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Financial Services Agency

Annual Supervisory Policies for Major Banks for Program Year 2010¹

The Financial Services Agency (FSA) publishes its Annual Supervisory Policies for Major Banks for each program year so as to clarify its supervisory priorities. This is prescribed in the “Comprehensive Guidelines for Supervision of Major Banks” which show basic approaches for the supervisory process aimed at major banks.

In this Program Year, in accordance with “Basic Concepts on Supervision of Financial Institutions for the Future” as shown below, the FSA will place priority on the areas of 1) performing a smooth financial intermediary function, 2) risk management and stability of the financial system and 3) improving customer protection and convenience for users, and will supervise major banks while striving to have frank and deep discussions with them.

It should be noted that these supervisory policies were drawn up in light of the circumstances that surrounded financial institutions as of August 2010, and may be subject to review as necessary.

1. Environment Surrounding the Financial System, and Basic Concepts on Supervision of Financial Institutions for the Future **(1) Environment Surrounding the Financial System**

Although the Japanese economy has been picking up steadily, it remains in a difficult situation with risk factors from a possible slowdown in the global economy, fluctuations in financial and capital markets and the influence of deflation. Looking at the past year’s environment surrounding the financial system, large growth in fund inflows were seen in emerging economies, supported by their fast economic growth, while in Europe, fiscal problems that started in Greece worsened, and in the U.S., there was growing uncertainty in the economic outlook. In response, there is increased uncertainty in financial and capital markets with larger price fluctuations. Under these conditions, global trends have even greater effects on Japan than before.

In the year ended March 31, 2010, financial results in general greatly improved at major banks thanks to the reduction of credit costs, improved profit on securities, etc. However, conditions require continued observation of risks facing financial institutions.

Also, in the “New Growth Strategy” approved by the Cabinet in June this year, financial institutions are expected to back up and support the real economy and enterprises by providing funds with a focus on future growth potential. In order for financial institutions to play such a role, they must practice risk management as part of

¹ In this document, the term “major banks” refers to the banks commonly referred to as major banks, as well as Shinsei Bank, Aozora Bank, Citibank, and Japan Post Bank.

ensuring financial soundness.

(2) Approach Taken by Supervisory Authority

Amid these circumstances, the FSA is placing better regulation as the basis (engaging in frank and deep discussions with financial institutions, disseminating information to the outside, sharing and linking information on the economic and financial situations in Japan and overseas, and improving the transparency and predictability of regulatory actions) and striving to have it become further embedded and enhanced. In particular, in thoroughly performing a smooth financial intermediary function, and accurately managing various risks, customer protections, etc., financial institutions are strongly expected to be aware of long-term managerial issues. They are also expected to conduct positive managerial improvements, and make appropriate, fast and responsible business judgments under the appropriate leadership of management personnel. To this end, the FSA will take the following approaches as the supervisory authority.

1) Financial Administration with a High Risk Sensitivity

In order to accurately respond to currently conceivable risks, the FSA will gain a deeper understanding of the macro economy and financial and capital markets, and deepen its awareness of how these affect the soundness of financial institutions, so as to identify and understand the risks which accumulate in each financial institution and in the financial system with a forward looking perspective. The FSA will also enhance integration of on-site and off-site monitoring to detect risks at an early stage.

2) Financial Administration from a Citizen's and User's Point of View

The FSA will strive so as to further improve customer protection and convenience for users, by looking at things from a citizen's and user's point of view.

3) Supervisory Response with a Future Outlook

The FSA will strive to take actions that do not stop at short-term responses but that also thoroughly determine the progression of international discussions and consider environmental changes, while at the same time implementing long-term responses with an eye on the future.

4) Supervisory Response which Contributes to Financial Institutions Autonomously Improving Management and Making Better Business Judgments.

The FSA will help financial institutions autonomously improve management and make better business judgments via frank and deep discussions and the distribution of information with financial institutions.

In performing supervision, in addition to these approaches, the FSA will also bear the following points in mind.

- In addition to encouraging closer cooperation among inspection divisions, the Securities and Exchange Surveillance Commission (SESC), the Bank of Japan (BOJ)

and the FSA will also cooperate with overseas authorities via supervisory colleges, and positively contribute to international standards setting bodies.

- The necessity of reports and submitted documents will be periodically reviewed once per year, as part of consideration for reducing the burdens on financial institutions.
- Through the thorough fostering, securing and training of specialized human resources, the FSA will redouble efforts for human resource development.

2. Performing a Smooth Financial Intermediary Function

(1) Promote Initiatives of Financial Institutions for Encouraging Business Sustainability

The New Growth Strategy specifies building a new financial industry capable of providing growth capital that is suited to the category and characteristics of each loan, to support innovation-oriented business management from a long term perspective.

In addition to providing such growth funds, the financial institution provides detailed management advice and support, and exhibits consulting functions which match the borrower's lifecycle (support of startups and new business, support of management improvement, business rehabilitation, and succession of business), this leads to sustainability in the borrower's business, and also enhances the profitability of the financial institution, and consequently contributes to the stability of the financial system.

Considering the above, the FSA will understand the actual status of whether financial institutions:

- 1) are engaged in initiatives which emphasize future growth potential, according to the New Growth Strategy,
 - 2) are developing an organization which can exhibit consulting functions.
- (2) Performing Financial Intermediary Functions for Financing Small- and Medium-sized Enterprises (SMEs), and Loans to Individuals (Housing Loans, etc.)

1) Loans to SMEs

In the previous program year, while making efforts to determine the situation regarding business finance, the whole government including the FSA drew up a variety of plans for smooth finance. Business sentiment in SMEs is now in an improving trend, but they are wary of the outlook, and financial institutions are strongly expected to perform appropriate and positive financial intermediary functions.

Amid such circumstances, the FSA will make efforts while paying attention to the following points.

- While continuing to implement a questionnaire for SMEs, the FSA will further utilize the hotline for smooth finance. Through these kinds of efforts and the inspections, the FSA will have a firm grasp of the details of the financing climate of major banks and the state of borrower companies.
- The FSA will focus on investigating whether a bank makes finance decisions based on the management status and characteristics of borrower companies on an everyday basis, and based thereon, whether a bank makes accurate and detailed business judgments, whether a bank thoroughly gives explanations to customers that cover the actual situations, and whether a bank maintains appropriate management of associated risks.

- The FSA will focus on investigating whether the financial institutions deal properly with borrowers while considering the economic situation the borrowers are in, and whether the financial institutions have developed procedures and arrangements for consultation in response to requests from borrowing companies for changing loan terms etc., based on basic policies which Article 6 of the Act on Temporary Measure for Financial Support for Small and Medium Companies (2009 Act No.96, hereinafter referred to as “SME Finance Smoothing Act”) requires and which each financial institution creates itself.
- For major banks to precisely achieve what is called a good “ability to discern” the state of borrower companies, and to actively exhibit consulting functions, including providing support for management improvement and support for business restructuring, the FSA will aim to positively achieve a financial intermediary function that creates value to increase the added value of borrower companies.
- While linking up with related governmental bodies such as the Small and Medium Enterprise Agency, the FSA will aim for smooth business finance of the Emergency Guarantee System as part of economic measures.

2) Housing Loans

Work will also proceed for housing loans with emphasis placed on the following points.

- The FSA will focus on investigating whether the financial institutions deal properly with borrowers while considering the economic situation the borrowers are in, and whether the financial institutions have developed procedures and arrangements for consultation in response to requests from borrowers for changing loan terms etc., based on basic policies which Article 6 of SME Finance Smoothing Act requires and which each financial institution creates itself.
- In order to obtain customers’ understanding and approval, the FSA will strive to ensure that banks give customers appropriate and detailed explanations.
- Also with regard to new loans, while keeping in mind repayment plans that are not impossible for customers in the future, the FSA will work to ensure a smooth provision of funds with appropriate loan judgments that consider the customer’s economic situation.
- In the case of housing loans insured by group guarantee companies (including the cases in which the guarantee company, etc. obtained housing loans through subrogation), the FSA will focus on examining whether financial institutions are giving guidance to, having dialogues with and making requests of such companies as efforts to properly deal with the facilitation of financing, from the perspective of smooth financing also in such guarantee companies.

3) Efforts for Formation of a Sound Consumer Finance Market

Banks have not always played sufficient roles for loans to consumers (excluding housing loans). From the viewpoint of forming a sound consumer finance market in the medium and long term, there is a need for banks to actively handle loans to consumers.

It is thought that participation by banks for forming a sound consumer finance market will contribute to smooth enforcement of the Amended Money Lending Business Act.

Therefore, for loans to consumers, the FSA will work on supervision with the following points in mind, while considering the aims of the Amended Money Lending Business Act.

- Understand the actual situation as to whether the bank is dealing with consumer loans proactively, considering needs.
- The FSA encourages banks to build suitable screening systems which consider the actual situations of customers, to prevent customers from excess borrowing. The FSA also encourages banks to understand the customer's situation properly when examining a loan, instead of only relying on information of credit information institutions or guarantee examinations of credit guarantee companies, if using such information.

3. Risk Management and Stability of Financial System

Under appropriate management (governance), it is essential that major banks more thoroughly ensure strong and comprehensive risk management. This is necessary not only for the soundness of each financial institution and the stability of the financial system, but also for major banks to perform sufficient financial intermediary functions, providing a stable supply of funds in order to the support growth of the real economy and companies in a changing environment.

With the aim of ensuring that there is a smooth provision of funds to borrower companies while maintaining the financial health of the financial institutions themselves by their proper risk taking under strong risk management, the FSA will encourage autonomous efforts for each management measure while the FSA increases its own risk sensitivity.

In doing so, considering that trends of major banks have large effects on the financial system, the FSA will continue its efforts from the perspective of “macroprudential supervision.” That is, while realizing the strong relationships between trends of the macro economy or financial markets and financial intermediary functions or soundness of bank finance, cooperating with the Bank of Japan, and focusing on the risk concentration situation and course of effects, thereby analyzing and acting from the viewpoint of expectations as to whether the entire financial system will undergo sustainable and stable development. In its actual execution, the FSA will use a method which integrates diverse tools (a “multidisciplinary approach”), such as macroeconomic analysis, monitoring of financial markets, and individual financial institution supervision.

(1) Enhancement of Financial Foundations

Bearing in mind that equity capital is the basis for positive risk taking while also forming the basis of the market's confidence, the FSA will keep an eye on progressions in international discussions and encourage organizations to be strong in terms of equity capital including the securing of certain profits, from the viewpoint of improving the

practical tolerance of future stress.

(2) Improved Risk Management Techniques

1) Under the leadership and strong commitment of management personnel, keep an eye on changes in the environment surrounding the business, such as macroeconomic positions and market environment, including from the perspective of being able to maintain suitable risk-taking even when under stress, and investigate whether a bank is implementing appropriate risk management including stress tests. In doing so, the FSA will check the stress tests from the view point of whether they (a) assume the severest scenarios, not only mild economic recession scenarios, (b) include all exposures which should be included, and (c) do not rely too much on single model or estimation techniques. The FSA will also have thorough, deep and two-way dialogues with major banks on the characteristics and managerial issues of each risk.

2) Shares have a large weight among the risks that major banks possess, and so with regards to each of the directly owned shares and investment trusts including ETFs, as well as employee pension trusts, the FSA will accurately determine any profit and loss or effects on equity capital that arise from market movements, and in cases where risks have become actualized, investigate whether a bank has appropriate management, including tolerance, from a financial viewpoint. Especially for strategically held stocks, there are large risks due to price fluctuations because cutting losses is difficult, etc. Therefore, the FSA will investigate whether the bank has built a risk management system which considers such unique risks.

Also, considering the increased dependence on bonds and other market related earnings, the FSA will continue to watch carefully the status of efforts in major banks regarding the risks of a rise in interest rates.

3) As a lesson of the recent financial crisis, the limits of quantitative risk control techniques, such as economic capital models and VaR, are realized, and further improvements in risk management techniques are necessary. Considering this situation, the FSA will continue holding deep two-way dialogues with major banks on how risk management should be, and work to form mutual understanding.

(3) Responding to Grouping and International Developments

1) In major financial groups formed around major banks, in accordance with organizations becoming complicated and large-sized by expanding their operations to non-banking business, it has become hard to conduct organization-wide risk management, and it has become unclear where exactly in an organization risks are located. Therefore when supervising major financial groups, the FSA will carefully investigate whether an institution is appropriately maintaining comprehensive risk management for the overall group, and also whether management personnel are autonomously and appropriately building an internal control system with regard to conflicts of interest in management or the handling of customer information.

- 2) Considering that major banks desire to actively expand overseas business, the FSA will investigate the management systems for operations at overseas bases, including overseas subsidiaries. The FSA will especially focus on whether there is management of credit concentration risks and appropriate portfolio management by industry and region, including non-Japanese credit. Also investigate whether a comprehensive risk management system including overseas offices is developed and advanced. In doing so, the FSA will cooperate with overseas authorities when the need arises.
- 3) Regarding liquidity management, considering progress in international discussions, the FSA will investigate whether appropriate liquidity management systems are built in major banks. Especially investigate the appropriateness of cross-company liquidity management in the group, and of foreign currency liquidity management.

4. Improving Customer Protection and Convenience for Users

Improving customer protection and convenience for users in financial institutions not only helps to achieve a sound national economy, but it also helps to stabilize Japan's financial systems by increasing citizens' trust in financial institutions. In financial institutions, when implementing strict management of customer information and preventing people from abusing their position of power, and managing conflicts of interest, and also when implementing thorough customer protection based on a sense of security and trust, it is important to make use of originality and ingenuity with the customer's viewpoint in mind, and increase competitiveness by providing financial products and services.

Accordingly, in this program year the FSA will conduct investigations while placing priority on the following points in accordance with guidelines for supervision, aiming to have improved customer protection and better convenience for users in financial institutions.

In doing so, the FSA will respect the autonomous efforts of each bank, and proceed with supervision that places importance on incentives. Accompanying this, the FSA will also pay attention to ensure there are no warped incentives that may arise because financial institutions are pursuing quick profits or because they have conflicts of interest.

Furthermore, as the need arises the FSA will cooperate with the police authorities, and with the Consumer Affairs Agency, an institution for which there are high hopes with regard to its fulfillment of roles in the area of integrated promotion of consumer administration.

(1) Thorough Management of Information Security

Customer information forms the basis of financial transactions, and it is important to strictly manage it also from the viewpoint of protecting personal information. Furthermore, it is important to strictly manage corporate information in order to increase trust in market transparency and fairness. From these viewpoints, the FSA will firmly encourage the appropriate maintenance of internal control systems for information

security, and the enhancement of rules on professional conduct to prevent inappropriate actions of officers (such as information leaks or insider trading).

In addition, the firewall regulations were revised last year, and a principles-based framework was created to encourage financial institutions to have an autonomous management system to deal with conflicts of interest. With regard to these, the FSA will conduct investigations as to whether banks have made accurate responses concerning improved customer convenience and the prevention of conflicts of interest.

(2) Enhancing System for Providing Explanations to Customers

With regards to sales of products that carry risks, such as investment trusts, structured bonds and derivatives, the FSA will conduct investigations from the viewpoint of whether a bank has built its solicitation and explanation system with consideration for each customer. In particular, investigate whether i) a bank is giving appropriate and flexible explanations to customers based on their knowledge, experience, asset situation, and purpose of investment, with regards to the locations and characteristics of risks so that those customers can make accurate judgments, ii) a bank is making and collecting check sheets as needed to confirm whether the customer understands the content of the explanation.

Also, the FSA will investigate the legal compliance situation regarding the regulation of unsolicited offers, considering the situation of laws and regulations developed.

In addition, the FSA will strongly urge for the development of systems which enable people with visual and other disabilities to feel assured in using financial institution contact points and ATMs, and easily use financial services.

(3) Enhancing Systems for Processing Consultations and Complaints from Customers

It is extremely important to ensure customer trust in financial products and services, and have independent, timely and appropriate consultations and complaint handling, after implementing business management that makes good use of customer needs. From this viewpoint, the FSA will investigate whether banks are maintaining a consultation window, analyzing the causes of consultations and complaints, sharing information within the bank, taking measures and notifications to prevent the recurrence of complaints, and developing an internal controls system properly with which the top management is involved for conducting follow-ups on their implementation status.

The FSA will also investigate whether required systems have been prepared for the start of the financial Alternative Dispute Resolution (ADR) system to be introduced this October.

(4) Preventing Abuse of Financial Functions

In order to ensure security for users, the FSA will verify, based on the following perspectives, whether the major banks' management systems have been developed to prevent financial functions from being abused and to deal with victims properly. In doing so, the FSA will check the management systems to properly confirm customers' identities and to detect transactions that are strongly suspected of being illegal and make

appropriate responses (e.g., freezing of bank accounts).

- 1) Does a bank make efforts in countermeasures to eliminate crimes which harm the assets of others, such as furikome fraud? From the viewpoint of quick recovery of victim's damaged assets, in accordance with the Furikome Fraud Relief Act, does a bank deal with victims properly by halting transactions involving deposit accounts used in crime, providing information to the suspected victim regarding funds remaining in such accounts, distributing funds thereafter, etc.?
- 2) Does a bank make efforts to prevent unauthorized withdrawals from bank accounts by using counterfeit/stolen cash cards, stolen passbooks, and Internet banking? Does a bank pay compensation to victims properly according to the Depositor Protection Act and agreements within the industry?
- 3) Does a bank take actions to prevent money laundering and terrorist financing in domestic and overseas branches, to the extent that it meets international requirements for major banks?
- 4) Does a bank make efforts to cut relationships with antisocial groups, aiming to prevent damage from antisocial groups, with strong awareness in the entire organization including top management?

(5) Ensuring Business Continuity

Financial institutions' systems are essential infrastructure for running a business, and as those systems become more advanced and complex, the effects that system failures have on customer transactions are becoming larger and larger. Considering that major banks are playing core roles in financial systems, with regards to the continuity of each bank's systems, the FSA will confirm whether a bank is conducting appropriate risk management under the leadership and commitment of management personnel. Furthermore, the FSA will also confirm whether a bank is building a system with which it can ensure business continuity in the event of earthquakes or pandemic influenza, etc.