Toward Better Regulation

September 2007

Financial Services Agency

1. Three Objectives of Financial Regulation

1. Stability of financial system

2. Customer protection

3. Market fairness and transparency

2. Changes in Situation of the Japanese Financial Sector

	2000 2002 2005 2007	From now on: Better Regulation: improving the quality of financial regulation
Stability of Financial System	**Concern over financial system** October-November 1997: Serial failures of banks and securities companies (Hokkaido Takushoku Bank, Yamaichi Securities, etc.) 1998: Failures of Long Term Credit Bank of Japan and Nippon Credit Bank **Non-performing loans problem** Major banks March 2002: 8.4% → March 2005: 2.9% Regional banks 〃 : 8.0% → 〃 : 5.5% ＊Failure of Ashikaga Bank (2003) **Acceleration of repayment of public funds (2005~)** (Face amount of repayment ¥8.8trillion, Capital gains ¥1.3trillion, Income gains ¥0.7trillion) ＊Introduction of prompt corrective actions (1998) ＊Special inspection on major banks (2001) ＊Publication of inspection manual (1999) ＊Partial removal of blanket deposit insurance (2002) ＊Development of public recapitalization system & recapitalization (1998-2002: ¥10.4trillion) ＊Removal of blanket deposit insurance (2005) (except the payment and settlement deposits) ＊Implementation of Basel II (2007)	[Task] ●Entrenchment and sophistication of risk management at financial institutions ●Response to new type of risks Voluntary efforts by financial institutions
Customer Protection & Improvement of Customer Convenience	**Diversification of sales channels for financial products** ＊Over-the-counter sales of investment trusts by banks (1998) ＊Over-the-counter sales of insurance products by banks (2001) ＊Introduction of securities intermediary business (2004) ＊Deregulation of bank agency business (2006) **Non-payment problem at insurance companies** **Increase in damages caused by forex margin trading** **Insufficient systems and controls in place at banks** ＊Amendment to Financial Futures Trading Law (2004) ＊Administrative actions against insurance companies and amendment to supervisory guideline (from 2005 onward) ＊Administrative actions against banks and amendment to supervisory guideline (abuse of dominant position, real estate screening system, sales of investment trusts, etc.: from 2006 onward)	[Task] ● Establishing sustainable & continuous systems and controls for customer protection at financial institutions ●Establishing competitive environment for higher quality of services Voluntary efforts by financial institutions
Market Fairness & Transparency	**Progress of Japanese Financial "Big Bang"** ＊Financial System Reform Law (1998) (Change to registration system for securities firms, liberalization of brokerage fees, diversification of financial & investment products, etc.) **Major misconduct cases** ・Seibu & Kanebo (2005) ・Livedoor & Murakami Fund (2006) **Mistakenly placed order by securities firms & system troubles at stock exchange** (2005-06) ＊Introduction and expansion of civil money penalties (2005) ＊Enactment of Financial Instruments & Exchange Law (2006) (Revision of TOB system & reporting system for large shareholdings, introduction of quarterly reporting & internal control reporting systems) ＊Summary of issues published by "Council on Securities Companies, Financial Intermediation Functions" (2006) ＊Amendment to the Certified Public Accountants Law (2007)	[Task] Establishing norms of conduct for securities firms and other market intermediaries Voluntary efforts by financial institutions [Task] Improving reliability of market infrastructures ●Entrenchment of Financial Instruments & Exchange Law ●Enhancing market surveillance mechanisms ●Improving the quality of accounting and auditing

3. Better Regulation: Outline

I. Four Pillars of Better Regulation:
Direction to Take for Further Evolution of Our Supervisory Approach

1. Optimal combination of rules-based and principles-based approaches.
2. Risk-focused, forward-looking approach: prompt & effective response to high-priority issues.
3. Encouraging voluntary efforts by financial institutions and placing greater emphasis on incentives for them.
4. Improving the transparency and predictability of regulatory actions.

II. Specific Areas to Focus on

1. Enhanced dialogue with financial institutions and other relevant parties.
2. Effective dissemination of information.
3. Further cooperation with fellow authorities abroad.
4. Enhanced research functions for prompt recognition of market developments.
5. Human resource development.

4. Optimal Combination of Rules-Based and Principles-Based Approaches

1. Advantages of Rules-based and Principles-based Approaches

<u>Rules-based approach</u>: ensures predictability and eliminates arbitrariness in regulatory actions from the viewpoint of financial institutions.

<u>Principles-based approach</u>: encourages voluntary efforts by financial institutions and ensures the maximum freedom of business management.

2. FSA's View

- We pursue fair and transparent financial regulation and supervision, while placing emphasis on voluntary efforts by financial institutions.
- Rules-based and principles-based approaches are mutually complementary rather than exclusive.
  - Cases where rules-based approach is relatively effective:
    - ∗applying common rules to market participants including a large number of unspecified parties.
    - ∗imposing administrative sanctions under regulatory authority.
  - Cases where principles-based approach is relatively effective:
    - ∗ encouraging financial institutions to develop their own systems and controls for governance, risk management and legal compliance.
    - ∗ resolving a case in which there is a gap between rules because of newly-introduced products, services and sales methods.
- Self-regulatory organizations: an important role in improving the effectiveness of principles-based approach.

5. Example of Principles: “Principles for Businesses” (by UK FSA)

1. A firm must conduct its business with integrity.
2. A firm must conduct its business with due skill, care and diligence.
3. A firm must take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems.
4. A firm must maintain adequate financial resources.
5. A firm must observe proper standards of market conduct.
6. A firm must pay due regard to the interests of its customers and treat them fairly.
7. A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8. A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
10. A firm must arrange adequate protection for clients’ assets when it is responsible for them.
11. A firm must deal with its regulators in an open and co-operative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

(Source) UK Financial Services Authority (http://fsahandbook.info/FSA/html/handbook/PRIN/2/1)

6. Risk-focused, Forward-looking Approach: Prompt & Effective Response to High-Priority Issues

- Foreseeing and identifying promptly the areas where serious problems could be hidden and where huge risks might materialize in the future, and effectively allocating our resources to these areas.

Risk-focused
Forward-looking

Proactive Approach
(Identify potential risks in the financial system)

- Areas where serious problems could be hidden
- Areas where huge risks might materialize in the future

Effective Allocation

Limited Regulatory Resources

<Example: real estate funds>

- Carefully monitoring the developments in the real estate market, given its financialization and globalization
- Ensuring due process for appropriate pricing and investor protection, preventing transactions involving conflict of interest.
- Ensuring appropriate risk management at banks with real estate exposures.

7. Encouraging Voluntary Efforts by Financial Institutions and Placing Greater Emphasis on Incentives

Incentive compatible approach: examples in existing frameworks

●***<u>Financial Inspection Rating System</u>***

- Selective administrative response depending on financial inspection results (frequency, scope and depth of inspection).

●***<u>Basel II</u>***

- Refining risk measurement and promoting more advanced risk management at financial institutions.

●***<u>Relationship Banking framework for regional banks</u>***

- Incorporated into supervisory guideline and made permanent, not requiring planning and reporting in a mechanical and undistinguishing manner.

● ***<u>Publishing checkpoints in inspection and supervision and criteria for administrative actions</u>***

- Encouraging voluntary efforts by financial institutions.

8. Improving the Transparency and Predictability of Regulatory Actions

Pursuing fair and transparent financial regulation and supervision

●***Publication of inspection manuals and supervisory guidelines***

- Clarifying checkpoints in inspection and supervision and workflow of administrative actions.

●***Publication of annual inspection and supervisory policies***

- Publishing the priority issues in inspection and supervision in each operational year.

●***Publication of criteria for administrative actions***

- Presenting the checkpoints in deciding administrative actions.

●***Reform of no action letter system***

- Series of reforms since the introduction of the system in July 2001.