

Annual Supervisory Policies for Regional Financial Institutions for Program Year 2010¹

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 areas of 1) performing a smooth financial intermediary function, 2) risk management and stability of the regional financial system and 3) improving customer protection and convenience for users, and will 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 2010, and may be subject to review as necessary.

1. Environment Surrounding the Financial System, and Basic Concepts on Supervision of Financial Institutions for the Future

(1) Environment Surrounding the Financial System

Although the Japanese economy has been picking up steadily, it remains in a difficult situation with risk factors from a possible slowdown in the global economy, fluctuations in financial and capital markets and the influence of deflation. Looking at the past year’s environment surrounding the financial system, large growth in fund inflows were seen in emerging economies, supported by their fast economic growth, while in Europe, fiscal problems that started in Greece worsened, and in the U.S., there was growing uncertainty in the economic outlook. In response, there is increased uncertainty in financial and capital markets, with larger price fluctuations. Under these conditions, global trends have even greater effects on Japan than before.

In the year ended March 31, 2010, financial results in general greatly improved at regional financial institutions thanks to the reduction of credit costs, improved profit on securities, etc. However, conditions require continued observation of risks facing financial institutions.

Also, in the “New Growth Strategy” approved by the Cabinet in June this year, financial institutions are expected to back up and support the real economy and

¹ In this document, the term “Regional Financial Institutions” refers to regional banks, second-tier regional banks, shinkin banks and credit cooperatives.

enterprises by providing funds with a focus on future growth potential. In order for financial institutions to play such a role, they must practice risk management as part of ensuring financial soundness.

(2) Approach Taken by Supervisory Authority

Amid these circumstances, the FSA is placing better regulation as the basis (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 have it become further embedded and enhanced. In particular, in thoroughly performing a smooth financial intermediary function, and accurately managing various risks, customer protections, etc., financial institutions are strongly expected to be aware of long-term managerial issues. They are also expected to conduct positive managerial improvements, and make appropriate, fast and responsible business judgments under the appropriate leadership of management personnel. To this end, the FSA will take the following approaches as the supervisory authority.

1) Financial Administration with a High Risk Sensitivity

In order to accurately respond to currently conceivable risks, the FSA will gain a deeper understanding of the macro economy and financial and capital markets, and deepen awareness of how these affect the soundness of financial institutions, so as to identify and understand the risks which accumulate in each financial institution and in the financial system with a forward looking perspective. The FSA will also enhance integration of on-site and off-site monitoring to detect risks at an early stage.

2) Financial Administration from a Citizen's and User's Point of View

The FSA will strive so as to further improve customer protection and convenience for users, by looking at things from a citizen's and user's point of view.

3) Supervisory Response with a Future Outlook

The FSA will strive to take actions that do not stop at short-term responses but that also thoroughly determine the progression of international discussions and consider environmental changes, while at the same time implementing long-term responses with an eye on the future.

4) Supervisory Response which Contributes to Financial Institutions Autonomously Improving Management and Making Better Business Judgments.

The FSA will help financial institutions autonomously improve management and make better business judgments via frank and deep discussions and the distribution of information with financial institutions.

In performing supervision, in addition to these approaches, the FSA will also bear the following points in mind.

- 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. In doing so, the FSA will endeavor to strengthen its supervisory abilities, by working to enhance its provision of data analysis and observation information to contribute to the quality of monitoring, and thereby enable local financial bureaus to perform interviews in more depth considering the risk characteristics and financial vulnerabilities of each financial institution.

- The necessity of reports and submitted documents will be periodically reviewed once per year, as part of consideration for reducing the burdens on financial institutions.
- Through the thorough fostering, securing and training of specialized human resources, the FSA will redouble efforts for human resource development.

2. Performing a Smooth Financial Intermediary Function

(1) Further Promotion of Region-based Relationship Banking

Regional financial institutions which are supposed to grow in line with the regional economy while developing in a mutually supportive relationship should further promote their business model: region-based relationship banking.

Therefore, it is important that regional financial institutions contribute to improving local borrower companies and stimulating the regional economy, while aiming at a positive cycle which also contributes to enhancing their own financial soundness and profitability.

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, there are strong expectations that regional financial institutions will provide not only these efforts but also diverse financial services and suitable advice on management issues for small and medium companies and other users, using information which is built up through their long term business relationships.

In order for financial institutions to meet user expectations and needs, it is important that they develop and exercise the ability to propose measures to solve business issues faced by borrower companies, and the ability to provide services matching the needs of borrower companies, and sustainably perform financial intermediary functions focusing on value creation. It is also important that they actively announce to users easily understood information regarding such efforts.

From this viewpoint, the FSA will make efforts while paying attention to the following points.

- 1) Through various opportunities for interviews, the FSA will follow up on the progress of regional financial institutions' efforts in region-based relationship banking, while

constructively exchanging opinions in order to make such efforts more effective for both users and the regional financial institution, and thereby encourage the regional financial institution to make the autonomous efforts based on their innovative ideas.

In doing so, the FSA will continue to place emphasis on three areas, namely, (i) enhancing support to client companies according to their lifecycle, (ii) strictly implementing financing methods suitable for small- and medium-sized enterprises (SMEs), and (iii) contributing to a sustainable regional economy.

2) The FSA will investigate whether regional financial institutions endeavor to develop human resources and strategically use external institutions from a medium and long term perspective, thereby enhancing their ability to discern the business potential of borrower companies and building their know-how. The FSA will also investigate whether regional financial institutions make continual efforts in the entire organization to accurately respond to user expectations and needs.

3) The New Growth Strategy specifies building a new financial industry capable of providing growth capital that is suited to the category and characteristics of each loan, to support innovation-oriented business management from a long term perspective.

Based on this, the FSA will investigate whether regional financial institutions are actively providing loans towards strengthening growth foundations while considering local characteristics, emphasizing the future potential of companies, and considering user expectations and needs, and whether they are working to link this to their own earnings.

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

(2) Loans to SMEs

In the previous program year, while making efforts to determine the situation regarding business finance, the whole government including the FSA drew up a variety of plans for smooth finance. Business sentiment in SMEs is now in an improving trend, but they are wary of the outlook, and financial institutions are strongly expected to perform 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 these kinds of efforts and the inspections, the FSA will have a firm grasp of the details of the financing climate of regional financial institutions and the state of borrower companies.

2) The FSA will focus on investigating whether regional financial institutions make

finance decisions based on the management status and characteristics of borrower companies on an everyday basis, and based thereon, 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 appropriate management of associated risks.

3) The FSA will focus on investigating whether the financial institutions deal properly with borrowers while considering the economic situation the borrowers are in, and whether the financial institutions have developed procedures and arrangements for consultation in response to requests from borrowing companies for changing loan terms etc., based on basic policies which Article 6 of the Act on Temporary Measure for Financial Support for Small and Medium Companies (2009 Act No.96, hereinafter referred to as “SME Finance Smoothing Act”) requires and which each financial institution creates itself.

4) 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 as part of economic measures.

(3) Housing Loans

Work will also proceed for housing loans with emphasis placed on the following points.

1) The FSA will focus on investigating whether the financial institutions deal properly with borrowers while considering the economic situation which the borrowers are in, and whether the financial institutions have developed procedures and arrangements for consultation in response to requests from borrowers for changing loan terms etc., based on basic policies which Article 6 of SME Finance Smoothing Act requires and which each financial institution creates itself.

2) In order to obtain customers’ understanding and approval, the FSA will strive to ensure that regional financial institutions give customers appropriate and detailed explanations.

3) Also with regard to new loans, while keeping in mind repayment plans that are not impossible for customers in the future, the FSA will work to ensure a smooth provision of funds with appropriate loan judgments that consider the customer’s economic situation.

4) In the case of housing loans insured by group guarantee companies (including the cases in which the guarantee company, etc. obtained housing loans through subrogation), the FSA will focus on examining whether financial institutions are giving guidance to, having dialogues with and making requests of such companies as efforts to properly deal with the facilitation of financing, from the perspective of smooth financing also in such

guarantee companies.

(4) Efforts for Formation of a Sound Consumer Finance Market

Banks, etc. have not always played sufficient roles for loans to consumers (excluding housing loans). From the viewpoint of forming a sound consumer finance market in the medium and long term, there is a need for banks, etc. to actively handle loans to consumers. It is thought that participation by banks, etc. for forming a sound consumer finance market will contribute to smooth enforcement of the Amended Money Lending Business Act.

Therefore, for loans to consumers, the FSA will work on supervision with the following points in mind, while considering the aims of the Amended Money Lending Business Act.

1) Understand the actual situation as to whether regional financial institutions are dealing with consumer loans proactively, considering needs.

2) The FSA encourages regional financial institutions to build suitable screening systems which consider the actual situations of customers, to prevent customers from excess borrowing. The FSA also encourages regional financial institutions to understand the customer's situation properly when examining a loan, instead of only relying on information of credit information institutions or guarantee examinations of credit guarantee companies, if using such information.

3. Risk Management and Stability of the Regional Financial System

Under appropriate management (governance), it is essential that regional financial institutions more thoroughly ensure strong and comprehensive risk management. This is necessary not only for the soundness of each financial institution and the stability of the regional financial system, but also for regional financial institutions to perform sufficient financial intermediary functions, providing a stable supply of funds in order to support the growth of the real economy and companies in a changing environment.

With the aim of ensuring that there is a smooth provision of funds to borrower companies while maintaining the financial health of the financial institutions themselves by their proper risk taking under strong risk management, the FSA will encourage autonomous efforts for each management measure while the FSA increases its own risk sensitivity.

In doing so, considering that trends of regional financial institutions have large effects on the regional financial system, the FSA will continue its efforts from the perspective of "macroprudential supervision." That is, while realizing the strong relationships between trends of the macro economy or financial markets and financial intermediary functions or soundness of bank finance, cooperating with the Bank of Japan, and focusing on the risk concentration situation and course of effects, thereby analyzing and acting from the viewpoint of expectations as to whether all regional financial institutions will undergo sustainable and stable development. In its actual execution, the FSA will use a method which integrates diverse tools (a

“multidisciplinary approach”), such as macroeconomic analysis, monitoring of financial markets, and individual financial institution supervision.

(1) Improved Risk Management Techniques

1) Under the leadership and strong commitment of management personnel, keep an eye on changes in the environment surrounding the business, such as macroeconomic positions and market environments, including from the perspective of being able to maintain suitable risk-taking even when under stress, and investigate whether regional financial institutions are implementing appropriate risk management including stress tests. In doing so, the FSA will check the stress tests from the view point of whether they (a) assume the severest scenarios, not only mild economic recession scenarios, (b) include all exposures which should be included, and (c) do not rely too much on single model or estimation techniques. The FSA will also have thorough, deep and two-way dialogues with regional financial institutions on the characteristics and managerial issues of each risk.

2) With regard to 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 regional financial institutions have appropriate management including tolerance from a financial viewpoint. Especially for strategically held stocks, there are large risks due to price fluctuations because cutting losses is difficult, etc. Therefore, the FSA will investigate whether regional financial institutions have built a risk management system which considers such unique risks.

Also, considering the increased dependence on bonds and other market-related earnings, the FSA will continue to watch carefully the status of efforts in regional financial institutions regarding the risks of a rise in interest rates.

3) The FSA will verify whether regional financial institutions properly manage credit risks including current ledger control associated with exposures to large borrowers, and whether complex 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, properly managing progress on business improvement plans etc., and providing management consultation consistently to such customers.

4) As a lesson of the recent financial crisis, the limits of quantitative risk control techniques, such as economic capital models and VaR, are realized, and further improvements in risk management techniques are necessary. Considering this situation, the FSA will continue holding deep two-way dialogues with regional financial institutions on how risk management should be, and work to form mutual understanding.

(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 verify efforts by regional financial institutions in region-based relationship banking in order to work to enhance their earnings foundation from a medium and long term perspective. It will specifically identify user expectations and needs, then verify how the institutions incorporate these into management strategy and medium term management plans, how they are trying to practice these as an entire organization, etc.

2) Bearing in mind that equity capital is the basis for positive 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 organizations to be strong in terms of equity capital including the securing of certain profits, from the viewpoint of improving practical tolerance of future stress.

In doing so, in cases where a regional financial institution intends to reinforce its capital with a view to the future, the FSA will encourage regional financial institutions to actively consider the utilization of the Act on Special Measures for Strengthening Financial Functions, as one of its options.

3) It is important that shinkin banks and credit cooperatives are fully aware of the basic character of cooperative organization financial institutions, and the concept of mutual assistance which is in their background, demonstrating to the maximum their financial intermediary functions in the roles they should fulfill as financial institutions specialized in regional finance and SME finance. The FSA will scrutinize such efforts by cooperative organization financial institutions.

4) 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. Along with scrutinizing their situation, 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.

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 with the customer's viewpoint in mind, 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 in accordance with guidelines for supervision, 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 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 financial institutions are pursuing quick profits or because they have conflicts of interest.

Furthermore, as the need arises the FSA will cooperate with the police authorities, and with the Consumer Affairs Agency, an institution for which there are high hopes with regard 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 on professional conduct to prevent inappropriate actions of officers (such as information leaks or insider trading).

In addition, the firewall regulations were revised last year, and a principles based framework was created to encourage financial institutions to have an autonomous management system to deal with conflicts of interest. With regard to these, the FSA will conduct investigations as to whether regional financial institutions have made accurate responses concerning 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 regional financial institutions have built their solicitation and explanation system with consideration for each customer. In particular, investigate whether i) regional financial institutions are giving appropriate and flexible explanations to customers based on their knowledge, experience, asset situation, and purpose of investment, with regards to the locations and characteristics of risks so that those customers can make accurate judgments, ii) regional financial institutions are making and collecting check sheets as needed to confirm whether the customer understands the content of the explanation.

Also, the FSA will investigate the legal compliance situation regarding the regulation of unsolicited offers, considering the situation of laws and regulations developed.

In addition, the FSA will strongly urge for the development of systems which enable people with visual and other disabilities to feel assured in using financial institution contact points and ATMs, and easily use financial services.

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

It is extremely important to ensure customer trust in financial products and services, and have independent, timely and appropriate consultations and complaint handling, after implementing business management that makes good use of customer needs. From this viewpoint, the FSA will investigate whether regional financial institutions are maintaining a consultation window, analyzing the causes of consultations and complaints, sharing information within the regional financial institutions, taking measures and notifications to prevent the recurrence of complaints, and developing an internal controls system properly with which the top management is involved in conducting follow-ups on their implementation status.

The FSA will also investigate whether required systems have been prepared for the start of the financial Alternative Dispute Resolution (ADR) system to be introduced this October.

(4) Preventing Abuse of Financial Functions

In order to ensure security for users, the FSA will verify, based on the following perspectives, whether 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' identities and to detect transactions that are strongly suspected of being illegal and make appropriate responses (e.g., freezing of bank accounts).

- 1) Do regional financial institutions make efforts in countermeasures to eliminate crimes which harm the assets of others, such as furikome fraud? From the viewpoint of quick recovery of victims' damaged assets, in accordance with the Furikome Fraud Relief Act, do regional financial institutions deal with victims properly by halting transactions involving deposit accounts used in crime, providing information to the suspected victim regarding funds remaining in such accounts, distributing funds thereafter, etc.?
- 2) Do regional financial institutions make efforts to prevent unauthorized withdrawals from bank accounts by using counterfeit/stolen cash cards, stolen passbooks, and Internet banking? Do regional financial institutions pay compensation to victims properly according to the Depositor Protection Act and agreements within the industry?
- 3) Do regional financial institutions take actions to prevent money laundering and terrorist financing in domestic and overseas branches, to the extent that it meets international requirements for regional financial institutions?
- 4) Do regional financial institutions make efforts to cut relationships with antisocial groups, aiming to prevent damage from antisocial groups, with strong awareness in the entire organization including top management?

(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 have on customer transactions are becoming larger and larger. Considering that regional

financial institutions are playing core roles in financial systems, with regards to the continuity of each regional financial institution's systems, 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 it can ensure business continuity in the event of earthquakes or pandemic influenza, etc.