



# FSA Newsletter May, June 2007



Minister Yamamoto gave the lecture at American Chamber of Commerce in Japan (May 21)

## Topics

### [TOPICS]

- Solvency Margin Ratio Calculation Standard .....3
- Amendments to the Comprehensive Guidelines for the Supervision of Major Banks, etc. and Small- and Medium-Sized and Regional Financial Institutions and the Issuance of Requests Concerning Customer Explanations Including Advertising Representations .....5
- Upon Completion of the program for Further Financial Reform .....7
- The Japan-EU High-Level Meeting on Financial Issues .....10
- Background to the 2<sup>nd</sup> Japan-EU Monitoring Meeting on Developments in Accounting and Auditing Issues .....12
- Publication of Hedge Fund Survey Results (2006) .....14
- Revision of Inspection Manual for Deposit-Taking Institutions .....15
- 1<sup>st</sup> Meeting of the International Forum of Independent Audit Regulators(Tokyo Meeting) .....19
- Discussion Held by “Study Group on the Internationalization of Japanese Financial and Capital Markets” .....20

## [TOPICS]

### Solvency Margin Ratio Calculation Standard

The “Program for Further Financial Reform,” published by the Financial Services Agency (FSA) in December 2004, highlighted the need to review the calculation standard for the solvency margin ratio in order to improve insurers’ financial soundness and further optimize their risk management.

In response, (chaired by Takau Yoneyama, professor of the Graduate School of Commerce and Management, Hitotsubashi University), a group comprised of academicians and others as members, began deliberations in November of last year and published a report “Regarding Solvency Margin Ratio Calculation Standards” on April 3.

These deliberations represented the first opportunity for conducting comprehensive discussions on the solvency margin ratio since this ratio was introduced to Japan in 1996. The study group not only deliberated on the method for calculating the solvency margin ratio but also held comprehensive discussions on a wide range of issues such as how to evaluate solvency, how to further optimize insurance companies’ risk management and how to communicate the solvency margin ratio to policyholders.

The following are the major points that were discussed by the study group.

In light of these points, the FSA will conduct deliberations in order to implement specific revisions of the calculation standard for the solvency margin ratio and realize solvency evaluation based on economic value.

#### 1. Outline

##### ○Objectives for reform of Solvency Margin Ratio

<Concerning insurance companies>: to encourage change in the mindset of the management team by providing incentives for implementing measures to make their risk measurement and management techniques more advanced, particularly an implementation of ALM (asset liability management).

<Concerning policyholders>: To communicate the meaning of the solvency margin ratio through public disclosure by insurance companies in order to enhance consumers’ understanding regarding the ratio.

##### ○Improvements in credibility

\*To improve the credibility of the solvency margin ratio of 200% as a trigger point for early corrective action by reflecting the actual status of financial markets and enhancing confidence levels.

##### ○ Direction of solvency<sup>1</sup> evaluation

\* To aim to realize the solvency regime that recognizes the volatility of the net asset, the difference between the value of assets and the value of liabilities (net assets) on an economic value basis<sup>2</sup> as the risk quantity and manages the volatility appropriately.

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<sup>1</sup>Solvency refers to ability to pay insurance benefits.

<sup>2</sup>Evaluation based on economic value means evaluation of the asset-liability cash flow that is consistent with market value.

## **2. Approach to Implementing Specific Revisions**

To continue the use of existing evaluation techniques while improving them up until the introduction of an solvency evaluation based on economic value.

### ○ Approach to specific revisions

\*To update data used as a basis for calculation of the risk coefficients so as to reflect the most recent actual conditions of the market. It is necessary not only to replace old data with new but also to ensure the accountability of the new method so as to obtain public understanding.

\*To consider raise the confidence levels of the risk coefficients so as to improve the credibility of the solvency margin ratio. As a first step, it would be appropriate to raise the confidence level to around 95%.<sup>3</sup>

(Specific revisions)

#### ○Risks

<Assumed interest rate risk> To revise the risk coefficients based on the most up-to-date data, etc.

<Price volatility risk> To examine the risk based on the most up-to-date data after reviewing the confidence level and the measurement period.

<Effects of diversified investment> To consider a method for calculating the effects based on the asset composition ratios of each company.

#### ○Margin (excess ability to make payments)

<Tax deferred assets/tax effect equivalent amount/future profits> It is necessary to consider a certain degree of correction in relation to these items.

## **3. Efforts to Establish Solvency Evaluation Based on Economic Value**

To make constant efforts with a view to realizing solvency evaluations based on economic value by 2010.<sup>4</sup>

(Specific measures)

#### ○ Measure for liability evaluation based on economic value

\*To start work on waking the best estimates of the technical provisions.

#### ○Measure for sophisticating standard approaches

\*To aim to develop a standard approach for measuring interest rate risk, etc. in ways that reflect the ALM of the companies concerned

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<sup>3</sup>With regard to the price volatility risk, the current confidence level stands at 90%.

<sup>4</sup>The year 2010 is regarded as a watershed point for implementing solvency regime based on economic value in Europe.

## **Amendments to the Comprehensive Guidelines for the Supervision of Major Banks, etc. and Small- and Medium-Sized and Regional Financial Institutions and the Issuance of Requests Concerning Customer Explanations Including Advertising Representations**

### 1. Introduction

The Financial Services Agency (FSA) on March 30 revised the Comprehensive Guidelines for the Supervision of Major Banks, etc., the Comprehensive Guidelines for the Supervision of Small- and Medium-Sized and Regional Financial Institutions and the Guidelines for the Supervision of Financial Conglomerates.

Specifically, the amendments concerned:

- (1) provisions for customer explanations (e.g., explanations concerning deposit products involving derivatives transactions (hereinafter referred to as “structured deposits”))
- (2) requests for deregulation (e.g., exemption from notification obligation in regards to the status of the establishment of the internal control system on the occasion of the issuance of new shares through third-party allotment arrangements)
- (3) other areas (amendments to the regulatory criteria concerning business continuity plans formulated by financial institutions, etc.)

These amendments took effect on March 30 (the day on which the amended guidelines were published).

Meanwhile, on March 28, the Fair Trade Commission issued a cease and desist order to a financial institution due to an alleged violation of the ban, under the Act Against Unjustifiable Premiums and Misleading Representations,

on misrepresentation of advantage with regard to the advertising representation of structured deposits. In light of the purpose of the above-mentioned amendment point (1) and this latest case of the alleged misrepresentation, the FSA issued a notice of request to financial institutions and the All Banks Fair Trade Council with regard to customer explanations, including advertising representations.

Here, we will provide background to- and an outline of the amendment point (1) as we can assume that consumer interest in regards to this point is particularly strong.

We will also provide background to- and an outline of the notice of request issued to financial institutions and the All Banks Fair Trade Council.

### 2. Background to and outline of amendments to supervisory guidelines

Structured deposits refer to deposits that involve derivative transactions such as interest rate options and currency options. If structured deposits are, for example, held until maturity, they return higher yields than ordinary fixed term deposits. On the other hand, if they are cancelled prematurely, the depositors in some cases face a high probability of a principal loss as they need to bear the cost of restructuring the derivative transactions involved. With regard to sales (including advertising representations) and explanations concerning risky products, including structured deposits, the FSA called for the enhancement of the arrangement for the provision of explanations and the function of processing consultation requests and complaints as a priority item

under the Guidelines for the Supervision of Major Banks for PY 2006, formulated in August 2006, and is conducting supervision so as to make sure that sufficient explanation is provided so that customers can fully understand the risks involved in financial products as well as the characteristics thereof.

However, as the FSA's Counseling Office for Financial Services Users received information and complaints concerning the handling of premature cancellations of structured deposits, we revised the Guideline for Supervision as follows in order to ensure thorough compliance with rules related to customer protection and to improve user convenience.

(1) Regarding arrangement for providing explanations concerning structured deposits

With regard to structured deposits, the revised guidelines, taking account of the purpose of the provisions of Paragraph 1, Article 12-2 of the Banking Act and Article 13-3 of the Order for Enforcement of Banking Act, point to the need to pay attention to whether there exist arrangements for providing explanations in writing as follows, irrespective of the presence or absence of requests from the customer, except in cases where no problem is recognized in light of the status of the customer knowledge, experience and assets.

- 1) When premature cancellation could cause a principal loss, explanations must be provided with regard to the method of calculating the cancellation refund (together with the refund amount calculated based on assumptions deemed as reasonable in light of the economic conditions at the time of the explanation).
- 2) When the bank has the right to set the maturity date or to choose the currency in which refunds are to be paid, the possibility of the depositor being put at a disadvantage must be explained.

Moreover, the revised guidelines also adopt a new supervisory criteria aimed at judging whether financial institutions, when advising a partner financial institution about its structured deposits based on their partnership contract, provide information concerning the risks inherent to the product as well as the characteristics thereof in an appropriate manner.

(2) Addition of supervisory criteria concerning Article 13-3 of the Banking Act (prohibited acts)

Taking account of the addition of a provision concerning acts which banks are prohibited from engaging in, such as providing customers with false information, the section of the amended guideline that relates to "the arrangements for sales of and explanations concerning deposits, risky products, etc. and functions for handling consultation requests and complaints" requires examination of the possibility of supervisory actions in such forms as demanding reports in cases where prohibited acts, such as the provision to customers of potentially misleading representations, are suspected. A similar requirement was added regarding "the arrangement for customer explanations concerning credit transactions (loan contracts and the accompanying collateral and guarantee contracts) and the functions for handling requests for consultation and complaints."

2. Issuance of Notice of Request to Financial Institutions and All Banks Fair Trade Council

Structured deposits, following the amendment of the section regarding guidelines for supervision in relation to the arrangement for explanations concerning such products, is due to be subjected, under the Financial Instruments and Exchange Act, to restrictive measures such as regulations on advertising, requirements for the

provision of pre-contract-conclusion forms and the suitability rule.

Meanwhile, on March 28 this year, the Fair Trade Commission issued a cease and desist order to a financial institution due to an alleged violation of the ban, under the Act against Unjustifiable Premiums and Misleading Representations, on misrepresentation of advantage with regard to the advertisement of structured deposits. With regard to the advertisement by financial institutions, the FSA in August of last year urged all deposit-taking financial institutions to make thorough efforts to ensure easy-to-understand advertisement so as to prevent the misleading of customers, following a warning issued by the Fair Trade Commission against a financial institution regarding the content of its advertisements. As the latest case of misrepresentation occurred despite this action, the FSA is taking the matter very seriously.

As a result, on March 30, the same day as the date of the revision of the supervisory guidelines, the FSA urged all deposit-taking financial institutions to further enhance their arrangements for customer explanations, including those pertaining to advertising. In addition, the FSA urged the All Banks Fair Trade Council, which has established "rules concerning fair competition in relation to representations in the banking industry," in order to further enhance the standard for easy-to-understand advertisement so as to prevent the misleading of customers.

### **Upon Completion of the Program for Further Financial Reform**

The Program for Further Financial Reform, which covered a two-year period beginning in April 2005, has played an important role in moving Japan's financial regulations from the phase of concentrating efforts on the issue of nonperforming loans to the phase of working towards the establishment of a desirable financial system for the future. The FSA believes that during this process, the objective of the Program for Further Financial Reform has for the most part been achieved as laws such as the Financial Instruments and Exchange Act and the amended Moneylending Business Control and Regulation Law , etc., have been enacted, thus strengthening the market surveillance functions of the above-mentioned regulations.

The FSA believes that continued efforts aimed at tackling new challenges in response to changes in customers' needs are required, both in terms of socio-economic conditions and the financial environment. Major new challenges for the FSA include:

- (1) The further strengthening of the international competitiveness of Japan's financial and capital markets.
- (2) The assurance of thorough customer protection and enhancement of customer convenience.
- (3) The promotion of region-oriented finance.
- (4) The strengthening of governance and assurance of thorough compliance within financial institutions.
- (5) The further amelioration of the credibility of financial regulations and enhancement of human resources.

Although the Program for Further Financial Reform is coming to an end, the FSA will continue to strive to

implement a transparent and credible financial regulatory regime while establishing financial and capital markets that provide a high level of satisfaction to customers, contribute to regional economies and attract overseas investors.

The FSA has published the implementation status of various measures in the past two years. The following are major measures implemented during the period in question.

Implementation date	Major measures
June 2005	Drew up and published the “Guidelines for Financial Conglomerates Supervision,” which deal with issues that extend across various business sectors by clarifying regulatory viewpoints and points of attention concerning group-based risk management systems (published on June 24, 2005 and amended on May 1 and July 31 of 2006 and on March 30 of 2007).
July	Published “Financial Inspection Rating System for Deposit-Taking Financial Institutions,” which provides graded ratings of inspection results, in order to encourage financial institutions to improve their management systems (July 1).
	Opened “Counseling Office for Financial Services Users,” which single-handedly handles financial service users’ questions, comments and requests for consultation (July 19).
September	Drew up and published “Principles of Financial Regulation and Guidelines for Employees of Regulatory Divisions/Sections (Code of Conduct)” (September 2).
October	Revised the bank agent system through the amendment of the Banking Act in order to enable the designing of programs aimed at providing diverse and high-quality financial products and services (October 26)
	Drew up and published the “Comprehensive Guidelines for the Supervision of Major Banks” (published on October 28, 2005 and amended on March 31 and May 1 of 2006 and on January 23, March 13 and March 30 of 2007)
March 2006	Issued notification concerning First Pillar of Basel II (minimum capital requirements) (March 27).
June	The Financial Instruments and Exchange Act was enacted as comprehensive, cross-sectoral legislation intended to ensure customer protection (June 7).
	Published “Summary of Issues Discussed by Consultative Council on Market Intermediary Function of Securities Companies”, which was compiled based on deliberations on what securities companies should do in order to fulfill their intermediary market function, etc. (June 30).
	Published a summary of issues discussed by “Joint Study Group on Development of Financial and Capital Markets of Asia and Japan,” based on a study on measures aimed at transforming the Japanese market into Asia’s Financial Center”(June 30).
July	Reorganized the Securities and Exchange Surveillance Commission’s Executive Bureau, which previously comprised of two divisions and three sections, into an entity comprised of five divisions overseen by a single senior official, in order to strengthen the enforcement of the surcharge system as well as the execution of operations (July 1).
December	The Act concerning the Establishment of Related Acts in Line with the Enforcement of the Trust Business Act, which includes revision of the Trust Business Act, was enacted as legislation aimed at promoting the utilization of the trust function (December 8).
	The Act to Amend the Money-Lending Business Control and Regulation Law was enacted so as to resolve the issue of multiple debts (December 13).

	Revised the Inspection Manual for Deposit-Taking Institutions so as to deal with Basel II (December 26).
January 2007	Initiated discussion on ways to enhance the attractiveness of Japan's financial and capital markets as an international financial center at the "Study Group on the Internationalization of Japanese Financial and Capital Markets Under the Financial System Council's Sectional Committee on Financial System (January 30).
March	Submitted a "Bill to Amend the Certified Public Accountants Act" to the 166 <sup>th</sup> ordinary session of the Diet in order to enhance the public certified accountant and corporate auditor systems (March 13).
	Submitted a "Bill concerning Electronic Recording of Debts" to the 166 <sup>th</sup> ordinary session of the Diet in order to facilitate fundraising by business operators by specifying rules concerning electronically recorded debt under private laws and requirements for regulation of organizations that conduct electronic record-keeping for information relating to debt (March 14).
	Issued a notice concerning Pillar 3 of Basel II (market discipline) (March 23)
	Put Basel II into effect (March 31).

The Financial Services Agency (FSA) has published a draft of the Cabinet Office Ordinance for the Amendment of Part of the Ordinance for the Enforcement of the Banking Act.

Details of the amendment are as follows:

**1. Attached documents pertaining to the Ordinance for the Enforcement of the Banking Act, Shinkin Bank Act, Act on Financial Business by Cooperatives, Labor Bank Act, Act on Provision of Trust Business by Financial Institutions and Trust Business Act**

**(1) Status of capital adequacy ratios**

Revisions in this regard, including the addition of the item "value obtained by dividing the operational risk equivalent by 8%, etc.," are to be brought into alignment with the enforcement of the Basel II regulatory regime that took effect in the business term ending in March 2007.

**(2) The addition of the notice of attention concerning privately-placed bonds guaranteed by financial institutions**

This notice is to be added in order to indicate the value of privately-placed bonds guaranteed by financial institutions, as institution are now required to offset the acceptances and guarantees for such bonds with the relevant customers' liabilities for acceptances and guarantees and omit these figures from the balance sheets of their account books.

**(3) Other necessary revisions are to be made.**

**2. Attached Tables of the Ordinances for the Enforcement of the Banking Act, Long-Term Credit Bank Act, Shinkin Bank Act, Act on Financial Business by Cooperatives and Labor Bank Act**

The attached tables of the above Acts are to be revised in order to maintain consistency among the items that are required to be published in disclosure reports.

**3. Ordinance for the Enforcement of the The Law Concerning Emergency Measures for the Revitalization of the Financial Functions**

In the case where a financial institution has accepted a privately placed bond guaranteed on its own, the acceptance and guarantee should be offset by the relevant customer's liabilities for acceptance and guarantee. Under Article 4 of the Ordinance for the Enforcement of The Law Concerning Emergency Measures for the Revitalization of Financial Functions, however, the denominator used for the calculation of the ratio of nonperforming loans (loans) includes liabilities for acceptances and guarantees but not those for securities. Since privately placed bonds guaranteed by financial institutions, which are effectively substitutes for loans, should be included in the denominator, the definition of "loans" is to be revised so as to cover such bonds.

## **The Japan-EU High-Level Meeting on Financial Issues**

1. The Japan-EU High-Level Meeting on Financial Issues was held at the offices of the Financial Services Agency (FSA) in the afternoon of March 26, 2007. Such meetings provide the opportunity for Japan and the European Union (EU) to share information concerning financial regulation and, where necessary, to coordinate their positions. From the Japanese side, Deputy FSA Commissioner for International Affairs Junichi Maruyama participated in the latest session and Pierre Delsaux, Director, Directorate-F of DG Internal Market and Services represented the European Commission (EC).

2. First, the FSA explained Japan's preparations for the introduction of Basel II in March 2007 and outlined key points and a detailed implementation schedule of the Financial Instruments and Exchange Act, which was enacted last year.

3. The EC explained the technical measures to be implemented before the Markets in Financial Instruments Directive (MiFID) takes effect in November 2007 as well as the status of progress thereof. It also provided an update on the status of deliberations on cost effectiveness and investor protection in relation to investment funds. With regard to policy concerning credit rating agencies, the EC indicated that the current EU legislative framework is sufficient and that it will monitor the compliance of credit rating agencies with the IOSCO (International Organization of Securities Commissions) code, in cooperation with the Committee of European Securities Regulators (CESR).

4. Both sides recognized that hedge funds, which have been drawing increased interest recently, and the emergence of advanced financial techniques have made significant contributions to the efficiency of the financial system in recent years and agreed on the need to remain vigilant and attentive to the hedge fund industry and the instruments handled thereby, given the strong growth of this industry. The FSA briefed the EC on the results of its second survey on hedge funds (published on March 15, 2007).

5. The FSA and the EC also briefed each other and exchanged views concerning:

(1) The Solvency II initiative for which the EC is to adopt a Directive in July 2007, and (2) XBRL (eXtensible Business Reporting Language), a sophisticated method of financial disclosure, which the FSA is preparing to

introduce.

It should be noted that a press release providing an outline of the meeting was issued on the day after the meeting based on an agreement between the two sides. For details, please access [「Japan-EU High-Level Meeting on Financial Issues」 \(March 27, 2007\)](#) at "Press Releases" of the FSA's web site.

\*The next meeting is scheduled to be held in Brussels (the date of which has yet to be set).

Under the Financial Instruments and Exchange Law enacted in June 2006, listed companies will be subject to the internal control report system, effective from their respective first business years beginning in April 1, 2008. This system obliges managers to issue “assessments” of the effectiveness of their companies’ internal controls in regards to financial reporting and the auditors’ “audits” thereof.

With regard to the internal control report system, the manner in which it is to enforce in practice is drawing considerable interest. The Business Accounting Council (chaired by Hideyoshi Ando, a professor at Hitotsubashi University) conducted deliberations on this system while examining the status of enforcement in the United States, which has already introduced a similar system. On February 15, 2007, the council drew up a standard for assessment by managers and audits by auditors under this system as well as guidelines for applying said standard in practice (hereinafter referred to as the “Practice Standards”) and published these in a position paper.

The Standards and the Practice Standards mandate that internal controls are to be effectively and efficiently established and the status thereof evaluated and audited while simultaneously ensuring the efficacy of this system in securing the reliability of financial reporting without imposing excessive burden on companies and auditors. This system is expected to help improve the reliability of information disclosure as a whole through the enhancement of internal controls due to enforcement activities based on these Standards, etc.

All of the Standards and Practice Standards are comprised of three sections—Establishment of Internal Controls, Assessment and Audits. The Practice Standards cite specific items from the Standards and explain how they are to be applied in practice.

The key points of the Standards and the Practice Standards are as follows:

### **1. Setting an integrated standard for the establishment, assessment and audits concerning internal control over financial reporting**

The manner in which internal controls are to be established, assessed and audited is outlined in an integrated manner, with due consideration of the argument that the internal control report system in the United States may have been enforced in a conservative manner due to the fact that no such standard was available for the establishment and assessment of internal controls and the audit standard has, for practical purposes, been applied as a substitute.

## **2. Providing specific guidance for the establishment of internal controls**

It is difficult to demonstrate in a uniform manner how individual companies should establish and enforce internal controls since optimum methods vary from company to company depending on their individual circumstances, as well as on the nature and scale of the business conducted by the companies in question. Therefore, managers should ideally use creative thinking to come up with appropriate ways of establishing internal controls and exert these effectively in a manner suited to their companies' circumstances.

The Standard and the Practice Standards provide guidance in as specific a manner as possible, complete with numerical examples, with regard to the establishment, assessment and audit of internal controls in relation to financial reporting, while maintaining the basic stance of respecting each company's own creative process.

(Examples of specific guidance)

- Providing examples of the processes necessary for establishing internal controls in relation to financial reporting
- providing examples of assessment items in relation to company-level internal controls
- Specifying judgment methods and criteria for cases of "material weaknesses" that are subject to public disclosure
- Specifying reliability standards for sampling in relation to the verification of the enforcement status of internal controls

## **3. Reducing excessive financial burdens**

Steps have been taken to avoid excessive financial burdens with regard to assessments and audits so as to ensure that internal controls are established, assessed, and audited as efficiently and effectively as possible while seeking to ensure the efficacy of the internal control report system, based on examinations of the status of the equivalent system in the United States.

(Examples of steps aimed at reducing excessive financial burdens)

- Describing methods to determine the scope of the assessment of internal controls in relation to operational processes.
- Specifying appropriate processes for communication between managers and auditors.
- Stipulating that audit plans in relation to internal controls and those for financial statements should be drawn up in an integrated manner and that audit evidence can be used in both.
- Stipulating that records on the assessment procedures can be substituted with existing documents used by the company, which should be supplemented as necessary.
- Stipulating that small-size companies with simple structures should adopt an alternative system to segregation of duties and use outside experts, or take other measures that suit their own characteristics.

Companies to which the internal control report system is applicable are required to establish internal controls in a steady and well-planned manner in order to prepare for the application of the system, due to begin in

companies' respective first business years starting in April 1, 2008. The Practice Standards stress the importance of accurately grasping the risk of misstatements in financial reporting and establishing internal controls so as to prevent such misstatements. With due consideration of the purpose of these Standards, etc, all companies should use creative thinking to establish internal controls in a manner suited to their own circumstances, through such methods as concentrating their efforts on the matters of greatest importance while seeking efficiency with regard to trivial matters

## **Background to the 2nd Japan-EU Monitoring Meeting on Developments in Accounting and Auditing Issues**

The 2nd Japan-EU Monitoring Meeting on Developments in Accounting and Auditing Issues was held in Tokyo on March 23 and 26. This article provides the outline of equivalence assessments by the European Union (EU) on accounting standards and audits as background issues for this meeting.

### **I. Concerning the EU Equivalence Assessment on Accounting Standards**

#### **1. Outline**

The Prospectus Directive (adopted in December 2003), which relates to disclosure at the time of issuance of securities, and the Transparency Directive (adopted in December 2004), which relates to continuous disclosure, required EU companies listed on EU stock markets to use the IFRS (International Financial Reporting Standards), starting in January 2005.

Third-country companies listed on EU stock markets are also scheduled to be required to use the IFRS or "equivalent" standards, and the European Commission (EC) has been proceeding with equivalence assessments in regards to the standards used in Japan, the United States, Canada, etc. Initially, the EC planned to apply the requirement that the IFRS or equivalent standards be used in January 2007. However, it has decided to postpone the application for two years and continue its equivalence assessment until June 2008 in light of progress in the convergence of standards around the world.

#### **2. Recent Movements Concerning EU Equivalence Assessments of Accounting Standards**

Recent movements concerning EU equivalence assessments of accounting standards are as follows:

\*July 2005: The Committee of European Securities Regulators (CESR) published a "technical advice" document concerning equivalence assessments. The CESR recognized equivalence with regard to the Japanese standards as a whole, although it pointed out 26 points of divergence.

\*April 2006: The EC proposed a two-year extension of the equivalence assessment.

\*July 2006: The Business Accounting Council's Planning and Coordination Committee published a position paper entitled "Toward the International Convergence of Accounting Standards."

\*October 2006: The Accounting Standards Board of Japan (ASBJ) published its "Project Plan Concerning the Development of Japanese Accounting Standards -- Initiatives Towards the International Convergence of Accounting Standards in Light of the EU Equivalence Assessment."

\*November 2006: The FSA and the EC held the First Japan-EU Monitoring Meeting on Developments in

Accounting and Auditing Issues.

\*December 2006: The EC decided to extend the equivalence assessment for two years.

\*March 2007: The second Japan-EU Monitoring Meeting on Developments in Accounting and Auditing Issues was held.

### **3. Future schedule**

The schedule for the EU's equivalence assessment on accounting standards is as follows:

\*By April 2007: With regard to the accounting standards used in Japan, the United States, Canada, etc., the EC will compile an initial report on the work schedules of the accounting standard authorities of these countries and report its findings to the European Securities Committee and the European Parliament.

\*By May 2007: The CESR will provide advice to the EC in regards to an equivalent assessment mechanism.

\*By January 2008: The EC will determine the definition of equivalence and decide on the equivalence assessment mechanism.

\*By April 2008: The EC will submit a final report to the European Securities Committee and the European Parliament.

\*By June 2008: The EC will determine the equivalence assessment.

\*In January 2009: The application of the requirement for use of the IFRS or equivalent standards will begin.

## **II. Concerning EU Equivalence Assessment on Auditing**

### **1. Outline**

The EU adopted the Statutory Audit Directive in June 2006. This directive establishes requirements for statutory

audits to be implemented within the EU by auditors following the end of June 2006. To be more specific, the directive establishes requirements for auditor attributes, audit standards and rules concerning independence that must be observed by auditors in the implementation of audits, disclosure requirements for auditing firms and provisions for inspections and supervision by authorities.

Meanwhile, regarding third-country audit firms auditing third-country companies listed on EU stock markets, the directive stipulates that such audit firms (1) must be registered with the authorities of the EU countries and subject to oversight thereby and (2) must be subject to a third-country oversight regime recognized as equivalent to the regime required by the EU directive. The EC is now proceeding with equivalence assessment in this regard.

It should be noted that requirements established by this directive must be put into legislation by the end of June 2008.

### **2. Recent movements concerning EU equivalence assessment on auditing**

Recent movements concerning the EU's equivalence assessment on auditing are as follows:

\*March 2004; The EC published a draft of the Statutory Audit Directive.

\*June 2006: The EC adopted the Statutory Audit Directive.

\*January 2007: The EC published data concerning consultations about detailed rules regarding the implementation of Articles 45-47 of the Statutory Audit Directive.

\*March 2007: Japan sent a letter of comment concerning the above consultations.

\* For details, please access [“The second Japan-EU Monitoring Meeting on Developments in Accounting and Auditing Issues”](#) at [“Press Releases” \(March 27, 2007\)](#) of the FSA’s web site.

## **Publication of Hedge Fund Survey Results (2006)**

The Financial Services Agency (FSA) conducted a survey on hedge fund activities for the first time in 2005 for the purpose of investigating the status of hedge fund investments by domestic financial institutions as of the end of March 2005 and how they had been involved in the establishment and sale of hedge funds over the past five years, and published its findings in the [“Summary of Hedge Fund Survey Results and the Discussion Points”](#) on December 22, 2005.

As regulatory authorities as well as industry officials remained high interest to hedge fund activities thereafter, the FSA conducted a latest survey as of the end of March 2006 in order to update its findings, with the survey results published on March 15, 2007.

1. In the latest survey, the FSA applied the same definition of hedge fund as the one used in the previous survey, whereby a hedge fund is defined as a fund that (1) uses leverage, (2) charges a performance fee and (3) uses hedge fund strategies. The FSA sent a questionnaire to a total of 1,252 financial institutions regulated by the agency, with responses provided on a voluntary basis.

2. The survey showed that as of the end of March 2006, 348 domestic financial institutions held a total of approximately 7.4 trillion yen invested in hedge funds, up about 22% from approximately 6.1 trillion yen at the end of the previous year. As a trend was that a broad range of financial institutions continued to invest in hedge funds, with insurance companies accounting for 26% of the total outstanding investments in hedge funds, with city banks(major banks) accounting for 24%, regional banks for 15% and others (including credit associations and cooperatives) for 20%.

3. With regard to hedge fund sales, 101 domestic financial institutions sold approximately 3.0 trillion yen worth of funds to financial institutions, corporations, individuals, etc. during the period covered by the survey (from April 1, 2005 to March 31 2006), up about 40% from 2.1 trillion yen in the previous year. As a trend of the sales activities was an expansion in sales to individuals, with the proportion of such funds among total sales rising to 20%. Another prominent feature was that more than 50% of hedge funds sold in Japan were foreign-registered funds, registered primarily in the Cayman Islands, as was the case in the previous year.

4. The summary of the latest survey address to the way in which Japanese authorities deal with hedge funds. The FSA does not impose regulations or supervision that specifically targets hedge funds. Nevertheless, the FSA

is engaged in the monitoring of hedge fund activity with a view to (1) providing investor protection, (2) maintaining market fairness and transparency and (3) avoiding systemic risks. Moreover, the FSA is actively exchanging information and views with overseas authorities in this regard on a continuous basis and participating in discussions at international forums such as IOSCO (International Organization of Securities Commissions).

\*For details, please access [“Hedge Fund Survey Results \(2006\)”](#) (March 15, 2007) at “Press Releases” of the FSA’s web site.

## **Revision of Inspection Manual for Deposit-Taking Institutions**

### **1. Introduction**

The Financial Services Agency revised its Inspection Manual for Deposit-Taking Institutions (hereinafter referred to as “Financial Inspection Manual”) and issued the revised edition in the name of the general of the Inspection Bureau on February 16, 2007. Since its formulation on July 1, 1999, the Financial Inspection Manual has been revised several times. The latest revision is an extensive one that involves changes to the structure of the entire manual and the addition of new checklist items. Major characteristics of the revised edition include conformity with Basel II, emphasis on the proactive involvement of the management team in the establishment of the internal control system and the addition of the customer protection management system as a checklist item.

Below, we provide an outline of the revised Financial Inspection Manual.

### **2. Background to Revision of Financial Inspection Manual**

It was necessary to have the Financial Inspection Manual conform to Basel, which was to be introduced in the business year ending in March 2007. Moreover, the FSA believed that revision was also necessary in response to the various changes in the environment surrounding financial institutions over the seven-year period following the formulation of the manual. Therefore, the FSA on October 30, 2006 set up a study group comprised of private-sector business professionals and academics within the Inspection Bureau and the group held eight rounds of discussions. At the same time, the FSA published a draft of the sections of the revised manual pertaining to Basel II on November 16, 2006 and a draft of the remaining parts on December 26, 2006, and solicited public comments. Having taken account of the comments provided, the FSA completed the revision and published the revised edition on February 16, 2007, issuing a notification of the revisions in the name of the director-general of the Inspection Bureau.

The revisions took effect on April 1, 2007 and are applicable for inspections conducted thereafter. (However, with regards to items that involve account-closing procedures such as asset assessment and loan write-offs/loss provisions, the application begins with the business year ended in March 2007.

### **3. Common Format**

The latest revisions were extensive, due in part to the introduction of a format common for all types of system management inspections, and the contents of the previous manual were reworked so as to conform to this format.

As indicated by the fact that the rating grades used in the Financial Inspection Rating System are determined by the extent of the development of the relevant systems by the management team, the roles and responsibilities of the management team are essential in the development of the internal control system. Therefore, the common format adopted for the revised manual clarifies the roles and responsibilities that must be performed by the management team by dividing each checklist, in principle, into three sections: “I. Development and Establishment of Systems by Management,” “II. Development and Establishment of Systems by Managers” and “III: Specific Issues.”

Moreover, the revised manual attaches importance to internal controls not only for the purpose of establishing management policies, organizational structures and rules but also as a proactive process aimed at consistently improving existing systems.

To be more specific, the revised manual establishes checkpoints from the viewpoint of whether the management team is (1) formulating plans appropriately, (Plan) (2) developing and establishing rules and organizations appropriately (Do), and (3) implementing assessments (Check) and corrections (Action), specifically from the viewpoint of the so-called PDCA cycle.

Should any problem come to light as a result of reviews conducted by way of the use of the check items listed in Part II or III of the checklists, the manual requires that the inspectors exhaustively examine which process of the PDCA cycle has failed to function effectively, thus causing the problem. In addition, if the institution’s management fails to recognize weaknesses or problems recognized by the inspector, the revised manual requires that the inspector explore in particular the possibility that the internal control system is not functioning effectively.

It should be noted that under the revised Financial Inspection Rating System, if the effective functioning of the assessment (Check) and correction (Action) processes are recognized as producing favorable effects, this should be taken into account as a positive element in the rating process.

### **4. Scale-, Nature-, and Risk Profile-Oriented Risk Management Systems**

In the section entitled “Points of Attention for Inspectors” located at the beginning of the revised Financial Inspection Manual, it is noted that “inspectors should take care not to apply the criteria set forth in the check items in a mechanical and undistinguishing manner” with due consideration of the “scale and nature” of the financial institution inspected. It is also pointed out that “even a case where a financial institution does not literally meet the requirement of a check item should not be regarded as inappropriate if the arrangements and procedures put in place by the institution are reasonable from the viewpoint of securing of the soundness and appropriateness of its business and are thus deemed as effectively meeting the requirement or as sufficient in light of the institution’s scale and nature.”

For example, a large part of each checklist is devoted to descriptions related to the “management division,”

and when the management division as such is not in place at the institution inspected, the manual requires that the inspector examine whether the institution's organization is structured so as to sufficiently perform the functions of the management division described and ensure the functioning of the necessary check and balance mechanisms.

In addition, checkpoints for risk management systems underscore the importance of the development by financial institutions of risk management systems suited to their own strategic objectives, the scale and nature of their businesses and their risk profile. In particular, the manual points out that it is not only unnecessary for financial institutions to adopt overly complex or sophisticated market risk measurement and analysis methods in relation to the scale and nature of their business, etc. but it may even be inappropriate for them to do so.

## **5. Summary Contents of Checklists for Management Systems**

The revised manual comprises ten checklist items, up from the previous manual's seven items (See the attachment). The following are the major checkpoints included in the checklists.

### **(1) Checklist for Business Management (Governance) (for Basic Elements)**

Determine whether basic elements such as (1) a business management (governance) system by the representative directors, the non-representative directors and the board of directors, (2) an internal audit system, (3) an audit system by corporate auditors and (4) an external audit system have been implemented and are working effectively, as well as whether the business management (governance) of the institution inspected as a whole is functioning effectively.

### **(2) Checklist for Legal Compliance**

Determine whether the legal compliance system of the financial institution being inspected is functioning effectively across the entirety of the institution's businesses.

Determine whether the systems for implementing identity verification and dealing with suspicious transactions, antisocial forces, illegal acts etc. are functioning effectively.

### **(3) Checklist for Customer Protection Management**

Determine whether the systems for ensuring the following conditions are functioning effectively:

Sufficient customer explanations are provided in an appropriate manner.

Customer consultation requests, complaints, etc. are processed appropriately.

Customer information is managed appropriately with a view to preventing information leaks.

Outsourced business is conducted aptly and related customer information is managed appropriately.

Determine whether the systems for ensuring the protection of personal information, appropriate supervision of bank agents and the prevention of conflicts of interest are working effectively.

### **(4) Checklist for Comprehensive Risk Management**

Determine whether the comprehensive risk management system of the financial institution being inspected is suited to the scale and nature of the businesses of the financial institution in question and its risk profile and whether the system is functioning effectively.

Determine whether the risk management process designed to comprehensively identify, assess and monitor control risks faced by the financial institution being inspected is functioning effectively.

\*When the financial institution inspected uses a comprehensive risk measurement technique that involves quantitative measurements of various risks with a universal yardstick, check whether measurement is conducted appropriately.

#### **(5) Checklist for Capital Management**

Determine whether the system designed to ensure accurate calculation of capital adequacy is functioning effectively.

Determine whether the system for ensuring appropriate assessment of capital buildup is functioning appropriately.

#### **(6) Checklist for Credit Risk Management**

Determine whether the systems for ensuring that borrower screening, loan provision management and problem loan management are functioning effectively.

\* When the financial institution inspected uses a credit risk measurement technique that conducts quantitative measurement of credit risks with a universal yardstick, check whether said measurement is conducted appropriately.

#### **(7) Checklist for Asset Assessment Management**

Determine whether the system for ensuring accurate asset assessment is functioning effectively.

Determine whether the system for ensuring appropriate loan write-offs/loss provisions is functioning effectively.

#### **(8) Checklist for Market Risk Management**

Determine whether the system for ensuring appropriate measurement/analysis of market risks regarding both banking and trading accounts, with the use of market risk measurement/analysis techniques suited to the scale and nature of the financial institution being inspected, as well as its risk profile, is functioning effectively.

\* When the financial institution being inspected uses a market risk measurement technique that involves quantitative measurement of credit risks with a universal yardstick, check whether said measurement is conducted appropriately.

#### **(9) Checklist for Liquidity Risk Management**

Determine whether the system for managing both funding-liquidity risk and market liquidity risk is functioning effectively.

#### **(10) Checklist for Operational Risk Management**

Determine whether the system for managing operational risks in a comprehensive manner is functioning effectively throughout the institution.

\* When the financial institution being inspected conducts measurements of various types of operational risks with a universal yardstick, check whether said measurement is conducted appropriately.

Determine whether all of the systems for managing “administrative risk”, “information technology risk” and “other operational risks” are functioning effectively.

## **6. Conclusion**

The Financial Inspection Manual is intended to serve as a guideline for inspectors in their inspections of financial institutions, and financial institutions, for their part, should operate in a manner suited to the nature and scale of their business based on the principle of self-responsibility and by fully exploiting their resourcefulness and creativity.

The FSA expects to enhance the transparency of the financial regulation by clarifying its inspection checkpoints and thereby sharing points of view on necessary issues with financial institutions. It also expects that increased dialogue between financial institutions and inspectors, as well as enhanced efficiency and effectiveness of inspections due to the use of this manual, will lead to an improvement in financial institutions' internal control systems.

### **1<sup>st</sup> Meeting of the International Forum of Independent Audit Regulators (Tokyo Meeting)**

On March 22-23, the first meeting of the International Forum of Independent Audit Regulators (IFIAR) was held in Tokyo, with Japan serving as host of the gathering. The following is an outline of the IFIAR.

#### **1. Background to the Establishment of the IFIAR**

Since 2001, a string of massive accounting scandals in the U.S. and European markets have prompted global moves to enhance the credibility of markets by strengthening audit regulatory regimes, leading to the establishment of a series of audit regulatory bodies in major countries. In this context, the Financial Stability Forum called for the holding of an international conference intended to enable fledgling audit regulatory bodies to exchange information with one another. As a result, the Meeting of Heads of Auditor Oversight Bodies, in essence the predecessor to the IFIAR, was held in Washington in September 2004. Initially, auditing and regulatory bodies from nine countries including Japan and three international organizations participated in this forum. At its second meeting, the forum was renamed the Roundtable of Independent Audit Regulators, and since then, this group has been holding semiannual meetings. In the meantime, the need has grown, in light of the importance of high-quality audits, for the establishment of an international forum intended to strengthen cooperation among audit regulatory bodies. Therefore, the establishment of the IFIAR was formally approved at the Paris meeting in June 2006.

#### **2. Outline of IFIAR Tokyo Meeting**

The Tokyo meeting, the IFIAR's first gathering since its establishment, was held with the participation of audit regulatory bodies from major countries such as Japan, the United States, Canada and European nations that function independently from the auditing profession. In addition to these IFIAR members, six international organizations participated in the Tokyo meeting as observers, making this the biggest gathering of its kind since the launch of its aforementioned predecessor in 2004.

The Tokyo meeting provided the participants with opportunities not only to report on the status of activities in specific countries but also to exchange views on a variety of issues common to audit regulators in various

countries, such as elements necessary for enhancing the quality of audits, information exchanges among audit regulators and the availability of high-quality audits in situations wherein audit service markets are controlled by a small group of auditing firms. With regard to how to inspect audits and share experiences, which has been one of the major issues for the IFIAR, the participants decided to hold a workshop meeting in the Netherlands at the end of May 2007.

The Tokyo meeting paved the way for future IFIAR activities. The establishment of- and the authority granted to audit regulatory bodies vary from country to country. However, the IFIAR is expected to contribute to the improvement of the quality of audits on a global scale by enabling audit regulators to share their experiences and exchange views among themselves, thus enhancing their cooperation.

### **Discussion Held by “Study Group on the Internationalization of Japanese Financial and Capital Markets”**

The “Study Group on the Internationalization of Japanese Financial and Capital Markets” (hereinafter referred to as “Study Group”), established under the Financial System Council’s Sectional Committee on Financial System, has conducted intensive discussions based on the results of hearings with group members and outside experts, holding a total of 11 meetings since January of this year.

The basic views expressed in the discussions so far conducted are as follows:

- \*The role of asset management and financial services is important in ensuring sustainable growth for Japan’s economy amid the aging of society and the declining birthrate.
- \*It is necessary to enhance the international competitiveness of Japan’s financial market amid intensifying competition among markets around the world.
- \*To do so, it is essential to establish a market that is attractive to both domestic and overseas market participants by further promoting ongoing efforts to reform Japan’s financial and capital markets and by expanding their base.

It was also pointed out that the above-mentioned tasks should be regarded as national priorities as the implementation thereof is expected to bring about the following benefits:

- \* A diverse range of available financial instruments and services will provide investors with a variety of asset management opportunities.
- \* For companies seeking to raise funds, external financing obtained for business expansion will provide them with more growth opportunities.
- \* An increase in investment returns, combined with added value generated by the financial services industry in its role as intermediary, will boost the national income.
- \* The development of the financial and capital markets, through proper utilization of its resource allocation and governance functions, is expected to lead to improvements in the efficiency and productivity of economic

activities and produce positive overall economic results.

Based on the above-mentioned points, the Study Group on April 17 presented “Summary of Issues,” which outlined the findings of the discussions so far conducted.

As the Summary of Issues includes points that must be discussed further, the Study Group plans to hold more in-depth discussions focusing mainly on these points and deliberate on specific measures for enhancing the international competitiveness of Japan’s financial and capital markets.