Financial Services Agency

Summary Points from

Progress and Assessment of the Strategic Directions and Priorities 2015-2016

September 2016

Progress and Assessment of the Strategic Directions and Priorities 2015-2016: Its Roles in the JFSA's PDCA cycle

- This document lists key elements of the JFSA's *Progress and Assessment of the Strategic Directions and Priorities 2015-2016 ("the Report"),* which outlines the analysis on Japan's financial system and the challenges identified during the program year 2015 (July 2015 to June 2016).

- The Report is published as a part of the JFSA's PDCA cycle. The *Strategic Directions and Priorities* corresponds to the "Plan" stage of the cycle. The Report takes a role in the "Check" stage by reviewing the progress made during the year. The JFSA is committed to repeat the PDCA cycle for continuous improvement.

- *The Strategic Directions and Priorities 2016-2017* for program year 2016 (July 2016 to June 2017) will reflect findings and observations of the Report.

I. Current Conditions of the Financial System

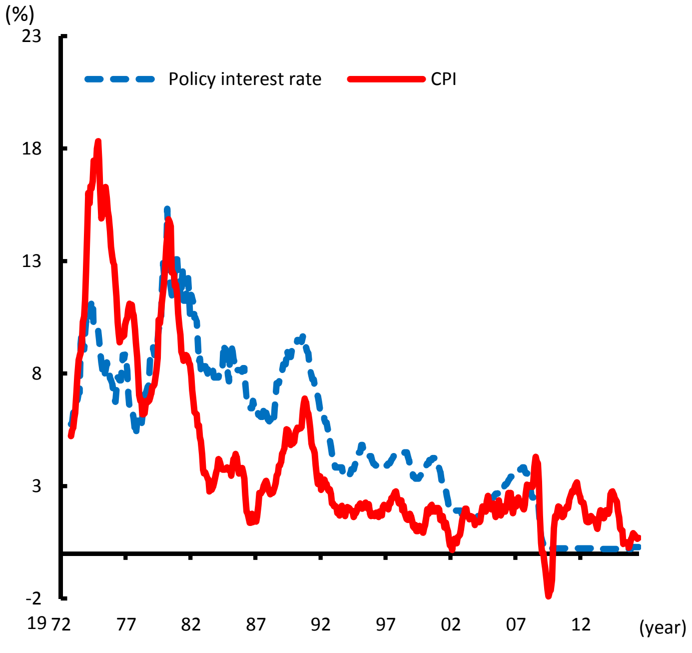
I-1. Global Economy and Financial Markets

I-2. Financial Stability in Japan and the Potential Risks

I-1. Global Economy and Financial Markets

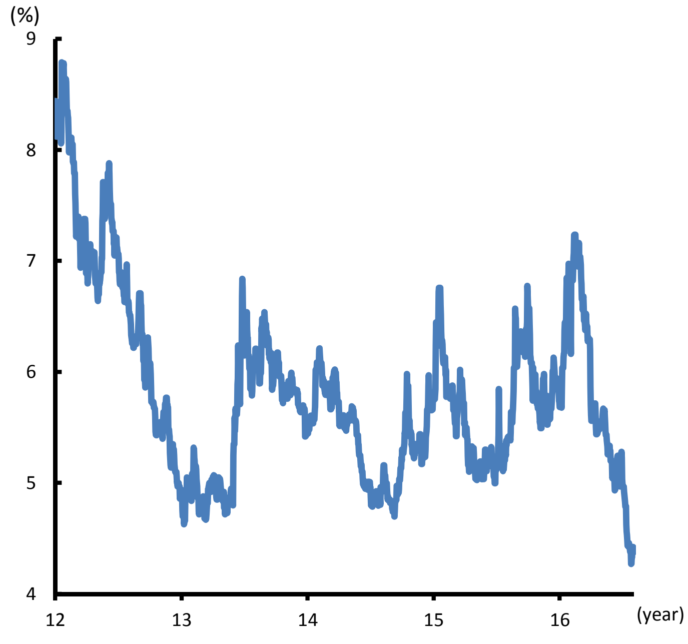
- The global economy is faced with structural oversupply resulting in deflationary pressures.
- Under the global trend of prolonged monetary accommodation to ease deflationary pressures, the price of risky assets has been pushed up worldwide by investors searching for higher yields.
- Over the past 12 months, surges in market volatility have been more frequent than before. The causes may include political factors and changes in market structure such as weakened market-making functions by banks and asset growth by nonbanks (i.e. expansion of shadow banking).

CPI and policy interest rate in advanced economies



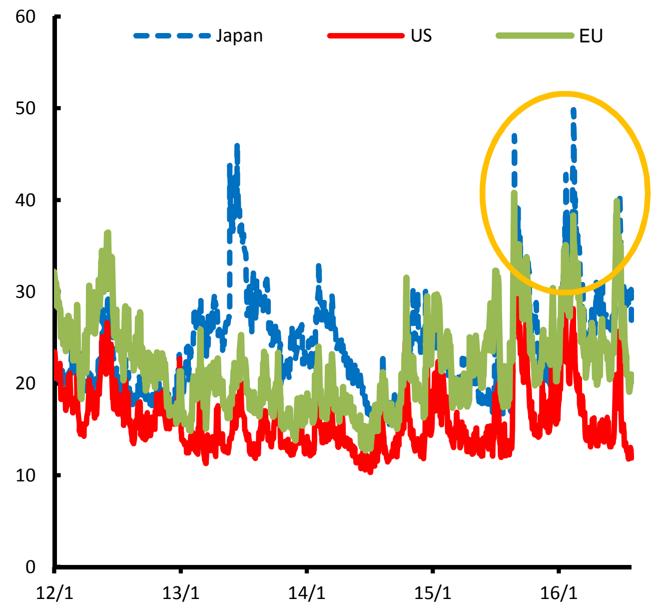
Note: Each line represents change in average of CPI or Policy interest rate in US, UK and Japan.
Source: Bloomberg

Spread on high-yield bonds of emerging economies



Note: OAS(Option Adjusted Spread) of Barclays USD Asia high-yield bond index.
Source: Bloomberg

Volatility index

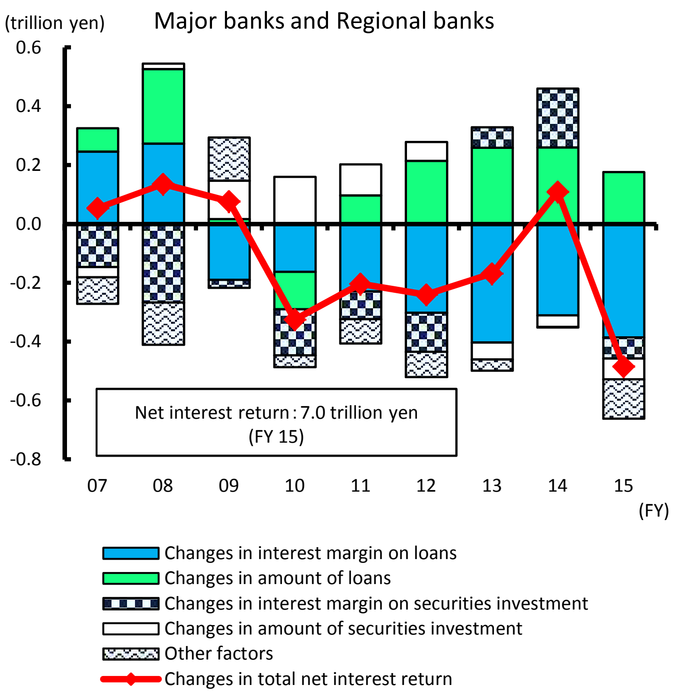


Source: Bloomberg

I-2. Financial Stability in Japan and the Potential Risks

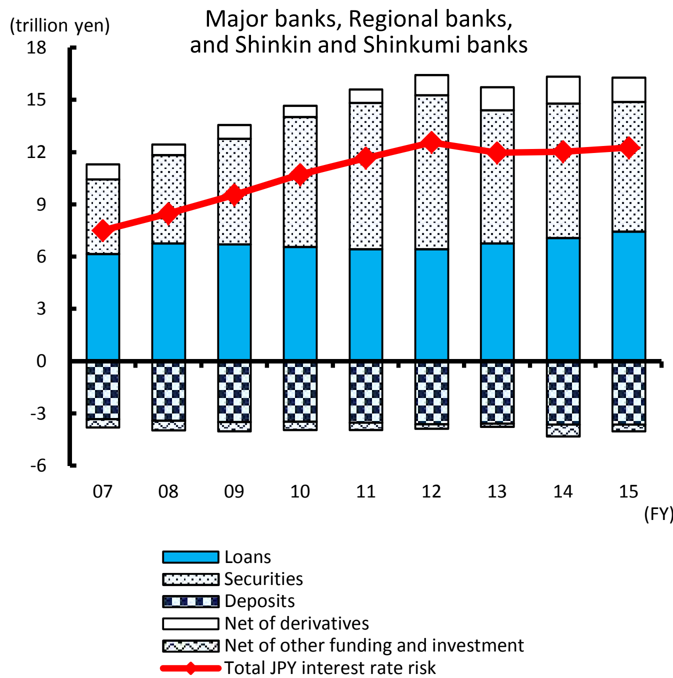
- The Japanese financial system is sound and stable in general, however, the following risks should be closely monitored.
  - ✓ Sustainability of business models which lend/invest long with short term financing, in the face of the continued interest rate decline
  - ✓ Foreign currency liquidity management to address increase in overseas credit exposures and securities investments
  - ✓ Downside effect of changes in the global economy and the financial market on banks' credit costs
  - ✓ Interest rate risk as low liquidity and extraordinarily low term premium is observed in the JGB market
  - ✓ Credit concentration risk to specific sectors, including lending to the real estate sector (e.g. apartment/house loans) though the loan growth is moderate compared to the past

Contributing factors of changes in net interest income (exc. Stocks)



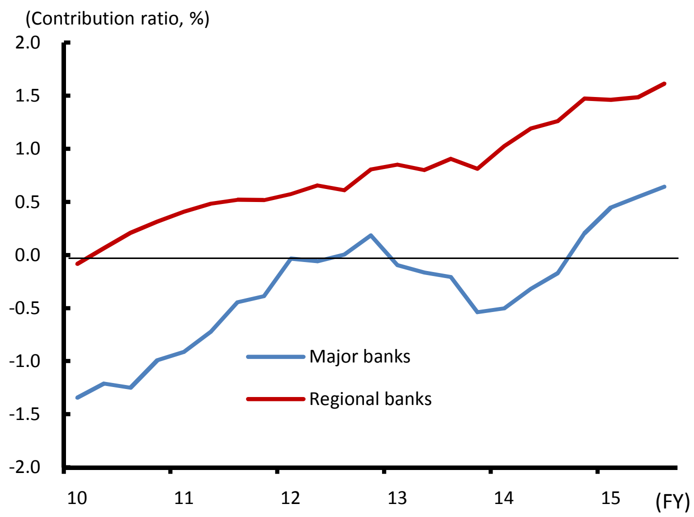
Source: JFSA

JPY interest rate risk



Source: JFSA

Real estate loans



Note: The contribution ratio represents contribution of real estate loans to changes in the total amount of loans.
Source: BOJ

II. Progress and Assessment of the Strategic Priorities

II-1. Efficient and Effective Financial Intermediation
and Sound Financial System

II-2. Towards More Active Capital Market,
Stable Asset Building and
Enhanced Market Integrity and Transparency

II-3. Strategic Policy Measures for Financial Innovation
led by IT Development

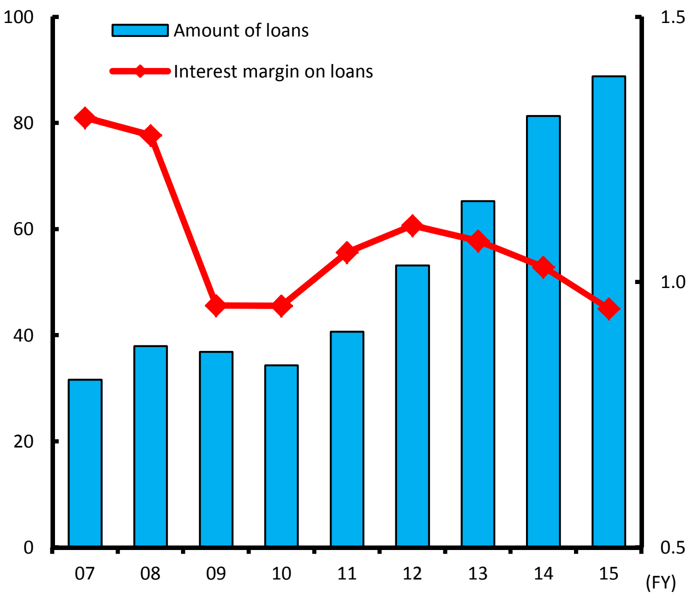
II-4. Addressing Global Challenges

II-1. Efficient and Effective Financial Intermediation and Sound Financial System (1/2)

Internationally Active Banks

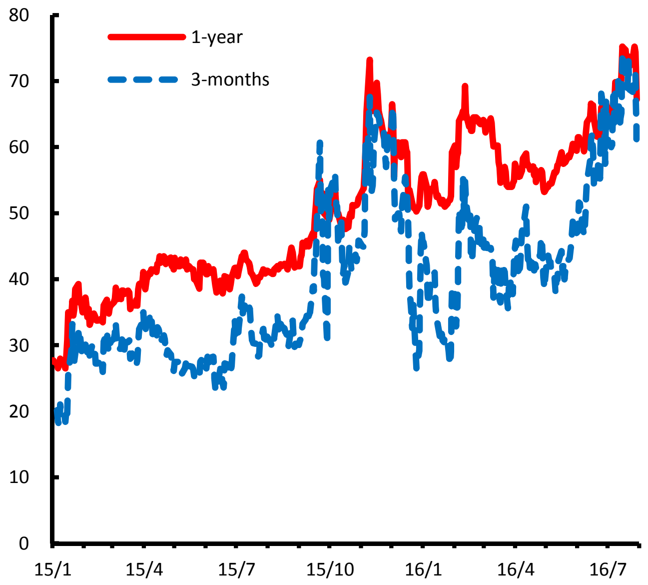
- Major banks need more flexible and timely exposure management to keep up with rapidly changing market environments, in line with the expansion of their overseas businesses
- The main challenge lies with securing stable foreign currency funding source, as the funding cost is rising while their demands are increasing.
- It is becoming more difficult to make profits by scaling up lending as loan margins are declining both domestically and globally. Securing revenue flows from JGB trading is also becoming difficult. Banks thus need to establish a stable revenue base by offering high-quality financial products that truly contribute to stable asset building for their customers, while controlling their own asset size.

Lending margin and loans outstanding (overseas businesses of major banks)



Source: JFSA

Cross-currency basis of JPY-USD



Source: JFSA

Contributing factors of ROA

	Major banks in US and EU (end of 2015)	3 major bank groups (end of FY 2015)
Return on assets	**0.45%**	**0.34%**
Gross return on assets	2.96%	1.36%
Net interest return on assets	1.27%	0.66%
Other return on assets	1.69%	0.70%
Cost on assets	-2.11%	-0.83%
Credit cost on assets	-0.16%	-0.05%

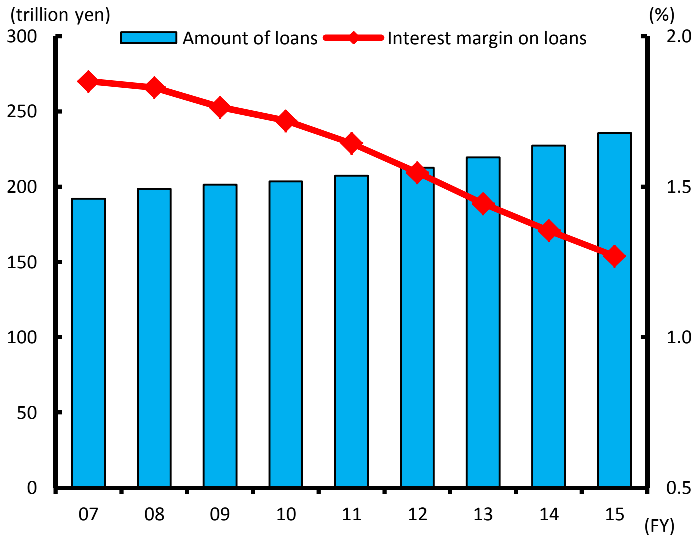
Note: Major banks in US and EU are G-SIBs excluding 4 G-SIBs in China and 3 major bank groups of Japan
Source: Published data from each company

II-1. Efficient and Effective Financial Intermediation and Sound Financial System (2/2)

Regional Banks

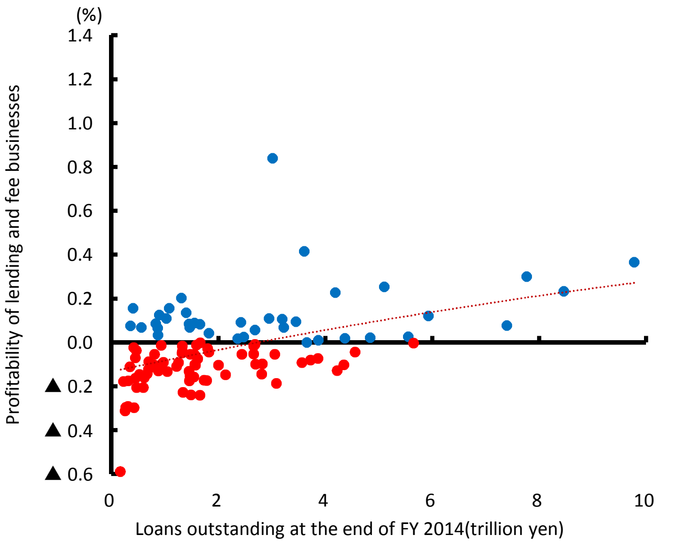
- Under the prolonged low interest rate environment, regional banks face difficulty in offsetting compressed loan margins by increasing lending volume. The profitability of the simple lending business model that largely relies on collaterals and guarantees may be diminished further as continued decline of credit demand is still anticipated due to the depopulation in Japan.
- Some banks have constructed the business model that makes profits by having better understanding of customers' businesses, satisfying their business needs , and contributing to increase in corporate value among customers.
- Corporate customers also have a tendency to prefer an offer of lending based on deep understanding of their businesses and/or support for business improvement, to that of lending at lower interest rates.

Lending margin and loans outstanding (Regional banks)



Source: JFSA

Estimated profitability of lending and fee businesses in 2025

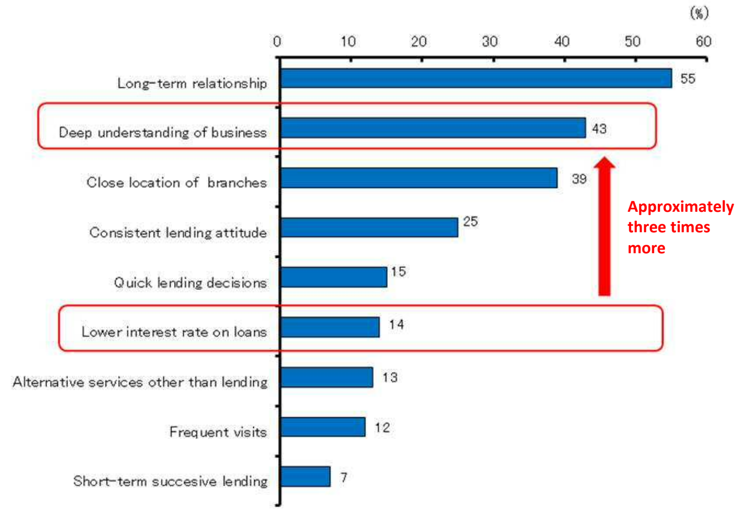


Rates of profit from loans and fee business = $\frac{\text{Profit from loans and fee business}}{\text{Outstanding amount of deposit}}$

Note: Profitability of banks should account for returns from securities investment, in addition to profit from loans and fee business.

Source: JFSA

What corporate customers expect from their main-banks



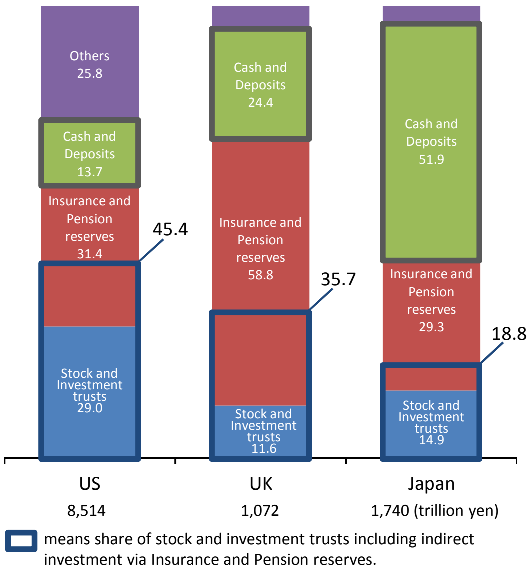
Source: JFSA

II-2. Towards More Active Capital Market, Stable Asset Building, and Enhanced Market Integrity and Transparency (1/4)

Promoting Households' Stable Asset Building (1/2)

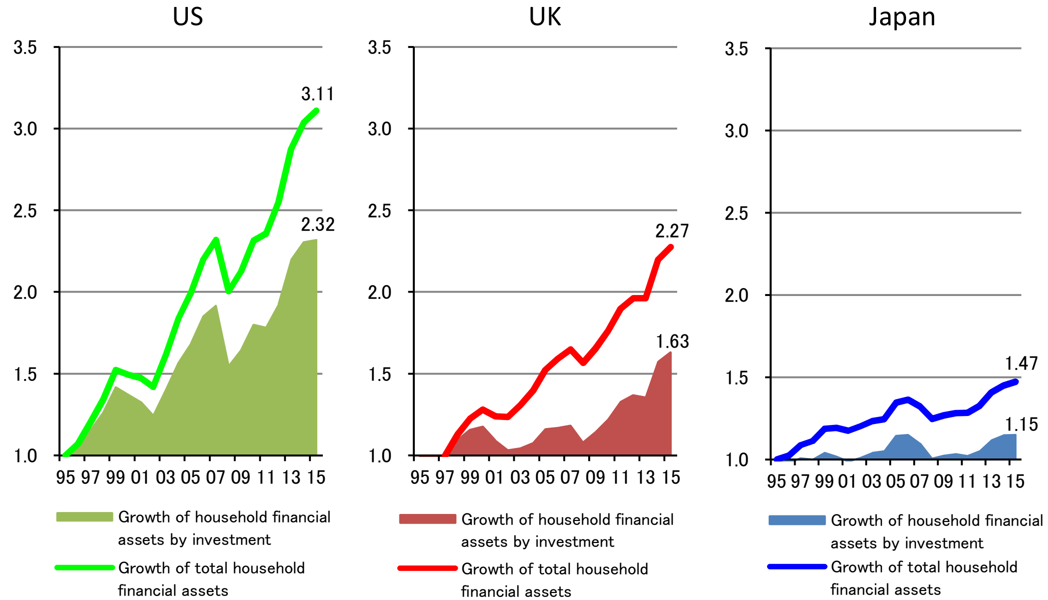
- 52% of household financial assets are held in cash and deposits in Japan. The share of stocks and investment trusts are lower than those in US and UK.
- Such a difference in portfolio of assets partly explains the lower growth of households' assets in Japan as compared to those two countries.
- Portfolio and time diversification is expected to bring about stable returns on investment in the long run through:
  - ✓ Benefiting from the growth of global economy with globally diversified portfolios.
  - ✓ Mitigating the risk of purchasing at too high prices by periodic investments.
  - ✓ Stabilizing investment returns by holding investment products for a longer time horizon.

Portfolio of households financial assets



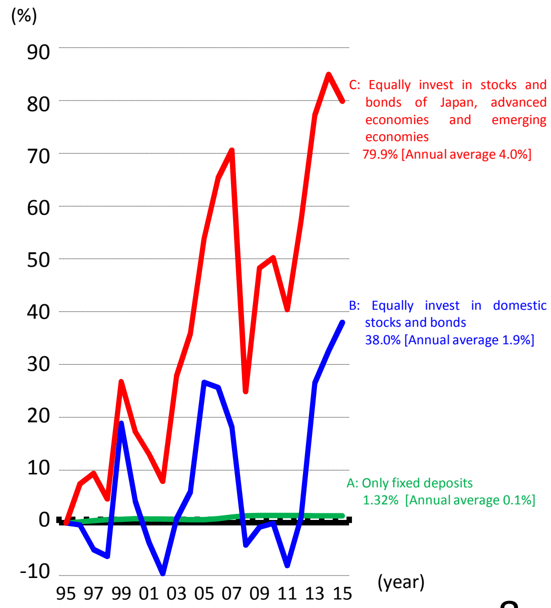
Note: Exchange rates at the end of 2015.
($1 = 120.3JPY, £1 = 177.3JPY)
Source: FRB, BOE and BOJ

Growth of household financial assets



Note: Base years are 1995(US, Japan) and 1997(UK).
Source: FRB, BOE and BOJ

Effect of long-term and diversified investments



Source: Bloomberg

II-2. Towards More Active Capital Market, Stable Asset Building, and Enhanced Market Integrity and Transparency (2/4)

Promoting Households' Stable Asset Building (2/2)

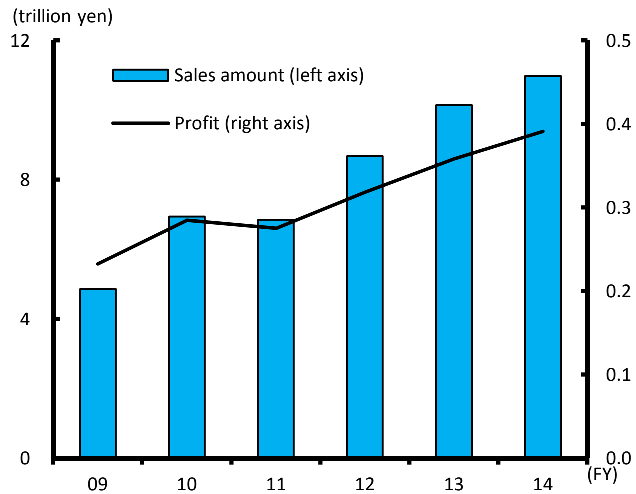
- To promote small periodic investments with diversified portfolios, the NISA (Nippon Individual Savings Account) scheme will require further improvement for its wider use, and more effective investment education must be in place.
  - ✓ The outstanding amount of investments through the NISA scheme has been increasing, but a percentage of periodic investments still remains at a low level.
  - ✓ A survey shows around 70% of respondents have never received any investment education, of which two-thirds are not interested in gaining financial literacy at all.
- A wide range of financial institutions engaged with developments and sales of investment products must ensure their own customer-oriented business conduct and fulfill the "fiduciary duty" for their customers
  - ✓ Many financial institutions are inclined to sell products with higher commission fees. As a result, the sales of investment trusts by banks and their sales revenues have been constantly increasing alike while a growth of outstanding investment trusts remains flat.

Comparing largest investment trusts in US and Japan

	Average asset size (trillion yen)	Sales fee	Trust fee	Rate of Return
		Average		Average of the past 10 years
Japan	1.1	3.20%	1.53%	-0.11%
US	22.6	0.59%	0.28%	5.20%

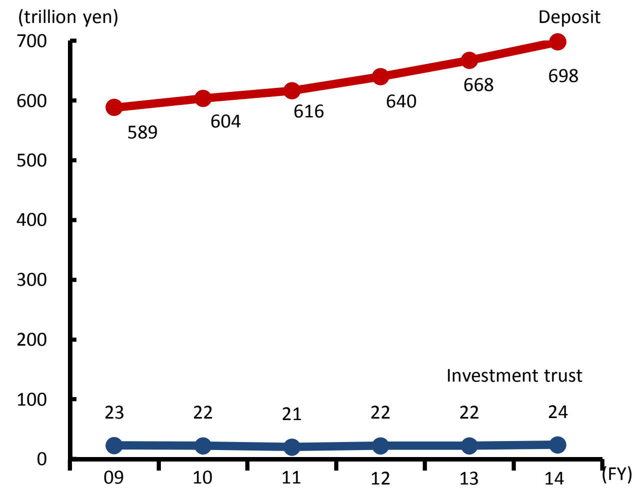
Note1: The asset size of US is converted at USD/JPY = 112.43.
Note2: The sales fee in Japan is at the upper end of fees.
The sales fee in US is a weighted average based on the amount in each share class.
Note3: The rate of return is calculated subtracting sales fee, assuming that the dividend is not reinvested.
Source: QUICK and published data from US asset management firms

Trends in sales of investment trusts



Note: Sum of major banks and regional banks
Source: JFSA

Amounts outstanding of investment trust sales and deposit



Note: Sum of major banks and regional banks
Source: Japanese Bankers Association and JFSA

II-2. Towards More Active Capital Market, Stable Asset Building, and Enhanced Market Integrity and Transparency (3/4)

Enhancing Corporate Value with Corporate Governance Reform

- Companies must enhance their corporate value over the medium- to long-term by adapting to changing business environments and by collaborating with various stakeholders, including but not limited to shareholders, such as customers, employees, business counterparts and local community.
- The Corporate Governance Code and the Stewardship Code are both in place for continuous improvement of corporate value. These two codes have brought about such changes in corporate behavior in Japan as:
  - ✓ Appointment of independent directors by listed companies
  - ✓ Reduction in cross-shareholdings
  - ✓ Sign of shift from a “silent” to “active” shareholder model by domestic institutional investors
- The next challenge is to deepen the corporate governance reform by focusing more on *substance* instead of *formality*.
- The JFSA will promote:
  - ✓ Efforts by asset managers, including those who act as trustee for pension funds, to strengthen their governance and management of conflict of interests; and
  - ✓ Engagement of asset owners with asset managers for enhanced stewardship activities

II-2. Towards More Active Capital Market, Stable Asset Building, and Enhanced Market Integrity and Transparency (4/4)

Securing Market Integrity and Transparency

(Improving audit quality)

- It is vital to establish a virtuous cycle in auditing: (1) an audit firm performing high-quality audit is rightly appreciated by clients and shareholders, and (2) such an audit firm is encouraged to further improve its audit quality.

(Other policy measures)

- For ensuring market integrity and transparency, the JFSA has taken measures to:
  - Strengthen market surveillance to address more globalized, complex and sophisticated financial transactions.
  - Ensure market confidence in IPO and other equity finance.
  - Improve the quality of disclosure and accounting standards.
  - Secure the robustness of financial market infrastructures and systems.

II-3. Strategic Policy Measures for Financial Innovation led by IT Development (1/2)

FinTech

- It is critical to ensure that financial innovation will bring about better financial services for customers. Accordingly, the JFSA intends to foster FinTech innovation so that it will contribute to enhanced user convenience, increased productivity and cost reduction, while at the same time ensuring consumer protection, prevention of fraud and market manipulation, and stability of the financial system.

- Financial institutions must make bold decisions promptly toward innovation, including reforms of their organization, human resources and IT systems.

- In this context, the JFSA has taken measures to:
  - ✓ Amend the Acts and regulations to facilitate banks in making strategic investments in FinTech companies, and to introduce an appropriate legal framework for virtual currencies
  - ✓ Launch the “FinTech Support Desk” for one-stop consultation and information sharing with FinTech companies
  - ✓ Establish the “Panel of Experts on FinTech Start-ups” to create favorable environment for FinTech entrepreneurship

II-3. Strategic Policy Measures for Financial Innovation led by IT Development (2/2)

Cyber Security

- A number of good practices with a risk-based approach can be identified among some financial institutions, whereas there remain those who are not equipped with a necessary framework due to lack of proactiveness by their senior management.
- There is a need to upgrade the capabilities of the financial industry to respond to cyber attacks by conducting a industry-wide exercise.

High Frequency Trading (HFT)

- The Financial System Council, an advisory body to the JFSA, has been reviewing the increasing influence of high frequency algorithmic trading on financial markets.
- The JFSA will consider appropriate regulatory options to deal with HFT in Japan, while monitoring progress in other jurisdictions.

II-4. Addressing Global Challenges (1/2)

Global Regulatory Reform

- The post-crisis global regulatory reform is critical in enhancing the resilience of the financial system. However, if excessive, it may create distortion through regulatory arbitrage by financial institutions and may cause disruption to flow of funds to support growth. The JFSA has raised such concerns to international regulatory community in view of the following perspectives:

  ✓ Strike a right balance between sustainable economic growth and financial stability

  ✓ Ensure an optimal regulatory framework in a holistic manner

  ✓ Take a forward looking approach to address potential threats to the financial system

  -> These concepts have gained recognition among the international regulatory community and the FSB (Financial Stability Board) and other standard-setting bodies have embarked on assessing the cumulative impacts of the reforms.

- The JFSA has organized a number of cross-sectional teams internally to take a strategic approach of seeking a solution to concurrently address both local and global challenges.

II-4. Addressing Global Challenges (2/2)

Global Network and Cross-Border Cooperation

- The JFSA has strengthened global network and bilateral/multilateral relationships with regulatory authorities worldwide to tackle the globalization of financial activities and transactions.
  - ✓ The decision this year by IFIAR (International Forum of Independent Audit Regulators) to locate its permanent secretariat in Tokyo is hoped to scale up Japan's global presence as a venue for multilateral regulatory cooperation.
  - ✓ The JFSA has reorganized the Asian Financial Partnership Center (AFPAC) into the Global Financial Partnership Center (GLOPAC), in order to broaden the scope of cross-border cooperation.

III. Reforming the JFSA

III-1. Governance of the JFSA

III-2. Supervisory Approaches

III-1. Governance of the JFSA

- The JFSA has taken actions to achieve a higher level of openness to suggestions and criticisms from outside, in order to address rapidly changing environments.
  - ✓ Introduction of a "monitoring post for financial administration" system with which independent private-sector experts seek opinions from financial institutions and other stakeholders and deliver them to the JFSA
  - ✓ Establishment of various advisory groups for better regulation and supervision

- The JFSA has introduced initiatives to change the mindset of JFSA staff members, so that improved individual performances to pursue the benefits of the nation will lead to higher organizational performance.
  - ✓ An organization-wide questionnaire survey to identify our organizational weaknesses
  - ✓ 360-degree assessment and post-assessment training for senior officials
  - ✓ Telework, flextime for improving work-life balance of the staff members

III-2. Supervisory Approaches

- The JFSA has advocated a future direction of its supervisory approaches from the following perspectives and raised the idea to relevant stakeholders both domestically and internationally:

✓ From ***Formality*** to ***Substance***

Priority is to enhance a flow of better quality financial services to customers (or *Best Practices*), rather than to conduct a formality check of financial institutions' compliance with rules and regulations (or *Minimum Standards*).

✓ From ***Backward-*** to ***Forward-looking***

Pay more close attention to sustainability of financial institutions' business models for the future, rather than their financial soundness at a specific point of time in the past.

✓ From ***Individual parts*** to ***Total picture***

Devote supervisory resources to address underlying root causes, rather than focusing too much on individual incidents.

- In the course of program year 2016, the JFSA will discuss the concept and potential methodologies for the new approaches with the recently established Advisory Group on Supervisory Approaches. The outcome of the discussion will be synthesized into a report in due course.