

Program for Further Financial Reform

— Japan's challenge:

Moving toward a Financial Services Nation —

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Financial Services Agency

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1. Introduction

Japan's financial system is entering a new forward-looking phase aiming at establishing a desirable financial system for the future, having now moved beyond the emergency reaction against the non-performing loans problem by implementing the "Program for Financial Revival" and other measures. This new phase could be described as one in which the attitude of Japan's financial administration toward the financial system changes from an emphasis on "financial system stability" to an emphasis on "financial system vitality." Additionally, as the use of IT in the financial industry progresses, the volume of internet transactions is increasing throughout the entire economy. Based on the changing outlook of the financial environment described above, it is necessary to create a concrete program for financial reform as part of overall structural reform, in order to contribute to sustainable economic growth, and to take accurate steps in response to both Japan's aging population with a falling birthrate, and the further globalization of the economy.

As a vision of a future desirable financial system, we could imagine a system in which any user of financial products and services has access to options for diversified and good-quality financial products and services at anytime, from anywhere, at an appropriate price. Additionally, for financial institutions offering financial products and services, an ideal financial system would be one that is convenient but less costly, and in which they can satisfy users' needs and raise their profitability by fully demonstrating their abilities. In other words, it would be a financial system that is superior in its convenience, price advantage, diversification, international aspect, and reliability, and in which users easily and safely can get the financial products and services they want.

In the process of establishing such a financial system, IT plays an extremely large role. There is significant room to improve users' satisfaction through the use of IT, which means convenient access to financial products and services through new channels such as the internet, a prompt and efficient offering of service and settlement, and a prompt offering of accurate and reliable information, etc. In the future, it is expected that, through the strategic use of IT, a desirable financial system will come to be realized, bringing with it increased convenience due to the diversification of distribution channels, and improved profitability for financial institutions resulting from the reduction of office expenses and other costs.

Taking the change in phase from "stability" to "vitality" into consideration, the financial administration must aim to establish a financial system in which the level of users' satisfaction is high, which is evaluated well internationally, and which is not led by the "public sector," but by the effort of the "private sector." We named this set of financial goals "Japan's challenge: Moving toward a financial services nation," and formulated this program for it. The purpose of this program is to point out a road map for reform which the financial administration should enact over the next two years, the "Concentrated Consolidation Period," in order to create a "financial services nation."

The shift "from savings to investment" will be accelerated through this reform, leading to diversification and efficiency in the means of asset management based on the following two conditions: 1) our financial markets become attractive internationally, and 2) money-flow, which has been too centered on indirect finance, changes to one which can offer options for diversified and high-quality financial products and services to people by utilizing direct and market-based indirect financing. This change can be thought of as contributing to the establishment of an economic structure with flexibility in dealing with risks, and as correcting the financial structure in which risks are concentrated excessively in banks.

In this program, we organized the contents of reform that we should develop in the future in terms of the five following points:

1. Institution building to enhance users' convenience drawing out private-sector vitality, and development and thorough implementation of user protection rules (Emphasis on users' needs and thorough implementation of user protection rules)
2. Strategic use of IT for strengthening the competitiveness of financial institutions and further developing financial infrastructure
3. Further development of a financial system which is internationally open and a financial administration with an international perspective
4. Establishment of a financial system which contributes to the realization of vibrant regional economies (Contribution to regional economies)
5. Establishment of a reliable financial administration that complements market discipline

As the phase of the financial system changes, it is necessary to clarify the basic principles of future financial administration to bring about a "Financial Services Nation" through the effort of the "private sector."

The following points are required as the basic principles of the future financial administration:

1. Thorough implementation of playing a financial administration's role as judge that complements market discipline
2. Establishment of a "Code of Conduct" for financial administration along with a full check of current regulations and repeal of unnecessary regulations
3. Development and thorough implementation of user protection rules so that users do not suffer unexpected losses

Additionally, the financial administration is required to become more transparent and take a leading role in enhancing convenience and efficiency through the promotion of e-government with the use of IT.

Regarding the implementation of this program, the FSA aims to draw up and publish "a work schedule" as a concrete schedule as soon as possible within this fiscal year. Additionally, we will undertake follow-up activity to establish a desirable financial system for users of financial products and services, through a steady implementation of the concrete measures included in this program. In the follow-up activity, we will, for instance, monitor whether indicators like diversification of individual financial assets are increasing or whether people's level of satisfaction with financial products and services is increasing as a result of the increase in the choices available for people's asset management.

2. Concrete measures

I. Creation of a vibrant financial system

(1) Emphasis on users' needs and thorough implementation of user protection rules

- ◇ **Establishment of a regulatory framework that promotes the offering of diverse and high quality financial products and services**
 - The FSA will promote new entrants into the financial industry and sound competition under fair rules so that diverse and high quality financial products and services will be offered timely and appropriately, responding to users' needs. Additionally, the FSA will strive to enhance users' convenience 1) by making it easier for financial institutions to separate providers/retailers and to expand distribution channels, and 2) by making it possible for users to purchase diverse and high quality financial products and services in a convenient and timely one-stop fashion.
 - Enhancement of the provision and distribution framework for financial products and services
 - ✓ Expansion of distribution channels of financial products and services and promoting diversification and price flexibility in insurance products
 - ✓ Approval of proper comparative advertising to promote fair competition
 - Diversification of the method of entry for banks and other financial institutions
 - Effective utilization of the premises and other facilities of financial institutions
 - Expansion of financing methods that do not rely excessively on real estate collateral and guarantees
 - Promotion of both a full check of current regulations and deregulation, in order to meet market participants' needs and promote sound competition as well as the cultivation of new business (Review of the regulations for financial products and services as well as for financial institutions and non-bank financial institutions)

- ◇ **Development and thorough implementation of user protection rules reflecting actual financial conditions**
 - The FSA will strive to establish overall uniform rules for transactions regarding financial products and services, protect personal information, and prevent financial crimes, etc., in order to develop financial rules for user protection reflecting actual financial conditions.
 - Enactment of the "Investment Services Law (tentative name)"
 - Development of rules for insurance transactions
 - ✓ Introduction of protection rules for policyholders of unregulated Kyosai, observance of the suitability principle for insurance contracts, strengthened monitoring of insurance advertisements
 - ✓ Review of the insurance policyholder protection program
 - Clarification of the responsibility for sales and explanations in relation to the separation of providers and retailers
 - Clarification of concrete protection rules for personal information aiming at the appropriate

protection of information, taking the usefulness of information regarding financial products and services into consideration

- Strengthening and thorough implementation of measures for the prevention of financial crimes such as crimes with counterfeit cards

◇ **Strengthening the framework for providing information and counseling in order to protect users**

- The FSA will strive to develop a framework which reduces the information gap between users and providers of financial products and services through strengthening information services for users so that users can conduct transactions with understanding and satisfaction.
 - Development of a counseling and complaint processing system and a dispute-settlement system in financial institutions and administration taking users' points of view into consideration
 - ✓ Establishment of the "Counseling Office for Financial Services Users"
 - ✓ Strengthening an alternative dispute resolution system
 - Expansion of financial and economic education making use of familiar examples, responding to the user's life cycle
 - Enrichment of public outreach by the government taking users' points of view into consideration
 - Establishment of financial institutions management that emphasizes user satisfaction

◇ **Smooth implementation of the scheduled removal of the remaining blanket deposit insurance**

- In order to implement the scheduled removal of the remaining blanket deposit insurance smoothly in April 2005, the FSA will take the following measures to ensure depositors' confidence.
 - Public relations activity for deeper understanding of the system and for penetration of information services
 - Further enhancement of disclosure by financial institutions
 - Ensuring financial institutions' measures for aggregating deposits held by the same party, etc. through inspection and supervision

(2) Strategic use of IT for strengthening the competitiveness of financial institutions and further developing financial infrastructure

◇ **Strategic use of IT**

- The FSA aims at promoting strategic use of IT, taking into consideration the fact that the relative importance of internet transactions has increased while, compared to other countries, Japanese financial institutions have fallen behind in IT investment and IT costs remain high. Additionally, the FSA aims at creating a financial environment in which financial products and services are provided immediately and at reasonable prices responding to users' needs.
 - Study toward legislation concerning e-banking in order to enjoy actively the results of technological

innovation, and to enhance the convenience of financial infrastructure and cost competitiveness

- ✓ Study toward legislation concerning electronic fund settlement and payment, and online financial transactions
- Study of measures to ensure the transparency of the IT investment process of financial institutions, and to encourage improved cost performance and risk management abilities.
 - ✓ Fact finding on both the current status of IT use and the execution of information exchange about system development among financial institutions (implementation of the IT caravan, etc.)
 - ✓ Promotion of low-cost operations through the application of market competition principles, such as introducing assessments by outside experts concerning IT investment, etc.
 - ✓ Establishing a system which contributes to enhancing customer convenience, such as a channel and outlet (branch) strategy that makes use of IT

◇ **Enhancing market functions and improving confidence in markets**

- In order to build a financial system that maximizes the potential of markets operating under the market competition principle, and to meet the wide range of users' needs, such as requests for asset formation based on self-responsibilities, the FSA will encourage the development of financial intermediation and capital distribution that utilizes market functions, improving users' confidence in direct and market-based indirect financing through the enhancement of disclosure.

- Enactment of the “Investment Services Law (tentative name)”(written again)
- Development of collective investment schemes
- Vitalization of private offering markets, including reviewing the definition of qualified institutional investors, etc.
- Further promotion of financial tax reform contributing to the effective utilization of financial assets, such as reviewing the securities taxation system in order to promote long-term investment
- Further enhancement of the corporate disclosure system
 - ✓ Strengthening internal control in regard to financial reporting, enhancing the disclosure of governance information, and implementing quarterly disclosure, etc.
- Strengthening internal control in audit firms, promotion of measures toward preventing conflicts of interest with non-audit operations, and checks by the Japanese government and the Japanese Institute of Certified Public Accountants (including inspections of audit firms by the Certified Public Accountants and Auditing Oversight Board)
- Further strengthening of market supervision and surveillance authorities
 - ✓ Strengthening the administrative civil money penalty system and the enforcement system, unification of market surveillance systems, and appropriate partnerships with self-regulatory organizations

◇ **Enhancing governance of financial institutions and promoting sound competition through highly-developed risk management**

- In order to enhance sound competition and new entry and exit of financial institutions, it is essential to promote the strengthening of the management ability of financial institutions based on their voluntary and sustainable efforts through ensuring self-clearing functions, expanding information disclosure, and ensuring the effectiveness of external audits. Additionally, it is necessary to develop an administrative

framework that complements such market disciplines and to establish an incentive structure.

- Clarifying management's responsibility regarding the accuracy of financial statements and the effectiveness of internal audits
 - Clarifying criteria to evaluate the qualifications for directors of financial institutions (Fit and Proper principle)
 - Ensuring effectiveness of governance utilizing the functions of outside directors, auditors and actuaries, etc.
 - Further enhancement of financial institutions' disclosure to strengthen market discipline
 - Promotion of measures of financial institutions responding to corporate social responsibility (CSR)
 - Study toward establishing a "Code of Conduct" by the financial industry itself
 - Motivation to improve management of financial institutions through inspection and supervision
 - ✓ Sharp, effective and selective administrative response through introduction of a rating system into inspections that is not only based on the financial situation, but also on various viewpoints of inspected institutions
 - Implementation of off-site monitoring to enhance the internal audit of financial institutions
 - Clarifying supervisory points concerning the governance of financial institutions
 - Examining the way of thinking on retirement or disposal of public funds (preferred shares, etc.)
 - Securing and training financial experts from strategic points of view (including the governance of capital injected banks), such as by establishing a "human resource pool" through coordination between the government and private sector
- Along with promoting enhanced risk management by financial institutions, the FSA will strive to develop rules to prevent the recurrence of the non-performing loans (NPLs) problem and to require major banks to make their best efforts to keep the NPL ratio under the level as of the end of March 2005. Additionally, the FSA aims to further upgrade financial institutions' indicators related to profitability and soundness and their external ratings.
- Developing rules and frameworks for financial institutions for advanced risk management and strengthening the Inspection and Supervisory bureaus, aiming at the implementation of Basel II (the new capital adequacy framework)
 - Further utilization of the early warning system framework
 - ✓ Proper monitoring of risks which are not included in the capital adequacy ratio, such as interest rate risk in the banking book
 - Early recognition and treatment for NPLs
 - ✓ Implementation of effective monitoring by the Inspection and Supervisory Bureaus (further strengthening of cooperation between the Inspection and Supervisory bureaus, etc.)
 - ✓ Vitalization of loan markets (Enhancing the pricing function for NPLs)
 - ✓ Strengthening measures for early business revitalization (early assessment of the possibility for business revitalization)
 - ✓ Study toward charge-off rules and measures responding to new financial tools, such as Debt-Equity Swaps (DES)
 - Enhancing risk management of major banks
 - ✓ Request major banks to make plans toward enhancing risk management, in preparation for the implementation of Basel II
 - ✓ Verification of bank's credit risk management system for large borrowers and revitalization

- plans for borrowers
- ✓ Issue business improvement orders when the gap between major banks' self-assessment and the result of the FSA's inspections is wide
- ✓ Study of the introduction of proper regulatory treatment of deferred tax assets in calculating capital adequacy ratios
- Enhancing risk management of securities and insurance companies
 - ✓ Review of the method of calculating the capital adequacy ratio of securities companies
 - ✓ Review of the solvency margin standard and enhancement of other rules related to financial soundness of insurance companies, such as the technical provision for newly introduced insurance products and performance monitoring
- Development of rules for the soundness of trust businesses

(3) Further development of a financial system which is internationally open and the financial administration with an international perspective

◇ Institution building responding to the internationalization and structural change of finance

- The FSA will develop a financial administrative and regulatory framework in response to 1) differentiation and specialization of various functions of financial institutions along with the deregulation of international finance; 2) conglomeratization and internationalization, and 3) structural changes, such as diversification of financial services through the emergence of new forms of transactions and products.
 - Study toward financial legislation for financial conglomerates and study of issues of hedge funds
 - Establishment of an inspection and supervision system that can address the inspection and supervision of financial conglomerates, the treatment of cross-sectoral problems, and the emergence of new forms of transactions and products
 - Development of infrastructure to promote liquidation and securitization of loans
 - Measures to activate derivative markets based on the needs of markets participants
 - Strengthening the functions of securities markets for small- and medium-sized enterprises
 - ✓ Development of a system and thorough publicity for the green sheet market
 - Promotion of the development of accounting rules which are able to respond to the emergence of new financial and economic transactions

◇ Efforts to raise the international position of Japanese financial markets

- In response to the increase in international competition among financial markets, the FSA will strive to strengthen the competitiveness of Japanese financial markets and raise their international position.
 - Shortening the time from contract to settlement and payment in securities transactions, etc.
 - Joint research with concerned parties for measures to make Japanese markets a financial base for Asia

◇ Implementation of a financial administration with an international perspective and active participation in international standard-setting activities

- As internationalization and financial conglomeratization progresses, the necessity of strengthening partnerships with overseas regulatory authorities is increasing, and the movement towards the convergence of regulation and standards is accelerating. Taking this situation into consideration, the FSA will strive to adhere to the equal treatment principle of domestic and foreign financial institutions; make the Japanese financial system and financial markets universal based on a clear philosophy and rules; and at the same time play a leading role in international standard-setting activities regarding financial services, participating actively, not passively, from a strategic standpoint.
 - Active actions toward international convergence of accounting standards
 - Active participation in drawing up trading and prudential rules for international financial products and services
 - Ensuring appropriate regulation, inspection and supervision of international financial conglomerates
 - Strengthening cooperation with overseas supervisory authorities
 - Promoting dialogues among financial regulators in Asia through active participation in negotiations of Economic Partnership Agreements (EPA)
 - Active participation in negotiations for the liberalization of financial services at the WTO

II. Contribution to regional economies

- ◇ **Revitalization and activation of regional economies, facilitation of small- and medium-sized enterprises (SMEs) financing**
 - The FSA will strive to further promote region-based relationship banking, with a view to promoting, under a competitive environment, revitalization and activation of regional economies, facilitation of SME financing such as by encouraging new businesses in the region, and strengthening of management functions of regional financial institutions, thereby ultimately realizing active and vital regional societies. In this context, the FSA will design a new action program inheriting the existing “Action Program concerning enhancement of Relationship Banking Functions,” by building on the assessment of its progress and paying due attention to the points listed below.

The FSA will study the role of public financing in regional SME financing, while striving to bring about a tax system that will promote further efforts by financial institutions toward their borrowers’ business revitalization, and to develop corporate disclosure and other frameworks. The FSA will also strive to activate direct financing markets in the regions.

- Overall evaluation of the existing “Action Program concerning enhancement of Relationship Banking Functions”
- Based on the new action program, the FSA requests that each financial institution draw up individual plans, taking unique characteristics of respective regions into account, to achieve 1) business revitalization and facilitation of SME financing, 2) strengthening of management functions, and 3) enhancement of convenience for regional users. The FSA also requests that each financial institution carry out the measures with “selection and concentration” under voluntary

management decisions and discipline imposed by disclosure.

- Development of a database regarding the state of SME financing
- Further promotion of enhanced information disclosure concerning results of assistance for corporate restructuring and the sharing of know-how underlying such achievements
- Review of the RCC's corporate revival function aimed at the intensive revival of SMEs, promotion of the liquidation of loans held, further utilization of business revival funds, and appropriate use of Debt-Debt Swaps (DDS)
- Utilization of experts and know-how regarding financial business practices
- Expansion of exit finance for revitalized enterprises through utilization of syndicated loans and other measures, and promotion of DIP finance which is truly useful for enterprises that take on business revival
- Promotion of efforts towards lending via methods such as non-recourse loans and project finance

◇ **Strengthening management functions of regional and small- and medium- sized financial institutions**

- The FSA will introduce a framework that emphasizes incentives so that regional financial institutions, while making use of their characteristics as region-based entities, will enhance their governance under discipline imposed by disclosure, thereby voluntarily ensuring soundness and improving profitability through enhancing their ability of risk management and business assessment and improving their earnings management system. The FSA will also promote sound competition by pushing forward diversification of regional financial institutions' businesses in response to various needs in the region as well as entry of new players.

- Promotion of efforts to enhance risk management and governance of regional financial institutions
 - ✓ Implementation of Basel II and selective adoption of the Internal Ratings-Based Approach
- Permeation of new business models of regional financial institutions and promotion of entry of new players
- Enhancement of disclosure to improve convenience for regional users

III. Establishment of a reliable financial administration

◇ **Improving the transparency and predictability of the financial administration**

- The FSA will strive to develop a framework to improve the transparency and predictability of financial administration and to achieve full accountability.
 - Establishment of the FSA's "Code of Conduct" (including further enhancement of the transparency and rules of administrative directives, and ensuring further transparency of administrative actions) and reconfirmation of the equal treatment principle of domestic and foreign financial institutions
 - Enhancement of the feedback system regarding the results of inspections of financial institutions
 - Promotion of the utilization of the no action letter system, publicizing the opinion regarding the interpretation of general laws and regulations in response to outside inquiries
 - Case studies of failed financial institutions and feedback for a future financial administration

- Ensuring transparency and objectivity as seen from the outside through active utilization of the FSA Compliance Relations Office
- Enhancement of public relations activities for policies through the use of local finance bureaus as well

◇ **Promotion of a convenient and efficient financial administration through e-government, etc.**

- Through e-government, etc., the FSA aims to lower administrative costs and to promote convenient and efficient financial administration for participants and users of financial markets.
 - Implementation of an efficient and sound administration and the enhancement of convenience for participants and users of financial markets through e-government, etc.
 - Study toward an effective inspection method for both the supervisory authority and financial institutions, responding accurately to the actual management conditions of financial institutions.
 - Full internal check and review of the FSA's organization and frameworks based on the "FSA's Full Check Project" (including the use of its research and study functions, etc.)
 - Measures to enhance the human resources of the financial services authority