August, 28, 2012
Financial Services Agency

Annual Supervisory Policy for Regional Financial Institutions for Program Year 2012[1]

The Financial Services Agency (FSA) publishes its Annual Supervisory Policy for Regional Financial Institutions for each program year so as to clarify its supervisory priorities. This is prescribed in the "Comprehensive Guidelines for Supervision of Small- and Medium-Sized and Regional Financial Institutions," which shows basic approaches for the supervisory process aimed at regional financial institutions.

In this Program Year, in accordance with "Basic Concepts on Future Supervision of Financial Institutions" as shown below, the FSA will place priority on the areas of 1) performing a smooth financial intermediary function, 2) risk management and stability of the regional financial system and 3) improving customer protection and convenience for users, and will supervise regional financial institutions while striving to have straightforward and in–depth dialogues with them.

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

1. Environment Surrounding the Financial System, and Basic Concepts on Future Supervision of Financial Institutions

(1) Environment Surrounding the Financial System

The Japanese economy, though remaining in a difficult situation, is recovering moderately owing to such factors as reconstruction demand following the Great East Japan Earthquake. This recovery is expected to take hold firmly. However, at a time when uncertainties involving the European sovereign debt problem remain high, a sense of deceleration is spreading in the world economy. While such overseas economic conditions and their impact on financial and capital markets have become downside risks for the Japanese economy, attention should be paid to such factors as constraints on electricity supply and the impact of deflation at the same time.

Under such situation, most regional financial institutions, excluding those in areas affected by the Great East Japan Earthquake, secured net profit by reducing credit costs amid a decline in net interest income in financial results in the fiscal year ending in March 2012.

Meanwhile, the world economy has continued to be volatile, and special attention should be paid to developments in foreign economic conditions, and in financial and capital markets. In doing so, amidst today's advancing globalization, it is important to

[1] In this document, the term "Regional Financial Institutions" refers to regional banks, second-tier regional banks, *shinkin* banks and credit cooperatives.

enhance the resilience of the economic and financial system, to minimize effects on Japan in the event of any crisis arising from emerging global economic risks.

Financial Institutions should contribute to the restoration and reconstruction of areas affected by the Great East Japan Earthquake and to the revitalization and development of Japan, considering the facts mentioned above. They must do so by securing their financial soundness and making efforts to appropriately and effectively control various risks while considering the impact that domestic and overseas economic trends, etc. could exert on the financial system.

(2) Approach Taken by Supervisory Authority

Under these circumstances, the FSA will continue to make “Better Regulation” (engaging in straightforward and in-depth dialogues with financial institutions, external communications, sharing information and collaboration on the economic and financial situations in Japan and overseas, and improving the transparency and predictability of administrative actions) the basis and strive to have it become further embedded and deepened. For discussions with financial institutions, the FSA will consider utilizing a Public-Private Roundtable.

In particular, in thoroughly performing a smooth financial intermediary function, protecting customers, effectively managing various risks, etc., financial institutions must be aware of their long-term corporate challenges. Accordingly they are strongly expected to conduct proactive managerial improvements, and make appropriate, prompt, and responsible business judgments under the appropriate leadership of management personnel.

In doing so, they must pay attention to the increasingly uncertain European situation at present, the fact that the current program year is the final year for the SME Financing Act, and the sustained expectations on their continued medium to long-term support for areas affected by the Great East Japan Earthquake and the subsequent nuclear power station accident, while considering the situations of disaster-affected areas and people. To this end, the FSA will continue to take the following approaches as the supervisory authority.

i) Financial Supervision and Administration with High Risk Sensitivity

In order to effectively respond to conceivable risks, the FSA will gain a deeper understanding of the macro economy and financial and capital markets, and deepen its understanding of how these affect the soundness of financial institutions, so as to identify and understand, with a forward-looking perspective, risks which accumulate in each financial institution and in the financial system. The FSA will also enhance the integration of on-site and off-site monitoring to detect risks at an early stage.

In addition, in order to maintain and secure financial functions even in the event of an unexpected contingency, the FSA will monitor whether financial institutions sufficiently prepare major risks in their business continuation plans, review these plans as necessary, and conduct relevant training, given the experience of the Great East Japan Earthquake last year (2011), past system glitches, and the possibility of future rolling blackouts under constraints on electricity supply. Given that problems with IT systems at the core of financial services would greatly affect people’s daily lives and the economy, the FSA will urge financial institutions to voluntarily check their risk management frameworks for system glitches and will monitor such IT system risks of financial institutions with a heightened alert even in normal times.

ii) Financial Supervision and Administration from a Citizen's and User's Point of View

The FSA will strive so as to further improve customer protection and increase convenience for users, by supervising from a citizen's and user's point of view.

iii) Supervisory Response with a Forward-looking Perspective

The FSA will strive to take actions while being aware of the progress in international discussions and closely monitoring any environmental changes. Its actions should thus include not only short-term responses, but also medium and long-term responses with an eye on the future, while considering common structural issues faced by Japanese financial institutions (strengthening profitability of their main business, etc.).

iv) Supervisory Response which Contributes to Financial Institutions' Self-improvement of their Management and Better Business Judgments.

The FSA will help financial institutions to improve their own management and make better business judgments via straightforward and in-depth dialogue and external communication with them. Above all, the FSA will promote exchanges of opinions and other methods to introduce to other financial institutions the innovative initiatives of each financial institution concerning the performance of the financial intermediary functions, risk management, improvement in customer protection, convenience for users, etc. The FSA will thereby work to enhance the quality of the entire financial industry.

When performing supervision, in addition to these approaches, the FSA will also emphasize the following points.

- In addition to encouraging closer cooperation with the Inspection Bureau and the Supervisory Bureau, and externally with the Securities and Exchange Surveillance Commission (SESC), and the Bank of Japan (BOJ), the FSA will also cooperate with the Japanese Institute of Certified Public Accountants, etc. Especially in order to promptly and accurately understand IT system risks and the situations faced by financial institutions, and to enable fast response, the FSA will implement and strengthen monitoring with seamless inspection and supervision, and consider participation by the staff of supervisory divisions in inspections, etc.
- The FSA will further promote the integrated supervision of regional financial institutions with local finance bureaus that are directly in charge of supervising these institutions, by sharing the same recognition with each bureau concerning managerial issues that each financial institution has been facing. In doing so, the FSA will, in collaboration with its Inspection Bureau, improve the quality of information provided to local bureaus for off-site monitoring, including the results of data analysis and information on focuses of supervision, so that each local bureau can deepen the quality of its interviews and other supervisory activities by focusing on the risk profile and

financial soundness of each financial institution. The FSA will also endeavor to further advance its supervisory ability by such means as improved business analysis that utilizes the results of interviews and other information reported by local finance bureaus.

- The necessity of collecting reports and submitted documents will be reviewed once a year, as part of consideration for reducing the burdens on financial institutions.
- Through thorough fostering, securing and training of professional human resources, the FSA will redouble efforts for human resource development.

2. Performing a Smooth Financial Intermediary Function

(1) Support toward Reconstruction following the Great East Japan Earthquake from Financial Aspects

Toward the full-blown restoration of the disaster-affected areas marking the first year for restoration, the financial intermediary function of regional financial institutions will be put to the test. In order to provide effective support, they should make speedy efforts to proactively provide new money in anticipation of customer enterprises' future expansion, etc. and resolve the so-called double loan problem (the burden of existing loans makes it difficult for borrowers to raise new money).

Recognizing the abovementioned point, the FSA will verify mainly whether financial institutions in the disaster-affected areas provide support—such as recommending and implementing optimum solutions including various public support measures for disaster-affected people after a fine-tuned analysis of the conditions surrounding each disaster-affected person—and whether they proactively take part in the efforts of local governments and other parties to promote extended restoration and revitalization in the disaster-affected areas.

i) Responses to the Double Loan Problem, Etc.

a) Utilization of the Corporation for Revitalizing Earthquake Affected Business and the Prefectural Industrial Revitalization Organizations

The FSA will check whether regional financial institutions provide careful explanations to disaster-damaged companies about the roles, functions, etc. of the Corporation for Revitalizing Earthquake Affected Business and the Prefectural Industrial Revitalization Organizations, and consider the proactive utilization of these organizations along with disaster-damaged companies. In doing so, the FSA will also check whether regional financial institutions positively consider bringing applications for Credit Guarantee Association-guaranteed loans to these organizations with a view to supporting disaster-affected people.

b) Utilization of the Individual Debtor Guidelines for Out-of-Court Workouts

The FSA will check whether regional financial institutions analyze further details of disaster-affected people's situations, provide them with careful explanations about advantages and effects of the Guidelines' utilization and proactively recommend utilization in accordance with their respective conditions.

c) Others

In addition to the abovementioned points, the FSA will check whether regional financial institutions proactively provide fine-tuned financial support, including the provision of their own new money and bridge loans to small and medium-sized enterprises that use projects to subsidize the restoration and development of SME group facilities, etc.

As moves are seen to proceed with the project for the promotion of collective relocation for disaster prevention and lift evacuation orders following the Fukushima nuclear plant accident, the FSA will check regional financial institutions' plans for the extended restoration of the disaster-affected areas and encourage them to proactively engage in restoration.

ii) Promoting Active Use of the Act on Special Measures for Strengthening Financial Functions (Special Disaster Measures)

The FSA will continue to encourage regional financial institutions located in the disaster-affected areas to proactively consider using the special disaster measures under the Act on Special Measures for Strengthening Financial Functions if they make business decisions to recapitalize themselves so as to play a proactive role in the post-disaster restoration and reconstruction.

As for financial institutions in which the FSA has implemented the government's capital participation under the special disaster measures, the FSA will appropriately follow up on their implementation of business-enhancing plans for continued contributions to the reconstruction of disaster-affected people's businesses and livelihoods, including the utilization of the Corporation for Revitalizing Earthquake affected Business, the Prefectural Industrial Revitalization Organizations, and the Individual Debtor Guidelines for Out-of-Court Workouts. As for cooperative financial institutions in which the government and their central organizations have implemented their joint capital participation under the special disaster measures, the FSA will closely watch how the central organizations provide business support to *shinkin* banks and credit cooperatives, and will further promote cooperation with these central organizations.

(2) Deepen Region-based Relationship Banking

For the stimulation and healthy development of local economies, it is important for local SMEs to stimulate economic activities through business expansion and business improvement. It is also important that related parties in the region, including regional financial institutions, coordinate and cooperate to proactively support the business efforts of SMEs. In particular, regional financial institutions play a pivotal role in local information networks, and have human resources and know-how. Thus there are great expectations that they will play a role not only in supplying funds, but also in actively supporting the management of local SMEs, and contributing to stimulate the local economy.

Therefore, it is important for regional financial institutions to explicitly set region-based relationship banking as their business model in their business strategies and business plans, and continuously promote their initiatives as an entire organization in wielding consulting functions for client enterprises, actively participating in the revitalization of the entire region, and actively transmitting information to the region and users of financial services. It should be done on their own initiatives and ingenuity with a longer-term point of view, in accordance with their size and business profiles as well as customers' expectations and needs. It is also important to connect such activities to the maintenance and expansion of their customer base, and to the improvement of their profitability and financial soundness.

In this respect, it is important for top managers of regional financial institutions to demonstrate their strong leadership in considering and implementing improvements and countermeasures so as to deepen their region-based relationship banking as their business model, based on new challenges found through analyses of past operations and on regional business environment changes.

Recognizing the abovementioned points, the authorities will focus on the following points in checking regional financial institutions' region-based relationship banking through such measures as various interviews, including those with top managers.

Furthermore, the FSA will work to provide incentives and develop the environment for financial institutions to deepen and solidly establish their initiatives for region-based relationship banking. It will also contribute to the sharing of information and know-how among financial institutions by holding symposiums that provide opportunities that regional financial institutions explain their own initiatives for region-based relationship banking, and that concerned parties in each region discuss and evaluate such initiatives. It will also give awards for highly advanced initiatives and those recommended to be widely practiced.

i) Demonstrating Active Consulting Functions in Accordance with the Life Stage of Customer Corporations

The FSA will assess whether regional financial institutions find and analyze challenges in businesses of their customer corporations through continuous daily transactions, timely propose optimum solutions according to customers' life stages, etc. in the following manners, and implement such proposals in cooperation with the customers.

- Do regional financial institutions accurately assess customer corporations' business values, growth potential, etc., provide new money for initiating or expanding new businesses, and provide positive support for new sales channel exploration, and business development efforts including their expansion into Asian markets? Are these measures leading to the exploration of potential demand?
- Do regional financial institutions provide individualistic services meeting customers' standpoints without plunging into a race to cut interest rates?
- Do regional financial institutions proactively utilize third party viewpoints, expertise and functions of outside organizations, etc. for cases where customer corporations need support for business turnaround, business changes, business succession, closure, etc.?

ii) Contributing to Stimulating the Local Economies

The FSA will also assess whether regional financial institutions proactively participate in regional efforts, including growth-industry development and industry accumulation, for boosting added value. In order to enable such contributions, they should attempt to collect regional information, and accumulate knowhow and human resources, etc. through daily and ongoing contact with users, relevant regional organizations, etc., from a medium to long-term perspective.

(3) Support Small and Medium-sized Enterprises (SMEs) Management

In March 2012, the Act concerning Temporary Measures to Facilitate Financing for SMEs was revised to finally extend its expiration until the end of March 2013. With the awareness that this year is a very important year for strongly promoting support for the real improvement of SMEs' financial profiles, the FSA will cooperate with relevant government agencies in embodying measures cited in the policy package for management support for SMEs (hereinafter referred to as the policy package) as compiled in April 2012. In doing so, the FSA will give priority to the following points based on the supervisory guidelines for encouraging financial institutions to serve consulting functions, as created in April 2011, and the supervisory guidelines for promoting region-based relationship banking, as revised in May 2011, etc.

i) In order to establish a process where financial institutions can boost their profitability and financial soundness through the improvement of borrowing enterprises' debt servicing capacity and the future expansion of sound money demand, the FSA will investigate whether financial institutions are actively consulting enterprises to make them aware of their business issues and make self-help efforts for business improvement and recovery, while taking note of the following points:

- Do regional financial institutions proactively utilize third-party viewpoints, expertise and functions of outside organizations, etc. for cases where borrowing enterprises need support for business turnaround, business changes, business succession, closure, etc.? Particularly, do they proactively consider and implement the utilization of SME Business Rehabilitation Support Cooperatives and the Enterprise Turnaround Initiative Corporation of Japan in view of progress in measures to enhance the functions and cooperation of these organizations based on the policy package?
- Do regional financial institutions proactively collaborate or cooperate with other financial institutions when those other institutions use outside organizations, etc. for supporting business turnaround?

In order to enhance each region's business turnaround support functions, the FSA will encourage each regional financial institution to cooperate with other regional financial institutions, the Organization for Small & Medium Enterprises and Regional Innovation, etc. in creating business turnaround funds.

ii) As part of their efforts on promoting region-based relationship banking, regional financial institutions are expected to develop and establish their ability to discern the business potential of borrower enterprises, without excessively depending on collateral and guarantees. They should also accurately focus on the business value of borrowing enterprises and contribute to enhancing it.

In view of these points, the FSA will verify whether regional financial institutions are implementing appropriate initiatives to establish loan practices which in principle do not require third party joint and several guarantee, except for managers of the borrowing enterprise, and to consider the guarantor's ability to pay when executing guarantee obligations. The FSA will especially verify whether there are objective and rational reasons for signing such a contract, and whether the contracting party agreed with this contract based on his/her voluntary will and thus it is confirmed in writing that it is due neither to pressure nor to demands from the financial institution, in cases where such contracts are signed in exceptional circumstances by a third party who does not substantially participate in the management of the company.

iii) The Act for Facilitating New Business Activities of Small and Medium-sized Enterprises was revised in June 2012 to create the "authorized business innovation support organization system," where by existing SME supporters, financial institutions, tax accountant corporations, etc. will be authorized to implement SME support operations.

If regional financial institutions apply to be authorized as business innovation support organizations, the FSA will examine the applicants while taking note of their consistency with region-based relationship banking efforts (continuous organized efforts based on a medium to long-term perspective) that regional financial institutions are expected to conduct.

iv) The FSA will continue to conduct questionnaire surveys on SME financing and further utilize the financing facilitation hotline. Through these efforts, inspections, etc., the FSA will conduct fine-tuned investigations on whether money required in a region is provided smoothly by confirming such matters as conditions of borrowing enterprises and regional financial institutions' lending trends based on such conditions.

(4) Response to Housing Loan Borrowers

Work will also proceed for housing loans with emphasis placed on the following points.

i) The FSA will intensively verify whether in response to requests from borrowers for changing loan terms, etc., the financial institutions deal properly with borrowers while fully considering the economic situation the borrowers are in, and considering the objective of the SME Financing Act, etc. Especially regarding interest rate cuts, the FSA will check whether the financial institutions plan to take inappropriate measures, such as uniform refusal to reduce interest rates.

ii) The FSA will strive to ensure that institutions give customers appropriate and detailed explanations in order to obtain customers' understanding and consent.

iii) Also with regard to new loans, the FSA will encourage financial institutions to maintain smooth financing with appropriate loan judgments that consider customers' status, including their economic circumstances, while keeping in mind repayment plans that remain feasible for customers in the future, taking into account the effects of interest rate fluctuations.

iv) In the case of housing loans insured by group guarantee companies (including the cases in which the guarantee company, etc. acquired housing loan claims through payment in subrogation), the FSA will intensively verify whether financial institutions are giving guidance to, having dialogues with, and making requests to such guarantee companies as efforts to properly deal with the facilitation of financing, from the perspective of smooth financing also in these companies.

(5) Efforts for Formation of a Sound Consumer Finance Market

From the viewpoint of forming a sound consumer finance market in the medium and long term, there is a need for banks, etc. to actively handle loans to consumers. Therefore, for loans to consumers, the FSA will continue its supervisory work from the previous program year with the following points in mind:

i) Understanding the actual situation as to whether the bank is dealing with consumer loans proactively, considering needs.

ii) Encouraging banks to build suitable screening systems which consider the actual situations of customers, so as to prevent customers from excess borrowing, and to understand the customer’s situation properly when examining a loan, instead of only relying on the information of credit information institutions or guarantee examinations of credit guarantee companies, if using such information.

(6) Promote Initiatives of Financial Institutions which Emphasize Growth Potential

It is envisaged in the New Growth Strategy, etc. that the financial industry should be organized as being capable of providing growth money that is suited to each characteristic of those receiving support by appropriately combining investment and loans, to support innovation-oriented business management from a longer term perspective. The “Comprehensive Strategy for the Rebirth of Japan” cites a specific financial strategy target of increasing the use of new financing methods (including equity-capital-like-debt borrowings, debt-equity swap, debt-debt swap, asset-based lending, etc.) in FY2020 by 50% from FY2010 (an interim target for FY2015 is a 20% increase from FY2010).

Based on the circumstances, regional financial institutions are expected to recognize their own roles, adopt business strategies for the medium to long-term improvement of profitability, and take actions, including the following, and the FSA will urge each regional financial institution to independently tackle these actions:

i) Appropriate and fine-tuned responses that are fully based on the situations of regional economies and customer corporations’ roles in regional economies, and closely meet customer needs (responses that regional financial institutions will make in cooperation with other financial institutions to meet customer needs, including the improvement of business management, the revitalization and realignment of business operations, and entrepreneurs)

ii) Using investment subsidiaries, equity funds, etc. to support corporate growth, business realignment and other efforts, including business founding, startup and new project launching

iii) Proactive utilization of diverse financing methods (including capital borrowings, debt-debt swap, debt-equity swap, asset-based lending, and electronically recorded monetary claims)

3. Risk Management and Stability of Regional Financial System

As sovereign debt problems in European peripheral countries get serious, it has been argued that the crisis could further deepen and expand due to sovereign credit concerns spreading to overall European financial markets and institutions, and thereby impact the real economy.

Under such a situation, the FSA will, with a heightened sense of alertness, supervise risks facing regional financial institutions, in terms of the macro-prudential viewpoints as given below.

(1) Supervision based on the Viewpoint of Macro-Prudence

It is vital that regional financial institutions ensure robust and comprehensive risk management thoroughly under appropriate management control (governance). This is necessary not only for the financial soundness of each financial institution and overall stability of the financial system, but also for regional financial institutions to fully perform financial intermediary functions by providing a stable supply of funds to support the growth of individual companies as well as the real economy in a changing environment.

It is important for the FSA, while enhancing its own risk sensitivity, to encourage voluntary efforts by individual financial institutions toward appropriate risk taking backed by robust risk management, thereby achieving a smooth provision of funds to borrower companies and the financial soundness of financial institutions at the same time.

To this end, it is critical for the FSA, as its basic stance for supervision, to continue to analyze and supervise from the macro-prudential perspective; striving to monitor whether the entire financial system would develop in a sustainable and stable manner. In doing so, the FSA will recognize strong feedback loops between trends in the macro economy/financial markets and financial intermediary functions/soundness of banking. It will pay particular attention to the situation of risk concentration and the channel of propagation, through cooperating with the Bank of Japan. In its actual operations, the FSA will continue to employ a variety of methods which integrate diverse tools, such as macroeconomic analysis, monitoring of financial markets, and supervision of individual financial institutions (i.e., “multidisciplinary approach”).

i) Risk areas to be focused on

- The FSA will continue to be vigilant over possible impacts of the European sovereign debt problem on the financial system and the real economy, as well as any effects of recent trends in U.S. economic and financial developments, and trends in China and other emerging markets, etc. on regional financial institutions.
- As sovereign risk attracts attention in Europe and the rest of the world, debts held by banks, particularly government bonds, have increased in the share of overall bank assets. Under the situation, the FSA will continue to closely monitor and verify regional financial institutions’ risk management systems, for example in terms of whether they consider the potential impact of increases in long-term interest rates and

whether they have enhanced their capital sufficiently to absorb potential losses.

- With regard to stocks that are directly held by financial institutions, the FSA will accurately identify any profit and loss that could arise from market movements as well as its effects on the capital adequacy of financial institutions. It will also continue to assess whether regional financial institutions appropriately manage risks, including financial tolerance, in cases where these risks have become actualized. Especially for stocks that are held for strategic reasons, there may be larger risks due to price fluctuations because of their nature, such as that loss-cutting is relatively difficult. Therefore, the FSA will verify whether regional financial institutions have built a risk management system which considers such unique risks.

  The FSA will also check whether regional financial institutions that hold structured bonds and other complex financial products are prepared to fully understand the characteristics of each product upon purchasing each, and to conduct appropriate risk management based on these characteristics, etc.
- The FSA will check whether regional financial institutions conduct appropriate follow-up on the periodic management of large and complex credits, and on the preparation and implementation of highly feasible, fundamental business reconstruction plans, whether they book appropriate provisions according to customers' situations, and whether they appropriately manage credit risks to secure financial discipline.
- The FSA will pay attention to the characteristics of housing loans, financial institutions' growing competition, etc. and check whether regional financial institutions have established risk management systems that take into account not only the management of repayment arrears, etc. but also the risk of default stemming from interest rate fluctuations, prepayment trends, default tending to arise after a certain period of time from the loan provision (seasoning effect), etc.

ii) Improved Risk Management Techniques

As with risk management techniques, the FSA will verify whether regional financial institutions appropriately implement not only quantitative risk control techniques (e.g., standard economic capital models and VaR control) but also stress tests covering tail risks. It is also checked whether senior management makes effective use of stress testing results. Specifically, the FSA will continue to verify that stress testing and other risk management techniques are conducted, under strong leadership and commitment by senior management, so as to simulate how various events would impact the real economy and financial/capital markets, and to identify how they would directly and indirectly affect bank operations, including in terms of whether an appropriate level of risk taking can be maintained in times of stress.

In doing so, stress tests will be checked relative to the following points:

a) Whether stress tests cover not only moderate recession scenarios but also the most severe scenarios (e.g., considering impacts from simultaneous fluctuation of stock prices, interest rates, foreign exchange rates, etc.)

b) Whether stress tests cover all exposures that should be captured

c) Whether stress tests are not too dependent on a single model or estimation method

The FSA will also continue to have in-depth dialogues with regional financial institutions on the characteristics of each risk and business management challenge.

iii) Enhancement of Financial Foundations

Given the application of Basel III (international standards) from March 2013 and future revisions to domestic standards, the FSA will encourage regional financial institutions to make efforts to improve and enhance their capital bases in a forward-looking manner. In doing so, the FSA will check mainly whether financial institutions seeking to improve and enhance capital bases through the accumulation of internal reserves base their medium to long-term capital policies on highly feasible earning plans reflecting real regional conditions, etc. and whether they work out flexible capital raising plans based on the uncertainties of the earning environment. Particularly, the FSA will supervise cooperative financial institutions in close cooperation with their central organizations that operate their recapitalization systems.

Given that the revised Act on Special Measures for Strengthening Financial Functions was implemented in June 2011 and the deadline for applications for the government's capital participation was extended until the end of March 2017, the FSA will continue to encourage financial institutions to proactively consider using the act for recapitalization for their forward-looking business management.

(2) Enhanced Risk Management Systems to Support Initiatives for Stronger Profitability

In light of both the current financial environment and uncertainties over prospects of Japan's real economy, strengthening profitability by banks will likely gain more importance among management challenges for the banking business, in order for them to continue operations on stable footing.

For financial institutions to work to solidly strengthen their profitability, instead of only treating risk management from a preventive and defensive viewpoint, it is important to study how to integrate risk management with profit management, to substantially underpin and back up initiatives to strengthen their profitability.

i) Considering that profits play an important role in preparing against risks, the FSA will verify the profitability status of regional financial institutions.

In doing so, considering the fact that strengthening profitability has been a structural issue for regional financial institutions, the FSA will work to investigate how practical initiatives in region-based relationship banking are specifically positioned in business strategy and business planning in an effort to enhance the earnings base of regional financial institutions from a medium and long-term perspective. The effort of region-based relationship banking includes the support for borrowing enterprises to obtain sales channels and the support for their advance into overseas market such as Asia including financial institution's overseas advance. The FSA will also investigate how this has been practiced at the entire organization level.

ii)Some regional banks are oriented toward actively developing their overseas operations. The FSA will investigate the systems for managing the operations at overseas locations of such banks. For example, the FSA will investigate whether there is appropriate risk management, including credits for non-Japanese clients. The FSA will also investigate whether comprehensive risk management systems have been developed and upgraded, including for overseas locations. In doing so, the FSA will cooperate with overseas authorities where necessary.

iii) The FSA will investigate whether regional financial institutions develop appropriate risk management systems, such as arranging, managing, and using related data, to understand and identify risks which accompany their development of new businesses.

iv) In the organizational structure of cooperative financial institutions, such as *shinkin* banks and credit cooperatives, their central organizations play a role in supplementing and supporting the operations of their affiliated financial institutions. Along with scrutinizing their situation, the FSA will further collaborate with the central organizations of *shinkin* banks and credit cooperatives, so that they will be able to fully play such a role for helping these cooperative institutions proactively exercise their financial intermediary functions.

4. Improvement of Customer Protection and Convenience for Users

Improving customer protection and convenience for users in financial institutions not only contributes to developing a sound national economy, but also helps stabilize the Japanese financial system by enhancing citizens' trust in financial institutions. It is important in financial institutions to raise their competitiveness by providing original and ingenious financial instruments/services that accurately reflect customers' needs. This effort should be backed by a sense of security and trust that could be achieved by thorough protection of customers' interests. In doing so, the management of a financial institution should fully provide leadership in implementing such measures as strict control of customer information, prevention of the abuse of dominant bargaining power, and management of conflicts of interest.

For customer protection, particularly, nominal compliance with laws is insufficient; financial institutions should fully understand the effects and purposes of specific laws, identify compliance levels required by customers and society for highly public, reliable financial institutions, and meet their expectations.

To this end, a financial institution must discuss and make an appropriate judgment as to whether individual financial products and services are suitable for sale and solicitation in light of the attributes of their customers (e.g. knowledge, experience, wealth level, and objectives), before developing these instruments and services. After this, in selling and soliciting financial products and services, it is essential to provide appropriate and flexible explanations that suit the customers' attributes. In addition, financial institutions must also recognize that complaints and requests for consultations from customers after sale may provide them with opportunities to discover potential customer needs, and thus must respond to them appropriately and actively.

Considering the above, in this program year, the FSA will intensively assess the efforts of financial institutions that aim to improve customer protection and increase convenience for users in the following area, in accordance with its supervisory guidelines. In doing so, the FSA will respect the self-improvement efforts of each financial institution and proceed with supervision in a manner that places emphasis on the incentives to make such efforts.

Consequently, in this program year, the FSA will also pay attention to (1) under what kinds of management policies, what kinds of financial products and services financial institutions are providing to customers with what kinds of attributes, (2) whether there are warped incentives that may arise due to pursuing short-term profits or the existence of conflicts of interest, (3) whether an internal checking system for managerial and other staff members has been developed to verify that management policies are thoroughly implemented by the sales staff. Meanwhile, the FSA will cooperate with the police authorities and the Consumer Affairs Agency as deemed necessary.

(1) Ensuring Business Continuity

i) IT System Inspections, etc.

Computer systems of financial institutions are at the core of their settlement systems. These computer systems have a strong public aspect as social infrastructure. If a failure occurs, it could have a large impact on user convenience and society, and could inevitably lead to loss of the financial institution’s credibility. Therefore, in the last program year, the FSA encouraged each bank to conduct voluntary inspections under active leadership by the management, regarding the awareness of risks in its IT systems, business strategy on investments for IT systems, risk management to cope with the occurrence of malfunctions, etc.

Based on the above, the FSA will verify the following points in the current program year:

a) Whether top managers of financial institutions fully recognize the prevention of computer system glitches and the prompt recovery from such glitches as great business management challenges and have built sufficient relevant systems (for example, whether financial institutions outsourcing computer system management have taken such measures as the appropriate internal distribution of system experts without leaving outsourcees to undertake system management)

b) Whether financial institutions have identified data-processing capacities and have considered systemic and administrative responses to cases where demand exceeds capacity limits

c) Whether financial institutions continuously sort out present underlying system risks and implement methodical investment in system maintenance and improvement

d) Whether financial institutions make and implement specific plans for the succession of their present systems and technologies and for the development of relevant experts

e) Whether financial institutions have fully understood the details of outsourced systems, specified how to share roles, responsibilities, etc. with outsourcees in advance and made monitoring arrangements to the systems including outsources

The FSA will also verify such points as whether top managers identify risks accompanying the replacement and integration of systems and conduct project management appropriately.

Given that regional financial institutions have joint centers and other important outsources, the FSA will particularly focus on their outsourcee management systems, including how these institutions as outsourcers audit their outsourcees.

ii) Validation of Business Continuity System

Being mindful of the experience of the recent Great East Japan Earthquake, the FSA will verify whether financial institutions conduct self-assessments as to whether their existing business continuity plans have effectively functioned, whether they have sufficiently assumed major risks, such as earthquakes and other natural disasters, pandemic influenza and large electricity blackouts, and whether they have built up sufficient countermeasures, etc. The FSA will also identify whether financial institutions have confirmed the effectiveness of their BCPs (including securing fuel, securing staff for continuing business operations, system back-up measures, and customer services regarding clearance, payment, etc.) and have reviewed these systems as necessary through training.

Among measures for the immediate future, financial institutions are implementing electricity-saving measures throughout Japan, including regions covered by Hokkaido Electric Power Co., Kansai Electric Power Co., Shikoku Electric Power Co. and Kyushu Electric Power Co., as electricity supply decreases with nuclear power plants halted. In some regions (including those covered by Kansai Electric), financial institutions are preparing for rolling blackouts as a precaution. The FSA will continue to identify each financial institution’s electricity-saving measures this summer and whether business continuity could remain unaffected at system centers and other key business bases. Given that system glitches and other troubles have occurred even in regions other than those subject to rolling blackouts, the FSA will confirm whether financial institutions and their outsourcees check the preparation of BCPs, the establishment of private power generators and back-up centers, and training for securing the effectiveness of BCPs as necessary.

(2) Ensuring Information Security Control

Customer information forms the basis of financial transactions, and it is important to strictly manage it from the viewpoint of protecting personal information. Furthermore, it is important to strictly manage corporate information in order to increase trust in market transparency and fairness. From these viewpoints, the FSA will strongly encourage the appropriate maintenance of internal management systems for information security, and the enhancement of rules on professional conduct to prevent inappropriate actions by officers (such as information leaks or insider trading).

Particularly, insider trading at financial institutions is a problem that not only could lead to their groups’ loss of trustworthiness, reputation, etc. but also could injure the soundness of the financial system and citizens’ trust in the system greatly. In this respect, the FSA will confirm whether financial institutions have built sufficient internal management systems, including the frequency and details of ex post facto checks and reporting to top managers, to prevent illegal acts on a group-wide basis covering subsidiaries, sister companies, etc.

After reviewing firewall regulations, the FSA built a principle-based framework encouraging financial institutions to develop their voluntary conflict-of-interest management systems. In this respect, the FSA will verify whether financial institutions attempt to take accurate measures to harmonize increased customer convenience with conflict-of-interest prevention, etc.

(3) Enhancement of the Framework for Providing Explanations to Customers

Regarding the sales of risky products, such as investment trusts, structured bonds and derivatives (including foreign exchange derivatives), and insurance solicitation, the FSA will consider the following points in supervising financial institutions. Given that deposit-handling banks have customers who prioritize the safety of principal, the FSA will particularly note that the following points cover the development, promotion and sales of not only the abovementioned products but also other risky products that could lead to a loss of principal.

Problems are still emerging in regard to banks' previous contracts for foreign exchange derivatives against the backdrop of current foreign exchange market conditions, etc. In the future, the FSA will check not only whether financial institutions give explanations on losses for worst scenarios when selling these derivatives but also whether they respond carefully and appropriately to customers' claims and consultation requests.

i) Systems for Sales of Investment Trusts, Structured Bonds, Derivatives, Insurance Products, etc.

The FSA will intensively verify whether financial institutions establish and make functioning frameworks for solicitation and explanation to each customer, as well as for follow-up after sales that suit the customer's circumstances and are compliant with regulations on unsolicited offers. In particular, the FSA will particularly focus on the following points:

a) Whether financial institutions make appropriate sales preparations, including the targeting of suitable customers according to risks, complexity and characteristics, of the products they develop, promote and sell, and whether they swiftly and appropriately implement sales strategy revisions, including changes of the targeting of customers, in consideration of customer claims, risk fluctuations, etc. even after sales

b) Whether financial institutions fully confirm customers' investment purposes and intentions so as to identify customer attributes, and make customer cards, so that customers' investment intentions are shared among customers and financial institutions

c) Whether financial institutions give appropriate and flexible explanations about risks and inherencies of products to customers in light of their knowledge, experience, wealth level, and the purpose of investment, so as to help them make the right decision for each investment (particularly, whether financial institutions give appropriate explanations on profit or loss, sales and promotion fees, and other matters that influence customers' investment decisions)

d) Whether financial institutions make check-sheets as needed and collect them from customers to confirm their understanding about the contents of explanations

e) Whether financial institutions provide customers with warning documents

f) Whether the salary and bonus systems of the sales staff and managers are not biased and do not have excessive links to gaining short-term profits

g) Whether the sales system and product composition place too much emphasis on gaining fee earnings

h) Whether measures are taken to prevent harmful practices and events, such as the abuse of the dominant bargaining position and false recognition by customers regarding similarities to deposit instruments.

ii) Systems for Sales of Currency Selection Type Funds

In addition to the points mentioned above in i), the FSA will focus on the following points:

a) Whether adequate explanations are provided to customers in sales, in light of peculiarities and risk characteristics of mutual funds, including those investing in foreign stocks and bonds, currency selection funds, and monthly distributable funds

b) Whether financial institutions implement prudent sales management, including the requirement for managerial officials' approval on sales of currency selection funds and other highly risky products, particularly for customers who prioritize the safety of principals

c) Whether financial institutions, when selling or cancelling investment trusts, provide adequate explanations on losses or profits, sales and cancellation fees, trust fund fees and other costs, the possibility of including part or all of dividends in principal repayments, and other key matters that could influence customers' investment decisions (particularly, whether financial institutions provide careful explanations on these points to switch from some investment trusts to others, while preventing any unnecessary switching by customers)

d) Whether financial institutions are doing business from the customer's viewpoint, for instance, creating and providing documents to customers (e.g. prospectus) with easily understood descriptions of information on risk characteristics, fees and dividends

e) Whether financial institutions, when concluding currency selection type fund investment contracts with customers with no experience in investment in such funds, receive customers' statements specifying their understanding of product and risk characteristics, and keep these statements

f) Whether financial institutions provide customers with fine-tuned investment support, including timely and adequate information in a case where rapid changes in market trends are likely to gravely affect standard sales prices of investment trusts

iii) Sales Systems to Corporate Customers (Pension Funds, etc.)

There are differences in the knowledge and understanding of financial products between financial institutions and their corporate customers as well as individual customers, in regard to the development, sales, and promotion of the abovementioned financial products and services. Therefore, the FSA will check whether financial institutions implement adequate development and revision of sales strategies, explanations to customers upon sales and solicitation, follow-up actions based on market environment changes, etc.

iv) Others

The FSA will strongly encourage financial institutions to develop systems to allow people with disabilities and elderly people to easily and securely utilize financial services through counters and ATMs at financial institutions.

(4) Enhancement of the Framework for Processing Consultations and Complaints from Customers

It is extremely important for financial institutions to have proactive, timely and appropriate consultations and complaint handling, in order to ensure customer's trust in financial products and services, and to positively utilize the customers' needs for better management of business. From this viewpoint, the FSA will assess whether financial institutions develop an internal control system, under the involvement of the top management, for maintaining a consultation window, analyzing the causes of consultations and complaints, sharing information within the institution, taking measures and notifications to prevent the recurrence of complaints, and following up the implementation of these measures, in an appropriate manner.

Also, in connection with the financial Alternative Dispute Resolution (ADR) system that was introduced in October 2010, the FSA will carefully watch whether financial institutions are: i) making sincere efforts for quick dispute resolution, such as active disclosure of required information; ii) preparing arrangements for facilitating easy use of the system nationwide; iii) introducing the ADR system to customers as needed when they make consultations; and iv) providing explanations anew on the ADR system when customers' consent is difficult to obtain between parties or when financial damages are difficult to determine.

(5) Preventing Abuse of Financial Functions

In order to ensure security for users, the FSA will verify, based on the following perspectives, whether regional financial institutions develop management systems to prevent financial functions from being abused and to take adequate care of crime victims. In doing so, the FSA will check IT systems and other arrangements at financial institutions to properly confirm customers' identities, and to detect transactions that are strongly suspected of being illegal and take appropriate actions, including the freezing of deposit accounts.

i) Do financial institutions make efforts to eliminate crimes including the "Furikome Fraud" that harm other people's assets? In particular, do financial institutions place priority on taking measures against Furikome Fraud that misuses earthquake recovery donations? From the viewpoint of prompt recovery of victims' financial damages, in accordance with the Furikome Fraud Relief Act, do financial institutions deal with victims properly by halting transactions involving deposit accounts used in crime, providing information to the suspected victim regarding funds remaining in such accounts, distributing funds thereafter, etc.?

ii) Do financial institutions make efforts to prevent unauthorized withdrawals from counterfeit/stolen cash cards, stolen passbooks, and internet banking? Do financial institutions pay compensation to victims properly according to the Depositor Protection Act and agreements within the industry? Do financial institutions make efforts to enhance cooperation with police through such measures as the conclusion of a crime prevention agreement with police to respond to various cyber attacks, etc.

based on the fact that the Act on the Prohibition of Unauthorized Computer Access was revised in May 2012 to toughen penalties for unauthorized access? Do financial institutions adopt appropriate personal identification methods for internet banking, including variable passwords and electronic certificates, and others that do not depend only on fixed IDs or passwords, to deal with transaction risks in consideration of individual and corporate customer attributes?

iii) Do financial institutions develop systems to respond to the revised Act on Prevention of Transfer of Criminal Proceeds that will take effect in April 2013 for preventing money laundering and terrorist financing transactions? International discussions on tougher measures against money laundering and terrorist financing transactions have made progress, with the Financial Action Task Force giving a revised FATF recommendation in February 2012. Do financial institutions develop systems for cross-sectional cooperation and information-sharing between relevant divisions for organized efforts to prevent money laundering and terrorist financing transactions?

iv) Do financial institutions make appropriate efforts, such as developing procedures and arrangements to cut relationships with antisocial groups, aiming to prevent antisocial groups from damaging the financial institution, managers, and various stakeholders such as customers, with strong will of the top management and the entire organization to eliminate antisocial groups from financial transactions? Do financial institutions develop group-wide internal management systems (including monitoring) that allow subsidiaries, sister companies, and other affiliates or divisions engaged in operations other than commercial banking to make the same efforts that the financial institution makes?