FSA Newsletter May 2006

Kaoru Yosano (Minister of State for Economic & Fiscal Policy and Financial Services) delivers an address at a meeting of Directors of Local Financial Bureaus (April 27).

Yoshitaka Sakurada (Senior Vice Minister for Financial Services) delivers an address at a meeting of Subcommittee on Certified Public Accountants System, Financial System Council (April 26).

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Amendments to the "Comprehensive Guideline for Supervision of Major Banks, etc.," the "Comprehensive Guideline for Supervision of Small- and Medium-Sized and Regional Financial Institutions" and the "Comprehensive Guideline for Supervision of Insurance Companies"

Foreword

The Financial Services Agency (FSA) amended parts of the "Comprehensive Guideline for Supervision of Major Banks, etc.," the "Comprehensive Guideline for Supervision of Small- and Medium-Sized and Regional Financial Institutions", and the "Comprehensive Guideline for Supervision of Insurance Companies" on March 31, 2006.

The amendments relate to: (1) the clarification of the specific perspectives of the provisions on the qualities of directors of financial institutions (Fit and Proper principle); (2) the implementation of the second pillar of Basel II; (3) the supervision of bank agents; and (4) the revision associated with amendments to the Banking Law (excluding (3)). The nature of the amendments is outlined below.

1. Provisions on Qualities of Directors, etc. of Financial Institutions (Fit and Proper Principle) (Amendments to the "Comprehensive Guideline for Supervision of Major Banks, etc.," the "Comprehensive Guideline for Supervision of Small- and Medium-Sized and Regional Financial Institutions", and the "Comprehensive Guideline for Supervision of Insurance Companies")

Provisions on the aptitude of directors and operating officers of banks and insurance companies were newly established when the Banking Law and the Insurance Business Law were amended in 2001. As a supervisory authority, the FSA has been conducting supervision properly with respect to the qualities of directors of banks and insurance companies pursuant to the said provisions.

In response to the revelation of scandals, etc. attributable to the responsibility of the management of financial institutions and the occurrence of incidents developing into social problems in recent years, the Program for Further Financial Reform announced in December 2004 declared to clarify the specific perspectives of the provisions on the qualities of directors of financial institutions (Fit and Proper principle) as a policy measure.

With this in mind, the FSA decided to clarify the specific perspectives and the supervision techniques in relation to the provisions on the aptitude of directors of banks and insurance companies, in order to improve the predictability of the parties concerned and to enhance the governance of financial institutions. Specifically, the FSA clearly defined knowledge and experience to execute governance in a precise, fair and efficient manner and sufficient social credibility as qualities that a financial institution should specifically look for when determining the aptitude of directors in the resolution process for the election of directors of the financial institution.

Examples of what banks should specifically look for in terms of knowledge and experience to execute governance in a precise, fair and efficient manner include: sufficient knowledge and experience to understand and implement the perspectives of governance under the regulations related to the Banking Law, etc. and supervisory guidelines; sufficient knowledge of and experience in compliance and risk management; sufficient knowledge of and experience in compliance and risk management required for the sound and proper administration of bank operations; and knowledge and experience required to properly execute other operations within the bank's capacity.

Examples of what banks should specifically look for in terms of sufficient social credibility include: whether or not the directors have ever engaged in antisocial behavior; whether or not the directors have ever been fined (including punishment equivalent to a fine under foreign laws and regulations) for violating the provisions of financial laws and regulations in Japan such as the Securities and Exchange Law or similar foreign laws and regulations, or for committing a crime under the Criminal Code or the Law concerning Punishment of Physical Violence and Others; and whether or not the directors have belonged or belong to a companies subjected to administrative action by a financial supervisory authority in relation to compliance—such as a Business Improvement Order, Business Suspension Order, or revocation of license, registration or approval—and allowed the facts which led to the said action to arise, either intentionally or by gross negligence (due to exceptionally severe carelessness, despite acknowledging a certain outcome and being able to avert it), while

being a party to the conduct or being in the position to give directions and orders to the wrongdoer.

The perspectives of the provisions on the qualities of directors are examples of matters to be checked by the FSA in regards to whether or not the aptitude of directors are properly determined in the process of electing directors in each financial institution, on the basis of voluntary efforts made in such a process. They are not to be applied to specific matters for the purpose of making a snap judgment on their aptitude.

Accordingly, it is important for the financial institutions themselves to consider and properly figure out the qualities of directors and other individuals at a particular point in time in a comprehensive manner, under the principle of self-responsibility, taking into account the aforementioned perspectives.

2. Implementation of the Second Pillar of Basel II (Amendments to the "Comprehensive Guideline for Supervision of Major Banks, etc." and the "Comprehensive Guideline for Supervision of Small- and Medium-Sized and Regional Financial Institutions")

The amendments are as follows:

(1) The perspectives of the comprehensive risk management system have added to the "Comprehensive Guideline for Supervision of Small- and Medium-Sized and Regional Financial Institutions"; and

(2) The guidelines on the Early Warning System[*1] including monitoring the interest rate risk in the banking book in the "Comprehensive Guideline for Supervision of Major Banks, etc." and the "Comprehensive Guideline for Supervision of Small- and Medium-Sized and Regional Financial Institutions" have revised.

They were included in the "Implementation Framework of the Second Pillar of Basel II[*2]" published in November 2005 and, this time, have been incorporated into the supervisory guidelines.

The purpose of the amendments is to clear the FSA's approach based on that: the second pillar emphasizes that financial institutions should fulfill their self-responsibility for appropriately assessing and managing various risks they face, and maintaining sufficient capital; It also mentions that supervisors should review and evaluate risk management methods which are adopted by individual financial institutions on their own initiative and take appropriate supervisory actions as necessary.

In terms of the evaluation of the comprehensive risk management system, financial institutions need to establish a clear risk management policy that is commensurate with the size, characteristics and complexity of their businesses, and assess the various risks inherent in each business department aggregately and quantitatively. It is also necessary to maintain sufficient level of capital both in terms of quality and quantity in comparison with such aggregated risks. For these reasons, the FSA will assess financial institutions' preparedness in terms of the comprehensive risk management system as well as the capital adequacy assessment process.

As for the revised guidelines on the Early Warning System, it would be effective and efficient to utilize the existing early warning thresholds that focus on specific indicators for individual risks, as a tool to implement the second pillar of Basel II, together with the aforementioned FSA's approach to encourage each financial institution to make its own efforts to build a comprehensive risk management system, and to review its effectiveness. With regards to the "interest rate risk in the banking book" and "credit concentration risk" which are explicitly regarded as important risks to be covered under the second pillar, the FSA has incorporated its supervisory measures for these two risks into the framework of the Early Warning System, so as to ensure that these risks are managed in an appropriate manner on an individual basis.

More specifically, in reviewing the interest rate risk in the banking book, an "outlier" level[*3] has been set and appropriately monitored within the framework of the "Stability Improvement Measures" in the Early Warning

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[1] The Early Warning System is a framework whereby remedial actions are prompted to financial institutions with capital adequacy ratios above the required minimum (not subject to prompt corrective actions) at an early stage. It is a tool that enables the FSA to monitor such aspects of each financial institution as profitability, credit risk, market risk, and liquidity risk, and in accordance with the results of such monitoring, the FSA requests individual institutions to submit reports or order operational improvement as necessary if those financial institutions could not satisfy certain thresholds that are pre-determined for each of these risks commonly for each institution.

[2] "The International Convergence of Capital Measurement and Capital Standards: a Revised Framework" issued by the Basel Committee on Banking Supervision (June 2004)

[3] It is whether the interest rate risk amount in the banking book (*i.e.* a decline of the economic value of the overall positions of an financial institution, which is calculated as a result of either (1) an upward and downward 200 basis point parallel rate shock, (2) or 1st and 99th percentile of observed interest rate changes using a 1 year (240 working days) holding period and a minimum of 5 years of observations) exceeds 20% of the sum of Tier 1 and Tier 2 capital.

System.
The FSA will conduct appropriate monitoring of credit concentration risk within the framework of the "Credit Risk Improvement Measures" in the Early Warning System. To achieve this end, certain thresholds have been set in terms of credit concentrations on a particular industry, and the capital adequacy ratio assuming[*4] that a risk to a specific large borrower had become apparent.
There exist some small- and medium-sized and regional financial institutions for which it may not be appropriate to immediately require a highly sophisticated comprehensive risk management system, in light of their scale and risk profile. Therefore, the Early Warning System will form the basis for the supervision of these financial institutions, and in the course of conducting interviews and requesting reports based on the Early Warning System, the FSA may encourage individual institutions – where necessary, to establish a desirable level of system for comprehensively managing various risks, commensurate with the scale and risk profile of each institution.

3. Supervision of Bank Agents (Amendments to the "Comprehensive Guideline for Supervision of Major Banks, etc." and the "Comprehensive Guideline for Supervision of Small- and Medium-Sized and Regional Financial Institutions")

In principle, the existing capital requirements and multi-operations restrictions have allowed a bank's subsidiary to act as a bank agent provided that it specialized in bank agency operations. A new bank agency business system has been established pursuant to the Law for Partial Amendments to the Banking Law, etc. enforced on April 1, 2006.
The new system is expected to ensure and improve users' access to financial services and make financial institutions efficiently utilize their diverse sales channels, partly by allowing ordinary businesses to enter into the bank agency business. On the other hand, the FSA decided to ensure the sound and proper operation of bank agency businesses, in order to prevent unfair trading based on the exploitation of business relationships as ordinary businesses.
For the supervision of bank agents, it is necessary to supervise bank agents and the banks with which they are affiliated ("affiliate banks") so as to ensure that bank agency businesses are executed in an appropriate and steady fashion, considering that under the new system, entry into the bank agency business is subject to approval and agents who wish to engage in non-bank agency operations on the side are subject to authorization on an individual basis.
Especially in cases where a bank agent wishes to engage in non-bank agency operations on the side (e.g., cases where an existing ordinary business enters into the bank agency business), it is necessary to bear in mind that the bank agent is strongly required to be well-prepared in terms of operations structure in order to prevent tie-in sales (loans), loans extended by favoritism, diversion and other inappropriate handling of customer information.
On the other hand, considering that the affiliate bank is held responsible for taking measures to ensure the sound and proper operation of the bank agent's bank agency business, it is necessary to focus on the supervision of the affiliate bank when supervising the agent: the affiliate bank must be supervised first, so that operations related to the bank agent's bank agency business would be executed in a sound and proper fashion.

4. Amendments to Provisions Unrelated to Supervision of Bank Agents (Amendments to the "Comprehensive Guideline for Supervision of Major Banks, etc." and the "Comprehensive Guideline for Supervision of Small- and Medium-Sized and Regional Financial Institutions")

In conjunction with the latest amendments to the Banking Law, provisions other than those related to the supervision of bank agents were amended to clarify the perspectives of supervision, including preventing inappropriate transactions from occurring in the event of M&A financing, etc.

Afterword

The latest amendments are as outlined above. The amended provisions have been applied from April 1, 2006 onwards (a part of Basel II relating to the "outlier" level will be applicable from April 2007). The FSA is committed to smoothly reflecting them in the actual supervision process.

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[4] An assumption in which a certain amount of the unsecured portion of claims (net of loan-loss provisions)to large borrowers who are classified as "need special attention" or below was recognized as a loss.

Interim Summary of Issues on Sales and Solicitation of Insurance Products in accordance with Suitability Rule

The Study Team on Insurance Product Sales and Solicitation (Chair: Professor Shuya Nomura, CHUO UNIVERSITY Faculty of Law), which is organized under the auspices of the Financial Services Agency (FSA), recently (March 1, 2006) put together and released to the public a document entitled "Interim Summary of Issues on Sales and Solicitation of Insuranse Products in accordance with Suitability Rule."

1. Background to Study

In consideration of suggestions that there are still a large number of complaints about sales and solicitation activities in the insurance industry and that product features have become difficult for consumers to understand due to more diversified and complicated product lineups, the Study Team on Insurance Product Sales and Solicitation is being convened, with members including experts and service users, and is conducting studies for the purpose of tackling such suggestions in a professional and practice-oriented fashion, in order to improve user protection and user convenience.

The Team recently compiled an interim summary of issues as described below, based on the results of studies conducted since September 2005, focusing on compliance with the suitability rule in insurance agreements.

2. Overview of Interim Summary of Issues

(1) Whereabouts of Problems: Perception Gap between Agents, etc. and Consumers during Sales and Solicitation for Insurance Products

It is important for consumers to properly choose and purchase insurance products that meet their needs. However, the Team made the following suggestions as to whether that is actually possible.

(i) Due to the complexity, etc. of insurance products, consumers' understanding of product features is limited.

(ii) Consumers who have no immediate need to take out insurance have difficulty in properly identifying their own needs.

(iii) Unless the consumer has collected and understands information on other options such as alternative insurance products and optional extras, it is difficult for the consumer to make the final judgment as to whether the insurance product he/she is about to buy truly meets his/her needs.

On the other hand, the reality of insurance sales is that agents, etc. make customized proposals by narrowing down and designing insurance products demanded by the customer, in consideration of the customer's attributes and needs. In such cases, agents, etc. and customers are deemed to be making a collaborative effort: for example, the customer provides certain information to the agent, etc., based on which the agent, etc. narrows down the insurance products that meet the customer's needs and makes a proposal.

However, the Team suggested that there is a perception gap between the agent, etc. and customers with respect to the aforementioned collaborative effort, as described below.

[Perception of Agent, etc.]

The agent, etc. recognizes that there is a limit to providing an insurance product that best suits the customer's needs, as the collaborative effort is made purely as a service to the customer.

[Customers' Perception]

Customers expect the agent, etc. to give advice based on his/her expertise and recommend an insurance product that meets customers' needs.

Due to such expectations, there are cases in which the customer passively purchases the recommended product without confirming whether or not it truly meets his/her needs.

The Team looked into effective measures to eliminate such a perception gap and ensure smooth collaborative efforts, so that customers can purchase insurance products that meet their needs.

(2) Role of Agents, etc. and Consumers to Eliminate Perception Gap

The approach presented by the Team is to require the agent, etc. and the consumer to perform the following roles, assuming that the process from solicitation to purchase of insurance products is a collaborative effort between them.

[Role of Agent, etc.]

(i) The agent, etc. must properly collect information on the customer's needs, and recommend an insurance product based on that information.

(ii) The agent, etc. must make efforts so that the explanation is not misunderstood by the customer in the

solicitation process, and if any lack of understanding or misunderstanding has been identified on the part of the customer, provide a more intelligible explanation or clear up the misunderstanding.

[Role of Consumer]

(i) The customer must properly provide the agent, etc. with information on his/her needs.

(ii) The customer must NOT purchase an insurance product recommended by an agent, etc. straight away; he/she must confirm that the features of the recommended product meet his/her needs and determine whether or not to purchase it based on the principle of self-responsibility.

The Team suggested that in order to crystallize such an approach, it would be effective to establish the following framework, by referring to the so-called suitability rule and foreign legal systems.

(3) Details of Framework: Intention Confirmation Form

To make sure that the customer has the opportunity to make a final confirmation as to whether or not the insurance product he/she is about to purchase meets his/her needs before signing the agreement, the Team suggested that it would be effective to prepare, issue and store a form designed to collect information on the customer's needs and confirm that the insurance product meets his/her needs (hereinafter referred to as "Intention Confirmation Form").

The Team pointed out the following merits of the Intention Confirmation Form:

(i) The customer will be able to confirm his/her needs and whether or not the insurance product meets his/her needs before signing the agreement, and will be able reconsider whether or not to sign the agreement.

(ii) The agent, etc. will confirm whether or not the insurance product meets the customer's needs in the process of preparing the Intention Confirmation Form, and will be able to reconsider whether the recommendation is appropriate or not.

(ii) Both parties will be able to confirm the purchase process afterwards. It will help prevent and solve problems, etc. that might arise afterwards.

a. Details of Intention Confirmation Form

The Team stated its views that the following information should be written on the Intention Confirmation Form.

(i) Information on the customer's needs learned by the agent, etc.

(ii) Main reasons why the recommended insurance product is deemed to meet the customer's needs.

(iii) Customer's needs that cannot be met, if any, and other matters that are worth noting, if any.

The agent, etc. needs to be provided with information on the customer's needs in order to determine his/her needs. The Team has made the following suggestions on this matter.

- Information on needs may vary widely, ranging from the type of coverage required for insurance against death, etc. to the exact amount of insurance premiums and other particulars of the main policy and each optional extra.
- It would be appropriate for the Intention Confirmation Form to cover information on needs that would at least be required as exemplified below.

(i) What kind of cover is sought? (Coverage for bereaved family compensation in the event of death, medical coverage for cancer and three major diseases, etc.)

(ii) Is a savings component required?

(iii) Are market risks tolerated?

(iv) Period of coverage sought, requests concerning insurance premium, amount insured, priority items, etc., if any.

- In addition to the above, as the needs relating to the particulars of the insurance policy (such as the exact amount insured and the exact amount of insurance premium for the main policy and each optional extra) are also important, it would be appropriate to require the agent, etc. to reconfirm whether or not the customer's needs are met with respect to important items in the ultimate insurance policy, by such means as questioning.

The Team considers that it would be appropriate to confirm with the customer any information on needs provided by him/her in the Intention Confirmation Form, and to allow the customer to request the correction of any information that contradicts with facts.

For the purpose of clarifying the person who prepared and issued the Intention Confirmation Form, the Team considers that it would be appropriate to expressly state the name of the agent, etc. when preparing and issuing the Form.

As for the media format in which the Intention Confirmation Form should be provided, the Team considers that it would be appropriate to provide it in document format, as it is necessary to store it to enable the customer to confirm the purchase process afterwards. While it may be possible to provide the Form by email or in other electronic media format if the customer consents to it, the Team considers that it would be appropriate to make it storable (e.g., printable) for customers.

b. Scope of Application of Intention Confirmation Form

The Team stated in its view that it would be appropriate to apply the Intention Confirmation Form to the following cases where solicitation involves the agent, etc. and the customer making a collaborative effort based on the exchange of information, etc. between each other and customer protection requirements are high due to the type of the product.

(i) Products with investment attributes

(ii) In the case of protection-oriented products, the Intention Confirmation Form should be applied in cases where the disadvantage incurred by the customer as a result of the product not meeting his/her needs is substantial, such as those with a long insurance period.

(iii) Policy exchange and conversion

(4) Approach to Cases in which Intention Confirmation Form is Inapplicable

Even in cases where there is no need to prepare or issue the Intention Confirmation Form, the Team considers that it would be appropriate to store documents, etc. which checks important matters regarding the customer's needs that must be confirmed carefully.

In regards to what kind of information on the customer should be collected in each stage of the sales and solicitation process, and how to provide an explanation to the customer when the insurance product is found to not meet his/her needs, the Team considers that it would be appropriate to require insurance companies, etc. to develop a proper system based on their own judgment.

It is necessary to develop a system that can verify the appropriateness of sales and solicitation activities afterwards. Such a system should be established with respect to each product characteristic, such as the length of the insurance period. For example, storage of questionnaires and documents outlining the negotiation process has been suggested as a possibility.

(5) Other Activities Required among Agents, etc.

Other activities required among agents, etc. pointed out by the Team are as follows.

(i) Provide an explanation according to the customer's level of understanding and eliminate misunderstanding.

- In the event that an agent, etc. discovers that the customer does not understand or misunderstands his/her explanation, the agent, etc. must strive to provide a more intelligible explanation and eliminate misunderstandings.

(ii) Expressly state the positioning of the agent, etc.

- Upon solicitation, it would be appropriate for the agent, etc. to expressly state the range of insurance companies that he/she can deal with (whether or not the agent, etc. is exclusive or nonexclusive; if nonexclusive, the number of insurance companies he/she can deal with and other such information should be expressly stated).
- If the customer is about to make a declaration, it would be appropriate for the agent, etc. to expressly state the existence of the right to receive the declaration.

(6) Positioning under Laws and Regulations

As for the positioning under laws and regulations, the Team has pointed out that for example, the Intention Confirmation Form could be positioned as the duty of developing a system under Article 53 (7) of the Enforcement Regulations of the Insurance Business Law being fulfilled in concrete terms, and the rules could be clearly defined in the supervisory guidelines.

Inspections to Contractors of Financial Institutions, etc.

The Financial Services Agency (FSA) was entitled to inspect contractors for financial institutions, etc. (banks, insurance companies, etc. set forth in the Banking Law, Insurance Business Law, etc.) under the Banking Law, Insurance Business Law, etc. on April 1, 2006. With this in mind, FSA published on March 31, 2006 the Inspections to Contractors of Financial Institutions, etc., which clarifies the approach to basic procedures, etc. for the inspections in consideration of public comments, with the aim of ensuring the effectiveness and transparency of inspections. The content is outlined below. As contractors for financial institutions, etc. are wide-ranging, the FSA will properly determine the contractors that are actually subject to inspections by taking various factors into consideration, such as the nature and scale of the operations outsourced from financial institutions, etc., in accordance with the spirit of laws and regulations.

1. Basic Approach

Inspections targeted at contractors may be conducted to the extent required when deemed especially necessary in the event of setting foot in, asking a question or inspecting a financial institution, etc. under the provisions of the Banking Law, etc. Accordingly, for example, in cases where a financial institution, etc. is to be inspected, the FSA will inspect a contractor if inadequacies in clerical processes, system failure, etc. on the part of the contractor have the potential to undermine the appropriateness of the operations of the financial institution, etc., and in turn, the interest of the users, when the actual status is difficult to be identified by an on-site inspection of the financial institution, etc. Inspections targeted at contractors will be conducted in accordance with the Financial Inspection Basic Guidelines (July 1, 2005) (Note) (hereinafter referred to as "FIBG").

2. Inspection Procedures

An inspection targeted at a contractor will be conducted as part of an inspection targeted at a financial institution, etc. (the outsourcer) in accordance with site investigation procedures, etc. under FIBG. However, the contractor will be treated as follows, in consideration of the fact that its characteristics are different from those of the financial institution's branch and other factors.

(1) Inspections Conducted with or without Prior Notification

In principle, site investigations must be conducted without giving prior notification according to FIBG. The FSA will determine whether or not to give prior notification when inspecting a contractor on a case-by-case basis, by comparing and examining the efficiency and effectiveness of inspections, taking into account a wide range of factors in a comprehensive manner, including the scope of verification and the matters of interest in inspections, as well as the burden on contractors.

(2) Prior Explanation of Important Matters to Contractors, etc.

In order to ensure the transparency of inspection procedures, etc., the FSA will provide a prior explanation of important matters, etc. to contractors and give presentations on inspection orders, etc. in accordance with FIBG. The explanation of the important matters will be comparable to the explanation given to the financial institutions, etc. regarding the matters referred to in the appendix to FIBG titled List of Matters to be Explained, etc., such as the scope of verification.

(3) Treatment of Inspection-related Information

Inspection-related information will also be treated in accordance with FIBG. In cases where a contractor wishes to disclose inspection-related information to a third party, the contractor will be required to obtain approval from the FSA.

3. Treatment of Inspection Monitoring and Inspection Results Notice

As an inspection targeted at a contractor will be conducted as part of an inspection targeted at a financial institution, etc., inspection monitoring will be conducted and the inspection results notice will be issued with respect to the financial institution, etc. that outsources the operations, not the contractor.

4. Other

Other basic approaches, implementation procedures, etc. for inspections targeted at contractors will be executed in accordance with FIBG.

[Featured]

Overview of Basel II (the New Capital Adequacy Framework)

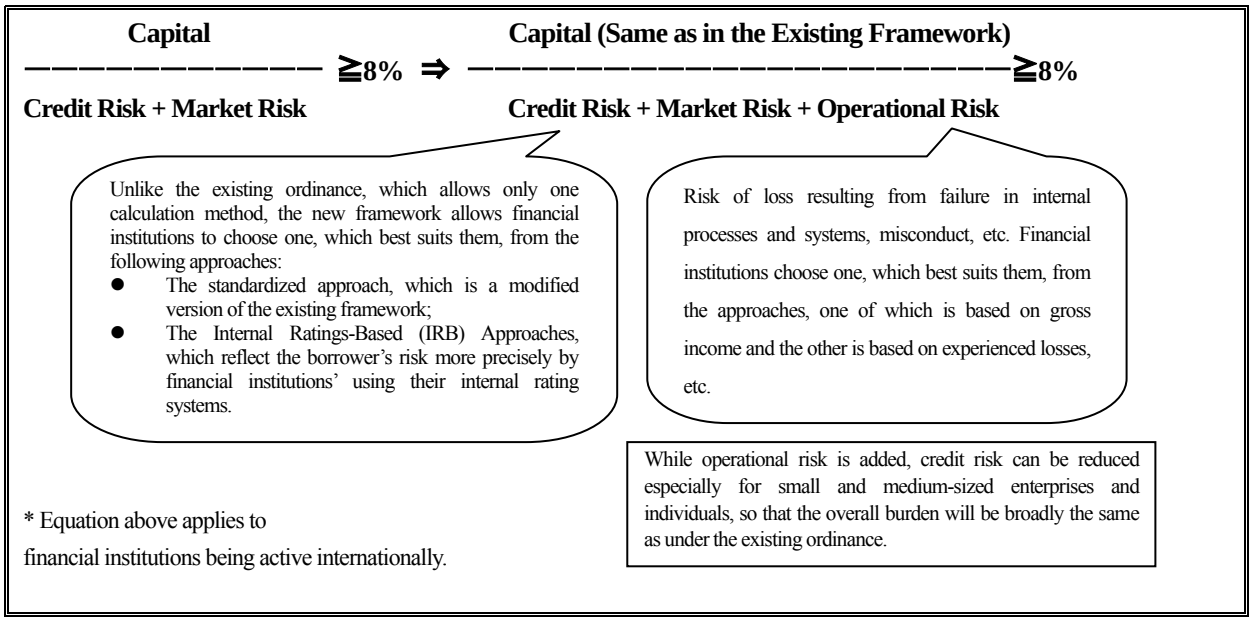
As a part of the framework that is to be applied as from the end of March 2007, the Financial Services Agency (FSA) published the draft rule text on the third pillar (market discipline) for public consultation at the end of March 2006. With the published ordinance on the first pillar (minimum capital requirements) and the supervisory guidelines on the second pillar (supervisory review process), it constructs the overall implementation framework of Basel II in Japan.

This article outlines the first and third pillars, and briefly explains about some of the reference materials published at the end of March 2006: (i) the preliminary results of mapping between the ratings assigned by eligible external credit assessment institutions (ECAIs) and their corresponding risk weights prescribed in the ordinance; (ii) "Publication Items of Eligible Ratings to Securitization Transactions in Japan" (draft); and (iii) the frequently-asked-questions (FAQs) on the new framework. For information on the second pillar, please refer to the January edition of the FSA Newsletter.

1. The First Pillar

The first pillar sets forth the minimum capital requirements. Its most distinctive feature is that it further improves the precision of measurement of risks (as a denominator) in the calculation of the capital adequacy ratio compared to the existing ordinance (*i.e.* Basel I).

Specifically, it newly introduced the measurement of operational risk into the calculation of the capital adequacy ratio, in addition to improving the precision of credit risk measurement. (There is no considerable difference from the existing ordinance in terms of market risk).



(1) Credit Risk

There are three approaches to measuring credit risk: the standardized approach, the Foundation Internal Ratings-Based Approach (FIRB) and the Advanced Internal Ratings-Based Approach (AIRB). Financial institutions are now able to choose one from the three approaches.

(Note) The FIRB and the AIRB are subject to the approval of the FSA.

The standardized approach is the simplest approach, which is a modified version of the existing framework. Major points of such modification are as follows:

(i) The risk weight for exposures to small- and medium-sized enterprises and individuals is reduced from 100% (in the existing framework) to 75% in consideration of the diversification of risk into small accounts. The risk weight for housing loans is reduced from 50% (in the existing framework) to 35%.

(ii) The risk weight for past due loans, which is past due for more than 3 months, is higher than non-past due loans, and could be decreased according to the provisioning rate.
(iii) For exposures to corporations, appropriate risk weights can be used according to their creditworthiness. (Risk weights are from 20% to 150% according to the ratings given by eligible ECAIs. However, banks can choose to apply a 100% risk weight to all exposures without using the ECAIs.
On the other hand, the IRB approaches are approaches in which financial institutions with advanced risk management system calculate the required capital using risk parameters such as the probability of default (PD) estimated by themselves. In FIRB approach, the financial institution only estimates the PD and uses the internationally-prescribed values for the loss given default (LGD) and the exposure at default (EAD). In AIRB approach, the financial institutions estimate PD, LGD and EAD, and calculate the required capital based on these estimates.
In such a framework that allows financial institutions to choose one from the three approaches, financial institutions will be prompted to choose one from various alternatives and advance their risk management system on their own initiative.

(2) Operational Risk
Operational risk refers to the risk of losses resulting from a failure in internal processes and systems, misconduct, etc. Three options are given to financial institutions for measuring operational risk: the Basic Indicator Approach (BIA), the Standardized Approach (TSA) and the Advanced Measurement Approaches (AMA).
(Note) TSA and AMA are subject to the approval of the FSA.
In the BIA and TSA, gross income shall be used as an indicator of operational risk, and the required capital shall be calculated by multiplying gross income by a certain factor. In AMA, financial institutions shall calculate the amount of risk through their own measurement approaches based on the experienced losses, etc. and decide the required capital based on the risk amount.

2. The Third Pillar
Basel II prescribes the disclosure of the capital adequacy ratio, its breakdown, the calculation methods of each type of risk and other quantitative information, in order to improve the effectiveness of market discipline through the enhancement of disclosure.
The draft rule text on the third pillar prescribes the disclosure items and requires the disclosure of information on these items at least twice a year (once a year in the case of small financial institutions other than banks) pursuant to the disclosure requirements under the Banking Law, etc. In addition, it emphasizes financial institutions' efforts toward more frequent (*e.g.* quarterly) disclosures for encouraging them to disclose their actual circumstances. Moreover, banks adopting the IRB (credit risk) and/or the AMA (operational risk) approaches will need to implement the semi-annual and/or quarterly disclosures in an appropriate manner as a part of the requirements for the approval of such approaches. The same requirement will also apply to internationally-active financial institutions.

3. Eligible External Credit Assessment Institutions (ECAIs) and the Mapping
The mapping between the ratings assigned by eligible ECAIs and the risk weights prescribed in the ordinance is a process to determine what risk weights should correspond to the individual rating grades set by each eligible ECAI whose ratings can be used in the standardized approach for credit risk.
The mapping, with respect to ECAIs that wish to be eligible, is determined by six qualitative criteria on appropriateness (i.e., objectivity, independency, transparency, disclosure, human resources/organizational structure, and credibility) and other quantitative criteria such as the default rate, which are presented in the "Eligibility of External Credit Assessment Institutions Usable in Basel II" published on March 31, 2005. (For further information on eligible ECAIs and the mapping, please refer to the website of the FSA.)
The mapping may be revised, when it is necessary, before the implementation of Basel II at the end of March 2007, for the existing mapping was tentatively published to be in time of the parallel run period which commences at the end of March 2006.

4. "Publication Items of Eligible Ratings to Securitization Transactions in Japan" (Draft)
Risk profiles of securitization transactions are apt to be more complicated and various than that of ordinary exposures to corporations. As risk weights on securitization exposure shall be calculated with the ratings by eligible ECAIs in Basel II, such risk weights will vary significantly according to the applied ratings. In the circumstances, it

is deemed extremely important to ensure the appropriateness of the ratings that can be used for securitization exposures.
However, individual ratings could not be checked thoroughly by the market as it is difficult for third parties to identify the individual securitization transactions in detail. In addition, due to limited historical default data, it is difficult to test the statistical significance of the default rate that is observed in each rating by the experienced default value (for example, three-year cumulative default rate). With such characteristics in mind, Basel II requires that "a rating must be published in an accessible form and included in the ECAI's transition matrix "), for that the appropriateness of ratings to securitization exposures should be ensured through market discipline.
The FSA considers that to satisfy the need of publication, it is necessary to make information, of which the extent is that third parties (not stake holders) can assess the appropriateness of external credit assessments, accessible easily to market participants by such means as the website and reports of the eligible ECAIs. Based on the view, the FSA published the individual publication items for public consultation on March 31, 2006.

5. FAQs

The FSA summarizes its current approach to facilitate the implementation of Basel II and foster a further advancement of risk management system at each financial institution. The FSA intends to have dialogue actively with financial institutions advancing their risk management system and prompts further advancement of risk management system. In the process, the FSA plans to continue reviewing FAQs and revise, when it is necessary, with the purpose above in mind.

[From the Office of International Affairs]

Review of the "Core Principles for Effective Banking Supervision" (The Basel Core Principles)

On 6 April 2006, the Basel Committee on Banking Supervision (hereafter, "the Basel Committee") issued, for public consultation, updated versions of the "Core Principles for Effective Banking Supervision" (or better-known as the "Basel Core Principles") and the "Core Principles Methodology", whose original versions were issued in September 1997 and October 1999, respectively.

Much like their original versions, the Basel Committee prepared the updated documents in collaboration with banking supervisors in non-G10 jurisdictions as well as the International Monetary Fund (IMF) and the World Bank. The FSA, together with the Bank of Japan, has been deeply involved in this review process and has made positive contributions to it.

The Basel Core Principles are the "minimum requirements" applicable to banking supervisors in all countries. They have been used by national supervisors as a benchmark for assessing the quality of their supervisory systems and for identifying future works needed to ensure sound supervisory practices. The Basel Core Principles and its Methodology have also been used by the IMF/World Bank in the context of the Financial Sector Assessment Program (FSAP).

Although the Basel Core Principles and its Methodology have worked quite well in the enhancement of supervisory practices around the world, changes have occurred in banking regulations and supervisory techniques over the years, and much experience has been gained through implementing the Core Principles in individual countries. Therefore, updating the Core Principles to reflect these changes and experiences will ensure their continued validity and usefulness, while keeping such changes to a minimum in order to maintain their continued relevance as flexible, globally applicable standards. The review does not in any way call into question the validity of previous work already conducted, especially country assessments and reform agendas based on the 1997 Principles.

The revised Basel Core Principles stress the importance of the independence, accountability, and transparency of banking supervisors (Principle 1). A new "umbrella" Principle 7 that recommends banks to have integrated risk management systems, and the enhanced principles and criteria for interest rate, liquidity, and operational risks, are also good examples of improvements that are to be achieved in the revised documents. In addition, the updated Principle 6 on capital adequacy requirements also clarifies that the assessment of compliance with this principle will not be based on whether or not a country has implemented Basel II – a new capital adequacy framework for internationally active banks in G10 countries. Instead, such assessment will be made against the capital standard chosen by the country, consistent with the recognition of the Basel Committee that Basel II may not be the first priority for all non-G10 supervisors in terms of what is needed to strengthen their supervisory systems.

The Basel Committee invites comments on the revised Basel Core Principles and the Core Principles Methodology by 23 June 2006. For further details, please visit the following BIS website: http://www.bis.org/press/p060406.htm

[Primer on Financial Literacy]

Supervisory Guidelines and Administrative Guidelines

Administrative Guidelines refer to guidebooks for staff in administrative divisions compiled before the launch of the Financial Supervisory Agency in June 1998. At the time, the Ministry of Finance conducted a sweeping review and carried out the radical abolition of financial notices, etc. and switched to ministerial ordinances, announcements, etc. in order to improve administrative transparency, as part of its efforts to shift towards transparent and fair financial administration based on rules. As part of this, the Administrative Guidelines regarding the interpretation of laws and regulations aimed at standardized administrative management, procedures in administrative divisions and financial soundness, operational appropriateness and other focuses of financial institutions were formulated and released to the general public.

On the other hand, **Supervisory Guidelines basically refer to all-in-one guidebooks for staff in administrative divisions that are packed with necessary information, providing a structured overview of the basic approach to the supervision process, evaluation items in supervision and matters to consider in administrative processes in consideration of the content of the existing Administrative Guidelines, for the purpose of building a comprehensive supervision system based on more multifaceted evaluations.** In other words, Supervisory Guidelines may be regarded as Administrative Guidelines that have been progressively deconstructed and newly formulated. Due to increased recognition that it is necessary to build a comprehensive supervision system based on more multifaceted evaluations in order to carry out supervisory operations more appropriately in accordance with the characteristics of each type of business since the formulation of the Administrative Guidelines, progress was made in the formulation of Supervisory Guidelines for each type of business, triggered by the formulation of the Comprehensive Guidelines for Supervision of Small- and Medium-Sized and Regional Financial Institutions.

1. Comprehensive Guidelines for Supervision of Small- and Medium-Sized and Regional Financial Institutions

The report entitled "Enhancement of Relationship Banking Functions" released to the public by the Second Subcommittee, Sectional Committee on Financial System of the Financial System Council on March 27, 2003 pointed out the need to look into policies to build a comprehensive supervision system based on more multifaceted evaluations by taking into account the impact, etc. of corporate governance, management quality and commitment to local communities and client companies (local contributions) on profitability and financial soundness without being limited to the areas provided for in the existing Administrative Guidelines, on the grounds that (1) small- and medium-sized and regional financial institutions (RFIs) are basically characterized by their operations in limited service areas and their services that are closely tied to certain areas and business types, and (2) RFIs tend to go unchecked by the market, and have the possibility of exercising relatively weak governance.

With this in mind, the formulation of the Comprehensive Guideline for Supervision of Small- and Medium-Sized and Regional Financial Institutions was explicitly stated in the Action Program concerning Enhancement of Relationship Banking Functions, which was formulated in March 2003 with the aim to revitalize small- and medium-sized enterprises (SMEs) and invigorate the regional economy, and at the same time, resolve the non-performing loan (NPL) problem of RFIs. In response, the Comprehensive Guideline for Supervision of Small- and Medium-Sized and Regional Financial Institutions was formulated and released to the public in May 2004 as a structured overview of the basic approach to the supervision process, evaluation items in supervision and matters to consider in administrative processes for RFIs, in consideration of the content of the existing Administrative Guidelines.

In conjunction with the formulation of the Comprehensive Guideline for Supervision of Small- and Medium- Sized and Regional Financial Institutions, RFI-related items in the Administrative Guidelines (Volume I: Deposit-handling Financial Institutions) were deleted.

2. Formulation of Comprehensive Guideline for Supervision of Major Banks, etc.

On the other hand, with respect to major banks, efforts were being made at the time when the Comprehensive Guideline for Supervision of Small- and Medium-Sized and Regional Financial Institutions was formulated, in order to fulfill the target of reducing the NPL ratio to about a half of the ratio in the year ended March 31, 2002

(8.4%) by March 31, 2005 based on the Program for Financial Revival (October 2002), etc. Accordingly, it was deemed appropriate to formulate comprehensive guideline for the supervision of major banks once the NPL problem was resolved.
Subsequently, the NPL ratio at major banks in the year ended March 31, 2005 fell to 2.9%. In response to the resolution of the NPL problem at major banks, the Comprehensive Guideline for Supervision of Major Banks, etc. was formulated and released to the public in October 2005. Its formulation was aimed at establishing a comprehensive supervision system focusing on sophisticated risk management, appropriate governance, etc. required by major banks, etc. that are deemed to be expected to provide world-class financial services and contribute to Japan's economic progress and improvement in people's lives, in consideration of the significance of the Comprehensive Guideline for Supervision of Small- and Medium-Sized and Regional Financial Institutions, etc.
In conjunction with the formulation of the Comprehensive Guideline for Supervision of Major Banks, etc., the Administrative Guidelines (Volume I: Deposit-handling Financial Institutions) were abolished.

3. Formulation of Supervisory Guidelines for Other Types of Businesses, etc.

With respect to other types of businesses, Supervisory Guidelines were formulated one after the other as a structured overview of the basic approach to the supervision process, evaluation items in supervision and matters to consider in administrative processes in order to carry out supervisory operations more appropriately according to the characteristics of each type of business, in consideration of the content of the existing Administrative Guidelines (June 2005: Comprehensive Guideline for Supervision of Financial Futures Dealers, July 2005: Comprehensive Guideline for Supervision of Securities Companies, August 2005: Comprehensive Guideline for Supervision of Insurance Companies, March 2006: Comprehensive Guideline for Supervision of Small-claims and Short-term Insurance Businesses). In conjunction with the formulation of the Supervisory Guidelines for each type of business, the related sections of the corresponding Administrative Guidelines were abolished.
Furthermore, in order to add new points to consider following the revision of laws and to clarify the focus of supervision to deal with new trends in the financial sector, progress was made in the formulation of Supervisory Guidelines outside the framework of Administrative Guidelines (December 2004: Comprehensive Guideline for Supervision of Trust Companies, etc., June 2005: Guideline for Supervision of Financial Conglomerates).

【Hot Picks from the Financial World】

* We deliver the hottest information of the times in this section, selected from among questions and answers given at the Minister's press conferences etc. If you wish to find out more, we invite you to visit the "Press Conferences" section of Financial Services Agency's website.

Q. What are your thoughts on the series of accounting incidents which may cause distrust in the accounting profession? How will the Financial Services Agency (FSA) respond to auditing firms?

A. Auditors conduct audits by profession, but in addition to this aspect, they characteristically engage in their duties with a huge social responsibility. This is not limited to Certified Public Accountants and auditing firms in that, for example, lawyers are also in an occupation with huge social responsibilities. In that sense, it is extremely regrettable that a series of scandals involving auditors have arisen. It is necessary to properly examine what to do in response to the scandals and take measures somewhere, including addressing how auditing firms or auditors ought to be, rather than just reprimanding those who were involved in the scandals in various ways. While we have not formally decided where to hold proper discussions, the Financial System Council is already in place, so we will consult with them and take urgent action to properly deal with audits in general for the future.

(from the press conference following a cabinet meeting on Friday, March 31, 2006)

Q. Yesterday, the Japanese Institute of Certified Public Accountants (JICPA) announced that it would introduce voluntary regulations. JICPA claims that it would be preferable to tackle it by voluntary regulations rather than government regulations. What are your thoughts on this?

A. Looking into the history of bar associations would be helpful here. There is a law called the Practicing Attorney Law, which sets forth a so-called registration system that does not allow attorneys to practice unless they are registered with the local bar association. Bar associations are extremely autonomous organizations that do not tolerate government intervention, but instead impose self-discipline.

Although the registration system of Certified Public Accountants (CPAs) is not as far-reaching in itself as that of the bar associations, I highly appreciate their efforts to steer it based on their own judgment and to reduce misconduct and other such incidents by establishing a code of ethics and other provisions.

While it is sad that auditors have to be audited, the CPAs created such a framework of their own accord, so we need to positively observe how it will be steered and managed in the future.

(from the press conference following a cabinet meeting on Friday, April 7, 2006)

Q. The round-table conference at the FSA will compile an interim report on the money lending industry. What are your views on the treatment of interest rates in gray zones, and what kind of action will be taken in the future?

A. Actually, I talked about various matters with Mr. Terada—the head of the Civil Affairs Bureau of the Ministry of Justice—at the end of last week. I suggested that the FSA administration staff and the Ministry of Justice have discussions on how to deal with the Law Concerning the Regulation of Receiving of Capital Subscription, Deposits and Interest on Deposits and the Interest Rate Restriction Law this week, as these Laws are under the shared jurisdiction of the FSA and the Ministry of Justice. He said he would be happy to do so.

However, the Law Concerning the Regulation of Receiving of Capital Subscription, Deposits and Interest on Deposits is actually a law under the jurisdiction of the Criminal Affairs Bureau of the

Ministry of Justice, so I would like to have talks with the Criminal Affairs Bureau as well. This is because what was intended by the legislation at the time of enactment inevitably appears to have been gradually modified by precedents set by the Supreme Court. If the Supreme Court has presented a certain approach through such precedents, the government, especially the legislature, has the responsibility and obligation to seriously consider how to deal with it.

(from the press conference following a cabinet meeting on Tsuesday, April 18, 2006)