（Provisional translation）

Final Report

of the

Working Group on Financial Inspection Manuals

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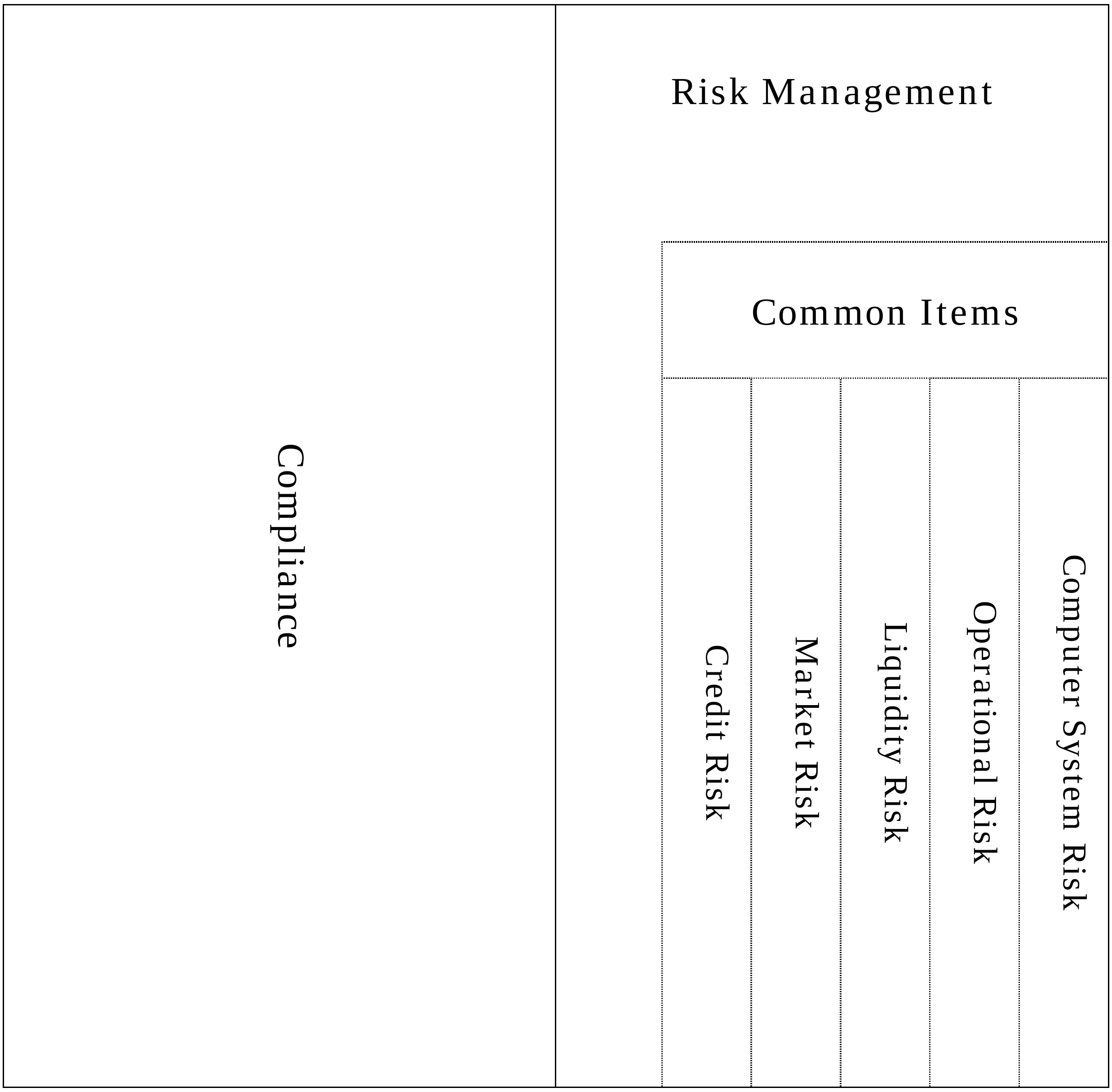

Final Report of the Working Group on Financial Inspection Manuals

PART 1. BASIC CONCEPTS

Preface

Intent behind formulation of the Financial Inspection Manuals

For Japan to chart a path for economic growth in the next century, it is vital that it stabilize and revitalize its financial system and restore confidence in it both at home and abroad. This is a step that cannot be avoided. Financial institutions will need to speedily write off defaulted loans, rebuild strategic operations, restructure, and engage in active disclosure of business and financial information. The regulatory authorities, for their part, will need to enhance the inspection and regulatory regimes. Together, these efforts must establish financial institution management and financial regulation that are in line with international perspectives and acceptable to depositors and taxpayers.

On July 2, 1998, the ruling coalition formulated a "Comprehensive Plan for Financial Revitalization (Second Report)," which included a clear policy statement mandating, as part of programs to strengthen the inspection and regulatory regime, "the formulation and publication within the year of inspection manuals and checklists that draw upon outside expertise." Again in the "Emergency Economic Stimulus Plan" of November 16, the government advocated the enhancement of inspection and regulatory tools by formulating and publishing inspection manuals (including checklists) that could be used to provide effective supervision of financial institutions.

The creation and publication of Financial Inspection Manuals is expected to improve the inspection and oversight functions of regulatory authorities, enhance transparency in administration, and encourage financial institutions to base their management on the principle of self-responsibility. This in turn can be expected to establish confidence in the financial regulatory regime as a whole.

Deliberations of the Working Group on Financial Inspection Manuals

The Working Group was organized as a project team with in the Inspection Department of the Financial Supervisory Agency on August 25 of last year. In the intervening months, the Working Group met a total of fourteen times to discuss basic concepts for financial inspection, the nature of Financial Inspection Manuals, and concrete drafts of the manuals in light of domestic and international trends in financial inspection and developments at the Basle Committee on Banking Supervision. This led to the publication of an "Interim Report" on December 22.

The Working Group resumed meetings in February of this year and has met a total of ten times since to review relevant sections of the draft manuals in light of public comments received about the "Interim Report." During this time, the Working Group also held interviews with interested organizations that had provided public comments.

Future issues

The Working Group is publishing its "Final Report" today as the product of its twenty-four meetings. The Working Group anticipates that the authorities will move forward with work based on this "Final Report," and that Financial Inspection Manuals will be finalized and published shortly. The Group would like to underscore, however, the dizzying pace at which the financial environment is changing would urge that the manuals be subject to continual review and updating.

I. Basic Concepts for Financial Inspection

Purpose of financial inspection

Financial institutions are private companies and should basically be managed in accordance with the principle of self-responsibility. However, unlike ordinary companies, the main creditors of financial institutions are their depositors, i.e., the general public. Steps must therefore be taken to appropriately protect the interests of the general public. Besides, given the nature of financial institutions, the bankruptcy of one institution could cause a chain reaction that has a significant and detrimental impact on the financial system as a whole and also on the real economy through the mechanism of credit contraction. Further, the funding services that financial institutions supply are of great significance to all economic activities in a country. These are the reasons why the state must take an interest in the sound and proper operation of financial institutions.

It is from this perspective that financial institutions are inspected by the regulatory authorities—"to ensure the sound and proper operations of banks" (Banking Law, Article 25 etc.). The nature of inspections must be subject to constant review. Regulators must strive to make inspections adequate to the task of ensuring the sound and proper operation of financial institutions without delving into points that are not necessarily relevant from the perspective of "sound and proper operation." Ensuring the sound and proper operation of financial institutions is the basic purpose of inspection, a purpose that must be reconfirmed anew every time an inspection is performed.

Position of financial inspection

However, sound and proper operation shall not be ensured by financial inspections alone. The Banking Law (Article 1) states "In implementing this law, due consideration shall be given to respect each bank's own initiative with respect to the management of banking business." The sound and proper operation of financial institutions must, first and foremost, be achieved through rigorous adherence to the principle of self-responsibility and through reinforcement of market disciplines.

The management of financial institutions must take the responsibility for ensuring that their operations are sound and proper by enhancing their own internal control systems, including their internal auditing functions. The job of external auditors is to conduct rigorous outside checks of whether operations are sound and proper, accomplishing this with independent audits of the institution's financial statements. Having gone through this process, the institution's financial statements, business policies, and other relevant information must be widely disclosed, so that they can be monitored by investors through the markets (supervision in the form of market disciplines).

The public involvement of the regulatory authorities should be as a complement to the principle of self-responsibility and supervision in the form of market disciplines, making up for areas in which they are inadequate to fully assuring the sound and proper operation of the financial system. Therefore, inspections by the authorities should assume that financial institutions have internal controls in place and that accounts are subject to external audit by auditing firms. Inspections must maintain linkage and coordination with these systems, and must be conducted effectively, efficiently, and according to predetermined rules for the purpose of ensuring the sound and proper operation of financial institutions.

Basic principles of financial inspection

The concepts described above form the foundation for the basic principles of financial inspection discussed below.

Financial inspection assumes internal controls by the financial institution itself based on the principle of self-responsibility and rigorous external audits by external auditors, and it seeks to complement these systems (principle of complementation). Therefore, authorities must use inspections to strongly encourage financial institutions to establish proper internal controls and external audits based on the principle of self-responsibility. In addition, inspections should assume that these controls and audits are indeed being performed in an appropriate manner, and should emphasize ex-post checking that focuses on "process examination" for the internal control and external audit systems. The onus is on the financial institution to explain whether internal controls are appropriate; the authorities are in the position of verifying this. It is neither possible nor necessary for financial inspection to inspect everything.

The resources available to the authorities and institutions are limited and must be utilized in an effective manner. Financial inspections should therefore be fully linked and coordinated with auditing functions so that they are performed as efficiently and effectively as possible (the principle of efficiency). Inspections should seek to make greater use of auditing functions by coordinating with the work of internal auditors and external auditors. Furthermore, it should be assumed that financial institutions have their own controls in place, including regular appraisals of assets. Financial inspections should be prioritized dynamically so that the frequency and scope of inspection reflects the degree to which financial institutions are actually accomplishing this.

Finally, financial inspections must be conducted effectively so that they serve to ensure the sound and proper operation of financial institutions (the principle of effectiveness). Inspection departments should accurately communicate to institutions any problems found in their management or operation, and should maintain close coordination with the supervisory departments that are empowered to enact regulatory measures, thereby encouraging timely and appropriate corrective actions.

II. Basic Concepts Underlying the Financial Inspection Manuals

(1) Shift from regulator-led inspections to self-management-style inspections

In light of the basic principles of financial inspection described in the previous section, the Financial Inspection Manuals must provide further encouragement for the shift from regulator-led inspections to self-management-style inspections by financial institutions.

More specifically, even though the manuals are essentially handbooks for the inspectors, they should be published as a means of encouraging financial institution to operate under the principle of self-responsibility. Likewise, manuals should wherever possible be in the form of checklists, which will be easier for financial institutions to use in their management.

Secondly, the focus of inspections should not just be on results, i.e., whether improprieties have taken place. Rather, they should be weighted towards process examination that verify whether the institution has the proper internal controls and external auditing in place to prevent improprieties from occurring.

Thirdly, manuals should not be “one size fits all” lists of common check items for all financial institutions. If anything, they should actively include check items geared towards the most advanced financial institutions.

Finally, manuals should be aware of the roles and responsibilities of the senior management, auditors, and external auditors within the internal control and external auditing system, and should ask whether, from the perspective of the principle of self-responsibility, these roles are appropriate and where the locus of responsibility lies. In particular, inspection should endeavor to work “from the top down,” by first confirming whether top managers are fully cognizant of the various risks to which their institution is exposed, whether they make needed allocations of resources, and whether they are engaged in appropriate internal controls.

(2) Shift in emphasis from assessment of asset quality to inspection of risk management

Assessments of asset quality were emphasized in previous financial inspections, but today’s financial institutions are exposed to a wide range of risks, including credit risk, market-related risk, and operational risk. While assessments of asset quality will continue to be an important component of financial inspection because of the insight they provide into the soundness of institutional operations, inspections of “risk management” in the broad sense will also be important.

Behind this shift in emphasis is the growing diversification and magnitude of the risks to which financial institutions are exposed. Finance is becoming more global, advances in computer technology are bringing greater degrees of automation, and innovations in financial technology are bringing new instruments to the markets (for example, derivatives). These developments are in turn magnifying and widening the risks to which financial institutions are exposed. Japan is also seeing the signs of change in what have long been hallmarks of its financial system: the “main bank” system that underpinned lending operations, and the insistence on collateral for all lending.

Meanwhile, on the regulatory side, regulated interest rates have already become a thing of the past; free interest rates are becoming established, and the Financial Big Bang will bring even greater liberalization to financial-institution operations. The scope of financial-institution activities is widening from the traditional businesses of depositing taking, lending, and payment services to areas like fund management and fund-raising (investment banking services). The days of “convoy-style” regulation are over and a new period of financial realignment is beginning in which the institutions will be searching for new structures and businesses based on the principle of self-responsibility. These trends are forcing each financial institution to structure adequate risk management systems.

This does not mean that all risks should be held to a minimum. One of the basic functions of financial institutions is the diversification of risk; their role is to take necessary risks while also appropriately managing those risks. It is the responsibility of financial institutions to provide a smooth supply of funding to borrowers engaged in sound businesses.

One of the causes of the recent “bad debt crisis” that has plagued financial institutions was the failure to engage in appropriate risk management in the past. It is worth considering whether the current worries about “credit contraction” do not stem from a reluctance to lend because institutions lack confidence in their risk management. It is the establishment of appropriate risk management systems that is the key to overcoming the current bad debt crisis and arriving at the starting line for a true revitalization of the financial services industry.

The establishment of risk management systems at financial institutions is also important as a means of facilitating adjustments in the industrial structure of the Japanese economy. In the postwar “catch-up” industrial structure, in which Japan applied basic technologies imported from more advanced countries in Europe and North America to achieve quantitative expansion, it may in many instances have been rational to judge creditworthiness as an extension of a company’s past performance. However, Japan has in recent years been making the transition to a more creative industrial structure that seeks to develop innovative new technologies and businesses even while recognizing the potential for a certain level of default. Venture businesses are the classic example. For Japan to be able to complete this transformation into a creative industrial structure that does not hesitate to take needed risks, it must have a financial services industry that is willing to supply funding on the assumption that risk will be involved.

Furthermore, the international trend is to see risk management as the basis for financial-institution operation. If the Japanese financial services industry is to truly be rebuilt, then we must forcefully communicate the soundness of our risk management to both the domestic and the international publics.

To sum up, monitoring the risk management systems of financial institutions is on par with the Prompt Corrective Actions and other balance sheet regulations as a core tool for financial regulators.

III. Nature of the Financial Inspection Manuals and Checklists

(1) Nature of the Financial Inspection Manuals

The Financial Inspection Manual are only *handbooks* to be used by inspectors when they inspect financial institutions. It is expected that, as part of their efforts to ensure sound and proper operations and in accordance with the principle of self-responsibility, individual financial institutions will fully exercise their creativity and innovation to voluntarily create their own detailed manuals. These institutional manuals should make note of the content of the Financial Inspection Manuals and be adapted to the size and nature of the institution.

The check points in the Financial Inspection Manuals represent criteria to be used by inspectors in evaluating the risk management and compliance systems of financial institutions. They do not constitute direct statutory obligations to be achieved by institutions. Care must be taken that the Financial Inspection Manuals are not employed in a manner that is mechanical and unvarying. There may be cases in which the letter of the checklist description has not been fulfilled, but the institution has nonetheless taken measures that are, from the perspective of ensuring the soundness and appropriateness of its operations, rational, and these measures are equivalent in their effects to the descriptions for the check point or are sufficient given the size and nature of the institution. In such cases, the institution’s measures would not be deemed inappropriate.

The Working Group considers it extremely important that the nature of the Financial Inspection Manuals be adequately communicated to both inspectors and financial institutions.

(2) Structure of the Financial Inspection Manuals

The draft manuals were written with the structure outlined below. This structure is based on the concepts described above and draws on the principles articulated by the Basle Committee on Banking Supervision in its “Framework for Internal Control Systems in Bank Organizations.”

1) Compliance

The Working Group has formulated a draft manual for inspections to verify the compliance of the institution, its directors, and its employees, to all applicable laws ordinances, and other rules.

2) Risk management

The Working Group has formulated a draft manual for inspections to verify the existence and operation of systems to manage the various risks to which financial institutions are exposed. The manual takes account of the following risk categories:

a. Credit risk

Credit risk is the risk that a financial institution will incur losses because the financial position of a borrower has deteriorated to the point that the value of an asset (including off-balance-sheet assets) is reduced or extinguished. Among credit risks, the risk that the financial institution will incur losses because of political or economic conditions in the country of a foreign borrower is referred to as "country risk."

b. Market risk

Market risk is the risk that the financial institution will incur losses because of a change in the value of an asset it holds (including off-balance-sheet assets) due to changes in market-related risk factors such as interest rates, securities prices, or foreign exchange rates. This specifically includes interest-rate risk, price-fluctuation risk, and foreign exchange risk.

c. Liquidity risk

Liquidity risk is the risk that a financial institution will incur losses because an unforeseen outflow of funds leaves the institution no recourse but to raise funds at far higher interest rates than normal or, because it is forced to engage in transactions at prices that are markedly more disadvantageous than normal due to a lack of depth in the market. Specifically, this includes market liquidity risk and cash-flow risk.

d. Operational risk

Operational risk is the risk that a financial institution will incur losses because its management or employees have failed to perform their jobs properly, have caused accidents, or have engaged in improprieties.

e. Computer system risk

Computer system risk is the risk that a financial institution will incur losses because its computer systems have failed or malfunctioned or are otherwise inadequate. Computer system risk also includes the risk of losses from inappropriate use of computers.

IV. Relationship between Financial Inspection and Regulatory Measures

To enhance the inspection and regulatory system, the regulatory authorities must develop full ties and coordination between departments performing financial inspection and departments performing monitoring and enacting regulatory measures, thereby enabling both to fulfill their responsibilities.

(1) Relationship between financial inspection and regulatory measures

It is important that there be full linkage and coordination between the inspections performed by inspection departments and the regulatory measures taken by supervisory departments if financial inspections are to be effective.

The Banking Law provides a flow that leads from financial inspection to regulatory measures, which can be summed up as follows. It should be emphasized, however, that while each of these steps will normally be taken, the nature of the problem or its degree of impact on institutional management and the financial system in general may be such that measures in the same step are repeated (for example, repeated reports under Article 24) or that measures at a certain step are skipped in favor of those at the next level. Nonetheless, the identification of problems in an inspection will not immediately lead to specific regulatory measures. Should orders be issued as provided for in Articles 26 and 27 of the Banking Law, the financial institution will be provided with an opportunity to argue its side of the case. We would also emphasize the need for full communication and discussion between inspectors and financial institutions even at Step 1.

Step 1: The inspector discusses with the financial institution problems identified during an on-site inspection and measures that can taken for improvement.

Step 2: The authorities, based on the notification of inspection findings, ask the financial institution for a report on the status of improvements as per Article 24 of the Banking Law.

Step 3: Should the financial institution be found to have failed to make improvements, the authorities issue an order for the submission and implementation of an improvement plan as per Article 26 of the Banking Law.

Step 4: If improvement is still not seen, the authorities issue an "operations improvement order" as per Article 26 of the Banking Law.

Step 5: If improvement is still not seen, the authorities issue an order to suspend all or a part of operations as per Article 26 of the Banking Law. In some cases, directors and other officials may be ordered dismissed as per Article 27 of the Banking Law.

Step 6: The authorities revoke the institution's license as per Article 27 of the Banking Law.

The Working Group sees the need for a clear articulation of the relationship between financial inspections and regulatory measures and the processes by which they will be coordinated. This should be done with reference to the framework outlined above and to examples provided in other countries.

(2) Reinforcement of monitoring

There is also a need to reinforce the monitoring conducted by the authorities under Article 24 of the Banking Law and other provisions. Inspections are "on-site" whereas monitoring is "off-site." They are therefore complementary in nature. In some countries, the emphasis in monitoring is on quantitative analysis of balance sheets and other documentation, where the emphasis in financial inspection is on checking risk management systems, and in many cases this seems to work effectively. Japan urgently needs to consider ways to enhance monitoring and to coordinate monitoring and inspection in light of the inspection manual concepts discussed in this “Final Report” and with an eye to enhancing the inspection and supervision system of the regulatory authorities.

PART 2. DRAFT FINANCIAL INSPECTION MANUALS

I. Compliance System Checklist

II. Risk Management Systems Checklists

(1) Risk Management Systems Checklists (Common Items)

(2) Credit Risk Management Checklist and Manual

1) Credit Risk Management System Checklist

2) Credit Risk Management Manual

(3) Market Risk Management Checklist

(4) Liquidity Risk Management Checklist

(5) Operational Risk Management Checklist

(6) Computer System Risk Management Checklist