

**The Japan Financial Services Agency's
New Financial Monitoring Policy
(Summary)**

The Japan Financial Services Agency (J-FSA) has announced its new financial monitoring policy for its oversight of the financial institutions under its supervision as well as the financial system. In order for more proactive identification of risks to the financial institutions and the financial system as a whole, the J-FSA intends to enhance its supervisory oversight function by further integrating its on-site inspection and off-site supervision into a continuous and seamless monitoring. The followings are some highlights of the newly adopted monitoring policy.

I. Mission of FSA in the current economic and market conditions

The world economy has shown some uncertainties including slow-down in the Chinese economy, the situation of emerging markets and developing economies, and the European debt problem. Under the current monetary easing policies adopted by major central banks in the world, possible impacts to the financial markets by rapid and huge money flow across borders are worth vigilance.

In the Japanese economy, the persisting deflation is ending due to the economic policies by the current Government and the Bank of Japan. However, in the medium and long-term perspective, there remain challenges including decreasing and aging population as well as sustainability of budget deficits

Under these conditions, financial institutions are expected to play important roles in the followings; (i) an effective financial intermediation with appropriate risk management, (ii) supporting a complete end of persisting deflation and contributing to sustainable economic growth and business expansion, (iii) and sustainability of safety and soundness of each financial institution and the entire financial system. The J-FSA is fully committed to ensure this positive cycle to work. To that end, the J-FSA needs to address potential risks pertaining to this positive cycle by timely and effective

oversight of economic and market changes and to encourage financial institutions to develop adequate internal control to provide better services to their customers.

II. The approach of the new financial monitoring policy

1. Real-time monitoring of developments within the financial sector and financial systems

The risks for financial institutions and the financial system may change subject to economic developments in Japan as well as overseas. In order for timely and effective policy response to these changes, continuous monitoring of developments within the financial institutions and markets will be enhanced.

Also analysis of macro-economic developments with possible impact to safety and soundness of the financial system will be incorporated into the financial monitoring.

2. Identification of common issues and risks across each industry and proactive policy response

On-site inspections so far conducted have been focused on an ex-post snap-shot review of safety and soundness of a particular financial institution at a specific time. However, for proactive policy responses to address potential risk and vulnerabilities to the financial system, identification of issues and risks that are common across the financial industry or the financial system as a whole is required, in addition to reviews of individual financial institutions' issues.

Under the newly introduced horizontal reviews, thematic approaches will be adopted and common issues and areas will be reviewed across the industry, e.g., oversight of overseas operations under the expanding international business, contribution of the revitalization of rural economies, and interest rate risk management in the current portfolios.

3. Encouraging towards the best practices

In addition to reviews of compliance with and risk management at minimum standard level required by laws, regulations and inspection manuals, higher level or best practices of risk management are necessary subject to business and risk profiles

of financial institutions. This is the case, in particular, for large financial institutions which are competing with global top players.

Dialogues which would encourage financial institutions upgrading towards the best practices level will be conducted as part of the new financial monitoring.

III. The structure of the new financial monitoring policy

1. The introduction of horizontal reviews

The J-FSA will introduce horizontal reviews to identify important issues and challenges that are common across the institutions. The horizontal reviews will be applied to SIFIs, regional banks, and large insurers as a trial this year.

The horizontal reviews are useful to identify potential risks and vulnerabilities pertaining to the financial industry and the financial system as a whole. Also through the horizontal reviews, the best practices will be identified for each risk management area. Gaps between the best practices and the current ones would be shared with financial institutions which are encouraged to upgrade their levels towards the best practices.

2. Macro-prudential monitoring of financial systems

Continuous monitoring of business strategies and risk profiles of individual financial institutions will be conducted, including regular reviews of various reports and documents from the institutions (figures, policies and procedures, minutes and records of meetings, audit reports and etc.) as well as discussions with their management and staff. This will allow identification of potential risks and vulnerabilities to the financial systems in a timely fashion.

Analysis of macro-economic developments at domestic and global level, including the vulnerabilities reports by the FSB, is incorporated into the above exercise to identify potential risks and vulnerabilities of the financial system. Policy response will be taken as necessary to address the risks.

3. Monitoring of the SIFIs (Systemically Important Financial Institutions)

Japanese SIFIs, as global players, need to achieve the global best practices for their risk managements, rather than minimum standards. Horizontal reviews of the SIFIs, which will address common important issues including group-wide risk management and oversight of overseas businesses, will identify gaps vis-à-vis the global best practices. The results of the horizontal reviews will be feed-backed to the SIFIs to encourage them to upgrade towards the global best practices.

In order for benchmarking, information on the best practices among global players will be sought in cooperation with foreign supervisors.

The monitoring teams for SIFIs consist of Examiners in Charge (EiC) and experts/specialists for each risk and business category.

4. Monitoring of regional banks

The monitoring of regional banks will focus on sustainability of business strategy under local economic environment. Horizontal reviews of significant issues among regional banks, including revitalization of local economies, will be conducted.

For effective monitoring of regional banks. the J-FSA intends to obtain deeper understanding of and acquaintance with local economic conditions, in cooperation with Local Bureaus.

5. Monitoring of foreign banks

The J-FSA plans to enhance and update basic information necessary for monitoring of all foreign banks in Japan, and surveys on current business and risk profile including global oversight by headquarters will be conducted. Based on the survey results, on-site monitoring of all foreign banks in Japan will be conducted as target inspections for a short period.

Enhanced communication with senior management of headquarters or parent companies as well as their home country supervisors will also be sought.

6. Monitoring of insurance companies

The J-FSA intends to enhance off-site risk assessment of business and risk

profiles of insurance companies. Horizontal reviews of large insurance companies (both life and non-life insurers) will focus on significant issues including business strategy under the aging Japanese populations as well as expanding overseas business.

IV. Issues or focuses of financial monitoring

1. Analysis of sustainability of business models of financial institutions

Review of future sustainability of business strategy and models for profits origination will be enhanced. This will facilitate identification of potential risks due to possible gaps between business models and changing economic environment.

2. Review of banks' ability for loan appraisals

The J-FSA will try to identify obstacles behind banks' cautious approaches for taking credit risks without collaterals and guarantees. The monitoring will review how growth potentials of borrowers are taken into account as part of credit risk appraisals by financial institutions.

3. More risk-based review of asset classification

The monitoring will put more focus on higher risk categories of assets which are materials to safety and soundness of banks, including large exposures and highly concentrated sectors. Less attention will be paid to small and low risk exposures pertaining to safety and soundness, and banks' asset classification, subject to effective credit risk management with appropriate provisions, will be accepted by on-site inspections.

4. More focus on substantive compliance functions

The J-FSA will review fundamental effectiveness of compliance functions, rather than ad-hoc and superficial compliance with insignificant and trivial rules and procedures.

5. More focus on internal audit functions

The monitoring will focus more on effectiveness of internal audit functions at financial institutions. Also cooperation among internal audit, audit committee and external audit functions will be reviewed.

6. Enhanced cooperation with foreign supervisors and other regulatory bodies

The J-FSA intends to enhance further cooperation with foreign supervisors for oversight of Japanese SIFIs as well as foreign institutions, in particular, G-SIFIs, through bilateral and multilateral communications on particular firms. Cooperation with other regulatory bodies, including SESC, Bank of Japan as well as relevant agencies and self-regulatory bodies will be enhanced as well.

7. Enhanced information and intelligence collection mechanism

In addition to the existing information/intelligence collection mechanism such as for customer complaints, more FSA-wide mechanism needs to be established, to cover wider range of information and intelligence that are useful for financial monitoring.

8. Upgrading expertise of inspectors

The J-FSA plans to recruit more experts from private sectors for individual risk and business categories for monitoring. Training of inspectors with knowledge and expertise on global best practices will be enhanced.

9. Closer communication with financial institutions and more attention to regulatory costs

The J-FSA intends to be more conscious about regulatory costs for financial institutions, and intends to focus on material issues for on-site inspections with more effective off-site risk assessment prior to on-site visits. Closer and constructive communications with the institutions regarding financial monitoring will be sought.
