Highlights of the Financial Monitoring Report

Financial Services Agency

4 July 2014

Objective of the report

To publish for the first time the results and challenges of financial monitoring during July 2013 to June 2014 based on the FSA's Financial Monitoring Policy (announced in 2013)

Outline of the report

Chapter I　Overview of financial systems

Chapter II　Financial monitoring of financial sectors

1. 3 major bank groups
2. Regional banks
3. Foreign banks
4. Insurance companies

Chapter III　Horizontal review by themes

1. Governance
2. Internal controls for anti-social forces and money laundering
3. Investment trust sales businesses
4. IT governance

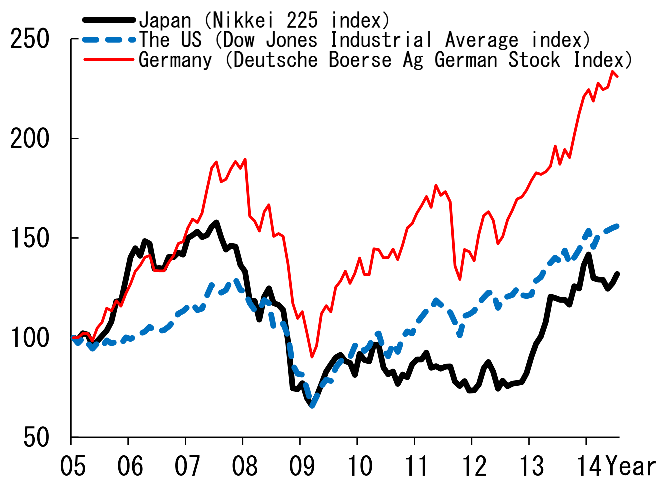
Chapter IV　Measures taken by the FSA

Chapter I Overview of financial systems

1． Economic and market trends surrounding financial sectors

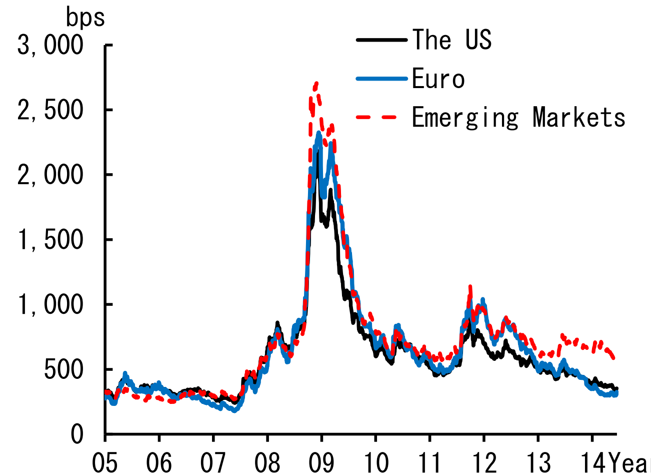
— The world economy is recovering, mainly in advanced countries. With the continuing worldwide monetary easing, the prices of risk assets have recovered to the pre-Lehman Crisis level.

Stock prices of Japan, the US, and Germany
（End of 2004 as 100）



Source: Bloomberg

Spread of high-yield bonds



Source: Bank of America Merrill Lynch
（used with permission）

— Going forward, as some advanced countries will move toward the normalization of monetary policies, we should be vigilant against the potential rise in interest rates and volatility of various types of assets.

— Particular attention should be paid to: trends in flow of funds to emerging economies; delay in economic recovery in some advanced countries; policy changes in countries and regions in need of structural reforms; and other geopolitical risks.

2．Recent money flow in Japan

－　Due to the measures taken by the government and the Bank of Japan to overcome deflation, the Japanese economy is recovering gradually.

－　Annual changes in assets and liabilities of depository corporations (comparison between 2013 and 2012 year ends)

(i) Amounts of JGB decreased, while amounts of foreign bonds and investment trusts increased.

(ii) Overseas loans increased drastically. Domestic loans to small and medium sized enterprises (SMEs) began to increase, while loans to large enterprises and individuals had been already increasing.

＜Assets＞ (in trillion yen)

Loans		
Domestic	＋34	＋47
Overseas	＋13	
Securities		
Government	▲31	
Stocks, Investment trusts	＋21	
Outward investments, etc.	＋15	
Deposit with BOJ	＋58	

＜Liabilities/Capital＞ (in trillion yen)

Deposit	＋44
BOJ loans, etc.	＋22
（Increase in value of issue of shares, etc.）	＋22

Source: Bank of Japan “Flow of Funds,” etc.

3. Risk Trends

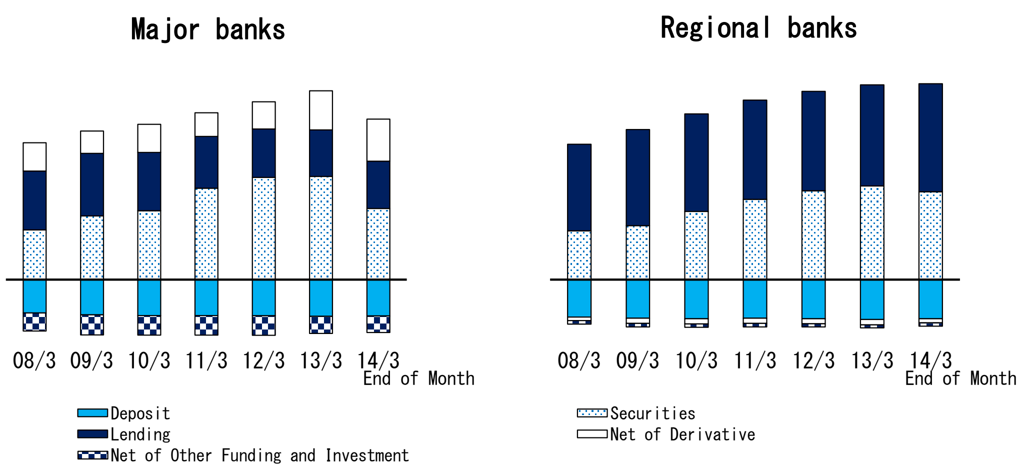
— Interest rate risk (yen denominated)

⇒Major banks: interest rate risk is decreasing due to shortened duration and reduction in bond holdings (mainly JGBs).

⇒Regional banks: interest rate risk remains flat mainly due to increase in investment of corporate bonds offset by decrease in JGBs.

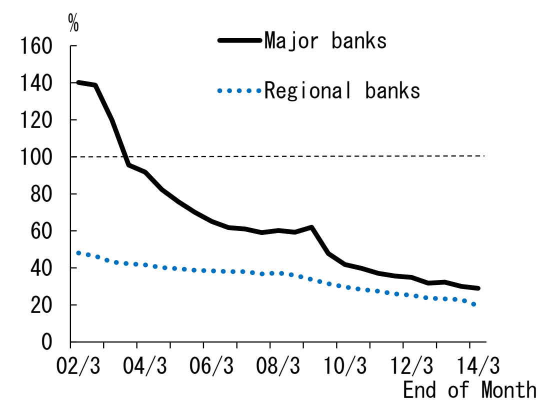
— Appropriate risk management is crucial for market risk from stockholdings and credit risk from increase in overseas loans.

Yen denominated interest rate risk



Note: The graphs show the change in net present value on the assumption that the interest rate has shifted upward in a parallel manner.

Ratio of equity holding



Note: Ratio of equity holding (polygonal line) is: securities available for sale (original stock values) divided by Tier 1 (based on the end of each term)

Source: FSA

1．Group Governance

【Group Management】

— Given the diverse and global nature of the 3 major bank groups' business model, the groups are strengthening group-wide governance (retail, wholesale, international business, etc.) by holding companies.

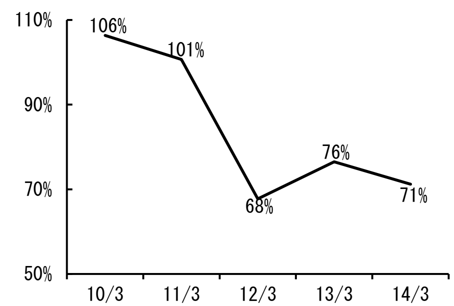
【Group Compliance】

— As banking-securities joint wholesale business is promoted, if a securities company within a group were to gain business opportunities against the will of a client company with the bank's implied influence, it would violate the principle of fair competition. Appropriate preventive measures against such business conduct are needed.

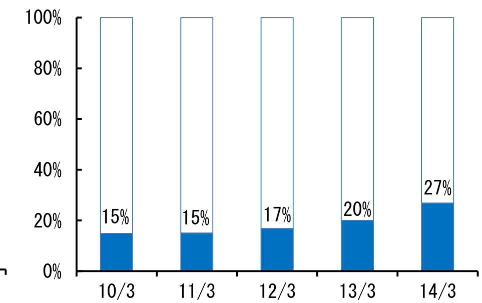
【Group Risk Management】

— As credit to the same borrower from subsidiaries or overseas offices in a group is increasing, holistic risk management by the holding company is becoming increasingly important.

Change in rate of the commercial bank's net profit to net profit of the entire group
（average of 3 major bank groups）

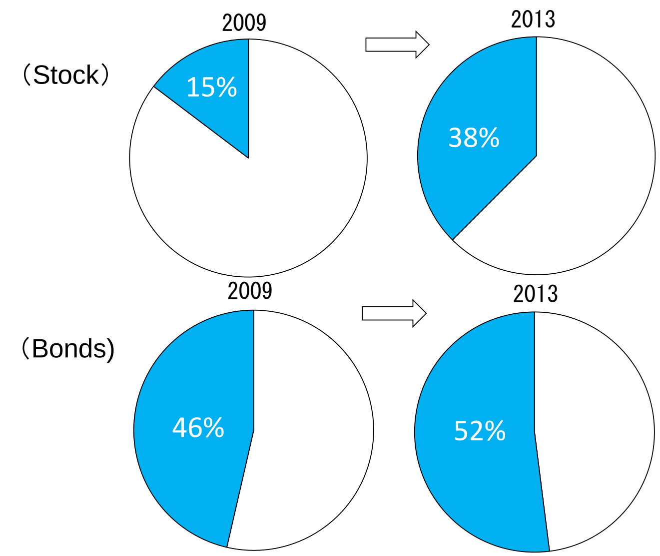


Change in the rate of profit from the international sector to that of the entire group
（average of 3 major bank groups）



Source: published data from each company

Percentage of newly issued stocks and newly issued bonds subscribed by 3 major bank groups



Source: Bloomberg

2． Loan business

【Loans to small and medium sized enterprises】

― Starting to change the lending stance in order to respond actively to meet the needs of SMEs, but a lack of experienced middle-aged staff is undermining the quality of credit assessment as a whole (The 3 major bank groups limited the recruitment of new graduates around the 2000’s). Measures such as utilization of retired experienced staff to train less-experienced staff have been taken.

【Loans to large enterprises】

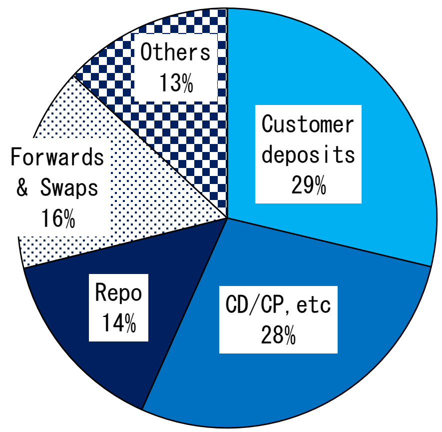
― Credit to non-Japanese enterprises is increasing, and thus industry analysis and credit management with a global perspective are becoming more important.

― As Japanese enterprises are expanding into overseas markets, providing more advanced financial services, including global cash management services and effective settlement in addition to loans from overseas offices, is still a challenge for major banks.

― In the domestic market, depending on the industry type, some large enterprises are losing international competitiveness and facing low profitability due to excessive competition. Taking into account trends of the entire industry and providing financial services which contribute to the growth of enterprises are crucial.

3． Foreign-currency liquidity risk management

Foreign currency funding structure
（average of 3 major bank groups）



Source: FSA

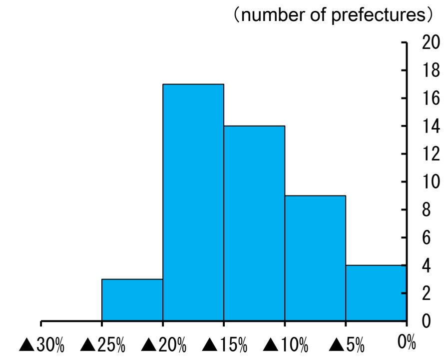
― Foreign-currency denominated loans are increasing more than foreign-currency denominated deposits. There is a need to continue working on strengthening stable foreign-currency funding and sophisticating foreign-currency liquidity risk management, in response to expanding loans.

4． Trust business（MUTB, MHTB, SMTB）

― In an aging society, the 3 major trust banks are strengthening property succeeding trust business (educational trusts, testamentary trusts, etc.) that involves generational transfer of the assets from the elderly to the young. Product knowledge and customer explanation system of major trust banks are at a certain level. However, as the business is getting more complex, further enhancement of the expertise and skills of staff, including sales staff of agents for trust, is necessary.

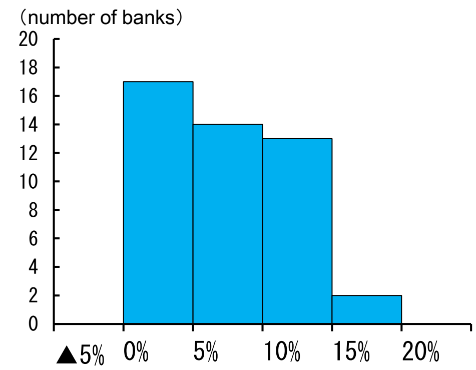
1． Mid and long term sustainability of business model

Rate of decrease in lending to small and middle sized enterprises by prefecture（2012-2025 estimates）



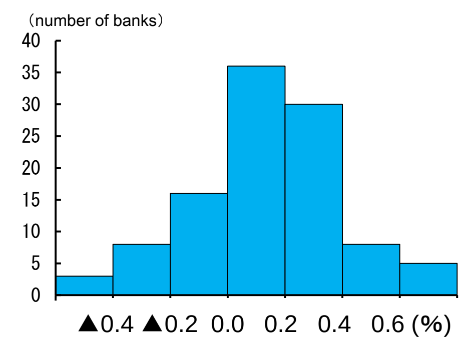
Source: FSA

Bank target of increase in loans in medium-term management plan（3 years）



Source: published data from each bank

Distribution of rate of returns for each regional bank (estimates)



Source: FSA

– With the shrinkage of the working population, loan markets are expected to get smaller in each region. Despite such an observation, a lot of regional banks target the increase of lending in their medium-term management plan.

– In order to expand loans, regional banks are increasing lending that can be made with relatively lower costs for appraising borrowers, but brings low profit, such as lending to large enterprises in metropolitan areas and lending to local governments.

– Profitability of lending of regional banks seems to be declining overall. Further cost reduction to deal with this problem could lead to weakening of sales strength and/or ability to appraise borrowers, etc.

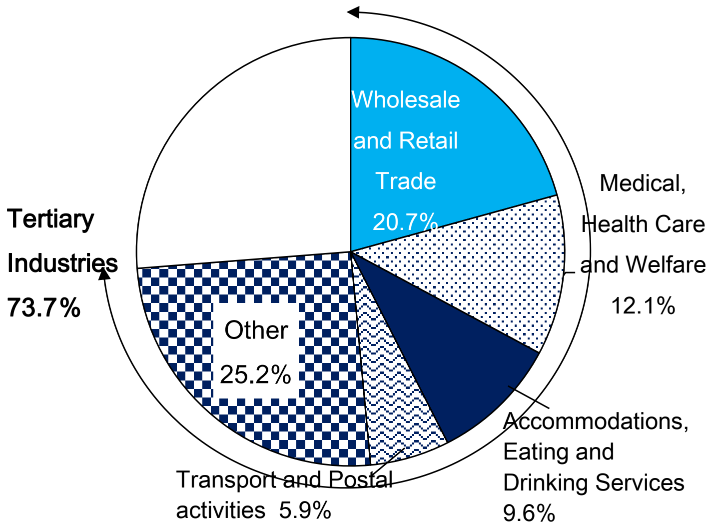
2．Stability of local economies and role of regional banks

- About 70% of the GDP and employment of the local economies depend on the service industry, but this industry tends to face an excessive over-supply as the population is decreasing.

- As there is a shortage of workers, to stabilize employment and wages through gradual integration of companies and improvement of productivity is important for the Japanese economy’s growth strategy.

- Supporting the improvement of productivity of enterprises and industries will lead to sustainability of bank businesses.

Proportion of employees by industry in local areas



Note: excludes 3 metropolitan areas （Tokyo, Nagoya, Osaka）

Source: Ministry of Internal Affairs and Communications

Chapter II-2　Regional banks

- Regional banks tend to depend on financial data of borrowers and collaterals and guarantees when making loans.

- Banks are expected to:
  (i) give useful advice to borrowers, taking the changing business environment into consideration;
  (ii) provide finance in line with the appropriate business strategies of borrowers.

FSA had a continued dialogue with banks from this perspective.

（Case study of business assessment）

Example (i) In some regions, for retail businesses like supermarkets, expansion of the size of business does not always lead to an improvement of profitability. Profit management of each branch is more important than pursuing sales or expanding sales area without business efficiency.	⇒ Instead of providing finance to expand the sales area, banks should provide advice on business restructuring, like changing area strategy and narrowing sales items, and provide financial needs along with it.
Example (ii) In some regions, there are cases where textile retailers play a key role as price setters. Some textile manufacturers are determined to engage in sales to retain control over price setting.	⇒ Banks should propose finance for IT-related investment to manage each branch's profit and information of well-selling products.

3． Earnings and risk management function of regional banks

Through the monitoring of relatively small regional banks, the following cases were observed. More enhancement of earnings and risk management is expected.

【Earnings management】

－ There were cases where banks did not have a clear identification and understanding of their profitability in each business line and region as well as their own strengths and weaknesses.

【Credit concentration】

－ Some banks had a large exposure towards certain sectors, like real estate rental business.

【Interest rate risk】

－ With the anticipation of rising interest rates, some banks are shifting toward domestic equity and foreign bonds rather than JGBs, while other banks are holding more JGBs and lengthening the duration in order to maintain the earnings level.

Chapter II-3　Foreign banks

1． G-SIFIs* (23 foreign banks)

*Global Systemically Important Financial Institutions

－　After the global financial crisis, a number of foreign banks in Japan tended to deleverage their balance sheets, but with the Japanese financial market booming since last year, some G-SIFIs are starting to re-expand their business in Japan. The establishment of an internal control system that responds to such changes of business is important.

－　Since the business of foreign banks in Japan depends on the management policy of headquarters and group-wide financial soundness, understanding of group-wide soundness and communication with group senior management and their supervisory authorities were enhanced.

2． Non G-SIFIs (36 foreign banks)

－　Business contents of Non G-SIFIs were categorized into several groups and monitoring is focusing on areas with high risk considering their business models

(i) Inter-office transfer model: Taking client domestic deposits and transferring them internally to headquarters/other offices for investment.

(ii) Commercial bank model: Taking client deposits domestically and lending them in and out of Japan.

(iii) Remittance model: Providing money transfer service to foreign residents in Japan.

(iv) Other: Proprietary investment with headquarter funding, etc.

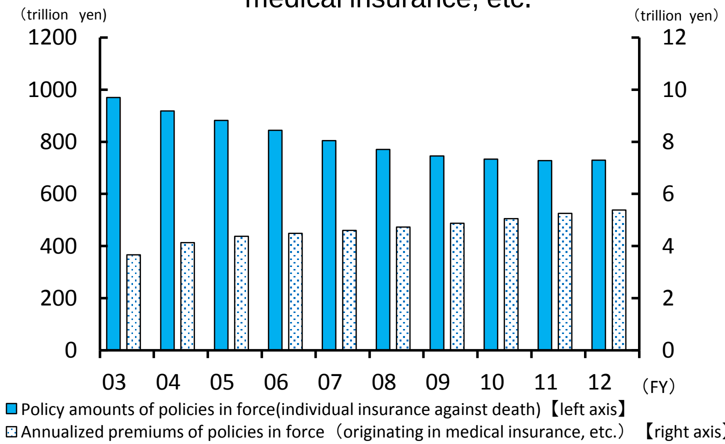
Chapter II-4　Insurance companies

1．Major life insurance companies

（Nippon Life, Dai-ichi Life, Meiji Yasuda Life, Sumitomo Life）

— Due to the decreasing birthrate and aging population, a decrease of death benefits, an increase of medical insurance, etc. and an increase of the enrollment rate of the elderly are recent characteristics. Large life insurers should provide and explain their products and services in a way that fits these characteristics. Customer follow-up, including confirmation of policyholders' satisfaction, is also needed.

Situation of contracts of life insurance and medical insurance, etc.

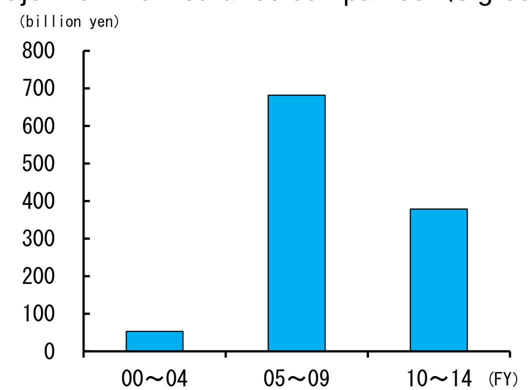


Source: data from journal *Insurance* by Insurance Research Institute

2．Major non-life insurance companies **(Tokio Marine, MS&AD, NKSJ)**

— To address active overseas business expansion and more frequent natural disasters, establishment of a proper governance structure, including overseas branches/subsidiaries and enhancement of the risk management system are challenges for large non-life insurers.

Investment for acquisition of foreign insurance companies
Major non-life insurance companies（3 groups）



Source: published data from each company

Chapter III　Horizontal review by themes

１．Governance

－　Board of directors and executive management team

【Effective performance of board of directors】

・　Use outside director's perspective to enhance effective discussion and achieve diversity of the board of directors.
　The number of outside directors has increased in some large financial groups and the discussion by the board of directors tends to become more intense by focusing on crucial issues.

・　To ensure that outside directors can play their expected roles, their independence, competency and knowledge, commitment to management, and support system, for example, to provide necessary information for the decision making are important.

【Diversity and nomination process of executive officers】

・　Need to establish an executive management team that suits the increasing overseas business and expanding diversity of business.

・　The right human resource policy regarding executive officers is important to maximize corporate value.

– Audit by audit committee and internal audits

- In advanced foreign banks, ex-post checks of compliance with internal rules as well as the following are being practiced:
  (i) pre-emptive internal audit to prevent risks from crystallizing;
  (ii) internal audit that evaluates the validity of internal rules themselves.

  To put excellent staff in an internal audit division, improvement of career path of internal auditors is also being practiced.

- In order to strengthen the audit performance as a whole, close communication between internal auditors, audit committees, and external auditors is needed.

- An internal audit system is important for the governance of financial institutions. It is crucial that CEOs and other board members of financial institutions understand and recognize the importance of internal audits.

2． Internal controls for anti-social forces and anti-money laundering

－　For the 3 major bank groups, internal control for anti-social forces and money laundering is mostly well-developed, but they should continue to explore well-advanced monitoring systems of anti-money laundering.

－　For regional banks, there is a need to set up a system to gather information on anti-social forces, not limited to their business area, and enhance the cooperation between related divisions (division that deals with anti-money laundering and division that deals with anti-social forces).

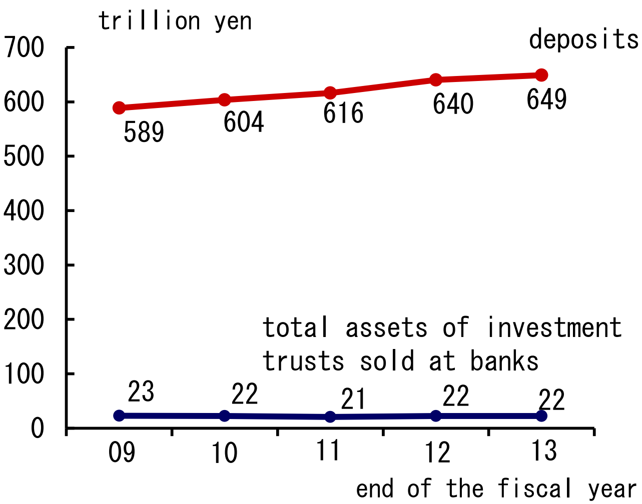
－　Insurance companies, as a whole industry, need to continue working on the establishment of a system to counter anti-social forces and gather information on them.

－　With the cooperation of industry groups and the relevant organizations such as the National Police Agency, the FSA will support further enhancement of internal control for anti-social forces and anti-money laundering.

3． Investment trust sales businesses

— Total assets of investment trusts sold at banks are stagnating, but as the average holding period of retail investors has been shortening, investment trust sales and profits (commission fees) of investment trusts have increased.

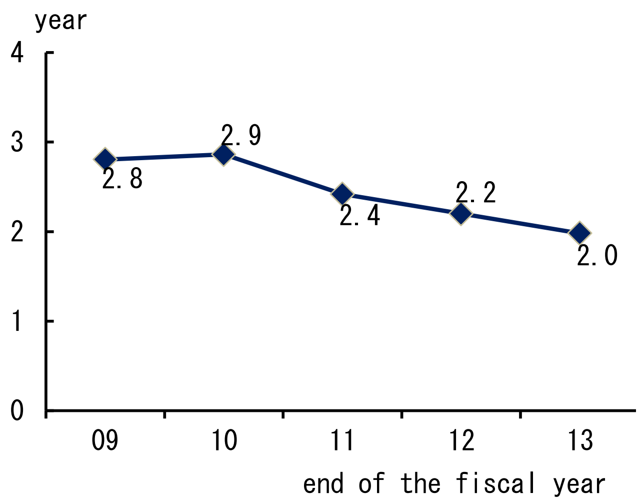
Comparison of total assets of investment trusts sold at banks and deposits(※)



（※） major banks and regional banks

Source: FSA,
Japanese Bankers Association

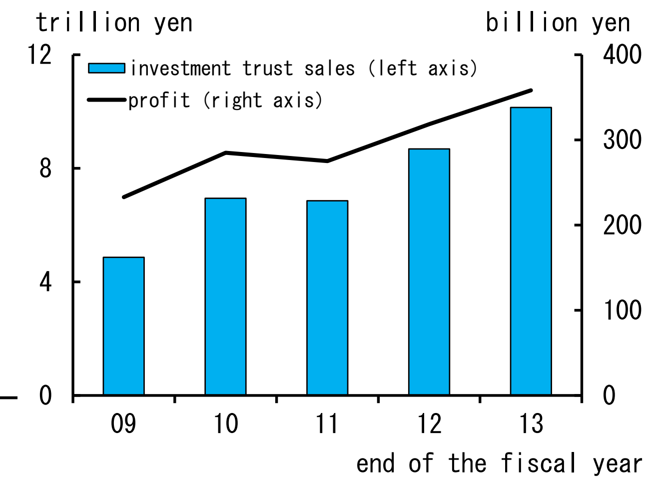
Average holding period of retail investors for investment trusts



Note: stock investment trusts, average balance for each term excluding the value of redemption

Source: The investment trusts association

Change in investment trust sales and profits(※)

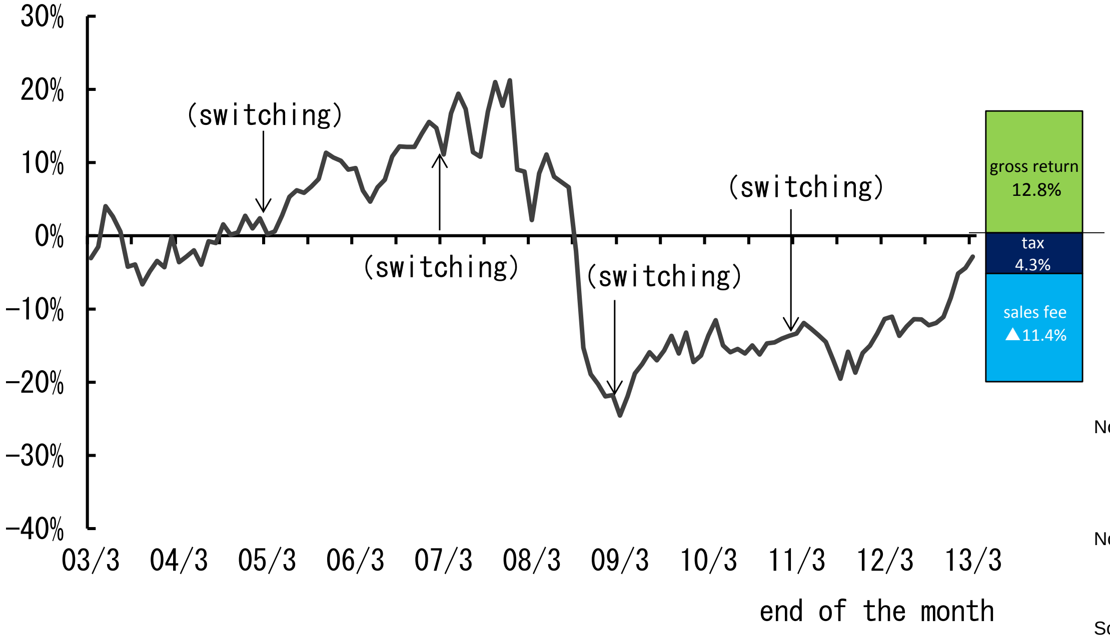


（※） major banks and regional banks

Source: FSA

Chapter III　Horizontal review by themes

— The following graph shows the estimates of profit status in case of switching to the most popular investment trust every two years for a decade from March 2003.



〔details of profit and loss at the end of March, 2013〕

※Please note that results may differ depending on timing of investment, interval of switching or other assumptions.

Note1： The leading fund in sales which 5 or more banks handle is chosen as "popular investment trust". (If same as the previous term of investment, the next leading fund will be chosen.)
Note2：Calculation assumed initial charge and rate of income tax to be 3.15% and 10% respectively. Also assumed dividends are not re-invested, but received.
Source: QUICK

Changes in most popular investment trusts provided by banks

	2009/4	2010/4	2011/4	2012/4	2013/4	2014/4
1	Emerging country, bond [currency-selection BRL]<monthly dividend>	US REIT [no JPY hedge] <monthly dividend>	US REIT [no JPY hedge] <monthly dividend>	US REIT [no JPY hedge] <monthly dividend>	Domestic equity <annualy dividend>	US high-yield bond <monthly dividend>
2	Global REIT(including Japan) [no JPY hedge] <monthly dividend>	Global REIT(including Japan) [no JPY hedge] <monthly dividend>	US high-yield debt securities <monthly dividend>	Emerging country, high-dividend-yield share <monthly dividend>	US high-yield bond <monthly dividend>	US REIT [no JPY hedge] <monthly dividend>
3	AUD/NZD denominated high-grade bond <monthly dividend>	BRL denominated bond <monthly dividend>	Global REIT(including Japan) [no JPY hedge] <monthly dividend>	Emerging country, bond [JPY hedge]<monthly dividend>	US REIT [no JPY hedge] <monthly dividend>	Emerging country, high-dividend-yield share <monthly dividend>

Source: QUICK

Chapter III　Horizontal review by themes

- Banks have been giving incentives that place importance on present profit to sales department, but especially in the 3 major banks, positive changes can be seen.
  For example:
  (i) evaluation of business that places more importance on total assets rather than profit;
  (ii) selling of investment trusts suitable for long-term holding, such as those with dividends paid less often and lower commission fees.

- It is important to pursue the following positive cycle by selling investment trusts.

  Banks provide best financial products that accurately meet the needs of retail investors.

  ↓

  Bring a successful investment experience to retail investors.

  ↓

  Profits of banks from investment trusts sales will gradually and stably increase.

4． IT governance

- In major foreign banks, an IT management section is placed in each business department, and a business strategy using IT is established. For some banks, about 20 to 30 percent of IT investments are strategic investments.

  On the other hand, the Japanese 3 major banks place more importance on the stability of the banking IT system, and the IT system department is planning and integrally developing the system of the entire banking group. Compared to major foreign banks, the ratio of IT investments to profit is smaller and the ratio of strategic investments to IT investments is about 10 percent. Incorporating cutting-edge IT into business strategy is needed.

- 80 percent of regional banks jointly centralized the core banking IT systems in order to reduce costs. Regional banks’ management should also have active discussions to establish the alignment of business and IT strategies.

- It remains a challenge to take counter-measures to prevent increased and more complex cyber attacks on financial institutions.

Chapter IV　Measures taken by the FSA

1．Cooperation with foreign authorities

－　Enhanced cooperation with foreign authorities by exchanging information regularly.

2．Gathering and utilizing information

－　Set up a market intelligence task force within the FSA to gather market intelligence information that will be helpful for financial monitoring.

－　Establish an (IT) system that integrally manages and utilizes information from supervision and inspection or reported by financial institutions.

3．Upgrade expertise of inspectors

－　To accumulate more information on best practices, employ external experts or train internal personnel with specialized skills.

4．Reform the way of on-site monitoring

－　Reform the way on-site monitoring is conducted to:
(i) identify issues and risks in a forward looking manner;
(ii) focus on the root cause of material issues;
(iii) plan and coordinate on-site monitoring flexibly and efficiently.

－　Further coordination between the inspection and supervisory bureaus.