I. Outline

The Commissioner of the Financial Supervisory Agency (Minister of Finance as for the period up to and including June 21, 1998; same hereinafter) must consult with the SESC each year regarding inspection policies and other basic matters related to its inspections of financial institutions (Article 20(1) of the Law Establishing the Financial Supervisory Agency).

In addition to administrative personnel, the Commissioner of the Financial Supervisory Agency places much importance on listening to the opinions of people in neutral positions in order to carry out inspections in an appropriate manner. The above provision also obliges the Commissioner of the Financial Supervisory Agency to place importance on the SESC's advice and enables the SESC to make necessary proposals regarding the policies of financial institution, foreign exchange, and securities company inspections (centering on financial soundness). Proposals can refer to the basic policy including points to be emphasized in inspections, as well as the basic plan of inspections including the number of inspections to be conducted.

The Commissioner of the Financial Supervisory Agency must also report to the SESC on a quarterly basis on the manner in which inspections are carried out. If necessary, the SESC can make proposals to the Commissioner concerning the operation and policies of inspections of financial institutions (Article 20(2)–(3) of the Law Establishing the Financial Supervisory Agency).

In inspection year 1997, no problems were acknowledged concerning inspections operations. Accordingly, no proposals were required.

II. Proposal Concerning Basic Policy and Plan of Inspections

The SESC, responding to a request from the Minister of Finance for its opinions on the "Basic Policy and Plan of Inspections for Inspection Year 1997," submitted its opinions as follows:

1. Content of "Basic Policy and Plan of Inspections for Inspection Year 1997"

On July 29, 1997, the Minister of Finance submitted his "Basic Policy and Plan of Inspections for Inspection Year 1997" as follows:

I. Basic Inspection Policy

The operation environment surrounding securities companies and other financial institutions remains severe. Despite steady progress in settling bad debts, deteriorating asset portfolios are believed to have a significant impact on their operations.

Meanwhile, there is a growing need for financial institutions to comprehensively embrace principles of self-discipline and for a new and highly transparent financial system centering on market principles to be built. To immediately address this need, in April 1998 we are going to introduce a new monitoring system entitled Prompt Corrective Action, which is based on the premise of self-assessment of assets by financial institutions and the utilization of external surveillance. It is important to implement effective and appropriate inspections while stressing an accurate response to market conditions.

It is also important to address recent improper acts committed by financial institutions. This will entail the implementation of more strict and productive inspections. For the smooth transition of the inspection function to the Financial Supervisory Agency to be established by July 1, 1998, it is important to ensure the implementation of effective and efficient inspections.

Against this backdrop, for inspection year 1997 (July 1997 to June 1998) we will endeavor to conduct accurate financial institution, foreign exchange, and securities company inspections (excluding those under the SESC's jurisdiction) as follows:

1. Important inspection items

(1) Financial institution inspections

[1] The deteriorating asset portfolio situation of financial institutions has a major impact on such institutions' operations. In particular, after the introduction of the Prompt Corrective Action system, in light of the necessary measures that will be taken irrelevant to the capital-asset ratio level, we also place emphasis on examination management systems and continue to accurately grasp actual situations as well as income and expenditure content. At the same time, we work to verify that financial institutions are upgrading their self-assessment systems.

[2] As for internal control systems of financial institutions, we also utilize external surveillance systems and focus on whether or not compliance systems are functioning properly, while working to accurately monitor the implementation of internal control procedures and

functions, including checks of the implementation of disclosure.

[3] Considering that risk factors facing financial institutions are becoming more diverse and complex, we endeavor to accurately monitor risk management systems in market-related business. This includes the ongoing utilization of checklists.

[4] We also strive to accurately monitor the business operations of the trust bank subsidiaries of securities companies and financial institutions, as well as of their life insurance and non-life insurance subsidiaries.

(2) Foreign exchange inspections

[1] We monitor the status of fulfillment of obligations by the Foreign Exchange and Foreign Trade Control Law to confirm the legality of external transactions conducted by authorized foreign exchange banks. We also conduct checks on the status of upgrading relevant control systems.

[2] We work to gain an accurate understanding of various risk management systems related to foreign exchange business, including derivative transactions, from the perspective of maintaining international credit (maintaining soundness) of authorized foreign exchange banks.

Note: Under the revised Foreign Exchange and Foreign Trade Control Law, the Authorized Foreign Exchange Bank System, as well as former foreign exchange inspections, was abolished.

(3) Securities company inspections

[1] In relation to the financial condition of securities companies, despite progress in addressing bad debts stemming from losses incurred in supporting affiliated companies, the operations of securities companies have further deteriorated as a result of losses due to declining stock prices.

For this reason, we will continue working to gain an accurate understanding of the financial condition of securities companies from the perspective of maintaining the soundness of such companies.

[2] In relation to internal control systems of securities companies, we place importance on compliance with various regulations related to maintaining soundness, based on the premise that securities companies fully

adopt principles of self-discipline, while working to gain an accurate understanding of internal control systems.

[3] Considering international trends in securities inspection and supervision, we endeavor to gain an accurate understanding of various risk management systems related to securities transactions, including derivative transactions.

[4] We strive to gain an accurate understanding of the operations of financial institutions' securities subsidiaries.

2. *Increasing inspection efficiency*

It is more important than ever before to conduct effective and efficient inspections in order to respond accurately to Prompt Corrective Action and facilitate the smooth transfer of the inspection function to the Financial Supervisory Agency.

To this end, we concentrate on credit risk management, internal control, and market-related risk management systems, while fostering positiveness and flexibility of inspections. We also further seek efficient and concentrated inspections by utilizing regional finance bureaus' inspections.

II. Basic Inspection Plan

1. *Scheduled financial institution inspections*

Banks	77
Shinkin banks	203
Insurance companies	18
Total	298

2. *Scheduled foreign exchange inspections*

Authorized foreign exchange banks	44

3. *Scheduled securities company inspections*

Securities companies	104
Investment trust companies	3
Investment advisory firms	68
Total	175

Note: The above figures are set according to our original basic plan, and we work to enhance efficiency and focus by carrying out inspections in a flexible manner. The schedule may change in the course of transferring the inspection function to the Financial Supervisory Agency.

2. Opinions Expressed by the SESC

On August 5, 1997, the SESC expressed its opinions on the above basic policy and plan, as follows:

"On Basic Policy and Plan of Inspections for Inspection Year 1997"

We expect that the Japanese financial system will respond to economic and social structural changes and effectively fulfill its function as part of the domestic economic infrastructure, thus contributing to stable development as we approach the 21st century. Amid calls for financial institution management with self-regulation and subject to checks by free and fair markets, financial administrative authorities face an urgent need to change their role from providing preliminary guidance to conducting inspections and supervision, which is more harmonious with market principles.

The Financial System Reform also underscores the ideal role for financial administrative authorities, which is reflected in the new Prompt Corrective Action to be introduced in April 1998.

We believe that the "Basic Policy and Plan of Inspections for Inspection Year 1997" proposed by the Minister was formulated based on ample understanding of this situation and is generally appropriate. We would like to see it implemented with your particular attention to points described below.

In addition, taking into consideration improper acts by leading financial institutions of this country, we request that efforts be made to conduct effective inspections, and that violations of laws be dealt with very strictly.

[1] The SESC has been emphasizing the self-regulating effect of disclosure through the regulation in the market, and continues to strengthen its emphasis on this area. Meanwhile, the scheduled Prompt Corrective Action will serve to narrow the discretion of administrative authorities and help assure transparency. At the same time, it will have the benefit of encouraging self-regulation in financial institution management. Considering that the two methods above will fulfill their extremely important roles in the new financial system, we anticipate that inspections to grasp disclosure levels will continue to be implemented accurately and that fully reliable checks of self-assessment of assets by financial institutions be made, because it is crucial that the self-assessment of assets by financial institutions be carried out properly for the effective function of the Prompt Corrective Action.

[2] Products and services provided by financial institutions are expected to become even more diversified as

the Financial System Reform progresses, and to this end we request that accurate checks of risk management continue to be made. We also ask that inspections of internal control systems be not limited to a superficial level but fully reflect the actual status of system operations.

[3] The SESC requests that due attention be paid to growing imbalances in the financial condition of financial institutions, and that frequency, content, and other aspects of inspections be determined in a flexible manner according to the respective institutions.

III. Inspection Results and Outline of the Results

The SESC received quarterly reports describing the status of inspections of financial institutions and problems uncovered by inspections in inspection year 1997 (year under review). The Minister of Finance submitted reports as for the first three quarters, and the Commissioner of the Financial Supervisory Agency submitted the report as for the final quarter. The contents of all four reports are summarized below.

1. Inspection priorities

(1) Inspections were conducted with emphasis on important inspection items of the basic inspection policy for the year under review and with due consideration to the opinions of the SESC submitted on August 5, 1997. We conducted inspections that reflected the specific nature of each institution to be inspected.

(2) In principle, financial institution and foreign exchange inspections of the same institution are carried out simultaneously, and inspections of securities companies are carried out in tandem with inspections conducted by the SESC.

(3) Since the Financial System Reform has allowed financial institutions and securities companies to enter each other's market, we conducted inspections of securities company subsidiaries of financial institutions at the same time as inspections of their parent financial institutions. Similarly, when we conducted inspections of securities companies, we also inspected those companies' trust bank subsidiaries and related investment trust companies.

2. Inspection results

(1) Status of inspections (Table 4)

During inspection year 1997, we commenced inspections of 239 banks, etc., 35 authorized foreign exchange banks, etc., and 147 securities companies, etc.

Among inspections commenced during the year under review, Notices of Conclusion had been presented to and inspections were completed on 236 banks, etc., 35 authorized foreign exchange banks, etc., and 144 securities companies, etc., by the end of the year (June 30, 1998).

In addition, inspections commenced in inspection year 1996 but not completed by June 30, 1997, were all completed during the year under review. These were inspections of 93 banks, etc., 40 authorized foreign exchange banks, etc., and 38 securities companies, etc.

Table 4: **Status of Inspections**

Category	*Inspections planned*	*Inspections commenced*	*Inspections completed*
Financial institution inspections			
Banks	77	55	92
Shinkin banks	203	172	218
Insurance companies	18	12	19
Total	298	239	329
Foreign exchange inspections			
Authorized foreign exchange banks	44	35	70
Trading companies	–	0	1
Designated securities companies	–	0	4
Total	44	35	75
Securities company inspections			
Securities companies	104	97	122
Investment trust companies	3	1	3
Investment advisory firms	68	49	57
Total	175	147	182

Note: The "Inspections completed" column includes the number of companies of which inspections had been commenced in the previous inspection year and were completed during the year under review (July 1, 1997, to June 30, 1998), with the presentation of Notices of Conclusion to the companies.

(2) Total personnel per inspection (Table 5)

In the year under review, 95 man-days were assigned per financial institution inspection (on-site period basis), 31 man-days per foreign exchange inspection, and 42 man-days per securities company inspection (Table 5).

Table 5: Total Personnel per Inspection

Category	*Man-days per inspection*
Financial institution inspections	
Banks	139
Shinkin banks	75
Insurance companies	106
Average	(95)
Foreign exchange inspections	
Authorized foreign exchange banks	30
Trading companies	43
Designated securities companies	17
Average	(31)
Securities company inspections	
Securities companies	57
Investment trust companies	82
Investment advisory firms	8
Average	(42)

3. Summary of inspection results

(1) Financial institution inspections

[1] Banks

(a) Financial condition and the management of loan examination

Amid continued severe operation conditions surrounding financial institutions, there has been progress in addressing bad debts through write-offs and other means, and there are signs of improvement in companies' financial condition. However, active measures still need to be taken.

As for the management of loan examination, although self-assessment systems are being reinforced in line with the introduction of the Prompt Corrective Action, in many cases, more effective systems are required in order to upgrade and reinforce the control of examinations. The conditions of borrowers were not fully grasped in some cases.

(b) Profit-loss situation

Many banks have reported declines in net income caused by decreasing income from the sale of bonds including national government bonds, and falling fund-derived income, as well as declines in recurring profit stemming from the write-off of a large amount of bad debt, etc. Some banks reported losses.

(c) Internal controls and risk management systems

Numerous cases of insufficient internal control systems have come to light. These include continued cases of insufficient and inappropriate administrative procedures as well as insufficient functioning of the guidance of the head office and mutual check systems.

Concerning risk management in market-related transactions, including derivatives transactions, it was found that more productive systems need to be set up and upgraded. Insufficient checking functions between the front offices and back offices at the operational level were recognized.

Regarding the disclosure of bad debts, while an expansion of the scope of debts to be examined is under consideration, we discovered some cases of inadequacy. However, disclosure was conducted adequately in most cases.

[2] Shinkin *banks*

(a) Financial condition and the management of loan examination

Amid continued severe operation conditions surrounding financial institutions, the financial condition of the majority of *shinkin* banks was found to be deteriorating.

In line with the introduction of the Prompt Corrective Action, we conducted short-term inspections of self-assessment systems. These inspections revealed cases of discrepancy in categorization of borrowers and debt type, as well as cases where checks by the auditing divisions of sales divisions' self-assessment systems were not functioning.

Concerning the management of loan examination, despite the introduction of financial analysis systems and other measures to set up the management systems, there were cases in which the terms of loans were dependent on past ones. Also, there were cases where the examination of borrowers' business plans was insufficient. These cases illustrate the need to set up productive systems to reinforce and upgrade the management.

(b) Profit-loss situation

Many *shinkin* banks have reported declines in net income and recurring profit caused by decreasing loan interest rates and the increased write-off of bad debts. Some banks reported losses.

(c) Internal controls and risk management systems

Cases of insufficient and inappropriate control systems have come to light, including continued cases related to fundamental administrative procedures. These illustrate the need to set up and upgrade control systems through the guidance of the head office, more thorough check systems, etc.

[3] Insurance companies

(a) Financial condition and profit-loss situation

The financial condition of insurance companies has deteriorated as a result of unstable business performances of borrowers, such as nonbanks. Nevertheless, insurance companies are generally maintaining financial soundness thanks to the active write-off of debt and allocation of reserves.

Regarding the profit-loss situation, net income levels have generally languished as insurance companies have failed to suppress expenses in the face of stagnating insurance premiums. Some companies are compensating for declining interest income through profit-taking through the sale of securities.

(b) Internal controls and risk management systems

Although some companies are working to prevent improper acts by changing their internal inspection policies, there have been cases where nullifying contracts was unavoidable, as well as cases of inappropriate insurance solicitation including the fabrication of contracts. These cases illustrate the need to upgrade internal controls and compliance systems.

Although insurance companies have set up risk management systems, those systems remain inadequate as the companies have not formulated fundamental risk management measures, such as loss-cut rules and hedging methods. These cases illustrate that the reinforcement and upgrading of risk management systems will remain an issue for the future.

(2) Foreign exchange inspections

[1] Authorized foreign exchange banks

(a) Obligation to confirm the legality of external transactions

In general, institutions have adequately fulfilled their obligation to confirm the legality of external transactions as specified by the Foreign Exchange and Foreign

Trade Control Law.

(b) Exchange position regulations

Although some institutions have incorrectly reported their exchange positions to the authority, most of them have adequately complied with exchange position regulations.

[2] Trading companies

Trading companies have generally performed favorably in their handling of mutual accounting transactions.

(3) Securities company inspections

[1] Securities companies

(a) Profit-loss situation and financial condition

For the majority of securities companies, the profit-loss situation deteriorated in inspection year 1997 owing to declining commission income. Among these, some companies ultimately terminated operations owing to the exposure of a large amount of off-balance-sheet debts and large extraordinary losses.

In addition, consecutive net losses have led to declines in net asset values.

The majority of companies also reported declines in capital adequacy ratios.

(b) Internal controls and risk management systems

Inspections revealed numerous cases of failure to issue the certificate of securities deposit, to collect advance payments from new customers, etc. These illustrate the need to reinforce the awareness of the importance of compliance with various laws and regulations and to upgrade internal control systems.

Furthermore, inspections revealed problems with risk management systems, including failure to set up internal standards for loss-cut rules and non-functioning internal check systems. These illustrate the need to upgrade and reinforce risk management systems.

[2] Investment advisory firms

With the exception of certain companies that reported higher revenues as a result of increased pension-related contracts, numerous investment advisory firms experienced declines in investment advisory fees owing to depressed stock market conditions.

Inspections of operations revealed cases of insufficient and improper administrative procedures. These included unauthorized securities transactions for customers and the failure to submit required reports to customers.