

Progress Status of Initiative toward Better Regulation  
—from May 2008 to December 2008—  
<Outline>

## Introduction

- The Financial Services Agency (FSA) has been engaged in an initiative to improve the quality of financial regulation (Better Regulation) since the summer of 2007.
- This is the second report on the progress status of the initiative toward Better Regulation, following the first report that was issued in May 2008.

## I. Four Pillars of Better Regulation

### 1. Optimal Combination of Rules-Based and Principles-Based Supervisory Approaches

(1) The FSA made efforts to ensure all FSA employees are fully acquainted with the purpose of the “Principles in the Financial Industry (the Principles)” on which it agreed in April 2008 with financial institutions and market participants and to promote the common understanding of the purpose of the Principles with the relevant parties.

\*The FSA specified in its Annual Supervisory Policies that the Principles should be applied in daily supervisory activities.

\* In light of the principles of improving user convenience and managing risks properly, the FSA gave priority to “establishing an appropriate risk management system corresponding to the features of various types of loans and financial products” and “ensuring smooth financing to small and medium-sized enterprises (SMEs) and support for regional industries” and conducted inspections with a focus on encouraging financial institutions to make voluntary efforts to improve management, including by positively evaluating superior initiatives.

(2) Under the Act for Amendment of the Financial Instruments and Exchange Act (enacted in June 2008), the FSA is set to reform the firewall regulations and introduce the requirements for financial institutions to establish systems for managing conflicts of interest. In order to promote voluntary efforts by financial institutions to establish these systems, the FSA established a principles-based regulatory framework, under

which it prescribed fundamental rules and seeks to ensure the effectiveness of regulation through appropriate monitoring of the implementation of the rules by the financial institutions.

## **2. Timely Recognition of Priority issues and Effective Response**

(1) In order to identify the impact on Japan of the global financial market turmoil, drops in prices of securitized products, the shortage of market liquidity, and volatile movements in the stock market as quickly as possible, the FSA has been keeping a close watch not only on market developments but also on the financial soundness of financial institutions and the actual practices of their risk management.

\*In order to ensure accurate understanding of the impact on the financial system and to dispel uncertainties, the FSA published the exposures of Japanese financial institutions to securitized products in light of leading disclosure practices (June, September and November 2008).

\*The FSA strived to examine points of attention regarding financial institutions' risk management, such as conducting appropriate stress testing with due consideration of the declining market liquidity and grasping the nature of the underlying assets of securitized products and their price movements. These points were reflected in the Comprehensive Guidelines for Supervision (August 2008).

In addition, in light of the severe environment surrounding regional economies and SMEs due to factors such as changes in global price systems and the deterioration in the real economy, the FSA promptly investigated the current situation and quickly implemented measures to enhance the stability of the financial system and facilitate financing for SMEs.

Through the above measures, the FSA strived to ensure that financial institutions properly maintain their financial intermediary function.

\*Senior FSA officials were dispatched across Japan in order to precisely grasp the actual state of financing for SMEs (August 2008).

\*The FSA implemented measures to maintain the financial intermediary function (e.g. change in the treatment of restructured loans, partial relaxation of the capital adequacy requirement and amendment of the Act on Special Measures for Strengthening Financial Functions).

(2) The FSA conducted inspections with a focus on important risks that could have a serious impact on the management of financial institutions amid the ongoing drastic

changes in the economic and financial conditions both in Japan and abroad.

\*In the Basic Policy for Financial Inspection, the FSA placed emphasis on “establishing an appropriate risk management system corresponding to the features of various types of loans and financial products” and “ensuring smooth financing to SMEs and support for regional industries” (as already mentioned above) in light of the increase in loans and other financial instruments with complex structures, such as those using the securitization scheme, and the growing need for financial institutions to actively exercise their financial intermediary function in an appropriate manner suited to the actual state of SMEs.

\*The FSA introduced simplified inspections for financial institutions with a limited range of business operations in order to reduce the burden of paperwork regarding minor risks on financial institutions.

### **3. Encouraging Voluntary Efforts by Financial Institutions and Placing Greater Emphasis on Providing Them with Incentives**

(1) Under the Act for Amendment of the Financial Instruments and Exchange Act, the FSA reformed the firewall regulations and introduced a framework under which financial institutions are required to establish systems for managing conflicts of interest and make self-disciplinary efforts in light of their own circumstances (as already mentioned above).

(2) The Act for Amendment of the Financial Instruments and Exchange Act introduced a rule for increasing or reducing the amount of administrative monetary penalties. From the viewpoint of providing an incentive for voluntarily establishing a compliance system and preventing the recurrence of violations, the administrative monetary penalties may be reduced for entities that report certain violations at an early stage. Furthermore, from the viewpoint of preventing violations, the amount of penalty may be increased for persons who engage in violations repeatedly.

(Note) The above rules are applicable not only to financial institutions subject to supervision by the FSA but also to market participants in general, including individual investors.

(3) The FSA enhanced efforts related to the Financial Inspection Rating System that are intended to strengthen the incentive for improving management.

\*Good initiatives taken and creative practices conducted by financial institutions are positively evaluated and clearly reflected in the financial ratings assigned to them.

\*A collection of examples of “Grade A” cases was compiled as a reference to be communicated to all relevant parties.

\*The distribution of Grade A and Grade B was added to the published report on the distribution of grades assigned through the Financial Inspection Rating System.

(4) The FSA took care to provide an incentive for financial institutions to further promote relationship-based local banking by compiling and publishing financial institutions' progressive responses to changes in economic conditions.

#### **4. Improving the Transparency and Predictability of Regulatory Actions**

(1) The FSA revised the Inspection Manuals so as to specify the matters that inspectors should bear in mind when conducting financial inspection, such as a "priority-driven approach focusing on important risks," "identification of problems, evaluation of appropriate improvement efforts and examination of static and dynamic aspects" and "promotion of accurate understanding of examination findings (sense of satisfaction)" (August 2008).

(2) In light of the environment surrounding financial institutions, such as the increasingly severe economic situation and the growing need to properly manage risks inherent in financial instruments, the FSA clarified the priority issues for regulatory activities in program year 2008.

\*In the Basic Policy for Financial Inspection, the FSA placed emphasis on "establishing an appropriate risk management system corresponding to the features of various types of loans and financial products" and "ensuring smooth financing to SMEs and support for regional industries" (as already mentioned above).

\*In its Annual Supervisory Policies, the FSA gave priority to ensuring the "exercise of the financial intermediary function and a sense of security and convenience for users" as well as "risk management and financial stability" in light of the importance of ensuring a virtuous cycle of prudent risk-taking and risk management by financial institutions leading to smooth provision of funds and the maintenance of the financial soundness of the banks' own financial positions amid the severe economic situation.

## **II. Five Areas of Immediate Focus**

### **1. Enhancing Dialogue with Financial Institutions and Other Relevant Parties**

In light of the financial market turmoil in Japan and abroad and the severe conditions faced by regional economies and SMEs, the FSA started direct dialogue with SME managers and SME associations across Japan.

(1) The FSA dispatched senior officials across Japan in order to grasp the actual state of financing for SMEs and conducted hearing surveys with 51 SMEs and SME associations (August 2008). In addition, it conducted questionnaire surveys with prefectural chambers of commerce and industry and other entities with regard to the business conditions, fund-raising situation, etc. of SMEs (August to early September, and November). Together with the Small and Medium Enterprise Agency, the FSA conducted extensive hearings in 150 locations across Japan (From October onwards).

(2) The FSA increased frequency of hearings regarding the financial results of major banks and the monitoring of inspections. It actively held forums for an exchange of opinions with market participants and financial industry representatives.

## **2. Enhancing Dissemination of Information**

(1) The FSA has sought to effectively communicate its viewpoints and the measures it has taken through the active use of lectures, speeches, and interviews with media organizations with regard to the current global financial situation and the efforts Japan is making to deal with it.

(2) The FSA almost doubled the number of press releases in the English language issued on its Web site compared with the same period of the previous year. It also increased the number of English-language press releases issued simultaneously with their Japanese versions.

(3) In order to facilitate financing for SMEs, the FSA held a variety of briefing sessions across Japan aiming at ensuring that relevant parties are fully acquainted with the FSA's Basic Policy for Financial Inspections and the contents of the Inspection Manuals.

## **3. Strengthening Cooperation with Foreign Authorities**

(1) The FSA disseminated information, on the occasion of international summit and ministerial meetings (e.g. the World Economic Forum on East Asia in June, the G-7 meeting in October and the Summit on Financial Markets and the World Economy in November), regarding the experiences Japan has had and the lessons it has learned as a result of its efforts to stabilize the financial system following the collapse of the bubble economy in the 1990s.

(2) In response to the global financial market turmoil, active debates and deliberations are underway on how to stabilize the financial system not only at summits and ministerial meetings but also at a variety of international conferences and by international organizations. The FSA actively participated in these international debates and deliberations while maintaining cooperation with the authorities of various countries. Furthermore, the FSA strengthened its cooperation with foreign supervisory authorities in line with the globalization of financial institutions' business operations and financial transactions.

- The FSA quickly and steadily implemented measures that authorities were urged to implement in a report issued in April 2008 by the Financial Stability Forum.
- In May, the FSA joined the Senior Supervisors Group, which comprises the supervisory authorities of major countries and which concerns major LCFIs (large and complex financial institutions), and exchanged opinions and information with foreign authorities.
- The FSA established supervisory colleges comprised of major relevant foreign authorities to large financial institutions based in Japan.

#### **4. Enhancing Research Functions for Prompt Recognition of Market Developments**

(1) The FSA established the Office for Supervisory Policy, Financial Market & Risk Analysis in July 2008 in order to promote the advancement of risk analysis, such as the timely identification of market trends and risk characteristics through the collection and analysis of indexes and other statistical data related to financial institutions and an exchange of opinions with working-level officials of financial institutions and market participants. Inspection departments made efforts to identify important risks in light of the scale and characteristics of individual financial institutions and used their analysis results in actual inspections.

(2) In cooperation with the Bank of Japan, the FSA devoted efforts to identify the conditions of the short-term money markets as well as the markets for corporate bonds and CP (commercial paper). The information thus collected was shared throughout the FSA.

(3) The FSA, with the Ministry of Finance, established a new information-gathering service regarding the provision of financing by financial institutions (called "Daijin Meyasubako," or the Minister's mailbox for facilitation of financing), which directly reports the complaints and requests received to the Minister of State for Financial Services (who holds concurrently the Minister of Finance), and reflected the information collected through the service in its inspection and supervision as

necessary and appropriate. Information regarding financing for SMEs was shared with the Small and Medium Enterprise Agency.

## **5. Redoubling Efforts for Human Resource Development**

(1) In July 2008, the FSA adopted a new personnel appointment policy that gives due consideration to individual FSA employees' knowledge and skills by referring the replies to a career path questionnaire survey, and that assigns young employees to positions requiring a high level of expertise in order to develop their skills and knowledge of such areas.

(2) The FSA improved its in-house training programs so as to better help employees acquire expert knowledge and skills and develop international perspectives and skills, while increasing the number of employees sent as trainees to foreign government agencies, graduate schools in Japan and abroad, and diplomatic missions abroad.

(3) The FSA actively employed professionals, like lawyers and certified public accountants, and the people with the experience of working for private companies. This includes recruiting computer system experts and market risk experts for inspection.

## **III. Progress Status of Efforts to Tackle “Future Tasks” Pointed Out in the Previous Report**

### **1. Efforts to Better Acquaint FSA Employees with the Concept of Better Regulation**

(1) The FSA specified in its Inspection Manuals five items that are particularly important in improving the quality of the conduct of inspections and made efforts to ensure that all inspectors are acquainted with the items and act accordingly. Supervisory departments held training programs intended to ensure that all supervisors are fully acquainted with the aforesaid principles and act accordingly.

(2) The FSA will continue efforts to further ensure that FSA employees are acquainted with the concept of Better Regulation and act accordingly.

### **2. Enhancement of Working-Level Dialogue**

(1) The FSA enhanced dialogue, as shown by an increase in the frequency of hearings regarding the financial results of financial institutions and an extensive exchange of information conducted by the newly established the Office for

Supervisory Policy, Financial Market & Risk Analysis with working-level officials of financial institutions about the institutions' conditions.

(2) In the future, the FSA needs to deepen discussions with financial institutions about the Principles through its dialogue with them and improve the predictability of regulatory actions by enhancing its framework for hearings to identify their points of question regarding the interpretations of laws and regulations.

### **3. Expansion of Opportunities for Disseminating Information**

(1) The Minister of State for Financial Services, the FSA Commissioner and senior FSA officials delivered a variety of speeches (these speeches were frequently delivered in English). The FSA also made efforts to enhance the contents of its Web site, including the revision of the design of its homepage.

(2) The FSA will continue efforts to expand opportunities for disseminating information.