August 28, 2012
Financial Services Agency

Annual Supervisory Policy for Major Banks for Program Year 2012[1]

The Financial Services Agency (FSA) publishes its Annual Supervisory Policy 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" 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 straightforward and in-depth dialogue with them.

It should be noted that this supervisory policy was made considering the circumstances that surrounded financial institutions as of August 2012, and may be subject to review as necessary.

1. Environment Surrounding the Financial System, and Basic Concepts on Supervision of Financial Institutions

(1) Environment Surrounding the Financial System

The Japanese economy, though still in a difficult situation, is recovering moderately owing to such factors as reconstruction demand after the Great East Japan Earthquake. This recovery is expected to take hold firmly. However, at a time when uncertainties involving the European sovereign debt problem remain high, a sense of deceleration is spreading in the world economy. While such overseas economic conditions and their impact on financial and capital markets have posed downside risks for the Japanese economy, attention should be paid to such factors as constraints on electricity supply and the impact of deflation at the same time.

Under such situation, Major Banks secured net profits by reducing credit costs amid a decline in net interest income in financial results in the fiscal year ending in March 2012.

Meanwhile, the world economy has continued to be volatile, and special attention should be thus paid to developments in foreign economic conditions and financial and capital markets. In doing so, amidst today's advancing globalization, it is important to enhance the resilience of the economic and financial system, to minimize effects on our country in the event of any crisis arising from global economic risks. Particularly in Europe, where the sovereign debt problem is growing more serious for some peripheral countries, the sovereign debt crisis is expected by some people to deepen and expand through the spreading of sovereign credit fears to financial markets and institutions, and

[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.

through the subsequent impact on the real economy. In the United States, there is a downside risk stemming from such factors as the continued high unemployment rate and decline of real estate prices. In emerging countries, attention should be paid to such matters as the pace of economic expansion and hikes in real estate and other prices.

Financial institutions should contribute to the restoration and reconstruction of areas affected by the Great East Japan Earthquake and to the revitalization and development of Japan, considering the facts mentioned above. They must do so by securing their financial soundness and making group-wide efforts to appropriately and effectively control various risks while considering the impact that domestic and overseas economic trends, global fund flows, and international commodity market trends could exert on the financial system.

(2) Approach Taken by Supervisory Authority

Under these circumstances, the FSA will continue to make “Better Regulation” (engaging in straightforward and in-depth dialogue with financial institutions, external communications, sharing information and collaboration on the economic and financial situations in Japan and overseas, and improving the transparency and predictability of administrative actions) the basis and strive to have it become further embedded and deepened. For discussions with financial institutions, the FSA will consider utilizing the Public-Private Roundtable.

In particular, in thoroughly performing a smooth financial intermediary function, and protecting customers, effectively managing various risks, etc., financial institutions must be aware of their long-term corporate challenges. Accordingly they are strongly expected to conduct proactive managerial improvements, and make appropriate, prompt and responsible business judgments under the appropriate leadership of management personnel. In doing so, they must pay attention to the increasingly uncertain European situation at present, the fact that the current program year is the final year for the SME Financing Act, and sustained expectations on their continued medium to long-term support for areas affected by the Great East Japan Earthquake and the subsequent nuclear power station accident, with consideration given to the situations of disaster-affected areas and people. To this end, the FSA will continue to take the following approaches as the supervisory authority.

1) Financial Supervision and Administration with High Risk Sensitivity

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

In addition, in order to maintain and secure financial functions even in the event of an unexpected contingency, the FSA will monitor whether financial institutions sufficiently prepare for major risks in their business continuation plans, review these plans as necessary, and conduct relevant training, given the experience of the Great East Japan Earthquake last year (2011), past system glitch cases, and the possibility of future rolling blackouts under constraints on the electricity supply. Given that problems with IT systems at the core of financial services would greatly affect people's daily lives and the economy, the FSA will urge financial institutions to voluntarily check their risk management frameworks for system glitches and will monitor such IT system risks of financial institutions with a heightened alert even in normal times.

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

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

3) Supervisory Response with a Forward-looking Perspective

The FSA will strive to take actions while being aware of the progress in international discussions and closely monitoring any environmental changes. Its actions should thus include not only short-term responses, but also medium and long-term responses with an eye on the future, while considering common structural issues faced by Japanese financial institutions (strengthening profitability of their main business, etc.).

4) Supervisory Response which Contributes to Financial Institutions' Improvement of their Management and Better Business Judgments

The FSA will help financial institutions to improve their own management and make better business judgments via straightforward and in-depth dialogue, and external communication with them. Above all, the FSA will promote exchanges of opinions and other methods to introduce to other financial institutions the innovative initiatives of each financial institution concerning the performance of financial intermediary functions, risk management, improvement in customer protection, convenience for users, etc. The FSA will thereby work to enhance the quality of the entire financial industry.

When performing supervision, in addition to these approaches, the FSA will also emphasize the following points.

- In addition to encouraging closer cooperation internally among the Inspection Bureau and the Supervisory Bureau, and externally with the Securities and Exchange Surveillance Commission (SESC), and the Bank of Japan (BOJ), the FSA will also cooperate with foreign authorities via supervisory colleges, actively contribute to international standard-setting bodies, and exchange information with the Japanese Institute of Certified Public Accountants, etc. Especially in order to promptly and accurately understand IT system risks and the situations faced by financial institutions, and to enable prompt response, the FSA will implement and strengthen monitoring with seamless inspection and supervision, and consider participation by the staff of supervisory divisions in inspections, etc.
- The necessity of collecting reports and submitted documents will be periodically reviewed once a year, as part of consideration for reducing burdens on financial institutions.
- Through thorough fostering, securing, and training of professional human resources,

the FSA will redouble efforts for human resource development.

2. Performing a Smooth Financial Intermediary Function

According to the "New Growth Strategy" decided by the Cabinet in June 2010 and the "Action Plan for the New Growth Strategy" announced by the FSA in December 2010, financial institutions are expected to support the real economy and business enterprises. The financial sector is also expected to lead the economy as a growing industry itself. Furthermore, a financial strategy is cited as one of 11 growth strategies for the further enhancement of growth potential in the "Comprehensive Strategy for the Rebirth of Japan," adopted by the Cabinet in July 2012.

Based on these strategies, more specifically, Major Banks should provide money for growth in line with customer needs and their business plans while closely watching domestic and overseas economic and financial market trends. Specifically, they should expand the supply of growth money to finance corporate growth, revitalization and realignment of business operations and entrepreneurial endeavors while assessing business performances accurately. By doing so, it is important for Major Banks to provide growing industries and markets with the money they want. For example, they are expected to appropriately perform their financial intermediary function to provide risk money to businesses in a start-up stage through equity via fund vehicles.

Considering the above, in this program year, the FSA will supervise the performance of financial intermediary functions by Major Banks from the following viewpoints.

(1) Response to the Great East Japan Earthquake from Financial Aspects

The FSA will check whether each financial institution appropriately responds to consultations and requests for altering lending terms in ways to suit the situation of disaster-affected people. In an effort to handle the overlapping debt problem, the FSA will pay attention to whether each institution promptly and effectively responds to borrowers' consultations and requests based on the Individual Debtor Guidelines for Out-of-Court Workouts as released in July 2011 (particularly, whether each financial institution takes proactive actions, including a positive recommendation for borrowers' utilization of the Guidelines based on a more detailed analysis of disaster-affected people's situations and a sufficient study on optimum solutions meeting borrowers' respective situations).

As reconstruction demand is expected to gain momentum in the future, the FSA will also check whether each financial institution appropriately meets money demand toward restoration and reconstruction, and disaster-affected people's rehabilitation of livelihood and business operations.

(2) Promote Initiatives of Financial Institutions for their Growth Potentials

It is envisaged in the New Growth Strategy, etc. that the financial industry should be organized as being capable of providing growth money that is suited to each characteristic of those receiving support by appropriately combining investment and loans, to support innovation-oriented business management from a longer term perspective. The "Comprehensive Strategy for the Rebirth of Japan" cites a specific financial strategy target of increasing the use of new financing methods (including equity-capital-like-debt borrowings, debt-equity swap, debt-debt swap, asset-based lending, etc.) in FY2020 by 50% from FY2010 (an interim target for FY2015 is a 20% increase from FY2010).

Based on such circumstances, Major Banks are expected to recognize their own roles, adopt business strategies for the medium to long-term improvement of their profitability, and take actions, including the following. Accordingly the FSA will urge each major bank to actively do so.

1) Appropriate and fine-tuned responses that are fully based on situations of regional economies and customer corporations' roles in regional economies, and closely meet customer needs (including responses that Major Banks may make in cooperation with other financial institutions to meet customer needs through improvement of business management, revitalization and realignment of business operations, and support for entrepreneurial activities)
2) Using investment subsidiaries, equity funds, etc. to support corporate growth (including entrepreneurships, start-ups and new project launchings), business realignment and other efforts,
3) Proactive utilization of diverse financing methods (including equity-capital-like-debt borrowings, debt-debt swap, debt-equity swap, and asset-based lending)
4) Supporting Japanese companies' expansion into Asian and other foreign markets
5) Enhancing financial services for Japanese and non-Japanese customers in Asia and other foreign markets
6) Enhancing project financing and other finance for infrastructure development, etc.
7) Appropriate provision of services using electronically recorded monetary claims

(3) Perform Financial Intermediary Functions for SME Finance, and Loans to Individuals (Housing Loans, etc.)

With the recognition that SMEs were continuing to face severe business conditions, the SME Financing Facilitation Act was revised in March 2012 to extend its expiration again for one year until the end of March 2013. With the awareness that this year is a very important year for strongly promoting the exit strategy for the support of real improvement of SMEs' business profiles, the FSA will take the following actions in relation to bank loans to SMEs and to individuals (including residential mortgages), based on such guidelines as the "Policy Package for Management Support to SMEs" compiled in April 2012.

1) Loans to SMEs

・ In order to establish a cycle where financial institutions can boost their profitability and financial soundness by improving borrowing enterprises' debt servicing capacity through the future expansion of sound money demand, the FSA will verify whether financial institutions are actively performing consulting functions for enterprises to make them aware of their business issues and make efforts for business improvement and recovery, while cooperating as necessary with outside experts and organizations (including SME Business Rehabilitation Support Cooperatives and the Enterprise Turnaround Initiative Corporation of Japan), such as SME groups and other financial institutions, Credit Guarantee Associations, etc.

- In particular, for borrowing enterprises that allowed changes to their loan terms or other measures based on the SME Financing Facilitation Act, the FSA will intensively verify while their repayment burdens are eased, whether they are devising highly viable and drastic business rehabilitation plans, and whether their lenders are cooperating sufficiently with other financial institutions and appropriately with outside organizations (especially the SME Rehabilitation Support Co-operatives and the Enterprise Turnaround Initiative Corporation of Japan for cases where coordination is required between creditors due to seriousness in financial deterioration of borrowing enterprises) in business turnaround , etc. for such borrowing enterprises.
- As for new loans, the FSA will encourage financial institutions to facilitate their provision of money to customer enterprises through their finely-tuned lending decisions based on their accurate assessment of these customers' business values, future growth potential, etc.
- The FSA will verify whether Major Banks are implementing appropriate initiatives to establish loan practices which in principle do not require third party joint and several guarantee, except managers of the borrower company, and to consider the guarantor's abilities to pay when executing guarantee obligations. The FSA will particularly verify whether there are objective and rational reasons for signing such a contract (ie., third party joint and several guarantee), and whether a contracting party agreed with this contract terms based on his/her voluntary will and thus it is confirmed in writings that it is due neither to pressure nor to demands from the financial institution, in cases where such contracts are signed in exceptional circumstances by a third-party that does not substantially participate in the management of the company.

2) Housing Loans

- The FSA will intensively verify whether, in response to requests from borrowers for changing loan terms, etc., the financial institutions deal properly with borrowers while fully considering the economic situation the borrowers are faced with, and considering the objective of the SME Financing Facilitation Act, etc. Especially regarding lending rate reductions, the FSA will check whether the financial institutions do not plan to take inappropriate measures, such as a uniform refusal to reduce lending rates and whether they provide appropriate explanations to customers.
- The FSA will strive to ensure that banks give customers appropriate and detailed explanations in order to obtain customers' understanding and consent.
- Also with regard to new loans, the FSA will encourage financial institutions to maintain smooth financing with appropriate loan judgments that take account of customers' situations, including their economic circumstances, in view of repayment plans that would remain feasible for customers even after taking into account effects of interest rate fluctuations.
- In the case of housing loans insured by group guarantee companies (including cases where a guarantee company, etc. acquires housing loan claims through payment in subrogation), the FSA will intensively verify whether financial institutions are giving guidance to, having dialogue with, and making requests to such guarantee companies so as to ensure that they properly deal with the facilitation of financing.

3) Efforts for the Formation of a Sound Consumer Finance Market

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. Therefore, the FSA will continue its work from the previous program year on supervision for loans to consumers with the following points in mind.

- Understanding the situation as to whether banks are dealing actively with consumer loans, considering their own needs.
- Encouraging banks to build up appropriate screening systems which consider the situations of customers, in order to prevent customers from being entangled with excess borrowing. The FSA also encourages banks to properly grasp customers' situations on their own for loan examination, instead of relying solely on information from credit information institutions or guarantee examinations of credit guarantee companies even when using them.

3. Risk Management and Financial System Stability

As sovereign debt problems in European peripheral countries get serious, the crisis could further deepen and expand due to sovereign credit concerns spreading to overall European financial markets and institutions, and thereby impact the real economy.

Under such a situation, the FSA will, with a heightened sense of alertness, supervise risks facing Major Banks, in terms of the macro-prudential viewpoints as given below:

(1) Supervision based on the macro-prudential viewpoints

It is vital that Major Banks ensure robust and comprehensive risk management thoroughly under appropriate management control (governance). This is necessary not only for the financial soundness of each financial institution and overall stability of the financial system, but also for Major Banks to fully perform financial intermediary functions by providing a stable supply of funds to support the growth of individual companies as well as the real economy in a changing environment.

It is important for the FSA, while enhancing its own risk sensitivity, to encourage voluntary efforts by individual financial institutions toward appropriate risk taking backed by robust risk management, thereby achieving a smooth provision of funds to borrower companies and the financial soundness of financial institutions at the same time.

To this end, it is critical for the FSA, as its basic stance for supervision, to continue to analyze and supervise from the macro-prudential perspective; striving to monitor whether the entire financial system would develop in a sustainable and stable manner. In doing so, the FSA will recognize strong feedback loops between trends in the macro economy/financial markets and financial intermediary functions/soundness of banking and will pay particular attention to the situation of risk concentration and the channel of propagation, through cooperating with the Bank of Japan. In its actual execution, the FSA will continue to employ a variety of methods which integrate diverse tools such as macroeconomic analysis, monitoring of financial markets, and supervision of individual financial institutions (i.e., "multidisciplinary approach").

1) Risk Areas Requiring Special Attention

- The FSA will continue to be vigilant over possible impacts of the European sovereign debt problem on the financial system and the real economy, as well as any effects of recent trends in U.S. economic and financial developments, and trends in China and other emerging markets, etc. on Major Banks.
- As sovereign risk attracts attention in Europe and the rest of the world, debts held by banks, particularly government bonds, have increased in the share of overall bank assets. Under the situation, the FSA will continue to closely monitor and verify Major Banks' risk management systems, for example in terms of whether they consider the potential impact of increases in long-term interest rates and whether they have enhanced their capital sufficiently as absorbency of potential losses.
- As for housing loans, in view of their product characteristics and the intensifying competition among financial institutions, the FSA will verify whether Major Banks have established a risk management system that takes into account not only the management of payment in arrears, but also default risk stemming from interest rate fluctuation, prepayment trends, and peculiarities of housing loans (e.g., default tends to occur after a certain period of time from loan underwriting).
- Risk of equity holdings could weigh more on Major Banks than other risks to which they are exposed. In this vein, the FSA will continue to verify, with regards to shares, etc. held by banks, whether possible impacts of market fluctuations on their incomes and capital are accurately identified and whether financial robustness would be appropriately maintained even if such risk materializes. The FSA will also monitor progress in reduction by Major Banks of their holdings in strategically-held stocks.
- As a crisis deepens further, it is likely that a financial institution could experience tighter liquidity first. As such, the FSA will verify whether Major Banks (particularly including Japanese banks' overseas bases and foreign banks' Japanese bases) have built up an appropriate system for managing liquidity risk associated with foreign currencies, etc. Among others, the FSA in cooperation with the Bank of Japan will verify the appropriateness of group-wide liquidity management (including cross-border liquidity management between a head office and overseas branches), of foreign currency liquidity management, and of a level of necessary liquid asset holdings.

2) Improved Risk Management Techniques

As with risk management techniques, the FSA will verify whether Major Banks appropriately implement not only quantitative risk control techniques (e.g., standard economic capital models and VaR control) but also stress tests covering tail risks. It is also checked whether senior management make effective use of stress testing results. Specifically, the FSA will continue to verify if stress testing and other risk management techniques are conducted, under strong leadership and commitment by senior management, so as to simulate how various events would impact the real economy and financial/capital markets, and to identify how it would directly and indirectly affect bank operations, including in terms of whether an appropriate level of risk taking can be maintained in times of stress.

In doing so, stress tests will be checked relative to the following points:

i) Whether stress tests allow not only for moderate recession scenarios but also for the most severe scenarios (e.g., considering impacts from simultaneous fluctuation of stock prices, interest rates, foreign exchange rates, etc.)
ii) Whether stress tests cover all exposures that should be captured
iii) Whether stress tests are not too dependent on a single model or estimation method

Furthermore, the FSA will continue in-depth two-way dialogue with Major Banks on their risk characteristics and business management challenges.

3) Enhanced Financial Strength

Since capital provides the basis for active risk taking and forms the foundation of market confidence, the FSA will encourage financial institutions to strengthen their capital base, including through securing a reliable stream of profits, in order to improve their resilience and robustness against future stresses, while also considering the new international regulatory framework.

(2) Enhanced Risk Management Systems to Support Initiatives for Stronger Profitability

In light of both the current financial environment and uncertainties over prospects of Japan's real economy, strengthening profitability by banks will likely gain more importance among management challenges for the banking business, in order for them to continue operations on stable footing.

Major Banks are currently striving to strengthen their profitability by expanding their operations in Asia and other regions overseas and by developing business lines outside traditional commercial banking operations such as deposits, loans, and cash settlement. It has also been witnessed that some mergers and acquisitions over foreign financial institutions were undertaken by banks with the aim of effectively expanding their profit opportunities on a group-wide basis.

It is vital that, along with these initiatives, financial institutions build up systems to manage risks appropriately. In this context, it is important to look into how to integrate risk management with profit management as a way to substantially underpin and back up initiatives to strengthen their profitability, instead of looking at risk management as a measure for preventive and defensive purposes.

1) Strengthening of Group-wide Risk Management System

- Large financial groups, being formed around Major Banks, are expanding their operations to non-bank businesses out of the necessity for stronger profitability. Accordingly, it has become their major challenge to accurately grasp differing risk situations in each different business category and to build an optimal risk structure throughout the group. Hence, when supervising large financial groups, the FSA will verify whether comprehensive risk management systems for the overall group have been put in place appropriately.

  Specifically:

  1) the FSA will intensively verify risk governance issues, in particular whether each financial holding company has built a system to effectively manage risk situations (covering administrative, operational, reputational, and other wide-ranging risks), on a group-wide basis, of non-bank subsidiaries (including

securities business subsidiaries) with different business models and corporate cultures;

2) the FSA will verify whether each holding company or parent bank thoroughly implements independent and effective risk management, in view of the current financial conditions, so as to identify unexpected or hidden risks (uncovered risks), particularly in relation to group business operations with risk profiles differing from those for ordinary commercial banking (e.g., securities business with exposure to complex derivative transactions).

- The FSA will also check whether each financial institution has set up an appropriate risk management system to detect and identify risks accompanying new business operations, including through collecting, managing, and utilizing relevant data, before launching them.

2) Approach to Overseas Operations

Major Banks have been attempting to enhance their profitability by actively expanding overseas business operations, including provisions of financial services for non-Japanese customers in Asia and other overseas regions. Against this backdrop, the FSA will verify management systems for business operations by overseas bases (including subsidiaries) in terms of risk management, while closely monitoring management efforts for profitability enhancement. For instance, the FSA will focus its eyes on whether credit risks, including those for non-Japanese customers, are appropriately managed and whether comprehensive risk management systems covering overseas branches and subsidiaries have been developed and upgraded accordingly.

The FSA will also verify whether Major Banks appropriately manage foreign currency liquidity in line with their efforts for boosting overseas expansion. In doing so, the FSA will cooperate with foreign authorities as necessary.

(3) In-depth Supervision of Large, Complex and Internationally Active Financial Institutions

The FSA will conduct more in-depth supervision, particularly of large, complex and internationally active financial institutions, in view of international discussions at the FSB (Financial Stability Board) and other forums, with the abovementioned supervisory key points on risk management systems in mind, and taking into account the following perspectives: i) it will be vital to have effective macro-prudential supervision given their potential impact on the entire financial system, and ii) it will be a priority for those financial institutions to build risk management systems as a way to prop up efforts to further enhance their profitability, looking ahead to the introduction of a new international capital requirement framework. In doing so, the FSA will encourage Japanese financial institutions to strengthen their risk management systems, in comparison with the corresponding risk management systems of foreign financial institutions which are large, complex and internationally active.

The FSA will continue to work on formulating recovery and resolution plans (RRPs) for such financial institutions, while considering the macro-prudential perspective that a crisis at a financial institution in question could impact the entire financial system, and also in light of ongoing discussions at the FSB and other international forums. In addition, the FSA will verify whether enhancements to capacity for collecting data on a group-wide basis is envisaged in their systems, being aware of the emerging global expectation that financial institutions should improve their data collection capacity for timely and appropriate detection of risk information.

The FSA will also conduct more in-depth verification and utilization of stress tests in terms of the impact that a financial institution's operations could have on the entire financial system. Specifically, the FSA will develop a common scenario for the abovementioned key risk areas, request financial institutions to implement such stress tests, the results of which will be verified by us. The FSA will proactively utilize stress tests on those financial institutions from macro-prudential perspectives, while cooperating with the Bank of Japan.

(4) New Entry Banks, Foreign Bank Branches, etc.

1) Besides Major Banks, it is important for new entry banks and trust companies, etc. to work on establishing their new business models, which was expected at the time of new entry into the business, in parallel with having legal compliance systems more embedded. On the other hand, it is also important that they put in place a risk management system which is compatible with their business size and current business model, where they experience a rapid expansion of the business or encounter a deviation from the business model initially planned at the time of entry.

2) It is expected that subsidiaries and branches of foreign banks in Japan add diversity to Japanese markets by providing new services not on offer by Japanese banks, or by supporting foreign companies' activities in Japan. But there is a concern that they may be directly or indirectly controlled by their own foreign head offices beyond the reach of Japanese law, and that regulation and governance within their Japanese branches may not function sufficiently as a result of the management and control styles adopted by their head offices.

In this vein, it is important that subsidiaries and branches of foreign banks in Japan are given sufficient authority and responsibility to establish governance and internal control systems on their own inside the jurisdiction of Japan. It is also necessary for them to thoroughly implement customer protection measures, including by conveying accurate information to customers concerning deposit protection. With these supervisory key points in mind, the FSA will conduct in-depth supervision over them in terms of their governance (management control) and risk management (including liquidity management), while paying attention to international discussions.

In doing so, the FSA will exchange views with senior management at head offices and through the supervisory college and other frameworks with home supervisory authorities, while taking into account the global environment surrounding internationally active financial institutions and domestic discussions at the Financial System Council of Japan.

4. Improvement of Customer Protection and Convenience for Users

Improving customer protection and increasing convenience for users in financial institutions not only contribute to developing a sound national economy, but also helps to stabilize the Japanese financial system by enhancing citizens' trust in financial institutions. It is important for financial institutions to increase their competitiveness by providing original and well-thought-out financial instruments/services that accurately reflect customers' needs. This effort should be backed by a sense of security and trust that could be achieved by thorough protection of customers' interests. In doing so, the management of a financial institution should fully provide his/her leadership in implementing measures such as strict control of customer information, prevention of the abuse of dominant bargaining power, and management of conflicts of interest.

For customer protection, particularly, nominal compliance with laws is insufficient; financial institutions should fully understand the effects and purposes of specific laws, identify compliance levels required by customers and society, as highly public and reliable financial institutions, and meet their expectations.

To this end, a financial institution must discuss and make appropriate judgments as to whether individual financial products and services are suitable for sale and solicitation in light of the attributes of their customers (e.g. knowledge, experience, wealth level, and objective), before developing these instruments and services. In selling and soliciting financial products and services, it is essential to provide appropriate explanations that suit the customers' attributes mentioned above. In addition, financial institutions must recognize that complaints and requests for consultations from customers after sale may provide them with opportunities to discover potential customer needs. Therefore, they must respond to them appropriately and actively.

Considering the above, in this program year the FSA will intensively assess the efforts of financial institutions that aim to improve customer protection and convenience for users, in accordance with its supervisory guidelines. In doing so, the FSA will respect the self-improvement efforts of each bank, and proceed with supervision in a manner that places emphasis on the incentives to make them take such efforts.

Consequently, in this program year, the FSA will also pay attention to (1) under what kinds of management policies, financial institutions are providing what kinds of financial products and services to customers with what kinds of attributes, (2) whether there are warped incentives that may arise due to pursuing short-term profits or the existence of conflicts of interest, (3) whether an internal checking system for employees including executives has been developed to verify that management policies are thoroughly implemented by the sales staff.

Meanwhile, the FSA will cooperate with the police authorities and the Consumer Affairs Agency as necessary.

In the previous program year, particularly, various questions were raised, including trust banks' desirable roles, in regard to the investment and management of pension funds. The FSA will confirm whether trust banks take appropriate actions for securing the reliability of pension fund investment and management and make positive responses to information and consultation requests from customers, in line with the government and the financial industry to prevent pension fund investment and management problems.

Recently, the reported manipulation of the London interbank offered rate (LIBOR) has gained global attention. The reliability of important financial market benchmarks must not be affected. Financial institutions that offer benchmark interest rates must acknowledge the public nature of banking operations and be sure to secure their fairness and transparency. In this respect, the FSA will continue to check internal management systems of financial institutions involved in offering benchmark rates.

(1) Ensuring Business Continuity

1) IT System Inspections, etc.

Computer systems of financial institutions are at the core of the systems that are used to settle accounts. These computer systems have a strong public aspect as social infrastructure. If a failure occurs, it could have a large impact on user convenience and society, and could inevitably lead to the financial institution's losing credibility. Therefore, in the last program year, the FSA encouraged each bank to conduct voluntary inspections under active leadership by the management, regarding the awareness of risks in its IT systems, business strategy on investments for IT systems, risk management to cope with the occurrence of malfunction, etc.

Based on the above, the FSA will verify the following points in the current program year:

i) Whether top managers of financial institutions fully recognize the prevention of computer system glitches and the prompt recovery from such glitches as great business management challenges and have built sufficient relevant systems (for example, whether financial institutions outsourcing computer system management have taken measures such as the appropriate internal distribution of system experts without leaving everything to outsourcees to undertake system management)

ii) Whether financial institutions have identified their data-processing capacities and have considered systemic and administrative responses to cases where demand exceeds capacity limits

iii) Whether financial institutions continuously sort out present underlying system risks and implement methodical investment in system maintenance and improvement

iv) Whether financial institutions make and implement specific plans for the succession of their present systems and technologies, and for the development of relevant experts

v) Whether financial institutions have fully understood the details of outsourced systems, specified how to share roles, responsibilities, etc. with outsourcees in advance and made monitoring arrangements to the system including outsourcees

The FSA will also verify such points as whether top managers identify risks accompanying the replacement and integration of systems, and whether they conduct project management appropriately.

2) Validation of Business Continuity System

Being mindful of the experience of the recent Great East Japan Earthquake, the FSA will verify whether financial institutions conduct self-assessments as to whether their existing business continuity plans have effectively functioned; whether they sufficiently assumed major risks, such as earthquakes and other natural disasters, pandemic influenza and large electricity blackouts; and whether they built up sufficient countermeasures, etc. The FSA will also identify whether financial institutions have confirmed the effectiveness of their BCPs (including securing fuel, staff for continuing business operations, system back-up measures, and customer service regarding clearance, payment, etc.) and have reviewed these systems as necessary through training.

Among measures for the immediate future, financial institutions are implementing electricity-saving measures throughout Japan, including regions covered by Hokkaido Electric Power Co., Kansai Electric Power Co., Shikoku Electric Power Co. and Kyushu Electric Power Co., as electricity supply decreases with nuclear power plants halted. In some regions (including those covered by Kansai Electric), financial institutions are preparing for rolling blackouts as a precaution. The FSA will continue to identify each financial institution's electricity-saving measures this summer and whether business continuity could remain unaffected at system centers and other key business bases. Given that system glitches and other troubles have occurred even in regions other than those subject to rolling blackouts, the FSA will confirm whether financial institutions and their outsourcees check the preparation of BCPs, the establishment of private power generators and back-up centers, and training for securing the effectiveness of BCPs as necessary.

(2) Thorough Management of Information Security

Customer information forms the basis of financial transactions, and it is important to strictly manage it 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 strongly encourage the appropriate maintenance of internal management systems for information security, and the enhancement of rules on professional conduct to prevent inappropriate actions of managers (such as information leaks or insider trading).

Particularly, financial institutions' insider trading is a problem that not only could lead to their groups' loss of trustworthiness, reputation, etc. but also could injure the soundness of the financial system and citizens' trust in the system greatly. In this respect, the FSA will confirm whether financial institutions have built sufficient internal management systems, including the frequency and details of ex post facto checks and reporting to top managers, to prevent illegal acts on a group-wide basis covering subsidiaries, sister companies, trust banking divisions, etc.

After reviewing firewall regulations, the FSA built a principle-based framework of encouraging financial institutions to develop their voluntary conflict-of-interest management systems. In this respect, the FSA will verify whether financial institutions attempt to take accurate measures to harmonize improved customer convenience with the conflict-of-interest prevention.

(3) Enhancement of the System for Selling Risky Products

Regarding the sale of risky products, such as investment trusts, structured bonds and derivatives (including foreign exchange derivatives), and insurance solicitation, the FSA will consider the following points in supervising financial institutions. Given that deposit-handling banks have customers who prioritize the safety of principal, particularly, the FSA will note that the following points cover the development, promotion, and sales of not only the abovementioned products but also other risky products that could lead to a loss of principal.

Problems are still emerging in regard to banks' previous contracts for foreign exchange derivatives against the backdrop of current foreign exchange market conditions, etc. The FSA will check not only whether financial institutions give explanations on losses for worst scenarios when selling these derivatives but also whether they respond carefully and appropriately to customers' claims and consultation requests.

1) Systems for Sale of Investment Trusts, Structured Bonds, Derivatives, Insurance Products, etc.

The FSA will intensively verify whether financial institutions establish and make functioning frameworks for solicitation and explanation to each customer and for follow-up after sales that suit the customer's circumstances and are compliant with regulations on unsolicited offers. In particular, the FSA will especially focus on the following points:

i) Whether financial institutions make appropriate sales preparations, including the targeting of suitable customers according to the risks, complexity and characteristics of the products they develop, promote and sell, and whether they swiftly and appropriately implement sales strategy revisions, including changes of the targeting of customers, in consideration of customer claims, risk fluctuations, etc. even after sales

ii) Whether financial institutions fully confirm customers' investment purposes and intentions so as to identify customer attributes, and make customer cards, so that customers' investment intentions are shared among customers and financial institutions

iii) Whether financial institutions give appropriate and flexible explanations about risks and inherencies of products to customers in light of their knowledge, experience, wealth level, and the purpose of investment, so as to help them make a right decision for each investment (particularly, whether financial institutions give appropriate explanations on profit or loss, sales and promotion fees, and other matters that influence customers' investment decisions)

iv) Whether financial institutions make check-sheets as needed and collect them from customers to confirm their understanding about the contents of explanations

v) Whether financial institutions provide customers with warning documents

vi) Whether the salary and bonus systems of the sales staff and managers are not biased and do not have excessive links to gaining short-term profits

vii) Whether the sales system and product composition do not place too much emphasis on gaining fee earnings

viii) Whether measures are taken to prevent practices or events, such as the abuse of the dominant bargaining position and false recognition by customers with deposits and risky products.

2) Systems for Sale of Currency Selection Type Funds

In addition to the points mentioned above in 1), the FSA will focus on the following points:

i) Whether adequate explanations are provided to customers in sales, in light of the peculiarities and risk characteristics of mutual funds, including those investing in foreign stocks and bonds, currency selection funds, and monthly distributable funds

ii) Whether financial institutions implement prudent sales management, including the requirement for managerial officials' approval on sales of currency selection funds and other high-risk products, particularly for customers who prioritize the safety of principal

iii) Whether financial institutions, when selling or cancelling investment trusts, provide adequate explanations on losses or profits, sales and cancellation fees, trust fund fees and other costs, the possibility of including part or all of dividends in principal repayments, and other key matters that could influence customers' investment decisions (particularly, whether financial institutions provide careful explanations on these points to customers planning to switch from some investment trusts to others, while preventing any unnecessary switching for customers)

iv) Whether financial institutions are doing business from the customer's viewpoint, for instance, creating and providing documents to customers (e.g. prospectus) with easily understood descriptions of information on risk characteristics, fees and dividends

v) Whether financial institutions, when concluding currency selection type fund investment contracts with customers with no experience in investment in such funds, receive customers' statements specifying their understanding of product and risk characteristics, and keep these statements

vi) Whether financial institutions provide customers with finely-tuned investment support, including timely and adequate information in a case where rapid changes in market trends are likely to gravely affect standard sales prices of investment trusts

3) Sales Systems to Corporate Customers (Pension Funds, etc.)

There are differences in knowledge and understanding of financial products between financial institutions and their corporate customers as well as individual customers, in regard to the development, sales, and promotion of the abovementioned financial products and services. Therefore the FSA will check whether financial institutions implement the adequate development and revision of sales strategies, explanations to customers upon sales and solicitation, ex-post follow-up actions based on market environment changes, etc.

Regarding pension fund trusts, particularly, the FSA will check whether trust banks take appropriate measures (including trust banks' cooperation with pension funds in meeting diversified investment requirements and their adequate confirmation of pension funds' suitability for investment) to secure their responsibilities and faithful execution of duties as pension fund investment management trustees. If trust banks undertake asset management alone with investment managed by discretionary investment managers, the FSA will verify whether trust banks appropriately check trust asset investment conditions as third parties.

4) Others

The FSA will strongly encourage financial institutions to develop systems to allow people with disabilities and elderly people to easily and securely utilize financial services through counters and ATMs at financial institutions.

(4) Enhancement of the Framework for Processing Consultations and Complaints from Customers

It is extremely important for banks to have proactive, timely and appropriate consultations and complaint handling, in order to ensure customer's trust in financial products and services, and to positively utilize the customers' needs for better management of business. From this viewpoint, the FSA will assess whether banks develop an internal management system, under the involvement of the top management, for maintaining a consultation counter, analyzing the causes of consultations and complaints, sharing information within the institution, taking measures and notifications to prevent the recurrence of complaints, and following up the implementation of these measures, in an appropriate manner.

Also, in connection with the financial Alternative Dispute Resolution (ADR) system, which was introduced in October 2010, the FSA will carefully watch whether financial institutions are:

i) making sincere efforts for quick dispute resolution, such as active disclosure of required information;

ii) preparing arrangements for facilitating easy use of the system nationwide;

iii) introducing the ADR system to customers as needed when they make consultations; and

iv) providing explanations anew on the ADR system when customers' consent is difficult to obtain between parties or when financial damages are difficult to determine.

(5) Preventing Abuse of Financial Functions

In order to ensure security for users, the FSA will verify, based on the following perspectives, whether Major Banks develop management systems to prevent financial functions from being abused and to take adequate care of crime victims. In doing so, the FSA will check IT systems and other arrangements at financial institutions to properly confirm customers' identities, and to detect transactions that are strongly suspected of being illegal and take appropriate actions, including the freezing of deposit accounts.

1) Do banks make efforts to eliminate crime, including the "Furikome" Fraud, that harms other people's assets? In particular, does the bank place priority on taking measures against Furikome Fraud that misuses earthquake recovery donations? From the viewpoint of prompt recovery of victims' financial damages, in accordance with the Furikome Fraud Relief Act, do banks deal with victims properly by halting transactions involving deposit accounts used in crime, providing information to suspected victims regarding funds remaining in such accounts, and distribute funds thereafter, etc.?
2) Do banks make efforts to prevent unauthorized withdrawals from counterfeit/stolen cash cards, stolen passbooks, and internet banking? Do banks pay compensation to victims properly according to the Depositor Protection Act and agreements within the industry? Do banks make efforts to enhance cooperation with police through such measures as the conclusion of a crime prevention agreement with police in order to respond to various cyber-attacks, etc. based on the fact that the Act on the Prohibition

of Unauthorized Computer Access was revised in May 2012 to toughen penalties for unauthorized access? Do banks adopt appropriate personal identification methods for Internet banking, including variable passwords and electronic certificates that do not depend only on fixed IDs or passwords, to deal with transaction risks in consideration of individual and corporate customer attributes?

3) Do banks develop systems to respond to the revised Act on Prevention of Transfer of Criminal Proceeds taking effect in April 2013 for preventing money laundering and terrorism financing transactions? International discussions on tougher measures against money laundering and terrorism financing transactions have made progress, with the Financial Action Task Force giving a revised FATF recommendation in February 2012. Do banks develop systems for cross-sectional cooperation and information-sharing between relevant divisions for organized efforts to prevent money laundering and terrorism financing transactions?

4) Do banks make appropriate efforts, such as developing procedures and arrangements to cut relationships with antisocial groups, aiming to prevent antisocial groups from damaging the financial institution, managers, and various stakeholders such as customers, with the strong will of top management and entire bank organizations to eliminate antisocial groups from financial transactions? Do banks develop group-wide internal management systems that allow subsidiaries, sister companies, a real estate division for a bank with trust banking services, and other affiliates or divisions engaged in operations other than commercial banking to make the same efforts that the bank makes?