

# Challenges for Financial Sector Supervisors

December 17, 2007

- **Challenges going forward**

1. **Aiming for Better Regulation**

2. **Coping with Global Financial Market Turbulence**



Masamichi Kono  
DDG, Supervisory Bureau  
Financial Services Agency



# 1. Aiming for Better Regulation

# Objectives of Financial Regulation

1. Stability of the Financial System

2. Customer Protection

3. Fair and Transparent Markets

# Change of Phase for the Japanese Financial Sector

	2000	2002	2005	2007	From now on	Better Regulation: improving the quality of financial regulation	
Stability of the Financial System	<p><b>Concern over financial system</b> October-November 1997: Serial failures of banks and securities companies (Hokkaido Takushoku Bank, Yamaichi Securities, etc.) 1998: Failures of Long Term Credit Bank of Japan and Nippon Credit Bank</p>		<p><b>Non-performing loans problem</b> Major banks March 2002: 8.4% → March 2005: 2.9% Regional banks " : 8.0% → " : 5.5%</p>		<p><b>Acceleration of repayment of public funds (2005~)</b> (Face amount of repayment ¥8.8trillion, Capital gains ¥1.3trillion, Income gains ¥0.7trillion)</p>		<p>[Task]</p> <ul style="list-style-type: none"> <li>● Entrenchment and sophistication of risk management at financial institutions</li> <li>● Response to new type of risks</li> </ul> <p>↓</p> <p>Voluntary efforts by financial institutions</p>
	<p>* Introduction of prompt corrective actions (1998)</p> <p>* Publication of inspection manual (1999)</p> <p>* Development of public recapitalization system &amp; recapitalization (1998-2002: ¥10.4trillion)</p>		<p>* Failure of Ashikaga Bank (2003)</p> <p>* Special inspection on major banks (2001)</p> <p>* Partial removal of blanket deposit insurance (2002)</p>		<p>* Removal of blanket deposit insurance (2005) (except the payment and settlement deposits)</p> <p>* Implementation of Basel II (2007)</p>		
Customer Protection & Customer Convenience	<p><b>Diversification of sales channels for financial products</b></p> <p>* Over-the-counter sales of investment trusts by banks (1998)</p>		<p>* Over-the-counter sales of insurance products by banks (2001)</p>		<p>* Introduction of securities intermediary business (2004)</p> <p>* Deregulation of bank agency business (2006)</p>		<p>[Task]</p> <ul style="list-style-type: none"> <li>● Establishing sustainable &amp; continuous systems and controls for customer protection at financial institutions</li> <li>● Establishing competitive environment for higher quality of services</li> </ul> <p>↓</p> <p>Voluntary efforts by financial institutions</p>
	<p>* Increase in damages caused by forex margin trading</p>		<p><b>Non-payment problem at insurance companies</b></p> <p>Inadequate systems and controls in place at banks</p>		<p>* Amendment to Financial Futures Trading Law (2004)</p> <p>* Administrative actions against insurance companies and amendment to supervisory guideline (from 2005 onward)</p> <p>* Administrative actions against banks and amendment to supervisory guideline (abuse of dominant position, real estate screening system, sales of investment trusts, etc.: from 2006 onward)</p>		
Fair and Transparent Markets	<p><b>Progress of Japanese Financial "Big Bang"</b></p> <p>* Financial System Reform Law (1998) (Change to registration system for securities firms, liberalization of brokerage fees, diversification of financial &amp; investment products, etc.)</p>		<p><b>Major misconduct cases</b></p> <ul style="list-style-type: none"> <li>• Seibu &amp; Kanebo (2005)</li> <li>• Livedoor &amp; Murakami Fund (2006)</li> </ul>		<p><b>Mistakenly placed order by securities firms &amp; system troubles at stock exchange (2005-06)</b></p>		<p>[Task] Establishing norms of conduct for securities firms and other market intermediaries</p> <p>↓</p> <p>Voluntary efforts by financial institutions</p> <p>[Task] Improving reliability of market infrastructures</p> <ul style="list-style-type: none"> <li>● Entrenchment of Financial Instruments &amp; Exchange Law</li> <li>● Enhancing market surveillance mechanisms</li> <li>● Improving the quality of accounting and auditing</li> </ul>
			<p>* Introduction and expansion of civil money penalties (2005)</p>		<p>* Enactment of Financial Instruments &amp; Exchange Law (2006)</p> <p>Revisions of TOB system &amp; reporting system for large shareholdings, introduction of quarterly reporting &amp; internal control reporting systems</p> <p>* Summary of issues published by "Council on Securities Companies, Financial Intermediation Functions" (2006)</p> <p>* Amendment to the Certified Public Accountants Law (2007)</p>		

# Aiming for Better Regulation

## I. What is Better Regulation ? (FSA's Supervisory Approach)

1. Optimal combination of rules-based and principles-based approaches.
2. Risk-focused, forward-looking approach: prompt & effective response to high-priority issues.
3. Encouraging voluntary efforts by financial institutions and placing greater emphasis on incentives for them.
4. Improving the transparency and predictability of regulatory actions.

## II. Specific Areas of Priority

1. Enhanced dialogue with financial institutions and other relevant parties.
2. Effective dissemination of information.
3. Further cooperation with authorities abroad.
4. Enhance research function for real-time monitoring of market developments.
5. Human resource development.

# Optimal Combination of Rules-Based and Principles-Based Approaches

## 1. Advantages of Rules-based and Principles-based Approaches

Rules-based approach: ensures predictability and eliminates arbitrariness in regulatory actions from the viewpoint of financial institutions.

Principles-based approach: encourages voluntary efforts by financial institutions and ensures maximum freedom of business management.

## 2. JFSA's View

- Pursue fair and transparent financial regulation and supervision, placing emphasis on voluntary efforts by financial institutions.
- Rules-based and principles-based approaches are complementary for each other, not mutually exclusive.
  - Cases in which a rules-based approach is relatively effective:
    - \*Applying common rules to market participants including a large number of unspecified parties.
    - \*Imposing administrative sanctions under regulatory authority.
  - Cases in which a principles-based approach is relatively effective:
    - \* Encouraging financial institutions to develop their own systems and internal controls for governance, risk management and compliance.
    - \* Timely corrective action when there is a gap in existing rules for newly-introduced products, services and/or sales methods.
- Self-regulatory organizations: expected to play an important role in improving the effectiveness of the principles-based approach.

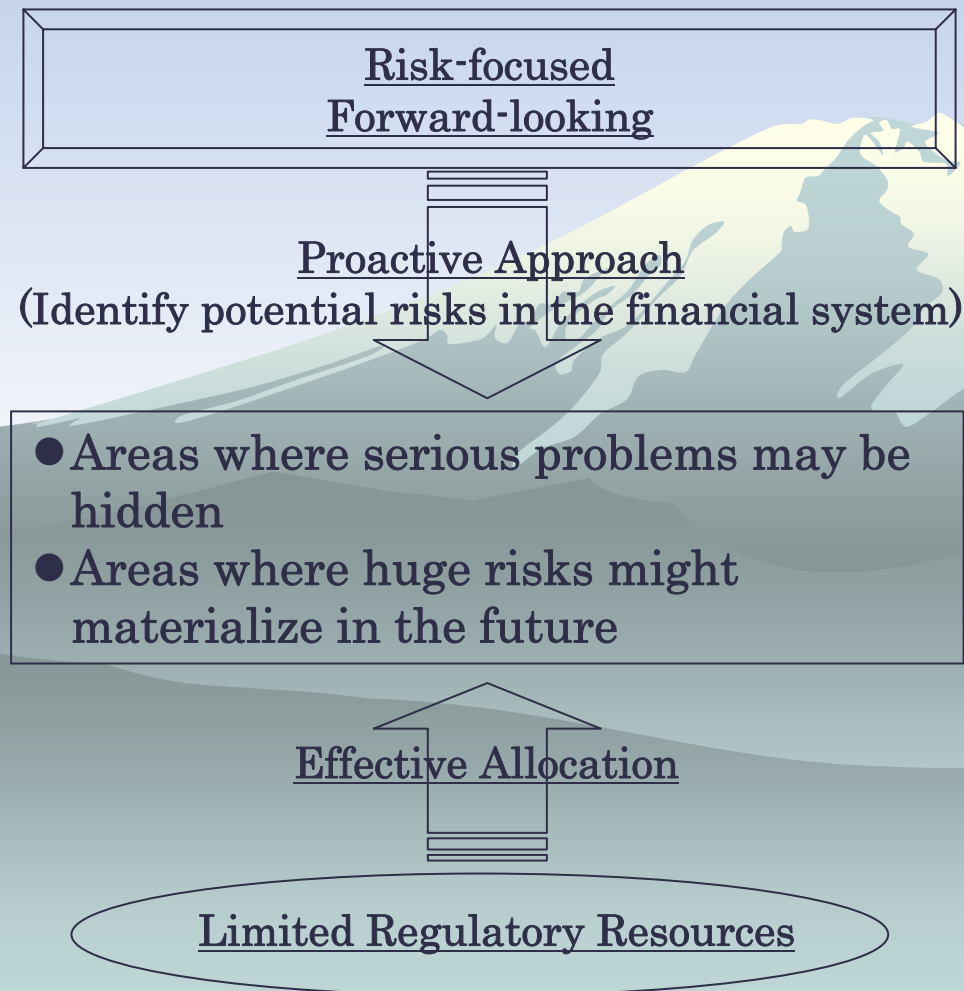
# Example of Principles: “Principles for Businesses” (by UK FSA)

1. A firm must conduct its business with integrity.
2. A firm must conduct its business with due skill, care and diligence.
3. A firm must take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems.
4. A firm must maintain adequate financial resources.
5. A firm must observe proper standards of market conduct.
6. A firm must pay due regard to the interests of its customers and treat them fairly.
7. A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8. A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
10. A firm must arrange adequate protection for clients' assets when it is responsible for them.
11. A firm must deal with its regulators in an open and co-operative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

(Source) UK Financial Services Authority (<http://fsahandbook.info/FSA/html/handbook/PRIN/2/1>)

# Risk-focused, Forward-looking Approach: Prompt & Effective Response to High-Priority Issues

- Foresee and promptly identify the areas in which serious problems may be hidden and where huge risks might materialize in the future
- Effectively allocate necessary regulatory resources to these areas.



<Example: real estate funds>

- Carefully monitor developments in the real estate market which is increasingly linked to financial markets and becoming global
- Ensuring due process for appropriate pricing and investor protection, preventing transactions involving conflicts of interest.
- Ensuring appropriate risk management at banks with real estate exposures.



# Encouraging Voluntary Efforts by Financial Institutions and Placing Greater Emphasis on Incentives

## Incentive-compatible approach: examples in existing frameworks

- *Financial Inspection Rating System*

- Selective administrative response depending on financial inspection results (frequency, scope and depth of inspection).

- *Basel II*

- Refining risk measurement practices and promoting more advanced risk management methods at financial institutions.

- *Relationship Banking Framework for Regional Banks*

- Incorporated into supervisory guidelines and promoting voluntary efforts of regional financial institutions.

- *Publishing guidelines for inspection and supervision, clarifying criteria for administrative actions*

- Encouraging voluntary efforts for improvement by financial institutions.

# Improving Transparency and Predictability of Regulatory Action

## Pursuing fair and transparent financial regulation and supervision (examples)

- *Publication of inspection manuals and supervisory guidelines*

- Clarifying guidelines in inspection and supervision, and due process for administrative actions.

- *Publication of annual inspection and supervisory policies*

- Indicating priority issues in inspection and supervision for each business year.

- *Publication of criteria for administrative actions*

- Clarifying the criteria in deciding on administrative actions.

- *Reform of no-action letter system*

- Series of reforms since the introduction of the system in July 2001.

## 2. Coping with the Global Financial Market Turbulence

The background of the slide features a stylized illustration of a mountain range. The central peak is the most prominent, with a bright yellow and white glow emanating from its summit, suggesting a sunrise or a bright light source. The mountain slopes are rendered in various shades of green and teal, with some darker green areas indicating shadows or rocky terrain. The sky above the mountains is a clear, light blue gradient. The overall aesthetic is clean and modern.

# Current assessment

- Given the prevailing uncertainty, it is too early to draw definitive conclusions.
- However, the effect of recent global financial market turbulence on Japanese financial institutions and markets appears to have been limited so far.
- This has been due to factors such as:
  1. The health of Japanese financial institutions has been steadily improving, as shown, for example, in lower NPL ratios and higher capital ratios.
  2. Exposures of Japanese financial institutions to sub-prime loans and related products have been limited. (In total, ¥1.4 trillion or around \$13 billion for sub-prime loans and related products etc.)
  3. Implementation of Basel II for all deposit-taking institutions as of end-March 2007

# Issues that need to be addressed

Three important uncertainties regarding sub-prime related products:

- Uncertainty regarding the incidence of risk
- Uncertainty in pricing/valuation
- Uncertainty of liquidity for ABCP conduits and other vehicles



Task Force (Financial Market Strategy Team) formed under the Minister to analyze the situation, and develop policy recommendations

# Major Recommendations of the FMST

( Issues to be considered at the global level)

- Transparency in origination, arrangement, and distribution of securitized products; *inter alia* proper transmission of risk information for such products
- Enhanced risk management by financial institutions and investors; prompt implementation of Basel II
- Proper disclosure and appropriate internal controls at CRAs, and appropriate use of the ratings by the investors
- Appropriate pricing and accounting of securitized products
- Proper treatment in the accounting of conduits and SIVs



# Major Recommendations of the FMST (continued)

(Measures to be taken at the domestic level)

- Closer monitoring of market developments and financial institutions by the supervisory authorities
- Further coordination with authorities of other countries
- Examination of issues arising from the originate-to-distribute model
- Improving the traceability of risks incorporated in securitized products



# Major Recommendations of the FMST (continued)

- Securitization to be based on the availability of sufficient data
- Indication of principles and the search for best practices in the context of the “better regulation” initiative
- Study proper regulation of CRAs, and means to ensure the appropriateness of rating models
- Monitor and consider proper valuation and accounting of securitized products





# Broader Issues to Bear in Mind

- Housing and real-estate markets and their effects on the economy in general
- Developments in currency markets, stock markets and other financial markets
- Oil and commodity market developments
- Monetary policy
- Fiscal policy (incl. tax policy)
- Other macro-economic issues

# Thank You

