



FSA Newsletter October 2006



The first press conference by Minister Yamamoto
(September 26)



Minister Yamamoto took over the post from former
Minister Yosano (September 27)

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【Topics】

The Status of Non Performing Loans as of end-March, 2006

On August 8, 2006 the Financial Services Agency (FSA) released to the public the status of non performing loans as it stood as of the end of March 2006.

A brief explanation of the status of non performing loans as of the end of March 2006 is given as follows:

The balance of non performing loans (NPLs) of all banks nationwide (on the basis of loans subject to disclosure under the Financial Reconstruction Law) totaled 13.4 trillion yen as of March 31, 2006, a 4.6 trillion yen decrease from 17.9 trillion yen recorded in March 31, 2005.

The respective NPL ratios of major banks, regional banks and all banks nationwide were lower than in March 31, 2005, each of which was a record low since data on loans subject to disclosure under the Financial Reconstruction Law became available to the public in March 31, 1999.

	March 31, 2004		March 31, 2005		March 31, 2006
Major banks	5.2%	➡	2.9%	➡	1.8%
Regional banks	6.9%	➡	5.5%	➡	4.5%
All banks nationwide	5.8%	➡	4.0%	➡	2.9%

In particular, the NPL ratio of major banks decreased by 1.1 percentage points to 1.8%, from 2.9% as at March 31, 2005 when the objective of halving the NPL ratio under the “Program for Financial Revival” (October 2002) was successfully achieved.

The NPL ratio of regional banks has also been steadily decreasing as a whole, as regional banks are making steady progress in their efforts to enhance region-based banking relationships.

The FSA will continue taking all possible steps in the supervision of financial institutions in the future, lest a NPL problem should reemerge and harm the Japanese economy.

* For further information, please visit the FSA’s website and go to either [“The Status of Non Performing Loans as of end-March 2006 \(August 8, 2006\)”](#) under [“Press Releases.”](#), or [“End - March, 2006 \(released on August 8, 2006\)”](#) under [“Status of Non-Performing Loans”](#).

The Requests for FY2007 Tax Revision

On August 31, the Financial Services Agency (FSA) submitted the “Requests for FY2007 Tax Revision” to the Ministry of Finance and the Ministry of Internal Affairs and Communications. This year, we have requested tax measures required to further invigorate the financial system for the purpose of helping realize:

- 1. A wealthy, strong and attractive Japanese economy; and**
- 2. A safe, flexible and diverse society.**

1. From the perspective of realizing a wealthy, strong and attractive Japanese economy, our requests included the following:

- (1) For the purpose of accelerating and establishing the shift “from savings to investment” that has started to gain momentum:
 - (a) Sustain the preferential tax rate of 10% with respect to capital gains from listed stocks, etc.; and
 - (b) Take appropriate tax reduction measures with respect to dividend income.
- (2) Allow offsetting between capital losses and dividend income from listed stocks, etc. as an effort to standardize taxes imposed on financial instruments.
- (3) For the purpose of preventing the recurrence of the non-performing loans (NPL) problem at financial institutions and tackling the vulnerability of deferred tax assets as an asset class,
 - (a) Expand the scope of tax-free write-offs and provisions for bad debt; and
 - (b) Lift the freeze on the carry-back refund system for losses and extend the eligible period, etc.
- (4) Broadly speaking, adopt the approach taken by the existing tax system for trusts and give due consideration to facilitating trust transactions with respect to tax measures associated with the revision of the Trust Law.

2. For the purpose of realizing a safe, flexible and diverse society, our requests included the following.

- (1) Establish a new general-purpose life insurance premium deduction scheme that not only meets diverse needs but is also simple and easy to understand, to assist self-supporting efforts in bereaved family/old-age/medical/nursing security.
- (2) Enhance the system of catastrophe reserves for fire insurance, etc. to deal with risks in everyday lives, such as natural disasters.

The Summary of FY2007 Budgetary Requests

1. Introduction

The diversification of financial products and services is giving rise to the need to enhance market surveillance functions and promote consumer protection measures for the purpose of protecting users of financial services and enabling them to perform transactions safely and with a sense of security. Considering that Japan Post is due to be privatized in October 2007, it is also important to respond to the postal services privatization appropriately. Furthermore, it is necessary to develop an information system to improve user convenience and operational efficiency. The Financial Services Agency (FSA) has made organizational, staffing and budgetary requests required to take various measures, etc. to tackle these issues.

2. Details of Organizational and Staffing Requests

In making organizational and staffing requests for FY2007, the FSA has set three priority areas for framework development, namely, “enhancement of market surveillance functions”, “promotion of consumer protection measures” and “response to postal services privatization”.

(1) Enhancement of Market Surveillance Functions

As the scope of disclosure inspections and civil penalties investigation was expanded and funds became a new target of supervision in conjunction with the enforcement of the Financial Instruments and Exchange Law, we will substantially enhance our framework to watch and monitor securities markets required to properly implement the Financial Instruments and Exchange Law. We will also enhance our framework for planning and legislation systems for constantly-evolving markets and corporate disclosure systems, and enhance our inspection and supervision frameworks targeted at auditing firms and Certified Public Accountants (CPAs).

(2) Promotion of Consumer Protection Measures, etc.

We will develop inspection and supervision frameworks targeted at loan companies, banks, insurance companies, consultation and PR frameworks for financial services users, and frameworks for planning and legislation systems to promote consumer protection measures.

(3) Response to Postal Services Privatization

Considering that the Postal Savings Bank and the Postal Life Insurance Company will launch banking operations and insurance operations, respectively, in October 2007 under the Japan Post Privatization Law, we will develop inspection and supervision frameworks to further improve the efficiency and convenience of the financial system in Japan as a whole by facilitating the smooth privatization of postal services.

For the purpose of developing these frameworks, we have requested that our staff be increased by 195 persons in total, consisting of 34 additional staff members requested in the Planning and Coordination Bureau, 27 in the Inspection Bureau, 36 in the Supervisory Bureau, 86 in the Securities and Exchange Surveillance Commission (SESC) and 12 on the Certified Public Accountants and Auditing Oversight Board (CPAFOB).

(Reference: Staffing Request for FY2007)

	Number of Staff at End of FY2006	Increase in Staff Requested for FY2007	Increase in Staff Requested for FY2006 (Actual Staff Increase)
Planning and Coordination Bureau	304	34	51 (16)
Inspection Bureau	454	27	36 (6)
Supervisory Bureau	221	36	40 (21)
Subtotal	979	97	127 (43)
SESC	318	86	66 (19)
CPAFOB	43	12	2 (2)
Total	1,340	195	195 (64)

(Note) In addition, the Financial Intelligence Unit (FIU; an organization engaged in sorting and analyzing information on transactions suspected of being related to crime and providing such information to the law enforcement authorities) is to be transferred to the National Police Agency in conjunction with legislation for enhancing measures to fight money laundering and terrorist financing.

3. Details of Budgetary Requests

In our budgeting requests for FY2007, we thoroughly reviewed all over our expenditure and asked for a total of approximately 24.9 billion yen (up 18.1% year-on-year), taking into account: (1) funds required to increase our staff (by 195 persons) to enhance market surveillance functions and promote consumer protection measures; (2) funds required to develop an information system based on operational and system optimization plans aimed at improving user convenience and operational efficiency; and (3) funds required to conduct inspections and surveillance timely and enhance collaborative efforts with overseas authorities.

It should be noted that we have requested 48.15 trillion yen for government guarantees earmarked for the Deposit Insurance Corporation, based on the view that such budgeting will serve as continued assurance of stability for the financial system.

【Supervisory Policies for Administrative Year 2006】

Annual Policies for the Supervision of Securities Companies

The Financial Services Agency (FSA) released to the public the “Annual Policies for the Supervision of Securities Companies, etc. for Administrative Year 2006” on August 30, 2006. The Supervisory Policies indicate the key areas to be examined during annual supervision separately from the Supervisory Guidelines, for the purpose of improving administrative transparency and the predictability of audited securities companies. This is the second set of the Supervisory Policies, following the first set formulated and published last year (Administrative Year 2005).

I. Basic Approach

1. Understanding of Current Status of Securities Businesses, etc.

While various measures have been taken to invigorate the securities market since the reform of the financial system, the previous administrative year—which was marked by the settlement of the non-performing loans (NPL) problem at major banks and balanced economic recovery—may be regarded as the beginning of a full-fledged transition phase in which the shift “from savings to investments” accelerates.

However, the previous year was also marred by various problems in the Japanese securities market, such as a huge erroneous buy order for stocks, a system failure at a securities company and unfair trading by investors.

2. Basic Approach

Based on such an understanding of the current status of securities businesses, etc., we will expand our scope from securities companies to “securities companies, etc.”, a category which will also include investment trust management companies, investment corporations, investment advisory businesses and financial futures dealers, in order to promote voluntary efforts that cut across industries and strictly enforce customer protection before the full-fledged enforcement of the Financial Instruments and Exchange Law in the next administrative year. We will take strict and proper action with respect to these businesses focusing on the following three priorities:

- (1) Customer protection;
- (2) Establishment of appropriate business operation systems; and
- (3) Proper demonstration of market intermediation functions, etc. of securities companies.

II. Priorities

1. Customer Protection

(1) Establishment of Solicitation and Explanation Systems

Securities companies, etc. need to establish appropriate solicitation and explanation systems considering the characteristics of securities transactions in recent years, as exemplified by the rapid increase in individual investors, the increasing complexity and diversification of financial instruments, and the diversification of sales channels. For this purpose, the FSA will examine the systems of securities companies, etc. for compliance with laws and regulations related to solicitation and explanation as well as their frameworks for screening advertisements, and take strict supervisory action in the event that any problems arise.

(2) Proper Response to Inquiries and Complaints

As operations of securities companies, etc. are unsustainable without customers’ support and trust, it is their vital and ineluctable responsibility to deal sincerely with inquiries and complaints from customers. From this perspective, we will examine their framework for dealing with inquiries and complaints.

(3) Establishment of Customer Information Management System

As it is important to build a system to properly manage customer information including both personal information and corporate information, we will take strict supervisory action in the event that any problems arise in relation to customer information management systems of securities companies, etc.

(4) Strict Enforcement of Segregated Custody

It is indispensable that securities companies, etc. hold customers’ assets separately from their own assets in

order for customers to perform securities transactions with a sense of security. In the event that any problems arise in the framework of segregated custody at securities companies, etc., we will promptly request that the situation be rectified.

(5) Protecting Customers from Asset Management Businesses, etc.

We will continue to conduct strict checks as to whether there are any breaches of duty in regards to loyalty or managerial competence on the part of investment trust management companies, investment corporations' asset management businesses and investment advisory businesses with respect to customers, and check the appropriateness of their advertisements, etc.

(6) Protecting Customers from Financial Futures Dealers

We will take strict supervisory action in the event that foreign exchange margin trading businesses are found to have problems in observing the codes of practice concerning the prohibition of unsolicited calls, advertising regulations, etc.

2. Establishment of Appropriate Business Operation Systems

(1) Governance Systems of Securities Companies, etc.

It is important that governance is properly exercised in order for the market to make sound progress based on the strict enforcement of compliance and risk management among securities companies, etc.

From such a perspective, we will examine the representative director's awareness of and efforts towards compliance and risk management, and whether the management checking functions of the board of directors, etc. and internal audit functions are being properly demonstrated, especially in consideration of the recent problems regarding the inappropriate business operations by the executive committee of investment corporations and other such incidents.

(2) Development of Sophisticated and Robust Compliance and Risk Management Systems

It is important that the compliance department and the risk management department play their respective roles in an appropriate manner, in addition to improving the management team's awareness of and proactive involvement in compliance. With this in mind, we will examine the management team's awareness of compliance, the appropriateness of compliance and risk management systems, the functions of the internal audit department, etc. when an application for registration is filed by securities companies, etc. and on other such occasions.

(3) Dealing with Governance of Financial Conglomerates

In consideration of the problems that came to light in the previous year and other such incidents, we will examine the management system of financial conglomerates and the concurrent postal system between securities companies, etc. and other financial institutions.

(4) Ensuring Financial Soundness

We will monitor the regulatory capital ratio, examine the risk management system of security company groups that are expanding principal investment businesses, and examine the capital adequacy, etc. of financial conglomerates on a group-wide scale.

(5) Prevention of Conflict of Interest, etc. at Registered Financial Institutions and Securities Brokers

We will examine registered financial institutions as to what they are doing to prevent conflict of interest arising between their securities operations and other operations such as banking operations and to prevent their dominant positions from being abused, etc. We will also examine securities brokers as to whether they are properly identifying the solicitation systems, etc. of affiliated securities companies, etc.

3. Proper Demonstration of Market Intermediation Functions, etc.

(1) Improvement of Reliability of Operations

We will make the following efforts in addition to following up on the "Summary of Issues by the Round Table Conference on the Financial Market Intermediation Function of Securities Companies" (hereinafter referred to as "Summary of Issues"):

1) Prevention of Recurrence of Erroneous Buy/Sell Orders

In consideration of the industry-wide inspections conducted by the FSA and the establishment of self-

imposed regulations by the Japan Securities Dealers' Association (JSDA), we will examine measures, etc. to prevent erroneous buy/sell orders by securities companies and prompt them to make proper improvements if there are any problems. We will also endeavor to identify how position limits and risk limits should be set by each security company by conducting interviews, etc.

2) Collateral Margin in Margin Transactions

In consideration of the self-imposed regulations established by the JSDA in response to an incident in which the margin for collateral securities was set at zero with no advance notice, etc. provided, we will keep a close eye on securities companies' responses.

3) Suitable Long-Term Computer System Management Systems

In consideration of the increase in securities transactions involving the use of computer systems in recent years as well as the state of system failures occurring in securities companies lately, we will intensively examine the computer system management operations of securities companies and take strict action if there are any problems, including taking administrative action.

We will also examine systems built for identifying the progress made in providing new services, etc. and examining Business Continuity Plans (BCPs) of securities companies.

(2) Demonstration of Checking Functions Targeted at Issuers

In consideration of the problems that have occurred in the issue market in recent years and the fact that underwriting services will now be subject to a registration system under the Financial Instruments and Exchange Law, we will endeavor to identify the actual state of underwriting and other such operations of securities companies, in addition to following up on the "Summary of Issues". In doing so, we will prompt them on appropriate improvements if any problems or structural inadequacies are found.

(3) Demonstration of Checking Functions Targeted at Investors

In consideration of the recent incidents involving market manipulation, insider trading, etc. resulting in punitive action, we will examine the effectiveness, etc. of trading management and screening systems of securities companies, in addition to following up on the "Summary of Issues", and take strict supervisory action if any problems are found.

In regards to preliminary hearings, we will examine the system development status of securities companies in consideration of the revision of cabinet orders, etc.

(4) Maintenance of Market Player Self-Discipline

As the environment is changing as exemplified by the expansion of the scope of activities of securities companies, attention needs to be given to conflict of interest between functions as a market intermediary and functions as a market player in an increasing number of cases. It is therefore important to build an appropriate internal control system.

Accordingly, we will examine the development of "Chinese Walls" in securities companies and the extent to which they comply with various laws and regulations, in addition to following up on the "Summary of Issues", and we will take strict supervisory action if any problems are found.

Furthermore, we will examine the extent to which securities companies have endeavored demonstrate self-discipline, beyond the scope of compliance.

III. Supervisory Methods

1. Ensuring Proper Collaboration with Inspection and Surveillance Departments

We will collaborate with the Supervisory Bureau, the Executive Bureau of the Securities and Exchange Surveillance Commission (SESC), etc., such as exchanging useful information and sharing awareness of problems in accordance with the proper division of roles.

2. Ensuring Collaboration with Self-regulatory Organizations

We will properly collaborate with self-regulatory organizations in each industry, including following up on the "Summary of Issues". In particular, we will encourage self-regulatory organizations to enhance and demonstrate their functions, including conducting audits and taking punitive action.

3. Relationship with Securities Companies, etc.

Supervisory authorities will give due consideration to respecting the voluntary efforts made by securities

companies, etc. relating to their business operations, etc. and endeavor to ensure sufficient communication with securities companies, etc.

4. Enhancement of Collaboration with Overseas Supervisory Authorities, etc.

In consideration of the increasing number of financial conglomerates and the growth in cross-border securities transactions, we will strive to further enhance collaboration with overseas supervisory authorities, etc. through the exchange of information and opinions.

Annual Policies for the Supervision of Major Banks

The Financial Services Agency (FSA) drew up its “Annual Policies for the Supervision of Major Banks for Administrative Year 2006” (hereinafter referred to as “Supervisory Policies”) based on the Comprehensive Guideline for the Supervision of Major Banks, etc. established in October 2005 (hereinafter referred to as “Supervisory Guideline”) and released them to the public on August 9, 2006. The outline of the Supervisory Policies is as follows.

(Note) Administrative Year 2006: From July 1, 2006 to June 30, 2007

1. Background, etc.

The FSA decided to draw up “Annual Policies for the Supervision of Major Banks” and release them to the public in response to the Supervisory Guideline, which set forth that “at the beginning of each administrative year, the FSA will draw up supervisory policies for the administrative year and release them to the public in order to clarify the supervisory priorities”.

Upon supervising major banks, etc. in Administrative Year 2006, we will conduct offsite monitoring comprising various interviews including “comprehensive interviews” and “risk management interviews” in accordance with the Supervisory Policies.

2. Composition

The Supervisory Policies start with the presentation of the “Basic Approach” to fulfilling the basic objectives of financial administration, and then set forth three supervisory priorities for Administrative Year 2006, namely, “strict enforcement of customer protection rules and improvement of convenience”, “sophistication of risk management, etc.”, and “responses to financial globalization, etc.”

3. Basic Approach

The “Basic Approach” section briefly explains the events leading up to the development of the Supervisory Policies and then describes our understanding of the current state of major banks, etc. and our basic approach to the three priorities mentioned above.

(1) Circumstances Surrounding Major Banks, etc. and Their Expected Roles

This section first describes the following changes in the circumstances surrounding major banks, etc.

- 1) Introduction of the bank agency system under the revised Banking Law (April 2006) and the improvement and enhancement of provisions for customer protection pursuant to the revised Banking Law and the Financial Instruments and Exchange Law established during the ordinary Diet session this year
- 2) Enhancement of measures to prevent financial crime such as the enforcement of the so-called “Counterfeited and Stolen Credit Cards and Depositor Protection Law” (February 2006) and the convocation of the Study Group on Information Security (March through June 2006)
- 3) Recent termination of the zero-interest-rate policy by the Bank of Japan
- 4) Implementation of Basel II (new capital adequacy requirements) for the year ending on March 31, 2007

In addition, it addresses the fact that under such circumstances, financial institutions are in general required to provide a wide range of high-quality financial products and services that meet customers’ needs by taking advantage of their respective strengths. In particular, it states that major banks, etc. are expected to contribute to Japan’s economic progress and help improve people’s lives by providing services of the highest level in the world and play a crucial role in the global financial market, as they have a huge influence on the Japanese economy due to their large size, and engage in financial activities

on an international scale in many cases.

(2) Basic Approach to Priorities

Please refer to each item in “4. Priorities” below.

4. Priorities

In consideration of the circumstances surrounding major banks, etc. and the expectations placed on them referred to in (1) above, we will continue to make efforts to enhance collaboration with inspection divisions upon supervising major banks, etc. in Administrative Year 2006, in addition to executing supervisory administration in a strict, effective and efficient manner by giving priority to the following three areas:

(1) Enforcement of Customer Protection Rules and Improvement of Convenience

Major banks, etc. are implementing a wide range of efforts, including diversifying the financial instruments they deal in and expanding their fee-charging businesses. We will carry out supervision intensively so as to make sure that customer protection and convenience are not disregarded in such efforts. Specifically, we will conduct supervision by focusing on the following matters, while actively utilizing information from the Counseling Office for Financial Services Users, etc. in addition to reports from financial institutions and inspection results.

- 1) Improvement and enhancement of explanation systems and consultation and complaints handling functions
- 2) Enhancement and strict enforcement of measures to prevent financial crime, etc.
- 3) Ensuring the appropriateness of computer system risk management systems
- 4) Strict enforcement of compliance with relevant laws and regulations such as the Anti-Monopoly Law in business operations
- 5) Development of screening and loan management systems according to borrowers' needs
- 6) Ensuring appropriate business operations by bank agents
- 7) Ensuring the appropriateness of portfolio/sales-related operations for structured bonds, etc.

(2) Sophistication of Risk Management, etc.

In order for financial institutions to ensure financial soundness based on their own voluntary and sustainable efforts, it is important that they perform risk management in an appropriate manner. Therefore, we will conduct supervision by focusing on the following matters, as to whether efforts are being made towards the implementation of Basel II and whether efforts are being made to advance risk management to adapt to the diversification of risks associated with the expansion of operations of major banks, etc. Specifically, we will conduct supervision with respect to:

- 1) Dealing with Basel II
- 2) Dealing with the diversification of risks through such means as diversification of invested assets
- 3) Improving the quality of capital

(3) Response to Financial Globalization, etc.

In response to the globalization of the financial sector and other such changes, major banks, etc. are becoming increasingly conglomeratized and are expanding their overseas operations. Considering that such efforts are leading to increased revenue but are at the risk of giving rise to poor operational control, we will conduct supervision by focusing on the following matters, including whether an appropriate operational control framework is developed:

- 1) Supervision of financial conglomerates
- 2) Operational control concerning overseas operations

Annual Policies for the Supervision of Small- and Medium-Sized and Regional Financial Institutions

Since Administrative Year 2004, the Financial Services Agency (FSA) has been drawing up supervisory policies and releasing them to the public at the beginning of each administrative year, in order to clarify its supervisory priorities upon conducting the supervision of small-and medium-sized and regional financial institutions (RFIs) in the administrative year.

For this administrative year, the FSA released “Annual Policies for the Supervision of Small-and Medium-sized and Regional Financial Institutions for Administrative Year 2006” (hereinafter referred to as “Supervisory Policies 2006”) on August 9. The Supervisory Policies 2006 introduce the FSA’s basic standpoint in conducting supervision and its supervisory priorities, as outlined below.

(Note) Administrative Year 2006: From July 1, 2006 to June 30, 2007

1. Basic Standpoint

The Supervisory Policies 2006 starts with the presentation of the “Basic Standpoint”, in which the circumstances surrounding RFIs are explained, especially in regards to recent changes in the environment. The basic approach to conducting efficient and effective supervision is also explained.

(1) Current Circumstances Surrounding RFIs

Specific changes in the environment stated explicitly in this section are as follows.

- 1) Firstly, efforts in region-based relationship banking have been made by RFIs. Since the formulation of the Action Program in April 2003, RFIs have been making efforts to promote region-based relationship banking, which are generally making steady progress. However, their customers rated efforts to “facilitate business revitalization and small and medium-sized enterprise (SME) financing” such as the provision of loans without excessively relying on collateral and guarantees as well as business revitalization and efforts to “enhance convenience for regional customers” as inefficient. It is thus necessary to continue efforts to promote region-based relationship banking with consideration to the aforementioned area.
- 2) Secondly, there is a growing need to improve customer protection in financial transactions and to enhance measures to prevent financial crime, as exemplified by the enactment of the Financial Instruments and Exchange Law and the introduction of the law that protects depositors having their credit cards counterfeited or stolen.
- 3) Thirdly, there are new interest-rate and market environments stemming from the termination of the zero-interest-rate policy by the Bank of Japan. Also, the New Basel Capital Accord (Basel II) will be implemented in March, 2007.

(2) Basic Approach to Supervision Process

Based on aforementioned changes of the current circumstances surrounding RFIs, the FSA will carry out supervisory administration in an effective and efficient manner in Administrative Year 2006, so as to ensure the following:

- 1) Respect for voluntary efforts made by financial institutions in their business operation
- 2) Ensuring sufficient communication with financial institutions
- 3) Continued coordination with inspection divisions
- 4) Further enhancement of coordination between regional financial bureaus and the FSA

2. Priorities

In consideration of the changes in the environment referred to in 1 (1) above, the Supervisory Policies 2006 set forth the following three priorities: (1) “adherence to customer protection rules and improvement of convenience in the region”, (2) “facilitation of business revitalization and SME financing” and (3) “further sophistication of risk management.”

The FSA takes the view that the internal control systems need to be enhanced by the management’s leadership under the current circumstances where there are a wide range of issues to be addressed by financial institutions. Based on this view, the Supervisory Policies 2006 explicitly state that special attention will be given to the appropriateness of governance when taking supervisory actions with respect to the following three priorities.

(1) Adherence to Customer Protection Rules and Improvement of Convenience in the Region

The top priority set forth by the Supervisory Policies 2006 is the “adherence to customer protection rules and improvement of convenience in the region”. This was the second priority last year—the top priority last year being “further promotion of region-based relationship banking”. Considering that the

improvement of convenience for customers in the region had been a major factor in the new action program for region-based relationship banking and that convenience was deemed insufficient according to customer surveys, it was given top priority so as to reaffirm the trends in financial administration to giving utmost importance to customers' viewpoints.

Moreover, in consideration of the need to provide an appropriate explanation to customers and borrowers due to changes in the financial climate as exemplified by the recent diversification of financial instruments and the interest rate rise associated with the termination of the zero-interest-rate policy by the Bank of Japan, as well as the frequent misconduct financial institutions' employees and institutions' poor awareness of abuse in dominant position, the FSA will conduct supervision by focusing on:

- 1) Strengthening of explanation systems and of consultation and complaints handling functions
- 2) Compliance with laws and regulations
- 3) Enhancement and strict enforcement of measures to prevent financial crimes
- 4) Establishment of customer information management systems
- 5) Ensuring appropriate management of computer systems

(2) Facilitation of Business Revitalization and SME Financing

The second priority is "facilitation of business revitalization and SME financing", bearing in mind that among the region-based relationship banking efforts, "business revitalization efforts" and "provision of loans without excessively relying on collateral and loans" are still rated as insufficient.

The FSA will continue to follow up on the progress of region-based relationship banking efforts, and conduct supervision by focusing especially on:

- 1) Business revitalization efforts; and
- 2) Provision of loans without excessively relying on collateral and guarantees.

(3) Further Sophistication of Risk Management

The third priority is "further sophistication of risk management", as it was last year. The FSA will look into the financial institutions' development of appropriate risk management systems, especially in consideration of recent securitization efforts, the trend of expansion of asset management with complex risk profiles as exemplified by real estate funds and other various fund products, and new interest-rate and market environments due to the termination of the zero-interest-rate policy by the Bank of Japan.

This includes perspectives that take into account the implementation of Basel II (new capital adequacy requirements) in March, 2007, specifically, whether or not financial institutions are properly calculating and managing their capital adequacy ratios in accordance with the First Pillar (minimum capital requirement), and whether or not their capital mainly consists of Tier 1 capital, considering that the disclosure of the basic elements of capital (Tier 1) is required under the Third Pillar (market discipline).

- 1) Ensuring reliability of asset appraisal and credit risk management
- 2) Development of market risk management systems
- 3) Preparation for Basel II

【Featured】

Overview of “Financial Instruments and Exchange Law” (Part 2)

The law for amending the Securities and Exchange Law and other financial laws (2006 Law No.65) and the law for abolishing and amending the related laws to implement the law for amending the Securities and Exchange Law and other financial laws (2006 Law No.66) were promulgated on June 14, following the approval and passage of the respective bills at the 164th Diet session held on June 7, 2006.

More specifically, the legislations can broadly be divided into the following four basic elements:

- (1) Development of a cross-sectoral legal system to protect investors regarding financial instruments with strong investment characteristics (legal system based on so-called “Investment Services Law”);
- (2) Enhancement of the disclosure system;
- (3) Reinforcement of self-regulatory functions of stock exchanges; and
- (4) Strict approach to unfair trading, etc.

Part 1 reviewed the following subjects in “1. Building a Cross-sectoral Legal System to Protect Investors regarding Financial Instruments with Strong Investment Characteristics (Legislation “Investment Services Law”):”

- 1) Transition from Securities and Exchange Law to Financial Instruments and Exchange Law;
- 2) Expansion of scope of regulated products;
- 3) Regulated cross-sectoral operations; and
- 4) Relaxation of restrictions on market entry according to nature of operations.

This part also reviews “1. Building a Cross-sectoral Legal System to Protect Investors regarding Financial Instruments with Strong Investment Characteristics (Legislation “Investment Services Law”)”.

* The Securities Exchange Law and the Financial Instruments and Exchange Law are hereinafter referred to as “SEL” and “FIEL”, respectively.

1. Building a Cross-sectoral Legal System to Protect Investors regarding Financial Instruments with Strong Investment Characteristics (Legislation “Investment Services Law”) (Continued)

5) Reorganizing regulation on conduct of financial instruments business

The FIEL stipulates many rules of conduct for financial instruments firms primarily for the purpose of investor protection.

a) Rules of Conduct relating to “Sales and Solicitation”

Financial instruments firms should comply with the following rules in conducting “sales and solicitation” for securities and derivative transactions.

Regulation of advertisements, etc. (Article 37)	- Indicate that the advertiser is a financial instruments firm and the registration number. - Concerning profit prospects, an advertisement should not make claim that differ significantly from the truth or in a way that may mislead people.
Obligation to issue documents before signing contract (Article 37-3)	- Indication that the firm is a financial instruments firm, and the registration number. - Outline of contract, brief description of fees, etc. must be included. - “Possibility of incurring losses” and “possibility that the loss may exceed the value of deposit received from customers” must be stated, if any.
Obligation to issue documents at a time of contract (Article 37-4)	- The terms and conditions, etc. of the contract for financial instruments transactions must be stated.
Various prohibited conducts (Article 38)	- Solicitation by making false statements or by providing decisive judgments on uncertain matters is prohibited. - Solicitation of customers who have not requested such solicitation by making visits or phone calls is prohibited (a ban on unwanted solicitation). - Solicitation without confirming the customer’s intention to accept solicitation in advance (Obligation to confirm customer’s acceptance of solicitation). - Continued solicitation of customers who have once indicated that they do not wish to enter into a contract is prohibited (a ban on re-solicitation).
Prohibition of compensation of losses (Article 39)	- Guarantee against losses, guarantee of yields, subscription of loss compensation and execution of loss compensation are prohibited.

Requirement for suitability (Item 1, Article 40)	- Efforts must be made to avoid business situations in which inappropriate solicitation could result in lack of investor protection in light of the customer's knowledge, experience, asset position and purpose of signing a contract.
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b) Rules of Conduct relating to “Investment Advisory”, “Investment Management” and “Customer Asset Administration”

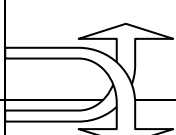
- Financial Instruments firms should comply with, for example, the duty of loyalty and fiduciary duty (Articles 41 and 42), etc. in conducting “investment advisory” or “investment management”.
- Financial instruments firms should comply with fiduciary duty and the obligation of segregation of assets (Article 43 through Article 43-3) in conducting “customer asset administration”.

6) Flexible Regulation according to Customer Categories

Rules of conduct based on the existing SEL, etc. are applied across the board regardless of the categories of investors. In contrast, the FIEL has established the following systems to facilitate the supply of risk capital while assuring customer protection.

a) Classification of Professional Investors and General Investors

- Investors corresponding with qualified institutional investors, the Japanese government, the Bank of Japan, and corporations to be designated by cabinet office ordinances are regarded as professional investors (paragraph 31, Article 2 of FIEL).
- Among them, corporations to be designated by cabinet office ordinances (public companies are presumed) are eligible to be treated as general investors (Article 34-2).
- Corporations corresponding with general investors are eligible to be treated as professional investors (Article 34-3).
- All individuals are basically regarded as general investors. However, individuals who meet certain criteria to be designated by cabinet office ordinance may be treated as professional investors (Article 34-4).

	(Institutional Investors)	(Individual Investors)	
Professional Investors	<ul style="list-style-type: none"> • Qualified institutional investors • Government of Japan • Bank of Japan 		 (Always treated as a professional investor)
	<ul style="list-style-type: none"> • Public companies • Corporations above a certain size 		
General Investors	<ul style="list-style-type: none"> • Corporations other than those listed above 	<ul style="list-style-type: none"> • Individuals who meet certain criteria 	 (Always treated as a general investor)
		<ul style="list-style-type: none"> • Individuals 	

b) Exceptions for Professional Investors

Sales and solicitation to professional investors are exempt from rules of conduct set for correction of the information disparity will be exempt (Article 45. On the other hand, the dealer will not be exempt from the rules of conduct set for market integrity such as the prohibition of compensation of losses, etc.).

(Reference) Reporters of special business activities

Under the FIEL, financial instruments firms are required to register for self-offering for interests in collective investment schemes and self-management of properties of collective investment schemes (refer to 2) and 3)). However, in order to promote financial innovation through the sound development of funds dealing with professional investors, registration is not required.

Instead, notification in the form of “Reporters of special business activities” is required for firms dealing with such funds (concretely funds dealing only with qualified institutional investors as well as general investors with less number of investors than the number to be designated by government ordinances). Limited rules of conduct such as the prohibition of compensation of losses, etc. (Article 63) will be applied.

7) Treatment of Deposits, Insurances, etc. with Strong Investment Characteristics

The latest legislation aims to build a cross-sectoral legal system for customer protection through the revision of other financial laws in addition to the FIEL, based on the view that the same customer protection rules should be applied to financial instruments with the same economic functions.

a) Deposits, Insurances, Trusts, etc.

- Among financial instruments, deposits are regulated by the Banking Law, insurance by the Insurance Business Law and trusts by the Trust Business Law. Therefore, they are not directly subject to regulation by FIEL, but the respective financial laws have been amended to apply the same rules of conduct as those under FIEL to “sales and solicitation” of deposits, insurances, trusts, etc. with strong investment characteristics.
- For example, the Banking Law applies the same rules of conduct in the FIEL *mutatis mutandis* to “sales and solicitation” for “contracts on specific deposits, etc.” (deposits, etc. with the risk of diminishing the principal due to fluctuations in the interest rate, exchange rate, etc. to be designated by cabinet office ordinances) concluded by banks, etc. (Article 13-4 of the revised Banking Law).

b) Real Estate Syndications

- Real estate syndications are excluded from the scope of regulations under the FIEL as they will continue to be regulated by the Real Estate Syndication Business Law, which stipulates many regulations unique to real estate (paragraph 2-5-c of Article 2 of the FIEL). On the other hand, the Real Estate Syndication Business Law has been amended to apply the same rules of conduct as those under FIEL.

c) Commodities Futures Transactions

- The FIEL explicitly states that commodities futures trades will continue to be regulated by the Commodity Exchange Law and will not be subject to the FIEL due to their aspects as a commodities market system (paragraphs 24-4 and 25-3 of Article 2 of the FIEL). On the other hand, the Commodity Exchange Law has been amended to apply the same rule of conduct as those under the FIEL.

8) Development of Other Systems for Customer Protection

a) Financial Instruments Sales Law

The Law on Sales of Financial Products (“Financial Products Sales Law”) established in 2000 sets forth special provisions on damages under the Civil Code relating to the sale of a wide range of financial instruments, including deposits, insurances and securities. The Financial Products Sales Law provides for matters to be explained by dealers to customers when selling financial instruments, and stipulates that dealers are liable for damages if they fail to provide necessary explanation upon the sale of a financial instrument, the firm will bear liability for damages, whether at fault or not, with any losses incurred on the principal being presumed to be losses to be compensated.

Principle of Claims for Damages under Civil Code		Financial Products Sales Law	
i. Malfeasance ii. Intention/ negligence	⇒ iii. Causation	Violation of duty to explain (corresponds to i.) (* No need for a customer to provide for ii. through iv.)	⇒ Presumption of loss as loss to principals
(* A customer should prove all requirements for i. through iv.)			

The latest legislation amended the Financial Products Sales Law to enhance user-protection. For example, the scope of duty to provide explanations of financial instruments firms have been enhanced (Article 3 of the revised Financial Products Sales Law), including:

- “Possibility of incurring losses beyond the original principal” was added to the matters to be explained, in addition to “possibility of loss to principal” which is designated in the SEL;
- “Important part of schemes of financial instruments” was added to the matters to be explained;
- The criteria for determining whether or not a financial instruments firm has fulfilled its duty to provide an explanation must be based on the method and depth of explanation required to suit the customer’s knowledge, experience, asset position and purpose of signing the contract, by incorporating the requirement for suitability.

b) Other (Recognized Investor Protection Association System, etc.)

In addition to the above, the FIEL has developed various systems for investor protection, including developing a system of “recognized investor protection associations” (Article 79-7 onwards) as a framework for the government to recognize private organizations that resolve complaints and mediate disputes relating to financial instruments businesses other than so-called self-regulatory organizations (SROs) and enhance the reliability of such businesses.

The next edition (Part 3) will review other provisions amended under the FIEL.

【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.

“Hot Picks from the Financial World” for this month feature an excerpt of finance-related statements made at the inaugural press conference by Mr. Yuji Yamamoto, who assumed office as Minister for Financial Services on September 26.

If you wish to find out more, we invite you to visit the “[Press Conferences](#)” section of Financial Services Agency’s website.

【Opening Statement at Inaugural Press Conference by Yuji Yamamoto, new Minister for Financial Services】

Let me first talk about the Prime Minister’s orders I have been given. In regards to financial services, one of his orders was to reform the system of moneylending businesses to curb and provide a remedy for multiple debts. He also urged me to develop and implement a framework that enables people to use financial instruments with a sense of security, including properly implementing the Financial Instruments and Exchange Law. He also instructed me to make comprehensive efforts, including making enhancements to market surveillance functions aimed at strictly enforcing market discipline, while developing an environment adapted to globalization in order to turn Tokyo into a global financial center through such means as aggressive deregulation and construction of a world-class stock exchange system.

In regards to “re-challenge” or second-chance programs, he asked me to make policy efforts to create a society that does not lock in winners and losers but offers diverse options to people in each stage of their lives. Especially in regards to supportive measures, he ordered me to consider building a flexible and diverse social framework that enables people have another go, creating diverse work styles, schooling and life styles, and working out supportive measures according to individual circumstances.

I am committed to fulfilling both of these responsibilities as hoped by the Prime Minister by making thoroughgoing efforts.

Q. In regards to the bill for the amendment of the Moneylending Control Law, what is your stance, commitment or views you previously held with respect to the industry?

A. Looking at the interest rates and the circumstances under the existing Law Concerning the Regulation of Receiving of Capital Subscription, Deposits and Interest on Deposits, the amendment makes the Law much stricter compared to the current standards. While I acknowledge that there are proposals to make it even stricter, we need to look for the optimal point where our society will have no people with multiple debts and at the same time, meet the needs of people who require credit based on trends. It is not a matter of whether it is better to be strict or lax: we need to have a highly discerning eye to look at the times, so we hope to work on finding the optimal point while listening to various people’s opinions.

Q. There have been some claims from a long time ago that Japan is overcrowded with banks. What is your view on this, especially with respect to regional banks?

- A. The specific circumstances of each region, the status of the borrower and the needs for financial services vary widely, so one cannot categorically claim that it is overcrowded with banks, or argue what would be the appropriate number or size of banks. The financial sector is merely a lubricant, corresponding to the bloodstream in the human body. Regardless of whether it is overcrowded with banks, companies can be invigorated and the economy can be boosted through the allocation of funds required to meet demand. Categorically arguing that it is overcrowded with banks might give rise to circumstances similar to the one faced by Hokkaido after the collapse of Hokkaido Takushoku Bank, so we would like to address this matter carefully.

(from [the inaugural press conference on Tuesday, September 26, 2006](#))

Q. What kind of management principles and objectives are deemed appropriate for the acquirer of Ashikaga Bank?

- A. Firstly, what matters the most is to make it function as a bank and as a financial institution, so it is important that the acquirer has a management team with appropriate management principles, in addition to capital enhancement.

Furthermore, as Ashikaga Bank is a regional bank in charge of Tochigi Prefecture's economy, the acquirer should truly care about the regional economy and be willing to share its fate with the regional economy, rather than just pursuing the logic of capitalism.

(from [the press conference following a cabinet meeting on Friday, September 1, 2006](#))

Q. the working group is deemed to play a central role in taking up the requests of the locals in the future, but how exactly is it going to be done? Secondly, there are some concerns among locals about members of the working group not necessarily being knowledgeable of Tochigi Prefecture's economy. What are your thoughts on this?

- A. The working group will, as a matter of course, look into specific information, including the selection process. As this includes proposals made by private businesses, the deliberation and screening processes should be limited to members of the working group as a general rule.

However, we will of course conduct interviews as well, so we intend to carefully listen to the opinions of the governor of Tochigi Prefecture, the local business community, the council and other interested parties.

(from [the press conference following a cabinet meeting on Friday, September 1, 2006](#))

Q. What is your view on the impact of the problems raised by Mr. Gotoda you just mentioned on the current issue concerning the revision of moneylending business regulations?

- A. The FSA's draft bill must accurately reflect the opinions of the Round Table Conference on Money-lending Business established under Director-General Mr. Mikuniya. Strenuous efforts were also made to prepare a draft that accurately reflects the approaches taken by LDP's Research Commission on the Finance and Banking Systems and the New Komeito. As a matter of course, we held meetings with key members of the ruling parties in the process and consequently produced a draft in accordance with the suggestions of both parties. With respect to sensitive areas, we made proposals with footnotes stating "this is an idea". The fact that this has become a subject of debate should be welcomed.

(from [the press conference following a cabinet meeting on Friday, September 8, 2006](#))

Q. Upon his resignation, Mr. Gotoda repeatedly stated that the latest draft was compiled while ignoring your opposition to the preferential measures. What is your opinion on this?

A. I have talked about the preferential measures probably twice at an open forum. I stated at the Round Table Conference that it would be a problem if an exception became a non-exception, that is, if a clause for an exception is created to survive permanently. It is no good to make a permanent system instead of a provisional, interim preferential measure. At the Round Table Conference, I indicated that it must purely be provisional.

In addition, I stated at a press conference here that if the system is to be changed, measures to alleviate radical change must be taken and interested parties must be allowed to make a “soft landing”, so the FSA’s draft is in agreement with what I have in mind.

(from [the press conference following a cabinet meeting on Friday, September 8, 2006](#))

Q. There are criticisms against the FSA that the preferential measures set forth in the FSA’s draft might be aimed at protecting moneylenders. What is your view on this?

A. The FSA presented the best draft it could in accordance with the LDP’s report and the Round Table Conference’s interim report. What we have presented was an idea, so it is the LDP’s job to determine what to do with it.

(from [the press conference following a cabinet meeting on Tuesday, September 12, 2006](#))

Q. What are your thoughts on nighttime stock trading?

A. Nighttime trading of stocks will undoubtedly be convenient for investors. Especially for individuals engaged in work during the day who want to carry out investment activities at night, I can imagine that it would be extremely convenient for them to be liberated from the existing time constraints. On the other hand, the market and the trading volume in nighttime trading is extremely small compared to the likes of Tokyo Stock Exchange (TSE) and Osaka Securities Exchange (OSE), so it is necessary to carefully monitor whether prices are formed in a fair manner at all times. Due to the small market size, acts in violation of the Securities and Exchange Law are more likely to occur, such as insider trading and market manipulation. Market operators and the FSA must pay considerable attention to this.

(from [the press conference following a cabinet meeting on Friday, September 15, 2006](#))

Q. What are your views on the FSA’s role in imposing financial sanctions against North Korea?

A. The FSA has two roles: the first is customer identification. This is partly to prevent other people’s names or fake names from being used in transactions in order to fight terrorist financing, but first and foremost, banks are responsible to confirm the identity of the person for bank transactions, tax affairs and other such matters.

The latest measure requires that the ID of customers be properly checked in such cases involving remittance. If the ID of the holder of a bank account has been checked in advance, customer identification is not needed for the remittance of funds withdrawn from such a bank account because it has already been done. Nonetheless, the FSA is urging financial institutions to properly check the ID of customers. This is one of FSA’s roles.

In addition, the Organized Crime Punishment Law stipulates that if a bank acknowledges suspicious transactions, the bank must confirm certain facts and file a report on such transactions. The FSA’s other big job, which relates to proceeds of crime, is to request financial institutions to closely monitor such suspicious transactions.

(from [the press conference following a cabinet meeting on Tuesday, September 19, 2006](#))