July 13, 2009
Financial Services Agency

Progress Status of Initiative toward Better Regulation
– from May 2008 to June 2009 –
<Outline>

Introduction

The Financial Services Agency (FSA) has been engaged in an initiative to improve the quality of financial regulation (Better Regulation) since the summer of 2007.

Since then, the global financial market turmoil triggered by the U.S. subprime mortgage problem developed into a world-wide financial crisis, in particular, following the collapse of a major U.S. investment bank, Lehman Brothers, in September 2008. Amid the drastically changing environment for financial regulation, the FSA has strived to accurately grasp and analyze the current situation, and has implemented various types of measures in a short period of time, keeping its viewpoints regarding "Better Regulation" in mind when carrying out crisis response measures.

During this past year, the FSA has continued its own initiatives to further promote Better Regulation in conducting inspection and supervision, and to move ahead with it into the future.

Ⅰ. Changes in the Financial Regulatory Environment and Better Regulation

1. Changes in the Financial Regulatory Environment and Better Regulation

(1) Significance of Better Regulation Today

Until the latest financial crisis became evident, it was widely recognized, mainly in the U.S. and Europe, that easing financial regulations would promote financial innovation and this in turn would lead to the development of financial and capital markets. The financial crisis, however, revealed that there are cases where the financial innovation as shown in the expanded origination and distribution of complex financial products does not necessarily lead to enhancing the function of the market mechanism.

In order to make financial markets function better and enhance the stability of the national economy and welfare, the regulation-free environment is not optimal and the need for public-sector involvement is being increasingly recognized.

At the same time, since low-quality public-sector involvement and regulation aggravate the distortion of markets, for instance, by encouraging regulatory arbitrage, it is required to make efforts to ensure high-quality regulation.

Accordingly, the importance of enhancing the quality of regulation (Better Regulation) has been reaffirmed.

(2) Significance of the "Four Pillars of Better Regulation" and the Future Direction

First Pillar (Optimal combination of rules-based and principles-based supervisory approaches)

In view of the latest financial crisis, there has been a global movement to strengthen rules-based regulation. On the other hand, in the "Better Regulation" promoted in Japan, rules and principles are complementary, rather than mutually exclusive. Japan is therefore seeking to ensure the effectiveness of the entire regulatory framework through an optimal combination of these two approaches.

Japan intends to continue to implement principles-based regulation and supervision in the areas where principles rather than rules are more compatible, while dealing properly in the areas where stricter rules are deemed necessary in view of the latest financial crisis.

It is important to continue to ensure a proper balance between rules and principles, while fully taking into account that the conditions of the financial services industry and the regulatory environment differ from one country to another and that an optimal balance between rules and principles could also change.

Second Pillar (Timely recognition of priority issues and effective response)

The importance of effectively utilizing the limited administrative resources in high-priority areas remains unchanged. Amid the globally changing environments surrounding financing and markets in this past year, the FSA has identified risk factors and implemented necessary measures at an early stage from the perspective of maintaining the soundness of the financial system. In particular, the FSA has encouraged the financial institutions to ensure the appropriate balance of the risk-management and risk-taking, so that the economy and market would not be negatively affected, while recognizing the strong correlations between global economic and market developments and the behavior and soundness of the financial institutions.

Through such efforts as improving communications with diverse market participants and reinforcing collaboration with the central bank and among international financial regulators, it is important to strengthen the ability to establish timely policies through the collection and analysis of a wide range of information on the impact of global economic and financial market developments on the financial institutions and the impact of financial institutions' behavior on the economy and markets.

Third Pillar (Encouraging voluntary efforts by financial institutions and placing greater emphasis on providing them with incentives)

In view of the latest financial crisis, various measures to strengthen regulations are now being discussed. However, we should keep in mind that financial vitality is basically brought about by the voluntary efforts of the financial institutions and market participants. Voluntary efforts by the financial institutions and market participants are also important from the perspective of enhancing their risk management.

Therefore, we intend to continue to encourage financial institutions and market participants to make voluntary efforts and place greater emphasis on providing them with incentives. However, in light of the lessons learned from the latest financial crisis, it is important to keep a close watch on whether they are motivated by distorted incentives, such as short-term profits and conflicts of interest.

As a supervisory authority, it is important to identify what incentives the behavior of financial institutions and market participants are based on and to conduct monitoring in order to ensure that their behavior will lead to better market functions rather than market distortion.

Fourth Pillar (Improving the transparency and predictability of regulatory actions)

In this past year, the FSA sought to disseminate its viewpoints at various international conferences and symposiums. The FSA also published its viewpoints in a question-and-answer format on matters frequently asked by users.

The FSA will strive to improve the transparency and predictability of regulatory actions by continuously disseminating information in Japan and abroad, as well as enhancing dialogue with financial institutions.

2. Examination of Responses to the Crisis

The global financial market turmoil and the recession in the world economy caused deterioration in the real economy and a decline of the stock prices in Japan, which have had adverse impacts on Japan's financial system. However, since Japanese financial institutions did not focus their financing business on seeking profits for leveraging and removing assets from their balance sheets, Japan's financial system has remained relatively stable compared with those in the U.S. and Europe.

If financial institutions had become excessively cautious about risk taking and their financial intermediary function had declined, it might have triggered a negative spiral of a deteriorating real economy, causing adverse effects on the soundness of the financial institutions, and thus resulting in a further reduction of their risk-taking abilities.

The FSA, recognizing the interrelations between the financial sector and the real economy, closely monitored the financial soundness of financial institutions, market developments, and the business conditions and fund-raising situation of the corporate sector in collaboration with related organizations, including the Bank of Japan, the Ministry of Finance, and the Small and Medium Enterprise Agency. In particular, with regard to facilitating financing, the FSA made efforts to collect information on borrowers and disseminate information on the need to facilitate financing. At the same time, the FSA took necessary measures from the perspective of ensuring the soundness of individual financial institutions. It also addressed the prevention of price formation deviating extremely and constantly from fundamentals on the stock market as a matter of priority.

In conjunction with the above measures, and based on the recognition that international cooperation is essential to overcome and prevent a recurrence of the global financial crisis, the FSA actively participated in international discussions and is promoting the establishment of a framework for regulation and supervision from a medium- and long-term viewpoint in cooperation with other countries.

<For examinations of individual measures to cope with the financial crisis, see the text (Japanese version)>

Ⅱ. Efforts for Better Regulation in Inspection and Supervision

1. Changing the Administrative Attitude of FSA Employees toward Better Regulation

It is no exaggeration to say that the level of inspection and supervision of a country depends on the every move of officials engaged in inspection and supervision. In particular, since inspectors meet the executives and employees of financial institutions on business on a daily basis, individual inspectors’ daily behavior has a major impact on the executives and employees of the financial institutions. For this reason, it is important to continuously promote all inspectors to improve their administrative attitude by offering the basic principles of Better Regulation.

The FSA worked out the basic stance, in five principles, toward financial inspection (March 2008) and stipulated them in the preamble of the Inspection Manuals (August 2008).

- (i) Inspection focusing on important risks (“risk-focused, forward-looking” approach)
- (ii) In-depth analysis and clarification of causes of problems necessary for fundamental improvement
- (iii) Identification of problems, evaluation of appropriate improvement efforts and examination of static and dynamic aspects
- (iv) Explanation of the basis for ratings and pointing out problems, and clarification of items to be considered for improvement
- (v) Accurate understanding of examination findings (sense of satisfaction)

2. Current Progress

Financial inspection: Action Plan I was prepared (June 2008) to systematically promote Better Regulation. Characteristic measures are as follows.

- (i) Operational improvement of interim reports (Senior FSA officials check the progress of inspection)
- (ii) Monitoring of all inspections (Senior FSA officials visit financial institutions and

hear opinions from executives directly)

(iii) Examiners in charge at major banks (A system to appoint chief inspectors in multi-year posts has been introduced to timely identify important management issues and select the most important examination area)

(iv) Improvement of the notification of inspection results (In order to provide incentives for improving management, Grade B, which accounts for 70% of inspection results, has been divided into three categories: “B close to A,” “average B,” and “B close to C.”

(v) Cross inspection and joint training (From the standpoint of unifying inspection criteria at the FSA and local finance bureaus and of enhancing the inspection ability of local finance bureaus, the FSA and local finance bureaus will promote the mutual dispatch of inspectors and implement joint training)

(vi) Holding briefing sessions on “the Supplement to the Financial Inspection Manual” (Briefing sessions will be held across the country with the aim of helping the managers of smaller businesses when they conduct loan negotiations with financial institutions or seek assistance for improvement of the management)

Securities inspection: In light of the purpose of Better Regulation, the Basic Inspection Policy and Inspection Program for Business Year 2008 was published (July 2008). The Securities and Exchange Surveillance Commission (SESC) strived for efficient and effective inspection, while keeping the following points in mind.

(i) An adequate combination of principle-based inspection focused on the improvement in financial instruments firms’ business management systems, and the rule-based verification of their compliance with market rules.

(ii) A sharper risk-focused approach, with a more forward-looking mind-set, in selection of financial instruments firms to be inspected, as well as of areas to be inspected.

(iii) More emphasis placed on interactive dialogues with the financial instruments firms, with a view to encouraging their voluntary efforts toward developing stronger internal control functions.

(iv) More transparency and predictability in inspection methodology, for example through the publication of the revised “Inspection Manuals for Financial Instruments Firms.”

Financial supervision: In order to conduct hearings in accordance with the features of business and the risks of individual financial institutions, instead of conducting uniform hearings with all financial institutions:

(i) the FSA prepared materials that analyzed the features of individual financial institutions from various angles, such as risk category, profitability, and capital adequacy, and shared them with local finance bureaus; and

(ii) the local finance bureaus made efforts to conduct in-depth hearings in accordance with the features of the individual financial institutions by utilizing the analyzed materials.

In addition, the FSA reorganized redundant hearing items, set priority issues, shared the recognition of management problems of regional financial institutions with local finance bureaus, and conducted hearings focused on facilitating financing to small and medium-sized enterprises and on important management issues of the financial institutions.

3. Overhaul of the Current Progress, and Future Tasks

Financial inspection: The FSA examined and evaluated the progress of Action Plan I through the intensive discussions with inspectors and listening to their opinions and clarified the tasks to be tackled in the future. The results of the evaluation can be summed up as follows.

(i) Financial institutions and authorities now have more frank exchanges of opinions than before.

(ii) Inspectors' awareness has improved.

(iii) The inspection level of local finance bureaus has increased, narrowing the gap with that of the FSA.

(iv) The importance of the understanding and cooperation of financial institutions has been reaffirmed

(v) The FSA now understands which measures are effective in disseminating Better Regulation.

(vi) However, financial inspection can still be improved. It is by no means yet sufficient in terms of conducting inspection conducive to the voluntary improvement of financial institutions. In addition to extending and strengthening the efforts made so far, it is necessary to enhance the level of all inspectors (strengthening their inspection and examination abilities).

Securities inspection: Responding to the increase in the number of firms to be inspected due to a series of revisions of the Financial Instruments and Exchange Act, and the financial crisis, the SESC launched "The Project for Reviewing the Inspection Process" (September 2008).

Based on the results of further discussions, the SESC revised "the Basic Inspection Guidelines" (June 2009). The main points in the revision are as follows.

- Further improvement of inspections focused on internal management and risk management
- The trial introduction of prior notice inspection
- Enhancement of interactive dialogue with the senior management of the inspected firms (exit meeting etc.)

- Preparation of a “list of materials to be submitted” for each type of firms as a standard example of materials to be submitted at the beginning of inspections
- Enhancement of the inspection monitoring system by providing opportunity for the inspected firms to submit their opinions by means of filling out questionnaires format via mail or e-mail.

Financial supervision: Continuing to make further efforts to strengthen the monitoring system is important. In particular, in view of the recent financial crisis, it is important to identify risks that may affect the financial system as a whole and address them. It is, therefore, necessary to establish a system to respond to drastic changes in the financial and economic conditions based on international discussions, while promoting collaboration with inspections.

4. Efforts for the 2nd Stage of Better Regulation

It is important to make efforts for the second stage of Better Regulation based on the results of the overhaul and tasks clarified from the overhaul, and continuously develop the Better Regulation.

Financial inspection: Based on exchanges of opinions with individual inspectors, the FSA worked out Action Plan II for comprehensive efforts to upgrade the Better Regulation and prepared a time schedule to systematically promote the efforts. The main points are as follows.

(i) Thorough implementation of the five principles prescribed in the preamble of the Inspection Manuals

(ii) Dissemination of information concerning Better Regulation, Basic Policy for Financial Inspection and the Supplement to the Financial Inspection Manual and enhancement of interactive dialogue by gathering regional and on-the-spot information.

(iii) Efforts to promote the advancement of information gathering and examination methods

(iv) Efforts to enhance human resource development

Specific efforts for strengthening inspection and examination abilities are as follows.

(i) Enhancing and strengthening pre-inspection analysis and increasing checkpoints of back-office operations, and cooperation with the Supervisory Bureau

(ii) Strengthening cooperation with the Securities and Exchange Surveillance Commission and foreign authorities

(iii) Enhancing an inspection technique concerning the smooth financing to small and medium-sized enterprises

(iv) Building a database of inspection know-how

(v) Fostering inspectors in charge of loans and those in charge of insurance companies and foreign financial institutions

(vi) Securing personnel with expert knowledge and skills (e.g. experts in computer systems and market risk, actuaries, lawyers, and accountants)

Securities inspection: The SESC intends to steadily implement measures incorporated in the “Basic Inspection Guidelines” and focus on the following points in line with the Basic Inspection Policy and Inspection Program for Business Year 2009.

(i) Risk-based inspection taking into account the size and risk profiles of each business operator

(ii) Inspection to encourage inspected firms to become aware of their roles as gatekeepers that contribute to ensuring fairness and soundness in the financial and capital markets

(iii) Inspection that takes a proactive approach toward the emerging risks to prepare for the future

Financial supervision: The quality of monitoring will be further enhanced for the effective and efficient supervision. Specifically:

(i) efforts to enhance monitoring will be expanded to other types of industries, including insurance companies and securities companies, and identification and analysis of inter-industry risks will be further promoted; in order to accurately grasp and cope with risks that may affect the financial system as a whole, further efforts will be made to enhance the system, considering international discussions;

(ii) operation processes, including collection, analysis and utilization of data necessary for monitoring will be made more efficient and advanced, by strengthening the collaboration of the information analysis functions between financial inspection and supervision; and

(iii) the ability of officials in charge of inspection and supervision will be enhanced by formulating and implementing more practical training programs in line with the monitoring process and by utilizing information on supervisory methods of other countries.