

Basic Policy for Financial Inspections in Program Year 2012

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

As part of these efforts, the FSA specified basic concepts for financial inspection in the “Basic Guidelines for Financial Inspection” and develops, at the beginning of every program year, a “Basic Policy for Financial Inspections,” which explains the basic policy for the conduct of inspections and the focus of examinations for the year.

It should be noted that this basic policy for financial inspections was drawn up in light of the circumstances that surrounded financial institutions as of August 2012, and may be subject to review as necessary.

I. Foreword

The Japanese economy, although still in a severe condition, is slowly recovering on the back of post-earthquake reconstruction demand and other factors. However, as the uncertainty about the European debt crisis remains high, signs of slowdown in the global economy have been spreading, which represents a downside risk for the Japanese economy. In addition, close attention should be paid to the constraints in electric power supply and the impact of deflation, etc.

In such circumstances, financial institutions are expected to proactively contribute to achieving self-sustained growth. They are also expected to function as a backup supporter of businesses and to lead the economy by acting as a growth industry. In addition, as the population is aging and demand for financial asset management is growing, financial institutions are expected to provide good-quality financial products and services that suit customers’ needs. As well, financial institutions are expected to proactively develop their procedures and arrangements and take other measures while focusing on their future business models in response to the progress in revisions of international financial regulations.

In view of such situations, the basic objectives of financial inspections in the current program year should continue to be (i) to examine whether financial institutions have developed procedures and arrangements to play a role in smooth and appropriate financing to

borrowers and to provide good-quality financial products and services to users, and (ii) to examine whether financial institutions have developed both a sound financial base and a robust and comprehensive risk management system to play such a role.

II. Basic Policy for the Conduct of Inspections

When conducting inspection activities, it is becoming even more important for the FSA to strengthen its capability to understand the actual status, anticipate problems while enhancing its sensitivity to risk, and share the recognition of the problems with financial institutions through in-depth dialogue taking into account their voluntary initiatives, so that financial institutions can voluntarily improve management. Therefore, the FSA will continue to place the Better Regulation initiative as a guideline on financial administration and continue to proceed with its implementation.

To be specific, the FSA will conduct more in-depth inspections through dialogue with financial institutions, based on the following five principles mentioned in the preamble of the Inspection Manual: (i) examination focusing on important risks, (ii) in-depth analysis and clarification of causes of problems necessary for fundamental improvement, (iii) identification of problems, evaluation of appropriate improvement efforts, and examination of static and dynamic aspects, (iv) explanation of the basis for problems pointed out and ratings, and clarification of items to be considered for improvement, and (v) full understanding of examination results. The FSA will also undertake the following measures from the perspective of further developing the Better Regulation Initiative, etc.

1. Improvement in Quality of Inspection and Enhancement of Information Delivery Capability, etc.

(1) Improvement in Quality of Inspection

Amidst more diverse and complex risks faced by financial institutions in recent years and the resulting increase in the sophistication of risk management approaches taken by them, the FSA is required to further enhance its examination ability. In such circumstances, it is necessary to improve the quality of financial inspection by strengthening the ability to understand the actual status and further enhancing sensitivity to risk, by improving examination techniques, etc.

Therefore, in the current inspection program year, the FSA will actively implement initiatives including the following:

- (i) Further enhance and strengthen the content of analysis and examination by utilizing the knowledge obtained through research and studies on advanced financial engineering and exchanging opinions with domestic and foreign financial institutions.
- (ii) Strive to incorporate advanced inspection methods through close cooperation with overseas inspection authorities.

- (iii) Extend the scope of inspection and improve the efficiency of examining procedures by actively and effectively utilizing newly introduced information analysis tools, etc.
- (iv) Strengthen information analysis and management, and enhance sensitivity to the risks inherent in individual information, as well as further promote the effective utilization of information provided to the FSA.
- (v) Enhance and strengthen human resources for specialized examination by hiring external specialists and fostering human resources who have advanced expertise.
- (vi) Regarding the inspection of insurance companies, further enhance and strengthen the content of analysis and examination, particularly of the risk management system, based on the revised Insurance Inspection Manual.

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

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

To this end, the FSA will work toward further enhancing its examination system in order to capture the latent risks for financial institutions and financial systems at an early stage, by implementing effective integration of on-site and off-site monitoring, while it optimally allocates roles between the Inspection Bureau and the Supervisory Bureau in accordance with the characteristics of both on-site and off-site monitoring through further promoting dual duties for staff and sharing the results of monitoring between those two bureaus.

Specifically,

- Regarding risks threatening financial institutions' financial soundness, the FSA will further integration of the Inspection Bureau's on-site data collection and analysis functions with the Supervisory Bureau's off-site monitoring data collection and analysis functions.
- Regarding IT system risks, the FSA will continue further enhancement of the integration of on-site and off-site monitoring mainly by the cross-organizational unit between the Inspection Bureau and the Supervisory Bureau (in which the Inspection Bureau's IT system specialists are simultaneously assigned to posts for IT system monitoring in the Supervisory Bureau) launched in the previous program year.

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

Especially regarding IT system risks, the FSA is implementing effective on-site and

off-site monitoring. For example, the inspection division is sharing the information regarding IT system modification and failure events held by supervisory divisions. Also, cooperation between IT system specialists of the FSA Inspection Bureau, and Local Financial Bureaus' inspection and supervisory divisions is being strengthened.

(3) Enhancement of Information Delivery Capability

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

2. Enhancement of the Coordination with Related Institutions

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

3. Enhancement of the Coordination with Auditors, Auditing Committee Members, and External Auditors

Audits of directors' execution of duties, etc., conducted by auditors and audit committee members play an important role to ensure effective governance at the financial institutions. In addition, the role of external audits, which is to examine the effectiveness of internal control systems of financial institutions, is further increasing in its importance as a result of the introduction of internal control audit systems, etc.

In view of these circumstances, the FSA will enhance the opportunities for exchange of opinions with auditors, auditing committee members of financial institutions and external auditors.

4. Reduction of the Workload on Financial Institutions

Regarding the workload on financial institutions, while considering the situation of implementation of financial inspections and opinions from industry groups, the FSA developed a policy for reducing the amount of materials to be submitted in advance, and is steadily implementing the policy. In addition, the FSA also seeks to reduce the burden related to the on-site inspections by, for example, refraining from holding hearings from departments responsible for the general meeting of shareholders and settlement of accounts, on the day of the general meeting of shareholders and during the fiscal year-end period.

In the current program year, the FSA continues to work on the steady execution of the

policy and other measures, to reduce the workload imposed on financial institutions by financial inspections.

5. Response for Earthquake Recovery and Conservation of Electricity

(1) Response for Earthquake Recovery

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

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

In the current program year, the FSA will focus on examining whether or not procedures and arrangements are developed to:

- provide conscientious responses to consultations and requests for loan condition changes from debtors, corresponding to the actual conditions of debtors.
- enable appropriate responses to consultations and requests regarding overlapping debt problems, based on the “the Individual Debtor Guidelines for Out-of-Court Workouts.”
- quickly and actively implement measures for early business revitalization of disaster-stricken companies, including accurately grasping the actual business conditions of such companies, and encourage such companies to consult with the industrial reconstruction organizations and the Rehabilitation Support Organization for Companies Damaged by the Great East Japan Earthquake regarding the utilization of their support programs and simultaneously urging those organizations to initiate the consultation process with disaster-stricken companies.

(2) Conservation of Electricity

When carrying out a financial inspection of a financial institution which is conserving electricity, the FSA will take into account the electricity conservation action plan submitted to the supervisory department and consider reducing burdens on the financial institution in the operation of financial inspections.

III. Priority Inspection Items

1. Development of Governance System

(1) Appropriate Governance

It is important for the management to take responsibility for developing an appropriate governance system, in order to exercise the financial intermediary function,

thorough legal compliance and protection of customers, and accurate management of various risks. Therefore, when conducting financial inspections, the FSA will focus on examining the following points not only through open dialogues with the management, but also through examinations of some branches and an exchange of opinions with external auditors, etc., as necessary.

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

(2) Group Governance and Risk Management of Financial Holding Companies, etc.

In recent years, more and more financial groups such as banks and insurance companies operate under a financial holding company structure.

In such circumstances, the FSA will focus on examining the following points, in consideration of the size and characteristics of the financial group, the role expected of the financial holding company within the group, and other factors:

- Whether group governance functions are exercised sufficiently on subsidiaries of the financial holding company, and whether a comprehensive risk management system is developed to accurately assess overall risks.
- In cases of groups that include companies in other types of business whose business models and corporate culture are different, whether a system is developed to ensure

the financial soundness and operational appropriateness of the financial institutions in that group.

- In cases of groups that have different types of risk profile from those associated with general commercial banking business, such as businesses of a securities subsidiary that are exposed to complicated derivative transactions, etc., whether an effective risk management system covering all businesses in the group is developed to ensure there is no unanticipated and hidden risk (unidentified risk) that may be associated with current financial conditions

In addition, the FSA will focus on examining the following points, taking into account the fact that many large financial groups are aggressively expanding their operations by, for example, extending their network of branches in Asia and other regions of the world, and considering the size and characteristics of the financial group's overseas operations and other factors:

- Whether a governance system is developed to ensure global governance, such as the management and supervision of foreign establishments by Japan headquarters and the strengthening of partnership between Japan headquarters and all regional headquarters.
- Whether a global risk management system for the entire group is developed, in which risks are shared among Japan headquarters and all regional headquarters and managed in accordance with a unified policy.
- Whether a system is developed to foster and secure human resources needed to implement an effective global governance and risk management and to develop a system infrastructure for the entire group.

(3) Business Continuity Management

Financial institutions have been facing more diverse and complex risks in recent years, as shown by the occurrence—often unprecedented—of large-scale natural disasters, IT system failures, and other such events. In view of this, and in terms of management issues, it is becoming important to review previous risk scenarios and prepare effective risk management systems in normal times for crisis response, including securing the safety of customer data, settlement, payment of funds, etc. to meet customer needs.

Therefore, the FSA will focus on examining whether the management has responsibly:

- developed business continuity management that assumes major risks, so that it can ensure continued minimum operations as a financial institution when a crisis occurs, especially an emergency response system that enables quick collection of accurate information regarding damages caused by natural disasters and system failures, etc.

- in light of the recently experienced large-scale natural disasters, IT system failures, etc., verified whether the previous crisis management manual and business continuity plan have functioned effectively, and appropriately revised the business continuity management as needed.

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

2. Further Promotion to Facilitate Financing

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

The expiration of the Act concerning Temporary Measures to Facilitate Financing for SMEs, etc., was extended by one year for the last time, to March 31, 2013. The current period is an extremely important phase for implementing support that truly improves the management of SMEs, namely an “exit strategy.” Given such a situation, a “policy package for management support for small and medium-size enterprises” was developed in April 2012 in order to pursue the “exit strategy.”

In the current inspection program year, the FSA will focus on examining the following initiatives taking into consideration the said policy package, etc.

In addition, as the expiration of the Act concerning Temporary Measures to Facilitate Financing for SMEs is approaching, consideration will be given to ensure that financial inspections of loans to SMEs will not be overly strict.

(1) Loans to SMEs

- (i) Initiatives in light of the last extension of the Act concerning Temporary Measures to Facilitate Financing for SMEs

While the exit strategy for the Act concerning Temporary Measures to Facilitate Financing for SMEs is being implemented, financial institutions are expected more than ever to provide the best possible support for the management improvement and business reconstruction of SMEs.

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

- to appropriately focus on the possibility of management improvement and business reconstruction, etc., and provide the best possible support for SMEs, while demonstrating an appropriate consulting function.
- to give support for SMEs that have not yet created a business improvement plan, in order to help create rational and highly feasible plans, bearing in mind the state

of those SMEs.

- to actively provide support for achieving the goals of business improvement plans and periodically grasp the status of progress on a continuing basis.
- to assist the management improvement and business reconstruction, etc., of SMEs, in a smooth and appropriate partnership with external experts, SME-related organizations, credit guarantee associations, and other financial institutions, as well as with the Enterprise Turnaround Initiative Corporation and the Small and Medium Size Business Rehabilitation Support Co-operative, etc.
- to meet customers' needs by actively utilizing a wide range of financial methods, such as capital type borrowings and ABL (Asset Based Lending).

(ii) Initiatives reflecting actual business conditions of SMEs

Financial institutions are expected to appropriately demonstrate consulting and financial intermediary functions in view of the actual business conditions SMEs based on appropriate risk management.

Therefore, while considering the size and characteristics of financial institutions, the FSA will focus on examining whether they have developed procedures and arrangements for:

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

The FSA will also focus on examining whether financial institutions have

established financial practices, which in principle do not seek individual co-surety by third parties other than business managers. When financial institutions exercise a debt guarantee, the FSA will focus on examining whether they have developed procedures and arrangements for conscientious responses, such as allocating burdens in a rational method according to the repayment capacity of each debt guarantor with due attention given to the guarantors' actual living situations.

If excellent initiatives and innovative ideas are recognized in management consultation and management guidance as well as management improvement and business reconstruction, the FSA will evaluate them positively in financial inspections, clearly reflect the results in financial inspection ratings, etc., and make them widely known by describing them in Collection of Reference Cases.

(2) Housing Loans

- The FSA will also focus on examining whether financial institutions have developed procedures and arrangements for proper response in screening and proper customer explanations when their customers request new loans (including funding after making changes to loan conditions).
- When there is a debtor's consultation or request for changes in loan conditions, the FSA will focus on examining whether financial institutions respond appropriately with sufficient consideration given to that debtor's economic status.
- In the case of housing loans insured by guarantee companies within the same financial group (including the cases in which the guarantee company, etc., obtained housing loans through subrogation), the FSA will focus on examining whether financial institutions are giving guidance to, having dialogues with, and making requests of such companies as efforts to properly deal with the facilitation of financing.

3. Development of a Legal Compliance System

The maintenance and construction of a strong legal compliance system helps a financial institution gain the confidence of its customers, and is essential for providing smooth financial functions. Violations of laws and regulations by financial institutions could lead to loss of trust from society and cause significant damage to the management of such financial institutions.

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

- (1) Response to Anti-Social Forces, and Promotion of Measures on Anti-Money Laundering, and Combating the Financing of Terrorism (AML/CFT)

Initiatives to eliminate organized crime groups have been enhanced and strengthened at the national and local government levels, including the enforcement of the Organized Crime Exclusion Ordinance in October 2011 in all prefectures, and the revision to the Act on Prevention of Unjust Acts by Organized Crime Groups in July 2012. In such circumstances, a resolute stance of rejecting and eliminating relations with anti-social forces is necessary for financial institutions to maintain people's trust and to ensure the appropriateness and soundness of their business.

Therefore, the FSA will cooperate closely with related institutions, and focus on examining their development of procedures and arrangements in consideration of the conditions of individual operating areas:

- to prevent transactions with anti-social forces, such as by collecting and analyzing information on anti-social forces.
- to effectively reject relations with anti-social forces in light of the characteristics of financial services (for example, prior screening before entering into business relations, monitoring after entering into business relations, and procedures related to the termination of business relations).

In addition, international discussions are underway at the Financial Action Task Force (FATF) to strengthen countermeasures to money laundering and terrorism financing; for example, the revised FATF Recommendations were published in February 2012. In such circumstances, it is becoming more important for financial institutions to avoid being used for the purpose of money laundering and/or being used to provide funds to terrorists, etc.

Therefore, the FSA will focus on examining whether financial institutions have developed procedures and arrangements:

- to appropriately handle personal identification and suspicious transactions.
- to respond to the revised Act on Prevention of Transfer of Criminal Proceeds to be enacted in April 2013.

Furthermore, the FSA will also focus on examining whether financial institutions have developed a cross-departmental system and an information sharing system:

- to deal with anti-social forces and to implement preventive measures against money laundering and terrorism financing in an organized manner.

(2) Actions to Prevent Unfair Transactions in Financial Markets

Recently, in financial markets, unfair transactions have been revealed one after another. In Japan, some officers and employees of financial institutions have conducted unfair trade practices to benefit themselves and third parties, taking advantage of insider information, etc. Internationally, people are casting a critical eye on the case of the manipulation of LIBOR, one of the most important benchmarks in financial

markets. These unfair transactions and other illegal activities are serious problems that could damage the public trust in financial institutions and cause harm to the transparency and fairness of markets.

Therefore, in the current program year, the FSA will focus on examining whether financial institutions have, for the prevention of unfair transactions, developed:

- internal control and compliance systems to ensure appropriate information management and operations.
- necessary and sufficient procedures and arrangements for the management and screening of sales and purchase transactions, particularly of securities, etc.

(3) Actions to Prevent Inappropriate New Business

Regarding financial institutions' new business, the FSA will focus on examining whether they have, for the prevention of inappropriate transactions, developed procedures, and arrangements:

- for prior investigation of the legality of new businesses and transactions with a complex scheme.

(4) Legal Risk Management of Wholesale Businesses

In recent years, financial institutions' wholesale businesses (e.g. targeting corporate customers), in which banking, securities, trust, and other services are offered in collaboration, are growing. In wholesale businesses, the transaction amount per trade is large compared with retail businesses, and in many cases, non-routine and complex products and services are arranged to meet the needs of individual customers. This makes the legal risk management extremely important.

Therefore, in the current program year, the FSA will focus on examining the following points, particularly for the wholesale businesses:

- whether financial institutions have developed procedures and arrangements to appropriately perform legal checks, etc., as necessary before executing any transactions with customers.
- whether financial institutions have developed internal control and compliance systems for the management of sensitive corporate information obtained through wholesale businesses.

4. Protection of Customers and Improvement of Users' Convenience

The enhancement of customer protection and user convenience by financial institutions contributes not only to the sound development of the national economy but is also important for the stability of the financial system by increasing the trust of the people in them. It is important that financial institutions enhance their competitiveness, for example

by providing financial products and services using innovative ideas based on the principle of ensuring a sense of security and trust through the implementation of measures to thoroughly protect customers. Especially for customer protection, they are expected to go beyond simply complying with laws and regulations, by checking the level sought by customers, and meeting those expectations as trusted financial institutions with very public aspects.

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

(1) Protection of Customers

(i) Thorough management of information on customers

Customer information forms a base for financial transactions, and in light of personal information protection, it is necessary to strictly manage such information.

Therefore, the FSA will focus on examining:

- whether financial institutions have developed internal control and compliance systems for the management of information on customers

(ii) Ensuring appropriate and safe financial transactions

Ensuring appropriate and safe financial transactions is essential for the protection of customers.

Therefore, the FSA will focus on examining whether financial institutions have developed procedures and arrangements:

- necessary for the prevention of financial damage that may be caused by illegal uses of deposit accounts, including “Furikome” billing fraud.
- to create internal rules for proper handling of the procedures stipulated in the Furikome Fraud Relief Act.
- to provide needed information and take other actions for people who could be victimized by financial crime using forged or stolen cash cards and crime related to Internet banking.
- to enhance information security measures, including measures to protect information used for identity verification, in order to prevent damage from financial crime as described above.

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

In order to gain the trust of customers and reflect their needs in business operations, it is very important for financial institutions to proactively make quick

responses to consultation requests and complaints from customers.

From this viewpoint, the FSA will focus on examining whether financial institutions are meeting customers' consultation requests and responding to their complaints properly; to be more specific, whether financial institutions analyze the causes of such complaints, actively adopt appropriate measures to prevent recurrences, raise institution-wide awareness about the measures, and follow up on their implementation.

In addition, as for the financial ADR system (alternative dispute resolution system for the financial sector), in light of factors such as the application of conduct regulations on each financial institution and an increase in the number of those that use the financial ADR system, the FSA will focus on examining whether financial institutions have developed procedures and arrangements for:

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

(iv) Appropriate explanations to customers

With the increasing complexity and diversity of financial products and services, users expect and demand higher standards from financial institutions. Especially when financial institutions sell products with higher risk and insurance products, they need to provide accurate explanations concerning the characteristics of the products and where risks reside while taking customers' actual needs into consideration.

Therefore, the FSA will focus on examining substantially whether financial institutions act appropriately in dealing with customers while sufficiently considering each customer's knowledge, experience, and understanding of risk, etc., in accordance with the purpose of relevant laws and regulations.

In addition, the FSA will pay adequate attention to whether financial institutions are not imposing an excessive workload on customers in terms of time and procedures.

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

confirming:

- that procedures and arrangements are developed for monitoring compliance with the regulation of unsolicited offers, and appropriateness of solicitations for switching among investment trusts.
- that procedures and arrangements are developed and well-functioned for explanations and after-sale follow-up, based on the suitability principle and customers' investment aims, etc.

In addition, in recent years, in light of the situation where troubles associated with the solicitation of certain insurance products by banks are increasing, including insufficient explanation of product risks, etc., to elderly people, the FSA will also focus on examining whether financial institutions:

- have appropriately functioning measures to prevent confusion regarding deposits and bad practices, such as abuse of superior position.
- have appropriately functioning measures to prevent such bad practices as the use of non-public financial information in the insurance solicitation without obtaining the customer's agreement

(2) Increasing Convenience for Users

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

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

5. Development of Risk Management System

(1) Enterprise Risk Management

As transactions between financial institutions are becoming more and more advanced and complex due to the evolution of financial engineering, financial institutions are expected to develop risk management systems to reliably identify and manage risks that do not fit any conventional risk category. In addition, in the prolonged European debt crisis and the growing downside risk for the global economy, they need to develop enterprise risk management systems while understanding that risks will amplify and spread in a chain reaction as a result of stress events in the financial and capital markets, etc.

Therefore, the FSA will focus on examining whether financial institutions:

- have developed enterprise risk management systems which suit their size, characteristics, and risk profile
- have developed procedures and arrangements to comprehensively manage diverse risks, understanding that risk measurement methods have limitations and weaknesses caused by underlying assumptions, models and calculation methods, etc.
- have developed procedures and arrangements to, on an as-needed basis, analyze the appropriateness of the enterprise risk management methods, and to review such methods and their underlying assumptions through ongoing verification (backtesting, etc.).
- have conducted stress tests under severe scenarios (for example, simultaneous shocks of multiple phenomena, such as a sharp rise in interest rates, stronger yen, and lower stock prices), assessing how the harshest but plausible market environmental changes could impact economies and financial and capital markets, and could lead to influence their own business directly and indirectly. The FSA will also examine whether stress tests are conducted to test all relevant exposure, and whether or not the financial institutions are overly dependent on a single model or estimation method.
- report the results of stress tests, etc., and analysis to the management and use them in their business.

(2) Management of Credit Risk

(i) Loans to corporations

The FSA will focus on examining whether financial institutions have developed procedures and arrangements for:

- appropriate screening and credit management based on a sufficient understanding of the actual status of borrowers, for syndicated loans and credit to overseas, and for large borrowers which could have large effects on the financial institutions' business.
- appropriate management of risks of credit concentration in specific company groups and industries, etc.
- practical early warning for debtors to review credit ratings based on risk information in a timely and appropriate manner; and whether financial institutions are making efforts to develop procedures and arrangements to check the status of external audit of borrowers, including whether or not unlisted companies have external auditors or external auditors have changed during the period, as they strive to understand the actual status of borrowers.

(ii) Housing loans

In a prolonged low interest rate environment in Japan, the competition for housing loans among financial institutions is intensifying, making the housing loan interest rates even lower. As a result, financial institutions are expected to implement thorough risk management.

Therefore, the FSA will, while considering financial institutions' sizes and characteristics, focus on examining whether financial institutions have developed procedures and arrangements not only to monitor overdue status, etc., but also to manage the interest rate risks, the prepayment risks and the special characteristics of seasoning effect, etc.

(3) Market Risk Management

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

- effectively manage risk and loss limits
- comprehensively consider risks in the management of financial instruments, bonds, and stocks, etc., which contain diverse risks
- accurately understand interest rate risks in which market movements affect assets and liabilities held, and risks of not being able to easily sell held assets in the markets due to the drying-up of liquidity in the markets

(4) Liquidity Risk Management

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

Therefore, in the current inspection program year, for Japan's financial institutions which have overseas locations and foreign banks which have locations in Japan, the FSA will, while considering their sizes and characteristics, continue to focus on examining:

- whether they have developed procedures and arrangements to appropriately manage liquidity risk on a global basis

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

(5) Information Technology System Risk Management

IT systems of financial institutions are at the core of settlement systems, and have

very public aspects as social infrastructure. If a failure occurred, this would not only inconvenience users, but it would also have significant impacts on society, and could result in losing credibility for the financial institution.

Therefore, in the current program year, the FSA will fundamentally strengthen the workforce for examining the IT system risk management procedures and arrangements, and conduct examinations as appropriately as possible.

(i) Examinations based on the results of comprehensive self-inspections of IT system risks

Regarding the IT system risk management procedures and arrangements, comprehensive self-inspections of IT system risks were conducted mainly by the FSA Supervisory Bureau in 2011; and in June 2012, based on the results of the said inspections, the FSA revised the Financial Inspection Manual, in which focus points in the inspection are listed regarding the appropriate development of IT system risk management procedures and arrangements.

In the current program year, the FSA will focus on examining the following, based on such said focus points,

- whether the management prioritizes IT system risk management, including the prevention of IT system failures and quick response to system failures.
- whether there are clear responsibilities that management must fulfill and actions it must take when an IT system failure occurs.
- whether risks regarding the capacity of IT systems are identified and assessed, and the sufficiency of IT system capacity is secured, while considering changes in the external environment.
- whether risks inherent in IT systems are detected on an ongoing basis, and investments to maintain and improve the systems are made in a planned manner.
- whether procedures and arrangements are developed to take necessary actions in response to IT system failures, assuming the worst scenario.
- whether, regarding the contingency plans, reviews of the assumed scenarios are conducted as necessary, and training is conducted regularly to ensure the effectiveness of the plans.
- whether private electric generators, back-up centers, etc., are appropriately checked and examined as necessary.

(ii) Response to the expansion of operations and updating or integrating of IT systems

Financial institutions are expected to appropriately manage IT system risks in such events as the expansion of operations and updating or integrating of IT systems.

Therefore, the FSA will focus on examining whether financial institutions have developed procedures and arrangements:

- to manage IT system risks in response to the expansion of operations, including the growth of overseas operations in line with the progress in global business
- to accurately identify the risks that may arise when updating or integrating IT systems, and appropriately manage such projects

(iii) Management of IT system outsourcing

The use of outsourcing and cloud service and the sharing of IT systems are spreading and growing in financial institutions.

In such circumstances, the FSA will focus on examining whether:

- financial institutions have developed procedures and arrangements to appropriately understand and manage the details of the outsourced functions, potential risks associated with such outsourced functions, the structure of systems used by the outsourced contractors, and response actions to take in the event of system failures, including an allocation of IT systems experts.
- roles and responsibilities are clearly allocated between the financial institutions and the outsourced contractors, etc., regarding the system development, operation, and management; whether cooperation and reporting procedures and arrangements are developed between them; and whether contingency plans are developed.
- financial institutions are appropriately checking whether the outsourced contractors, etc., have procedures and arrangements in place to appropriately perform the outsourced functions.
- financial institutions are monitoring, regularly or on an as-needed basis, to see whether the outsourced contractors, etc., are appropriately performing the outsourced functions.

(6) Risk Management Associated with Trust Business

(i) Management associated with trust business

The framework for legal compliance and risk management of trust business is very different from that of banking business. Moreover, risk characteristics vary depending on the type of trust business, such as pension trust, money trust, and real-estate trust.

In such an environment, in carrying out trust business, a financial institution is expected to fulfill the duty of due care of a prudent manager in accordance with the characteristics of each trust business type, and to develop procedures and arrangements to appropriately manage risks associated with trust business. On the other hand, in reality, cases are often found where such procedures and arrangements are not necessarily fully in place.

In view of these conditions, in the current inspection program year, the FSA will

focus on examining:

- whether systems for legal compliance, protection of customers, and operational risk management have been developed according to the characteristics of each trust business type.
- whether risk-based internal audits are conducted according to the characteristics of each trust business type.
- whether appropriate and effective procedures and arrangements are developed to allow the management and risk management departments to control the trust business.

Particularly, after problem cases were revealed in the previous inspection program year, various issues have been raised regarding the roles that should be played by trust banks, which manage assets entrusted by pension funds, etc.

In light of this, regarding the management of assets entrusted such as by pension funds, the FSA will focus on examining whether procedures and arrangements are developed:

- to ensure the fulfillment of due care of prudent manager and duty of loyalty, including the compliance with the trust contracts concluded with their customers, and with the guidelines for the management of trust property, and to appropriately manage trust property.
- when accepting trust property, to properly understand the attributes of the settlors/customers (knowledge, experience, status of property, etc.), and to provide appropriate explanations based on such attributes; and after the acceptance of trust property, to provide appropriate explanations about the administration method of the trust property, management performance, etc.

(ii) Management associated with outsourcing of trust business

In the trust business, there are many cases where many functions, including those at the core are outsourced.

In light of such circumstances, the FSA will focus on examining whether:

- financial institutions have developed procedures and arrangements to, when outsourcing functions, appropriately assess and manage risks, including operational risk associated with outsourcing, taking into consideration the characteristics, importance, etc., of the relevant functions.
- financial institutions are appropriately checking whether the outsourced contractors have procedures and arrangements in place to appropriately perform the outsourced functions.
- financial institutions have developed procedures and arrangements to monitor, regularly or on an as-needed basis, whether the outsourced contractors are

appropriately performing the outsourced functions.

(7) Risk Management Associated with Insurance Business

Risks surrounding the insurance business are becoming more diverse and complex, influenced by such factors as the changes in the global economy, including the European debt crisis, and the occurrence of large-scale natural disasters in and outside Japan, so higher levels of risk management are required.

In such circumstances, based on the Insurance Inspection Manual revised in February 2011, the FSA will, while considering insurance companies' sizes and characteristics, focus on examining whether they:

- make progress in developing and establishing enterprise risk management systems together with business strategy.
- conduct stress tests in light of changes in the global financial and capital markets and the occurrence of large-scale natural disasters in and outside Japan, and whether the results are used in business decisions.
- develop procedures and arrangements for comprehensive asset liability management (ALM) corresponding to liability characteristics, under the solid leadership and commitment of the management.
- develop procedures and arrangements to manage insurance underwriting risks, such as aggregated risk including at foreign establishments, as Japan and other countries are experiencing large-scale natural disasters; and regarding reinsurance, develop procedures and arrangements to examine the effectiveness of such transactions and to manage companies to which the reinsurance is ceded.
- develop procedures and arrangements to manage risks associated with asset management operations, and whether or not there are operational problems from the perspective of securing financial soundness, such as a case where the investment ratio in risk assets is raised without developing appropriate risk management procedures and arrangements.

IV. Basic Framework for Inspections

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

1. Major Banks

(1) Targeted Inspections

While the FSA inspects major banks basically through targeted inspections that narrow down the areas examined, in the areas in which risks are increasing across the

banks, particularly credit extension to overseas borrowers, the FSA will conduct theme-specific horizontal inspections as necessary.

(2) Strengthening of EiC Functions

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

The EiC and the assistants to the EiC, who have simultaneous posts in the Supervisory Bureau, participate in various hearings, etc., organized by the Supervisory Bureau. They thereby stay familiar with the situation of the entire financial group they are in charge of, and strive to identify and understand any risks arising in the financial group as quickly as possible.

2. Regional Financial Institutions

The FSA will conduct more thorough prior analyses than in the past, narrow down the examination areas, and actively perform targeted inspections and simple inspections, and thereby perform more focused financial inspections based on financial institutions' sizes, characteristics, etc.

For those financial institutions aiming to expand their overseas operations, the FSA will examine the development status of procedures and arrangements to manage businesses at their overseas establishments.

In addition, for financial groups operations that extend to more than one Local Finance Bureau's district, the FSA will strengthen partnership between the Local Finance Bureaus to ensure more effective inspections.

3. Newcoming Banks

The FSA will examine, at an appropriate time after the start of operations, the status of development of legal compliance procedures and arrangements, as well as various risk management procedures and arrangements to suit the planned new business model when entering a new business.

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

4. Financial Institutions which Also Engage in Trust Business and Trust Banks

In full consideration of recent problem cases concerning trust business and changes in business environment, and based on the Inspection Manual for Trust and Banking

Companies, the FSA will examine the status of development of systems for legal compliance, protection of customers, and operational risk management, as well as the development status of procedures and arrangements for management of outsourcing contractors.

5. Insurance Companies, etc.

In recent years, there have been many cases where insurance companies actively undergo mergers and expand their overseas operations. In February 2011, the FSA completely revised the Insurance Inspection Manual in order to strengthen the examination of procedures and arrangements for enterprise risk management.

In light of these situations, having enhanced and strengthened its inspection system, the FSA will focus on shortening the inspection cycle and will continue to conduct examinations based on the revised Insurance Inspection Manual in the current program year. Also, it will actively use prior analyses to narrow down the examination areas, and conduct more focused financial inspections according to the insurance companies' size and characteristics, etc., through the active use of targeted inspections and simple inspections. Moreover, the FSA will focus on the establishment of the Insurance Inspection Rating System, the trial application of which started in April 2012.

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

6. Large Financial Groups

(1) Inspections of Financial Conglomerates

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

(2) Response to Global Business Expansion

The FSA will conduct inspections of the foreign establishments of Japanese financial groups and Japanese establishments of foreign financial institutions with due attention given to the situation of global finance, in coordination with foreign authorities.

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

In view of the fact that financial institutions engaged in a variety of large-scale international activities are required by the Financial Stability Board (FSB), etc., to enhance their data collection ability so as to ensure the swift and appropriate obtaining

of risk information, the FSA will examine the status of progress in the development of procedures and arrangements for the improvement of data collection ability on a financial-group basis.

7. Foreign Banks and Foreign Insurance Companies

The FSA will perform analyses in advance in order to narrow down the examination areas, and conduct more focused financial inspections according to the financial institutions' size and characteristics, etc., through the active use of targeted inspections and simple inspections.

Also, in order to gain an in-depth understanding of the status of governance and legal compliance, etc., at Japanese establishments of foreign banks and insurance companies (including subsidiaries established in Japan) and to share perspectives on problems, the FSA Inspection Bureau will perform off-site hearings in cooperation with the Supervisory Bureau. Then, based on the results of the hearings, if necessary, it will actively exchange opinions with the management of their head offices, regional headquarters, or parent companies, as well as with officers in charge of risk management departments, internal audit departments, etc. It will also strengthen cooperation with the authorities in the home countries of the foreign banks and insurance companies through the supervisory college, etc.

8. Financial Companies, etc. (Money Lenders, Issuers of Prepaid Instruments, Clearing Organizations, Fund Transfer Business Operators, Credit Guarantee Corporations, etc.)

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

For issuers of prepaid instruments, clearing organizations, and fund transfer business operators, the FSA (the Local Financial Bureau) will examine the development status of various procedures and arrangements in response to the Payment Services Act as well as the status of business operations.

For credit guarantee corporations, the FSA (the Local Financial Bureau) will examine the development status of various procedures and arrangements in response to the Credit Guarantee Association Act, based on the content of the Comprehensive Guidelines for the Supervision of Credit Guarantee Associations, etc.

In inspections of financial companies, the FSA will strengthen cooperation between the Local Financial Bureaus which conduct financial inspections and the FSA Inspection Bureau. It will also strengthen cooperation, through, for example, exchanging opinions as necessary, with self-regulatory organizations in order to conduct effective inspections.

9. Designated Dispute Resolution Institutions (Designated Dispute Resolution Institutions under the Financial ADR System)

In view of the fact that the volume of cases handled has been increasing since the start of the system in 2010, the FSA will examine the status of development and implementation of procedures and arrangements, including the necessity of enhancing the functions of the organization.

10. Outsourcing Contractors and Agents

For financial institutions, outsourcing is progressed, especially in the areas of IT system development and operations, and in recent years, there have been more cases of outsourcing to shared service centers, etc., by multiple financial institutions. Also, there are cases of re-outsourcing of financial institutions' businesses from the outsourcing contractors. In addition, in such cases, there are cases of outsourcing and re-outsourcing to overseas outsourcing contractors.

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

In view of these conditions, in addition to inspecting the financial institutions' management over such contractors (including overseas outsourcing contractors) and agents, the FSA will also continue to actively conduct financial inspections of outsourcing contractors and agents. In addition, in cases of the re-outsourcing from outsourcing contractors, the FSA will also examine the status of the financial institutions' management over such re-outsourcing operations.

11. Policy-based Financial Institutions

Against the backdrop of global financial uncertainty, deterioration of the economic environment, and the occurrence of large-scale natural disasters in recent years, the policy-based financing system of policy-based financial institutions is growing in their roles and operations.

In light of these circumstances, in the current program year, the FSA will strengthen cooperation with competent authorities by, for example, further enhancing the exchange of opinions with them, and conduct effective inspections based on the accurate understanding of the status of business operations of policy-based financial institutions.

12. Agricultural Cooperatives

Inspections of agricultural cooperatives are conducted through cooperation between the Ministry of Agriculture, Forestry and Fisheries and prefectural governments upon the request of prefectural governors based on the Standards and Guidelines concerning the

Implementation of the “Requested Inspection Prescribed in the Agricultural Co-operatives Act” (three-party requested inspection). The FSA is currently examining the development status of procedures and arrangements to manage credit risks, asset assessment, etc.

In the current program year, based on the discussion at the Government Revitalization Unit’s subcommittee on regulatory and institutional reforms, the FSA will make efforts to increase the frequency of inspections of agricultural cooperatives, while considering the status of requests made by prefectures.

Basic Plan for Financial Inspections for PY2012

| | | Number of institutions to be inspected | The previous program year (PY 2011) | |
|---------------------|---|--|--|---|
| | | | Number of institutions to be inspected | Actual number of inspected institutions |
| | Banks | 80 | 80 | 78 |
| | Shinkin banks Credit cooperatives | 155 | 160 | 161 |
| | Labor banks (Rokin) Federation of agricultural co-operatives associations and Federation of fishery co- operative associations | 35 | 25 | 23 |
| | Total of deposit-taking financial institutions | 270 | 265 | 262 |
| Insurance companies | | 30 | 25 | 25 |
| | Non-banking money lenders | 70 | 80 | 76 |
| | Issuer of prepaid payment instruments | 150 | 140 | 146 |
| | Others | 45 | 35 | 31 |
| | Total of other financial institutions | 265 | 255 | 253 |

Note:

- (1) These inspection numbers may be changed as necessary.
- (2) The figure on "Banks" is the aggregated number of banks and bank holding companies. That of "Insurance companies" is the aggregated number of insurance companies and insurance holding companies.