

(Provisional translation)
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Financial Services Agency

Annual Supervisory Policies for Regional Financial Institutions¹ for Program Year 2009

The Financial Services Agency (FSA) publishes its Annual Supervisory Policies for Regional Financial Institutions for each program year so as to clarify its supervisory priorities. This is prescribed in the “Comprehensive Guidelines for Supervision of Small- and Medium-Sized and Regional Financial Institutions,” which show basic approaches for the supervisory process aimed at regional financial institutions.

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 the regional financial system, 2) performing a smooth financial intermediary function and 3) improving customer protection and convenience for users, and supervise regional financial institutions 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 regional 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 Regional Financial Institutions for Program Year 2009, the economy is showing movements of picking up recently while in a difficult situation. However, the environment surrounding financial institutions 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 confusion in domestic and overseas financial markets and deterioration in the real economy meant that financial institutions managements incurred losses in the holding of marketable securities and

¹ "Regional financial institutions" refers to regional banks, second-tier regional banks, shinkin banks and credit cooperatives.

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

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 a 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 will work more closely with inspection divisions, the Securities and Exchange Surveillance Commission (SESC), and the Bank of Japan (BOJ), and will also endeavor to more extensively execute supervisory administration in an integrated manner by sharing its understanding of regional financial institutions’ issues, etc., with local financial bureaus, which are directly in charge of supervising regional financial institutions.
- 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 Regional Financial System

Because of the confusion in international financial markets and deterioration in the real economy, many regional financial institutions were affected by increased losses in the holding of marketable securities and disposal loss of nonperforming loans (NPLs) for the fiscal year ending March 2009.

Amid these circumstances, in order to thoroughly continue performing financial intermediary functions and under appropriate management (governance) it is essential that regional financial institutions ensure strong and comprehensive risk management, and by extension also contribute to the stability of the regional 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 regional financial institution's management. 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 regional financial institutions themselves.

(1) Enhancement of Risk Management

1) Under the leadership and strong commitment of management personnel, regional financial institutions keep an eye on changes in the environment surrounding the business of macroeconomic positions and market environments, and the FSA investigates whether regional financial institutions are implementing appropriate risk management including stress tests. Then, based on the results of stress tests implemented by each regional financial institution, the FSA holds thorough, deep and two-way dialogues with regional financial institutions on the characteristics and managerial issues of each risk.

2) So with regard to the share-price-change risks inherent in each of the directly owned shares and investment trusts including ETFs, 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 regional financial institutions have appropriate management including tolerance from a financial viewpoint.

3) The FSA will verify whether regional financial institutions properly manage credit risks associated with exposures to large borrowers and whether new forms of credit are properly managed; and whether they pay careful attention to customers who are struggling to realize improved management, by taking measures such as paying visits regularly and providing management consultation consistently to such customers.

(2) Improving Profitability and Financial Soundness

1) Bearing in mind that profits play an important role in preparing against risks, the FSA will verify the profitability status of regional financial institutions. In doing so, the FSA will identify what kind of strategies are being built and executed by regional financial institutions to enhance their profit base, including the progress of their efforts in region-based relationship banking.

2) 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 encourage regional financial institutions to enhance their equity capital from the viewpoint of improving practical tolerance of future stress.

(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 functions and the soundness of financial institutions 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 regional financial system as a whole.

Furthermore, The FSA will exchange opinions with regional financial institutions about what problems they have found and what lessons they have learned in risk management after experiencing the recent financial crisis, thereby encouraging them to work toward strengthening their infrastructure for risk management and business management.

3. Performing a Smooth Financial Intermediary Function

(1) Facilitating Smooth Business Finance for Organizations Including SMEs through Promotion of Region-Based Relationship Banking,³ etc.

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.

In particular, while the regional economy and SMEs are still in a severe situation, there is a strong demand that regional financial institutions, which are supposed to grow in line with the regional economy while supporting each other, should prove the true value of their business model: region-based relationship banking. In order to meet such demand, it is becoming increasingly important for regional financial institutions to actively perform their financial intermediary functions focusing on value creation, so as to increase the added value of borrower companies, while properly using their ability to discern the business potential of borrower companies. In this course, regional financial institutions are expected to provide support for borrower companies for their management improvement and business rehabilitation, depending on the conditions of these companies.

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

- 1) Finding facts and encouraging efforts toward facilitating corporate finance
 - (a) While continuing to implement a questionnaire for SMEs and exchange opinions with SMEs, the FSA will further utilize the hotline for smooth finance. Through this questionnaire and these kinds of efforts, the FSA will have affirm grasp of the details of the financing climate of regional financial institutions and the state of borrower companies.

³ "Region-based relationship banking" refers to a business model in which the financial institution accumulates information on customers by maintaining a close relationship with them over a long period of time and provides financial services, such as loans etc., based on such information. (Report by the Second Subcommittee of the Sectional Committee on Financial System of the Financial System Council dated March 27, 2003).

(b) The FSA will investigate whether regional financial institutions make finance decisions based on the management status and characteristics of borrower companies on an everyday basis, and based on those things whether regional financial institutions make accurate and detailed business judgments, whether regional financial institutions thoroughly give explanations to customers that cover the actual situations, and whether regional financial institutions maintain the appropriate management of associated risks.

(c) 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.

2) Development of the environment for promoting region-based relationship banking

Regional financial institutions have already been making various efforts in region-based relationship banking, such as support for management improvement, support for business rehabilitation, and financing that does not depend excessively on collateral or guarantee. However, many of their specific measures are still deemed inadequate by customers. The FSA will, by taking the opportunity to hear opinions from top managements, aim to encourage regional financial institutions to actively perform their financial intermediary functions focusing on value creation, and also promote their active efforts based on their innovative ideas. From this viewpoint, the FSA will continue to implement the following measures:

(a) The FSA will follow up on the progress of regional financial institutions' efforts in region-based relationship banking, and thereby encourage them to proactively make efforts that accurately meet the user needs of the region. In doing so, the FSA will continue to place emphasis on three areas, namely, 1) enhancing support to client companies according to their lifecycle, 2) strictly implementing financing methods suitable for SMEs, and 3) contributing to a sustainable regional economy.

(b) The FSA will motivate regional financial institutions to make extensive efforts by introducing examples and giving praise to progressive efforts and efforts that should be practiced broadly.

3) Utilization of the “Act on Special Measures for Strengthening Financial Functions”

The “Act on Special Measures for Strengthening Financial Functions” aims to help financial institutions properly and fully exercise their financial intermediary functions to SMEs through injection of public capital. The FSA will continue to encourage regional financial institutions to proactively consider the utilization of this framework as a means of enhancing their capital bases based on their forward-looking business judgment.

4) Collaboration with the central organs of cooperative institutions

In the organizational structure of cooperative financial institutions, such as shinkin banks and credit cooperatives, their central organs play a role in supplementing and supporting the operations of their affiliated financial institutions. The FSA will further develop collaboration with the central organs of shinkin banks and credit cooperatives, so that they will be able to fully play such a role for helping these cooperative institutions perform financial intermediary functions.

(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 regional financial institutions to carry out 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 regional financial institutions 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 regional financial institutions

In doing so, the FSA will respect the autonomous efforts of each regional financial institution, 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 regional 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 regional financial institutions have made accurate responses with regards to improved customer convenience and the prevention of conflicts of interest.

(2) Enhancing Systems for Providing Explanations to Customers

With regard 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 regional financial institutions have built a business promotion system from the viewpoint of customers, and whether regional financial institutions are giving appropriate and flexible explanations to customers based on their attributes and experiences and with regard 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 regional financial institutions 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 Financial Instruments and Exchange Act, which was revised this June, mentioned the financial Alternative Dispute Resolution (ADR) system, the FSA is encouraging regional financial institutions 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 regional financial institutions 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 regional financial institutions' 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 the regional financial institution's accounts).

- 1) Do the regional financial institutions make efforts to eliminate the *furikome* fraud (e.g., alerting customers of the fraud around ATMs)? Do the regional financial institutions deal with victims properly and promptly in accordance with the *Furikome* Fraud Relief Act⁴?
- 2) Do the regional financial institutions make efforts to prevent unauthorized withdrawals from their accounts by using counterfeit/stolen cash cards, stolen passbooks, and Internet banking? Do the regional financial institutions pay compensation to victims properly according to the Depositor Protection Act⁵ and agreements within the industry?
- 3) Do the regional financial institutions take actions to prevent money laundering and terrorist financing?
- 4) Do the regional financial institutions make efforts to cut relationships with antisocial groups aiming to prevent damage from antisocial groups?

(5) Ensuring Business Continuity

Financial institutions' systems are an essential infrastructure for running a business and as those systems become more advanced and complex, the effects that system failures have on customer transactions are becoming larger and larger. Considering that regional financial institutions play a key role in the settlement system, with regard to the continuity of each regional financial institution's system, the FSA will confirm whether regional financial institutions are conducting appropriate risk management under the leadership and commitment of management personnel. Furthermore, the FSA will also confirm whether regional financial institutions are building a system with which they can ensure business continuity in the event of earthquakes or pandemic influenza, etc.

⁴ Act on Payments, etc., of Distribution as Relief for the Damage related to Funds in Deposit Accounts, etc., Used for Criminal Activities.

⁵ Act on Protection, etc., of Depositors and Postal Saving Holders from Unauthorized Automated Withdrawal, etc. Using Counterfeit Cards, etc., and Stolen Cards, etc.