(Provisional Translation)
August 26, 2011
Financial Services Agency

Basic Policy for Financial Inspections in Program Year 2011

I. Foreword

The Financial Services Agency (FSA) is not only making efforts to ensure the stability of the financial system, the facilitation of financing and the protection of users, but is also engaging in vigorous activities to strengthen the competitiveness of the Japanese financial and capital markets, and the financial system, which supports economic growth, while working hard to establish reliable and transparent financial regulations.

After the downturn due to the impact of the Great East Japan Earthquake, the Japanese economy is now expected to pick up with the restoration of supply chains and moderate recovery of overseas economies. However it is necessary to take full account of the effect of electric power supply restrictions and the echo of nuclear disaster. Also attention needs to be paid to the impacts of growing uncertainty in the global economy and fluctuations in the exchange rates and stock prices on Japan’s economy.

Under such circumstances, financial institutions are expected to proactively contribute to recovering quickly from the disaster and achieving self-sustained growth. They are also expected to function as a backup supporter of the real economy and to lead the economy by acting as a growth industry. Amidst progress in revisions of international financial regulations, financial institutions are also expected to proactively develop their procedures and arrangements while focusing on their future business models.

In view of such situations, the basic objectives of financial inspections in the current program year should continue to be (i) to examine whether financial institutions have developed procedures and arrangements to play a role in smooth and appropriate financing to borrowers (including disaster victims) and to provide good-quality financial products and services to users, and also (ii) to examine whether financial institutions have developed both a sufficient financial base and a robust and comprehensive risk management system to play such a role.

It should be noted that this basic policy for financial inspections was drawn up in light of the circumstances that surrounded financial institutions as of August 2011, and may be subject to review as necessary.

II. Basic Policy for the Conduct of Inspections

1. Promoting the Implementation of the Five Principles Prescribed in the Preamble of the Inspection Manual

Under conditions of continued increasing uncertainty, such as widespread direct and indirect effects of the disaster and recent international financial and economic conditions, when conducting inspection activities, it is becoming even more important for the FSA to anticipate problems while enhancing its sensitivity to risk, and share the recognition of the problems with financial institutions through in-depth dialogue so that they can make voluntary management improvement. Therefore, the FSA places the Better Regulation initiative as a guideline on financial administration and will continue to proceed with its implementation.

To be specific, the FSA will conduct more in-depth inspections through dialogue with financial institutions, based on the following five principles mentioned in the preamble of the Inspection Manual: (i) Examination focusing on important risks, (ii) In-depth analysis and clarification of causes of problems necessary for fundamental improvement, (iii) Identification of problems, appreciation of appropriate improvement efforts, and examination of static and dynamic aspects, (iv) Explanation of the basis for ratings and pointing out problems, and clarification of items to be considered for improvement, and (v) Full understanding of examination results (“Feeling of Agreement”).

2. Activities to Develop the Better Regulation Initiative

(1) Continual and deeper implementation of the Better Regulation initiative

The FSA will implement a comprehensive action plan (Action Plan II; (i) implementing and strengthening the Better Regulation initiative, (ii) enhancing dialogue with financial institutions and strengthening the dissemination of information, (iii) improving the inspection capability, and (iv) enhancing human resource development and increasing the size of the staff), with the aim of conducting inspections that contribute more to voluntary improvement efforts by financial institutions in a consistent manner.

The FSA will also work for deeper implementation of the Better Regulation initiative, by working on various measures written in this basic policy (strengthen analysis capability and information delivery ability, strengthen the integration of on-site and off-site monitoring, etc.).

(2) Enhancement of the coordination with related institutions

From the viewpoint of improving the effectiveness and efficiency of financial inspections, the FSA will further enhance its coordination with the Bank of Japan, overseas authorities and self-regulatory organizations, etc., including the sharing of information and awareness of issues about financial institutions/systems.

(3) Enhancement of the coordination with auditors

In view of the increasing importance of external audits, which support the effectiveness of the internal control systems of financial institutions, including the introduction of internal control audit systems, the FSA will further strengthen coordination with auditors who conduct accounting audits and internal control audits of financial institutions, by enhancing the opportunities for exchange of opinions, etc.

(4) Reduction of the workload on financial institutions

Regarding the workload on financial institutions, in the previous inspection program year, while considering the situation of implementation of financial inspections and opinions from industry groups, the FSA created a policy for reducing the amount of materials to be submitted in advance, and then moved to implement the policy. In the current program year, the FSA continues to work on the steady execution of that policy, to reduce the workload imposed on financial institutions by financial inspections.

3. Enhancement of Analysis Capability and Information Delivery Capability

In order to identify and understand risks which are shared across different business forms and potential risks which can affect the entire financial system, the FSA Inspection Bureau takes actions such as analyzing information obtained in financial inspections of individual financial institutions, and sharing those analysis results with the Supervisory Bureau and the Planning and Coordination Bureau.

Meanwhile, there is an increasing need to closely monitor the effects, which arises from the widespread direct and indirect impacts of the disaster and recent financial and economic conditions, on Japan’s financial system., Therefore, the FSA is further strengthening its analysis capabilities, improving and upgrading its analysis techniques, expanding the coverage of its analyses, etc.

The FSA will also work on institutional development to further advance analysis abilities, by promoting the hiring of external specialists and the fostering of human resources who have advanced expertise, and developing information technology infrastructure which enables advanced analyses.

Moreover, among the analysis results, useful information for financial institutions’ voluntary management improvement and business decisions is provided through dialogue between the FSA and industry, such as at forums for information exchange with industry organizations. In order to boost risk awareness throughout the entire financial industry, the FSA will continue to periodically publish its Financial Inspection Results Casebook, and actively deliver information as needed.

4. Enhancement of the Integration of On-site and Off-site Monitoring (Inspection and Supervision)

In order to effectively and efficiently perform financial inspections that are fully focused on the risk characteristics of financial institutions, the FSA needs to further enhance the integration of on-site and off-site monitoring.

The FSA will work for enhancing its examination system further in order to capture the latent risks for financial institutions and financial systems at an early stage; by promoting more dual duties for staffs and the sharing of monitoring results between the Inspection Bureau and the Supervisory Bureau, and thus the integration of on-site and off-site monitoring, while optimally allocating roles in accordance with the characteristics of both on-site and off-site monitoring.

Specifically,

- Regarding risks threatening financial institutions' financial soundness, the FSA will evolve integration of the Inspection Bureau's on-site data collection and analysis functions with the Supervisory Bureau's off-site monitoring data collection and analysis functions.
- Regarding IT system risks, the FSA has assigned the Inspection Bureau's IT system specialists to simultaneous posts for IT system monitoring in the Supervisory Bureau, and launched a cross-organizational unit between the Inspection Bureau and the Supervisory Bureau. The FSA will further enhance the integration of on-site and off-site monitoring mainly by the unit.
- The FSA will also work for early and accurate understanding of the other types of risks than IT system risks.
- When a prompt examination is especially required, the FSA will also consider having the Supervisory Bureau staffs participate in financial inspections.

Local Financial Bureaus have also begun active efforts for the integration of on-site and off-site monitoring to enable the sharing of information between inspection and supervisory divisions, such as through joint hearings by both divisions. They will work for more efficient operations, while continuing to cooperate with supervisory divisions.

Especially regarding IT system risks, the FSA will implement effective on-site and off-site monitoring. For example, inspection division will share the information regarding IT system modification and failure event held by supervisory divisions. Also cooperation between IT system specialists of the FSA Inspection Bureau, and Local Financial Bureaus' inspection and supervisory divisions is going to be strengthened.

5. Response to Great East Japan Earthquake

(1) Response for Earthquake Recovery

To achieve quick recovery and reconstruction of disaster areas, financial institutions are expected to provide appropriate financial services, such as supplying funds, and play active roles.

To this end, since immediately after the earthquake, the FSA has requested that financial institutions provide conscientious responses to consultations and requests for loan condition changes by small- and medium-size enterprises (SMEs) and housing loan borrowers affected by the earthquake directly and indirectly.

In examinations of whether a financial institution is fulfilling its financial intermediation function, while also considering the financial institution's damages by the disaster, the FSA will focus on its development of procedures and arrangements to:

- provide conscientious responses to consultations and requests for loan condition changes from debtors, corresponding to the actual conditions of debtors.
- enable accurate responses to consultations and requests regarding overlapping debt problems, based on the "the Individual Debtor Guidelines for Out-of-Court Workouts."

(2) Considerations for Financial Institutions Located in Disaster Areas

For a financial institution with a head office or many branches located in areas with extensive earthquake damage and areas suffered from the nuclear power plant accident, financial inspection execution dates will be decided with consideration given to responses to suffered debtors and recovery status of the financial institution itself, etc.

Also, when carrying out a financial inspection of a financial institution which is conserving electricity, the FSA will take into account the electricity conservation action plan, etc. submitted to the supervisory department. In the operational aspects of the financial inspection, it will act with consideration given to burdens on the financial institution.

III. Basic Framework for Inspections

In the current program year, the FSA will seek the following basic frameworks for inspections so as to further improve the effectiveness of financial inspections and reduce the workload imposed by inspections of financial institutions.

1. Major Banks

(1) Targeted Inspections

While the FSA inspects major banks basically through targeted inspections that narrow down the areas examined, the FSA will conduct theme-specific horizontal inspections as necessary.

(2) Strengthening of EiC Functions

In financial inspections, the Examiner in Charge (EiC: Chief Inspector of an assigned institution over several years) and assistants to the EiC conduct in depth analysis in advance.

The EiC has a simultaneous post in the Supervisory Bureau, and participates in comprehensive hearings, inspection follow-up hearings, hearings on current business issues, etc. by the Supervisory Bureau. The EiC thereby gains a timely and appropriate understanding of the situation of the entire financial group he or she is in charge of, keeps an eye on risks which could emerge in the future, and verifies the examination areas with great need for targeted inspections, etc.

2. Large Financial Groups

(1) Inspections of Financial Conglomerates

The FSA will inspect the governance and risk management systems of financial institutions on a group basis, as well as their internal control systems with respect to the management of conflicts of interest (including between banks and securities companies) and the handling of customer information, in coordination with the Securities and Exchange Surveillance Commission as necessary.

(2) Response to global business expansion

The FSA will conduct inspections of the Japanese financial groups (including insurance companies) that engage in international business activities and Japanese establishments of large foreign financial institutions (including insurance companies) with due attention given to the situation of global finance, in coordination with foreign authorities.

The FSA will also attempt to identify global risks at an early stage, by dispatching staff at the Inspection Bureau and making strategic use of resident examiners abroad.

3. Regional Financial Institutions

Local Financial Bureaus, etc. will perform full analyses in advance, narrow down the examination areas, and actively perform targeted inspections and simple inspections. The FSA will thereby perform more focused financial inspections based on the financial institution’s size and characteristics, etc.

4. Foreign Banks, etc.

The FSA will perform analyses in advance in order to narrow down the examination areas, and actively perform more focused financial inspections based on the financial institution’s size and characteristics, etc.

Also, in order to solidly understand the status of governance and legal compliance, etc. for foreign banks based in Japan, the FSA Inspection Bureau will perform off-site hearings in cooperation with the Supervisory Bureau, and as needed, exchange opinions with the management of their head offices or regional headquarters, risk management departments, internal audit departments, etc. It will also strengthen cooperation with the authorities in the home countries of the foreign banks.

5. Financial Institutions which also engage in Trust Business

The series of revisions to the Trust Business Act and Trust Act since 2004 removed restrictions on the types of assets which can be entrusted. This expanded the opportunities for uses of trusts.

Therefore, based on the trust inspection manual, the FSA will examine the status of development of procedures and arrangements to ensure duty of the care of a good manager, duty of loyalty, etc. and to appropriately control operational risks, corresponding to the characteristics of individual trust accounts.

6. Newcoming Banks

The FSA will examine the status of development of legal compliance procedures and arrangements and various risk management procedures and arrangements to suit the planned new business model when entering a new business.

Also, if the size of the bank's assets is growing fast, or if differences arise from the business model originally envisioned when it entered initially, the FSA will verify the status of development of various risk management procedures and arrangements which suit the banks business expansion and current business model.

7. Insurance Companies

The FSA will conduct financial inspections based on its complete revision of the Insurance Inspection Manual.

Also, the FSA will actively use previous analysis to narrow down the examination areas, and conduct more focused financial inspections based on the financial institution's size and characteristics, etc.

For small-amount and short-term insurance providers, in order to ensure appropriate operations, the FSA will focus on conducting financial inspections of the providers which have not been inspected.

8. Financial Companies, etc. (Money Lenders, Issuers of Prepaid Instruments, Fund Transfer Business Operators, etc.)

For money lenders registered with a Local Financial Bureau, the FSA (the Local Financial Bureau) will examine the status of their development of various procedures and arrangements in response to the revised Money Lending Business Act, based on the content of the Comprehensive Guidelines for the Supervision of Money Lending Business Operators, etc.

For issuers of prepaid instruments, the FSA (the Local Financial Bureau) will examine the development of various procedures and arrangements in response to the Payment

Services Act.

For fund transfer business operators, while the FSA (the Local Financial Bureau) confirms the status of their actual operations, especially if part of their fund transfer business is outsourced, it will also examine the management situation of the outsourcing contractor, etc. as needed.

In inspections of financial companies, the FSA will strengthen cooperation between the Local Financial Bureaus which conduct financial inspections and the FSA Inspection Bureau. It will also exchange opinions to strengthen cooperation with self-regulatory organizations.

9. Clearing Organizations

The FSA will conduct IT system risk inspections of safety, etc. as needed. It will also work closely with the Supervisory Bureau to follow up on problems found in financial inspections.

10. Outsourcing Contractors and Agents

For financial institutions, outsourcing is progressed, especially in the areas of IT system development and operations, and in recent years there are more extensive cases of joint outsourcing of IT systems by multiple financial institutions. Also, there are cases of re-outsourcing from the outsourcing contractor to third parties, including to overseas ones.

Some agents, especially among insurance agents, are becoming larger and embarking on a wider range of businesses, such as transactions not done in person.

In view of these conditions, in addition to inspecting the financial institutions' management over such contractors and agents, the FSA will also continue to actively conduct financial inspections of outsourcing contractors and agents.

In these cases, the FSA will examine the status of measures by the financial institution to ensure proper business operations of the outsourcing contractors and agents. The FSA will also examine proper business execution by outsourcing contractors and agents, based on those measures.

IV. Priority Inspection Items

1. Development of Governance System

(1) Appropriate Governance

The leadership and commitment of management based on proper business management is critically important, in order to exercise the financial intermediary function, thorough legal compliance and protection of customers, and accurate management of various risks. Therefore, when conducting financial inspections, the FSA will focus on examining the following points not only through dialogues with the management, but also through examinations of some branches as necessary.

- Whether the financial institution adequately analyzes and deliberates strategic objectives (earnings, costs, capital policy, etc.) based on its management policy in light of current business conditions and the medium-term business outlook, and from the viewpoint of their rationality and sustainability.
- Whether the strategic objectives set for individual businesses based on the strategic objectives for the financial institution as a whole are consistent with risk management policies concerning various risks.
- Whether the strategic objectives and the management policy of various risks have solidly penetrated through the entire organization, including sales offices, and have been implemented.
- Whether the financial institution has developed a robust governance system regarding risk taking, risk management, legal compliance and the protection of customers in the whole group, including at foreign establishments, and whether the system is functioning properly.
- Whether directors and auditors, etc. are holding substantive discussions at meetings of the board of directors, etc., and whether directors and auditors, etc. are performing the duties of executing and supervising business.
- Whether the effectiveness of internal audits (whether the audits are based on a risk-focused, forward-looking approach and whether their coverage and depth are adequate) is ensured, and whether the checking and monitoring function of the audits is used to improve management.

(2) Group Governance of Financial Holding Companies

For financial holding companies which control financial groups such as banks and insurance companies, the FSA will focus on the examination of whether group governance functions are exercised sufficiently on subsidiaries of the financial holding company, while considering the financial group’s size, characteristics and expected roles of the financial holding company in the group.

(3) Business Continuity Management

Amidst more diverse and complex risks faced by financial institutions in recent years, events are occurring which in some cases were often not imagined, such as the Great East Japan Earthquake and large IT system failures. In view of this, reviewing previous risk scenarios and preparing systems in normal times for crisis response are becoming important management issues. Therefore, the FSA will focus on examining whether the management has responsibly:

- developed a business continuity management which assumes major risks, so that it can ensure continued minimum operations as a financial institution when a crisis occurs.

- verified whether the previous crisis management manual and business continuity plan have functioned effectively, and appropriately revised the business continuity management as needed.

  (Regarding “IT System Risk Management,” see IV.5.(5) below)

2. Further Promotion to Facilitate Financing

It is expected that financial institutions will continue to promote the facilitation of financing and provide proactive support toward improved management of debtors, while paying due attention to ensuring their own sound and appropriate business operations.

The expiration of the Act concerning Temporary Measures to Facilitate Financing for SMEs, etc. was extended by one year, to March 31, 2012. In view of this, the FSA will continue to focus on examining whether financial institutions have developed procedures and arrangements to be able to sufficiently demonstrate their consulting function and their smooth and active financial intermediary function, based on appropriate risk management.

After a cycle of financial inspections on the status of implementation of this Act, examinations of financial facilitation shall be done as part of the usual financial inspections.

(1) Loans to SMEs

(i) Management consultation, management guidance, management improvement support

While considering financial institutions’ sizes and characteristics, the FSA will focus on examining whether financial institutions have developed procedures and arrangements for:

- actively engaging in steady efforts on a daily basis, such as management consultations by visiting their customers, and for providing conscientious management consultations and guidance to SMEs, and supporting their creation of management improvement plans at each stage of their lifecycle (support of startups and new business, support of management improvement, business rehabilitation, and succession of business).
- providing loans that ensure the smooth exercise of the financial intermediary function in line with the purposes of the Supplement to the Financial Inspection Manual (the debtors should be evaluated with due consideration of unquantifiable factors, such as technological capability and the abilities of managers, rather than based merely on formal facts, such as incurring losses and being in a state of negative net worth) while making conscientious efforts to grasp the actual circumstances of the debtors.
- appropriately responding to requests from and consultations with customers for new loans (including funding after making changes in loan terms) by conducting appropriate screening, etc., and for making proper explanations to customers when

rejecting requests, so that smooth and active financial intermediary functions can be demonstrated.

- examining whether financial institutions have established financial practices which in principle do not seek individual co-surety by third parties other than business managers.

When financial institutions exercise a debt guarantee, the FSA will focus on examining: whether they have developed procedures and arrangements for conscientious responses, such as allocating burdens in a rational method according to the repayment capacity of each debt guarantor with due attention given to the guarantors' actual living situations.

- If excellent initiatives and innovative ideas are recognized in management consultation, management guidance and management improvement, the FSA will appreciate them positively in financial inspections, clearly reflect the results in financial inspection ratings, etc, and make them widely known by describing them in Collection of Good Practice and Inspection Findings.

(ii) Changes in loan conditions

When a request for changes in loan conditions is received from an SME, it is important that the financial institution demonstrates its consulting function, and solidly works on business improvement or business reconstruction of the SME, leading to improvement of the repayment abilities of the SME and sound funding demand in the future. This should also lead to improvements in the financial institution's profitability and financial soundness.

Therefore, the FSA will consider the sizes and characteristics of financial institutions, and focus on examining whether they have developed procedures and arrangements:

- for taking required measures as stipulated in Article 6 of the Act concerning Temporary Measures to Facilitate Financing for SMEs, etc. in response to requests from debtors for changes to loan conditions, etc.
- to appropriately focus on the possibility of business reconstruction, and support the creation of a rational and very feasible business improvement plan for SMEs with steadily worsening business, while demonstrating an appropriate consulting function.
- especially when changing the loan conditions for an SME which has not yet made a business improvement plan, to consider the actual state of the SME, and support the solid creation of a rational and very feasible business improvement plan.
- for periodically and continually grasping the progress status of the business improvement plan after it is created, and actively working to support the achievement of the plan.

(2) Housing Loans

- The FSA will also focus on examining whether financial institutions have developed procedures and arrangements, such as appropriate screening, for proper response to consultations with or requests from customers for new loans (including funding after making changes to loan conditions), and for proper customer explanations when rejecting requests.
- When there is a debtor’s consultation or request for changes in loan conditions, the FSA will focus on examining whether financial institutions respond appropriately with sufficient consideration given to that debtor’s economic status.
- In the case of housing loans insured by guarantee companies within the same financial group (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.

3. Legal Compliance System

The maintenance and construction of a strong legal compliance system helps the financial institution gain the confidence of its customers, and is part of its core infrastructure for providing smooth financial functions.

Therefore in the current inspection program year, the FSA will focus on examining the following initiatives by financial institutions for the development of legal compliance systems.

(1) Response to Anti-Social Forces

A resolute stance for rejecting and eliminating relations with anti-social forces is important for maintaining the people’s faith in financial institutions, and for ensuring appropriate and sound operations of financial institutions. If there are improper demands from anti-social forces, the financial institution must not comply, and must respond appropriately according to laws and regulations, etc.

Therefore, the FSA will cooperate closely with related institutions, and focus on examining their development of procedures and arrangements to prevent transactions with anti-social forces, such as by collecting and analyzing information on anti-social forces.

The FSA will also focus on examining whether financial institutions have developed procedures and arrangements for personal identification and suspicious transactions, to prevent anti-social forces using them for the purpose of providing funds to terrorists or money laundering, etc.

(2) Actions to Prevent Inappropriate New Business, etc.

Financial institutions' wholesale businesses have been expanding recently: their business of arranging syndicated loans and asset securitization, M&A advisory business, etc.

As part of this, for financial institutions to prevent inappropriate transactions in new business, the FSA will, while considering financial institutions' sizes and characteristics, focus on examining whether financial institutions have developed procedures and arrangements for:

- clear and appropriate rules on transactions and operations with prior legal checks.
- prior investigation of the legality of transactions in new businesses and complex schemes.

4. Protection of Customers and Improvement of Users' Convenience

The enhancement of customer protection and users' convenience by financial institutions contribute not only to the sound development of the national economy but are also important for the stability of the financial system by increasing the trust of the people in them. It is important that financial institutions enhance their competitiveness, for example by providing financial products and services using innovative ideas based on the principle of ensuring a sense of security and trust through the implementation of measures to thoroughly protect customers. Especially for customer protection, they are expected to go beyond simply complying with laws and regulations, by checking the level sought by customers, and meeting those expectations as trusted financial institutions with very public aspects.

Therefore, in the current program year, the FSA will continue to focus on examining the following activities of financial institutions related to the protection of customers and the improvement of users' convenience. In addition, it will cooperate with the Consumer Affairs Agency as necessary.

(1) Protection of customers

(i) Thorough management of information on customers, etc.

As customer information forms a base for financial transactions, and in light of personal information protection, it is necessary to strictly manage such information. It is also necessary to strengthen the management of corporate-related information in order to enhance reliance on market transparency and fairness. In view of these points, the FSA will focus on examining whether financial institutions have developed internal control systems for the management of information on customers, etc., including the prevention of employee and officer misconduct (such as the leakage of internal information and insider trading).

(ii) Ensuring appropriate and safe financial transactions

Ensuring safe financial transactions is essential for the protection of customers. Therefore, the FSA will focus on examining whether financial institutions have developed procedures and arrangements:

- necessary for the prevention of financial damage that may be caused by illegal uses of deposit accounts, including “Furikome” billing fraud. It will especially examine whether they have taken active measures against Furikome billing fraud that misuses donations for the earthquake.
- such as creating internal rules for proper handling of the procedures stipulated in the Furikome Fraud Relief Act.
- to provide needed information and take other actions for people who could be victimized by financial crimes using forged or stolen cash cards and crimes related to Internet banking.
- for enhancing information security measures, including measures to protect information used for identity verification, in order to prevent damage from financial crimes as described above.

(iii) Active responses to consultation requests and complaints (including responses to the financial ADR system)

In order to gain the trust of customers and reflect their needs in business operations, it is very important for financial institutions to proactively make timely and appropriate responses to consultation requests and complaints from customers. From this viewpoint, the FSA will focus on examining whether financial institutions are meeting customers’ consultation requests and dealing with their complaints properly. To be more specific, the FSA will examine whether financial institutions analyze the causes of such complaints, actively adopt appropriate measures to prevent their recurrence, raise institution-wide awareness about the measures and follow up on their implementation.

In addition, as for the financial ADR system, in light of factors such as the application of conduct regulations on each financial institution from last year, the FSA will focus on examining whether financial institutions have developed the following procedures and arrangements for:

- introducing the financial ADR system as needed when there are consultations, etc. from customers.
- responding quickly when a designated dispute resolution institution requests submission of documents, etc., unless there is a proper reason not to.
- proper alternative measures in case of an absence of designated dispute resolution institutions.

(iv) Appropriate explanations to customers

Amid the increasing complexity and diversity of financial products and services, users expect and demand higher standards from financial institutions as well as from financial products and services. When financial institutions sell insurance products and investment products, they need to provide accurate explanations concerning the characteristics of the products and where risks reside while taking customers' actual needs into consideration.

Therefore, the FSA will continue to focus on examining substantially whether financial institutions act appropriately and flexibly in dealing with customers while sufficiently considering each customer's knowledge, experience and understanding of risk, etc., in accordance with the purpose of relevant laws and regulations. In addition, the FSA will pay adequate attention to whether financial institutions are not imposing an excessive workload on customers in terms of time and procedures.

Especially if a financial institution is selling investment products, such as funds investing in foreign stocks and bonds, currency selection type funds, monthly dividend type funds, other such investment trusts, structured bonds or currency derivatives, the FSA will focus on examining whether the financial institution has developed procedures and arrangements for:

- monitoring of compliance with the regulation of unsolicited offers, and appropriateness of solicitations for switching among investment trusts.
- explanations and after sale follow-up, based on the suitability principle and customers' investment aims, etc. The FSA will also examine whether these are functioning.

For insurance solicitation by banks, etc., the FSA will also focus on examining whether financial institutions:

- have developed procedures and arrangements to take appropriate measures to prevent bad practices, such as abuse of superior position and confusion with deposits.
- have appropriately functioning measures to prevent bad practices, such as the use of non-public financial information in the insurance business without obtaining the customer's agreement.

(2) Improvement of convenience for users

In light of the increasingly high standards that people expect and demand from financial institutions, financial institutions need to make further efforts to improve convenience for users by discovering user needs, providing environments where physically disabled and elderly people can confidently use financial services, and developing new products and services if they are to obtain the support and trust of customers and maintain their business foundation.

Therefore, in the current program year, the FSA will continue to positively appreciate excellent financial institutions' initiatives to improve convenience for users.

5. Development of Risk Management System

(1) Comprehensive risk management

As transactions between financial institutions are becoming more and more advanced and complex due to the evolution of financial engineering, financial institutions need to develop risk management systems while taking it into consideration that risks that do not fit any conventional risk category will arise, and that risks will amplify and spread in a chain reaction as a result of stress events in the financial and capital markets.

Therefore, the FSA will continue to focus on examining whether financial institutions have developed comprehensive risk management systems which suit their size, characteristics and risk profile. As part of this, the FSA will also examine the development of procedures and arrangements to appropriately manage the major risks which must be considered in Pillar 2 of the Basel II framework, such as interest rate risks in the banking book.

In the current inspection program year, in view of the lessons of the recent global financial crises and current domestic and foreign financial and economic conditions, the FSA will focus on examining whether financial institutions have:

- developed procedures and arrangements to comprehensively manage diverse risks, understanding that risk measurement models have limitations and weaknesses caused by underlying assumptions and calculation methods, etc.
- conducted stress tests under severe scenarios (for example, simultaneous shocks of multiple phenomena, such as higher interest rates, stronger yen, and lower stock prices) , assessing how the harshest but plausible market environmental changes could impact on economies and financial and capital markets, and lead to influence their own business directly and indirectly. The FSA will also examine whether they use the results in business decisions.

For major financial groups and major banks, the FSA Inspection Buerau will cooperate with the Supervisory Bureau to follow up on financial inspections implemented until the previous inspection program year, regarding comprehensive risk management systems.

(2) Credit Risk Management

In view of the importance of credit risk management in financial institutions, the FSA will consider the size and characteristics of financial institutions, and focus on examining whether they have developed procedures and arrangements for:

- appropriate screening and credit management based on sufficient understanding of the actual status of borrowers, for syndicated loans and credit to overseas which are tending to increase, and for large borrowers which could have large effects on the financial institutions' business.

- appropriate management of risks of credit concentration in specific company groups and industries, etc.
- practical early warning for debtors to review credit ratings based on risk information in a timely and appropriate manner.

For housing loans, in view of the characteristics of the product and rising competition among financial institutions, the FSA will, while considering financial institutions' sizes and characteristics, examine whether financial institutions have developed procedures and arrangements not only to monitor overdue status, etc. but also to manage the interest rate risks, the prepayment risks and their special characteristics of seasoning effect, etc.

(3) Market Risk Management

In view of recent financial and capital market trends, the FSA will, while considering financial institutions' sizes and characteristics, focus on examining whether financial institutions have developed procedures and arrangements to:

- effectively manage risk and loss limits.
- comprehensively consider risks in the management of financial instruments, bonds and stocks etc., which contain diverse risks.
- accurately understand interest rate risks in which market movements affect assets and liabilities held.

(4) Liquidity Risk Management

In recent global financial crises, foreign financial institutions faced problems in aspects of fund liquidity. There were also cases seen in which Japan's financial institutions had problems obtaining foreign currency liquidity in foreign business.

Therefore, in the current inspection program year, for Japan's financial institutions which have overseas locations and foreign banks which have locations in Japan, the FSA will, while considering their sizes and characteristics, focus on examining whether they appropriately manage liquidity risk on a global basis.

In doing so, the FSA will focus on the appropriateness of liquidity management across all companies in groups (including liquidity management among headquarters and branches across international borders), the appropriateness of foreign currency liquidity management and the status of holding the liquid assets needed.

(5) Information Technology System Risk Management

IT systems of financial institutions are at the core of settlement systems, and have very public aspects as social infrastructure. If a failure occurred, this would be not only inconvenience of users, but also it would have significant impacts on society, and could result in losing credibility for the financial institution. Therefore this July, the FSA Supervisory Bureau requested comprehensive self-inspections of IT system risks to financial institutions.

Considering the results of these self-inspections, the FSA will focus on examining whether:

- management is well aware of the importance of IT system risk management, including for the stably operated IT systems.
- there is a clear business strategy on IT system investments.
- when updating or integrating IT systems, the risks are accurately understood at the management level, and an appropriate project management system is developed.
- there are clear responsibilities management must fulfill and actions they must take when an IT system failure occurs,

The FSA will also focus on examining whether:

- procedures and arrangements are developed to continually ensure sufficient IT system related functions and processing abilities, while considering changes in the external environment.
- specific procedures and arrangements are developed to ensure the effectiveness of contingency plans.

In addition, the FSA will examine whether:

- amidst progress in the sharing and outsourcing of IT systems and cloud service usage in financial institutions, roles and responsibilities are clearly allocated between the financial institutions and the IT system center and IT system developers contracted by the financial institutions, whether cooperation and reporting procedures and arrangements are developed, and whether contingency plans are developed.
- considering the progress in global business, IT system risk management procedures and arrangements are developed to handle the expansion of overseas operations in financial institutions.

(6) Group-wide risk management of major financial groups

With attention focused on foreign economic conditions, and on financial and capital market movements, major financial groups are aiming to expand their revenue base, and are expanding their foreign locations especially in Asia. There is also increasing cooperation between banks and securities companies, and the development of comprehensive risk management systems as a group on a global basis is a challenge.

In view of this situation, the FSA will, while considering financial institutions' sizes and characteristics, focus on examining whether:

- risk management systems are developed across the group to suit the characteristics of its business and risks, based on stronger cooperation in the group.
- appropriate risk management systems are developed, considering the expansion of overseas business. Especially with the expansion of overseas locations, amidst an expansion seen in the functions of regional headquarters to manage these locations, whether appropriate risk management systems are developed in each region.
- procedures and arrangements are developed to ensure global governance, such as control by Tokyo headquarters.
- procedures and arrangements are developed for overseas human resource development and IT system infrastructure development.

(7) Risk Management in Insurance Companies

Based on the revised Insurance Inspection Manual, the FSA will, while considering insurance companies' sizes and characteristics, focus on examining whether:

- there is progress in developing and establishing enterprise risk management systems together with business strategy,
- procedures and arrangements are developed for comprehensive asset liability management (ALM) corresponding to liability characteristics, under the solid leadership and commitment of management.
- stress tests are conducted which suit domestic and foreign financial and capital market trends, and whether the results are used in business decisions.

Basic Plan for Financial Inspections in PY2011

		Number of institutions to be inspected	(Reference) Basic Plans for Financial Inspections in Past Program Years	
			2010 Program Year	2009 Program Year
	Banks	80	105	100
	Shinkin banks Credit cooperatives	160	260	170
	Labor banks (Rokin) Federation of agricultural co-operatives associations and Federation of fishery co-operative associations	25	5	15
Total of deposit-taking financial institutions		265	370	285
Insurance Companies		25	20	20
	Non-banking money lenders	80	90	100
	Issuers of prepaid payment instruments	140	145	165
	Other	35	20	25
Total of other financial institutions		255	255	290

Notes:

(1) The above "Number of institutions to be inspected" are expected numbers. The number of inspections may change.

(2) "Banks" includes bank holding companies. "Insurance Companies" includes insurance holding companies.

(3) The number "deposit-taking financial institutions" to be inspected in the 2011 Program Year is much less than in the previous program year. This is mainly because:

[1] "Inspections on the states of implementation of the Act concerning Temporary Measures to Facilitate Financing for SMEs, etc." comprised nearly half of "deposit-taking financial institutions" in the previous program year. However, one round will be completed by this September. After that, these will only be the usual inspections, which require more inspectors and days (usual inspections require about twice the inspectors and days of financial facilitation inspections)

[2] In consideration of financial institutions located in disaster areas, Tohoku Financial Bureau's number of inspections is being reduced.