

## **Basic Policy for Financial Inspections in Program Year (PY) 2008**

### **I. Foreword**

The Financial Services Agency (FSA) is not only making efforts to ensure the stability of the financial system and the protection of users, but is also engaging in vigorous activities to strengthen the competitiveness of the Japanese financial and capital markets while working hard to establish reliable and transparent financial regulations.

In the previous program year, the FSA conducted financial inspections following its new initiative to improve the quality of financial inspection (“better regulation” initiative). The FSA took a priority-driven approach, while especially focusing on the responses of financial institutions to the increasing complexity and diversity of risks. Other measures included proper operation of the Financial Inspection Rating System that was put into full force in January this year.

In the current program year, it is the most important issue for the FSA to further disseminate and ingrain the concept of “better regulation” within the Inspection Bureau and the Ministry of Finance’s Local Finance Bureaus.

The FSA intends to implement measures following the preamble of the recently revised Inspection Manual (II), and focus on priority inspection items selected in light of the conduct of inspections in the previous program year and the current circumstances surrounding financial institutions (III).

### **II. Basic Concept on Conduct of Inspections**

#### **(1) Priority-Driven Approach Focusing on Important Risks**

The FSA will conduct inspections with a priority-driven approach focusing on risks that are particularly important in managing of individual financial institutions, by gathering highly relevant information regarding business operations of respective financial institutions and market developments, and thereby precisely identifying where risks lie. To this end, the FSA will enhance its back-office functions and engage in effective cooperation with the Supervisory Bureau and other relevant organizations.

The FSA will then conduct inspections in the following manners, while paying due consideration to the scale and nature of financial institutions and seeking to reduce their burden associated with inspections.

- Conduct in-depth analysis and examination of major banks, under a system where a chief inspector of a major bank will be assigned to examine a specific major bank for several years (a Japanese version of the ‘Examiner-in-Charge’ system)
- Actively conduct targeted inspection of major and regional financial institutions, insurance companies, etc.
- Introduce simplified inspections aimed at small financial institutions with a limited

range of business operations (small branches of foreign banks and credit associations operating exclusively among particular occupations or business sectors).

(2) In-Depth Analysis and Clarification of Causes of Problems that would lead to Achieving Fundamental Improvement

The FSA will conduct in-depth analysis and clarification of the cause of problems through effective dialogue with the financial institution concerned, so that the two sides can share common perspectives on the course of improvement. For example, with regard to governance issues, such analysis and clarification will be conducted if an inconsistency is detected between the objectives of the financial institution's management strategy and its basic policy for internal control.

(3) Identification of Problems, Evaluation of Appropriate Improvement Efforts and Examination of Static and Dynamic Aspects

While the FSA duly evaluates financial institutions' appropriate efforts toward improving and enhancing their internal control systems, the FSA will fully examine not only static conditions of the problem identified on inspections but also dynamic conditions, such as progress in the improvement of the internal control system, for example.

The FSA will constantly review the Financial Inspection Rating System, which was put into full force in January this year, as well as the operation of the system, in order to enhance its effectiveness as a guideline for financial institutions to make sustained improvements in their management on their own initiative.

(4) Explanation of the Basis for Ratings and Pointing out Problems, and Clarification of Items to be Considered for Improvement

When holding dialogue and discussions with financial institutions about the issues pointed out in inspections and inspection rating results, the FSA will explain specifically and logically why those issues have been raised and why those ratings have been given. Also, when pointing out problems, the FSA will focus on issues that are important for the management of the financial institution. When notifying the inspection results, the FSA will clarify the items that need to be improved if higher inspection ratings are to be achieved.

Moreover, by enhancing the collection of examples of issues pointed out in financial inspections, the FSA will proactively provide financial institutions with useful information for them when they consider what items should be improved and how improvement measures should be taken.

(5) Accurate Understanding of Examination Findings (Sense of Satisfaction)

When proceeding with its examination with due consideration to the points mentioned in (2) to (4) above, the FSA will help financial institutions to obtain an accurate understanding (a sense of satisfaction) on the findings of the examination through further

enhanced dialogue with the management team and at working level, and thus encourage their management improvement efforts.

Since on-site monitoring of inspections provides a useful opportunity to collect frank opinions of financial institutions about inspections, the FSA will conduct monitoring with regard to all inspections, including by enhancing “cross monitoring” (such as monitoring by the FSA of inspections by the Local Finance Bureaus). The results of monitoring will be used to further improve the inspection process.

#### (6) Enhancement of Effectiveness of Inspections

Efforts will be made to further strengthen the Inspection Bureau’s cooperation with the Supervisory Bureau and the Securities and Exchange Surveillance Commission and the cooperation between the FSA and the Local Finance Bureaus, including information sharing. In order to develop necessary human resources, the FSA will promote joint training programs and cross inspections (e.g. participation of inspectors from Local Finance Bureaus in inspections conducted by the FSA) and proactively employ outside professionals (experts in computer systems, market risks, etc.), as part of efforts to enhance its inspection capacity.

### III. Inspection Priorities

Amid the drastic changes in the economic and financial environment both at home and abroad, it is critical for financial institutions to set strategic objectives that clarify their company-wide profit targets and corresponding strategies for both risk-taking and allocating human and physical resources. They must conduct appropriate risk management in line with such strategic objectives.

In this context, the managements of financial institutions need to further enhance their governance system. For its part, when inspecting financial institutions, the FSA will focus on whether they have in place proper legal compliance and risk management systems that conform to their strategic objectives, and whether their governance system for controlling the entire institution is functioning effectively. In particular, in-depth examination will be conducted regarding the following matters.

It should be noted that the following items are the inspection priorities as of August 2008, and may be reviewed, reflecting the situation surrounding financial institutions.

#### (1) Establishment of Appropriate Risk Management System Corresponding to Features of Various Types of Loans and Financial Products

It is becoming increasingly essential for financial institutions to precisely identify the risks inherent in various types of loans and financial products, and further to promptly detect changes in those risks through active monitoring. The FSA will examine whether financial institutions precisely identify risks by closely watching market developments and using stress tests as necessary, and whether they conduct appropriate risk management and Asset Liability Management (ALM).

Regarding holding companies, the FSA will examine whether they are conducting comprehensive management of various risks faced by their entire group, including those risks associated with the consolidated structure of corporate groups that individual group companies could not cope with on their own.

##### (i) Enhancing Screening and Management System of Various Types of Loans and Financial Products

There is an increasing number of financing projects that involve two or more lenders, including syndicated loans and financing for securitization schemes. In such cases, failure to appropriately obtain necessary information or to conduct proper screening and risk management could cause all participants in the financing schemes to suffer the consequences. Meanwhile, alternative investments, such as investments in credit derivatives and structured products as well as provision of capital in investment funds, might possess risk profiles that are complex and unclear. They could cause larger-than-expected losses unless risks across various risk categories (credit risk, market risk, and liquidity risk) are adequately managed (multi-track risk management).

Such being the case, the FSA will examine whether financial institutions fully analyze and grasp the nature of large-scale or complex loan schemes, such as syndicated loans and financing for securitization schemes, as well as their risk characteristics. Regarding housing loans, the FSA will examine whether financial institutions conduct appropriate risk management with due consideration of the possibility of interest rate fluctuations. In cases where external data models are used, the FSA will examine whether financial institutions avoid relying excessively on the models and instead try to use the models flexibly, reflecting their own loan portfolios. With regard to alternative investments, the FSA will examine whether financial institutions conduct risk management paying due consideration of risk profiles.

(ii) Promoting Measures Responding to Basel II Implementation

The subprime mortgage problem has drawn renewed attention to the effectiveness of Basel II as a tool for financial institutions to precisely identify risks and establish appropriate risk management systems, even though some argue for further improvement of its robustness.

In this context, the FSA will examine whether those financial institutions employing the Internal Ratings-Based Approach have established effective procedures for ensuring the reliability and objectivity of internal ratings systems on a voluntary and sustained basis. The focus of the inspection will include processes for accumulating and examining data and operation of the internal rating system.

In addition, the FSA will examine whether financial institutions identify and manage their major risks, including interest rate risk in their banking books, corresponding to their scale and nature of the risk profiles, and whether they disclose information on various risks properly.

(2) Improvement of Control System at Internationally Active Banks

Amid accelerating financial globalization, Japanese financial institutions, headed by major institutions, are aggressively expanding their overseas business operations in order to capture new profit opportunities and strengthen their earnings bases. Establishing appropriate risk management systems to support such moves would contribute to strengthening their international competitiveness.

Financial institutions need to pay due consideration to the fact that overseas business operations are conducted under regulatory and business environments that are different from those at home. In this context, the FSA will examine whether they collect information and identify risks sufficiently, including those aimed toward enhancing their Anti-Money Laundering (AML) system. In doing so, the FSA will further strengthen cooperation with authorities in the United States, Europe and Asia.

Meanwhile, with a view to allowing financial institutions to improve their international competitiveness, the recent amendment of the Financial Instruments and Exchange Act has

made it possible for financial institutions to expand the scope of their business operations, on the condition that they strengthen their internal control systems. Thus, financial institutions are required to move on their own initiative. Under such circumstances, when conducting inspections on financial conglomerates operating in the Japanese market, the FSA will pay due attention to whether those financial conglomerates are building appropriate internal control systems such as those for managing customer information, while cooperating with the Securities and Exchange Surveillance Commission as necessary.

### (3) Promotion of Customer Protection and Improvement of User Convenience

In order to improve convenience for users, financial institutions have been making efforts to introduce and improve a variety of financial services. The Financial Instruments and Exchange Act, which was fully put into force last year, has established an institutional framework that encourages financial institutions to introduce a variety of services.

When financial institutions provide a variety of high-quality financial services, they need to engage not only in the basic activities necessary for the protection of customers, such as the management of customer information and prevention of abuse of advantageous positions and conflicts of interest, but also in active efforts to improve convenience for users.

#### (i) Enhancing Procedures and Arrangements for Promoting Customer Protection and Improving User Convenience.

Amid the increasing complexity and diversity of financial products and services, users expect and demand higher standards from financial institutions as well as from financial products and services. When selling risky financial products, financial institutions are required to explain to customers precisely where the risks lie. The FSA will examine whether financial institutions act flexibly in dealing with customers while sufficiently considering each customer's knowledge, experience and understanding of risk, in accordance with the purpose of the Financial Instruments and Exchange Act. In addition, the FSA will pay attention to whether customers are in effect bearing excessive burden in terms of time and procedures.

Regarding insurance companies, the FSA will examine in depth whether they are adequately making efforts toward improvement in order to prevent the recurrence of the non-payment of insurance claims. Also, the FSA will examine whether financial institutions (including deposit-taking institutions) are striving to improve their arrangements and procedures for providing services and information that satisfy the true needs of their customers throughout the life of products, from solicitation to the termination of contracts.

(ii) Enhancing Procedures and Arrangements for Timely and Appropriate Responses to Consultation Requests and Complaints from Customers

It is crucial for financial institutions to proactively make timely and appropriate responses to consultation requests and complaints from customers in gaining their confidence and reflecting their needs in business operations. From this viewpoint, the FSA will examine the efforts of financial institutions to meet their customers' consultation requests and resolve their complaints. Specifically, the FSA will examine whether financial institutions properly analyze the causes of such complaints, draw up measures to prevent their recurrence, communicate the measures through the entire organization and follow up on their implementation.

(iii) Ensuring Fair and Safe Financial Transactions

Ensuring fair and safe financial transactions is also crucial for customer protection. From this viewpoint, the FSA will examine whether financial institutions are striving to improve procedures and arrangements for preventing transactions with anti-social forces, such as cooperating closely with relevant organizations to collect and analyze information concerning anti-social forces, in the context of AML efforts.

In addition, in response to the enforcement of the law intended to provide relief to the victims of "furikome" billing fraud cases, the FSA will examine whether financial institutions have implemented the measures necessary for preventing fraud using deposit accounts illegally, including adopting systems that freeze banking accounts when suspicious transactions are detected.

In light of the increase in the number of crimes related to Internet banking and victims of forged or stolen cash cards, the FSA will also examine the status of arrangements and procedures for enhancing information security measures, including measures to protect information used for identity verification.

(iv) Appropriate Management of Information Technology Risk

Financial institutions' computer systems constitute the basic infrastructure of their business operations. In line with the increase in sophistication and complexity of the systems, the potential impact of system failures on transactions with customers has constantly grown larger. The FSA therefore will examine whether financial institutions take measures to prevent damage to customer convenience when they upgrade or integrate their systems. Specifically, the FSA will examine whether financial institutions manage projects appropriately and properly conduct management of service providers in case of outsourcing, and whether they take measures including conducting thorough tests and rehearsals by comprehensively identifying systems and operations which potentially contain risks that could entail significant influence on and damage to their customers and settlement systems. The FSA will also examine whether they have effective contingency plans in place, in case system problems occur.

In recent years, IT has been widely used not only as a tool for enhancing management efficiency in financial institutions, but also as a business infrastructure for providing higher quality information and services to their customers. In light of the expected impact of active usage of IT on financial institutions' management, the FSA will examine and evaluate the effectiveness of financial institutions' IT usage.

#### (4) Ensuring Smooth Financing to Small and Medium-Sized Enterprises and Support for Regional Industries

Ensuring smooth financing to small and medium-sized enterprises (SMEs), which support Japan's economic foundations, is one of the most important tasks for financial institutions. SMEs are facing an increasingly severe business environment amid surges in the prices of crude oil and raw materials. Therefore regional financial institutions including regional banks, Shinkin Banks and credit associations, which serve as financial centers for regional economies, are strongly expected to vigorously exercise their financial intermediary functions in their respective regions by properly and proactively taking risks under their own responsibilities and judgments and establishing appropriate risk management systems matching such operations.

For its part, the FSA is implementing a variety of measures in line with the "Urgent Measures for Enhancing Growth Potential," adopted by the cabinet in April this year, with a view to facilitate SME financing and rehabilitating regional industries. Paying due consideration to these measures, the FSA will examine whether financial institutions have established systems that enable them to exercise their financial intermediary functions smoothly and proactively reflecting the actual state of SMEs, coupled with appropriate risk management.

##### (i) Ensuring Smooth Financial Intermediation

When financial institutions judge whether to extend loans to SMEs and conduct assessment on such loans, it is important to understand the actual state of the SMEs, sufficiently considering the features peculiar to the management and financing of SMEs. From this viewpoint, the FSA will make further efforts to communicate the supplement to the Financial Inspection Manual, "Treatment of Classifications Regarding Credit to Small and Medium-Sized Enterprises," to end-users including SME managers through increased public relations efforts, so that SMEs can use it in their efforts for fund-raising.

When examining financial institutions' procedures and arrangements for providing funds to SMEs, the FSA will focus on whether their lending stances are in line with the aims of the supplement to the Financial Inspection Manual, thereby encouraging them to sufficiently exercise functions of financial intermediation for SMEs that maintain sound business operations. In doing so, the FSA will pay special attention to whether financial institutions make loan decisions and conduct risk management with due consideration not only of surface factors such as borrowers' net losses and negative net worth and changes

of loan terms, but also of their management and financial characteristics. In addition, the FSA will positively evaluate the financial institutions' adoption of financing methods suited to SMEs, such as those involving assessment of the value of businesses without relying excessively on real estate collateral or personal guarantees, and clearly reflect the results in financial inspection ratings.

(ii) Supporting Business Rehabilitation of SMEs

Regional financial institutions are expected to play a central role in supporting the business rehabilitation of SMEs and the rehabilitation of regional economies. In some cases, financial institutions have already made significant achievements in business rehabilitation by providing continuous management guidance to troubled SMEs under management improvement plans, in cooperation with the relevant parties. Meanwhile, measures to ensure the financial stability of debtor companies through the enhancement of their capital bases have been implemented one after another. For example, the revision of the Financial Inspection Manual in March this year has enabled financial institutions to count subordinated loans whose features are sufficiently close to equity as part of capital when the FSA classifies the financial institutions' borrowers on loan assessment.

In order to encourage such efforts by regional financial institutions toward corporate and regional rehabilitation and promote their use of the above tools to ensure the financial stability of borrowers, the FSA will examine the actual status of the efforts, disseminate superior initiatives and innovative ideas in a collection of examples of issues pointed out in financial inspections, positively evaluate them in inspections and clearly reflect the results in financial inspection ratings.

(End)

## II . Basic Plan for Financial Inspections for PY2008

		Number of institutions to be inspected	The previous program year (PY 2007)	
			Number of institutions to be inspected	Actual number of inspected institutions
	Banks	95	90	97
	Shinkin banks Credit cooperatives	175	180	176
	Labor banks (Rokin) Federation of agricultural co-operatives associations and Federation of fishery co-operative associations	15	15	14
	Total of deposit-taking financial institutions	285	285	287
Insurance companies		20	15	16
	Non-banking money lenders	120	160	156
	Issuers of prepaid cards	155	165	171
	Others	10	20	17
	Total of other financial institutions	285	345	344

Note:

- (1) These inspection numbers may be changed as necessary.
- (2) The figure on "Banks" is the aggregated number of banks and bank holding companies. That of "Insurance companies" is the aggregated number of insurance companies and insurance holding