Transforming the JFSA's supervisory approaches

Recommendation to the Financial Services Agency by the
Advisory Group on Supervisory Approaches[1]
March 17, 2017[2]

Provisional translation

1. Introduction

The Financial Services Agency (JFSA) has made a multitude of reforms in recent years and its supervisory approaches, which were formulated during the Japanese financial crisis in late 1990s and early 2000s, are undergoing a major transformation. The agency, however, is yet to present an overall design of what it intends to attain. Legacy approaches, organizational design and guidelines stay while new initiatives are pursued. Stakeholders may be receiving mixed messages.

A regulator's ultimate goal is enhancing national welfare by contributing to the sustainable growth of the national economy and wealth. Regulators have to continuously update their supervisory approaches by asking themselves if their approaches are consistent with their ultimate goal, if their approaches meet the requirements of the changing environment, and if mechanical repetition of their past approaches are creating unintended consequences. The Advisory Group on Supervisory Approaches was formed in August 2016 to recommend to the JFSA how it could discharge this responsibility. This report is the product of its deliberations conducted over six meetings.[3]

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[2] This provisional translation was published on June 15, 2017.

[3] The group discussed issues to be reviewed in general on August 24, 2016; the role of supervision and dialogue on best practices on September 30, 2016; prudential policy on October 24, 2016; supervisory methods, JFSA's organization structure and human resource policies on November 22, 2016; the Inspection Manuals and the Supervisory Guidelines on December 12, 2016; and the draft report on February 24, 2017.

Our key recommendations on the direction of the reform are as follows:

- Ensure that the agency's supervisory approaches are consistent with its ultimate goal, not just with intermediate goals.
- Do not focus only on form: see substance. Do not focus on backward-looking checks: be forward-looking. Do not be satisfied with the analysis of elements: have holistic views.
- In addition to securing financial institutions' compliance with minimum requirements, have dialogue with them on best practices. Shift from a framework dominated by static regulation to that complemented by dynamic supervision.

To complete the transformation, the agency will need to make a range of specific changes. The reports make recommendations on the changes to be made in supervisory processes and techniques, organizational structure, human resource policies, information infrastructure, the Inspection Manuals and the Supervisory Guidelines, dialogues with stakeholders, and the coordination between domestic policy formulation and contribution to the global regulatory reforms.

We expect that the JFSA will form its own views on the issues discussed in this report and publish them with the timelines for the implementation of the recommendation. We also expect the agency to engage with the management of financial institutions and users of financial services in developing more specific policies.

We believe that the principles proposed in this report are applicable to the supervision of financial institutions in general, but they may need to be supplemented by policies specific to the sizes and the types of financial institutions. We expect the JFSA to develop such policies going forward.

2. The evolution of JFSA's approaches so far

To respond to pressing challenges that arose during the financial crisis—such as restoring public confidence in regulators, resolving non-performing loan problems, and protecting consumers—the JFSA resorted to supervisory approaches that focused on *ex post* compliance checks and asset quality reviews. These approaches helped the agency resolve the pressing challenges at the time.

The environment and priorities for regulatory policy, however, have changed since then. Conventional methods and approaches no longer assure that regulatory policy will attain its ultimate goal.

First, even after non-performing loan problems and other issues were resolved, the economy continued to stall in Japan. As the population is shrinking and getting older, it has become clear that stabilizing the financial system alone cannot achieve the ultimate goal of regulatory policy, i.e., enhancing national welfare by contributing to the sustainable growth of the national economy and wealth. To achieve this goal, regulators need to place more emphasis on improving financial intermediation and benefits financial services provide to users.

Second, financial institutions are facing a more challenging business environment with the shrinking of domestic markets, the long-term global trend for low interest rates, and new competition from FinTech and other innovations. Although the past problems arising from non-performing loans were resolved, it is now increasingly unlikely that financial institutions will be able to attain their sustainable soundness unless they maintain their profitability by sound risk taking.

Third, the sources and types of risk for financial institutions are changing at an accelerating speed. This change is making it even more important for financial institutions to develop forward-looking capability to identify and respond to risk.

Moreover, it is recognized that the past approaches may have created unintended consequences as well.

To face these challenges and problems head on, the JFSA launched a program for "better regulation" in 2007. The main pillars of this program included a better combination of rules and principles, and more emphasis on incentivizing financial institutions to voluntarily make improvements. The JFSA started to take further steps in around 2013, including respecting the judgment of financial institutions when classifying individual assets and promoting a shift to lending based on the soundness of borrowers rather than collaterals and guarantees only, as well as conducting continuous, integrated on-site and off-site monitoring focused on financial institutions' governance, business models and other underlying factors.

While we at the Advisory Group believe that these directions are appropriate, we recognize that the JFSA is still in the middle of its journey. We find that the framework established after the financial crisis now coexists with programs that were launched in the intervening years. The agency should develop a coherent program which shows the principles for the reforms and specific directions to be taken, and take a systematic, organized approach for transforming its supervisory approaches.

3. Directions to be taken

In this section, we discuss the role of regulators and the need for new supervisory approaches to be consistent with the role. Then, we will examine how the JFSA should respond to the new environment and challenges, as well as how to address the unintended consequences of the existing approaches.

1) Consistency with the ultimate goal

On its foundation, the JFSA defined its three goals as financial stability, consumer protection, and market integrity. Although these three traditional goals remain critical, they are only means to achieve the ultimate goal of regulatory policy: enhancing national welfare by contributing to the sustainable growth of the national economy and wealth. They are necessary but not enough for achieving the ultimate goal.

We recommend the JFSA to adopt a wider definition of its goals. The new goal should be enhancing national welfare by contributing to the sustainable growth of the national economy and wealth through securing both financial stability and effective intermediation, both user protection and better services, and both market integrity and vigor. The JFSA should continuously examine if its supervisory approaches are consistent with its goals in the current environment where it needs to face new priority issues and update the approaches accordingly.

Ideally, this goal should be realized by rational choices by users and free competition among financial institutions, or the free rein of market forces.

However, in reality, financial systems are subject to market failures. One reason for a market failure is that of external diseconomies where a contagion occurs due to interconnectedness. Another example of a market failure is that of information asymmetry where consumers are unable to make optimal decisions because of limited information available for them on financial services provided by financial institutions.

A major role for regulatory policy is to address market failures. However, even if a response is effective, it can have unintended consequences, or side-effects, and result in a regulatory failure. For example, if the regulatory authorities repeatedly and mechanically inspect compliance with regulations requiring provision of better information to consumers to mitigate information asymmetry, financial institutions may be induced to prioritize keeping records of compliance over providing information fit to the needs of customers.

Supervisory approaches should be designed to minimize the sum of market and regulatory failures, so as to maximize the effective functioning of market mechanisms. The JFSA should carefully monitor the unintended consequences of existing approaches and, if found, try to mitigate them.

2) Shifts in priorities

Compliance with the minimum standards alone cannot fully achieve the goal of regulatory policies. Dialogue on best practices as well as dynamic supervision for sustainable safety and soundness is also required.

From the 1990s to early 2000s, consumer protection and the financial stability were seriously threatened in Japan. At that time, the priority was to achieve a minimum level of safety and soundness and compliance with customer protection rules by inspecting that the minimum standards were met. Subsequently these goals were met and the new environment has created new issues and challenges that must now be prioritized. The importance of dialogue on best practices and dynamic supervision for sustainable safety and soundness has been heightened by this shift in priorities.

a. Dialogue on best practices

To reach the minimum level of the goal for regulatory policy, it is necessary to confirm compliance with the minimum standards and enforce the statutory requirements. However, reaching higher levels of achievement requires a dialogue on best practices. This dialogue should prompt financial institutions to aim higher taking on programs that are tailored to their specific circumstances.

In particular, as the challenges mentioned earlier—declining populations and the aging of society—become acute and minimum standards are being met, dialogues on best practices become more important. Today, there is a growing need for financial institutions to provide more effective financial intermediation to make a larger contribution to productivity enhancement in borrower companies, and to the sustainable growth of local economies. Financial institutions also need to offer better, more tailored products and services that yield optimal benefits for consumers in order to contribute to stable national asset formation.

How can a dialogue on best practices be conducted? One possible approach is for regulatory authorities to survey good practices among a wide range of financial institutions and how customers view the services provided by financial institutions to them. The knowledge gained from the surveys could then be shared and used to generate a dialogue that encourages financial institutions to take consumer oriented initiatives.

At the same time, these dialogues should not result in undue interference in the business of financial institutions. Regulators' role is to encourage financial institutions to identify their own challenges and to come up with their own creative responses, putting aside industry-wide conformism and inward-looking inertia.

Authorities can also help consumers and shareholders differentiate and choose among financial institutions. Their approaches, however, should focus on providing relevant information and improving the competitive environment. The fundamental role for regulatory authorities in achieving these objectives should focus on presenting useful information and on improving the environment in general.

b. Dynamic supervision for sustainable safety and soundness

In today’s rapidly changing environment, to ensure that financial institutions maintain safety and soundness, and continue supporting the economy, it is necessary to conduct dynamic supervision that goes beyond asset quality reviews and compliance check with the Basel Accord. It is all the more so under the changing business environment.

Financial institutions are facing increasingly tough, challenging conditions in their business environment due to shrinking domestic markets, the sustained global trend for low interest rates, and the emergence of new competition from FinTech and other innovations. Traditional approaches of prudential supervision have emphasized limiting excess risk taking by analyzing the balance sheets and the relationship between risk taken and capital held by financial institutions. However, in the current environment, it is becoming increasingly clear that financial institutions will not be able to maintain safety and soundness unless they secure profitability by smart risk taking.

Prudential supervision should determine if there is the right balance between risk, return, and capital, and if the current business model is sustainable in a changing environment. Supervisors should discuss and share views with a financial institution on the probability of its falling below the minimum standards, and, if the probability is significant, remedial measures. It will be necessary to set a deadline of the probability. However, the choice of remedial measures should be at the discretion and the responsibility of the financial institution. Regulators should avoid mechanically applying one-size-fits-all solutions. They should continue asking questions on issues, root causes, and the adequacy of remedial measures till the financial institution find satisfactory solutions.

The sources and types of risk that financial institutions face are changing at an accelerated pace. Therefore, there is a growing need to improve their capability to identify and respond to emerging risks. Again, there is no single approach that fits all financial institutions, and the level of response that can be considered satisfactory should depend on their condition. Each financial institution must therefore devise its own approach that matches its risk profile, business model, and changes in the environment that impact its operations. The regulatory authorities should aim to be current with advanced practices and to contribute to the enhancement of industry practices by engaging in dialogues with financial institutions, market participants and risk professionals.

c. Creating shared value with customers

In their 2011 article *Creating Shared Value*, Michael E. Porter and Mark R. Kramer argued that companies can find new markets and achieve a competitive advantage by creating shared value with customers, the community, and society in their core businesses. By providing high-quality products and services that meet customer needs and contribute to customers' growth, companies can solidify the foundations for their businesses and increase their corporate value.

Financial institutions can establish sustainable business models by providing financial intermediation that contribute to sustainable economic growth, and by providing products and services that contribute to stable national asset formation. A dialogue on best practices aims to facilitate this.

On the other hand, actions to achieve sustainable safety and soundness must go beyond immediate remedial measures and include initiatives aimed at transforming existing business models that allow them to grow together with their customers. Dynamic supervision aims to promote them.

A dialogue on best practices and dynamic supervision for sustainable safety and soundness, therefore, should be closely linked.

3) Transition from form, the past, and elements to substance, the future and a holistic view

Conventional supervisory approaches are effective for resolving non-performing loan problems and securing compliance with minimum consumer protection rules. However, mechanical repetition of the approaches can have negative side-effects for both regulatory authorities and financial institutions. These negative side-effects include:

- Focusing on form: Placing more than the necessary emphasis on collateral and guarantees, instead of focusing on the business prospects of borrowers; concentrating on generating proof of compliance with rules, instead of providing services that match customer needs.

- Focusing on the past: Focusing exclusively on balance sheets, which show the results of past business operations, instead of focusing on future sustainability of the business model; paying more attention to past incidents of noncompliance than to responding to changing customer needs.
- Focusing on individual elements: Concentrating on assessing individual assets instead of discussing risks that are important to the financial institution as a whole; reprimanding individual misconduct incidents, while paying little attention to identify the root cause of the problems and discussing remedies.

It is true that substance, the future, and a holistic view cannot be assessed without examining form, the past, and individual elements. However, negative side-effects can and do occur and make it more difficult for supervisors to contribute to their ultimate goals if form, the past, and individual elements get all the attention while the perspective of substance, the future, and a holistic view is neglected. Supervisory horizon should be expanded:

- From form to substance: In addition to checking statutory compliance, emphasize the substance and the quality of financial services.
- From the past to the future: In addition to confirming soundness at some point in the past, emphasize the sustainability of the business model.
- From individual elements to a holistic view: Instead of concentrating on a predefined set of issues, emphasize determining whether or not the priority issues are addressed.

4. Steps to be taken

The principles outlined above, such as ensuring consistency with the ultimate goal of regulatory policy, dialogues on best practices, dynamic supervision for sustainable safety and soundness, and taking a wider perspective covering substance, the future and a holistic view, cannot be made effective by simply repeating the mantra. They require a systematic, coordinated implementation of concrete reforms, including reforms in supervisory methods; organizational structure, human resource policy and information infrastructure; the Inspection Manuals and the Supervisory Guidelines; dialogues with a broad range of stakeholders; and coordination between domestic policy formulation and contribution to the global regulatory reforms.

1) Reviewing supervisory methods

a. Methods for dialogues on best practices

When addressing issues in compliance with minimum standards, regulatory authorities need to clarify remedial measures financial institutions should take. On the other hand, there is no single, correct practice to be aimed at through a dialogue on best practices. Rather, diversity in practices among financial institutions is desirable. Dialogues on best practices should therefore be conducted in a way which can encourage financial institutions to take actions on their own initiatives and responsibility.

There should be a shared recognition between supervisors and bankers that a dialogue for best practices is a process distinct from the process of confirming compliance with minimum standards. An approach for regulatory authorities would be to prompt financial institutions to take voluntary action by asking them the right questions and providing them with suitable information. They could also aim to secure an environment where customers can make rational choices. These approaches may work to alleviate industry-wide conformism and financial institutions' inward looking inertia.

The methods developed so far by the JFSA in this regard can be classified into the following categories.

- Methods for collecting and accumulating information thorough horizontal review and interviews with borrowers, and providing sanitized information to financial institutions. These could be useful as it is often difficult for financial institutions to get information on other financial institutions as well as on the views of their customers.
- Methods for helping financial institutions objectively assess themselves, including progress in realizing the goals set by themselves, for example, by setting benchmarks for financial intermediation.
- Methods to help customers assess financial institutions so that they can make rational choices in selecting those institutions that are putting customers first, such as promoting voluntary disclosure by financial institutions and publicizing reports summarizing information gained from supervision.
- Methods to share principle-based codes between authorities and financial institutions.

Continual effort should be made to develop new methods and improve existing ones, learning from trials and experimentation.

b. Methods for dynamic supervision that ensures sustainable safety and soundness

Dynamic supervision aims to verify the balance between risk, return and capital, and the sustainability of business models, and assess the probability that the financial institution will breach the minimum standards in the future. It can be useful to run simulations based on medium-term scenarios, such as persistent low interest rates or a declining population, not just on temporary shock scenarios. These methods of analysis should be reviewed and improved in a learning-by-doing manner.

Even when these analyses identify material risk of future breach of standards, authorities should take a flexible approach which encourages financial institutions to find solutions fit to their specific conditions and problems. The approach should differ from corrective actions taken after a breach. At the same time, it will be necessary to ensure appropriate actions are taken because, if not addressed, the risk may eventually have a negative impact on customers and financial stability. The existing early warning mechanism will also need to be reviewed.

To encourage financial institutions to enhance their capability to identify and respond to emerging risks in a forward-looking manner, supervisors should also be current with risks in the financial system. Macroprudential supervisory approaches should be further developed. International personal networks would be useful in accumulating informal information on risk. Stress tests can also be used to verify if financial institutions have established risk governance which will allow them to deal with emerging risks in a forward-looking manner.

c. Methods to formulate forward-looking, holistic views with focus on substance

In addition to the methods mentioned above, supervisors should work to improve methods to formulate forward-looking and holistic views with emphasis on substance. For example, methods should be developed and improved for:

- Determining whether financial institutions are correctly evaluating the potential of a customer's business when extending loans, instead of the conventional approach of focusing on collateral, guarantees, and the current balance sheet.
- Identifying the root causes of misconducts at a financial institution, such as the business model or governance, instead of focusing only on specific incidents.
- Assessing the effectiveness of the group governance and risk management, instead of individually analyzing the member entities of a financial group.

Where periodic on-site inspections are carried out every few years based on the checklists in the Inspection Manuals, and off-site supervisory teams focus simply on licensing, authorization and sanctions on past incidents, it would be difficult to formulate a forward-looking and holistic view on the substantive characteristics of a financial institution. Further strides should be made in developing integrated, continual on-site/off-site monitoring that begins with off-site identification and the analysis of risk, then moves as necessary to in-depth, on-site discussions, and follows through with continuous off-site monitoring.

Although in the past it was assumed that on-site inspection reviews with financial institutions' internal processes, while off-site supervision assesses their substantive conditions, this distinction should be abandoned. A comprehensive, holistic approach should be adopted to capture both management and risk control processes, and the conditions of business operations and financial soundness.

The existing financial inspection rating system assumes that ratings are given in concluding a periodic inspection. The rating system must also be made consistent with integrated, continual on-site/off-site monitoring. In-depth, constructive dialogues with top management on the priority managerial issues facing the financial institution should be made an integral part of monitoring. Use of objective data and a comparative analysis of financial institutions will make such dialogues more effective.

Dialogues with customers and other stakeholders of financial institutions will help supervisors understand conditions of a financial institution, and supervise them taking into account customer's perspective. When urging financial institutions to make improvements in their business models or in governance, it is not enough to just hold discussions with the management team or departments responsible for compliance and risk management. Dialogue with external directors should play an important role. Constructive dialogue between institutional investors and financial institutions should also be encouraged. Regulators' networking with potential new entrants to financial businesses, such as FinTech ventures which have non-traditional cultures, will be useful in coping with future developments in finance.

2) Developing a new organizational structure, human resource policies, and information systems

To transform into the new supervisory approaches, the JFSA should develop a new organizational structure, human resource policies and information systems fitted to the approaches.

- The JFSA should review its internal organization to make continual monitoring integrating on-site and off-site processes more effective and to strengthen coordination functions. An organizational structure should be developed so that markets and economic intelligence and assessments of risks accumulated in the financial sector could inform the agency-wide strategy and monitoring programs.
- Human resource policy should emphasize recruiting and developing staff with skillsets needed to formulate a forward-looking, holistic view of a financial institution or the financial system with emphasis on substance, and to conduct dialogues on best practices. Such skillsets could include the ability to ask the right questions, explain policy intentions, and establish relationships based on mutual trust, and proficiency in macro-economic environments, business revitalization, historical backgrounds of local economies and regional financial institutions.
- It will also be necessary to find and train experts and to strengthen the internal structure and systems for collecting and analyzing information. These changes will help implement more dynamic supervision for sustainable safety and soundness.

- Strategies should be put in place for accumulating expertise as well as training and securing staff with a strong understanding of the critical emerging issues, including the use of distributed ledger technology, artificial intelligence, big data, and cybersecurity.

It is essential to create an attractive organization to secure human resources capable of supporting and implementing the new approaches.

The JFSA, in comparison with its overseas counterparts, is more dependent on internal resources. The possibility of using outside experts should be examined as a way to secure resources and to improve the quality of its operations. Collaboration with the Bank of Japan should also be promoted further.

3) Fundamental review of the Inspection Manuals and the Supervisory Guidelines

The Inspection Manuals have provided guidance on on-site examination conducted by the Inspection Bureau of the JFSA, while the Supervisory Guidelines have guided off-site monitoring, licensing, authorization, administrative sanctions and other activities conducted by the Supervisory Bureau. The guidance provided by the two documents on the conduct of on-site examination and off-site monitoring have made the following contributions:

- Ensuring transparency, fairness, and external accountability in supervision
- Providing a common basis for discussions between financial institutions and regulatory authorities
- Raising the standards of self-management in financial institutions
- Providing quality control for supervision
- Accumulating lessons from past incidents and experience, and securing continuity in supervisory policies

On the other hand, following criticisms on them have been raised:

- Examiners excessively focus on confirming a checklist. Some examiners, depending too much on checklists, have made formalistic and trivial comments, which in turn lead to a tendency to lose sight of more substantial issues as well as the holistic views.
- Formalistic compliance with checklists by financial institutions leads to formalistic self-management and compliance-oriented risk management.

- A culture is being fostered that assumes everything must be okay as long as the minimum standards are being met.
- The Inspection Manuals and the Supervisory Guidelines prevent dynamic responses by financial institutions to changes in the environment and priority issues, and provide an excuse for avoiding any real self-transformation.

Given the concerns outlined above, it is necessary to fundamentally review the Inspection Manuals and the Supervisory Guidelines, taking account of the direction recommended in this report. The review process should incorporate discussions with financial institutions and other stakeholders so that a common understanding will be formed.

The following changes should be made in the Inspection Manuals and the Supervisory Guidelines:

- They should attain appropriate balance between rules and principles. They should focus on the descriptions of underlying logic and purposes of supervision. Illustrative examples and cases would be useful.
- They should provide guidance on how dialogues on best practices and dynamic supervision can be implemented. The guidance should be continuously improved.
- They should present methods devised to promote dialogue in ways that respect the diverse, proactive initiatives of financial institutions (including principles for preventing inappropriate intervention in managerial matters by regulatory authorities).
- They should be designed so that financial institutions can use them when implementing voluntary measures for achieving better risk management and improved governance.
- They should be integrated to present a comprehensive view of continuous, integrated on-site/off-site monitoring.

Supervisory viewpoints are subject to wide differences in timeframes, ranging from subjects that hardly ever change to issues that demand quick action. Similarly, there is a broad spectrum in their level of maturity, ranging from those based on a consensus that already exists domestically and internationally to other points that require a trial and error before standard thinking is established. Addressing all of these issues in a single document would hinder timely actions and create misunderstandings on the maturity of the guidance provided.

To flexibly and dynamically shift the supervisory focus to reflect changes in the environment and priority issues, and to provide materials for dialogues that match the various levels of maturity, it is recommended to use a combination of the following materials or documents:

- Materials for promoting the exchange of views on issues still at low levels of maturity where the basic concepts and focal points have yet to be established (discussion papers).
- Materials for quickly conveying views on specific situations and issuing alerts (circulars, summary of JFSA remarks at meetings with the industry).
- Documents outlining priority issues for each program year (JFSA Strategic Directions and Priorities).

Some of the items in the above materials may evolve into more permanent viewpoints which should be shared widely. They then could be integrated into the manuals and guidelines.

4) Dialogue with a wide range of stakeholders

As previously noted, a common understanding of the new directions has not yet been fully shared within the JFSA, or with financial institutions and their customers. The JFSA must ensure that these new directions take root among all staff members and that they permeate the whole organization. Further, the JFSA should present these new directions to stakeholders including financial institutions, customers and institutional investors, and seek their comments.

Supervision from a broader viewpoint focusing on substance, the future, and a holistic view; dialogues on best practices; and dynamic supervision are much more difficult to implement than conventional supervision. For example, it will become more critical for regulatory authorities to exercise sound judgment. To satisfy the requirements and objectives of the new directions, it will be necessary for regulatory authorities to deepen their dialogue not only with financial institutions but also with a wide range of stakeholders, including business corporations, consumers and other players in the market. Such dialogue will help the JFSA to make sure that its judgments are not self-righteous, that its actions are agile and current with changes in the environment, that its supervisory practices are consistent with the ultimate goal of regulatory policy, that its policies are based on customers' viewpoints, and that an environment is provided so that effective governance is exercised at financial institutions.

5) Coordination between domestic policy formulation and contribution to the global regulatory reforms

Japan's regulatory policy cannot be independent from international regulatory standards. However, in the past, the international sections of the JFSA tended to negotiate in international fora to minimize the burden of adopting international standards, while the domestic sections independently addressed domestic issues. The international and domestic sections of the JFSA tended to perform their responsibilities within a narrowly defined scope.

There are many commonalities between the problems that global regulatory reforms intended to address and the challenges that Japanese regulators face. Joint works by the JFSA's domestic and international sections should be encouraged so that Japan contributes to global discussions with constructive suggestions based on the experience in Japan and uses the accumulated wealth of international discussions to resolve its own domestic issues.