

Annual Supervisory Policy for Regional Financial Institutions for Program Year 2011¹

The Financial Services Agency (FSA) publishes its Annual Supervisory Policy 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 shows basic approaches for the supervisory process aimed at regional financial institutions.

In this Program Year, in accordance with “Basic Concepts on Future Supervision of Financial Institutions” 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 this supervisory policy was drawn up in light of the circumstances that surrounded regional financial institutions as of August 2011, and may be subject to review as necessary.

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

(1) Environment Surrounding the Financial System

Due to the effects of the Great East Japan Earthquake, the Japanese economy remains in a difficult situation. However, reflecting supply chain reconstruction, the Japanese economy is expected to continue to pick up. Even in this situation, there are downside risks that could stem from constraints of electric power supply, the consequences of the nuclear accident, further slowing down of overseas economies, and volatile fluctuations in exchange rates and stock prices.

Even when Japan is in such a difficult situation, the world economy has been moving on instead of halting, and special attention should be paid to movements in foreign economic conditions and financial and capital markets. In doing so, amidst today’s advancing globalization, it is important to enhance the resilience of the economic and financial system, to minimize effects on our country in the event of any crisis from emerging global economic risks.

Under these circumstances, except for financial institutions in disaster areas, many regional financial institutions obtained net profits in the fiscal year ending in March 2011,

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

due partly to reduced credit costs. However, in contributing to the recovery and reconstruction of disaster areas, and to the revitalization and development of Japan, financial institutions must practice risk management as part of ensuring financial soundness, while paying attention to effects on the financial system due to domestic economic trends due to effects of the disaster, and that of real economies in overseas countries, etc.

(2) Approach Taken by Supervisory Authority

Amid these circumstances, the FSA will continue to place 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 deepened.

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 each long-term managerial issue. They are also expected to conduct positive managerial improvements, and make appropriate, fast and responsible business judgments under the appropriate leadership of management personnel.

Moreover, for recovery and reconstruction from the Great East Japan Earthquake, this program year is “a year where the true value of financial intermediary functions by financial institutions is tested.” Under this awareness, each financial institution needs to provide flexible and detailed responses for its customers, including response to demand for funds for rebuilding the lives and businesses of disaster victims. To this end, the FSA will continue to 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 its understanding 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.

It is also important to check whether major risks are fully assumed in the financial institution’s business continuity plan, in order to maintain and ensure financial functions even if an unexpected event occurs. This should include the consideration of the experience of the recent Great East Japan Earthquake. Moreover, IT systems are at the core of financial services, and the occurrence of a problem can greatly affect people’s lives and the economy. With this in mind, it is important that even in normal times the FSA urges each financial institution to conduct voluntary inspections of the design of its risk management system in case a failure occurs. As the supervisory authority, the FSA should sort and analyze these inspection results.

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 Forward-looking Perspective

The FSA will strive to take actions to follow the progression of international discussions and consider environmental changes. In addition to a short-term response, it will also implement medium and long-term responses with an eye on the future, while considering common structural issues faced by Japanese financial institutions (strengthening profitability of their main business, etc.).

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

The FSA will help financial institutions to autonomously improve management and make better business judgments via frank and deep discussions and the distribution of information with financial institutions. Above all, the FSA uses exchanges of opinions and other methods to introduce to other financial institutions the innovative initiatives of each financial institution concerning the performance of financial intermediary functions, risk management, improvement in customer protection and convenience for users, etc. It thereby works to enhance the quality of the entire financial industry.

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

- The FSA will facilitate closer cooperation between its Supervisory Bureau and Inspection Bureau, as well as cooperation with the Securities and Exchange Surveillance Commission (SESC), and the Bank of Japan (BOJ). Especially in order to promptly and accurately understand IT system risks and the situations faced by financial institutions, and to enable fast response, the FSA will implement and strengthen monitoring with seamless inspection and supervision, and consider participation by the staff of supervisory divisions in inspections, etc.
- The FSA will further promote the integrated supervision of regional financial institutions with local finance bureaus that are directly in charge of supervising these institutions, by sharing the same recognition with each bureau concerning managerial issues that each financial institution has been facing. In doing so, the FSA will, in collaboration with its Inspection Bureau, improve the quality of information provided to local bureaus for off-site monitoring, including the results of data analysis and information on focuses of supervision, so that each local bureau can deepen the quality of its interviews and other supervisory activities by focusing on the risk profile and financial vulnerabilities of each financial institution. The FSA will also endeavor to further advance its supervisory ability by such means as improved business analysis that utilizes the results of interviews and other information reported by local finance bureaus.
- The necessity of collecting reports and submitted documents will be periodically reviewed once a 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) Response to the Great East Japan Earthquake from Financial Aspects

- 1) Each financial institution is implementing measures to facilitate financing, such as responding as much as possible to requests for changing loan terms, etc. and stop-gap fund loans for small and medium-sized enterprises (SMEs) and housing loan borrowers directly or indirectly affected by the disaster. They are also providing a variety of support from financial aspects, such as for depositor withdrawals and providing information on deposits of missing persons. While considering the disaster situation of financial institutions, the FSA is checking whether they are appropriately responding to consultations and requests for changing loan terms etc., according to the actual situations of borrowers. The FSA will also focus on whether they promptly and appropriately respond to consultations and requests from borrowers, as part of their handling of the so-called double loan problem, based on the Guidelines of Workout for Restructuring Debt Owed by Individual Debtors created this July.

The FSA will also check whether they are appropriately responding to funding demand for recovery and reconstruction and for rebuilding the lives and businesses of disaster victims.

- 2) The Act for Revision of the Act on Special Measures for Strengthening Financial Functions was enforced this July, and earthquake special measures were established for capital participation by the national government. The FSA will encourage regional financial institutions to positively consider utilizing this Act, if they make decisions, as their business judgment, that capital reinforcement is appropriate in order to play active roles in the recovery and reconstruction from the earthquake.

In particular, an earthquake special measure for cooperative financial institutions has been prepared. This enables joint capital participation by the national government and the central organization of cooperative financial institutions that provide business support and complementary functions to individual cooperative financial institutions, and in doing so, the central organization enters into a business instruction contract with each cooperative institution under its umbrella. As such functions of central organizations are increasingly becoming important, the FSA will carefully monitor the status of central organizations in fully performing their functions to help cooperative institutions further exercise their financial intermediary functions. The FSA will also achieve closer cooperation with the central organizations.

(2) Further Promotion of Region-based Relationship Banking

In light of issues and the direction of improvements in region-based relationship banking, the FSA revised its supervisory guidelines in May, and showed the following basic concepts in order to further encourage initiatives by regional financial institutions.

- For the stimulation and healthy development of local economies, it is important to stimulate economic activities through the business expansion and business improvement of local SMEs. It is also important that related parties in the region including regional financial institutions coordinate and cooperate to proactively support business efforts of SMEs. In particular, regional financial institutions play a pivotal role in local information networks, and have human resources and know-how. Thus there are great expectations that they will play a role not only in supplying funds, but also in actively supporting the management of local SMEs, and contributing to stimulate the local economy.
- Therefore, it is important for regional financial institutions to explicitly set the region-based relationship banking as their business model in their business strategies and business plans, and continuously promote their initiatives as an entire organization in wielding consulting functions for client enterprises, active participations in the revitalization of the entire region, and active transmission of information to the region and users of financial services. It should be done on their own initiatives and ingenuity with a longer-term point of view, in accordance with their size and business profiles as well as customers' expectations and needs. It is also important to connect such activities to the maintenance and expansion of their customer base, and to the improvement of their profitability and financial soundness.
- To this end, it is important for the senior management of each financial institution to fully exercise its leadership in developing and improving its frameworks for headquarters' support for branches, cooperation with external experts and external organizations, evaluation of business achievements that contribute to motivating staff, fostering specialized human resources, and accumulation of technical know-how.

Based on these fundamental concepts, the FSA will advance the following initiatives.

- 1) The FSA will use various opportunities, including interviews with top management, to follow up on the status of initiatives for region-based relationship banking in each financial institution, and exchange opinions in-depth so that such initiatives would become more effective for both customers and regional financial institutions. It will thereby encourage each financial institution's efforts while demonstrating their initiative and ingenuity.

In doing follow-up, instead of simply evaluating the quantitative results of individual tools from a short-term viewpoint, the FSA will evaluate whether each financial institution is continuously promoting various initiatives as an entire organization from a longer-term viewpoint, while focusing on the positioning of these initiatives in their business planning and the development status of internal frameworks.

- 2) The FSA will work to provide incentives and develop the environment for financial institutions to deepen and solidly establish their initiatives for region-based relationship banking. It will also contribute to the sharing of information and know-how among financial institutions by holding symposiums that provide

opportunities for regional financial institutions to explain their own initiatives for region-based relationship banking, and for concerned parties in each region to discuss and evaluate such initiatives. It will also give awards for highly advanced initiatives and those recommended to be widely practiced.

(3) Loans to Small and Medium-sized Enterprises (SMEs)

With the awareness that SMEs continue to face severe business conditions, the Act concerning Temporary Measures to Facilitate Financing for SMEs, etc. was revised in March 2011. This Act's expiration was extended one year to March 31, 2012. Along with this, the FSA created Guidelines for Supervision to encourage financial institutions to wield their consulting functions. In addition, the Guidelines for Supervision was also revised in May in connection with the promotion of region-based relationship banking. The revised guidelines articulated the consulting functions that should be wielded by regional financial institutions. In view of this situation, the FSA will take actions with a particular focus on the following points:

- 1) The FSA will intensively verify whether regional financial institutions continuously assess the business conditions and characteristics of borrower companies on a day-to-day basis, and based thereon, whether regional financial institutions establish adequate frameworks for making accurate and detailed loan decisions, for inducing staff members, including those at branch offices, to provide customers with sufficient explanations about their services and risks, etc., and for appropriate management of associated risks.
- 2) The FSA will intensively verify whether financial institutions are actively wielding their consulting functions to enable borrowing enterprises to be aware of their business issues and make self-help efforts for business improvement and business recovery. This should aim to solidly establish the following flow: improve the debt serving capacity of the borrowing enterprise, lead to the expansion of future sound funding demand, and result in enhanced profitability and financial soundness of the financial institution. In doing so, the following are examples of points that the FSA will especially focus on:
 - For borrower enterprises, including those that changed their loan terms based on the “Act concerning Temporary Measures to Facilitate Financing for SMEs, etc.”, whether financial institutions are proactively assisting these borrowers in developing thorough and highly realizable business rehabilitation plans and to achieve fundamental business recovery, while their repayment burden has been reduced.
 - Whether financial institutions are providing unique financial services tailored for individual borrowers, avoiding falling into interest rate competition.
 - In cases where financial institutions provide support for business matching, technology development to borrower enterprises, or support for their business expansion into Asia, whether such supports lead to gaining new sales channels or finding new demand.

- 3) As part of their efforts on promoting region-based relationship banking, regional financial institutions are expected to foster and wield their ability to discern the business potential of borrower enterprises, while avoiding excessive reliance on collaterals and guarantees. They should also accurately focus on the business value of borrower enterprises and contribute to enhancing it.

In view of these points, the FSA will verify whether regional financial institutions are implementing appropriate initiatives to establish loan practices which in principle do not require third party joint and several guarantee, except managers of the borrower company, and to consider the guarantor's abilities to pay when executing guarantee obligations. The FSA will especially verify whether there are objective and rational reasons for entering into such a contract, and whether the contracting party agreed with this contract based on his/her voluntary will and thus it is confirmed in writing that it is due neither to pressure nor to demands from the financial institution, in cases where such contracts are signed in exceptional circumstances by a third-party who does not substantially participate in the management of the company.

- 4) The FSA will continue to conduct a survey in the form of a questionnaire on business conditions and financing for SMEs, and will implement other initiatives including further utilization of the "Hotline for Smooth Financing." Through these efforts and on-site inspections, the FSA will have a firm grasp of the details of the financing climate of regional financial institutions and the status of borrower companies.
- 5) In collaboration with related governmental bodies such as the Small and Medium Enterprise Agency and Regional Bureaus of Economy, Trade and Industry, the FSA will encourage the use of various policy measures to facilitate corporate finance.

(4) Housing Loans

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

- 1) The FSA will intensively verify whether in response to requests from borrowers for changing loan terms, etc., the financial institutions deal properly with borrowers while fully considering the economic situation the borrowers are in, and considering the objective of the "Act concerning Temporary Measures to Facilitate Financing for SMEs, etc."
- 2) The FSA will strive to ensure that banks give customers appropriate and detailed explanations in order to obtain customers' understanding and consent.
- 3) Also with regard to new loans, the FSA will encourage financial institutions to maintain smooth financing with appropriate loan judgments that consider customers' status, including their economic circumstances, while keeping in mind repayment plans that remain feasible for customers in the future, taking into account the effects of interest rate fluctuations.
- 4) In the case of housing loans insured by group guarantee companies (including the

cases in which the guarantee company, etc. acquired housing loan claims through payment in subrogation), the FSA will intensively verify whether financial institutions are giving guidance to, having dialogues with, and making requests to such guarantee companies as efforts to properly deal with the facilitation of financing, from the perspective of smooth financing also in these companies.

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

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. Therefore, for loans to consumers, the FSA will continue its work from the previous program year on supervision with the following points in mind:

- 1) Understand the actual situation as to whether the bank is dealing with consumer loans proactively, considering needs.
- 2) The FSA encourages banks to build suitable screening systems which consider the actual situations of customers, to prevent customers from excess borrowing. The FSA also encourages banks to understand the customer's situation properly when examining a loan, instead of only relying on the information of credit information institutions or guarantee examinations of credit guarantee companies, if using such information.

(6) Promote Initiatives of Financial Institutions which Emphasize Growth Potential

The New Growth Strategy, etc. 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. In view of this, the FSA will work to assess initiatives taken by financial institutions which emphasize growth potential, from a standpoint, for instance, whether their lending approach emphasizes the profitability and future prospects of the business itself, such as the enterprise's technical abilities, selling abilities and growth prospects, or the future prospects for the concerned business sector. The FSA will also encourage the financial institution's own initiatives.

3. Risk Management and Stability of Regional Financial System

(1) Supervision based on the Viewpoint of Macro-Prudence

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 financial 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.

As such, while enhancing its own risk sensitivity, it is important for the FSA to encourage autonomous efforts of each financial institution for appropriate risk taking

backed by a robust risk management, with the aim of achieving both a smooth provision of funds to borrower companies and financial soundness of the financial institutions *per se*.

To this end, as its basic stance for supervision, it is essential for the FSA to continue to analyze and act from the viewpoint of Macro-Prudence, which is the expectation as to whether the entire financial system will undergo sustainable and stable development, while recognizing strong correlations between trends in the macro economy or financial markets and financial intermediary functions or the soundness of financial institutions, cooperating with the Bank of Japan, and focusing on the risk concentration situation and course of effects. In its actual execution, the FSA will continue to use a method which integrates diverse tools (a “multidisciplinary approach”), such as macroeconomic analysis, monitoring of financial markets, and supervision of individual financial institutions.

1) Risk areas to be focused on

- As to domestic economy, the FSA will continue to carefully watch the direct and indirect effects of the Great East Japan Earthquake. It will also carefully watch trends in China and other emerging markets, and recent economic and financial trends concerning the fiscal conditions of some European countries and the U.S., which affect regional financial institutions.
- With regard to stocks that are directly held by financial institutions, the FSA will accurately identify any profit and loss that could arise from market movements as well as its effects on the capital adequacy of financial institutions. It will also continue to assess whether regional financial institutions have appropriate management of risks including financial tolerance, in cases where these risks have become actualized. Especially for stocks that are held for strategic reasons, there may exist larger risks due to price fluctuations because of their nature, such as that loss-cutting is relatively difficult. Therefore, the FSA will verify whether regional financial institutions have built a risk management system which considers such unique risks.
- While government bonds and other bonds comprise an increasing percentage of regional financial institution assets, interest rate levels continue to be quite low. Considering these circumstances, the FSA will continue to carefully watch and investigate management systems concerning market risks in regional financial institutions, for example, whether they consider the influence of long-term interest rates hikes in terms of risk management.
- 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 regular visits, proper management of progress on business improvement plans etc., and providing management consultation and instruction consistently to such customers.

As to large borrowers with continuing business difficulties, the FSA will also

investigate whether financial institutions actively support fundamental business recovery or business reorganization of the borrower, having fully understood and analyzed its actual business situation, in cooperation with external experts, external institutions and other financial institutions as needed.

2) Improved Risk Management Techniques

As a lesson of the recent global financial crisis, the limits of quantitative risk control techniques, such as economic capital models and VaR, have been recognized, and thus further improvements in risk management techniques have been deemed necessary. Considering this situation, including the perspective of being able to maintain suitable risk-taking even under stressed circumstances, the FSA will continue to investigate whether, under the leadership and strong commitment of the management, each financial institution makes specific assumptions about how various phenomena could affect the real economy and financial and capital markets overall, and could directly and indirectly affect its own business (for example, as the most severe changes in the market environment which could be assumed, the effects if risks of changes in stock prices, interest rates, FX, etc. all occur at the same time), and investigate whether they are implementing appropriate risk management including stress tests. In doing so, the FSA will check the stress tests from the viewpoint of whether they (i) assume the severest scenarios, not only mild economic recession scenarios, (ii) include all exposures which should be included, and (iii) do not place excessive reliance on a single model or an estimation technique. The FSA will also continue to have thorough, deep and two-way dialogues with regional financial institutions on the characteristics and managerial issues of each risk.

3) Enhancement of Financial Foundations

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 financial institutions to strengthen their capital base, by such means as the securing of certain profits, from the viewpoint of improving the practical tolerance for future stress, while also considering the new international regulatory framework. The Act for Revision of the Act on Special Measures for Strengthening Financial Functions was enforced this July, and the application deadline for capital participation by the central government was extended for five years (until the end of March 31, 2017). Considering this, if financial institutions have determined to reinforce their capital base as part of its forward looking management, the FSA will encourage them to positively consider using this Act.

(2) Enhanced Risk Management Systems to Support Initiatives for Stronger Profitability

Considering the current financial environment and uncertainty in Japan's real economy, strengthening the profitability of financial institutions is expected to become an even more important business issue for the stable operation of financial institutions.

For financial institutions to work to solidly strengthen their profitability, instead of only treating risk management from a preventive and defensive viewpoint, it is important to study how to integrate risk management with profit management, to substantially

underpin and back up initiatives to strengthen their profitability.

- 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, considering the fact that strengthening profitability has been a structural issue for regional financial institutions, the FSA will work to understand how practical initiatives in region-based relationship banking are specifically positioned in business strategy and business planning, including supporting borrower companies in obtaining sales channels, and supporting their business expansions into Asia, in an effort to enhance the earnings base of regional financial institutions from a medium and long-term perspective. The FSA will also investigate how this has been practiced at the entire organization level.

- 2) Some regional banks are oriented to actively developing their overseas operations. The FSA will investigate the systems for managing the operations of overseas locations of such banks. For example, the FSA will investigate whether there is appropriate risk management, including that of credits for non-Japanese clients. The FSA will also investigate whether comprehensive risk management systems have been developed and upgraded, including for overseas locations. In doing so, the FSA will cooperate with overseas authorities where necessary.
- 3) The FSA will investigate whether regional financial institutions develop appropriate risk management systems, such as arranging, managing and using related data, to understand and identify risks which accompany their development of new businesses.
- 4) In the organizational structure of cooperative financial institutions, such as *shinkin* banks and credit cooperatives, their central organizations play a role in supplementing and supporting the operations of their affiliated financial institutions. Along with scrutinizing their situation, the FSA will further collaborate with the central organizations of *shinkin* banks and credit cooperatives, so that they will be able to fully play such a role for helping these cooperative institutions proactively exercise their financial intermediary functions.

4. Improving Customer Protection and Convenience for Users

Improving customer protection and convenience for users at financial institutions not only helps achieve a sound national economy, but also helps stabilize the Japanese financial system by enhancing citizens' trust in financial institutions. It is important for financial institutions to raise their competitiveness by providing original and ingenious financial instruments/services that accurately reflect customers' needs. This effort should be backed by a sense of security and trust that could be achieved by thorough protection of customers' interests. In doing so, the management of a financial institution should fully provide his/her leadership in implementing such measures as strict control of customer information, prevention of the abuse of dominant bargaining power, and management of conflicts of interest. In particular, compliance in terms of customer protection should not

mean a simple compliance with laws and regulations. Rather, it is important as trusted financial institutions with a highly public nature, that they are aware of the levels sought by customers, and meet those expectations.

To this end, a financial institution must discuss and make a judgment in an appropriate manner as to whether individual financial products and services are suitable for sale and solicitation in light of the attributes of their customers (e.g. knowledge, experience, wealth level, and objectives), before developing these instruments and services. After this, in selling and soliciting financial products and services, it is essential to provide appropriate and flexible explanations that suit the customers' attributes. In addition, financial institutions must also recognize that complaints and requests for consultations from customers after sale may provide them with opportunities to discover potential customer needs, and thus must respond to them appropriately and actively.

Considering the above, in this program year the FSA will intensively assess the efforts of financial institutions that aim to improve customer protection and convenience for users in the following area, in accordance with its supervisory guidelines. In doing so, the FSA will respect the autonomous efforts of each financial institution, and proceed with supervision in a manner that places emphasis on their incentives to make such efforts.

In particular, many consultations and complaints were received in the last program year regarding currency derivative products that financial institutions have sold to SMEs in the past. It became an opportunity to reconsider the behaviors of financial institutions as to whether management and marketing policies of financial institutions were appropriate, whether their compliance functions were sufficient, and whether policies set by the management were sufficiently implemented and penetrated to individual sales staff members. Consequently, in this program year, the FSA will also pay attention to (1) under what kinds of management policies, what kinds of financial products and services financial institutions are providing to customers with what kinds of attributes, (2) whether there are warped incentives that may arise due to desires to pursue short-term profits or the existence of conflicts of interest, (3) whether an internal checking system for managerial and other staff members has been developed to verify that management policies are thoroughly implemented by the sales staff.

Meanwhile, the FSA will cooperate with the police authorities and the Consumer Affairs Agency as deemed necessary.

(1) Ensuring Business Continuity

1) IT System Inspections, etc.

Computer systems of financial institutions are at the core of their settlement systems. These have a strong public aspect as social infrastructure. If a failure occurs, this could have large impacts on user convenience and the society, and could unavoidably lead to losing the credibility of a financial institution. Therefore, the FSA encourages each financial institution to conduct voluntary inspections under active leadership by the management, regarding the awareness of risks in its IT systems, business strategy on investments for IT systems, risk management to cope with the occurrence of failures, etc. The FSA will also intensively verify initiatives taken by each financial institution in these matters. Additionally, in connection with renewal and/or integration of IT systems, the FSA will also assess whether the management of each financial institution

is precisely aware of risks, and manages these projects in an appropriate manner.

2) Validation of Business Continuity System

Being mindful of the experience of the recent Great East Japan Earthquake, the FSA will verify that financial institutions conduct self-assessments as to whether their existing business continuity plans have effectively functioned, whether they sufficiently assumed major risks such as earthquakes and other natural disasters, pandemic influenza and large electricity blackouts, and whether they built up sufficient countermeasures, etc.

Electricity supply capacity has decreased after the earthquake, and as an immediate response, each financial institution has been implementing electricity conservation policies this summer in each area in Japan, especially in areas served by Tohoku Electric Power Company, Tokyo Electric Power Company and Kansai Electric Power Company. In conjunction with these measures, the FSA will carefully watch if there are any impacts on the business continuity of important locations, such as IT system centers.

(2) 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 strongly 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 two years ago, 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 assess whether financial institutions are working towards a right direction to achieve both improved customer convenience and prevention of conflicts of interest.

(3) Enhancement of the Framework for Providing Explanations to Customers

- 1) With regard to sales of products that entail risks, such as mutual funds, structured bonds and derivatives (including currency derivatives), the FSA will intensively verify whether financial institutions establish and make functioning frameworks for solicitation and explanation to each customer and for follow-up after sales, that are solicitous of the customer's circumstances and compliance with regulations on unsolicited promotion. In doing so, the FSA will have a particular focus on the following areas: i) whether financial institutions give appropriate and flexible explanations about risks and inherencies of products to customers in light of their knowledge, experience, wealth level, and the purpose of investment, so as to aid them to make a right decision for each investment; ii) whether financial institutions make check-sheets as needed and collect them from customers to confirm their understandings about the contents of explanations; iii) whether financial institutions provide customers with warning documents; iv) whether the salary and bonus

systems of the sales staff and managers are not biased with excessive linkage to gaining short-term profits; v) whether the sales system and product composition place too much emphasis on gaining fee earnings; and vi) whether measures are taken to prevent harmful practices and events, such as the abuse of the dominant bargaining position and false recognition by customers regarding similarities to deposit instruments.

- 2) The FSA will focus on investigating whether (i) adequate explanations are provided to customers in sales, in light of peculiarities and risk characteristics of mutual funds, including those investing in foreign stocks and bonds, currency-selective funds, and monthly distributable funds; (ii) adequate explanations are provided to customers regarding important items that can affect their investment decisions, such as expenses required for purchase and cancellation of mutual funds, including trust fees and commissions; and (iii) financial institutions are acting from the customer's viewpoint, for instance, creating and providing documents to customers (*e.g.* prospectus) with easily understood descriptions of information on risk characteristics, fees and dividends, etc.
- 3) In addition, the FSA will continue to carefully watch whether banks take appropriate measures when soliciting insurance products, so as to prevent harmful practices and events, such as the abuse of their dominant bargaining position and false recognition by customers regarding similarities to deposit instruments.
- 4) Furthermore, the FSA will strongly encourage the development of arrangements that enable elderly and/or disabled people to use financial services at ease, including teller windows and ATMs.

(4) Enhancement of the Framework for Processing Consultations and Complaints from Customers

It is extremely important for financial institutions to have proactive, timely and appropriate consultations and complaint handling, in order to ensure customer's trust in financial products and services, and to positively utilize the customers' needs for better management of business. From this viewpoint, the FSA will assess whether financial institutions develop an internal control system, under the involvement of the top management, for maintaining a consultation window, analyzing the causes of consultations and complaints, sharing information within the institution, taking measures and notifications to prevent the recurrence of complaints, and following up the implementation of these measures, in an appropriate manner.

Also, in connection with the financial Alternative Dispute Resolution (ADR) system that was introduced in October 2010, the FSA will carefully watch whether financial institutions are: i) making sincere efforts for quick dispute resolution, such as active disclosure of required information; ii) preparing arrangements for facilitating easy use of the system nationwide; and iii) introducing the ADR system to customers as needed when they make consultations.

(5) Preventing Abuse of Financial Functions

In order to ensure security for users, the FSA will verify, based on the following perspectives, whether financial institutions develop management systems to prevent financial functions from being abused and to take adequate care of crime victims. In doing so, the FSA will check IT systems and other arrangements at financial institutions to properly confirm customers' identities, and to detect transactions that are strongly suspected of being illegal and take appropriate actions, including the freezing of deposit accounts.

- 1) Do financial institutions make efforts in countermeasures to eliminate crimes including "Furikome Fraud" (e.g. phishing scams) that harm other people's assets? In particular, do financial institutions place priority on taking measures against Furikome Fraud that misuses earthquake recovery donations? From the viewpoint of prompt recovery of victims' financial damages, in accordance with the Furikome Fraud Relief Act, do 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 financial institutions make efforts to prevent unauthorized withdrawals of deposits by using counterfeit/stolen cash cards, stolen passbooks, and internet banking? Do financial institutions pay compensation to victims properly according to the Depositor Protection Act and agreements within the industry?
- 3) Do financial institutions take actions to prevent money laundering and terrorist financing?
- 4) Do financial institutions make appropriate efforts, such as developing procedures and arrangements to cut relationships with antisocial groups, aiming to prevent antisocial groups from damaging the financial institution, managers, as well as various stakeholders such as customers, with strong will of the top management and the entire organization to eliminate antisocial groups from financial transactions?