necessary.

3-2 Ensuring the soundness of Financial Instruments Business Operators, etc.

(i) Large-scale securities company groups, etc.

The FSA will strengthen the integrated approach to internationally active securities company groups with large and complex operations, enhancing the integration of on-site and off-site monitoring in order to gain an in-depth understanding of the soundness of management and the status of risk management in these groups. In order to monitor them more effectively and efficiently, the FSA will analyze management information and interview each business unit about business trends as necessary, develop better understanding of the condition of financial institutions and financial markets on a real time basis, and set out monitoring items forcefully from a forward looking perspective.

Further, while enhancing cooperation with financial supervisory authorities, etc. in various countries, the FSA will confirm these groups' compliance status not only in light of the standards set out in related laws and regulations but also in reference to global best practices. The FSA will also promote constructive dialogue with the groups regarding desirable business operations. Of note, the FSA will avoid setting monitoring items in a mechanical and uniform fashion, taking into account differences in the strategies taken by each group.

(ii) Small and medium-sized securities companies

The FSA will operate the early warning system properly, and endeavor to ensure early detection and resolution of problems by further enhancing cooperation with the Japan Securities Dealers Association and the Investor Protection Fund.