

Annual Supervisory Policies for Major Banks for Program Year 2009¹

The Financial Services Agency (FSA) publishes its Annual Supervisory Policies for Major Banks for each program year so as to clarify its supervisory priorities. This is prescribed in the “Comprehensive Guidelines for Supervision of Major Banks” which show basic approaches for the supervisory process aimed at major banks.

In this Program Year, in accordance with “Basic Concepts on Supervision of Financial Institutions for the Future” as shown below, the FSA will place priority on the three areas 1) risk management and stability of financial system, 2) performing a smooth financial intermediary function and 3) improving customer protection and convenience for users, and supervise major banks while striving to have frank and deep discussions with them.

It should be noted that these supervisory policies were drawn up in light of the circumstances that surrounded financial institutions as of August 2009, and may be subject to review as necessary.

1. Experience of Financial Crisis and Basic Concepts on Supervision of Financial Institutions for the Future

Last program year, the turmoil in the international financial markets was triggered by the subprime mortgage problem and pushed to a state of crisis by the bankruptcy of major financial institutions in the US. It was a year in which the economic crisis affected not only financial markets, but also the global economy as a whole including Japan’s real economy.

At the time of establishing the Annual Supervisory Policies for Major Banks for Program Year 2009, the economy is showing movements of picking up recently while in a difficult situation. However, the environment surrounding bank customers including small- and medium-sized enterprises (SMEs)² remains severe. In addition, the financial sector in Japan has so far remained relatively sound compared with the situation overseas, but the

¹ In this document, the term “major banks” refers to so-called major banks as well as Shinsei Bank, Aozora Bank, Citibank, and Japan Post Bank.

² The term “small- and medium-sized enterprises” includes micro enterprises.

confusion in domestic and overseas financial markets and deterioration in the real economy meant that bank management incurred losses in the holding of marketable securities centering on stocks and an increase in losses on bad debts, as seen in the closing of accounts for FY2009.

Amid these circumstances, while considering the concepts of better regulation in the last program year, we have been making efforts to deal with the financial crisis. Among those efforts, we reconfirmed the importance of “Better Regulation”.

Accordingly, the FSA is placing “Better Regulation” as a key component (engaging in frank and deep discussions with financial institutions, disseminating information to the outside, sharing and linking information on the economic and financial situations in Japan and overseas, and improving the transparency and predictability of regulatory actions) and striving to further have it become embedded and enhanced. In doing so, the FSA will pay attention to the following points in particular.

- 1) Financial institutions are expected to be aware of long-term managerial issues, conduct positive managerial reforms and make appropriate and responsible business judgments under the appropriate leadership of management personnel. The FSA more than ever will strive to (i) conduct financial administration with a high risk sensitivity that can detect at an early stage any risks that exist in each financial institution or financial system (ii) conduct financial administration that further improves customer protection and convenience for users by looking at things from a citizen’s and user’s point of view (iii) conduct financial administration that does not stop at short-term responses but that also thoroughly determines the progression of international discussions and considers environmental changes, while at the same time implementing long-term responses with an eye on the future, and (iv) help financial institutions autonomously improve management and make better business judgments via frank and deep discussions and the distribution of information.
- 2) The FSA, in addition to encouraging closer cooperation among inspection divisions, the Securities and Exchange Surveillance Commission (SESC) and the Bank of Japan (BOJ), will also cooperate with overseas authorities via supervisory colleges, and positively contribute to international standards setting bodies.
- 3) Through the thorough fostering, securing and training of specialized human resources, the FSA will redouble efforts for human resource development and permeating financial knowledge.

2. Risk Management and Stability of Financial System

Because of the confusion in international financial markets and deterioration in the

real economy, Japan's financial sector including major banks was affected by increased losses in the holding of marketable securities centering on stocks and disposal loss of nonperforming loans (NPLs).

Amid these circumstances, in order to thoroughly continue performing financial intermediary functions and under appropriate management (governance) it is essential that major banks ensure strong and comprehensive risk management, and by extension also contribute to the stability of the financial system. The FSA more than ever will pay attention in particular to the following points while increasing risk sensitivity, and will encourage autonomous efforts for each management measure. In doing so, the FSA will aim to ensure, considering that the current situation is one in which it is essential to have an appropriate balance between risk taking and risk management, that there is a smooth provision of funds to borrower companies while maintaining the soundness of the financial institutions themselves.

(1) Enhancement of risk management and financial foundations

- 1) Under the leadership and strong commitment of management personnel, financial institutions keep an eye on changes in the environment surrounding the business of macroeconomic positions and market environments, and the FSA investigates whether a bank is implementing appropriate risk management including stress tests. Then, based on the results of stress tests implemented by each bank, the FSA holds thorough, deep and two-way dialogues with major banks on the characteristics and managerial issues of each risk.
- 2) Shares have a large weight among the risks that major banks possess, and so with regards to the share-price-change risks inherent in each of the directly owned shares and investment trusts including ETFs, as well as employee pension trusts, the FSA will accurately determine any profit and loss or effects on equity capital that arise from market movements, and in cases where risks have become actualized investigate whether a bank has appropriate management including tolerance from a financial viewpoint.
- 3) Bearing in mind that equity capital is the positive basis for risk taking while also forming the basis of the market's confidence, the FSA will keep an eye on progressions in international discussions and encourage financial institutions to enhance their equity capital from the viewpoint of improving practical tolerance of future stress.

(2) Responding to grouping and international developments

- 1) In major financial groups, through the concentration of risks there has been an increase in the potential risks that can affect financial systems. Moreover, in accordance with organizations becoming large-sized and compartmentalized it has become hard to conduct organization-wide risk management and it has become unclear where exactly in an organization risks are located. Because of these things, when supervising major financial

groups, the FSA will carefully investigate whether an institution is appropriately maintaining comprehensive risk management for the group overall, and also whether management personnel are autonomously and appropriately building an internal control system with regards to conflicts of interest in management or the handling of customer information.

2) In accordance with the rapid deterioration in overseas economies, the importance of non-Japanese credit risk management has increased. Consequently, in each financial institution the FSA will investigate whether comprehensive risk management including overseas bases is being maintained, and also focus on the supervision of overseas bases. In doing so, the FSA will cooperate with overseas authorities when the need arises.

(3) Soundness of financial system

While responding to the above issues on a policy-by-policy basis, the FSA will be aware of the strong correlative relationships between (i) macroeconomics and movements in financial markets and (ii) the financial intermediary function and the soundness of banking finance, and have a good prescience of issues by considering the state of transactions in financial markets, while sufficiently cooperating with the BOJ as well as by scrutinizing the state of risk accumulation and the distribution mechanism, from the viewpoint of being able to continually and stably develop the financial system as a whole. In particular, the FSA will conduct analysis and respond to issues in the financial system on a priority basis for major banks that will be largely affected by these issues.

Furthermore, on an international basis, owing to the recent financial crisis there are moves to rethink areas such as the effectiveness of the method of comprehensive risk management that has been conducted so far, such as capital allocated management based on economic risk capital or limiting the amount of risks, and the risk management that financial institutions should have. Considering such circumstances, the FSA is working on having deep and two-way dialogues with major banks and having a shared awareness with regards to the risk management that financial institutions should have.

3. Performing a Smooth Financial Intermediary Function

(1) Facilitating smooth business finance for organizations including SMEs

In the last program year, while making efforts to determine the situation regarding business finance, the whole government including the FSA drew up a variety of measures aiming to have smooth finance. However, the managerial environment surrounding borrower companies including SMEs continues to remain severe and there are ongoing high hopes that financial institutions will serve appropriate and positive financial intermediary functions.

Amid such circumstances, the FSA will make efforts while paying attention to the following points.

- 1) While continuing to implement a questionnaire for SMEs, the FSA will further utilize the hotline for smooth finance. Through this questionnaire and these kinds of efforts, the FSA will have a firm grasp of the details of the financing climate of major banks and the state of borrower companies.
- 2) The FSA will investigate whether a bank makes finance decisions based on the management status and characteristics of borrower companies on an everyday basis, and based on those things whether a bank makes accurate and detailed business judgments, whether a bank thoroughly gives explanations to customers that cover the actual situations, and whether a bank maintains appropriate management of associated risks.
- 3) While linking up with related governmental bodies such as the Small and Medium Enterprise Agency, the FSA will aim for smooth business finance of the Emergency Guarantee System. In addition, while encouraging the appropriate use of a variety of measures, for major banks to precisely achieve what is called a good “ability to discern” the state of borrower companies, including providing support for management improvement and support for business restructuring, the FSA will aim to positively achieve a financial intermediary function that creates value to increase the added value of borrower companies.

(2) Detailed handling of housing loans

Also with regards to personal finance such as housing loans, the FSA will conduct supervision while keeping the following points in mind.

- 1) While customer’s earning environment remains severe, the FSA will encourage banking operations that sufficiently consider customers’ economic situations and lifestyles including revisions to repayment conditions.
- 2) Also with regards to new loans, while keeping in mind repayment plans that do not prove impossible for customers to adhere to in the future, the FSA will work to ensure a smooth provision of funds via detailed loan judgments that consider customers’ economic situations.
- 3) In order to obtain customers’ understanding and approval, the FSA will strive to ensure banks give them appropriate and detailed explanations.

4. Improving Customer Protection and Convenience for Users

Improving customer protection and convenience for users in financial institutions not only helps to achieve a sound national economy, but it also helps to stabilize Japan’s financial systems by increasing citizens’ trust in financial institutions. In financial institutions, when implementing strict management of customer information and preventing people from

abusing their position of power, and managing conflicts of interest, and also when implementing thorough customer protection based on a sense of security and trust, it is important to make use of originality and ingenuity from the customer's viewpoint and increase competitiveness by providing financial products and services.

Accordingly, in this program year the FSA will conduct investigations while placing priority on the following points, aiming to have improved customer protection and better convenience for users in financial institutions.

In doing so, the FSA will respect the autonomous efforts of each bank, and proceed with supervision that places importance on incentives. Accompanying this, the FSA will also pay attention to ensure there are no warped incentives that may arise because financial institutions are pursuing quick profits or because they have conflicts of interest.

Furthermore, as the need arises the FSA will cooperate with the Consumer Affairs Agency, an institution for which there is high hopes with regards to its fulfillment of roles in the area of integrated promotion of consumer administration.

(1) Thorough management of information security

Customer information forms the basis of financial transactions and it is important to strictly manage it also from the viewpoint of protecting personal information. Furthermore, it is important to strictly manage corporate information in order to increase trust in market transparency and fairness. From these viewpoints, the FSA will firmly encourage the appropriate maintenance of internal control systems for information security, and the enhancement of rules of professional conduct to prevent inappropriate actions of officers (such as information leaks or insider trading).

In addition, in June this year the firewall regulations were revised and a framework was created for a principal base to encourage financial institutions to have an autonomous management system to deal with conflicts of interest. With regards to these, the FSA will conduct investigations as to whether banks have made accurate responses with regards to improved customer convenience and the prevention of conflicts of interest.

(2) Enhancing System for Providing Explanations to Customers

With regards to sales of products that carry risks such as investment trusts, structured bonds and derivatives, the FSA will conduct investigations from the viewpoint of whether a bank has built a business promotion system from the viewpoint of customers, and whether a bank is giving appropriate and flexible explanations to customers based on their attributes and experiences and with regards to the locations and characteristics of risks so that those customers can make accurate judgments.

(3) Enhancing Systems for Processing Consultations and Complaints from Customers

It is extremely important to carry out independent, timely and appropriate

consultations and complaint handling while ensuring customer trust, after implementing business management that makes good use of customer needs. From this viewpoint, the FSA will conduct investigations to check whether banks are appropriately analyzing the causes of consultations and complaints, taking measures and notifications to prevent their recurrence, and conducting follow-ups on their implementation status.

Furthermore, considering that the Banking Act, which was revised this June, mentioned the financial Alternative Dispute Resolution (ADR) system, the FSA is encouraging banks to make the necessary preparations toward the start of this system. Also before the start of the system, with regards to the current industrial bodies autonomously linking with the ADR framework, the FSA will investigate whether banks are appropriately maintaining consultations and complaint handling systems.

(4) Preventing abuse of financial functions

In order to ensure security for users, the FSA will verify, based on the following perspectives, whether the major banks' management systems have been developed to prevent financial functions from being abused and to deal with victims properly. In doing so, the FSA will check the management systems to properly confirm customers' identity and to detect transactions that are strongly suspected of being illegal and make appropriate responses (e.g., freezing of bank accounts).

- 1) Does a bank make efforts to eliminate furikome fraud (e.g., alerting customers of the fraud around ATMs)? Does a bank deal with victims properly and promptly in accordance with the Furikome Fraud Relief Act³?
- 2) Does a bank make efforts to prevent unauthorized withdrawals from bank accounts by using counterfeit/stolen cash cards, stolen passbooks, and Internet banking? Does a bank pay compensation to victims properly according to the Depositor Protection Act⁴ and agreements within the industry?
- 3) Does a bank take actions to prevent money laundering and terrorist financing in domestic and overseas branches, to the extent that it meets international requirements for major banks?
- 4) Does a bank make efforts to cut relationships with antisocial groups aiming to prevent damage from antisocial groups?

(5) Ensuring business continuity

Financial institutions' systems are essential infrastructure for running a business and as those systems become more advanced and complex, the effects that system failures

³ Act on Payments, etc., of Distribution as Relief for the Damage related to Funds in Deposit Accounts, etc., Used for Criminal Activities.

⁴ Act on Protection, etc of Depositors and Postal Saving Holders from Unauthorized Automated Withdrawal, etc. Using Counterfeit Cards, etc. and Stolen Cards, etc.

have on customer transactions are becoming larger and larger. Considering that major banks are playing core roles in financial systems, with regards to the continuity of each bank systems, the FSA will confirm whether a bank is conducting appropriate risk management under the leadership and commitment of management personnel. Furthermore, the FSA will also confirm whether a bank is building a system with which it can ensure business continuity in the event of earthquakes or pandemic influenza, etc.