September 6, 2013
Financial Services Agency

Annual Supervisory Policy for Regional Financial Institutions for Program Year 2013[1]

The Financial Services Agency (FSA) publishes its Annual Supervisory Policy for Regional Financial Institutions for each program year so as to clarify its supervisory priorities. This is prescribed in the "Comprehensive Guidelines for Supervision of Regional Financial Institutions" which show basic approaches for the supervisory process aimed at Regional Financial Institutions.

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 an active financial intermediary function, including management support for small and medium enterprises (SMEs), 2) risk management and stability of the financial system、 and 3) improving customer protection and convenience for users, and will supervise Regional Financial Institutions while striving to have straightforward and in-depth dialogue with them. In addition, FSA will strive to understand conditions and issues facing financial institutions, by enhancing the integration of on-site and off-site monitoring, in accordance with the Financial Monitoring Policy.

It should be noted that this supervisory policy was made considering the circumstances that surrounded financial institutions as of September 2013, and may be subject to review as necessary.

1. Expected roles of Regional Financial Institutions and Basic Concepts on Supervision of Financial Institutions

(1)Expected Roles of Regional Financial Institutions

In view of the economic situations in Japan and overseas, and the market environment changes resulting from the quantitative and qualitative monetary easing by the Bank of Japan (BOJ), etc., it is important for financial institutions to continue to conduct appropriate and forward-looking risk management. At the same time, financial institutions are fundamentally responsible for proactive risk-taking to revitalize real economic activities. To pull Japan out of deflation, financial institutions are expected to enhance their consulting function and their ability to assess business performance accurately under appropriate risk management, and thereby actively provide funds, including new loans, to growing areas. Financial institutions should also gain momentum for their support of

[1] In this document, the term "Regional Financial Institutions" refers to regional banks, second-tier regional banks, *shinkin* banks, and credit cooperatives

improvement of SMEs' business profiles, and reinforcement of business structure. In addition, it is important to provide extensive support for steady wealth buildup in households. In this sense, financial institutions are expected to promote investment products, such as NISAs (the Japanese equivalent of Individual Savings Accounts) to individuals.

Considering the perspective above, it is increasingly important that each financial institution fully recognizes their expected roles, and the management personal should make responsible and prompt business judgments to respond to sudden social and economic changes and to international regulatory reforms. In the meantime, financial institutions should formulate their business strategies for the medium to long-term covering the next 5-10 year period with accurate understandings of the various risks involved.

(2) Approach Taken by Supervisory Authority

Under these circumstances, the FSA as the supervisory authority will confirm whether Regional Financial Institutions, under the appropriate leadership of management personnel, have enhanced their governance and risk management systems, properly verified the sustainability of their business models, and devised short and medium to long-term business strategies, including capital policy. The FSA will push this further through discussions with the management of Regional Financial Institutions, as necessary.

In this program year, 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. To this end, the FSA will continue to take the following approaches as the supervisory authority.

While taking the following approaches, the FSA needs to be aware that financial administration, if implemented through regulations only, may cause distortions in the regulatory regime and result in excessive control, which may negatively impact the real economy. Considering this, the FSA will endeavor to improve the quality of supervisory administration while reducing regulatory costs on a medium to long-term basis by improving the self-discipline of financial institutions and its own capabilities as a supervisory authority. For discussions with financial institutions, the FSA will consider utilizing a Public-Private Roundtable (task force on topics such as "roles of finance and developing new industries in the region," etc.).

① Financial Supervision and Administration with a 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 and analysis 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.

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. In addition, in order to maintain and secure financial functions even in the event of an unexpected contingency, it is important for the FSA to monitor whether financial institutions sufficiently prepare for major risks in their business continuation plans (BCPs), review these plans as necessary, and conduct relevant training, given the experience of the Great East Japan Earthquake (2011) and past system malfunction cases.

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 environmental changes. Its actions should thus include not only short-term responses, but also medium and long-term responses with an eye to the future, while considering the common structural issues faced by Japanese financial institutions (strengthening the profitability of their main business, etc.).

④ Supervisory Response which Contributes to Financial Institutions Autonomously Improving Management and Making 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 level of the entire financial industry.

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

- In order to promptly and accurately understand and enable quick response to risks faced by financial institutions and the financial system, the FSA, as the supervision authority, will cooperate with the Inspection Bureau to improve and reinforce the integration of on-site and off-site monitoring by incorporating the macro-prudential point of view. 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.

・ The FSA will further promote the integrated supervision of Regional Financial Institutions with local finance bureaus that are directly in charge of supervising these institutions, by sharing the same recognition with each bureau concerning managerial issues that each financial institution has been facing. In doing so, the FSA will, in collaboration with its Inspection Bureau, improve the quality of information provided to local finance bureaus for off-site monitoring, including the results of data analysis and information on focuses of supervision, so that each local bureau can deepen the quality of its interviews and other supervisory activities by focusing on the risk profile and financial soundness of each financial institution. The FSA will also endeavor to further advance its supervisory ability by such means as improved business analysis that utilizes the results of interviews and other information reported by local finance bureaus.

・ The necessity to collect reports and submitted documents will be periodically reviewed once a year, as part of consideration for reducing the burdens on financial institutions.

・ Through thorough fostering, securing, and training of professional human resources, the FSA will redouble efforts in human resource development.

2. Performing an Active Financial Intermediary Function, including Management Support for SMEs

To pull Japan out of deflation and achieve powerful growth, financial institutions are expected not only to support business improvement and recovery of customer enterprise, but also to play their primary role more effectively and give strong support for the development and growth of their customer enterprises, by actively providing funds including new loans, while controlling risk appropriately.

As such, it is important to encourage Regional Financial Institutions to become actively involved in the provision of new loans that will likely result in business improvement and recovery, development and growth of customer enterprises, taking into consideration the "Japan Revitalization Strategy" adopted by the Cabinet in June 2013.

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

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

Toward the full-blown restoration of the disaster-affected areas, the financial intermediary function of Regional Financial Institutions will be put to the test. In order to provide effective support, they should make speedy efforts to proactively provide new money in anticipation of customer enterprise’s future expansion, etc. and resolve the so-called double loan problem (the burden of existing loans makes it difficult for borrowers to raise new money).

Recognizing the abovementioned point, the FSA will mainly confirm whether Regional Financial Institutions in the disaster-affected areas provide support—such as recommending and implementing optimum solutions including various public support measures for disaster-affected people after a fine-tuned analysis of the conditions surrounding each disaster-affected person—and whether they proactively take part in the efforts of local governments and other parties to promote extended restoration and revitalization in the disaster-affected areas. Further, as reconstruction demand gets into full swing, the FSA will also check whether each Regional Financial Institution appropriately meets money demand toward restoration and reconstruction, and disaster-affected people’s rehabilitation of livelihoods and business operations.

① Responses to the Double Loan Problem, etc.

i) Utilization of the Corporation for Revitalizing Earthquake Affected Business, Prefectural Industrial Recovery Consultation Centers and Prefectural Industrial Reconstruction Corporations

The FSA will verify whether Regional Financial Institutions are providing careful explanations to disaster-damaged companies about the roles, functions, etc. of the Corporation for Revitalizing Earthquake Affected Business, Prefectural Industrial Recovery Consultation Centers, and Prefectural Industrial Reconstruction Corporations, and consider the proactive utilization of these organizations along with disaster-damaged companies. In doing so, the FSA will also verify whether Regional Financial Institutions positively consider bringing applications for Credit Guarantee Association-guaranteed loans to these organizations with a view to supporting disaster-affected people.

ii) Utilization of the Individual Debtor Guidelines for Out-Of-Court Workouts

The FSA will check whether Regional Financial Institutions analyze further details of disaster-affected people’s situations, provide them with careful explanations about the advantages and effects of utilizing the Individual Debtor Guidelines, and proactively recommend utilization in accordance with their respective conditions.

iii) Appropriate Response to Funding the Needs of Disaster-affected people

The FSA will verify whether Regional Financial Institutions handle the financing requests from disaster-affected people in a cautious manner, giving recommendations to use publicly available support programs, etc., and whether they are making efforts to facilitate financing based on detailed information of disaster-affected people's situations.

In addition to the above points, the FSA will verify whether Regional Financial Institutions proactively provide fine-tuned financial support, including the provision of their own new money and bridge loans to small and medium-sized enterprises that use projects to subsidize the restoration and development of SME group facilities, etc.

As moves are seen to proceed with the project for the promotion of collective relocation for disaster prevention and lift evacuation orders following the Fukushima nuclear plant accident, the FSA will check regional financial institutions' plans for the extended restoration of the disaster-affected areas and encourage them to proactively engage in restoration.

② Appropriate use of the Act on Special Measures for Strengthening Financial Functions (Special Disaster Measures)

As for financial institutions in which the FSA has implemented the government's capital participation under the special disaster measures, the FSA will appropriately follow up on their implementation of business-enhancing plans for continued contributions to the reconstruction of disaster-affected people's businesses and livelihoods, including the utilization of the Corporation for Revitalizing Earthquake Affected Businesses, Prefectural Industrial Recovery Consultation Centers, Prefectural Industrial Reconstruction Corporations, and the Individual Debtor Guidelines for Out-of-Court Workouts. As for cooperative financial institutions in which the government and their central organizations have implemented their joint capital participation under the special disaster measures, the FSA will closely watch how these central organizations provide management support to *shinkin* banks and credit cooperatives, and will further promote cooperation with such organizations.

(2) Promotion of Initiatives of New Loans by Financial Institutions which Emphasize Growth Potential

The FSA will encourage the active involvement of Regional Financial Institutions in the provision of new loans, by verifying their efforts to promote new loans that will likely result in business improvement, business recovery, development and growth of their customer enterprises. The FSA will intensively check the following points.

① Management policies for active provision of new loans (especially lending to SMEs and other small business owners); and how such management policies are disseminated to front line sales staff

② Whether Regional Financial Institutions set their lending policy based on an analysis of the outlook regarding the additional money demand in the economic recovery phase in the future.

③ Whether Regional Financial Institutions regularly conduct analyses regarding business categories and regions with potential growth of money demand, and set their strategy, policy, and specific goals based on the results of such analyses

④ Specific efforts or devices to identify funding needs

⑤ Whether Regional Financial Institutions respond to requests for new loans by borrowers even having changed loan terms or other measures, based on a full understanding of the borrower's financial conditions; in case of denial, whether Regional Financial Institutions clarify specific reasons to the borrower, and whether they do not refuse consultation and requests for new loans solely on the basis of past changes in loan terms.

⑥ Specific efforts or devices by Regional Financial Institutions to execute new financing through performing effective consulting functions aligned with the business life stage of the customer enterprise (support for developing sales channels, expanding into foreign markets)

⑦ Types of new loans that require mortgage collateral and guarantee provided by Credit Guarantee Association or personal guarantee

⑧ Specific efforts or devices for promoting ABL (including the use of electronically recorded monetary claims) and other measures of loans not dependent on mortgage collateral and guarantee, and for utilizing equity-capital-like-debt borrowings

⑨ Details of the credit screening standard for new loans, especially efforts or devices related to credit screening of SMEs and small business owners

⑩ Specific devices (such as qualitative assessment) and efforts for preventing excessive reliance on quantitative credit screening using scoring (screening on P/L and B/S)

⑪ Details of the system for processing complaints and consultation related to new loans

⑫ Whether Regional Financial Institutions consider efforts for promoting new loans when providing performance or personnel evaluations

⑬ Approach to analyze and disclose information in relation to the promotion of new loans and the status of Regional Financial Institutions' portfolios, including the loan-to-deposit ratio

(3) Deepen Region-based Relationship Banking

Regional Financial Institutions, with sufficient human resources and know-how, play a pivotal role in local information networks. Thus, there is strong expectation that they will play a role in not only supplying funds, but also in providing management support to regional SMEs and contributing to the revitalization of regional economies.

Regional Financial Institutions have been making efforts to promote region-based relationship banking. They should continue and reinforce such efforts involving an entire organization, by setting up a business model looking ahead to the future, recognizing that region-based relationship banking is a way to contribute to users, the economy, and society in the relevant region, as well as improving their own financial profiles.

Based on the above, the authorities will focus on the following points in checking Regional Financial Institutions' region-based relationship banking through such measures as various hearing interviews, including those with top managers.

① Demonstrating Active Consulting Functions in Accordance with the Life Stage of Customer Corporations

The FSA will assess whether Regional Financial Institutions find and analyze challenges not only in finance but also in businesses of their customer corporations through continuous daily transactions, while cooperating as necessary with outside experts and organizations, and timely propose optimum solutions according to customers' life stages, etc. in the following manners, and implement such proposals in cooperation with the customers:

・Whether Regional Financial Institutions accurately assess customer corporations' business values, growth potential, etc., provide new money for initiating or expanding new businesses, and provide positive support for new sales channel exploration and business development efforts, including their expansion into Asian markets, as well as identify potential demand based on the above initiatives.

・Whether Regional Financial Institutions provide services that will enhance the value of customer corporations without plunging into a race to cut interest rates.

・Whether Regional Financial Institutions proactively utilize third party viewpoints, expertise, and functions of outside organizations, etc. for cases where customer corporations need support for profit improvement in their main business, business turnaround, business changes, business succession, closure, etc.

② Contribution to Stimulating the Local Economies

The FSA will assess whether Regional Financial Institutions undertake the necessary coordination with local governments, economic organizations, and other Regional Financial Institutions, and proactively participate in efforts by structuring regional revitalization funds, etc. and other regional efforts, in order to develop growth areas and add value through industry accumulation.

In order to enable such contributions, they should attempt to collect regional information, and accumulate knowhow and human resources, etc. through daily and ongoing contact with users, relevant regional organizations, etc., from a medium to long-term perspective.

③ Active Transmission of Information to Regions and to Users

The FSA will verify whether Regional Financial Institutions make efforts to actively provide information concerning the specific goals and the expected outcome of their initiatives related to region-based relationship banking to relevant regions and to users. In addition, the FSA will verify whether the information concerning the initiatives for business improvement of SMEs and revitalization of regional communities is disclosed clearly and specifically for the benefit of the users of financial services, etc., based on the Ordinance for Enforcement of the Banking Act revised this year.

Furthermore, the FSA will work to provide incentives and develop the environment for financial institutions to deepen their initiatives for region-based relationship banking. It will also contribute to the sharing of information and know-how among financial institutions by holding symposiums that provide opportunities for Regional Financial Institutions to explain their own initiatives for region-based relationship banking, and for concerned parties in each region to discuss and evaluate such initiatives. It will also give awards for highly advanced initiatives and those recommended to be widely practiced.

(4) Support for business improvement, etc. to SMEs

This program year is considered crucial for financial institutions to start their full scale support for improvement of SMEs' business profiles, and reinforcement of business structure.

Comprehensive measures taken as the exit strategy of the SME Financing Facilitation Act ("SME Act") are being implemented under strong public-private cooperation. Considering this, each financial institution should work towards real improvement of SMEs' business profiles, by providing greater support for business improvement and recovery, such as support for devising highly effective business rehabilitation plans through performing an active consulting function while coordinating and cooperating with outside experts and other financial institutions.

In doing so, financial institutions are expected to make active and appropriate efforts to invigorate regional economies and facilitate finance in the regions, taking into account the purpose of the Act on Regional Economy Vitalization Corporation of Japan ("REVIC Act").

Needless to say, even after the expiry of the SME Act, financial institutions are continuously expected to provide fine-tuned support for SMEs, endeavor to provide a smooth supply of funds in response to changes in their loan terms, or other measures.

Based on the above, the FSA will confirm the following points.

① 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,

i) 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 REVIC and SME Business Rehabilitation Support Cooperatives), such as SME groups and other financial institutions, Credit Guarantee Associations, etc., and actively coordinating and cooperating through bank meetings, etc. with other financial institutions leading the support for business recovery.

ii) Whether Regional Financial Institutions give appropriate advice on not only financial aspects but also issues concerning the management of the borrower enterprises, such as increasing sales and business succession, focusing on the following:

・Do Regional Financial Institutions proactively utilize third-party viewpoints, expertise and functions of outside organizations, etc. for cases where borrowing enterprises need support for business turnaround, business changes, business succession, closure, etc.? Particularly do they proactively utilize and take cases to SME Business Rehabilitation Support Cooperatives and REVIC considering the purpose of the Comprehensive Measures currently promoted?

・Have they expanded the scope of their support to include small and micro enterprises that are looking for assistance, while cooperating as necessary with outside organizations and experts?

② Whether Regional Financial Institutions provide support to SMEs that allowed changes to their loan terms or other measures with modified lending conditions for devising management reconstruction plans that are truly effective, and periodically follow upon the progress of such plans.

③ In view of the purpose of the REVIC Act, whether financial institutions, in support for business turnaround and business activities for invigorating regional economy, are working in coordination with REVIC and other related organizations to contribute to the invigoration of regional economies and finance facilitation through the improvement of the region's overall economic strength.

④ Whether Regional Financial Institutions, in order to enhance their support for business recovery in each region, are providing support to SMEs via capital injections jointly with other Regional Financial Institutions, REVIC, and the Organization for Small & Medium Enterprises and Regional Innovation (SME Support Japan), and via the business turnaround fund that purchases receivables, and whether they are facilitating corporate growth by way of company foundations, new businesses, and business turnarounds by using investment subsidiaries and equity funds (e.g. the regional revitalization fund).

⑤ Whether Regional Financial Institutions are making efforts to develop and improve the skill sets of personnel who are engaged in business improvement, business turnaround and the primary business of their corporate customers by utilizing the SME Support Japan, SME Business Rehabilitation Support Cooperatives, SME support network, etc.; and whether their performance reviews and personnel evaluation frameworks incorporate efforts for business improvement, etc. as one of the parameters for review/evaluation.

⑥ Whether various financing methods (debt-debt-swaps, including equity-like debt, debt-equity swap and asset-based lending, electronically recorded monetary claims, etc.)

are utilized to facilitate regional finance and provide financial products and services required by the customer.

⑦ As part of their efforts on promoting region-based relationship banking, regional financial institutions are expected to develop and establish their ability to discern the business potential of borrower enterprises, without excessively depending on collateral and guarantees. They should also accurately focus on the business value of borrowing enterprises and contribute to enhancing it.

In view of these points, the FSA will verify whether Regional Financial Institutions are implementing appropriate initiatives to establish loan practices which in principle do not require third party joint and several guarantee, except for managers of the borrowing enterprise, and to consider the guarantor's ability to pay when executing guarantee obligations. The FSA will especially verify whether there are objective and rational reasons for signing such a contract, and whether the contracting party agreed with these contract based on his/her voluntary will and thus it is confirmed in writing 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 who does not substantially participate in the management of the company.

⑧ The Authorized Business Innovation Support Organization System was established in June 2012 to undertake highly specialized SME support by formally authorizing existing SME supporters, financial institutions, tax accountant corporations, etc. as SME support business operators. Since then, various organizations have been operating as authorized supporters. The FSA will confirm whether Regional Financial Institutions are providing support for business improvement of SMEs by obtaining authorization and are actively cooperating with other authorized SME supporters.

⑨ The FSA will conduct questionnaire surveys on SME financing and further utilize consultation desks for the facilitation of SME financing that opened in February 2013 at local finance bureaus and offices and the financing facilitation hotline. Through these efforts and inspections, etc., the FSA will conduct fine-tuned investigations into whether money required in a region is provided smoothly by checking the borrowing/repayment problems of borrowing enterprises and actions taken by Regional Financial Institutions.

(5) Initiatives for Loans to Individuals

① Mortgage Loans

As for mortgage loans, the FSA will specially consider the points listed below.

・The FSA will strive to ensure that banks give customers appropriate and detailed explanations about the characteristics of mortgage loans, including the potential fluctuation of interest rates, in order to obtain customers' understanding and consent, and will confirm whether the financial institutions are making efforts to establish the framework of such explanations.

・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.

・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.

・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 check 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.

② Efforts for 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, etc. 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 financial institutions are dealing actively with consumer loans, considering their own needs.

・Encouraging financial institutions 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 financial institutions 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 Stability of Regional Financial System

The FSA will, with continued close monitoring of the economic and market trends in Japan and overseas, conduct in-depth supervision on the risks facing Regional Financial Institutions, in terms of the macro-prudential point of view as given below. In addition, the FSA, through discussions with the management, as necessary, will encourage Regional Financial Institutions to further review their initiatives for strengthening profitability and medium to long-term business strategies—including overseas strategies.

(1) Supervision Based on the Macro-Prudential Point of View

It is vital for Regional Financial Institutions to 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 Regional Financial Institutions to fully perform financial intermediary functions by providing a stable supply of funds to support the growth of private companies as well as the real economy in a changing environment.

It is important for the FSA, while enhancing its own risk sensitivity as a supervisor, to encourage voluntary efforts by individual financial institutions toward appropriate risk taking backed by robust risk management, thereby achieving an active 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 the situation of macro economy and financial markets, as well as of financial intermediary functions and the soundness of banking, and will pay particular attention to the situation of risk concentration and the channel of propagation.

In supervising Regional Financial Institutions based on the macro-prudential viewpoints, the FSA will carefully consider the possibility that rational behavior of individual financial institutions, may, in aggregate, cause a negative impact on the overall economy ("fallacy of composition").

① Risk Areas which Should be Focused On

・The FSA will properly grasp the possible impacts of the trends in the European sovereign debt problem, China and other emerging markets, U.S. economic and financial developments, on Regional Financial Institutions.

・In the share of the overall assets held by financial institutions remains a large proportions of debts, particularly government bonds. Under the situation, the FSA will monitor risk management systems in financial institutions, for example in terms of whether they formulate portfolio management policy, including plans for bond holding, taking into account the medium to long-term perspective and the market outlook given the BOJ's quantitative and qualitative money easing, of whether they appropriately control the risks involved in the scenario analysis assuming the potential impact of increases in long-term interest rates and market volatility, and of whether they have enhanced their capital sufficiently as the absorbency of potential losses.

・With regard to stocks that are directly held by financial institutions, the FSA will accurately identify any profit and loss that could arise from market movements as well as its effects on the capital adequacy of financial institutions. It will also continue to assess whether regional financial institutions appropriately manage risks, including financial tolerance, in cases where these risks have become actualized. Especially for stocks that are held for strategic reasons, there may be larger risks due to price fluctuations because of their nature, such as that loss-cutting is relatively difficult. Therefore, the FSA will verify whether regional financial institutions have built a risk management system which considers such unique risks. The FSA will also check whether regional financial institutions that hold structured bonds and other complex financial products are prepared to fully understand the characteristics of each product upon purchasing

・The FSA will check whether regional financial institutions conduct appropriate follow-up on the preparation and implementation of highly feasible, fundamental business reconstruction plans including large and complex credits, whether they book appropriate provisions according to customers' situations, and whether they appropriately manage credit risks.

・As for mortgage loans, in view of their product characteristics, the intensifying competition among financial institutions, and market trends, the FSA will check whether Regional Financial Institutions have established a risk management system that takes into account not only the management of payment in arrears, but also losses of loans incurred due to the falling interest rate, prepayment trends, and peculiarities of housing loans (i.e, default tends to occur after a certain period of time from loan underwriting).

・For real estate financing, the FSA will check whether Regional Financial Institutions are making lending decisions and determining lending conditions appropriately by considering the lending period and loan to value (LTV) ratio (ratio of debt—e.g. loan—to the value of the property being financed), while closely monitoring market trends, especially in the three major metropolitan areas where the land price is shifting away from a declining trend and is stabilizing or increasing.

② Improved Risk Management Technique

As with risk management techniques, the FSA will encourage Regional Financial Institutions to appropriately implement not only quantitative risk control techniques (e.g., standard economic capital models and VaR control) but also stress tests to capture tail risks appropriately.

Furthermore, the FSA will continue in-depth and two-way dialogues with Regional Financial Institutions on their risk characteristics and business management challenges.

③ Enhancement of Financial Foundations

As to the capital policy necessary for Regional Financial Institutions in order to perform as appropriate financial intermediary functions in regions, the FSA will encourage regional financial institutions to make efforts to improve and enhance their capital bases in a forward-looking manner, while considering the new international standard, newly introduced from end-March in 2013 and the new domestic standard to be implemented in end-March 2014. In doing so, the FSA will check mainly whether financial institutions seeking to improve and enhance capital bases through the accumulation of internal reserves base their medium to long-term capital policies on highly feasible earning plans reflecting real regional conditions, etc. and whether they work out flexible capital raising plans based on the uncertainties of the earning environment.

Given that the revised Act on Special Measures for Strengthening Financial Functions was implemented in June 2011 and the deadline for applications for the government's capital participation was extended until the end of March 2017, the FSA will encourage financial institutions to utilize the above act (including Special Disaster Measures) when they plan to strengthen their capital position looking ahead to the future.

In terms of *shinkin* banks and credit cooperatives, their respective central organizations complement and support their businesses and play a key role in strengthening their financial foundations through joint capital participation with the government under the Act on Special Measures for Strengthening Financial Function. As such, the FSA as the supervisory authority will closely watch central organizations in relation to their management support for *shinkin* banks and credit cooperatives. Additionally, the FSA will further promote cooperation with these central organizations, including consideration of strengthening the financial bases of their affiliate financial institutions by utilizing the above act.

(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 financial institutions will likely gain more importance among management challenges for the banking business, in order for them to continue operations on stable footing.

In order for financial institutions to strengthen earnings ability steadily, 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 Considering that profits play an important role in preparing against risks, the FSA will verify the profitability status of Regional Financial Institutions.

In doing so, considering the fact that strengthening profitability has been a structural issue for Regional Financial Institutions, the FSA will work to investigate how practical initiatives in region-based relationship banking are specifically positioned in business strategy and business planning in an effort to enhance the earnings base of Regional Financial Institutions from a medium and long-term perspective. The effort of region-based relationship banking includes the support for borrowing enterprises to improve profits in their main business such as obtaining sales channels, etc. and the support for their advance into overseas markets, such as Asia, including financial institution's overseas advance. The FSA will also investigate how this has been practiced at the entire organization level.

② Some Regional Financial Institutions are oriented toward actively developing their overseas operations. The FSA will check the systems for managing the operations at overseas locations of such financial institutions. For example, the FSA will investigate whether there is appropriate risk management, including credits for non-Japanese clients. The FSA will also check whether comprehensive risk management systems have been developed and upgraded, including for overseas locations. In doing so, the FSA will cooperate with overseas authorities where necessary.

③ The FSA will investigate whether Regional Financial Institutions develop appropriate risk management systems, such as arranging, managing, and using related data, to understand and identify the risks which accompany their development of new businesses.

④ In the organizational structure of cooperative financial institutions, such as *shinkin* banks and credit cooperatives, their central organizations play a role in supplementing and supporting the operations of their affiliated financial institutions. Along with scrutinizing their situation, the FSA will further collaborate with the central organizations of *shinkin* banks and credit cooperatives, so that they will be able to fully play such a role for helping these cooperative institutions proactively exercise their financial intermediary functions.

4. Improvement of Customer Protection and Convenience for Users

Improving customer protection and increasing convenience for users in financial institutions not only contributes to developing a sound national economy, but also help to stabilize the Japanese financial system by enhancing citizens' trust in financial institutions.

It is important for financial institutions to ensure the protection of customers' interest and a sense of security and trust. In doing so, managers of a financial institution should fully provide leadership in establishing a solid business system, while 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, and meet their expectations, as highly public financial institutions that are expected to be reliable. 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 important to provide appropriate explanations that suit the customers' attributes mentioned above. At the same time, financial institutions should perform consulting functions properly from the customer’s viewpoint, truly understanding the customer’s needs for asset management, such as life and financial planning.

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, the FSA will intensively confirm the following efforts of financial institutions that aim to improve customer protection and convenience for users. In doing so, the FSA will respect the self-improvement efforts of each bank, and proceed with supervision which places emphasis on the incentives to make such efforts.

(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 impair user convenience and have a large impact on society, and could inevitably lead to the financial institution’s losing credibility.

Therefore, the FSA will confirm whether each financial institution, under active leadership by the management, is making efforts as detailed below.

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

vi) Whether top managers identify risks accompanying the replacement and integration of systems, and whether they conduct project management appropriately.

Further, if system glitches occur, the FSA will also confirm the causes and measures to prevent a recurrence of such glitches by conducting interviews even with outsourcees as needed.

Considering that Regional Financial Institutions have joint centers and other important outsourcees, the FSA will mainly confirm whether Regional Financial Institutions conduct audits on outsourcing contractors and whether appropriate measures are in place to prevent information leaks through outsourcing contractors.

② **Validation of Business Continuity System**

・ The FSA will check whether financial institutions are adequately prepared and able to continue the minimum required operation in a crisis event, including the following.

i) Whether financial institutions set up solid business continuity systems sufficiently assuming major risks, such as earthquakes and other natural disasters, pandemic influenza, and large electricity blackouts

ii) Whether financial institutions review their BCPs in light of experiences in major natural disasters and system glitches in the past, discussion results at the Central Disaster Prevention Council, etc.

・ The FSA will confirm whether business continuity could remain unaffected at system centers and other key business bases. More specifically, 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.

・ Additionally, the FSA will confirm whether financial institutions that offer Internet banking services have an adequate business continuity system in case of emergency.

・ Further, the FSA will check whether financial institutions take security measures for cyber-attacks, prepare systems in case of emergency, including those to minimize damage upon attack, and establish a monitoring and reporting system, etc.

(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, the FSA will confirm whether financial institutions have built sufficient internal management systems, such as reporting to management, to prevent illegal acts on a group-wide basis covering subsidiaries, sister companies, 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 confirm whether financial institutions attempt to take accurate measures to harmonize improved customer convenience with the conflict-of-interest prevention.

(3) Establishment of Systems for People with Disabilities, etc.

The FSA will strongly encourage financial institutions to develop facilities and systems to allow people with disabilities and elderly people to easily and securely utilize financial services through counters and ATMs at financial institutions. Also, the FSA will encourage financial institutions to make positive efforts to encourage their staff to participate in internal and external training and seminars, so they will be able to provide fine-tuned services aligned with the needs of people with disabilities.

(4) 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. It is important for financial institutions to make fine-tuned efforts to secure elderly customers' understanding of the products and risk characteristics, while accurately capturing changes in the level of their ability to make decisions for each investment through following-up carefully after sales.

In the sale of foreign exchange derivatives, the FSA will check whether the financial institutions are selling them appropriately, especially regarding troubles in the past. In addition, the FSA will also 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.

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 not 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.

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 that are compliant with regulations on unsolicited offers, taking into account the supervisory guidelines related to solicitation and explanation. In particular, the FSA will especially focus on the following points:

i) Do financial institutions make appropriate sales preparations, including the targeting of suitable customers according to the characteristics, complexity and risks of the products they develop, promote, and sell? Do 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) Do financial institutions give appropriate and flexible explanations about risks and inherencies of products to customers, providing documents with easily understood descriptions prepared in light of their knowledge, experience, wealth level, and the purpose of investment, so as to help them make the right decision for each investment? Particularly, do financial institutions give appropriate explanations on the product characteristics, price risk, sales and cancellation fees, trust fund fees and other costs, the possibility of including part or all of dividends in principal withdrawn and other matters that influence customers' investment decisions? Further, do 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?

iii) Especially for elderly customers, even if they have enough investment experience, do the financial institutions make fine-tuned efforts to secure their understanding of the products and risk characteristics, and to prevent or detect potential problems at an early stage, at each phase of the transaction (solicitation, order receipt, execution of transaction, and monitoring after execution) for each sales channel (face-to-face, telephone and over-the-counter)? In doing so, do they give advice in detail from the customers' point of view?

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

v) Do financial institutions provide customers with warning documents?

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

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

viii) Are measures 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?

ix) Are the necessary actions, such as system adjustments, taken to prepare for upcoming revisions to the self-regulatory regulations by the Japan Securities Dealers Association and other organizations in relation to the notification system for the total return of investment trusts and other financial products?

② **Systems for Sale of NISA (Nippon Individual Savings Account)**

The NISA system, scheduled to be introduced in January 2014, is expected to offer opportunities for a wide range of households to build-up assets by long-term and diversified investments. Especially, it is a noteworthy system that will support the Japanese people's self-supporting efforts (wealth buildup) to provide for old age and education. However, bank customers are largely retail depositors, who have little experience and knowledge of investment. As such, the FSA will check whether Regional Financial Institutions establish frameworks for explanations to customers and whether they provide and manage financial products that reflect the purpose of the NISA system, in accordance with the supervisory guidelines revised in August 2013.

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.

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

It is extremely important for financial institutions 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 check whether Regional Financial Institutions 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 confirm 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.

(6) Preventing Abuse of Financial Functions

In order to ensure security for users, the FSA will verify, based on the following perspectives, whether Regional Financial Institutions develop management systems to prevent financial functions from being abused in addition to taking adequate care of crime victims. In doing so, the FSA will also 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 financial institutions make efforts to eliminate crime, including the *"Furikome"* Fraud, that harms other people's assets? From the viewpoint of prompt recovery of victims' financial damages, in accordance with the Furikome Fraud Relief Act, do financial institutions continuously 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 financial institutions make efforts to prevent unauthorized withdrawals from counterfeit/stolen cash cards, stolen passbooks, and Internet banking? Do financial institutions pay compensation to victims promptly according to the Depositor Protection Act and agreement within the industry? Do financial institutions make efforts to enhance cooperation with the police through such measures as the conclusion of a crime prevention agreement with the 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 financial institutions take adequate security measures for customer protection, such as adopting 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 the rapid increase in illegal money transfer this year?

③ Do financial institutions develop systems to appropriately execute tasks, such as verification at the time of a transaction, preparation and preservation of such verification and transaction record, and reporting of suspicious transactions based on the revised Act on Prevention of Transfer of Criminal Proceeds ("PTCP Act") enforced in April 2013 for preventing money laundering and terrorism financing of transaction? For account opening requests from corporate customers, financial institutions should remain reasonable and take into account customer convenience by allowing simplified verification by requiring either one of specified documents under Article 4-1 and related ordinance of competent ministries, unless Article 4-2 of the PTCP Act is applicable to the transaction and additional verification is required.

Do financial institutions 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 financial institutions 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 organizations to eliminate antisocial groups from financial transactions? Do financial institutions develop group-wide internal management systems that allow subsidiaries, sister companies, and other affiliates or divisions engaged in operations other than commercial banking to make the same efforts that the financial institution makes?