

# Highlights of the Financial Monitoring Report for 2014-2015



Financial Services Agency

July 2015

## Objective

To publish the main results and challenges of financial monitoring from July 2014 to June 2015 based on the FSA's Financial Monitoring Policy (announced in 2014).

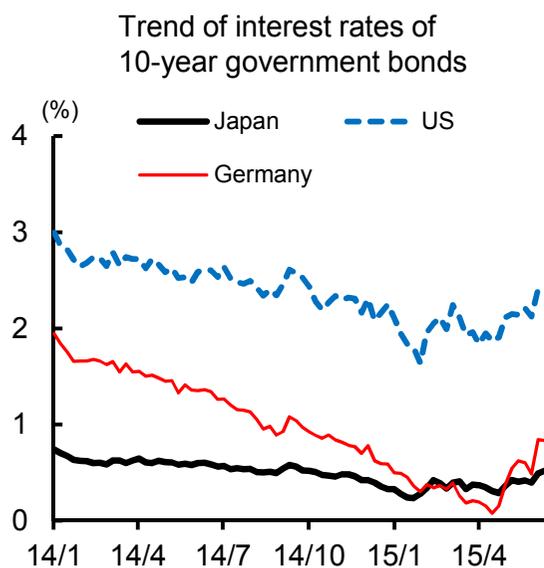
## Outline

1. Economic and market environment for financial sectors
2. Business trends of deposit-taking financial institutions
3. Three major bank groups
4. Regional banks
5. Roles of boards of directors
6. Issues of investment managers
7. Issues of sales of investment trusts
8. Effective cyber security measures

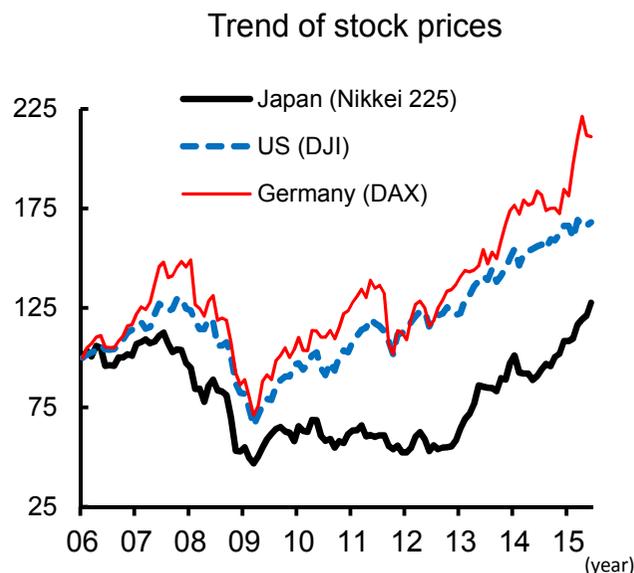
This translation is only for reference purposes. In cases where there are any differences between this translation and the original highlights in Japanese, the latter shall prevail.

# 1. Economic and market environment for financial sectors

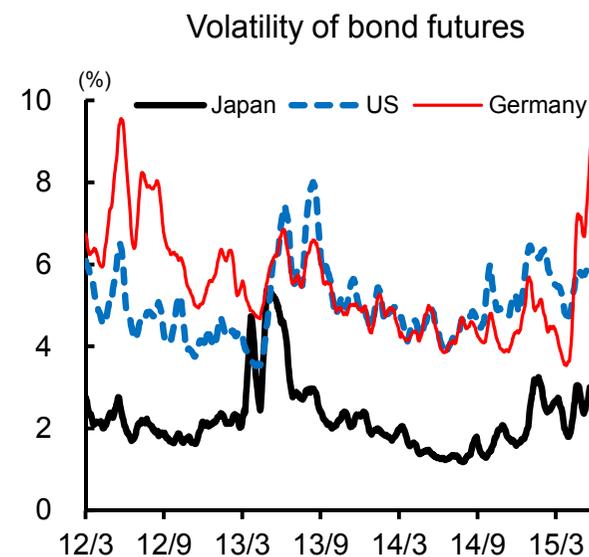
- The global economy is recovering, mainly in advanced countries. The economic growth rate is lower than the rate before the Lehman Crisis. The price of risk assets is rising under the global low interest rate.
- Due to changes in market structure, liquidity in the bond market became lower. Volatility of asset prices, which have been decreasing, is now undergoing a slightly upward trend.



Source: Bloomberg



Source: Bloomberg

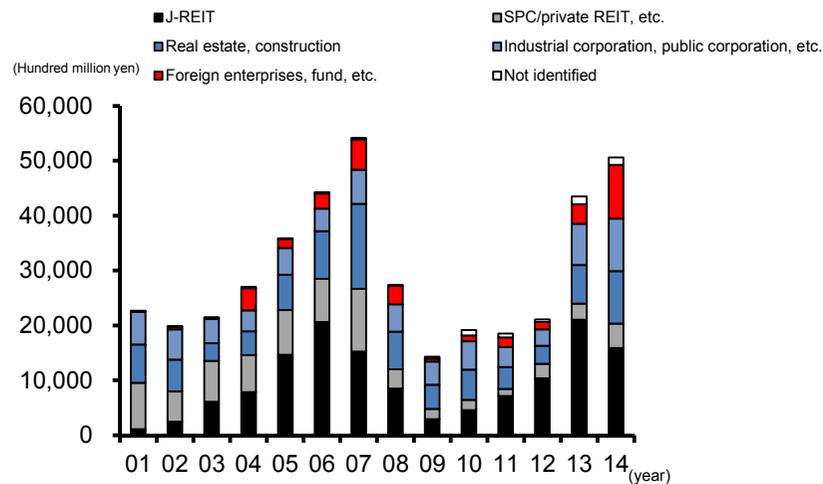


Source: Bloomberg

- As some advanced countries move toward normalization of monetary policies, particular attention should be paid to further rises in market volatility and increases of debt in emerging countries. We also need to pay attention to unstable factors such as the debt crisis in Greece and geopolitical risks.

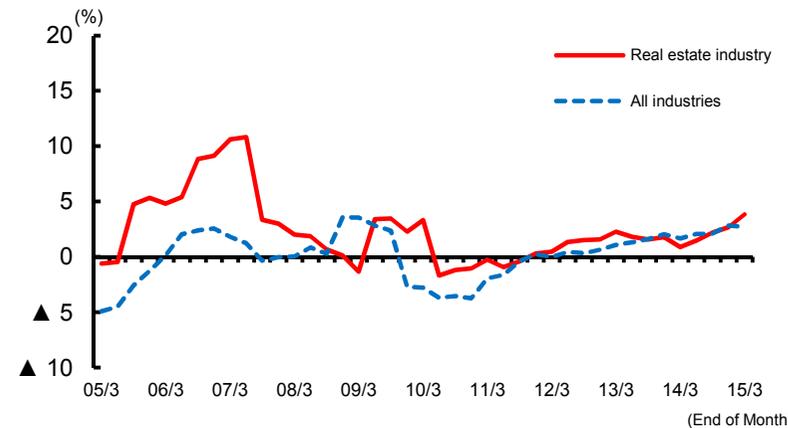
- Since the government and the Bank of Japan are taking holistic approaches to overcome deflation, the Japanese economy is recovering gradually.
- Interest rates of JGBs remain low, but volatility has temporarily shown a rise. The upward trend is continuing in the stock market as a result of better financial performance of enterprises and on-balance buying by trust banks/overseas investors.
- The price and transaction volume of real estate are growing, especially in the Tokyo market. Loans for the real estate industry are growing modestly. Investment from overseas is also increasing, and we need to continue paying attention to its trend.

Purchase and sales of real estate by sectors of buyers



Source: Urban Research Institute Corporation

Loans for real estate (year-on-year)



Note 1: Total loans of banks and *shinkin* banks in Japan (excluding loans for the Government of Japan)

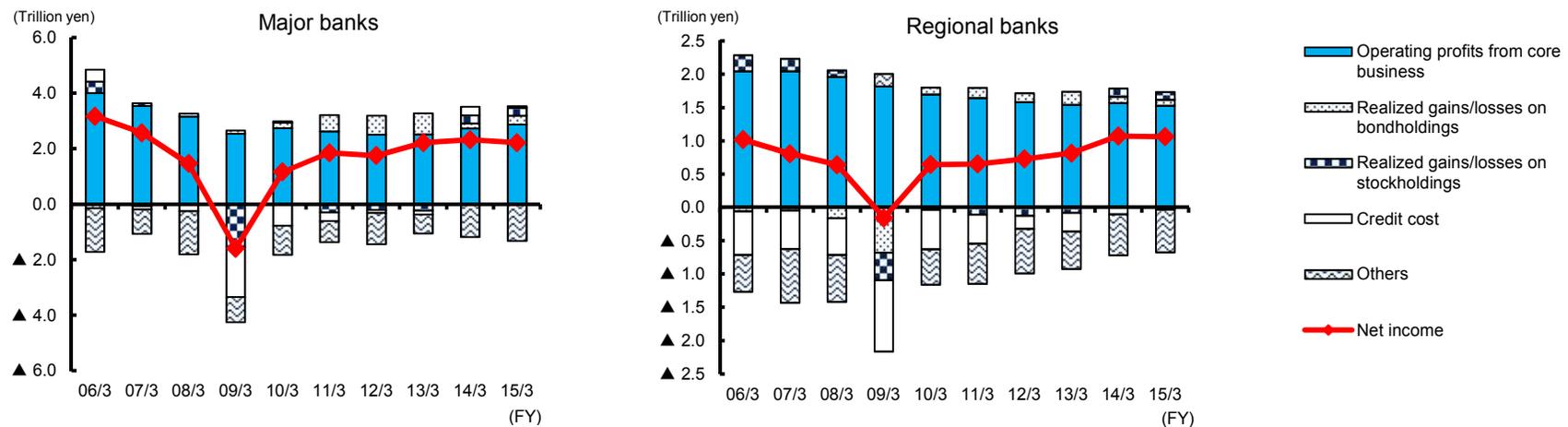
Note 2: Excluding loans for local governments, households, overseas yen loans and domestic loans transferred overseas.

Source: BOJ

## 2. Business trends of deposit-taking financial institutions

- Deposit-taking financial institutions maintain their financial soundness overall.
- Low credit costs and profits from sales of securities contribute to high net income.

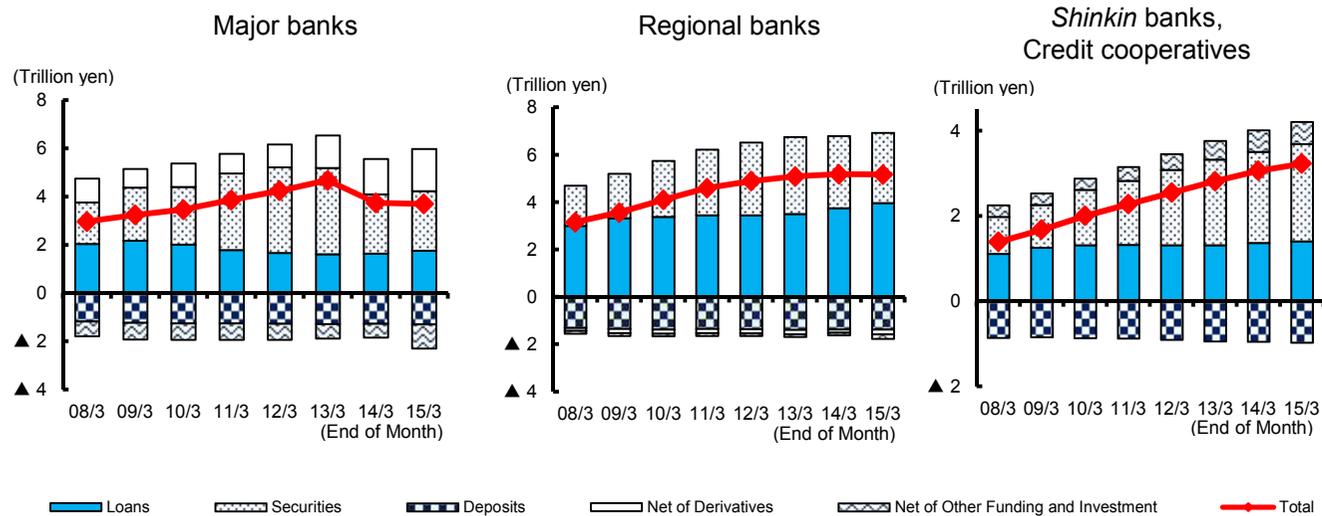
Financial results of deposit-taking financial institutions



Source: FSA

- For major banks and regional banks, JPY interest rate risk remains flat. For *shinkin* banks and credit cooperatives, average remaining maturity of securities has become longer and interest rate risk has been on a rising trend.
- Despite the decline in corporate bankruptcies, the rate of allowance for credit losses remains flat overall because some financial institutions are reviewing the policy of allowance for potential risks in the future.
- Appropriate management of JPY interest rate risk remains important.

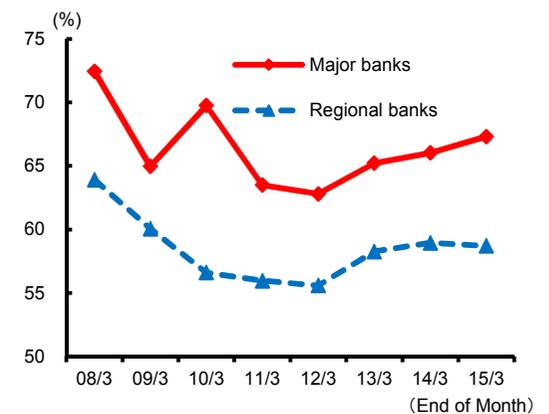
JPY interest rate risk



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

Source: FSA

Rate of allowance for credit losses



Note: The rate based on the amount of loans classified in Category III “potentially bankrupt borrowers”

Source: FSA

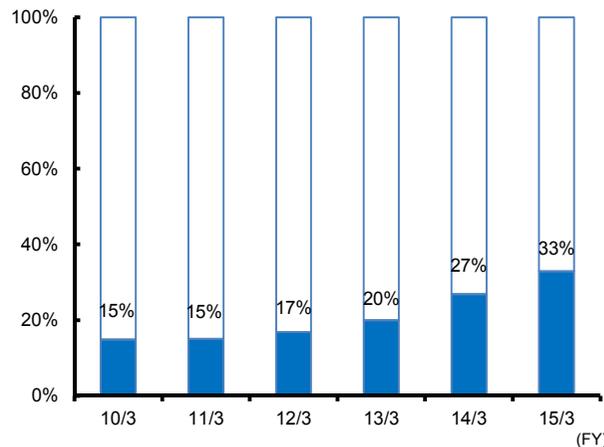
### 3. Three major bank groups

The FSA conducted a horizontal review regarding overseas businesses and stock price sensitivity among the three major bank groups.

#### (1) Overseas businesses

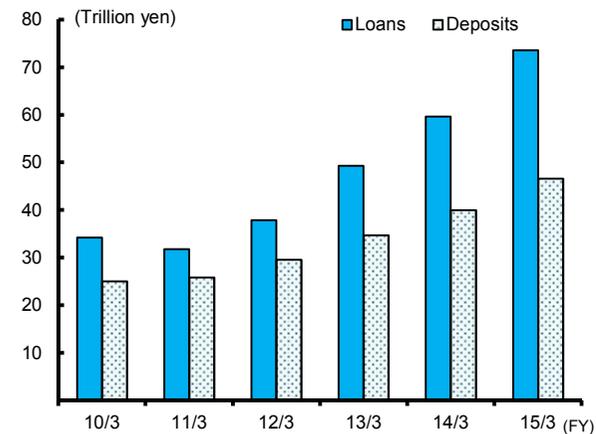
- The three major bank groups are expanding their overseas businesses, mainly through foreign currency denominated loans (especially in Asia).
- In response to rapid growth of foreign currency denominated loans, it is essential for the groups to develop a stable funding capacity and a liquidity risk management for foreign currencies.
- The three major bank groups should develop global governance, credit risk management and local hires such as compliance officers in line with their overseas business expansions.

Profits from overseas businesses



Note: Rate of profits from international business to net FG operating profits for MUFG, consolidated net banking business profits for SMFG, and net banking business profits for MHFG  
Source: Three major bank groups

Foreign currency denominated loans/deposits



Note 1: Foreign loans here refer to average loan balance of global business division for MUFG (total of bank and trust bank), average loan balance of international banking division for SMFG (bank), and average loan balance of international banking division for MHFG (bank).

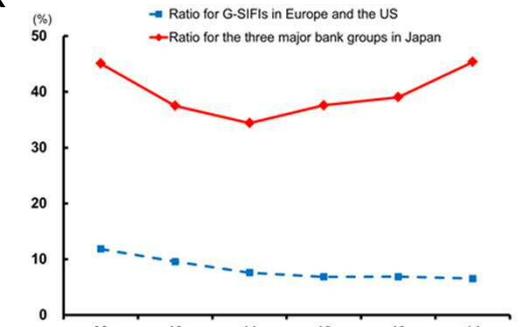
Note 2: Foreign currency denominated deposits here refer to average deposit balance of global business division for MUFG (bank), average foreign deposit balance of internal administration base for SMFG (bank), and average balance of foreign currency denominated customer deposits of internal administration base for MHFG (bank). For SMFG and MHFG, the figures are converted at 100 yen to 1 USD.

Source: Three major bank groups

## (2) Stock market risk

- Compared to G-SIFIs in Europe and the US, the three major bank groups have a higher rate of shareholdings to equity capital. This means that particular attention needs to be paid to the impact on equity capital due to a decline in the stock price.
- Currently, soundness of equity capital of the three major bank groups is as sufficient as that of G-SIFIs in Europe and the US, partly due to the net unrealized gains from shareholdings.
- In the past, economic/market downturns affected financial conditions of financial institutions through a drop in stock price, and restricted sufficient function of financial institutions. (occurrence of procyclicality)
- It is necessary for the three major bank groups to further strengthen their financial bases especially through reducing the risk of stock price fluctuation in order to be able to adequately respond to the economic/market changes and business support needs of enterprises during hard times.

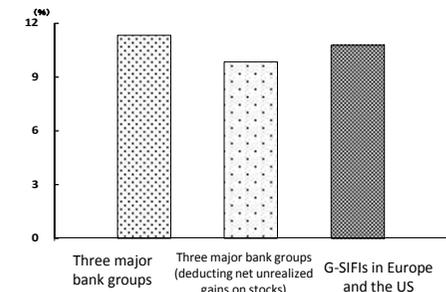
Ratio of shareholdings to equity capital (comparison between Japan and Europe / US)



Note: Shareholdings (market value) divided by Tier 1 (based on the end of each term) is the ratio of shareholdings to equity capital.

Source: published data from each company

Common Equity Tier 1 Ratio (comparison between Japan and Europe / US)

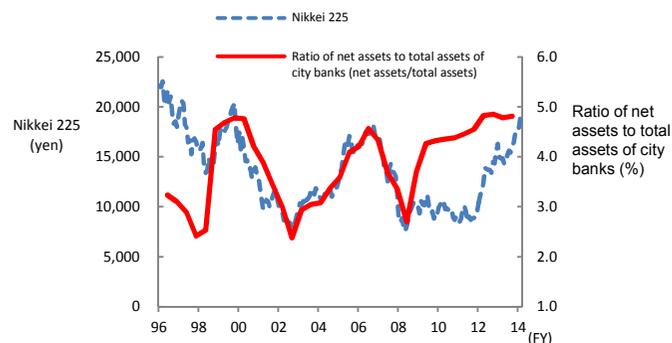


Note1: Common Equity Tier 1 ratio is estimated on the assumption of full implementation of Basel III (at the end of FY 2014, excluding some G-SIFIs in Europe and the US)

Note2: Common Equity Tier 1 ratio which deducts net unrealized gains on stocks is estimated on the assumption that the net unrealized gains of domestic stocks in the category of available-for-sale securities are zero.

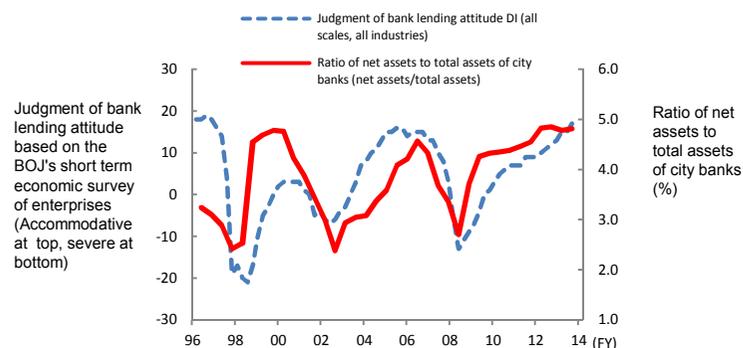
Source: FSA and published data from each company

Nikkei 225 and ratio of net assets to total assets



Source: Bloomberg and Japanese Bankers Association

Judgment of bank lending attitude and ratio of net assets to total assets



Source: BOJ and Japanese Bankers Association

Judgment of bank lending attitude based on the BOJ's short term economic survey of enterprises (Accommodative at top, severe at bottom)

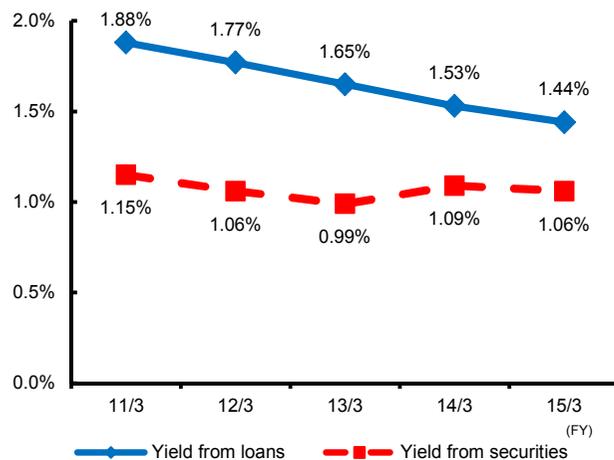
# 4. Regional banks

## (1) Mid- and long-term sustainability of business model

Since the Japanese population is predicted to shrink, the FSA monitored regional banks from the aspect of development of the mid- and long-term (5 to 10 years) sustainable business model.

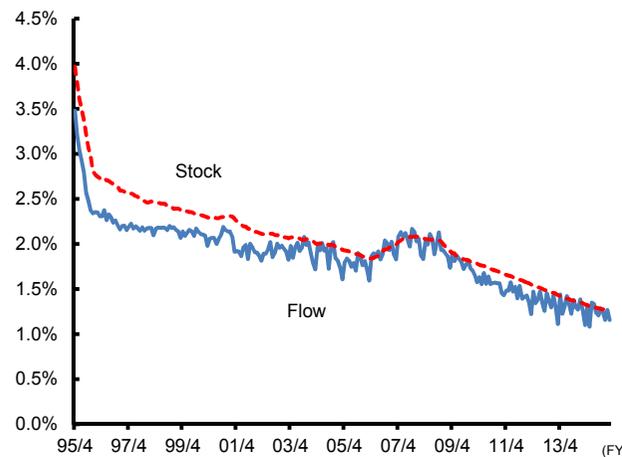
- Due to low yield from loans, regional banks' profitability of lending is declining overall. On the other hand, the influence the securities business of regional banks has on the entire management is increasing.
- As the interest rate is lowered, loans with relatively high yields tend to be repaid one after another to be replaced with new loans with lower interest rates. Assuming that this trend continues, the ordinary profits of about 20 percent of all the regional banks in the future (fiscal year ending March 2018) are calculated to be less than or half of what they are now (fiscal year ending March 2014).
- The extent of the decrease in yield from loans differs depending on banks. Since business models are different, some banks still maintain appropriate interest rates.

Trends of yield from loans for regional banks



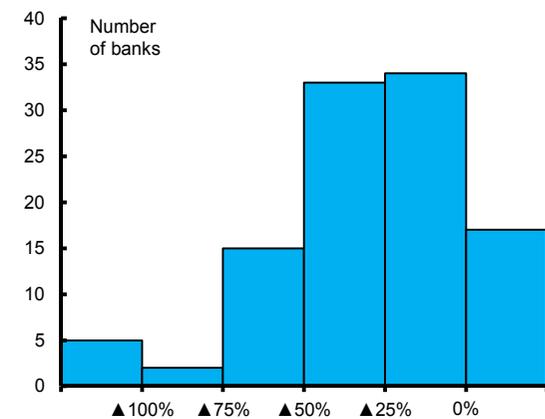
Source: FSA

Trends of average contract interest rates on loans and discounts for regional banks



Source: BOJ

Distribution of increase-decrease rate of ordinary profits for regional banks (estimated)

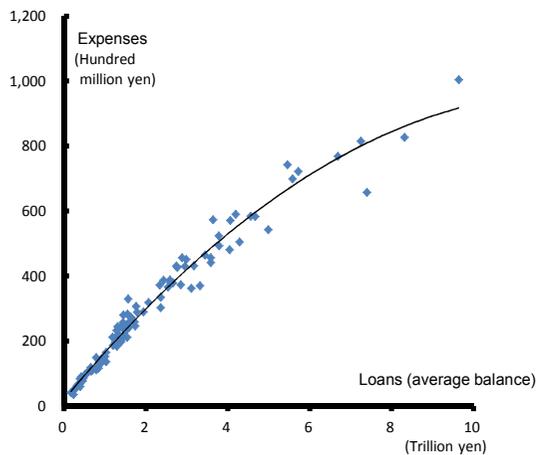


Note: Increase-decrease rate of estimated figures in 2018/3 to actual figures in 2014/3

Source: FSA

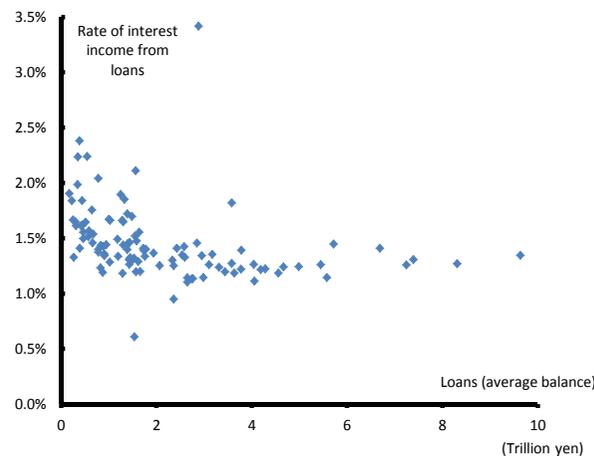
- Amounts of lending and expenses have a strong correlation. Economies of scale can also be seen. On the other hand, regarding the relationship between amounts of lending and the profitability rates of lending, relatively small-sized banks have a distribution of profitability rates with greater spread.
- Some banks utilize their business strategies with economies of scale, while other banks utilize their business strategies to clarify the differences between each other using their business models without depending on business expansion.

Relationship between loans and expenses in regional banks



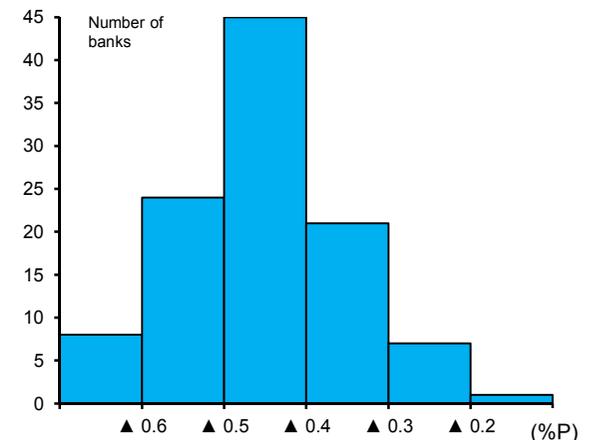
Note: As of the end of March 2015  
Source: FSA

Relationship between loans and rate of interest income from loans in regional banks



Note: As of the end of March 2015  
Rate of interest income from loans =  
(interest income from loans – provision for allowance for credit losses – write-offs of loans to bankrupt borrowers) / loans  
Source: FSA

Distribution of changes in yield from loans in regional banks (11/3-15/3)



Source: FSA

## (2) Evaluation of customers' business potential

The FSA reviewed how regional banks considered, provided and supported effective solutions based on an appropriate assessment of companies' business profiles and growth potential (evaluation of customers' business potential).

- Regarding the evaluation of customers' business potential, some banks have good practices they have been carrying out throughout their organizations with a strong commitment of management, such as developing policies in line with business strategy, establishing control frameworks and sharing with branch employees.

### **(Example 1)**

**A regional bank placed focus not on the achievement of target value but on business operations of each sales branch and established its performance evaluation system.**

The regional bank made a self-assessment that setting target values could sometimes lead to a business attitude which places importance on short-term profit, rather than providing financial services for customers and understanding customers' viewpoints.

Some branches focused more on the evaluation of operational process (whether or not branch employees understand their customers' business, find customers' issues, or provide appropriate solutions). As a result, their target values were also achieved.

Given that such initiatives were successfully achieved, the regional bank has decided to do the same thing for all branches.

### **(Example 2)**

**Branch employees recognized the need for the evaluation of customers' business potential, and developed methods for evaluation of customers' business potential on their own.**

The regional bank set up a management policy such that they would continue to work together with major regional industries, and branch employees understood the necessity of the evaluation of customers' business potential in order to achieve the policy. They have developed methods for an evaluation of customers' business potential on their own, as seen below.

- 1) Branch employees did specific interviews which focused on 100-1000 qualitative items when supporting the development of customers' business plan.
- 2) Branch employees conducted simple interviews on qualitative items as part of its customers' communication toolset.
- 3) Branch employees conducted qualitative analysis on an extensive number of relevant companies in major industries that could have a large influence on regional economies.

## 5. Roles of boards of directors

With the revised Companies Act and “Japan’s Corporate Governance Code” in mind, the FSA reviewed the composition of the boards of directors in financial institutions and nomination/performance of outside directors.

- Large financial institutions, mainly the three major bank groups, are taking initiatives to encourage their boards of directors to perform their roles properly.
  - Ensure effective discussions by boards of directors regarding important management matters.
  - Increase the number of outside directors and provide support for outside directors.
  - Enhance effective discussion at the nominating committee where more than half of the members are outside directors (clarification of personnel requirements, and consideration/planning of successors of top management).
- It is important for regional banks to address the following issues in order to enhance their governance.
  - Tone at the top management to listen carefully to and reflect outside directors’ opinions.
  - Selection of outside directors who have the expertise, experience and knowledge necessary to overcome management issues.
  - Measures for selection of outside directors through the clarification of roles expected of outside directors or use of outside human networks in local regions where it is strongly understood that there are few personnel to be outside directors.

## 6. Issues of investment managers

The FSA reviewed governance, product origination, human resources development, etc., from the viewpoint of whether financial institutions engaged in the investment management business fulfilled their roles and responsibilities (i.e., fiduciary duty) adequately.

- Many Japanese investment managers were established as affiliated companies of sales companies providing financial services. Therefore, investment managers and such sales companies have strong relationships.
  - Many CEOs, directors and audit committee members\* are from affiliated sales companies.
  - A large number of investment trusts were sold through affiliated sales companies.
  - In the process of product origination, sales companies are engaged in research on customers' needs and product design.
- The FSA has observed quite a few cases of provision of investment trusts which are easy for sales companies to sell and obtain high sales commissions.
- The FSA expects investment managers to ensure independence of their business from affiliated sales companies so as to develop financial products that are truly beneficial for their customers (i.e., appointment of professionals who are familiar with asset management business as members of management, as well as enhancement of checking functions by appointing independent outside directors, etc.).

\*Note: "Audit committee member" in this slide indicates *kansayaku* specified in the Companies Act.

## 7. Issues of sales of investment trusts

The FSA reviewed business objectives, performance assessment systems, sales promotion, and sales commission structures of financial institutions from the viewpoint of the development of solicitation and sales to support customers' asset building for the mid- and long-term.

- While many customers prefer “safety” in their investments, investment trusts with relatively high risk have been selling well. Some sales companies, which focused on consultative sales in order to recommend their customers to diversify their investment, cited balanced-type investment as a well-selling line.
- While many customers feel dissatisfaction with sales commissions, average sales commission rate has been increasing year by year due to increases in sales of investment trusts with complicated structures. It is necessary for sales companies to review once more whether they provide appropriate services proportional to their fees.

Investment trusts that have been selling well in Japan  
(based on net increase)

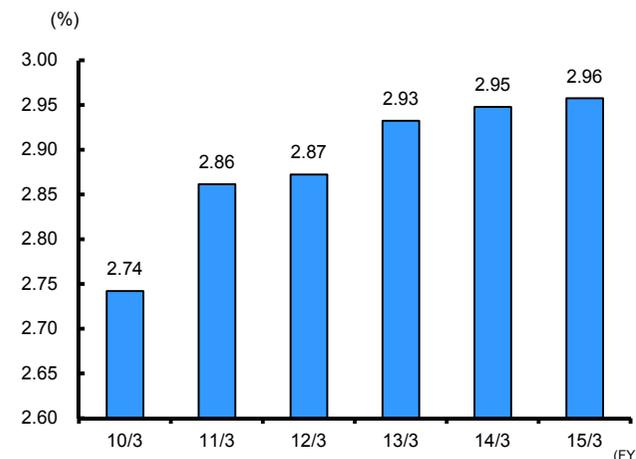
Investment strategy	Dividend	Net increase (100 million yen)	Maximum sales commission (tax included)
Global equities for certain sectors	Semiannually	1,049	3.24%
Equities for Asia/Oceania	Monthly	713	3.24%
Asia REIT	Monthly	568	3.78%
US REIT	Monthly	359	3.78%
Foreign equities (currency-selectionable)	Monthly	349	4.32%
Emerging market bonds	Monthly	332	3.24%
Domestic stocks (with options)	Monthly	310	3.24%
Emerging market equities	Monthly	273	3.24%
Diversified investment to global bonds/stocks	Annually	272	3.24%
Foreign REIT	Monthly	252	3.24%

Note 1: Net increase per month as of March 2015

Note 2: Investment trusts in this table are publicly offered equity investment trusts (excluding ETFs) that exclude new investment trusts offered for the first time in March

Source: QUICK

Trends of sales commission rates in Japan  
(weighted average balance)



Note: Investment trusts in this graph are publicly offered equity investment trusts (excluding ETFs)

Source: QUICK

## 8. Effective cyber security measures

Threats in cyberspace have become borderless and rapidly more complex.

The FSA reviewed measures for cyber security taken by financial institutions.

- The three major banks have arranged a set of measures for cyber security, taking into account their research on G-SIFIs' proactive approach. It is important to enhance the effectiveness of cyber security measures not only as an individual bank but also as an entire group.
- For other financial institutions, it is significant to improve the countermeasures against cyber attacks as well as the sharing of information.
- More specifically, administration according to the criticality of information, Defense-in-Depth (i.e., combination of information security at various stages throughout not only entry but also middle and exit of monitoring), and training of initial response for cyber attacks are important.
- Since it is becoming harder to prevent cyber attacks, it is necessary to continue addressing the issue under management's proactive initiatives to develop cyber attack countermeasures.

## Definitions of categories of the financial institutions used in the highlights

- Deposit-Taking Financial Institutions: Domestic banks, other banks, Citibank Japan, Shinhan Bank Japan, *Shinkin* Banks, Credit Cooperatives
- Domestic Banks: City Banks, Regional Banks (First-tier), Second-tier Regional Banks, Trust Banks
- City Banks: Mizuho Bank, Bank of Tokyo-Mitsubishi UFJ, Sumitomo Mitsui Banking Corporation, Resona Bank, Saitama Resona Bank
- Major Banks: Mizuho Bank, Bank of Tokyo-Mitsubishi UFJ, Sumitomo Mitsui Banking Corporation, Resona Bank, Mitsubishi UFJ Trust and Banking, Mizuho Trust and Banking, Sumitomo Mitsui Trust Bank, Shinsei Bank, Aozora Bank
- Three Major Bank Groups: Mizuho Financial Group (MHFG), Mitsubishi UFJ Financial Group (MUFG), Sumitomo Mitsui Financial Group (SMFG)
- G-SIFIs: G-SIBs (Global Systemically Important Banks) excluding Three Major Bank Groups
- Regional Banks: Regional Banks (First-tier), Second-tier Regional Banks, Saitama Resona Bank