Financial Services Agency

JFSA’s supervisory approaches

Replacing checklists with engagement

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金融庁

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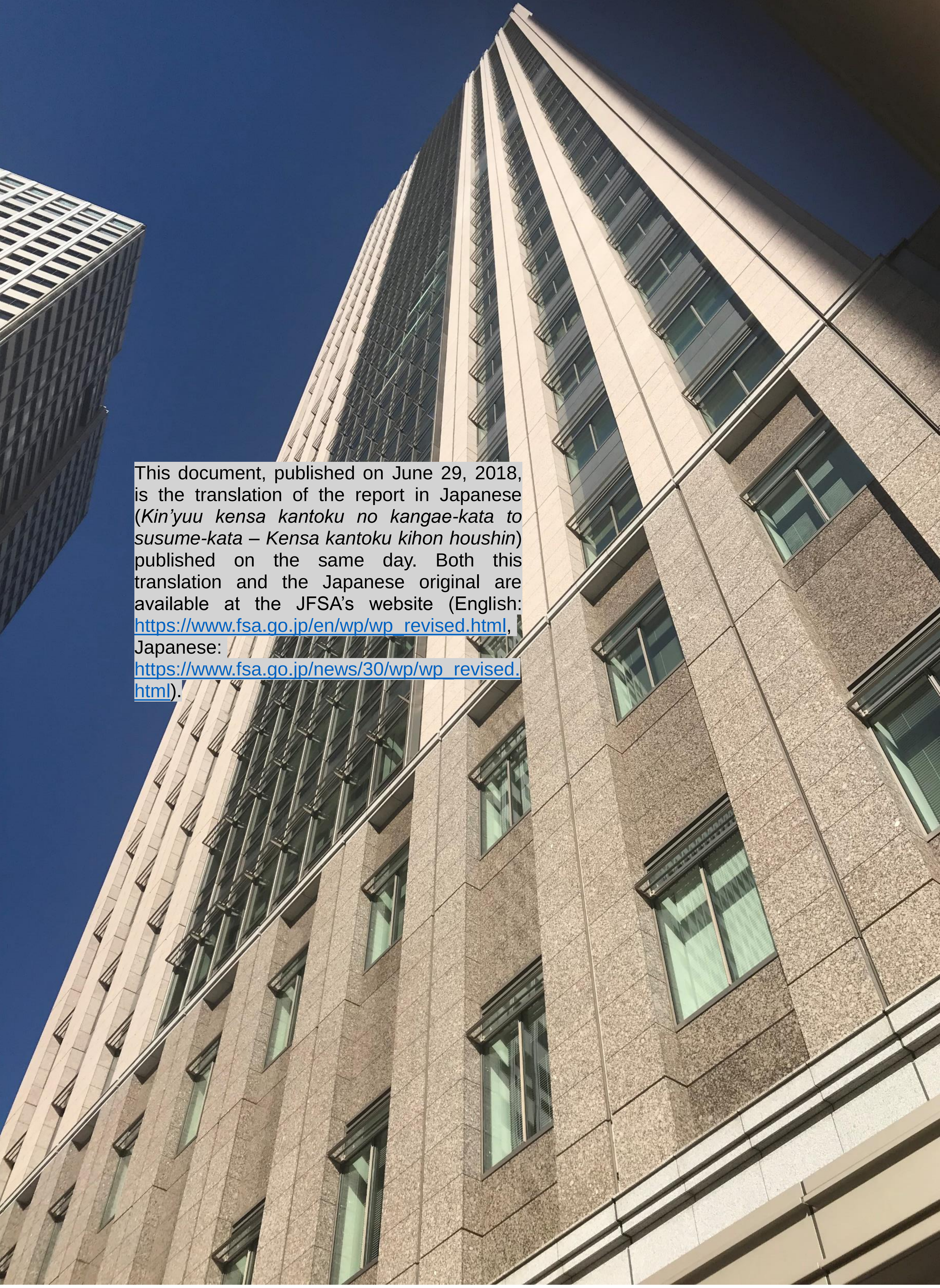

This document, published on June 29, 2018, is the translation of the report in Japanese (*Kin'yuu kensa kantoku no kangae-kata to susume-kata – Kensa kantoku kihon houshin*) published on the same day. Both this translation and the Japanese original are available at the JFSA's website (English: https://www.fsa.go.jp/en/wp/wp_revised.html, Japanese: https://www.fsa.go.jp/news/30/wp/wp_revised.html).

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JFSA's new supervisory approaches: Summary

Key principles

- Make supervisory approaches consistent with the ultimate goal of regulation, which is:
  - Enhancing national welfare by contributing to the sustainable growth of the economy and national wealth
  - by attaining both financial stability and effective intermediation, both consumer protection and better services, and both market integrity and vigor.
- Minimize the sum of market and government failures so as to make market mechanisms function best.
- Shift from rule-based compliance checks to balanced use of rules and principles.

Transforming supervisory approaches

- Expand the scope of its supervisory approaches from a backward-looking, element-by-element compliance check to substantive, forward-looking and holistic analysis and judgment. More specifically,
  - ✓ Focus the enforcement activities on the assessment of the overall effectiveness rather than on item-by-item compliance check,
  - ✓ Conduct dynamic supervision based on forward-looking analysis, and
  - ✓ Promote disclosure and engage with firms to support the pursuit of best practices.
- Focus on issues of firm-wide priority rather than try to check each and every items on common checklists.
- Shift from periodic on-site inspection to continuous and seamless monitoring and further the coordination between on-site and off-site activities.
- Accumulate in-depth knowledge on each firm and specialized analytical skills. Engage with a broader range of stakeholders.

Transforming the JFSA

- Enhance the Agency's own governance, quality control of supervision and make effective use of feedback from outside the Agency.
- Use theme-specific discussion papers for deeper engagement.
- Repeal the Inspection Manuals after the end of fiscal year 2018. Do not deny firms' established business practices but support firms' initiatives to innovate.
- Restructure the JFSA's internal organization, human resource policy and information infrastructure so that the Agency will be able to successfully implement the new supervisory approaches.

I. Introduction

This report aims to present how the Financial Services Agency (JFSA), Japan's integrated regulator of banks, insurance companies and capital markets, intends to transform its supervisory approaches so that both the Agency and the industry could continuously benefit from the interaction between them and reform and innovate themselves, for the Agency to upgrade the quality of its supervisory activities, for the industry to enhance its performance, and for both to better contribute to the unleashing of the unrealized potential of the Japanese economy.

The existing supervisory approaches which rely on the elaborate system of checklists may lead supervisors and financial institutions to split hairs while ignoring the elephant in the room. Rigorous loan by loan review conducted by the Agency contributed to the resolution of the non-performing loan problems, but might not be effective in preventing the next crisis. Compliance checks repeated year after year by the Agency have made firms improve their internal control, but may also have worked to stifle their initiative to innovate.

A panel of experts commissioned by the JFSA, the Advisory Group on Supervisory Approaches, submitted a report "Transforming the JFSA's supervisory approaches" to the Agency in March 2017, and recommended the Agency to recast its existing supervisory approaches, which focus on backward-looking, element-by-element check on the compliance with formal requirements, into those based on substantive, forward-looking and holistic analysis and judgment. The panel also recommended the Agency to review if its approaches are consistent with the ultimate goal of financial regulation. The current report is the JFSA's response to the panel's report and describes how it intends to operationalize the panel's recommendations.

The public consultation period on this report was closed on February 14, 2018. The Agency received various comments and published an outline of the comments as well as the response of the JFSA on its website (https://www.fsa.go.jp/en/wp/wp_revised.html). Additionally, during the public consultation period, the Agency held dialogue with financial institutions and their external auditors in eleven cities across Japan, and published a summary of the opinions obtained in the dialogue on its website (https://www.fsa.go.jp/news/30/wp/dialogues.html). The Agency intends to continuously engage in dialogue with consumers, financial institutions, market participants and other stakeholders and to continuously update this report and enhance its supervisory approaches.

The JFSA will also work to enhance its own readiness for the new supervisory approaches. The Agency intends to learn by doing and to reflect lessons learned in future revisions to this report.

This report describes approaches commonly applicable to supervision of financial institutions subject to JFSA regulations. The new supervisory approaches based on this report should be implemented commensurate with the size and characteristics of financial institutions and should not require small-scale financial institutions to engage in unduly complicated discussions. The Agency will supplement it with separate reports on approaches to more specific aspects of supervision.

Why do we need new approaches?

Because we want to see that both the JFSA and the industry continuously reform and innovate themselves, for the Agency to upgrade the quality of its supervisory activities, for the industry to enhance its performance, and for both to better contribute to the unleashing of the unrealized potential of the Japanese economy.

Current approaches

- ✓ The elaborate system of checklists help avoid overlooking minor flaws, but may deter us from focusing on priority issues.
- ✓ Rigorous loan by loan review should have contributed to resolving non-performing loan problems, but might not be effective in preventing the next crisis.
- ✓ Compliance checks repeated year after year may have improved firms' internal control, but may have worked to stifle their initiative to innovate.

New supervisory approaches

- ✓ Enforcement
  Profile firms through continuous monitoring and focus on priority issues of substance.
- ✓ Dynamic supervision
  Analyze if firms can sustain their safety and soundness and engage with them on forward-looking remedial measures, if needed.
- ✓ Disclosure and engagement
  Motivate firms and support their initiatives to innovate.

- ✓ Repeal the Inspection Manuals
- ✓ Enhance the Agency's own governance and quality control of supervision. Make effective use of feedback from the outside.

II. Why to regulate financial institutions

1. Regulatory goals

The ultimate goal of financial regulation is to contribute to the maximization of national welfare. Financial regulation can contribute to the nation's economic welfare both by enhancing flows, or promoting sustainable economic growth, and by enhancing stocks, or increasing national wealth.

Upon its establishment, the JFSA set three missions for itself: ensuring financial stability, promoting consumer protection, and maintaining market integrity and transparency. These missions corresponded to the priority issues of the time: the Agency had to restore trust in the Japanese financial system and markets, which had been undermined by the persistent growth of non-performing loans, a series of bank failures and incidents of serious misconduct.

The three goals – financial stability, consumer protection and market integrity – still remain critical today. They themselves, however, are not the ultimate goals. They are means to achieve the ultimate goal described above, and are indispensable but not sufficient in achieving it. Three goals had better be seen in perspective.

Ensuring financial stability is indeed an essential goal, but if regulators pursue financial stability as if it is the only overarching goal, financial institutions may become overly risk averse and refrain from discharging their intermediation functions, restraining economic growth, although sound economy is a key precondition for financial stability. Regulators should strike the right balance between ensuring financial stability and securing effective financial intermediation. We should aim at a virtuous cycle where sound banks support economy and sound economy makes banks sound.

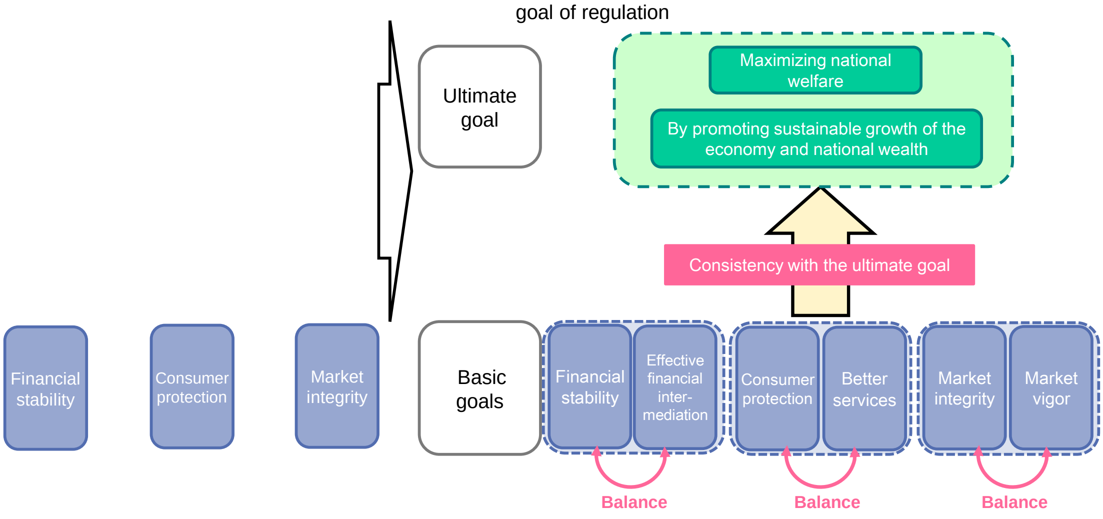
Similarly, regulators should secure firms' compliance with consumer protection rules, but compliance will only assure that they do no harm, not necessarily that they bring benefit. If financial institutions consider that compliance with rules is all that is expected of them and would not make efforts to improve their products or services to best suit the interests of customers, financial industry's contribution to the growth in national wealth will be much limited. We need to ensure that financial institutions abide by rules as a matter of course but should also expect that they creatively and innovatively strive for better services.

Lastly, market integrity and transparency is a precondition for the proper functioning of the market. However, should the Japanese market stay stagnant while markets across the world compete with each other vigorously, it cannot make enough contributions to efficient corporate financing or growth in household assets. We need a market which attracts critical information and players from around the world and provides a variety of opportunities for financing and investment. We should aim at having both integrity and vigor in our market.

The three goals of financial stability, consumer protection and market integrity should thus be balanced with the other three goals of effective intermediation, better services and market vigor. To achieve the ultimate goal of enhancing national welfare by contributing to the sustainable growth of the economy and national wealth, the JFSA aims to attain i) both financial stability and effective intermediation, ii) both consumer protection and better services, and iii) both market integrity and vigor, all in a balanced manner. This report calls the three balances as the basic goals of regulation, which are intermediate goals in our efforts to attain the ultimate goal.

Redefining regulatory goals: from "stability" to "stability and growth"

- The JFSA in its earlier days defined its mission as securing financial stability, promoting consumer protection, and maintaining market integrity and transparency.
- The JFSA will aim to:
  - Strike the right balance i) between financial stability and effective financial intermediation, ii) between consumer protection and better services and iii) market integrity and vigor, and
  - Make its supervisory approaches consistent with the ultimate goal of regulation



2. Market failures and the role of regulators

It goes without saying that the protagonists in financial markets are customers, market participants and financial institutions, not regulators. It would be better if the goals described above are achieved through free competition and market forces founded on rational choices made by customers, market participants and shareholders of financial institutions.

However, in reality, various forms of market failures prevent the protagonists from behaving in a manner which would maximize the national welfare. For example:

- Individual financial institutions optimize their behavior without incorporating negative or positive effects their behaviors have on the financial system or the macro-economy (negative or positive externality).
- Financial institutions have only a small part of information their customers have, and vice versa (information asymmetry).
- Even if multiple equilibria exist and efficiency gain can be attained by shifting to a better equilibrium, sometimes no financial institutions change their strategies as the first mover may become prey to other firms (the prisoner's dilemma).
- Limitations in cognitive capability or in knowledge and experience often prevent individuals from making a fully rational judgment (bounded rationality).
- Employees or management, when provided with incentives not fully aligned to the interests of shareholders or the financial institution, may prioritize their private short-term interests (the agency problem).

The role of supervisory authorities is to address market failures so that market forces would fully work and the governance mechanism of financial institutions properly functions. That is needed to attain each of the six elements in the basic goals of regulation, as described in the following:

- Financial stability: To attain financial stability, regulators need to address vulnerabilities in the financial system arising from negative externalities (A bank’s failure may have domino effects on other banks due to the interconnectedness, but the management of the bank may not take the potential spillover into their consideration.) and information asymmetries (Depositors who do not have enough information to distinguish good banks from bad banks may run on good banks.).

- Effective intermediation: Also, to promote effective financial intermediation, regulators need to address market failures arising from positive externalities (A bank’s contribution to the local economy benefits competing banks as well.), the prisoner’s dilemma (No bank exits from the strategy focusing on lending volume as the first mover may lose market share.) and information asymmetry (Difference in service quality among banks may not be well recognized by customers.).

- Consumer protection: Regulators must protect consumers of financial services against disadvantages stemming from information asymmetry and from limited means available for them to handle stress events.

- Better services: Also, market force may not work well to foster competition towards better services, as the differences in financial institutions' asset management capabilities or in their dedication to customers' best interest may not be properly appreciated by customers due to information asymmetries and bounded rationality, and thus may not lead to differentiated growth of firms. Regulators can address this by promoting disclosure by financial institutions and enhancing customers' financial literacy.

- Market integrity: Regulators enforce capital market rules to maintain market integrity and transparency, without which large information asymmetry both between securities issuers and investors and among investors themselves would stay and deprive a majority of investors the opportunities to make informed investment decisions.

- Market vigor: To promote market vigor, regulators should work to eliminate obstacles and provide necessary conditions for market agglomeration to happen, as the benefit of agglomeration is enjoyed throughout the market (positive externality) and individual market participants are not sufficiently incentivized to make decisions which would result in agglomeration.

3. Government failures

As in other areas of government intervention, financial regulators can incur cases of government failures in trying to address market failures. Once certain measures prove to be effective in rectifying market failures, regulators tend to apply them mechanically year after year, but that would increase the risk of unintended consequences and government failures.

Government failures may occur in cases like the following:
- Regulators may make excessive intervention and cause undue market distortions.
- Regulators may impose overly prescriptive regulations and stifle innovations.
- Supervisors may exercise large discretion and damage predictability in business environment.
- Supervisors may lack sufficient information, knowledge or expertise and fail to make appropriate or timely judgments.
- Supervisors may pursue their narrow goals so single-mindedly that they end up in harming the overall national welfare.
- Regulation and supervision may be implemented in such a way to unduly increase compliance costs incurred to financial institutions.

Regulators and supervisors should aim to minimize the sum of market failures and government failures so that market mechanisms would function most effectively.

4. Substantive, forward-looking and holistic analysis and judgment

How can the JFSA minimize government failures while addressing market failures effectively so that the ultimate goal of regulation can be best achieved?

In the late 1990s and early 2000s, the JFSA developed supervisory approaches based on compliance checks and asset quality reviews. Though the approaches proved effective a decade and a half ago, mechanical and repetitive application of them can lead supervisors and firms to be obsessed with the compliance with the letters of the rules (focus on form), backward-looking review of the evidence of the past (focus on the past) and analysis of details and elements (focus on elements).

Focus on form: If supervisors examine a firm in the light of forms, not substance, firms may be induced to focus on having simple and objective evidence to protect them. Bankers would find it easier to defend lending decisions by referring to collaterals and guarantees than by presenting bankers' own views on borrowers' future business prospects. Brokers may spend more time for creating evidence of compliance with product sales rules than for listening to customers' life plans and needs.

Focus on the past: Supervisors may satisfy themselves just by examining banks' balance sheets, which represent the consequences of their past activities, while complacent on the sustainability of banks' business models in the future. Supervisors may spend most of their time criticizing specific past incidents of misconduct but may fail to discuss whether firms meet the changing needs of the customers.

Focus on elements: Supervisors may focus on loan-by-loan classification while overlooking key risks to the banks' sustainability. They may also focus on a specific incident of non-compliance, while failing to identify root causes and reform needed to address them.

Analysis of the substance, the future, and the holistic conditions need to be founded on analysis of the form, the past and elements. If, however, supervisors stop at the analysis of form, the past and elements and would not proceed to form their views on substance, the future, and holistic conditions, they may create government failures as described above while not effectively addressing market failures. A supervisor's focus on the form, the past and elements tends to induce financial institutions to allocate their resources on issues of the form, the past and elements as well.

To better attain the ultimate goal of regulation, the JFSA will transform its supervisory approaches from those focused on the form, the past, and elements to those that emphasize the substance, the future, and the holistic analysis, as follows:

- From form to substance: The JFSA will expand its focus of reviews from form to substance, for example from compliance with the formal requirements to the quality of services provided and the effectiveness of risk management.

- From the past to the future: The Agency will not satisfy itself just by backward-looking analysis (for example, verification of safety and soundness at a certain point in time of the past) and augment forward-looking analysis (for example, review on the sustainability of the safety and soundness in the future).

- From element-by-element to holistic analysis: The JFSA will work to identify and address priority issues which have firm-wide implications, rather than focusing on firms' handling of specific incidents.

Making substantive, forward-looking and holistic judgment is harder to do than judging on the form, the past and elements. Action or inaction based on substantive, forward-looking and holistic judgment increases the risk that supervisors are accused of their misjudgment. In all aspects of financial regulation and supervision, as a natural tendency of bureaucracy, those who are in charge are tempted to rely on excuses based on the form, the past and elements. The JFSA should continue to ensure that it is not yielding to such temptations.

Substantive, forward-looking and holistic judgment can properly be made only if supervisors are competent enough to do so. The JFSA will systematically carry out reforms in its governance, quality control processes, manuals and guidelines, organizational structure, human resources development and information infrastructure.

Expanding the scope:
Towards substantive, forward-looking and holistic analysis and judgment

The Form

- Supervisors and firms focus on the questions if a loan is with collaterals or guarantees and if the evidence of compliance can be produced.

The Past

- Supervisors and firms focus on the balance-sheet figure in the past and past incidents of misconducts.

Element by element analysis

- Supervisors and firms focus on loan-by-loan classification and on specific incident of misconducts.

Expanding the focus of review

The Substance

- Supervisors and firms focus on the effective risk management and quality of service provided.

The future

- Supervisors and firms focus on the sustainability of firms' safety and soundness.

Holistic analysis

- Supervisors and firms analyze and identify priority issues and focus on addressing them.

III. Supervisory approaches

1. Three pillars of the new supervisory approaches

This chapter describes how the JFSA intends to expand the scope of its supervisory approaches from a backward-looking, element-by-element compliance check with formal requirements to substantive, forward-looking and holistic analysis and judgment so that the Agency will better contribute to the ultimate goal of regulation by attaining basic goals in a balanced manner. The new supervisory approaches have the following three pillars.

The first pillar is the enforcement of minimum standards. The JFSA will continue to enforce minimum standards it sets to attain financial stability, consumer protection and market integrity and transparency. In the past, however, the Agency's enforcement activities may have had the tendency to overly focus on a backward-looking, element-by-element check on the compliance with formal requirements, and to split hairs while ignoring the elephant in the room. Going forward, they will be guided more by substantive, forward-looking and holistic analysis and judgment.

The second pillar is the dynamic supervision. Compliance with minimum standards at present does not guarantee that regulatory goals will be satisfied in the future. Given that the breach of minimum standards incurs large costs to consumers, financial institutions and regulators, the JFSA will assess the likelihood that financial institutions breach standards in the future and calibrate its supervisory actions according to the likelihood and the significance of the possible breach.

The third pillar is the promotion of disclosure and engagement with financial institutions aimed to encourage financial institutions' pursuit of best practices. Given the rapid evolution of financial businesses, financial institutions' practices will quickly become outdated if they are designed just to satisfy minimum standards. Their business models and risk management practices should be renovated day by day. Also, better financial intermediation, better services and more vibrant markets can be attained only through firms' diverse initiatives to innovate themselves. The JFSA will encourage financial institutions' efforts to pursue best practices by promoting disclosure and by engaging with a financial institution with the aim to explore solutions fitted to the firm's own conditions and circumstances.

These three pillars provide a conceptual framework which shows a spectrum of available supervisory approaches. In the actual supervisory activities, the focus will naturally change as the discussion between the authority and the financial institution evolves. Therefore, it is not useful to label each and every supervisory activity as the exercise of one of the three categories. Besides, each of the three pillars above will be applied with gradations depending on the situation and they form a continuous spectrum. They are not totally distinctive from each other.

In addition, the three pillars above will be applied in accordance with respective circumstances, rather than mechanistically applied to all financial institutions. For example, in certain areas where many financial institutions need to accelerate improvement, the JFSA might specifically indicate the minimum level of standards needed to be satisfied and focus on the enforcement of such minimum standards. Also, for financial institutions which have fundamental issues in safety and soundness or compliance control, the JFSA will carry out rigorous enforcement of the minimum standards and make clear the necessary remedial actions. On the other hand, when a financial institution apparently meets the minimum standards at present but does not catch up with the changes in the business environment or expectations from the general public, the JFSA might focus on the promotion of disclosure and engagement.

The goal of financial regulation cannot be achieved if the Agency engages in dialogue with a financial institution only to encourage its pursuit of best practices at a time when rigorous enforcement of the minimum standards is the priority for said institution. Nor can it be achieved if the Agency focuses on enforcing the minimum standards when engagement to encourage the pursuit of best practices is more needed. The JFSA will conduct accurate profiling of the financial institutions on a day-to-day basis and identify, based on the facts, which issues warrant further discussions and which supervisory measure is appropriate to address them.

Notably, even after a specific supervisory process has proceeded for a certain financial institution, if previously unknown facts are recognized, the JFSA will incorporate them in its profiling and analyze if the current supervisory approach is appropriate. In addition, the JFSA will carefully communicate with the financial institutions on the background as well as the purpose of discussions in the course of its supervision.

Basel III, the international framework for prudential supervision of banks, also adopts three pillar approach, calling the minimum capital requirements as Pillar One, the supervisory review of the adequacy of the buffer above minimum requirements as Pillar Two and the disclosure requirements to make market discipline to function as Pillar Three. The three pillars of the JFSA's new supervisory approaches and Basel's three pillars share some common elements.

The rest of this report focuses on supervision of regulated financial institutions. It does not discuss issues related to the design of regulations. Neither does it cover market surveillance, which deals with a broader range of market participants including unregulated entities and largely focuses on enforcement of rules.

2. New environment, new issues and new priorities

The ultimate and basic goals of regulation do not change over time, but the priority issues the JFSA need to address do. The Agency will stay vigilant on the gap between the goals and the reality and on any imbalance among the degrees basic goals are attained.

As a new environment and issues emerge, the JFSA will continue to update both supervisory programs for individual financial institutions and the Agency-wide business plans through the PDCA (plan, do, check, action) cycle, identifying priority issues in a forward-looking and holistic manner.

As described below, the priorities for the JFSA have evolved with regard to all of the basic goals of regulations.

(Balancing financial stability and effective intermediation)
Until the early 2000s, resolving banks' non-performing loan problem had been the Agency's top priority, and it focused on reviews on the quality of individual loans and verifications of banks' compliance with the minimum capital requirements.

Over time, however, most financial institutions have satisfied the required minimum standards. Meanwhile, the business environment for financial institutions is becoming increasingly challenging due to aging and declining population, shrinking domestic market, persistent global low interest rates, and competition intensified by the rise of new technologies including FinTech. Under this unfavorable business environment, avoiding to take excessive risks alone is not enough for financial institutions to maintain sustainable profitability and soundness. The JFSA will not limit itself to enforcing the minimum standards but will engage in dynamic supervision, based on forward-looking analysis of the sustainability of financial institutions' business models and safety and soundness.

One possible way for a financial institution to survive in the unfavorable business environment described above is to grow with its customers and the regional economy by providing better financial intermediation and creating value shared with them. The JFSA, on its part, will do what it can do to prepare an environment which facilitates the pursuit of best business practices by financial institutions.

In addition, as the form and the locus of risks for financial institutions metamorphose exceedingly quickly, it is becoming more important for them to have the ability to assess and address emerging risks. Financial institutions should therefore update their risk management practices day by day in view of their own risk profiles and the changing business environment, not being satisfied with achieving common benchmarks established by the Agency. The JFSA will improve its approaches to encourage firms to pursue better risk management practices.

(Balancing consumer protection and better services)
Similarly, the priority issues have shifted in attaining consumer protection and better services. In the first half of the 2000s, recurrence of serious consumer protection incidents called the Agency to thoroughly probe breaches using the checklists and demand financial institutions to establish a minimum level of compliance controls. Over time, however, most financial institutions have developed their own basic rules and procedures for consumer protection.

Minimum level of consumer protection, however, does not guarantee provision of better services. Rigorous compliance with the letter of laws and regulations can co-exist with business practices which pay little attention to the interest of customers. Often, much less time is spent for identifying customer needs than for creating evidence of compliance. Complex products, fully compliant with laws and regulations, are designed to churn greater fees.

In 2017, the JFSA published the Principles for Customer-Oriented Business Conduct. The Agency engages with financial institutions referring to the Principles to promote better services. It also promotes disclosure by the financial institutions on their policy and the products and services they provide so that consumers can make an informed choice.

(Balancing market integrity and market vigor)
In addition, the Agency is embarking on new measures in its efforts to enhance market integrity and market vigor.

The Agency envisages a virtuous cycle which would transform the flow of funds and create a vibrant capital market. In the envisaged cycle, financial institutions involved in each step in the investment chain would strive to serve the best interests of customers and compete with each other to be more creative in offering better quality products and services. This would in turn enhance trust from customers in the market, augment flow of funds in the capital market, and result in the accumulation of information and expertise in the Japanese market. The JFSA will support the development of the environment which facilitates competition and the pursuit of best business practices by financial institutions.

As the market continues to experience transformational changes, ensuring market integrity and transparency would also require the JFSA to adopt new approaches and methods. To identify emerging risks for market integrity at an early stage, the JFSA will keep an eye on the developments in the Japanese and global economies, enhance its market intelligence, and conduct forward-looking analysis. The JFSA's own system of collecting and analyzing market information should be transformed to fit the changing market environment.

3. The first pillar: Enforcement

(1) Enforcing minimum standards

The first pillar of the JFSA's supervisory approaches is the enforcement of minimum standards, or checking compliance with common minimum standards and requesting remedial actions where deficiencies exist. The minimum standards have been established to ensure that financial institutions attain the minimum necessary level of financial safety and soundness, consumer protection, and market integrity and transparency. Examples of the minimum standards include accounting standards on loan classification, loan write-offs and loan loss provisioning, capital adequacy requirements, rules and regulations on consumer protection and market integrity, as well as the minimum levels of internal control as a precondition for adequate business management, customer protection and risk management.

At the time the JFSA was established, its top priority was the enforcement of minimum standards. Today, its significance remains unchanged as maintaining safety and soundness of financial institutions, protecting consumers and ensuring market integrity and transparency remain important goals.

(2) Potential side effects of the past approaches

Though enforcement of minimum standards is indispensable, the JFSA's past methodology of periodic and exhaustive inspection of financial institutions using the prescribed checklists could lead to the risk of focusing excessively on the form, the past and elements.

(Excessive focus on elements)
Without having the holistic view of the financial institutions, the regulators could be easily obsessed with revealing individual flaws and incidents. Such supervisory practices may incur unnecessary compliance costs to financial institutions. More importantly, financial institutions may be distracted away from true challenges for them.

(Excessive focus on the form)
If the regulators focus too much on verifying whether financial institutions have developed and implemented their internal rules and have established the internal control systems as prescribed by the checklists, they may not focus on whether in fact these internal rules and controls are effective in attaining compliance. Regulators may end up in allocating a large part of their resources for the tasks which should be carried out by financial institutions themselves.

(Excessive focus on the past)
Sometimes the regulators, financial institutions and the general public may become excessively obsessed with the past incidents of misconducts and

particularly with consequent regulatory sanctions, paying limited attention to the efforts to analyze the root causes of the incidents, such as governance and institutional cultures, and to take necessary remedial actions.

Should the regulators focus on the form, the past and elements, it has a negative spillover effect on financial institutions. They may concentrate on creating the evidence of compliance or on developing internal rules and internal controls precisely corresponding to the letter of the checklists. Once fixed, internal rules may not be changed flexibly and that may harm firms' innovative thinking.

(3) Principles for the first pillar

In order to attain the ultimate goals of regulation through the enforcement of minimum standards, the JFSA should shift from the approach which focused on the form, the past and elements to the one which emphasize the substance, the future and the holistic analysis and judgment.

Specifically, the JFSA will review its excessive reliance on a comprehensive set of prescriptive checklists and replace them with principles and engagement as the foundation of its supervision. In addition to the general reforms in the supervisory processes and in the use of checklists, which are described in III. 6 and in IV.3, respectively, the Agency will transform its approaches to the enforcement of the minimum standards according to the following principles:

- The objective of the Agency's enforcement activities is the evaluation of the effectiveness of firms' overall governance, institutional culture and internal control systems, not the assessment of the compliance with each and every item on the checklist.

- The JFSA will defer to financial institutions themselves matters of their primary responsibilities such as the verification of the internal rules and procedures and their implementation.

- The JFSA will make sure that the past communications from the supervisor would not result in an unchangeable de-facto rule for the financial institutions. An explicit process should be established which would enable firms to modify their business improvement plans submitted to the supervisor in the past. The JFSA will also review and improve the utility of its no action letter framework and the process to publish questions and answers.

- The regulator's action should also be calibrated according to the significance of the incident in question, rather than uniformly requiring the similar remedial actions in response to each and every incident. It should be assessed by analyzing whether it was an inevitable and exceptional derogation or it had deeper root-causes such as weak governance and inadequate institutional culture. In analyzing the potential root causes, the Agency will gather relevant facts, engage with financial institutions based on the facts, and make efforts to have a thorough view on the structure of the problems before reaching the conclusions.

- Rather than focusing solely on preventing the recurrence of similar incidents, the FSA should attach more importance to preventing issues which may be stemming from the same root causes. The JFSA should also engage with the sanctioned financial institutions on effective and forward-looking remedies and follow up on the implementation of planned remedies.

- The purpose and objectives as manifested in the overall structure of the relevant laws and regulations should guide the applications of specific legal provisions to an incident. The regulator should identify the interest the relevant law protects and act proportionate to the degree the interest is compromised.

4. The second pillar: Dynamic supervision

(1) Dynamic supervision to secure continued soundness

The second pillar of the JFSA's supervisory approaches is dynamic supervision, or an approach whereby supervisors i) analyze the future business environment and the likely developments in the financial institution in question, ii) assess the likelihood that the firm breaches minimum standards in the future, and iii) share supervisors' assessments with the firm and, if needed, engage with it to explore remedial measures to reduce the likelihood.

A firm's current compliance with the minimum standards does not guarantee that it will satisfy them in the future. The breach of minimum standards, once happens, incurs large costs to consumers, financial institutions, regulators and the society as a whole. In addition, a recovery from a breach is much more difficult financially and reputation-wise than prevention at an early stage. Regulators should be justified to take a preemptive approach to engage with firms with higher breach likelihood on possible remedies, even if they comply with the standards at the moment.

At its inauguration, the JFSA championed a rule-based approach and *ex post* enforcement and tried to exclude discretional judgment and *ex ante* guidance as much as possible. Naturally it tended to refrain from supervisory intervention based on uncertain future prospects. However, analysis of emerging risks and engagement on measures to avoid future problems are among the core components of supervision in many other parts of the world. The need for dynamic supervision is particularly acute in the current environment where financial institutions cannot maintain their safety and soundness without transforming their business model to meet the challenges of changing customer needs, greater squeeze on their profitability and rapid metamorphosis in the nature and locus of risks they face.

Dynamic supervision entails significant risk of government failure as it is based on the assessment of an uncertain future and is conducted at a stage when there is no breach of minimum standards. To minimize the risk, the JFSA will continuously enhance its ability to form views on the future by gathering information widely and timely and conducting in-depth and holistic analysis. It will also avoid imposing a one-size-fits-all solution across the industry and continue its efforts to develop approaches to engage in constructive two-way dialogue with an individual financial institution to explore possible solutions tailored to its own circumstances. Such approaches should be distinct from those for enforcement.

(2) Forward-looking analysis

Even if a financial institution currently satisfies the minimum requirements, the likelihood of its breaching them in the future may be high in such cases as follows:
- The firm is exposed to excessive amount of risks which are not captured by the existing standards.
- The firm's profitability and business model is not expected to be sustainable under future environments.
- The firm's governance or corporate culture is not effective enough to prevent or rectify reckless management.

Similarly, changes in their business models and strategies, changes in the social, economic and regulatory environment, as well as a higher level of expectations from the general public, may raise the likelihood of future breach of conduct rules by a financial institution, even when a clear incident of misconduct does not appear to exist at present.

To properly assess the likelihood of future breach of minimum standards, the JFSA will keep track of market, economic and social developments domestically and internationally and assess various channels through which the developments may affect the business of financial institutions. When a problem which might lead to future breach does exist but is hidden because of a favorable business environment, a stress test can be an effective tool in identifying such problem (see the Box on the next page).

The analysis on the future breach likelihood will be conducted with macro-prudential, or system-wide and through-the-cycle, perspectives. In many of the past financial crises, even though individual financial institutions executed risk-hedging transactions rational for each of them, those transactions were made in the same direction and collectively augmented unexpected volatilities in market prices and amplified credit cycles (fallacy of composition). Such possibilities need be duly accounted for.

<Box> Examples of analysis for dynamic supervision of safety and soundness

Below are the examples of forward-looking analysis to assess the sustainability of financial institutions' safety and soundness:

(Risks not fully captured by the existing minimum standards)
In many past financial crises unfolded in Japan and elsewhere, financial institutions satisfied the minimum capital adequacy requirement, a key benchmark of financial institutions' soundness, of the time. Nevertheless, they were exposed to an excessive amount of risks which the regulatory benchmark did not capture. For example:

- Though firms lent to quite diverse borrowers, many of the loans were commonly exposed to the significant risk of real estate price fluctuation, due to the nature of the borrowers' business or the use of real estate as collateral. The credit risk correlation among loan exposures was much higher than the capital adequacy standards assumed.
- Through firms had engaged in transactions assuming that they had born only limited risks, they had to step-in and bear substantial costs afterwards as there were no explicit ex-ante agreements on risk-sharing.
- Firms engaged in transactions designed for regulatory arbitrage.
- The amount of risks, which was calculated based on the past performance of loans and the past market volatilities, was an underestimation due to long-lasted favorable economic conditions.

Although the degree of risk concentration and the quality of risk management much affect the volatilities in firms' earnings, they are not necessarily parameters in the calculation of the regulatory capital adequacy ratio. The above and other elements should be considered in assessing a firm's risk profile.

(Sustainability of financial institutions' profitability and business models)
As the business environment for financial institutions becomes increasingly challenging, it is difficult for the financial institutions to maintain sustainable soundness unless they carefully take risks with reasonable returns. Thus curbing firms' risk-taking excessive to their capital adequacy level alone cannot secure financial stability anymore. The JFSA needs to pay more attention to firms' sustainable profitability.

Even if a firm records decent current earnings, it may cease to be profitable and impair their capital base in the future, if its business model is not sustainable, for example, in the following manner:

- Long-term loans and debentures the firm acquired under the past high interest rate environment will be gradually replaced with low-yielding assets.

- While shrinking population in the region is expected to lead to decrease in lending opportunities, the firm is wedded to a volume-oriented strategy and has not found an alternative business model which enables it to grow together with its customers and the local community.
- The firm is profitable by churning fees from investors, but the practice may erode customers' trust in it over time.
- The accounting profit is realized by selling securities with capital gains while those with latent capital losses are kept on the books.

Sustainability of business model would require special attention in such cases as mentioned above.

(Stress test)
A stress test is a methodology to perform a series of simulations under hypothetical adverse stress scenarios in order to assess how a financial institution or the financial system is affected under each scenario. It is a type of forward-looking analysis which can help regulators and firms identify problems which may not be revealed by statistical analysis of historical data.

A stress test by a financial institution, if designed and tailored to fit to its own circumstances and risk-profile, can usefully provide insights on channels of possible risk contagion and help it prepare for possible changes in the business environment.

On the other hand, if the supervisors specify common stress scenarios as a means to make pass-or-fail judgments on firms' capital adequacy, an inappropriate choice of the scenarios could result in an unintended distortion in the financial institutions' portfolio allocation. Further, if common scenarios are not supplemented by firm specific ones, the test can create a false sense of complacency as idiosyncratic vulnerability of each financial institution may stay unidentified.

The JFSA, with due regard to the possible negative consequences mentioned above, will explore how better to use supervisory stress tests using common scenarios (universal tests), as they can bring in benefits as shown below:

- During an extended period of boom and bubbles, firms attain continued earnings growth and stronger capital base. Bullish sentiments may prevail and make firms underestimate the risk their business entails. They may then be led to a euphoric view on the strength of their capital base and the sustainability of their business models. A stress test may reveal how the current perception on their soundness is dependent on the boom and bubbles.
- If many banks operate on the assumption that a flattening of the yield curve would be short-lived, a test with a scenario of continued

flat yield curve may reveal potential vulnerabilities. On the other hand, if banks build their business models assuming that the current low interest rate and abundant liquidity will stay, a scenario of tightened monetary policy may be useful.
- A universal stress test may be effective in evaluating the soundness of the financial system as a whole.
- A universal stress test may be effective in comparing simulation methods used across financial institutions.

(3) Flexible and effective supervisory responses

If the forward-looking analysis identifies firms' significant likelihood to breach minimum standards in the future, the JFSA will share the assessments with the firm and engage with it to explore possible remedial measures.

As the business environment for the financial industry is becoming increasingly challenging, firms may not be able to sustain their soundness merely by curbing excessive risk-taking, reducing cost and increasing business volume through aggressive marketing. In such cases, no simple mechanical rules can guide firms to sustainable solutions. Supervisory response therefore has to be flexibly tailored to firms' unique conditions and circumstances.

If the significant likelihood of breach in the future is not properly addressed, however, financial stability, consumer protection or market integrity would be compromised at some stage. Supervisory responses thus need be effective. Flexibility will be used to choose and apply most effective supervisory responses and does not mean tolerating forbearance.

To be both flexible and effective,
- The JFSA will analyze economic conditions and demographic changes in the market, the firm's business models, lending and investment policies and risk profiles, and other relevant factors, and form hypotheses on the root causes of the firm's weak performance.
- It will engage with firms to arrive at a common understanding on the issues and causes. The Agency will respect and pay much attention to the firm's own views, without unilaterally imposing the viewpoint of the authority, and will be ready to modify or discard its initial hypothesis as appropriate. If a common understanding cannot be reached, the Agency will clarify the difference and continue the dialogue.
- It will request financial institutions to develop specific preemptive measures based on the shared views and follow up on the implementation of the measures.

For the firms to plan and for the authority to follow-up on remedial measures, both sides should base their judgments on the facts, analyze and understand the current circumstances and identify the issues which truly need to be dealt with.

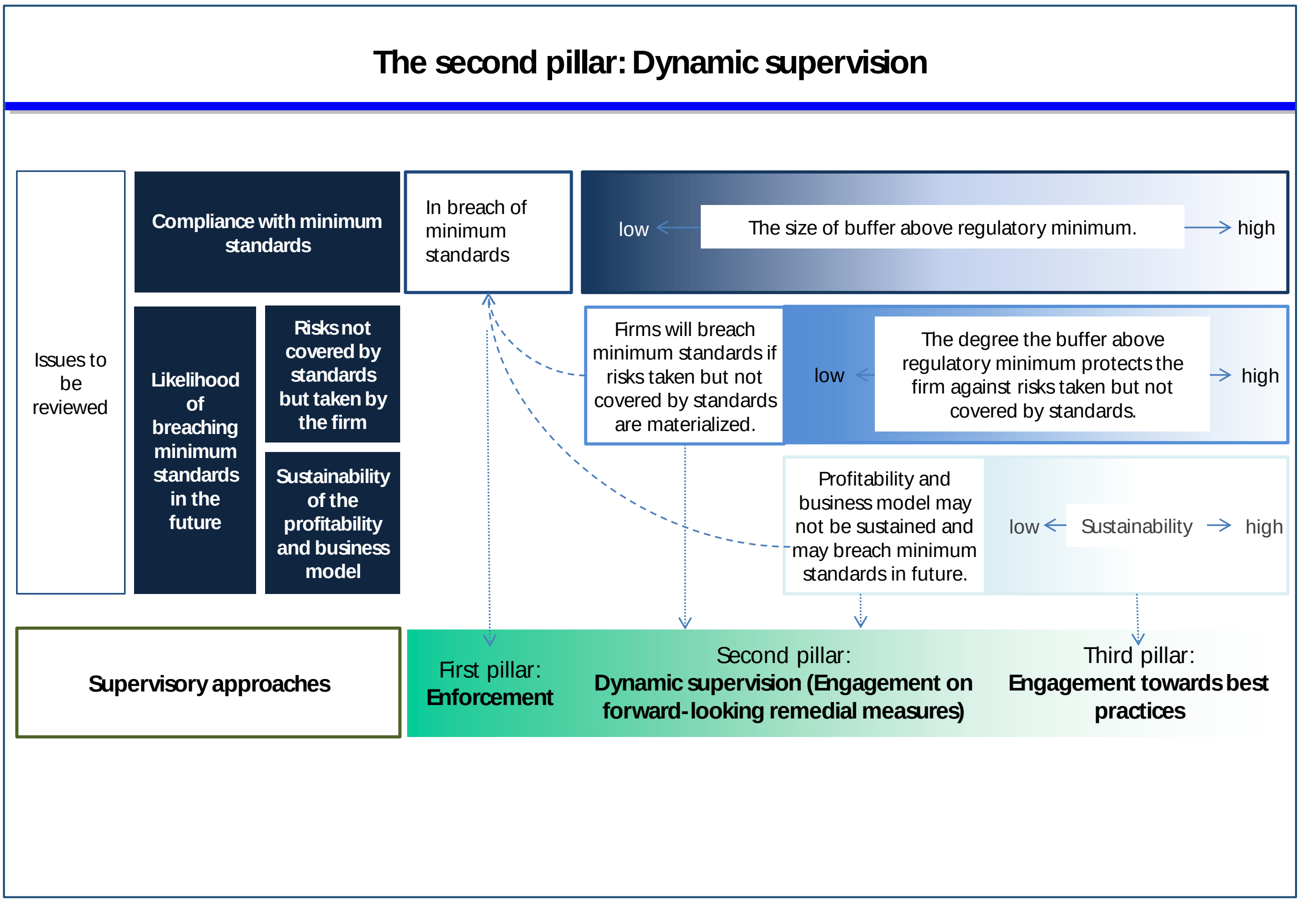
The remedial measures should squarely address those issues; they should not be superficial or pretending solutions.

These activities should be calibrated according to the likelihood of future breach, the importance of the minimum standards in question and the problems underlying the likelihood. When excessive risk-taking is simply the underlying problem, for example, the Agency will request the firm to establish and implement a remedial plan with a specific deadline. If the likelihood is very high, the supervisory approach will become very close to the first pillar approach, or the enforcement of the minimum standards.

Meanwhile, when the key issue is the concern on the sustainability of the business model under the changing future business environment and the firm's management is fully aware of the need to address the concern, the supervisory approach will become very close to the third pillar one, or the exploratory engagement.

There can be a wide spectrum of intensities in the second pillar approaches and the boundaries with other two pillars become blurred in marginal cases. Also, as mentioned in Section III 1. above, the three pillars will be applied in accordance with the current conditions of respective financial institutions. Even after a specific supervisory process has proceeded for a certain financial institution, if previously unknown facts are recognized, the JFSA will incorporate them to its profiling and analyze if the current supervisory approach is appropriate.

The JFSA's existing early warning mechanism use common thresholds predetermined for several key indicators and not based on substantive, forward-looking or holistic assessment. If a threshold is reached, supervisors would react by conducting interviews with firms and requesting reports from them. The JFSA will review the analysis and response the mechanism specifies and make it aligned to the process described above.



5. The third pillar: Disclosure and engagement

(1) Disclosure to visualize differences and engagement to explore best practices

The third pillar of the JFSA's supervisory approaches is composed of i) the promotion of disclosure which visualize the differences in firms' practices, ii) engagement with firms to explore best practices, and iii) provision of support to industry initiatives. The third pillar aims to promote an environment where firms compete with each other to more promptly adapt to future business environment and to excel in business practices.

The role of regulators under the third pillar stems from the three reasons: i) limited effectiveness of minimum standards in an environment of rapid change, ii) limited competition due to market and government failures, and iii) existence of unrealized potential in attaining virtuous cycle.

The first reason for regulators' third pillar activities is the limited effectiveness of minimum standards in an environment of rapid change. Most minimum standards are based on past regulatory experience and can quickly become obsolete under an environment of rapid change. Even if a firm satisfy all the relevant existing minimum standards, if its practices are weaker than its peers, it can easily become a pray to those who look for firms which buy products with hidden and uncompensated risks, have weaker defense against cyber-attacks, or are more likely to overlook transactions with money laundering or terrorist finance risks. To ensure that the objectives of the minimum standards are attained in fact, the regulators should encourage firms not to be satisfied with compliance with minimum standards but to proactively strive towards best practices.

The second reason for the third pillar is the limited competition due to market and government failures. Market mechanism, if it functions effectively, drives financial institutions to innovate towards practices better than their competitors. However, in reality, this may fail to happen as a result of the combined effects of market and government failures, as shown below:

- Regulation, in addition to stipulating the minimum level to be attained, sometimes unnecessarily prescribes how it should be attained and stifles innovations.
- Better products or services do not enjoy greater demand as users lack access to necessary information or financial literacy to interpret the information.
- Moral hazard created by safety net allows firms' management to stay complacent and maintain inward-looking corporate culture and follow-the-others style strategies.
- The first mover breaking away from the prevalent inefficient business model can become disadvantaged against its competitors at least for certain period of time.
- Benefits of a firm's contribution to the revitalization of the local economy and markets are shared with firms which have made no contribution (externality).

The JFSA will try to reduce undue restraints on firms' initiative, creativity and innovation by shifting away from the supervisory regime based on checklists (as discussed in IV. 3). In addition, it will implement the third pillar of its supervisory approaches to restore any weakened incentive to pursue best practices.

The third reason is the desirability to realize potential to attain virtuous cycle. At present, most financial institutions clear minimum standards and for them the likelihood of future breach is relatively limited. However, there should be further scope for a virtuous cycle to work between better financial stability and better financial intermediation, between better consumer protection and better services, and between market integrity and market vigor, and if the potential is exploited, the ultimate goal of supervision should be much better served.

A key to establishing this virtuous cycle is the creation of shared value between financial institutions and customers. In their 2011 article *Creating Shared Value*, Michael E. Porter and Mark R. Kramer argued that companies can find new markets and achieve a competitive advantage by creating shared value with customers, the community, and the society in their core businesses. By providing high-quality products and services that meet customer needs and contribute to customers' growth, companies can solidify the foundations of their businesses and increase their corporate value, according to their argument.

For example, if banks provide financial intermediary services that contribute to sustainable economic growth and asset management products and services that contribute to the formation of national wealth, they can grow with their customers and share value with them, and thereby more solidly sustain their business models. If a quick fix alone does not allow a bank to sustain its safety and soundness, it will have to find a business model with which it can grow with its customers.

Similarly, if market intermediaries pursue best practices in securing market integrity and transparency, asset managers enhance their asset management skills, and both of them better produce information, the securities industry will be able to grow with the capital market.

Whether or not such possibilities will be explored and realized successfully would have a significant impact on the achievement of the ultimate goal of regulation.

In short, the third pillar aims to support firms' efforts to meet the new challenges in changing environment, to mitigate market and government failures, and to better attain the ultimate goal of regulation by creating a virtuous cycle. However, it is not sufficient that financial institutions just wait for the authority to show an example of best practices and strive to achieve them. The best practices should be discussed and pursued within the financial institutions in light of their own circumstances. The third pillar approaches are in an early stage of development and there is no established methodologies yet. The JFSA will continue to explore how the pillar, particularly the three elements discussed below, can be improved.

(2) Disclosure to visualize differences

Effective disclosure will play a critical role in mitigating market failures and in promoting competition among firms to unleash their creative thinking and innovation. For example, information asymmetry can be effectively mitigated if third-party private companies develop criteria to assess products and services and publish their assessment. Better disclosure by firms on their products and services will also enable customers to make better choice. In addition, the supervisory authority can supplement consumers' financial literacy by publishing the summary of information it gathered and findings gained through its activities.

The JFSA has taken the following initiatives in recent years so that voluntary disclosure by firms would more effectively help customers and other stakeholders compare firms' products, services and policies:

- To help investors choose better asset management services, the JFSA published the “Principles for Customer-Oriented Business Conduct” and recommended firms to disclose if they subscribe to the Principles, and, if so, comply or explain about each principle. The JFSA has also embarked upon the development of common comparable performance indicators in this area.

- To help customers choose better banks and promote competition for better services, the Agency has established a range of common indicators on the degree banks contribute to the increase in customers’ corporate values and on other performance. It has also recommended banks to choose and disclose performance indicators most relevant to their business and policies. The Agency will continue to improve the utility of the indicators.

In addition, the JFSA has tried to assist consumers’ informed decisions by publishing its findings on the difference among financial institutions in the nature and quality of their products and services in its annual “Progress and Assessment of the Strategic Directions and Priorities” reports and other publications. The JFSA will continue to promote disclosure of information valuable for customers.

If consumers’ financial literacy improves as a consequence of the disclosure as well as financial education programs, the incentive will also grow for financial institutions to actively pursue best business practices. When the financial institutions which provide better products and services are chosen by the customers and become successful, it would in turn reinforce the functioning of the financial system.

Disclosure of financial institutions’ policies and actions can also help shareholders engage with them more effectively. Through corporate governance mechanism, financial institutions will be better incentivized to pursue best practices.

(3) Engagement to explore best practices

In addition to reforming its first and second pillars of supervisory approaches to eliminate undue constraints on firms’ initiatives to transform themselves, the JFSA will engage with firms to explore diverse range of good practices without presupposing specific answers or conclusions. The engagement may work to nudge firms away from the embedded culture of behaving as others do and of prioritizing firms’ internal peace.

The JFSA has access to diverse range of practices in the industry through its horizontal review of firms. It also surveys by interviews and questionnaires how customers view the firms and their products and services. It also exchanges views with overseas counterparts and learn about industry best practices in other countries.

The Agency thus should be in a position to provide insights which it has accumulated but is not readily available to individual firms, with due regard to sensitivities of business information. It can thereby support firms which proactively engage in new initiatives and provide stimulus for change to firms which have a tendency to follow industry trends and not open to new ideas. The engagement with a firm can be made particularly fruitful if the JFSA conducts comparative analysis of the firm vis-à-vis its peers.

Further, the Agency, by developing principles on best practices, can make its engagement with firms more focused on key questions and provide firms with opportunities to review their own business practices by examining whether or not to adopt such principles, which principles to comply with and which principles to explain the reason for non-compliance.

The pursuit of best business practices is matter for each financial institution to find its own way fitted to its own condition and circumstances and there is no common solutions or thresholds to satisfy. Needless to say, the JFSA must distance itself from unduly biasing firms' business judgments by imposing what the JFSA believes to be the best practice. The JFSA's regulatory power over financial institutions enhances the risk that the Agency's communication is misconstrued as a pressure or a request, and particular care needs to be taken to mitigate such risk.

Another important risk is that the JFSA engages with a firm without sufficient grasp of its conditions and circumstances, the firm invents several cases of new practices just to show them to the Agency, and both the Agency and the firm end up in wasting their precious time and resources. To minimize the risk, the Agency will try to acquire in-depth knowledge on firms' business environment and challenges they face through the monitoring and risk-profiling activities and to ask as relevant questions as possible without a presumption on the right answers.

(4) Industry initiatives

When the pursuit of best practices by individual firms alone does not deliver the expected outcomes, such as an increase in customers' trust in the industry and the revitalization of the market, voluntary industry guidelines and other industry-wide initiatives may work as an effective solution.

For example, promoting disclosure based on an industry-wide format and the provision of comparable information by an industry association may be useful when disclosure by individual firms alone is not sufficient for customers to compare and choose products and services.

The JFSA will support such industry-wide initiatives where appropriate, for example by participating in discussions at industry associations as an observer.

6. Reforms common to the three pillars

So as to better focus on substantive, forward-looking and holistic analysis and judgment, in addition to institutional reforms to be discussed in the next chapter, the JFSA will reform its supervisory processes common to the three pillars as follows.

(Fact-based supervision)
Accurate profiling based on relevant facts constitutes the cornerstone of the JFSA's new supervisory approaches. The Agency will make sure that facts drive all its judgments and activities; supervisors need to start from the facts, refer to the facts all throughout the supervisory process, and prioritize the facts over hypothesis or beliefs. The Agency will also conduct self-review of its profiling capability, as well as establish a mechanism to gather necessary information, with due consideration to the burden on the financial institutions.

(Focus on priority issues)
Previously, the JFSA's on-site inspection programs were not fully tailored to the challenges each specific firm faces and its nature of business, location, size and risk profiles, and the Agency repeated a comprehensive examination using the common checklist provided by the Inspection Manuals to most of the firms.

Mechanical repetition of the same inspection programs year after year could promote a tendency on the part of the JFSA to focus more and more on minor flaws while failing to address more fundamental issues. The firms may also be forced to allocate resources to address trivial irregularities.

To avoid obsession to details, the JFSA will i) gather data, conduct interviews, identify changes in the firm's business environment, and analyze the firm's overall condition, ii) identify priority issues to be examined, and iii) depending on the nature of issues, choose between on-site inspection and off-site monitoring and between firm-specific reviews and horizontal (i.e., theme-specific and industry-wide) reviews.

Under the previous method of periodic on-site inspection, examiners were expected to identify at least some problems which can be included in the Notice of Inspection Results, the report to be handed to the inspected firm at the conclusion of the inspection. It was also assumed that only problems on which both examiners and the firms reached common views through a process using the Confirmation Table can be included in the Notice of Inspection Results. Concerns were raised that this method could give examiners skewed incentives to focus on issues which appear relatively easy to reach consensus. In response, at present, examiners have options to use means other than Notice of Inspection Results to give feedback to the inspected firms. Examiners may choose to confirm where the two sides disagreed and continue discussion. The JFSA will continue to explore how best to monitor firms so that the process will be a productive and focused on priority issues.

(Continuous and seamless monitoring)
Previously, the JFSA deployed periodic on-site inspection and identified the areas for improvement based on the firms' snap-shot conditions. Depending on the nature of issues, off-site teams requested firms to submit remedial plans, followed up on the implementation of the plans, and depending on the nature of problems, issued formal Business Improvement Orders. However, this approach cannot make timely responses to changes in the business environment or new issues that may arise during the interval of periodic inspections. Also, due to the organizational separation of on-site and off-site teams and resultant silo effect, there was a risk that information on individual financial institutions obtained through on-site inspection may not be fully utilized in the off-site follow-up process.

To address these concerns, the JFSA is shifting towards a seamless monitoring approach. The new monitoring consists of risk-profiling of individual financial institutions based on continuous information gathering, flexible use of on-site inspection and off-site monitoring depending on the nature of the issues in question, and seamless monitoring of progress made by firms. Going forward, the JFSA will further the coordination between its on-site and off-site supervisory activities.

(Integrated assessment of firms' processes and conditions)
In the past, a division of labor between on-site and off-site teams was assumed. On-site inspectors were expected to be responsible to check whether certain process prescribed in the checklists are in place, while off-site supervisors were supposed to monitor the actual conditions of the financial institutions. Due to the assumption, even when the inspection teams identified problems in the firms' actual conditions, the description in Inspection Report focused mainly on deficiency in the process. On the other hand, off-site teams often lacked time and resources to deep dive into specific issues in firms' actual conditions. The Agency considers that previously assumed division of labor cannot be justified as the processes and actual conditions are causes and results and are not independent from each other. It will examine and analyze both of them in the overall cycle of monitoring activities.

(Accumulation of expert knowledge and skills)
In order to effectively engage with financial institutions, JFSA staff should maintain in-depth knowledge on individual financial institutions. The JFSA should also be able to conduct specialized issue-specific analyses such as those on business models, financial performance, governance, risk management and asset management.

To that end, the JFSA has already taken measures such as designating an Examiner in Charge for each of the largest banking groups in Japan, as well as forming examination teams specialized in individual risk categories**.** Going forward, the Agency will work to enhance its staff's expertise by reforming its supervisory processes, organization and human resource policies. Emphasis will also be placed on understanding the conditions of customers of financial institutions, particularly the industry characteristics of borrower companies.

(Wider engagement)
Until recently, most supervisory interactions were made with firms' specific sections responsible for managing relations with the authorities. However, as the focus of supervisory activities shift from technical compliance with each item of the checklists to firm-wide priority issues and firms' governance and institutional cultures, the JFSA will need to engage with firms' outside directors, external auditors, and top management as well as with customers and other stakeholders outside the firms.

With respect to the supervision of internationally active financial institutions, the JFSA will continue to enhance cooperation with its overseas counterparts through supervisory colleges and other means.

IV. Enhancing the JFSA's readiness for new supervisory approaches

The last Chapter of this report describes how the JFSA will transform itself to better carry out its new supervisory approaches. The new approaches will rely more on substantive, forward-looking and holistic analysis and judgment, and thus require the Agency to augment its capability to make sound judgments. The JFSA will systematically implement reforms to improve its governance, quality control, communications, organizational structure, human resource development and information infrastructure.

1. JFSA's governance

At the start of each business year, the JFSA publicly announces its priority issues in its "Strategic Directions and Priorities" report. After the business year, the Agency publishes a summary of its activities during the year in its "Progress and Assessment of the Strategic Directions and Priorities" report. Work-in-progress and newly identified priority issues will be presented in the next year's "Strategic Directions and Priorities" report. Through this PDCA cycle, the JFSA reviews its supervisory processes and reflects the lessons learned in its next supervisory programs.

The JFSA will use the above mentioned reports to have in depth engagement with stakeholders outside the Agency, including financial institutions, consumers and subject-matter experts, and input feedback from stakeholders into the PDCA cycle to improve its practices.

The Agency's initiative for better governance includes expanding the role of the Policy Evaluation Advisory Group, which is composed of independent external experts and was originally commissioned to conduct annual evaluation of JFSA's policies and activities. Referring to good practices of private companies which have effective governance mechanisms and whose outside directors play important roles, the Agency will further commission the Advisory Group to review the whole areas of the Agency's responsibilities more frequently and to advise how the Agency should identify and address new priority issues.

The JFSA will ensure similar mechanisms exist for more specific themes of supervision. Suggestions from external experts discussed at theme-specific advisory groups will also be reflected in the Agency's supervisory programs.

In order to maintain a high level of supervision comparable to international best practices, the JFSA will use insights gained through reviews conducted by international organizations (e.g., Financial Sector Assessment Program by the International Monetary Fund and peer review by the Financial Stability Board) and through dialogue with overseas counterparts in its efforts to improve its supervisory practices, while taking due consideration of Japan's own condition and circumstances.

2. Quality control

In the past, the overarching objective of the Agency's supervisory activities was to confirm that financial institutions abide by the minimum standards prescribed in the Agency's checklists. Under the new supervisory approaches, the role of substantive, forward-looking and holistic analysis and judgment will grow and it will become more critical for the Agency to develop and maintain control processes to secure and review the quality of supervisory activities and of judgments it makes in discharging its responsibilities.

(Internal quality control)
The Agency will institutionalize its internal quality control processes so that relevant decisions are not left to field officers alone but properly escalated to senior officials and that the following points are properly reviewed:

- Whether the Agency requests financial institutions to take necessary remedial measures without undue forbearance;
- Whether the Agency focuses on priority issues and avoid spending time on trivial matters;
- Whether the Agency poses relevant and material questions; and
- Whether the Agency avoids unduly interfering with firms' business judgment.

The Agency will have a process to incorporate organization-wide perspectives in deciding the supervisory approaches to be taken and key messages to be delivered to financial institutions so as not to allow individual supervisor's preoccupations to drive the process or an engagement to result in a provision of a disguised form of administrative guidance without organizational oversight.

The JFSA will also review the quality of reporting requirements it sets. It will examine if the requirements are sufficient but not excessive in view of the purpose of the requests and if the costs incurred to financial institutions are commensurate with the need. It will enhance internal coordination to eliminate duplication of requests. When making requests, it will provide sufficient explanation on the background and purpose of the request. After analyzing the reported information, it will feedback the outcome to reporting firms as much as possible.

(Feedback from stakeholders)
Feedback from regulated firms, their customers and other stakeholders has a key role in the Agency's quality control process. The Agency already has a process for inspected firms to challenge inspectors' views and have them reviewed by a panel (the Inspection Challenge Process). It dispatches its senior officials to conduct interviews with inspected firms' senior executives and staff members during or after on-site inspections and also send questionnaires to

inspected firms after Notice of Inspection Results are handed to them (the Inspection Monitor Process). In addition, any interested parties are invited to submit their comments, proposals and criticism on all aspects of the Agency's activities and policies either directly to the Agency (the Contact Desk for Comments) or to the third-party experts commissioned by the JFSA (the FSA Monitors), who recommend the Agency remedial actions where necessary.

To minimize the risks that the Agency is swept by misguided ideas and use its discretional power improperly and to secure that the Agency take timely and adequate actions in line with the new supervisory approaches, in addition to the measures to strengthen its governance, the JFSA will reinforce its processes so as to be able to receive unfettered and candid comments, as follows:

- The Agency will continuously invite insights from the Advisory Group on Supervisory Approaches to improve its supervisory approaches.
- The Agency will more actively invite interested parties to use the above mentioned FSA Monitors process.
- The Agency will commission consultants to have them interview firms and JFSA staff and review the quality of supervision.
- The Agency will expand the current challenge process for on-site inspections to include off-site monitoring.
- The Agency will improve its response to enquiries from firms on interpretation of laws and regulations and on other matters. It will also improve the process to publish responses which are likely to be useful for other as well.

The Agency will request the Advisory Group on Supervisory Approaches, the panel of experts which recommended the JFSA to transform its supervisory approaches, to regularly review the adequacy of the Agency's responses to comments and criticisms it receives from outside, and will reflect the Group's recommendations in the way the Agency conducts its business.

3. Communications on supervisory policies

To date, the JFSA expressed its supervisory policy through both the Inspection Manuals and the Supervisory Guidelines. The Supervisory Guidelines provide how laws and regulations should be applied in particular circumstances and how the procedures for licensing and regulatory sanctions should be operated. On the other hand, the Inspections Manuals take the form of a comprehensive checklist intended to show the JFSA's inspectors which aspects of the financial institutions they should look at when conducting on-site inspections.

The Manuals, however, simply show what firms should do and do not necessarily provide how the checklist is related to the ultimate and basic goals of regulation. Consequently, the Manuals promoted a tendency to focus on formalistic, backward-looking and item by item checks. To shift towards substantive, forward-looking and holistic analysis and judgment, the JFSA needs to make clear the underlying concepts, approaches and principles of supervision so that its supervisory activities and decisions will be properly guided by the ultimate and basic goals of regulation.

To attain these objectives, the JFSA intends to restructure the set of communications it makes on its supervisory policies. It will repeal the Inspection Manuals at a timing after the end of accounting year 2018 (after April 1, 2019). It will enhance its communications on underlying concepts, approaches and principles by issuing Discussion Papers on specific areas of supervision. To enhance transparency, principles will be illustrated by publications of case studies. Further, to adapt to changes in the regulatory environment and in its priorities, the JFSA will flexibly use its annual "Strategic Directions and Priorities" reports, *ad-hoc* circulars to financial institutions and summaries of JFSA officials' remarks at meetings with financial institutions, as measures to convey its messages.

(1) Inspection Manuals

The Inspection Manuals were intended to show the JFSA's inspectors which aspects of the financial institutions they should look at when they conduct onsite inspection. It was also expected that the Manuals were used as a reference by financial institutions when they develop their internal rules and policies.

The Manuals takes the form of a checklist and lists what firms should do without explicitly indicating why. They do not specify the level of effectiveness of firms' internal control but prescribe which specific internal rules and institutional arrangements should be in place.

During and after the financial crisis in Japan, the Inspection Manuals played a key role in bringing firms' internal control on asset quality reviews, risk management, compliance and customer protection to a minimum required level. However, as Manual-based comprehensive inspections are repeated year after year, the following concerns have emerged. In recent inspections, therefore, the inspectors no longer refer to the Manuals.

- Checklist tends to make JFSA's inspectors to split hairs to criticize non-substantive trivial irregularities while losing sight of more important issues.
- Firms are induced to focus on letters rather than spirit of the checklist and internal control and risk management are pursued as a compliance exercise rather than for their effects and functions.
- Corporate culture which prioritizes satisfying minimum standards and does not aspire for better practices are fostered.
- Past comments by inspectors are construed as an implicit rule which should be followed even after the changes in circumstances.
- Elaborate internal rules developed by financial institutions in line with the Inspection Manuals were regarded as golden rules that should be abided by at any cost, hindering firms' initiatives for innovations and sometimes being used inside firms as an excuse to avoid necessary reforms.

(Tables on loan asset review and the role they played)
The tables attached to the Inspection Manuals, which are also formulated as a checklist, specifically deal with classification of loan assets, loan write-offs, and loan loss provisioning (the Tables).

Following the repeal in 1998 of the Ministry of Finance's directive that governed the accounting of banks, the accounting standards applicable to non-financial companies started to be applicable to financial institutions as well. Around the same time, procedures for loan write-offs went through changes. Previously, banks had to obtain prior approval from the authorities when writing off bad loans, but the change enabled them to write-off loans on their own judgment based on their self-review of loan assets.

The Tables of the Manuals, which were published originally in 1999, provided, among others, methodologies to classify loans into four categories, from Type I to Type IV, based on pro-forma criteria such as presence of payment arrears, modification of the lending terms and the availability of collateral and guarantee. This simple method of classification was adopted at the time when a more sophisticated approach would have been difficult in the absence of sufficient data on the part of financial institutions.

The Tables, coupled with then-conducted "special inspections", which were characterized by a rigorous loan-by-loan review, have played a role in establishing a consistent, minimum level of practices among the financial institutions.

(Evolution in global practices)
However, global practices on asset quality reviews have evolved since then. For example, in the U.S., the Federal Reserve Board issued "Determining an Adequate Level for the Allowance for Loan and Lease Losses" in 2002 and defined the regulators' role as follows (emphases in original):

- To evaluate the methodology and process that management employs in compiling an *overall* estimate of the allowance for loan and lease losses (ALLL);
- To understand and evaluate the nature of the external and internal lending environment and how they might influence management's estimate of the ALLL;
- To determine the accuracy and reasonableness of management's estimate of the *overall* ALLL; and
- To evaluate the quality of the bank holding company's systems and management performance in identifying, monitoring, and resolving asset-quality problems.

In addition, new accounting standards which require banks to reflect reasonable and supportable forecasts in the provisioning will start to be applied in 2018 in the case of the International Financial Reporting Standards and in 2020 for firms adopting the U.S. accounting standards. Meanwhile, the Basel Committee on Banking Supervision is reviewing the relationship between the amount of expected losses under the capital adequacy standards and the amount of loan loss write-offs and provisions under the accounting standards.

(Measures taken so far in Japan)
In Japan, measures have been taken to supplement the pro-forma criteria specified by the Tables of the Inspection Manuals. The Supplement to the Manuals concerning Loans to Small and Medium-sized Enterprises published in 2002 confirms that borrower companies' overall conditions, including elements not specified in the Tables, should be reflected in asset quality reviews and illustrates the principle by example cases. In furtherance of the approaches taken by the Supplement, the JFSA emphasizes the importance of looking closely at borrower companies' growth potential and their business model sustainability.

Also as a recent initiative of the JFSA, in its "Financial Monitoring Policy for 2014-2015", the Agency announced that in its supervisory process, "the Agency in principle relies on asset quality review by the financial institutions in terms of small-sized loan assets, as long as the financial institutions' system of loan asset management is considered well established and effective." The JFSA further announced that "Except on large-sized loan assets with the potential to impact the safety and soundness of the financial institutions, the Agency will respect their judgments provided that they have sound internal control and effective risk management processes."

(Need for a further reform)
Despite these measures taken, some financial institutions still believe that they are mandated to follow the pro-forma criteria exactly as provided in the Tables. Some firms may believe that blind reliance on historical data and the availability of collaterals and guarantees would best protect them against inspectors' criticism while estimation of future losses based on borrowers' business prospects may entail the risk of going out of the safe harbor provided by the Tables. In spite of the accumulation of decades of experience and data under the self-review regime, progress and improvements in loan classification, write-off and provisioning practices have been rather limited, and the Tables may have contributed to this.

The situation should not be left unaddressed, since financial institutions cannot properly assess its own safety and soundness without appropriate loan classification, write off and provisioning. In addition, firms with adequate loan loss reserves and write off can flexibly take actions in a timely manner even in times of stress, choosing from a broad range of options including assisting borrowers' business turnaround or supporting a wind-down of businesses. In other words, sufficient loan write-off and loan loss provisioning are the preconditions for the financial system to perform its intermediation function in a resilient manner.

The supervisory approach focusing on the uniform, loan-by-loan quality review process relying on specified loan characteristics and historical data should be made more effective and flexible and reformulated to allow better practices. The new approach needs not assume that the Agency and the firm should agree on the classifications of each specific individual borrower. Nor should it assume that the firm should abide by the letter of each item of the Tables. Rather, the Agency should focus on the overall level of provisioning and on whether financial institutions have a well-functioning process fitted to the firms' business and borrowers' characteristics and which can properly assess the overall level of future losses according to the relevant accounting standards.

In addition, though the current approach tend to equate loan quality review with the prudential supervision, loan by loan classification alone is not enough to prevent the next formation of bad loans or ensure the overall soundness of financial institutions. It should be a part of substantive, forward-looking and holistic assessment of overall soundness of financial institutions and needs to be supplemented by the monitoring of the financial institutions' risk concentrations in their asset portfolio mix and the accumulation of other potential vulnerabilities in the ever-changing business environment.

More importantly, a bank's practices on loan classification, write off and provisioning should form a part of the overall design of its business and should be consistent with its underwriting and risk management practices. It is not appropriate if the Tables, by imposing a uniform practices, constrain firms' efforts to design business models fitted to its condition and circumstances.

For example, if a bank is to shift from a business model of minimizing the risk of creating a non-performing loan to a business model of controlled risk taking to remain profitable while staying sound, they will need a better capability to assess future losses. Then the bank should look at broader aspects of borrowers' business than the Tables typically presume. It may also want to look at future cash flows in wider cases than the Tables require.

Complex methodologies of estimating the loan loss probability and other parameters will not be necessary for financial institutions with a simple business model or a simple risk profile. Nor changing established business practices should be done in a hasty manner. Nevertheless, firms who want to do better should not be unduly constrained by the Tables.

(Repeal of the Inspection Manuals, including the Tables)
Accordingly, the JFSA intends to repeal the Inspection Manuals, including the Tables, at a timing after the end of accounting year 2018 (after April 1, 2019). Purpose of the repeal is not to deny established business practices of financial institutions but to support their own initiatives and creativity building on their current business practices. Although the Agency's intention should be clear, in order to avoid any potential misunderstandings, puzzles or concerns, the timing

of the actual repeal is set at a later date, as described above.

In the coming period, the JFSA intends to take the following steps, so that both the JFSA and financial institutions will be ready for the repeal:

- The JFSA will issue Discussion Papers on prudential policy and compliance risk management, use them as a basis of dialogue, and try to develop a common understanding on the new supervisory approaches between the Agency and financial institutions (see IV. 3. (3)).
- The JFSA will organize a study group comprised of financial institutions, external auditors and other experts, issue a Discussion Paper on loan classification, loan write-offs and loan-loss provisioning, and continuously advance dialogue with stakeholders.
- In possible cases of the repeal creating uncertainty over the application and interpretation of relevant laws and regulations, the JFSA will address such issues by revising the Supervisory Guidelines or through other means.[1]

(2) Supervisory guidelines

The Supervisory Guidelines provide guidance to JFSA staff how laws and regulations should be applied and how the procedures for licensing and other regulatory actions should be operated. As such, they contribute to transparency and predictability in JFSA's operations, and should continue to stay even after the repeal of the Inspection Manuals. Sections which overlap with the current Inspection Manuals, however, should be streamlined, and any clauses with excessive prescriptiveness should be rectified so as not to hinder financial institutions' initiatives for innovation.

(3) Reports on area/issue specific approaches

The contents of this report, which presents JFSA's common supervisory approaches applicable to all regulated financial institutions, are limited to high-level principles and would need to be supplemented by reports on approaches to more specific issues and areas under supervision.

The additional reports, though they may be more detailed than this report, should not aim to eliminate the need for judgment. Their objective should be to support JFSA staff make judgments by providing underlying concepts, principles and the link between the goals of regulation and specific issues of supervision. The JFSA will produce them according to the following principles:

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[1] With respect to the disclosure requirements on non-performing loans under the Banking Act and the Financial Revitalization Act, the standards of disclosure and the definitions of loan categories are prescribed by laws and regulations. However, the details concerning the application of the standards are specified by the Supervisory Guidelines and Inspection Manuals respectively. If the repeal of the Inspection Manuals should create uncertainty over the application and interpretation of rules under the Financial Revitalization Act, the JFSA will consider amending the Supervisory Guidelines as necessary.

First, the reports should not aim to provide quick and easy answers to complex questions and should not be written in a way to let the JFSA resort to the languages of the reports to cut short necessary dialogue with financial institutions. Rather, they should provide viewpoints which would facilitate the dialogue between the JFSA and financial institutions and help them think deeper and analyze the issue in question by referring back to principles and goals of regulation.

Second, the JFSA will not aim to create a comprehensive body of reports, and the reports will not aim to provide an answer to each and every possible question. Reports dealing with priority areas and issues will be published first, and a report focusing on a very narrow issue may be issued before reports covering wider areas. Topics may include general ones such as prudential policies, compliance risk management and effective financial intermediation, industry specific ones such as supervision of insurance companies, and more specific issues such as the use of stress testing, IT governance, and asset quality reviews.

Third, each report will tailor its contents so that they can be applied in a manner proportionate to the size and complexity of the financial institutions. It will also clearly indicate that the JFSA will not request smaller financial institutions to engage in unduly complex dialogue.

Fourth, when the approaches discussed by a theme specific report is not mature enough, the report will be issued as a Discussion Paper, with clear indication that it is issued to facilitate dialogue between the JFSA and stakeholders. A Discussion Paper may be recast as Principles if the approaches described have been well tested and proved.

Reports dealing with priority areas and issues will be published to serve as a basis for the engagement with the financial institutions to promote the pursuit of their best practices. It is not the Agency's intention to request the firms to modify practices or internal rules each time such report is published. Needless to say, the Agency no longer intends to apply the reports formalistically and use them in a box-ticking style exercise.

In addition to theme-specific reports, the JFSA may publish the outcomes of its horizontal supervisory reviews on specific issues. For example, after monitoring closely on specific consumer protection issue and accumulating sufficient observations on the issue, the Agency may publish the outcome of such review, areas for improvements, and supervisory viewpoints.

Further, the JFSA may, in certain areas, publish concrete standards together with the high-level principle. For example, if a wide range of the financial institutions are facing the common challenges for improvement, or if there is a limit for an individual institution's learning by doing, it may be helpful for the authority to show such concrete standards. Moreover, the Agency will continue to review and improve the reports and standards even after the publication, so that it can continuously support the financial institutions' efforts to pursue best practices.

(4) Periodic and occasional communications

In addition to the Supervisory Guidelines and reports on supervisory approaches, the JFSA will use periodic and occasional communications so that the agency's messages are delivered in a timely manner. The Agency's periodic communications include annual "Strategic Directions and Priorities" reports (issued since business year 2015), and summaries of JFSA remarks at monthly meetings with financial institutions (issued since 2017). Its occasional communications include issue-specific circulars to industry.

(5) New set of communications: Not canons but means for dialogue

The new set of communications, as described above and shown in the chart below, does not form a part of the system of laws and ordinances. It will not attain its objective if it is considered as a body of canons which supervisors and firms can blindly rely on. It should be used as a means for dialogue which helps both to think deeper and better and innovate themselves. During the supervisory processes, the JFSA will take due consideration of the differences in the purpose and objective of both its new and old policy documents and will provide thorough explanations to the financial institutions.

Scholastic body of detailed interpretation of words and phrases of the Inspection Manuals has been accumulated over the last two decades. Both the JFSA and the industry should refrain from starting anew a similar process with regard to the reports on supervisory approaches, principles or summaries of remarks.

Current and new set of communications

Body of rules and checklists showing what to do		Body of principles and concepts showing why and how
Inspection Manuals Comprehensive and detailed checklist.	→	**To be repealed after the end of fiscal year 2018 (after April 2019)** Not to deny firms' established business practices but to support firms' initiative to innovate.
Supervisory Guidelines Guidance on the application of laws and regulations to specific circumstances and on the regulatory procedures.		***Supervisory Guidelines*** Any clauses with excessive prescriptiveness should be rectified.
		***JFSA's Supervisory Approaches* report (This report)** Presents underlying concepts, approaches and principles of supervision without providing checklist.
		Principles e.g. Principles for Customer-Oriented Business Conduct (2017-)
	→	**Theme specific reports** Presents theme specific approaches. If the approaches is not mature enough, the report will be issued as a Discussion Paper to facilitate dialogue between the JFSA and stakeholders. In addition to the theme specific reports, the JFSA may publish the outcomes of its horizontal supervisory reviews on specific issues. Themes could include: ✓ Prudential policy ✓ Compliance risk management ✓ Better financial intermediation ✓ IT governance ✓ Loan classification, write-offs and loan loss provisioning.
		Further, the JFSA may, in certain areas, publish concrete standards together with the high-level principles.
Annual *Inspection Policies* and Annual *Supervisory Policies* Issued at the beginning of a business year.		**Annual *Strategic Directions and Priorities* report (2015-)** Issued at the start of a business. The progress during the year is reviewed at the end of the business year in the *Progress and Assessment of the Strategic Directions and Priorities* report and reflected in the next year's "*Strategic Directions and Priorities*" report.
Issue specific circulars to the industry Issued occasionally to communicate the Agency's views on specific issues and to give alert to the industry.		**Issue specific circulars to the Industry** **Summaries of JFSA remarks at monthly meetings with financial institutions (2017-)**

4. Internal organization, human resource development and information infrastructure

(1) JFSA's internal organization

The new supervisory approaches require continuous review and identification of priorities in the light of the changing domestic and global conditions. The JFSA should enhance its strategic planning and coordination function covering its whole areas of responsibilities.

As the supervisory program shifts from checklist-based, uniform and comprehensive review to monitoring focused on priority supervisory issues, the need for supervisors to possess insights on domestic and global market developments, expertise on risk management, business analysis skills, and other specialized knowledge will become even greater. Horizontal review across the whole financial system or the whole industry will also be needed. The JFSA will therefore strengthen its specialized teams of supervisors.

Insights on individual institutions and continuous engagement with them are indispensable if the JFSA is to effectively support the pursuit of best practices or to ensure sustainable safety and soundness. Until recently, however, on-site and off-site supervisory activities have been conducted independently, with on-site teams working at the Inspection Bureau and off-site teams at the Supervisory

Bureau of the JFSA, limiting the accumulation of shared knowledge. These operations need to be integrated.

To meet the challenges of FinTech and other technological development, and to attain more vibrant capital markets, the Agency needs to enhance its capability to design and propose a more robust legal framework.

In addition to the above, the Agency will enhance coordination between the headquarters and the Local Financial Bureaus so that staff at the latter will also fully embody the new supervisory approaches.

(2) Human resource development

In 2012, the JFSA staff members set out three goals: for them all to work towards the national interest; for each staff member to develop his/her unique strength to contribute to the national interest; and for the Agency to become a workplace which helps staff members' development.

The new supervisory approaches require JFSA staff not to limit themselves in mechanical application of the rules but to make a sound judgment in light of the ultimate and basic goals of regulation. This means that the three goals above are all the more important.

Also, to advance the new supervisory approaches, the JFSA needs diverse viewpoints, expert knowledge and skills, and the ability to transform itself flexibly, and thus should have appropriate diversity in its staff. Managers should enhance their skills to set forth goals and achieve them, rather than just to manage the process to repeat the previous year's routines. Its top management should demonstrate change leadership, creating a vision for the Agency and driving the Agency to make the vision a reality.

The JFSA wants to be a place where each individual staff member will find their own unique and diverse ways to grow and will be empowered to exercise their individual strength and skill sets to contribute to the goals of regulation.

The Agency therefore will:
- Appraise its staff based on merits (e.g., professional skills and capabilities) and achievements (e.g., initiatives taken to advance national interests),
- Clarify the job description of each position at the Agency, specifying tasks to be achieved and skills and experience required;
- Assign the right person in the right place based on the job description rather than on seniority, and actively recruit experts from outside;
- Develop longer-term staff rotation to improve skills and knowledge in specialized fields;
- Have its human resource division engage with members of the staff on their individual professional career developments;
- Provide professional training opportunities outside the JFSA, and enhance

internal training opportunities, for example, by adding case-study style programs designed to foster one's ability to make judgments in a situation where clear-cut answers cannot be found;

- Support research by staff and the publication of the results;
- Continuously eliminate sources of inefficiencies and rationalize its business processes; and
- Create an environment which accommodates diverse working styles and is conductive to creative thinking and interactions which would foster innovations.

(3) Information infrastructure

Better supervision needs to be backed by better data and analysis and use thereof. Enhancing information infrastructure is an important strategic goal of the Agency. The Agency will identify priority needs for analysis under the new supervisory approaches and build necessary information infrastructure. In developing the IT infrastructure, the JFSA will establish a governance mechanism which facilitates the intra-agency coordination among those who gather, cleanse, analyze, and use data and design and run IT systems.

Low priority reporting requirements should be reviewed and streamlined, with due considerations to the possibility that ad hoc requests or frequent changes in requirements increase reporting burdens and limit the use of data for time-series analyses.

The Agency will study how it can deploy information technologies to attain efficient, real-time and in-depth monitoring, with developments in RegTech on the part of reporting financial institutions in mind.

(4) Cooperation with the Bank of Japan

The JFSA has a strong cooperative relationship with the Bank of Japan (BOJ) in a number of areas at various levels, including through periodic meetings chaired by a BOJ Deputy Governor and the JFSA Commissioner. The knowledge and experience gained by the BOJ through discussions among central banks around the world, its analysis of financial markets and economies, on-site examination of financial institutions, and the production of the Financial System Reports are valuable inputs to the JFSA's supervisory activities. Similarly, the JFSA will share useful findings gained through its supervisory activities with the BOJ.

The JFSA and the BOJ have a framework for joint analysis on the need to activate the countercyclical-buffer requirements under the capital adequacy regulation for banks. The JFSA and the BOJ will also explore other possibilities for cooperation, including that related to information infrastructure.

(5) Domestic policy formation and the global regulatory reforms

Japan’s regulatory policy cannot be independent from international regulatory standards. However, in the past, the international section of the JFSA tended to negotiate in international fora to minimize the burden of adopting international standards, while the domestic sections independently addressed domestic issues. The international and domestic sections of the JFSA tended to discharge their responsibilities within a narrowly defined scope.

There are many commonalities between the problems that global regulatory reforms intend to address and the challenges that Japanese regulators face. The JFSA’s domestic and international sections will work together so that Japan contributes to the global regulatory community with constructive suggestions based on the experience in Japan and uses the accumulated wealth of international discussions to resolve its own domestic issues.


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