(Provisional Translation)

Monitoring of Foreign Bank Branches and Foreign Securities Companies

June 2025

Financial Services Agency

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1. Introduction

The FSA supervises and monitors foreign bank branches and foreign securities companies.[1]

These foreign financial institutions play an important role in the Japanese financial market by leveraging the strength of the group's network to support the overseas expansion of Japanese corporations and to facilitate market access for domestic and foreign institutional investors.

In recent years, the business activities of foreign financial institutions have increased due to changes in interest rates and the economic environment, progress in corporate governance reforms, and rising geopolitical risks in other parts of Asia. Under such circumstances, with the aim of supporting appropriate and sound business development of each Japanese entity, the FSA has endeavored to deepen its understanding of the business model of Japanese entities, and to monitor whether their governance, compliance, and risk management frameworks are suited to their business models. Specifically, based on the analysis of the regulatory reports on the business, financial conditions, and risk conditions and reports on the governance framework of the group submitted by each Japanese entity, the FSA has conducted interviews regarding the current status of the business, the compliance framework and the internal audit framework, and has endeavored to understand the strategies and strengths of each Japanese entity, as well as the effectiveness and issues of the three lines of defense model.

This report summarizes FSA's findings in recent years, including quantitative analyses, with a focus on large Japanese entities of US and European banks, as well as the situation of foreign bank branches of Asian banks.

2. Business

US and European banks operate corporate and investment banking business lines such as CIB (Corporate and Investment Banking) through foreign bank branches and foreign securities companies in Japan.[2] Business is conducted in cooperation with the head office and other offices of the group. The operations and technologies that support the business are operated and managed across multiple offices of the group.

(1) Banking

Foreign bank branches provide services such as deposits and loans, trade finance, fund settlement, and foreign exchange, mainly to Japanese corporations, and engage in foreign exchange and derivative transactions such as currency swaps with institutional investors, including Japanese banks. As for loans, in addition to stand-alone credit related to business needs such as working capital, foreign bank branches respond to customers' funding needs through syndicated

[1] Branches of foreign banks, foreign trust banks, foreign securities companies, and branches of foreign securities companies.

[2] Some groups have wealth management businesses in Japan. Some groups do not have foreign bank branches.

loans and project finance for large-scale projects such as corporate restructuring and new energy, as well as asset finance using aircraft and ships as collateral.

The outstanding balance of deposits and loans at the end of December from 2020 to 2024 at 11 major foreign bank branches shows an increasing trend (Figure 1 and 2)[3],[4].

Some foreign bank branches are strengthening their provision of liquidity, cash management services, and custody services, particularly to Japanese corporates operating on a cross-border basis. This is considered to have contributed to the increase in deposits.

Regarding loans, in addition to yen-denominated and foreign-currency-denominated loans and trade finance to Japanese corporate groups and Japanese financial institutions, there have been notable efforts in recent years to provide syndicated loans, project finance, and asset finance in collaboration with Japanese banks.

Figure 1: Deposits

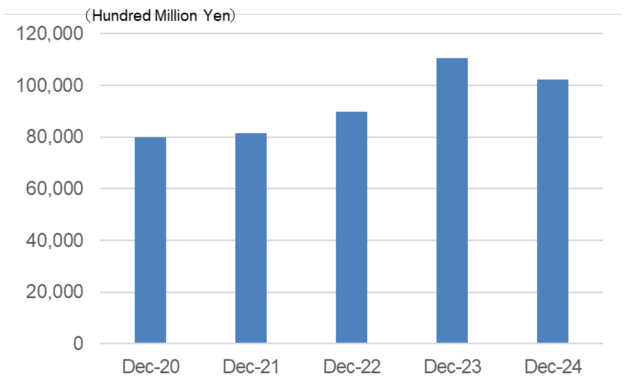
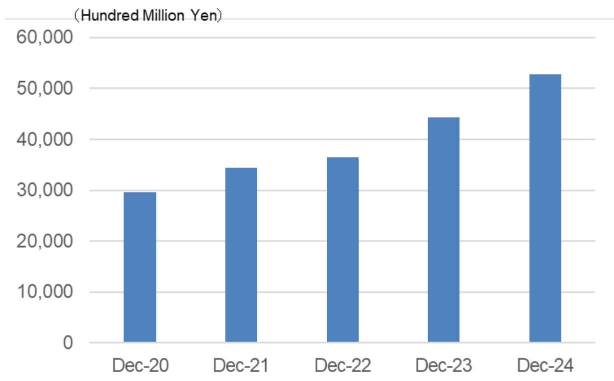


Figure 2: Loans



Note: A total of 11 foreign bank branches (10 branches in 2024).
Source: FSA

Some loans to Japanese multinational corporations are not booked at foreign bank branches, even though they are executed with the involvement of foreign bank branches. Regarding syndicated loans to Japanese corporates, based on external information obtained by the FSA, we understood that US and European banks play a central role in providing loans to overseas entities of Japanese multinationals, while also providing loans to domestic entities.

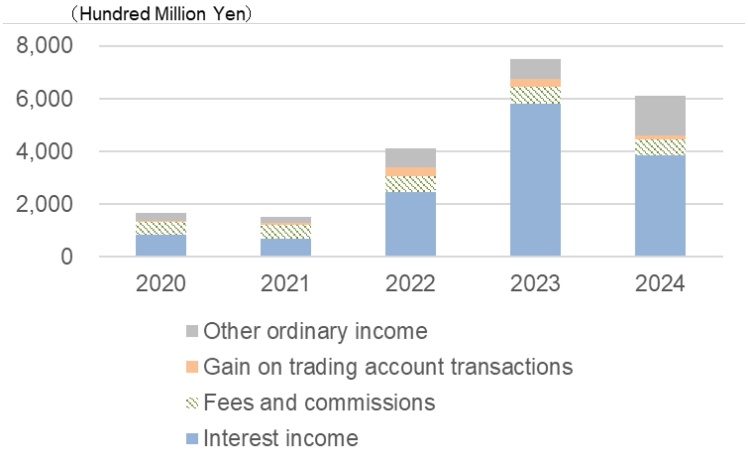
The revenues of the 11 major foreign bank branches from 2020 to 2024 (Chart 3) have been on an increasing trend, with "interest income" increasing significantly in terms of both amount and ratio. Revenues in 2024 were down from 2023, since only branches that end their fiscal year in December were included.

Interest income is mainly comprised of interest earned on loans, interest earned on deposits with

[3]Deposits and loans denominated in foreign currencies are impacted by exchange rate fluctuations.
[4]The aggregate balance of deposits at the end of December 2024 decreased from the previous year, mainly due to a decrease in deposits from certain operating companies.

the Bank of Japan, interest earned on fund transactions with the group's head office and other offices, and interest earned on swap transactions with Japanese banks. The increase in interest income is attributable to an increase in interest margins on loans and swap transactions reflecting recent changes in the interest rate environment, as well as an increase in the volume of these transactions.

Figure 3: Earnings Structure and Trends in Banking Business



Note: A total of 11 foreign bank branches. January through December (branches that end their fiscal year in December) or April through March (branches that end their fiscal year in March). Figures for 2024 are aggregates for 9 banks that end their fiscal year in December.
Source: FSA

Column A: Recent Development in CIB and Payments Business

Many banks provide integrated services, such as deposits and loans, fund settlement and remittances, fund raising support, M&A-related services, and custody services, to institutional investors and corporates through business lines such as CIB. In recent years, some groups have been putting effort into expanding the client base of CIB from large, cross-border enterprises to medium-sized enterprises and start-ups and strengthening their cash management capacities.

These developments are driven by the need for CIB services as medium-sized enterprises and start-up companies expand their businesses globally. For these companies, cash management in particular is a trigger for starting various transactions with the bank. Cash management is also a means to acquire sticky deposits.

In line with the group's strategy, some of the Japanese entities are also engaging in the provision of various services, such as cash management, to acquire Japanese medium-sized enterprises and start-ups as new clients and support their cross-border business development.

The core of cash management is the remittance and settlement of funds denominated in local currencies and the management of liquidity through actual and notional pooling, utilizing the group’s network of branches and systems across multiple countries. At corporations with cross-border operations, overseas subsidiaries in each country have local bank accounts and pay and receive funds from employees and business partners in the local currency. By using a liquidity management service, the excess or shortage of funds in each account can be concentrated in one account, thereby saving liquidity. The amount of funds to be maintained in each account can be predetermined, and when an excess or shortage occurs, funds can be automatically transferred to and from other accounts.

The FSA would like to deepen its understanding of these services from the viewpoint of whether they will lead to the acquisition of deposits and other businesses in Japan.

Column B: Custody Service

Some US and European banks have strengths in custody services. US or European entities of those groups sign agreements with institutional investors as global custodians concerning the safe custody and settlement of securities as well as the receipt of interest and dividends on securities. The Japanese entities, acting as a sub-custodian entrusted by the global custodian, provide custody services related to Japanese stocks and bonds.

Against the background of progress in corporate governance reforms and changes in the interest rate environment in Japan, overseas institutional investors are actively investing in Japanese stocks and bonds, and the importance of custody services is increasing. The FSA would like to deepen our understanding of custody services at each Japanese entity, and also monitor the operational risk management framework.

(2) Securities Business

Foreign securities companies conduct brokerage of cash equities and derivatives, bond trading, and various types of OTC derivatives transactions with Japanese and overseas institutional investors and financial institutions, as well as Japanese and foreign corporates, in accordance with their respective strengths. They also actively conduct proprietary trading for the purpose of market-making and earning profits.

Looking at the trading volume of stocks and bonds and the volume of derivative transactions for the 13 major foreign securities companies from 2021 to 2024 (Charts 4-9), the trading volume of stocks and bonds has been increasing except for the volume of bond option transactions. In each graph, the 2024 figure shows a decrease from the 2023 figure, since only companies that close their fiscal year in December are included in the 2024 figures.

Many Japanese entities trade in response to orders from domestic and foreign institutional investors. In recent years, some foreign securities companies have demonstrated their strengths in accepting orders for high-speed trading. Some securities companies also provide liquidity to the market as market makers by conducting high-speed trading on their own.

Figure 4: Equity Trading Value

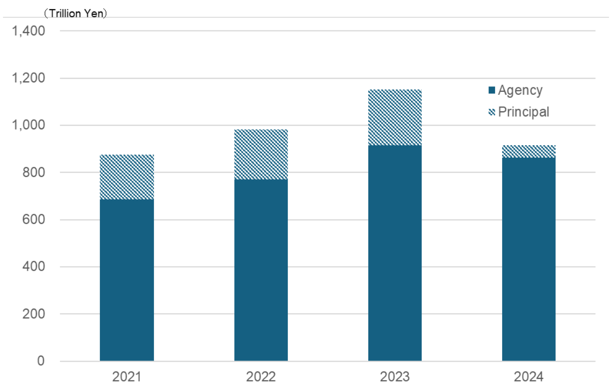
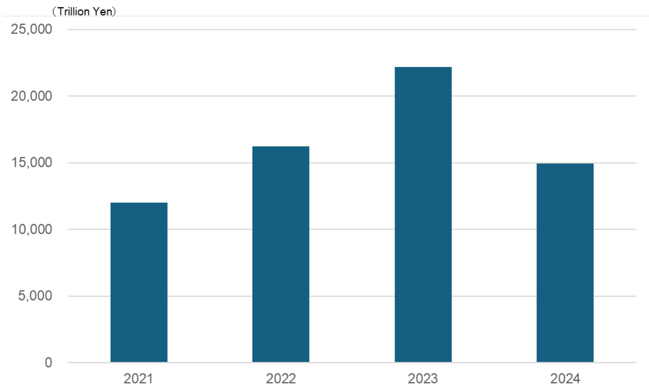


Figure 5: Bond Trading Value



(Note) A total of 13 foreign securities companies. January to December (companies that end their fiscal year in December) or April to March (companies that end their fiscal year in March). 2024 figures are aggregates of 10 companies that end their fiscal year in December.
Source: FSA

Figure 6: Stock Futures Trading Volume

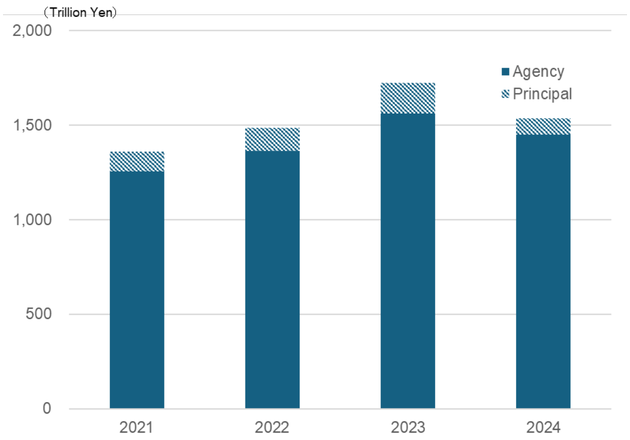
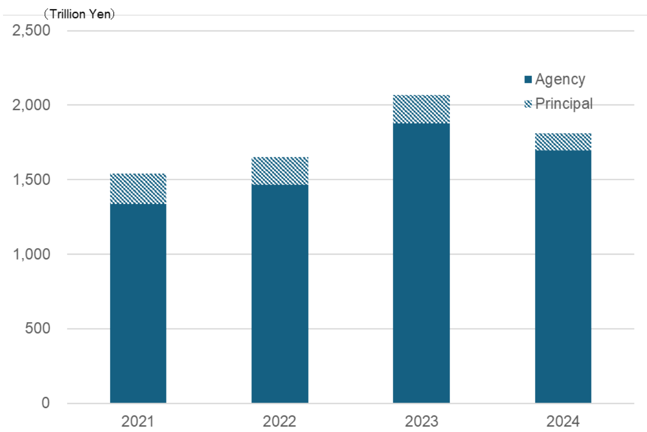


Figure 7: Bond Futures Trading Volume



(Note) (Source) Same as above

Figure 8: Stock Option Trading Volume

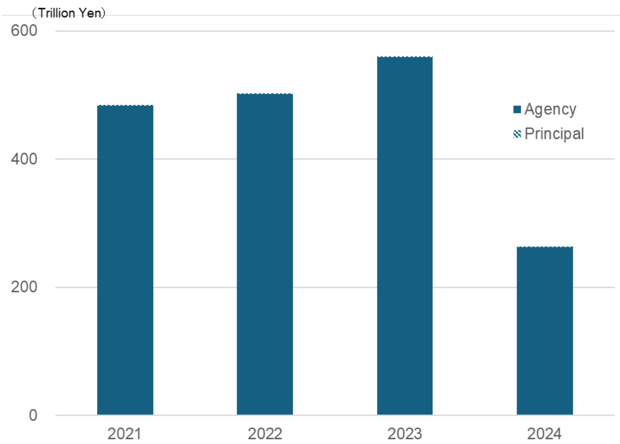
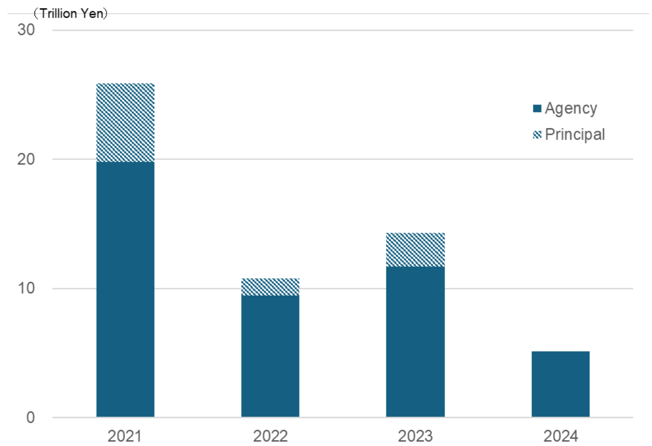


Figure 9: Bond Option Trading Volume



(Note) (Source) Same as above

In addition, Japanese entities demonstrate strength in having a global client base and supporting fund raising (ECM[5] and DCM[6]) through underwriting and secondary offerings of various securities issued in Japan and overseas by major Japanese companies and financial institutions, as well as supporting M&A activities. Their efforts are backed by factors such as corporate governance reforms.

Since these businesses are provided in collaboration with other entities within the group, FSA analyzed the size of these businesses at the group-level, based on external information obtained by the FSA.

In equity underwriting, US banks have a good record in domestic underwriting[7] and play a key role in overseas underwriting[8]. Overseas underwriting is often a large-scale project carried out together with domestic underwriting in the form of a global offering. Groups with good track records in overseas underwriting are likely to be involved in these projects as global coordinators. In such projects, foreign financial groups display their strength, as they have an underwriting base (client base and project execution capability) in both the overseas and the Japanese market to which the issuing companies seek access.

US banks and European banks also performed well in bond underwriting, particularly in overseas issuance[9]. As in the case of equities, this indicates their strength in access to overseas investors.

In the M&A-related business, US groups are major players in cross-border outbound M&A[10] and inbound M&A[11], demonstrating their strengths in terms of access to overseas investors and corporations.

Commissions that comprise the earnings of the 13 major securities companies have been trending steadily between 2021 and 2024 (Chart 10). Commissions received in 2024 were lower than those in 2023, since only companies that end their fiscal year in December were included in the 2024 data.

Each year, the "other fees received" account for the majority of commissions received.

Revenues earned by foreign securities companies from the handling of M&A transactions are accounted for as "revenues related to M&A." Revenues from contributions to earnings from overseas underwriting business, cross-border M&A, and trading business are accounted for as “dividends to Japanese corporations related to international transactions.”

"Others" under "Other fees received" includes revenues related to the distinctive businesses of each Japanese entity, such as system usage fees for accepting orders of high-speed trading.

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[5]ECM stands for Equity Capital Markets and generally refers to support for funding in equity markets.
[6]DCM stands for Debt Capital Markets and generally refers to support for funding in the bond market.
[7]Domestic equity underwriting refers to the act of underwriting new share issuance (public share offering) and secondary offering of shares already issued by Japanese companies in Japan.
[8]Overseas equity underwriting refers to the act of underwriting for the secondary offering of newly issued or already-issued shares overseas by Japanese companies.
[9]Overseas bond issuance by a Japanese company in yen or in a foreign currency.
[10]M&A transactions where the buyer is a Japanese company, and the seller is a foreign company.
[11]M&A transactions where the buyer is a foreign company, and the seller is a Japanese company.

Figure 10: Trends for Commission Received

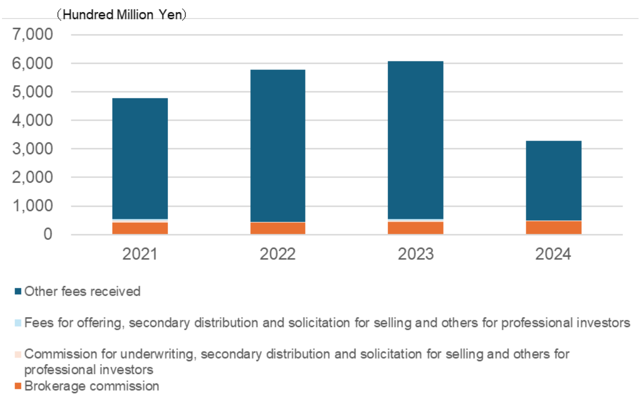
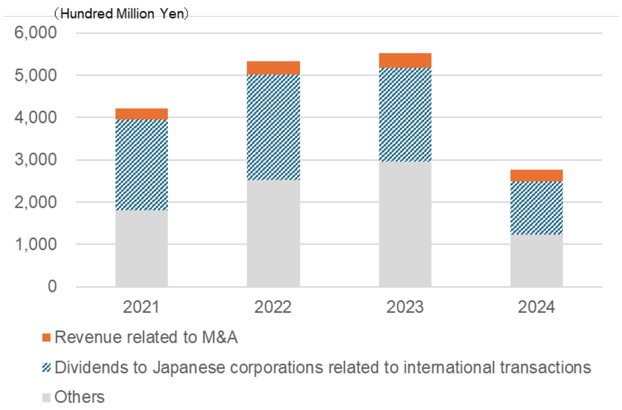


Figure 11: Trends for Other Fees Received



(Note) Total of 13 foreign securities companies. January to December (companies that end their fiscal year in December) or April to March (companies that end their fiscal year in March). Figures for 2024 are aggregates for 10 companies that end their fiscal year in December.
Source: FSA

Column C: International Governance Framework

In US and European banks, the CEO and other members of the Executive Committee manage the business under the supervision of the Board of Directors. Each business line and each function is managed by and reports to the respective heads at the Executive Committee level.

Overseas offices are managed through regions such as APAC. Some groups have established international departments to manage overseas offices.

At major entities outside their home countries, including Japanese entities, each business line or function reports to the respective heads at the regional level, and matrix reports to the Chief Country Officer. Either of the two is the primary reporter, depending on each entity.

The Chief County Officer for Japan reports to the CEO of the region. In groups with an international department, the regional CEO reports to the head of the international department. In groups without an international department, the regional CEO is often the regional head of a business line and reports to the group head of the business line.

While reporting through business lines or functions plays a central role in governance, to ensure appropriate and sound business management at the Japanese entities, it is important that the Chief Country Officer for Japan supervise each department within the entity and that he or she engage in necessary discussions and coordination with the region and the headquarters, including securing resources. The FSA will continue to pay attention to the international governance frameworks.

Column D: Cooperation with Home Regulators

The FSA has participated in supervisory college meetings as a member of the college, mainly for foreign financial groups with large entities in Japan, and deepened its understanding of the group's governance, business, and issues regarding risk management. In addition, the FSA has made efforts to share supervisory priorities and issues with the home country supervisors on multiple occasions including bilateral meetings. The FSA has utilized the knowledge gained from these efforts in monitoring Japanese entities. FSA understands that the home regulators also utilize information shared from FSA in many cases.

In 2024, the FSA held for the first time a global college of supervisors meeting for a foreign financial group, co-hosted by the home regulator and the Bank of Japan. Going forward, the FSA will continue to deepen cooperation with overseas regulators through active participation in college meetings in order to ensure effective monitoring of Japanese entities.[12]

Column E: Recovery and Resolution Planning (RRP) & Crisis Management Group (CMG)

For the G-SIB[13] groups, in addition to the requirement of recovery and resolution planning (RRP), a crisis management group (CMG) [14]has been established for the purpose of preparing for a cross-border financial crisis and taking necessary actions for crisis resolution in cooperation with relevant authorities. The FSA has participated in the meetings as a member of the CMG, mainly for foreign financial groups with large entities in Japan and has deepened its understanding of each group's resolution plan and the progress each group has made toward smooth implementation of the plan. The interest of the CMG meetings in recent years has shifted to assessing financial institutions' efforts to improve the feasibility of resolution plans. Specifically, there has been active discussion on the status of development of frameworks for measuring capital and liquidity required for each group in resolution, measures to smoothly provide capital and liquidity to significant subsidiaries, and communication strategy with external stakeholders, as well as the status of efforts to verify the feasibility of these frameworks. The FSA will continue to strengthen its preparedness for a crisis through active participation in the CMG meetings.

[12]Some college meetings are held on a regional basis, such as Asia-Pacific (APAC) meetings, while others are held globally.
[13]"Global Systemically Important Banks" (G-SIBs) are a group of financial institutions selected by the Financial Stability Board (FSB).
[14]Established in accordance with the Financial Stability Board (FSB) Key Attributes of Effective Resolution Regimes for Financial Institutions (published in 2011 and revised in 2014 and 2024).

3. Compliance

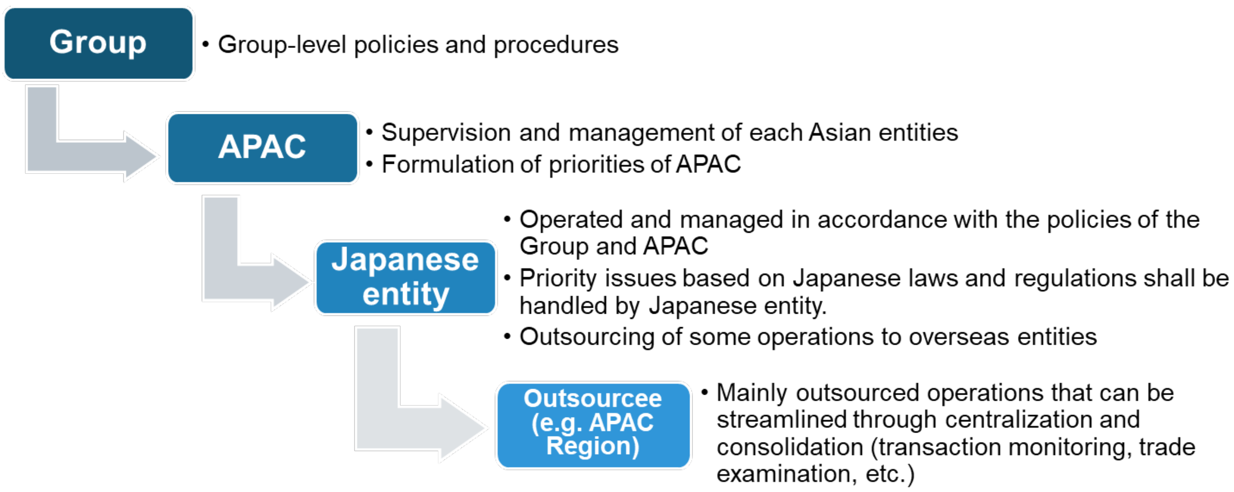
The FSA understands that the compliance framework developed and implemented at each Japanese entity is generally as follows:

(1) Compliance framework

I) Organization

- The compliance department at each Japanese entity is led by the Chief Compliance Officer. The members are partially double-hatted and are responsible for the foreign bank branch and the foreign securities company. The compliance department in each Japanese entity operates in accordance with the group's compliance policies and procedures. Issues related to compliance with Japanese laws and regulations are reflected in various procedures, such as risk assessment and the formulation of compliance plans.
- The compliance department outsources some activities to other entities in the group (mainly in the Asia-Pacific (APAC) region) while ensuring their appropriateness as the outsourcer. The outsourced activities include transaction monitoring relating to AML/CFT and trade surveillance, for which operational efficiency can be enhanced through centralization. However, in most cases, the outsourced entities are responsible for primary reviews, and secondary reviews are often conducted at the Japanese entity. Activities that require Japanese language skills, such as communication monitoring, and other priority issues based on Japanese laws and regulations are often handled by the Japanese entity.[15]
- The Chief Compliance Officer reports to the Chief Country Officer of the Japanese entity as well as to the regional compliance department.

Figure 12: Organization of the compliance department and allocation of duties



(Source) FSA

[15] In many cases, the outsourced entities conduct primary reviews to check whether transactions selected based on predefined transaction patterns or thresholds require further examination. As a result, transactions that require further examination are subject to secondary review at the Japanese entity.

II) Compliance Process

(a) Risk assessment

- Compliance risk is identified in accordance with group-level policies and procedures through (a) defining the scope and units of assessment (e.g., departments and business processes), (b) assessing inherent risk and the effectiveness of controls; and (c) determining of residual risk. For Japanese entities, risks specific to Japan, such as Japanese laws and regulations and market practices, are reflected in the assessment.
- In some Japanese entities, the compliance department carries out its own risk assessment. Some entities utilize Risk Control Self-Assessment (RCSA), whereby the self-assessment by the first line is challenged by the second line.

(b) Formulation and Implementation of a Compliance Plan

- The compliance department at each Japanese entity formulates a compliance plan consisting of monitoring, testing, training, and other relevant activities based on the group's priority and the results of risk assessment and carries out various activities in accordance with the plan.

(c) Reporting on Compliance Activities

- When issues such as suspected violations of laws and regulations are identified through monitoring by the compliance department, they are reported within the Japanese entity and to the group using a dedicated system for issue escalation. In addition, after the causes are identified and remediation plans are determined, the progress of remediation is followed up on until completion.
- The status of activities by the compliance department is regularly reported to the Management Committee.

III) Initiatives on important compliance topics

- The following are priorities and initiatives observed at many of the Japanese entities.

Priorities	Initiatives by the Compliance Department
AML/CFT	● Controls related to AML/CFT include implementation of risk mitigation measures such as sanctions screening and transaction monitoring. ● At some branches, efforts are being made to strengthen KYC and transaction monitoring for clients such as funds transfer service providers and payment receiving agents (“Shuno-Daiko”). ● Regarding transaction monitoring, many branches have introduced a system to detect and automatically stop remittances

Priorities	Initiatives by the Compliance Department
	to countries subject to economic sanctions and other remittances subject to monitoring. ● Given the heightened AML/CFT risks, some groups have established an AML/CFT function separate from the compliance function to strengthen controls.
Fraudulent Trading	● Measures to address market fraud include trade surveillance and communication monitoring. ● In trade surveillance, screening and verification are conducted by applying both group standards and Japanese standards. ● Communication monitoring is also conducted based on group and Japan-specific scenarios. In recent years, several groups' compliance departments have faced the challenge of dealing with off-channel communication, i.e., using personal communication tools for work.
Measures to Prevent Conflict of Interest	● Efforts to comply with the requirement to manage information of the investment banking division and to prevent conflict of interest include the development and monitoring of Chinese walls and firewalls within and between relevant divisions and the management of wall crossings. ● Considering recent cases of administrative disciplinary actions, each Japanese entity is reviewing its own control framework.
Customer-Oriented Business Conduct and Product Governance	● To ensure customer-oriented business conduct and product governance pertaining to the 3rd party distribution of structured bonds, each Japanese entity is making efforts such as review by the compliance department and screening and discussion by the new product committee.

(2) Initiatives Related to Strengthening the Compliance Framework

Many foreign financial groups are taking various actions related to strengthening their compliance framework against the background of issues pointed out by their home regulators. The Japanese entities are also taking actions in line with the group's actions.

I) Compliance with Laws & Regulations of Each Country

- Several groups have developed a framework for systematically recording laws and regulations of each country using a dedicated system and updating them through monitoring of regulatory trends. The Japanese entities were utilizing the framework to ensure appropriate regulatory change management.

II) Rebalancing the Three Lines of Defense Model

- Several groups have been rebalancing their three lines of defense model, such as transferring some of the operations of the second line to the first line, with the aim of increasing the first line's risk ownership and allowing the second line to focus on challenging the first line. Similar efforts were also seen at Japanese entities.

III) Strengthening Non-Financial Risk Management

- Several groups have changed their approach to managing compliance risk and operational risk by integrating the management of those risks as non-financial risk. Others have launched projects to strengthen operational risk management, including increasing staff numbers and strengthening coordination among relevant departments.[16]
- Behind these efforts is the growing importance of operational risk management, as pointed out by the home regulators. Since operational risk and compliance risk largely overlap with each other, banks intend to enhance the effectiveness and efficiency of risk management by managing them in an integrated manner and strengthening collaboration among relevant departments.
- Multiple groups are taking steps to improve data quality, such as digitizing and quantifying non-financial risks and unifying the formats for collecting and aggregating data.
- To digitize and quantify non-financial risks, it is necessary to calculate opportunity losses and conduct scenario analysis. Some groups are considering the use of AI to enhance these analyses.

[16]There are groups where the Chief Risk Officer (CRO) is responsible for non-financial risks, including operational risk and compliance risk. There are also groups where the Chief Legal Officer (CLO) or the Chief Compliance Officer (CCO) is responsible for non-financial risks.

Column F: Change Management

Several groups are making efforts to strengthen change management. Change management refers to a framework that ensures necessary actions are taken based on sufficient risk assessment in response to changes in laws and regulations, products and services, systems, and operations. An example of efforts to strengthen change management related to changes in laws and regulations is the recording of the laws and regulations of each country related to the group's business on a dedicated system to manage the changes and the status of responses to changes. Efforts by foreign financial groups related to changes in products and services, and operations are as summarized in "Lifecycle Management of Products, Services and Activities" (June 2024).[17] Regarding system changes, there are efforts to establish policies and procedures for system change management as a group, and manage the registration of changes, risk assessment, and necessary actions based on the risk using dedicated workflow tools. In addition, in the event of an issue caused by a system change, there are efforts to record the issue and the cause to strengthen change management.

If change management is insufficient, issues may arise in compliance with laws and regulations. Therefore, the FSA will pay attention to the effectiveness of change management at each Japanese entity.

Column G: RCSA

In each group, Risk Control Self-Assessment (RCSA) is primarily used as a framework for managing operational risk. Under RCSA, owners of the activities (mainly the first line) identify the processes involved in their activities, identify the risks inherent in those processes, assess the risk of those processes, assess the effectiveness of the controls in place to manage risk (control environment), and combine their assessment of the risk and control environment to determine whether risks are adequately mitigated.

In recent years, efforts have been made to improve the effectiveness of RCSA by developing a group-level taxonomy for processes, risks, and controls and using this taxonomy in RCSA. Some groups integrated compliance risk assessment and RCSA, where the results of RCSA by the first line are challenged by the second line. The internal audit department of some groups uses the same assessment unit as RCSA.

Since operational risk management plays an important role in ensuring sound business at the Japanese entities, the FSA will continue to pay attention to the groups’ efforts to enhance operational risk management including RCSA, as well as the implementation at the Japanese entities.

[17] Discussion Paper on Lifecycle Management of Products, Services and Activities

4. Internal Audit

The FSA understands that the internal audit framework developed and implemented at each Japanese entity is generally as follows.

(1) Internal Audit Framework

I) Organization

- The internal audit department at each Japanese entity operates under group-level policies and procedures. Compliance with local laws and regulations is reflected in various procedures, such as risk assessment and audit planning.
- Auditable entities within the Japanese entity may be covered by audits conducted by the Japanese internal audit team. They may be covered as part of audits conducted by the regional or group internal audit teams.
- In many cases, the Chief Audit Executive at each Japanese entity is responsible for reporting to both the regional head of internal audit and the Chief Country Officer of the Japanese entity. In some groups, there are audit executives in charge of specific business lines or functions at the regional or group level. In those groups, the Japanese internal audit team reports to the relevant executives.
- The group's internal audit department reports to the group Audit Committee and also reports to the CEO from an administrative perspective. This ensures the independence of the internal audit department and in turn improves the quality of assurance.

II) Internal Audit Process

(a) Risk Assessment

- As the nature and structure of business at the Japanese entity may change due to changes in the business environment, the internal audit team uses organizational charts, mappings to risk events, and other means to ensure the sufficiency of the audit universe.
- The internal audit department conducts risk assessment separately from RCSA and compliance risk assessment. Residual risk is determined based on the inherent risk of each auditable unit and the effectiveness of the control environment. The frequency of audits is determined by the risk. The results of the risk assessment are coordinated with group-wide audit priorities and priorities based on management's recognition of potential risks from a company-wide perspective and are reflected in the audit plan.
- To ensure the appropriateness of risk assessment, several audit teams compare and adjust risk assessment results across similar auditable entities within the group.

(b) Audit Planning and Execution

- The audit plan is designed to meet the audit frequency determined based on the residual risk of each auditable entity in the Japanese entity.
- In addition to risk-based audits, audits to validate the effectiveness of remediation for

audit findings and regulatory findings, audits for events that have a material impact on the control environment, such as large-scale system updates, and continuous monitoring of business activities are incorporated into audit plans and implemented. The audit department at each Japanese entity does not provide consulting services in principle.

- Audit plans are subject to ongoing review to reflect the results of individual audits and continuous monitoring.

(c) Reporting of Audit Results and Status of Activities

- The audit report includes audit scores, audit subjects, scope, procedures, findings and root-cause analysis, and a remediation plan that is owned by the management of the audited departments.
- The status of activities by the internal audit department is regularly reported to the Management Committee. In addition to audit results, findings in ongoing audits are shared with management.

(d) Follow-Up Process

- In many cases, audit results and findings are registered in a system owned by the internal audit department from the viewpoint of information sharing and visualization between the internal audit department of the group, regions, and the Japanese entity and related management. The progress of remediation is also managed through the system.
- With regard to audit-identified issues and regulatory issues, it is an important task of the internal audit department to validate the effectiveness and sustainability of the remediation.

(e) Quality Assurance (QA)

- Each Japanese entity evaluates and improves the quality of internal audits based on the standards set by the Institute of Internal Auditors (IIA).[18]
- Specifically, the QA team established in the internal audit department conducts internal assessments to determine whether the individual audits comply with group-level internal audit policies and procedures and whether audits are conducted efficiently and effectively. Furthermore, external reviews are regularly conducted at the group level.

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[18]See International Standard for the Professional Practice of Internal Auditing, 1300 Quality Assurance and Improvement Program (IAIS), which published a new Quality Assessment Manual in 2024.

III) Initiatives on Important Audit Themes

- Many of the internal audit departments mentioned compliance with Japanese laws and regulations and AML/CFT, as well as controls over Japan-specific IT systems and operations.

Priorities	Initiatives by the Internal Audit Department
Compliance with Japanese Laws and Regulations	● The internal audit department conducts audits of compliance with Japanese laws and regulations reflecting the business of each Japanese entity. ● For example, the internal audit department conducts audits focusing on the regulatory capital requirements, internal models for market risk, and risks in the money lending business. ● In addition, the internal audit department conducts thematic audits of the trade surveillance system for JGB futures, and the management framework for firewalls between banks and securities firms, as well as internal reviews and approvals of the origination and 3rd party distribution of structured bonds, referring to cases of administrative actions imposed on other companies.
AML/CFT	● Each Japanese entity periodically conducts audits of the timeliness and appropriateness of KYC and transaction monitoring, including other entities that provide outsourced services. ● Some groups have assigned auditors with AML/CFT expertise to group and regional audit teams to support audits of the Japanese entity.
IT Systems (Systems specific to the Japanese Entity) Third Party Risk	● As reliance on external systems and vendors is increasing, some Japanese entities are facing challenges in responding to system failures. ● To address such issues, some internal audit departments focus on recovery capabilities in the event of system failure. ● Through continuous monitoring, some internal audit departments recognized and pointed out issues in the governance of projects related to the updating and migration of systems unique to the Japanese entity.
Outsourcing	● Some groups have a dedicated team within the group that conducts audits on the outsourcer's oversight of third parties. Some groups conduct audits on the central outsourcing management team. Some groups set up an internal audit team

Priorities	Initiatives by the Internal Audit Department
	within the operation centers. ● Some audit departments identified issues with respect to the oversight of outsourcing related to regulatory reporting.
Operational Resilience	● As initiatives to strengthen group-wide operational resilience intensify, cybersecurity is being addressed by strengthening system audits at each Japanese entity. ● For example, there are cases where audits are conducted on the security structure of core systems and encryption during data transfer between entities.
Data Governance	● While the volume of data handled by Japanese entities is increasing as their business expands, there are challenges in data governance, such as traceability of data and systems for transactions, settlement, and accounting. ● To address these challenges, audits of cross-system data integrity and controls over the use of EUCs[19] are conducted as an example.
AI Governance	● As use cases of AI in the front office are expanding, each group is developing the definition of risks associated with the use of AI and the framework for managing AI. ● Some audit departments conduct audits from the perspective of whether AI has been introduced with a sufficient assessment of the appropriateness of data and models. ● Some audit departments conduct audits on whether AI is appropriately implemented and operating as intended, and whether it is contributing to improve productivity.

(2) Utilization of Data and AI

- In response to the increase in data volume accompanying the expansion of the group's business, some the internal audit departments have established data analytics teams to support the internal audit departments of each entity through the extraction, processing, and analysis of data for use in risk assessments and individual audits. This is to ensure completeness of the audit universe and accuracy of audits and to increase the accountability to audited departments.
- Some groups used AI to automate routine tasks, such as preparing draft audit reports and checking consistency between audit scores and findings.

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[19] EUC stands for “End User Computing”.

- Since it is not easy to recruit auditors who are familiar with audit issues specific to each Japanese entity with high language skills, some Japanese entities have vacancies in the audit department. However, the FSA understood that they were trying to optimize resources through the initiatives mentioned above.

Column H: Evaluation of Management's Risk Ownership in Internal Audits

Management in audited departments is required to take ownership of their own risks, i.e., to be aware and take measures to make the control environment function appropriately so that risks in their own departments are sufficiently mitigated. A sound organizational culture is fostered through such ownership.

In some firms, risk ownership of the management and organizational culture is assessed in audits. For example, some firms' auditors evaluate the appropriateness of management self-identified issues in risk assessments and individual audits. Some firms' auditors evaluate whether management is promoting activities necessary for the appropriate functioning of the control environment, separately from the evaluation of the effectiveness of the control environment.

The FSA shall deepen its understanding of various activities, such as the evaluation of risk ownership, and shall verify whether audits are conducted in response to changes in the organization, business, and environment.

5. Foreign Bank Branches of Asian and Other Regions' Banks

Most foreign bank branches of Asian and other regions' banks are focused on providing specific financial services. For example, some are seeking to strengthen ties with Japanese banks in areas such as syndicated loans and project finance. Some are focusing on trade finance between Japan and their home country or neighboring regions, providing loans for wealthy home-country residents to acquire real estate in Japan, and providing remittances to the hometowns of home-country residents.

Some foreign bank branches are expanding their offices in Japan to meet various funding needs in response to the entry of their home-country corporations into Japan. Some foreign banks are also setting up representative offices with the aim of entering the banking industry.

Under these circumstances, the FSA conducted monitoring to deepen the understanding of the business models of Asian foreign bank branches, which have a large number of branches operating in Japan and reviewed whether their risk management frameworks were developed per with their business models.

As for the business model of Asian foreign bank branches, the FSA found that some increased the ratio of securities investment in commercial banking activities. Other branches increased the amount of syndicated loans arranged by Japanese banks in lending activities. In light of these business changes and the occurrence of losses, foreign bank branches strengthened their risk management by enhancing interest rate risk measurement methods, strengthening concentration risk management by lowering credit limits, and introducing timely reviews of credit ratings.

Foreign bank branches operating solely in Japan, including Asian foreign bank branches, generally have small staff numbers and rely on their head offices for part of their operations, such as internal audits. Therefore, it is necessary to conduct monitoring of these foreign bank branches through dialogues with their head offices and close cooperation with the regulators in their home countries, as in the past.

6. Conclusion

The Japanese entities of US and European banks provide banking services such as deposits, various credit transactions, foreign exchange and fund settlement, and investment banking services such as fund raising and M&A support in Japan and overseas to Japanese multinational corporations. They also provide markets business such as sales and trading of securities and derivatives, to Japanese and overseas institutional investors. These businesses are conducted in cooperation with the head office and other entities of the group. The Japanese entities play a role in building relationships with clients in Japan and working as a liaison between the group.

The compliance department at each entity in Japan was conducting monitoring and other activities based on risk assessments that reflect the risks specific to the Japanese entities. Overall, the FSA recognized that the compliance framework has been developed and is being operated under the compliance risks of the business models of Japanese entities.

The internal audit department of each Japanese entity also conducted internal audits based on risk assessments reflecting the risks specific to each entity. The FSA recognized that the risks of the business models of the Japanese entities were generally covered.

On the other hand, some Japanese entities have been taking remediation actions, with regard to issues in compliance, outsourcing management, and operational risk management that were identified through inspections by the FSA and the SESC.

From the perspective of promoting appropriate and sound business, the FSA expects each Japanese entity to continue to make efforts to ensure the effectiveness of the three lines of defense model, including securing necessary resources, in light of business expansion and the complexity of business and operations.

The FSA understood that branches of foreign banks based in Asia and other regions have developed unique businesses such as trade finance and hometown remittances, in addition to participation in syndicate loans and project finance, and that some foreign banks have strengthened their risk management frameworks in alignment with their businesses.

The FSA will continue our efforts to gain a deeper understanding of the strengths and characteristics of the business as well as the operations and technologies that support the business, with the understanding and cooperation of the Japanese entities, and will monitor whether the three lines of defense model appropriate for their business models is developed and implemented.

Column I: Importance of Dialogue with Foreign Financial Institutions

The FSA's monitoring activities are based on close communications with the compliance departments of the Japanese entities. At the same time, the FSA recognizes the importance of engagement with senior management, businesses, risk management functions, technology functions, and operations functions. In these engagements, the FSA discusses business trends and challenges in Japan. In some cases, issues related to Japan's financial infrastructure and market practices may be raised for discussion. For example, during the market turmoil in August 2024 and April 2025, the FSA held dialogues with the markets departments of Japanese entities regarding their views on the market, including the trading activities of overseas institutional investors. On another occasion, the FSA held dialogues regarding their views on Japan's payment and settlement systems and stock and bond markets. These dialogues provide valuable insights into the FSA.

The FSA also engages actively in dialogues with the senior management of the group and regions. In these dialogues, the FSA exchanges views on a wide range of topics, including the governance structure of the group, business conditions and risk management issues, political situations, and geopolitical risks. If necessary, the FSA may communicate its supervisory focus on Japanese entities and request them to take group-wide actions.

The FSA will continue to actively engage in these dialogues. To further enhance the effectiveness of such dialogues, the FSA would like to ensure that an appropriate agenda is set and issues for discussion are made clear in advance.