

**Japan: Basel Core Principles for Effective Banking Supervision—
Detailed Assessment of Compliance**

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FINANCIAL SECTOR ASSESSMENT PROGRAM

JAPAN

BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING
SUPERVISION

DETAILED ASSESSMENT OF
COMPLIANCE

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GLOSSARY

AGM	Annual General Meeting
APTC	Act on Prevention of Transfer of Criminal Proceeds
AML/CFT	Anti-money laundering/Combating the financing of terrorism
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles for Effective Banking Supervision
BOJ	Bank of Japan
CAR	Capital adequacy ratio
CIS	Collective Investment Schemes
CP	Core Principles
CPAAOB	Certified Public Accounting and Auditing Oversight Board
DAR	Detailed Assessment of Observance Report
DICJ	Deposit Insurance Corporation of Japan
DVP	Delivery-versus-payment
EOL	Exchange of Letters
FATF	Financial Action Task Force
FIU	Financial Intelligence Unit
FSA	Financial Services Agency
FSMC	Financial System Management Council
FSB	Financial Stability Board
FSR	Financial System Report
FX	Foreign exchange
GAAP	Generally accepted accounting principles
ICAAP	Internal capital adequacy assessment program
JGB	Japanese government bond
JICPA	Japanese Institute of Certified Public Accountants
JPB	Japan Post Bank
JPI	Japan Post Insurance
JSDA	Japan Securities Dealers Association
KYC	Know Your Customer
OSE	Osaka Stock Exchange
OTC	Over the counter
MTM	Mark-to-market
MOF	Ministry of Finance
MUFJ	Mitsubishi UFJ financial group
NIM	Net interest margin
NPL	Nonperforming loans
PCA	Prompt Corrective Action
PM	Prime Minister
RCC	Resolution and Collection Corporation
RTGS	Real Time Gross Settlement

RWA	Risk-weighted assets
SESC	Securities and Exchange Surveillance Commission
SME	Small- to medium-sized enterprises
SRO	Self Regulatory Organization
SRP	Supervisory Review Process
STR	Suspicious transaction reports
TSE	Tokyo Stock Exchange
VAR	Value at risk
AGM	Annual General Meeting
APTC	Act on Prevention of Transfer of Criminal Proceeds
AML/CFT	Anti-money laundering/Combating the financing of terrorism
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles for Effective Banking Supervision
BOJ	Bank of Japan

I. CONTEXT, KEY FINDINGS, AND RECOMMENDATIONS

A. Introduction

1. **This detailed assessment of Japan’s compliance with the Basel Core Principles for Effective Banking Supervision (BCP) was conducted from November 28–December 16, 2011.** It follows the first assessment of the supervision framework conducted by the International Monetary Fund (IMF) in 2002.
2. **The assessment focused on the banking regulatory and supervisory framework currently in place and the oversight by the Japanese Financial Supervisory Authority (FSA) and the Bank of Japan (BOJ).** While the BOJ is not a regulatory authority per se as defined under the Banking Act, it conducts on-site examinations and off-site monitoring of banks with the objectives stipulated in the Bank of Japan Act.
3. **The assessment was held in the months following the Great East Japan Earthquake in March 2011 that had severely tested the resilience of the Japanese financial system.** Swift and decisive actions taken by the BOJ and the FSA helped maintain financial stability in Japan. Japan’s financial system had weathered well the initial shock of the earthquake and set in motion the process of gradual recovery.
4. **Japan has introduced various improvements to their regulatory and supervisory framework since the 2003 FSAP.** This included the FSA’s “better regulation” program that is focused on improving the quality of financial regulations. Amongst others, this program promotes a more risk-focused and forward-looking approach in new regulation. Both the BOJ and the FSA had also initiated improvements in supervisory practices following lessons learnt from the global financial crisis and the March 2011 earthquake.
5. **In general, banking supervision framework in Japan is structurally sound,** with a legislative and operational set-up that largely complies with the BCP.

B. Information and Methodology Used

6. **This Detailed Assessment of Observance Report was prepared as part of the FSAP Update mission to Japan.** It is Japan’s first full review under the BCPs that were revised in 2006. The assessment team¹ reviewed the legal framework for banking supervision, held discussions with staff from the FSA, BOJ, the Japan Bankers Association, as well as private sector participants in the banking and financial sectors. The team examined the current practice for on-site and off-site supervision by the Japanese authorities. The assessment team enjoyed excellent cooperation with its counterparts, who provided extensive

¹ The assessment was conducted by Arnoud Vossen (Head Pensions Supervision Department, Central Bank of the Netherlands and formerly Acting Executive Director, European Banking Authority) and Serene Chow (Deputy Director, Banking Department, Monetary Authority of Singapore). The assessors are grateful to the staff of the FSA and the BOJ, and for the comments and guidance provided by Messrs Towe and Das and other members of the FSAP team.

clarifications in the form of documents and oral explanations, and a comprehensive BCP self assessment.

7. **The assessment is based on several sources:** (i) the aforementioned self assessment received in October 2011; (ii) detailed interviews with staff from the FSA and BOJ; (iii) reading of laws, regulations, and other documentation on the supervisory framework; (iv) review of supervisory materials provided to the assessors during and after the FSAP mission; (v) meetings with other agencies and independent bodies, such as rating agencies, and audit firms; and (vi) meetings with the banking industry including the various banking associations, as well as with select individual institutions including city banks, regional banks, and foreign banks.

8. **The assessors had the full cooperation of the Japanese authorities and received information necessary for conducting the assessment.** The team extends its thanks to the management and staff of the various agencies and institutions for their openness and participation in the assessment process.

9. **The assessment has been conducted in accordance with the guidelines laid down in the Core Principles (CP) Methodology (October 2006) by the Basel Committee on Banking Supervision (BCBS).** It assessed compliance with both the “essential” and the “additional” criteria, but the ratings assigned were based on compliance with the “essential” criteria only. The methodology requires that the assessment be based on (i) the legal and other documentary evidence; (ii) the work of the supervisory authority; as well as (iii) the implementation in the banking sector. Full compliance requires that all these three prerequisites are met. The guidelines allow that a country may fulfill the compliance criteria in a different manner from the ones suggested as long as it can demonstrate that the overriding objectives of each CP are reached. Conversely, countries may sometimes be required to fulfill more than the minimum standards—e.g., due to structural weaknesses in that country. The methodology also states that the assessment is to be made on the factual situation of the date when the assessment is completed. However, where applicable, the assessors made note of regulatory initiatives such as the revised CP under consultation, that have yet to be completed or implemented.

10. **To determine the level of compliance of each CP the FSAP assessment has made use of five rating categories:** compliant; largely compliant; materially noncompliant; noncompliant; and non-applicable. An assessment of “compliant” is given when all essential criteria are met without any significant deficiencies, including instances where the relevant CP has been achieved by other means. A “largely compliant” assessment is given when there are only minor shortcomings, which do not raise serious concerns about the authorities’ ability to achieve the objective of the CP and there is clear intent to achieve full compliance with the CP within a prescribed period of time. A CP is considered to be “materially noncompliant” in case of severe shortcomings, despite the existence of formal rules and procedures and there is evidence that supervision has clearly not been effective, the practical implementation is weak or that the shortcomings are sufficient to raise doubts about the authority’s ability to achieve compliance. A CP is assessed “noncompliant” if it is not substantially implemented, several essential criteria are not complied with, or supervision is manifestly ineffective. Finally, a category of “non-applicable” is reserved (though not used in

this assessment) for those cases where the criteria would not be relevant for the Japanese situation.

11. The assessment of compliance with the BCPs is not--and is not intended to be--an exact science; reaching conclusions require judgments by the assessment team.

Banking systems differ from one country to another as do domestic circumstances. Also, banking activities are changing rapidly around the world after the crisis and theories, policies, and best practices are rapidly evolving. Nevertheless, by adhering to a common agreed methodology, the assessment should provide the Japanese authorities with an internationally consistent measure of the quality of their banking supervision in relation to the 2006 BCP which is an internationally recognized minimum standard.

12. For completeness, it should be noted that the ratings assigned during this assessment are not necessarily directly comparable to the ones assigned in terms of an FSAP performed using the pre-2006 BCP methodology. Differences may stem from the fact that the supervisory effectiveness standards were raised by the 2006 update of the BCP Methodology. The lessons drawn from the financial crisis also have a bearing on the expectations from the extant supervisory practices.

C. Institutional and Macroeconomic Setting, and Market Structure

13. Japan's financial system remains the second largest in the world and is characterized by the "main bank system" comprising three megabanks and several smaller sized banks. The authorities have aimed to increase the economy's reliance on capital markets since the launch of the Japanese "Big Bang" initiative in 1996. However, banks' dominance in the system remains fundamental. Benefiting from strong deposit bases, banks remain the main source of lending, in particular for small-to medium-sized enterprises (SMEs).

14. The domestic market is fragmented with about 2,000 deposit-taking institutions. The three megabanks are large by global standards and internationally active. The smaller-size banks mainly service local businesses. Overseas expansion, thus far, has been limited to the larger city banks. Since the early 2000s, consolidation within the sector has been gradual and it is expected to remain so. The customary classification of domestic banks is as follows:

- *City banks* (5) are large banks headquartered in major cities (three of them are "megabanks"). Their core business is traditional commercial banking. They have historically close ties with large industry groups and also substantial SME exposures. Overseas operations are limited but growing in the recent period.
- *Trust banks* (16) generally focus on both commercial and trust banking activities, including asset management and real estate brokerage. Their main clients are large (often export-oriented) corporations. Most are subsidiaries of other banks (only one is independent).²

² This would be Sumitomo Mitsui Trust and Banking Company.

- *Regional banks* (63) and *second-tier regional banks* (42) are generally small banks that operate within local prefectures with strong ties to the local economy.³ Many regional banks have to deal with the impact of declining local lending to SMEs and are cutting branch staff. Despite fierce competition and the large number of banks with limited market share, consolidation has progressed slowly for various reasons, including regional banks' business and ownership structures.
- *Foreign banks* (58) have a small market share. They are mostly involved in investment and private banking and lead financial derivatives trading.
- *Other banks* (17) are mainly internet banks or banks backed by retail service companies (e.g., Aeon bank), with retail banking franchises and partly owned by major city banks.
- *Japan Post Bank (JPB)*⁴ takes deposits and primarily invests in Japanese Government Bonds (JGBs) (¥146 trillion as of end-FY2010—i.e., 76 percent of total assets) and other local government and corporate bonds. Lending activities are limited (about 2 percent of total assets).
- *Cooperative style financial institutions* (271 credit associations (Shinkin banks) and cooperatives (158 credit unions) must provide most (Shinkin banks) or all (credit unions) of their financial services to their members (i.e., SMEs or individuals). Notable institutions in this category are Shinkin Central Bank and Shinkumi Federation Bank.⁵ Agricultural and fisheries cooperatives play an active role in taking farmers' deposits and providing credit, and the Central Cooperative Bank for Agriculture and Forestry (Norin-Chukin bank) is the central entity under the supervision of the Ministry of Agriculture and Fisheries (MoAF) as well as the FSA.

³ Regional banks are usually based in the principal city of a prefecture and operate within that prefecture, with strong ties with local enterprises and local governments. Second-tier regional banks serve smaller companies and individuals within their immediate geographical regions.

⁴ In October 2007, Japan Post was partly privatized and separated into four individual companies, including JPB and Japan Post Insurance (JPI). While the initial plan was to fully privatize the banking and insurance activities, the current government stopped the sale of Japan Post shares in 2009 and maintained government's involvement in Japan Post Group. JPB has total assets amounting to ¥193 trillion (40 percent of GDP), 76 percent of which are invested in JGBs. Deposits are the key funding source (equivalent to 90 percent of total assets). For JPI, total assets amount to ¥97 trillion and are primarily investment in JGBs and corporate bonds (80 percent of total assets).

⁵ Unlike other cooperative style institutions Shinkin Central Bank and Shinkumi Federation Bank are centralized institutions with accounts at the BOJ.

Key characteristics of the banking industry:

15. **High concentration.** JPB continues to hold a quarter of total deposits (about 40 percent of GDP), although this share has declined from about half of total deposits in the 1990s. City banks hold approximately forty percent of total deposits.

16. **Low core profitability.** Japanese banks suffer from weak profitability due, in particular, to low and declining net interest margin (NIM) amid sluggish borrowing demand of firms and households. In seeking new sources of profit, megabanks have tried to increasingly shift their lending and other activities abroad, particularly to Asia, including by accompanying Japanese corporations. However, this raises challenges related to their corporate governance (e.g., human resources, language, and information technology practices), local funding costs, and risk management (e.g., credit risk assessment, due to information barriers). While some megabanks have also tried to acquire global institutions for this purpose (e.g., parts of Morgan Stanley bought by Mitsubishi UFJ financial group (MUFG)), some of the above obstacles remain. Overall, bank revenues come mostly from interest revenue (70 percent of gross revenue), while fee income accounts for about 20 percent and securities trading (including JGBs) for the rest. The decline in net interest margins reflects both the low interest rate environment and shrinking lending, and limits the banks' capacity to build up capital, thereby limiting their future capacity to absorb losses.

17. **Asset structure.** Loans represent over half of total bank assets and securities about a quarter. In a context of limited credit demand and rising deposits, banks' JGB holdings have increased in the past few years, which have increased the banks' exposure to market risks.

18. **Loan quality challenges ahead.** Loan composition across sectors has not changed significantly in recent years, except for a general decline of retail mortgages. SME lending has been declining due to weak credit demand. Loan quality improved significantly since the early 2000s, but concerns regarding loan quality going forward remain due to weak growth and rising bankruptcy, in particular for regional banks.⁶

19. **Securities holdings and market risks.** Banks hold large JGB and equity portfolios. JGB exposures in the banking system have continued to grow in the recent period, increasing bank exposures to interest rate risk. According to BOJ estimates, a 1 percent rise in yields would increase the value of interest rate risk at major and regional banks by about ¥6 trillion, corresponding to 10 percent of major banks' Tier 1 capital and more than 30 percent of regional banks' Tier 1 capital respectively. Equity holdings are mainly held to support long-term relationships (and related businesses) with large corporations, and account for more

⁶ Risk pricing, especially for SME lending, could be hampered by government intervention. In November 2008, the FSA expanded the extent to which restructured loans to SMEs were not to be classified as problem loans for borrowers having submitted a five to ten year recovery plan. In December 2009, banks were asked to modify the terms and conditions of residential mortgages and loans to SMEs, if requested.

than half of city banks' Tier 1 capital. Since the early 2000s, banks have gradually reduced such exposures, including with government help. Banks generally have limited exposures to derivative markets.

20. **Favorable liquidity situation.** Banks benefit from a relatively large and stable deposit base (about 60 percent of household savings are held in deposits). As such, they have a strong liquidity position, with small dependence on short-term wholesale market funding except for their overseas operations. Loan-to-deposits ratios are at historic lows (less than 70 percent). Liquidity pressures appeared in the interbank market at the peak of the Lehman crisis, but have since disappeared.

21. **Bank capital.** Basel II was implemented in FY 2007. Capital requirements for internationally active banks are 8 percent of risk-weighted assets (RWA). For banks without foreign branches, the standard is 4 percent of RWA. Reflecting market pressures and expectations of Basel III, major banks have raised around 4½ trillion yen of capital in 2009–10, of which a portion remains as hybrid capital, particularly for the mega banks.

22. **At the time of the mission, the financial system had stabilized following the March 2011 earthquake due partly also to the policy measures taken by the government to support financial intermediation.** However, *the banking sector remains exposed to important vulnerabilities including* the large concentration to JGB exposures, quality of capital at megabanks and adequacy of capital at the non-megabanks in the face of low profitability and reducing loan demands. Operational, funding, and governance risks faced by banks expanding overseas are also areas of concern.

D. Preconditions for Effective Banking Supervision

Sound and sustainable macroeconomic policies

23. **The institutional framework supporting the conduct of sound macroeconomic policies in Japan follows the integrated approach.** A single universal regulator (the FSA)⁷ conducts both safety and soundness oversight and conduct-of-business regulation for all the sectors of financial services, while the BOJ⁸ conducts on-site examinations and off-site

⁷The FSA is an external agency of the Cabinet Office. It is responsible for ensuring the stability of the financial system; protection of depositors, insurance policyholders, and securities investors; and smooth intermediation, through such measures as planning and policymaking concerning the financial industry and market; and inspection and supervision of private sector financial institutions. It employs 1,300 people. The Securities and Exchange Surveillance Commission (SESC) is placed under the FSA and conducts market surveillance and onsite inspections of securities companies. However, it is not authorized to take administrative actions such as penalties: the FSA is responsible for these actions based on the advice of the SESC. The Certified Public Accountants and Auditing Oversight Board (CPAFOB), also within the FSA, is in charge of overseeing the quality review work performed by the Japanese Institute of Certified Public Accountants (JIPCA). As in the case of the SESC, the CPAFOB can only recommend sanctions, while the FSA imposes them.

⁸ The BOJ carries out monetary policy, and in addition, is responsible for financial stability and the effective settlement of financial transactions. BOJ's supervisory role is exercised through both on-site examinations and

(continued)

monitoring of its counterparty financial institutions. The Ministry of Finance (MOF)⁹ also retains an important role. The Deposit Insurance Corporation of Japan (DICJ)¹⁰ is responsible for implementing measures such as the reimbursement of insured deposits and financial assistance to reorganize failed banks. The reform of the previous supervisory system that established an integrated system in the late 1990s was a response to perceived weaknesses in the traditional inspection and supervisory practices of the MOF, which emphasized consultation and administrative guidance.

24. Close domestic coordination among the above agencies is required for effective macro prudential policy making. As the FSA, MOF, and BOJ frequently exchange information at multiple levels and there are also several councils covering various aspects of financial system policies, the lack of MOUs is not a major obstacle to effective cooperation.

25. As regards crisis management, the Financial System Management Council (FSMC) is activated when government intervention in a troubled financial institution is necessary. The FSMC consists of the Prime Minister (PM) (chair), the Chief Cabinet Secretary, Minister for Financial Services, the Minister of Finance, the Commissioner of Financial Services, and the Governor of the BOJ. It is convened by the PM to deal with financial institutions that face serious liquidity or solvency pressures. Since its creation, the FSMC has been used only twice, and since the blanket guarantee was lifted, the general bank resolution measure of providing partial depositor protection has only been used once. As stipulated in Article 38 of the Bank of Japan Act, the Prime Minister, and the Minister of Finance may request BOJ to take actions, when they find it especially necessary for the maintenance of stability of the financial system. When the request has been made, BOJ may undertake the necessary actions, including the provision of uncollateralized loans.

off-site monitoring. The on-site examinations are based on contractual relationships with most institutions that maintain deposits at the central bank. Conducting both on-site examination and off-site monitoring allows the BOJ to maintain a detailed understanding of the day-to-day health of financial institutions, and providing the necessary information for the BOJ to conduct its lender-of-last resort functions.

⁹ The *MOF* is responsible for managing the government's budget and debt, and for maintaining the credibility of the yen and the stability of foreign exchange markets (it decides on foreign exchange (FX) market interventions, which are implemented by BOJ). Following the creation of the FSA, it retained a role in the crisis management council. It is also responsible for the budgets of all of the country's public entities, including the FSA.

¹⁰ The *DICJ* is a quasi-autonomous governmental organization established in 1971, for the purpose of operating the deposit insurance system. The DICJ may provide for the payment of deposit insurance claims for the principal amount of ¥10 million per depositor other than deposits for payment and settlement purposes, which are protected in full. The DICJ's wholly owned subsidiary, the Resolution and Collection Corporation (RCC), handles management and disposal of assets purchased from failed financial institutions. For bank capital injection under the Deposit Insurance Act, DICJ would subscribe for the shares issued by financial institutions. For other capital injection operations, DICJ entrusts the subscription for shares issued by FIs to the RCC. DICJ will provide the funds to RCC for smooth subscription operations, guarantees RCC's borrowings, receive profits from the operations, approves RCC's exercise of voting rights as shareholders and permits RCC's disposal of subscribed shares.

26. **As regards the financial system as a whole, BOJ analyzes and assesses risks in the entire financial system and releases its findings in the Financial System Report (FSR) semi-annually.** The FSR aims to gauge risks in and challenges for Japan's financial system and to share recognition of the risks with a broad range of concerned parties, including financial institutions, so as to ensure stability of the financial system. BOJ's analysis and assessment of the financial system from the macro prudential perspective are reflected in its on-site examinations and off-site monitoring, seminars of BOJ's Center for Advanced Financial Technology, and international discussions.

27. **Separately, general advice regarding the financial system is provided via the Financial System Council (FSC) within the FSA.** The FSC, which comprises different sectional committees and subcommittees in the FSA, conducts wide-ranging deliberations on the financial system in response to requests from the Prime Minister, the Commissioner of the FSA, or the Minister of Finance. The FSC has conducted deliberations on matters that call for improvements of the financial system involving legislative measures, and has presented reports on the financial system from medium- and long-term perspectives (including disclosures and accounting issues).

Well developed infrastructure

28. **Overall, the infrastructure supporting effective banking supervision in Japan is well-developed.** The accounting standards in Japan have been extensively developed over the last 10–15 years. Banks are subject to the Japanese generally accepted accounting principles (GAAP) for regulatory reporting. Movements towards convergence between Japanese GAAP **and** international financial reporting standards (IFRS) started in March 2005. Under the August 2007 “Tokyo Agreement,” Japan established the timeline of end 2008 to eliminate the 26 major differences between Japanese GAAP and IFRS, with the remaining differences being removed by June 2011. Industry opinion is that Japan is at the final stages of convergence to IFRS. At the moment, Japanese GAAP allows for certain assets and liabilities to be reported as historical cost while the application of fair value accounting requires the reporting at the lower of historical cost or fair value under certain circumstances.

29. **The legislative framework for external audit requires external auditors to be independent in both fact and appearance.** The existing independence requirements are further bolstered by the establishment of the CPAAOB within the FSA that is in charge of overseeing the quality review work performed by the JIPCA. The CPA Act also imposes specific requirements on mandatory rotation from audit engagements of listed companies within a maximum period of seven years from the date of appointment with a two-year cooling off period. In addition, the CPA Act also requires larger audit corporations auditing 100 or more listed companies to follow a five-year rotation rule. The judicial system is relatively well-developed.

30. **The payment and settlement system is reliable and efficient.** There have been several structural **improvements** for the past decade with the implementation of Real Time Gross Settlement (RTGS) for all large-value payments, the introduction of liquidity saving

features in the RTGS, and the development of delivery-versus-payment (DVP) for all types of securities resulting in the reduction of risks in clearing and settlement of JGBs. Japan is the only jurisdiction, apart from the United States, that had adopted legislation mandating central clearing of standardized over the counter (OTC) derivatives by the end of 2012.

Effective market discipline

31. **Legislation in Japan contains several safeguards for disclosure and transparency.** The Banking Act requires a bank to publicly disclose an annual report both on solo and consolidated basis that details the banks' business and financial condition. Corporate law stipulates information disclosure for shareholders and the Financial Instruments and Exchange Act specifies the information disclosure requirements for listed companies. Listed companies are also required to publicly disclose and submit to the FSA, annual financial statements, as set forth in Article 435 of the Companies Act, which had been audited by external auditors in accordance with the Companies Act and Financial Instruments and Exchange Act. The financial statements should be accompanied by explanatory documents on the business and property and be made available to the public by placing them in branches. Securities Exchanges and Japan Securities Dealers Association (JSDA) have also required listed companies to timely disclose information on their performance information. The information on decision making in management such as capital raising, merger and acquisition and events such as disaster and lawsuits is made public through TDnet, the securities exchanges' online system. The reliability of financial disclosures is ensured by the legislative framework governing the external auditing function. Corporate governance requirements are also spelled out in the FSA' Supervisory Guidelines and Inspection Manuals, which, while they are not legally binding, are explicit expectations to be complied with by the banks, failing which, administrative actions could be taken by the FSA.

Public safety nets

32. **The Deposit Insurance Act defines the deposits that are protected in the case of a bank failure.** "Payment and Settlement deposits," namely current deposits or non-interest bearing ordinary **deposits** that satisfy the three conditions of (i) bearing no interest; (ii) being redeemable on demand; and (iii) providing normally required payment and settlement services, are fully protected. The other remaining deposits, such as time deposits, are protected up to a maximum principle of ¥10 million including interest, per depositor, per financial institution.

33. **The Deposit Insurance Corporation of Japan (DICJ) contributes to financial stability by managing the deposit insurance system and resolving failed banks.** In cases when a bank fails, the DICJ will make payouts to insurable deposits, inject capital in solvent banks (funded by government guaranteed borrowings from the market), and at the same time, take resolution actions and facilitate the collection of claims acquired from failed banks in coordination with the Resolution and Collection Corporation (RCC). Since 2008, capital injections have been based on the Financial Functions Strengthening Act. As of March 2010, the DICJ has injected capital under this Act in 13 banks, for a total amount of public funds of about ¥350 billion.

34. **The Deposit Guarantee Scheme is funded ex ante by periodical contribution from banks.** Insurance premium is determined as a flat rate to insured deposits. In addition, the DICJ has the powers to make borrowings and issue bonds in markets under the approval of the FSA and MOF, and the State may provide guarantee on the DICJ's financing. Currently, ¥51 trillion of guarantee lines are provided to the DICJ by the annual State budget. The DICJ is also allowed to ask the BOJ for temporary liquidity support guaranteed by the government.

Legal framework

35. **The legal framework for banking supervision in Japan is formulated on four levels. The first level is the Banking Act that has been approved by the Cabinet and passed by the Diet.** The second level is the Orders for Enforcement of the Banking Act that have been approved and issued by the Cabinet. The third level is the Ordinances for Enforcement of the Banking Act, which is issued by the FSA. The FSA is substantially involved in the drafting of laws, orders, and ordinances. As a fourth level, in order to implement and reinforce the legal framework, the FSA has developed and published supervisory guidelines and inspection manuals. In practice, the supervisory guidelines are mostly being used in the assessment of off-site activities of the FSA staff, whereas the inspection manuals are being used as guiding practice for the onsite activities of the FSA during their inspections. Financial institutions are expected to establish internal control system in reference to Supervisory Guidelines and the Inspection manuals which are public. Supervisory Guidelines and Inspection manuals are frequently updated to take into account developments in the banking industry and improvements in supervisory practices and focus.

Supervisory approach

36. **Both the BOJ and the FSA conduct day to day supervision of banks using both onsite inspections and off-site monitoring, and regular interactions with officials of the supervised entities.** Formally, and based upon Article 44 of the Bank of Japan Act, the FSA may request BOJ to submit the inspections reports describing the results of the onsite examinations and other related materials with respect to concerned financial institutions. With regard to off-site analyses and at senior management level, there exists more regular information exchange between the FSA and BOJ. Staff exchanges between the FSA and BOJ also take place regularly. Since 2007, the FSA has undertaken a "Better Regulation" program which sets out goals such as enhancing dialogues with financial institutions, strengthening cooperation with foreign supervisors, enhancing research function, and improving quality of employees. To that end, every year the FSA has published how it has achieved the goals listed in this program on its website. The FSA also publishes on an annual basis its objectives with respect to banking supervision. A distinction has been made in objectives for off-site and onsite. The objectives provide a general orientation for the execution of supervision. Concerning onsite supervision, the policy also indicates the planned number of examinations and their focus areas reflecting the issues recognized in the past examinations and risk awareness. Both BOJ and the FSA determine the frequency, scope, and the number of examiners, using the "risk-based" framework for on-site examinations. BOJ announces its

on-site examination policy on an annual basis, including the key issues in the conduct of on-site examinations and major findings in the previous year.

37. **Under Pillar II of the Basel II framework—the Supervisory Review Process (SRP)—banking supervisors are tasked with assessing the quality of banks’ internal governance, risk management, and internal control processes, taking due regard to each institution’s specific circumstances.** In accordance with this, the supervisory framework in Japan requires licensed institutions to establish internal control processes to identify all material risks and to ensure these risks are sufficiently managed—i.e., to identify, assess, mitigate, monitor, and communicate these risks. Checks are conducted through on-site and off-site activities in a manner commensurate the size, risk and complexity of the institution, and activities conducted.

E. Main Findings

Objectives, independence, powers, transparency, and cooperation (CP 1)

38. **The assessors concluded that in general the mandates for supervision are sufficiently clear and unambiguous.** However, the supervisory arrangements for some cooperative style institutions could be clarified. The FSA is the integrated supervisory authority for banking, insurance, and securities sector. City banks, regional banks, and shinkin banks are directly supervised by the FSA. The day-to-day supervision of the regional and shinkin banks is delegated to Local Finance Bureaus of the Ministry of Finance (MOF). Some cooperative style institutions are co-supervised by the FSA and the Ministry of Agriculture respectively the Ministry of Labor, based upon different arrangements. Co-supervision by the FSA and a Ministry on supervisory matters may lead to less clear decision making processes. It is therefore recommended to clarify and make transparent based upon which procedures the decision making process takes place between the FSA and the other ministries, whereby these decision making procedures should be structured in such a manner that the FSAs supervisory responsibilities would not be jeopardized. Further, agricultural and fishery cooperatives are supervised under the Agricultural Cooperatives Act and the Fishery Cooperatives Act under which they are allowed to take deposits, whereby daily supervision is conducted by local state government. Given (i) the limited size and the nature of their main business; (ii) the fact that the FSA together with the responsible Ministry of Agriculture has developed supervisory guidelines for these cooperatives; and (iii) the FSA could, upon request, undertake on-site examinations, we view that in general a sufficient basis for prudential supervision exists for these cooperatives. BOJ also conducts on-site examinations and off-site monitoring with regard to its counterparties (banks, major securities firms, and other financial institutions) in the context of its central banking function. Its supervisory activities are based upon contracts formulated in accordance with Articles 1 and 44 of the Bank of Japan Act.

39. **The institutional framework for supervision in Japan provides sufficient safeguards for the supervisor’s independence in its day-to-day supervision.** Nonetheless, in order to enhance the independence in decision-making by the FSA concerning some cooperative style institutions, the FSA is asked to clarify in detail and be transparent on the way co-decision effectively takes place on labor cooperatives and Norin-Chukin, which

should not jeopardize FSAs supervisory responsibilities, as mentioned above. The FSA could also consider strengthening the governance arrangements towards the Ministry of Finance's Local Finance Bureaus, to which the day-to-day supervision of regional and shinkin banks has been delegated by the FSA, by increasing the staff to oversee these activities and by improving the review processes

40. **The Japanese legal framework provides for clear provisions on the authorization of banking establishments.** It also provides for adequate information powers, as well as sufficient provisions for the supervisor to set prudential regulations via standards, guidelines and inspection manuals. The supervisor has in general sufficient powers to undertake remedial action. The ultimate responsibilities to revoke the banking license or issue an order to suspend whole or part of the banking business are delegated to the Minister for Financial Services, assigned by the PM, and has not been delegated to the FSA. As a consequence, while guidelines for assessing the application are developed by the FSA and proposals for those actions are prepared by the FSA, they would need approval by the Minister for Financial Services.

41. **Also the legal framework, especially the Banking Act,** includes sufficient powers to address compliance with laws as well as safety and soundness concerns and the legal protection for banking supervisors is adequately safeguarded.

42. **Predominantly informal arrangements exist for the cooperation between the FSA and BOJ and with foreign supervisory authorities.** The cooperation between the Japanese authorities should further be intensified. Given the bank's strategies to extend rather than reduce their overseas business, the arrangements with foreign authorities could be further enhanced as well.

Licensing and structure (CPs 2–5)

43. **In Japan, the permissible activities of institutions that are licensed and subject to supervision are clearly defined.** Also appropriate provisions for the licensing of banks are in place. The FSA might consider to more proactively engaging in monitoring of the credit markets, enforcing that only licensed institutions operate as a bank.

44. **The FSA has adequate powers in approving a transfer of a significant ownership in a bank to another party.** Every shareholder of a bank that would acquire 20 percent or more of shares needs to be approved as a major shareholder. Subsequent changes in the shareholding need to be reported but not approved unless the FSA exercises the power to impose the condition on the approval of the major shareholder that a possible future majority holding by the major shareholder should be subject to a pre-approval by the FSA. The FSA should consider strengthening its approval process for cases whereby the transfer would lead to a controlling interest by exercising the power above, given the consequences this might have for the business model and governance structure of the bank.

45. **The FSA does not require an ex ante approval of investments by a bank in another bank, in an ancillary business or a related banking business, although a prior**

notification of such investments is necessary. Acquisitions would need prior approval, except when it would be in an ancillary business. Investments in non-banking activities are limited by law and may not lead to a significant ownership or a controlling interest of the bank in question.

Prudential regulation and requirements (CPs 6–18)

46. **The FSA requires all institutions to calculate and maintain a minimum capital adequacy ratio (CAR).** It also has the power to impose higher capital requirements above the minimum on individual banks. However, the FSA's implementation of Pillar 2 of Basel II does not provide for setting extra capital charges in case the supervisory review process would indicate that not all material risks would have been captured. Also for domestic and internationally active banks different minimum capital levels and a different definition of capital are used, although a similar capital adequacy framework applies. Moreover, triggers for early intervention measures due to a shortfall in minimum capital levels, are set at a too low level, especially for domestic banks. In addition, we have noticed some (temporary) measures taken by the Japanese government end-2008, which include a partial relaxation of the capital adequacy requirement for banks. The assessors recommend to enhance the standards for capital adequacy and to streamline the rules applicable for domestically and internationally operating banks.

47. **The Japanese authorities have a sufficient regulatory framework for identifying and evaluating bank's risk management systems and processes.** In the assessors' views, there are sufficient on-site inspections and off-site monitoring carried out by the FSA and the BOJ to assess the adequacy of the risk management systems at banks. However, the role of the external audit function should be strengthened, and further focus should be put on bank's stress testing practices, bank's integrated risk management and bank's governance arrangements.

48. **Since the last decade, the FSA and BOJ have enhanced their onsite and off-site supervision of banks' credit risk management processes.** The banks the assessors visited had adequate processes and policies in place, with different levels of sophistication. Also the policies and practices of banks with regard to problem assets have improved considerably over the last ten years. In the assessor's view, problem loans are adequately identified and classified. However, in the subsequent evaluation for extra provisions and reserves, banks are expected to take a prudent stance in taking into account government measures that are aimed at providing enhanced financing and support to their clients, including the restructuring of their loans. The FSA should inspect this more intrusively.

49. **The large exposure and concentration limits applied to banks should be more rigorous.** It should have a higher impact on lending and investment levels to individual counterparts or groups of connected counterparties. Also, the systems observed at banks for managing concentration risks should be further developed, for instance by taking into account more detailed exposures to industries, geographical areas, etc.

50. **The Japanese regulations contain the basic provisions with regard to “exposures to related parties,”** including that these should be subject to the arms’ length rule. However, the FSA does not actively enforce these provisions via regular off-site monitoring in combination with focused on-site inspections.

51. **The FSA had stepped up on its reporting requirement for banks in terms of individual country exposures on both frequency and granularity to better monitor country and transfer risks and exposures.** More consideration could be given on the actual quality of the country exposures, due to a possible materialization of the country risks identified, and having in place a more forward-looking approach to the evaluation of these risks and provisions where necessary.

52. **The current supervisory framework with regard to liquidity risk complies with the criteria of the relevant CP.** Nonetheless, continued focus by both the BOJ and the FSA on the foreign currency funding profile of banks expanding overseas would be important given the banks’ reliance on wholesale funding in these markets and higher costs of funding overseas compared to their domestic funding profiles.

53. **The FSA has acknowledged the key risks arising from IT systems obsolescence or changes in IT systems as a result of mergers among entities within bank groups.** It has also intensified its supervision over the adequacy of integrated risk management for banks expanding overseas. A continued focus on these areas by the FSA would be paramount to ensure that banks’ IT systems and risk management processes are able to deal with the risks arising from changes in the banks’ risk profiles.

54. **The current supervisory framework with regard to interest rate risk in the banking book complies with the criteria of the relevant CP.** Nonetheless, the assessors support the envisaged change of the FSA’s internal policy to undertake a more intrusive, capital adequacy management for “outlier” banks following the results of the predefined (potential) parallel interest rate shift stress tests.

55. **While the framework for internal audit and control is largely in-line with the CP,** corporate governance functions at individual banks could be further improved through strengthening the independence of the internal audit function and Board of Company Auditors.

56. **The report of the 2008 Financial Action Task Force (FATF) Mutual Evaluation of Japan concluded that the anti-money laundering/combating the financing of terrorism (AML/CFT) framework prevailing at the time of the evaluation was not fully in-line with the FATF’s recommendations.** The assessors understand that the Japanese authorities are in the process of addressing the weaknesses identified in the evaluation. The Japanese are recommended to review their AML/CFT frameworks and bring them in-line with the FATF recommendations as soon as possible.

Methods of ongoing banking supervision (CPs 19-21)

57. **The FSA's current bottom up supervisory approach of having supervisory teams responsible for highlighting and following up on supervisory issues and concerns facing financial institutions** under their charge enables the FSA to promptly identify and deal with issues facing institutions with the highlighted supervisory concerns. However, the FSA should have a more formalized, analytical risk framework that might be used to assess the risk profile of an institution on a holistic basis. In addition, it is recommended to define more formalized criteria for the identification of systemically important financial institutions taking into consideration the probability and potential impact of a financial institution on the financial system that would allow the FSA to better prioritize its supervisory resources and intensity.

Accounting and disclosure (CP 22)

58. **While the accounting and disclosure practices in Japan comply with the relevant CP to a large extent, there is a risk that temporary government measures in place could lead to valuation practices differing from international standards.** These government measures could also result in some differing accounting and disclosure practices from international standards. The supervisory authorities may want to take steps to promote the prompt standardization of valuation, accounting and disclosure standards with international standards in all areas. The FSA may also wish to strengthen its authority over external auditors.

Corrective and remedial powers of supervisors (CP 23)

59. **The FSA has a range of supervisory tools and powers to take measures against banks which are in violation of laws, regulations or are engaging in unsafe or unsound business practices.** However, the FSA may also wish to consider reviewing its current Prompt Corrective Action (PCA) system with a view to increasing its effectiveness. Intervention efforts of the FSA could be further enhanced through the greater use of more direct supervisory tools such as penalties, immediate corrective actions, etc.

Consolidated supervision and cross-border banking supervision (CPs 24–25)

60. **The FSA has the general powers to effectively supervise banking groups on a consolidated basis.** However, it should continuously enhance the effectiveness of its cross-border supervision, including strengthening potential resolution tools as more banks expand overseas in the search for yield and undertake more diverse legal forms that could complicate crisis management or potential resolution.

61. **Progress in the cooperation and information sharing between the FSA and other home and host supervisors had been observed.** This has been achieved through various channels such as the Exchange of Letters (EOL) with overseas supervisors and the holding of regular supervisory colleges for the major bank groups. The FSA should continue to further strengthen home/host cooperation through engaging in more proactive cooperation with

foreign supervisors by ensuring that relevant information is shared swiftly and effectively to strengthen the FSA's ability to anticipate and deal with crisis situations and potentially any bank resolution situations.

**Table 1. Japan: Summary Compliance with the Basel Core Principles—
Detailed Assessments**

Core Principle	Grading	Comments
1. Objectives, independence, powers, transparency, and cooperation	LC	See below
1.1 Responsibilities and objectives	C	<p>The mandate for the FSA with respect to the supervision of stock-issuing banks is clear and publicly disclosed. Also the BOJ's role in undertaking supervisory activities is clear and disclosed.</p> <p>However, different types of co-operative style deposit-taking institutions are supervised via different arrangements between the FSA and the Ministries of Labor and Agriculture. Greater clarity and transparency is suggested for the decision making process between FSA and other Ministries where they co-supervise an institution. Further, agricultural and fishery cooperatives are supervised by local state government. Given the limited size and the nature of their main business, the fact that the FSA together with the responsible Ministry of Agriculture has developed supervisory guidelines for these cooperatives and that FSA could, upon request, undertake on-site examinations, we view that a sufficient basis for prudential supervision exists.</p>
1.2 Independence, accountability and transparency	LC	<p>The Banking Act and its delegation Order as well as the actual resources available for banking supervision, contain important safeguards against government and political interference in the FSA's day-to-day bank supervisory practice. Nonetheless, some major decisions concerning individual institutions are formally taken by the Minister for Financial Services, who has been assigned by the Prime Minister. In practice, such decisions are prepared and managed by the staff in the FSA, but need approval by the Minister for Financial Services. In addition, some institutions are co-supervised by the FSA and Ministries. Also the FSA could consider strengthening its governance</p>

		arrangements towards the MOF's Local Finance Bureaus, to which the day-to-day supervision of regional and Shinkin banks has been delegated by the FSA.
1.3 Legal framework	C	The Japanese legal framework includes clear provisions on the authorization of banking establishments and adequate information gathering powers. Prudential regulations are mainly set via standards, guidelines and inspection manuals which are publicly disclosed and adequately consulted upon.
1.4 Legal powers	C	The legal framework, especially the Banking Act, includes sufficient powers to address compliance with laws as well as safety and soundness concerns.
1.5 Legal protection	C	In general, the legal protection for banking supervisors, being civil servants, is sufficiently safeguarded.
1.6 Cooperation	LC	Predominantly informal arrangements for information sharing exist between the FSA and BOJ and with foreign authorities. The arrangements between the Japanese authorities should be intensified further and arrangements with foreign authorities could be enhanced. Appropriate arrangements for the protection of the confidentiality of such information are in place.
2. Permissible activities	C	In Japan the permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined
3. Licensing criteria	C	Appropriate provisions for the licensing of banks are in place.
4. Transfer of significant ownership	LC	The FSA has the power to review and reject any proposal to transfer significant ownership held directly or indirectly in existing banks to other parties. However, such powers for ex-ante approval do not explicitly exist for controlling interests.
5. Major acquisitions	LC	The FSA has the power to ex ante review major acquisitions by a bank, with the exception of acquisitions in ancillary business for which a pre-approval is not necessary. Also investments by a bank in another bank, in ancillary business or related banking business other than the acquisition of a subsidiary, either domestically or abroad, do not need prior approval of the FSA, although prior notification would be needed, Based upon this prior notification the FSA may require a bank to take measures if it is concerned about the potential impact this

6. Capital adequacy	MNC	<p>investment might have.</p> <p>Although the FSA has the legal power to impose higher capital requirements on individual banks that are commensurate with their risk profiles, the FSA's implementation of Pillar 2 of Basel II does not provide for setting extra capital charges in case the supervisory review process would indicate that not all material risks would have been captured. For domestic and internationally active banks different minimum capital levels are used, although a similar capital adequacy framework is used whereby similar risks lead to similar loss levels for which comparable capital levels should be available to absorb these losses. Moreover, triggers for early intervention measures due to a shortfall in minimum capital levels, are set too low, especially for domestic banks. Also in case a bank falls below its minimum level, it should no longer be allowed to pay dividends or executive compensation. On the quality of capital, domestic banks are still allowed to use deferred tax assets without a cap as part of capital, whereas for internationally active banks this has been capped at 20 percent. In addition, we have noticed some (temporary) measures taken by the Japanese government end 2008 for stabilizing the financial markets and facilitating finance, which includes a partial relaxation of the capital adequacy requirement for banks. In addition, accounting practices in Japan could in a number of cases lead to late recognition of losses together with capital adequacy requirements.</p>
7. Risk management process	LC	<p>The FSA and BOJ have sufficient frameworks for identifying and evaluating bank's risk management systems and processes and for requiring remedial actions. They also perform sufficient inspections and monitoring to assess the processes at banks. However, especially the role of the external audit function should be strengthened, and further focus should be put on banks' stress testing practices and banks' integrated risk management. The FSA's priorities (2011) are to be underlined, which are on enterprise wide risk management systems and the enhanced coverage and capture of risks by the bank's internal models. Also, the governance</p>

		arrangements at banks should be strengthened, promoting not only a more independent risk management and internal control function, but also an audit committee or a board of company auditors that can act independently from the board of directors, not only in 'form' but also in 'substance,' and which receives information on the implementation of risks management systems, of actual risks run and of identified breaches directly from internal and external audit or compliance, whereby the responsibilities of the business and internal control function are sufficiently kept separately.
8. Credit risk	C	The comprehensive work undertaken by the FSA in its on- and off-site supervision as well as BOJ work in this area provides a sound basis for the supervision of credit risks. In general, the banks we visited had a sufficient credit risk management system in place.
9. Problem assets, provisions, and reserves	LC	The policies and practices of banks with regard to problem assets have improved considerably over the last ten years. In the assessor's view, problem loans are adequately identified and classified. However, in the subsequent evaluation for extra provisions and reserves, banks are expected to take a more prudent stance, in taking into account possible factors such as possible changes in their business environment and government measures that are aimed at providing enhanced financing and support to their clients, including the restructuring of their loans.
10. Large exposure limits	MNC	The current large exposure rules are not sufficient. The current group concept does not sufficiently capture groups of related counterparties in as far they have a similar counterparty risk. Also, in calculating the exposures, not all exposures on a single counterparty or group of related counterparties are taken into account. Also, for domestic banks the same large exposure limits are applied as for internationally active banks, whereas their minimum level of capital is half of the level of an internationally active bank. And although we understand that the international discussions are still ongoing, the assessor's view is that in as far the limits should capture the event risk of a default

		of a single counterparty or group of connected counterparties, one should not solely rely on risk weighted exposures or exclude exposures, which in the current practice take place, which might be especially relevant under the current global market conditions. And lastly, limits should be set in such a way that after an event has occurred, a sufficient level of capital remains to absorb losses on going concern, which might be challenging, especially for domestically operating banks. With respect to bank's risk management systems, the assessors in their interviews with banks have heard of different systems to manage risk concentrations which might be further strengthened.
11. Exposure to related parties	LC	The law has basic provisions with regard to 'exposures to related parties,' including granting these exposures at arms' length. The FSA however does not actively enforce these provisions via regular off-site monitoring in combination with focused onsite inspections.
12. Country and transfer risks	C	While the FSA's approach in managing country and transfer risks are largely in-line with this criterion, more consideration should be given to the actual quality of country exposures and a more forward looking approach to asset evaluation and provisions.
13. Market risks	C	-
14. Liquidity risk	C	Liquidity risk supervision is performed by both BOJ and the FSA, with both authorities carrying out onsite inspections and off-site monitoring of banks in close coordination and cooperation.
15. Operational risk	C	Operational risk and crisis management framework is well established and in compliance with this Principle. Recent trends suggest that continued focus is needed on key risk areas such as information technology and the adequacy of integrated risk management for banks expanding overseas.
16. Interest rate risk in the banking book	C	The awareness, measurement, monitoring, and stress testing tools are in place to qualify for compliant grading under this principle. However, the FSA should note the comments on valuation and capital impact as further discussed under CP 22 and CP 6.

17. Internal control and audit	LC	Corporate governance functions at banks should be improved by strengthening the independence of the internal audit function and fit-and-proper requirements for the company auditors.
18. Abuse of financial services	LC	The weaknesses identified by the 2008 FATF evaluation have still not been addressed by changes to banking laws in Japan.
19. Supervisory approach	LC	Supervisory resources are not fully allocated according to the risk assessment results of banks as there is currently no formalized, analytical risk framework used to assess the overall risk profile of an institution, with the exception of regional banks. However, SIBs have been allocated more resources than other banks. There was also no formalized definition of systemically important banks factoring probability and potential impact analysis both from the financial stability and consumer protection dimensions.
20. Supervisory techniques	C	The off-site and onsite supervisory processes in place are generally in compliance with this Principle.
21. Supervisory reporting	C	The FSA has the means of collecting, reviewing, and analyzing financial institutions' prudential returns on both a solo and consolidated basis.
22. Accounting and disclosure	LC	The FSA does not have power to reject or rescind the appointment of an external auditor (EC 6). Temporary government measures including those taken to facilitate financing for small and medium-sized enterprises, relaxing the capital adequacy requirement for banks where mark-to-market (MTM) on "available for sale securities" in the banking book are required to be realized only when a loss of 50 percent was suffered, would affect the accounting representations, loan classifications, provisioning, valuations and capital adequacy.
23. Corrective and remedial powers of supervisors	LC	Trigger levels for the PCA system are set too low (EC 5). Intervention procedures of the FSA could be strengthened to ensure that remedial actions are taken by banks promptly.
24. Consolidated supervision	LC	Element of legal uncertainty under Articles 24-3, 52-31(3), 25-5 and 52-32(5) of the Banking Act that allows subsidiaries of the bank and banking holding company to refuse to submit report or materials requested by the FSA

		which might be an impediment to effective supervision.
25. Home-host relationships	LC	There is room to further strengthen home/host cooperation through proactive engagement and coordinated, effective and timely sharing of relevant information with foreign regulators.
<i>Aggregate: Compliant (C) – #, Largely compliant (LC) – #, Materially noncompliant (MNC) – #, Noncompliant (NC) – #, Not applicable (N/A) – #</i>		

Table 2. Japan: Recommended Action Plan to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
Responsibilities and objectives (CP 1.1)	Labor banks and Norin Chukin are co-supervised by both the FSA and the Ministry of Welfare respectively the Ministry of Labor. It should be clarified and made transparent based upon which procedures the decision making process takes place between the FSA and the other Ministries, whereby these decision making procedures should be structured in such a manner that the FSAs supervisory responsibilities should not be jeopardized.
Independence, accountability, transparency (CP 1.2)	See recommended action under 1.1. In addition; the FSA could consider further strengthening its governance arrangements with respect to the day-to-day supervisory activities of the Local Finance Bureaus by increasing the staff to oversee these activities and by improving the review processes.
Cooperation (CP 1.6)	The FSA and BOJ should further intensify their cooperation via more enhanced knowledge sharing, joint activities, and more regular sharing of findings from supervisory activities. Japanese authorities should engage in bilateral and/or multilateral memoranda of understanding with the most relevant foreign supervisory authorities.
Permissible activities (CP 2)	The FSA could more pro-actively engage in monitoring of the credit markets, in order to enforce more intrusively that only institutions that have a banking license, undertake banking business.
Licensing (CP 3)	Concerning the fit and properness of directors, senior managers and company auditors, regulations should reflect in substance that the person in question should not have a record of criminal activities or have any adverse regulatory judgment that would make him/her unfit for a senior position in a bank.
Transfer of significant ownerships (CP 4)	Japanese regulations should provide for an explicit supervisory approval of changes in ownership that would result in a controlling interest, for instance by utilizing FSA's powers to impose the condition on the approval of a major shareholder that a possible future majority holding by the major shareholder should be subject to a pre-approval by the FSA.
Major acquisitions (CP 5)	Japanese regulations should provide for an explicit supervisory approval of major investments. Also the scope for approval of acquisitions could be considered, by inclusion of acquisitions of ancillary business and business

Reference Principle	Recommended Action
Capital adequacy (CP 6)	<p>related to banking business.</p> <p>The FSA should as a supervisory instrument also use its possibility to set higher capital levels than the minimum, depending upon the actual risk profile of the bank concerned.</p> <p>The capital standards for domestically operating banks should be aligned with those for internationally active banks, whereby similar risks will lead to similar loss levels for which comparable capital levels should be available to absorb these losses.</p> <p>The triggers for early intervention measures due to a shortfall in minimum capital levels should be set at higher levels and should for domestic banks be as much as possible aligned with the internationally active banks, so that earlier more intrusive measures will be taken.</p> <p>In case a bank falls below its minimum level, it should no longer be allowed to pay dividends or executive compensation.</p> <p>For domestic banks, the elements of capital and the deductions and possible limits used, should in as far possible be in-line with those for the internationally active banks.</p> <p>Japanese authorities should ensure that their capital adequacy standards do not discourage the use of internal models, and better risk management techniques.</p>
Risk management process (CP 7)	<p>It is recommended that the FSA has arrangements with external audit on a regular exchange of information on audit findings and a direct notification of exceptions in case unusual transactions identified at the bank.</p> <p>The FSA and BOJ should have a continued focus in their inspections on improving the governance structures at the banks, including risk management, internal audit, and the independent role in substance of the company auditors and possibly an audit committee. The FSA should also encourage a separation between the business line and control functions at senior levels commensurate with the size and complexity of individual banks.</p> <p>The FSA and BOJ should have a continued focus in their inspections on the quality of enterprise risk management and stress testing as a regular risk tool of banks.</p>

Reference Principle	Recommended Action
Credit risk (CP 8)	<p>More supervisory attention could be given to the further integration of concentration risk rules within the context of credit risk management. More focus could be put on identifying and measuring counterparty credit risk of securities and related derivatives products, and integrating it into the day-to-day risk management practices. A continued and focused attention by both the FSA and BOJ on the credit management processes of banks is warranted</p>
Problem assets, provisions and reserves (CP 9)	<p>The FSA should investigate more intrusively that in the evaluation for extra provisions and reserves, banks take a more prudent stance in taking into account possible government measures that are aimed at providing enhanced financing and support to their clients, including the restructuring of their loans.</p>
Large exposure limits (CP 10)	<p>The group concept of connected counterparties should be extended.</p> <p>The definition of exposure should be changed so that all exposures from an individual client or group of connected clients are taken into account.</p> <p>The large exposure limit set should be commensurate with the minimum CAR applied and should take into account the expected buffer capital that should be kept after an event has occurred.</p> <p>Japanese authorities should consider setting limits as a percentage of Tier 1 or core Tier 1 capital rather than as a percentage of bank capital.</p> <p>The FSA is encouraged to examine the risk management systems of banks with a view to increasing bank's management of risk concentrations in their loan portfolios with respect to different regions and industries.</p>
Exposures to related parties (CP 11)	<p>The FSA should enforce the existing provisions more vigorously by introducing off-site monitoring for these exposures on a regular basis. In its onsite examinations the FSA should undertake focused inspections on related party exposures.</p>
Liquidity risk (CP 14)	<p>The risk assessment standards for assessing liquidity risks following the onsite examinations and offsite monitoring carried out by both the FSA and BOJ could be further enhanced for consistency in approaches and risk rating assessments of banks, with due regard to BOJ's and FSA's own objectives.</p>
Operational risk (CP 15)	<p>Continue with the current focus on IT system risks and the adequacy of banks' integrated risk</p>

Reference Principle	Recommended Action
	management.
Interest Rate Risk in the Banking Book (CP 16)	A more intrusive, capital adequacy management process for “outlier” banks following the results of the predefined (potential) parallel interest rate shift stress tests should be adopted by the FSA. Ensure the standardization of valuation rules with international standards for supervisory purposes
Internal Control and Audit (CP 17)	Strengthen the independence and effectiveness of the independent oversight functions within banks.
Abuse of Financial Services (CP 18)	Expedite the remediation of weaknesses identified through the 2008 FATF Mutual Evaluation.
Supervisory Approach (CP 19)	Develop a holistic risk rating assessment framework for individual financial institutions. Define criteria for identifying systemically important financial institutions that could better drive the allocation of supervisory resources and prioritization of supervisory intensity based on the risk and impact of financial institutions to the financial system.
Supervisory reporting (CP 21)	To further enhance the integrity of prudential reporting, the FSA may wish to consider requiring that external auditors opine whether or not filings have been accurately made. The FSA may wish also to explicitly require external auditors to immediately report any material shortcomings noted directly to the FSA.
Accounting and Disclosure (CP 22)	The FSA should be empowered to reject or rescind the appointment of an external auditor, and should promote the prompt alignment of valuation, accounting, and disclosure standards with international standards in all areas.
Supervisors’ Corrective and Remedial Powers (CP 23)	Rectify deficiencies in the current PCA framework. Use a wider range of intervention tools to avoid delays in remedial actions.
Consolidated Supervision (CP 24)	Ensure powers to supervise all entities within a group are not constrained by legal provisions. Continue to enhance the effectiveness of its cross-border supervision, including strengthening potential resolution tools.
Home-Host relationships (CP 25)	Engage more proactively in coordinated, effective and timely sharing of relevant information with foreign supervisors on a regular basis to strengthen ability to anticipate and deal with crisis situations and meet industry expectations. Continue efforts to sign more formalized arrangements including bilateral or multilateral agreements with foreign supervisors.

Authorities' response to the assessment

62. **The Japanese authorities wish to express their sincere appreciation to the IMF and its experienced assessors for the dedication, time and resources committed to this assessment.** It provided the authorities with an opportunity to comprehensively review their regulatory and supervisory framework through their self-assessments and dialogue with the IMF.

63. **The authorities welcome the overall assessment by the IMF that they have achieved a high level of compliance with the BCP.** They also appreciate the IMF's assessment that significant progress has been made since the last FSAP. The recommendations made by the IMF to further improve regulation and supervision in accordance with the BCPs are well received. While some initiatives towards reform are already taken since the time of the assessment, the authorities will thoroughly take into account these recommendations in their continuous efforts to strengthen their capacities for better regulation and supervision.

64. **In two areas where the authorities have received unfavorable grades, initiatives are already underway.**

65. **Concerning CP 6, on March 30, 2012, the FSA published the final capital adequacy rules for internationally active banks based on Basel III after a one month public consultation period.** The FSA will implement the new rules as from March 31, 2013, which is the end of the fiscal year 2012. The FSA is also now considering new capital adequacy rules for non-internationally active banks (domestic banks). The FSA expects the IMF to understand that non-internationally active banks engage in community based businesses and thus their minimum capital ratios should be set to balance the two objectives of facilitating their financial intermediary function in respective regions and ensuring safety and soundness of those banks.

66. **Concerning CP10, the Financial System Council, which has been established as an advisory body to the Prime Minister, the Commissioner of the FSA and Finance Minister, is now requested to review the large exposure regime in Japan.**

67. **Finally, the authorities strongly support the role the FSAP plays in promoting the soundness of the global financial system and financial stability in member countries through improving regulatory and supervisory practices around the world.**

II. DETAILED ASSESSMENT OF VARIOUS CPS

Table 3. Japan: Detailed Assessment of Compliance with the Basel Core Principles

Principle 1.	Objectives, autonomy, powers, and resources. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	See below
Assessment	Largely compliant
Comments	See below
Principle 1(1).	Responsibilities and objectives. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.
Description	<p>EC 1—There are laws for banking and for banking supervision. The legal framework for banking supervision in Japan is formulated on four levels. The first level is the laws that have been approved by the Cabinet and passed by the Diet. For banking supervision the basic law is the Banking Act, which has been amended several times. The second level consists of orders for enforcement that have been approved and issued by the Cabinet. The Banking Act provides for issuing such orders for enforcement in various areas. The third level consists of Ordinances for enforcement of the Banking Act. These are issued by the FSA. In practice the FSA is substantially involved in the drafting of laws, orders and ordinances. The fourth level consists of supervisory guidelines that have been issued by the FSA. In addition the FSA has also developed an inspection manual. In practice, the supervisory guidelines are mostly being used as basic criteria in the assessment in the off-site activities by the FSA staff, whereas the inspection manual is being used as guiding practice for the onsite activities of the FSA during their inspections. All pieces of legislation as mentioned above are being published in Japanese. In addition, the FSA provides an unofficial translation of the Banking Act, and the inspection manual in English on its website. However, not all ordinances and orders nor the supervisory guidelines are publicly available in English. For most areas, the supervisory guideline and inspection manual include the substance of the banking regulation. In practice the banks that we interviewed see the inspection manual as a regulation that applies to them, although it does not have a specific reference in law. In addition, the FSA issues so-called 'No action letters' as an official response to inquiries from banks. Frequently, the guidelines and inspection manual are amended where appropriate.</p> <p>The law also defines the authorities involved in banking supervision. The Japan Financial Services Authority (FSA) has been established by the Act for establishment of Financial Services Agency. In Article 2, the FSA is established as a government agency. The act stipulates in Article 3 the objectives and responsibilities of the FSA: the mission of the Financial Services Agency is to ensure the stable functioning of the financial system of Japan and to protect depositors, policyholders, securities investors</p>

and other persons equivalent thereto, while facilitating finance. So the FSA is the integrated regulator for the banking, securities and insurance sectors. Concerning the FSA's responsibilities, Article 4 of the FSA establishment Act mentions that the FSA has the authority to plan and draft proposals for the Japanese financial system as well as to inspect and supervise institutions. With regard to the banking sector these are: banks (city banks and regional banks), bank-holding companies, Shin kin banks, credit cooperatives, labor credit cooperatives, Norin-chukin Bank, and private business operators engaged in deposit-taking.

The FSA has been established as an extra-ministerial bureau of the Cabinet Office. The head of the Cabinet Office is the Prime Minister. The powers stipulated in the Banking Act belong to the Prime Minister, as the head of the Cabinet Office. Most of these powers have been delegated to the Commissioner of the FSA in accordance with paragraph 1 of Article 59 of Banking Act and Article 17 of the Order for Enforcement of the Banking Act. The powers not delegated to the Commissioner of the FSA are specified in the Order for Enforcement of the Banking Act. The most important powers which have not been delegated are the approval and revocation of the banking license, the issuance of orders for the suspension of whole or part of the banking operations of a supervised entity, and approval of the establishment of a bank holding company. For these powers not delegated, the Minister for Financial Services, assigned by the Prime Minister, has the ultimate responsibility of exercising the power in practice under Article 11 of the Cabinet Office Establishment Act.

All city banks and regional banks are stock companies and licensed under the Banking Act. The city banks are directly supervised by the FSA. Concerning regional banks, the FSA has delegated its supervisory powers to the Local Finance Bureaus of the MOF. Within the FSA there is a special unit that provides overall guidance to these Local Finance Bureaus on the direction of their supervision. This unit also manages possible remedial supervisory action towards regional banks. The day-to-day supervision, including inspections, is undertaken by the Local Finance Bureaus. Comparable regulations are applied for city banks and regional banks. Besides city banks and regional banks, there are so-called cooperative-type financial institutions. This group consists of Shinkin banks, credit cooperatives, labor banks, agricultural cooperatives and fishery cooperatives. They operate their business and are supervised under special acts. Shinkin Banks and credit cooperatives are supervised by the FSA in the same way as regional banks. So also here, the FSA has divisions for the supervision of those institutions that provide guidance and take remedial action, whereas the day-to-day supervision is delegated to the Local Finance Bureaus. The regulations applicable to these banks are the same as those for regional banks. In addition, there exist many small agricultural and fishery cooperatives as well as labor cooperatives that take saving deposits locally (there are about 700 agricultural cooperatives and about 150 fishery cooperatives). Agricultural cooperatives and fishery cooperatives are supervised by the Ministry of Agriculture, based upon the Agricultural Cooperatives Act and Fishery Cooperatives Act. Based upon these acts, these cooperatives are allowed to take deposits. Daily supervision is conducted by local state government. In as far these cooperatives engage in financing business, upon the request of the local state government, the FSA performs inspections on financial soundness Besides, and the FSA together with the Ministry of Agriculture has developed the supervisory guidelines for these cooperatives. There is one agricultural cooperative which, given its size, is co-supervised by the FSA and the Ministry of Agriculture. This is the central agricultural cooperative bank named Norin-Chukin. Although co-supervised, the FSA is the sole supervisor concerning the soundness of the institution. This means that the Ministry of Agriculture cannot intervene in the FSA's decisions in this area, for instance in case the FSA would take administrative action against the institution due to some material deficiencies in the institution's risk management systems. In other areas, like the establishment of foreign branches, the FSA and the Ministry of Agriculture co-

decide. As for labor cooperatives, they are co-supervised by the FSA and the Ministry of Labor. The regulations applied to these labor cooperatives (about 10) are no different from those applied to cooperative banks.

Besides the FSA, which is the integrated banking regulator in Japan, the BOJ also assumes the responsibility of maintaining a sound financial system. The Bank of Japan Act (Article 1, paragraph 2) stipulates that the Bank's objective is to ensure a smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of financial system stability. Article 44 of the Bank of Japan Act stipulates that the BOJ may, for the purpose of appropriately conducting or preparing to conduct business prescribed by the Articles 37 to 39, enter into contracts with certain financial institutions with which it undertakes business. Based upon these contracts the BOJ may undertake onsite examinations in the context of its function as lender of last resort for financial institutions. In practice the BOJ has signed such agreements with most Japanese banks. Besides onsite examinations, the BOJ also undertakes off-site monitoring and analysis. The BOJ has no administrative powers for corrective action by the institutions but would however communicate its findings and proposed follow-up action to institutions. From the interviews held with banks, indeed the FSA is also being perceived as the integrated supervisory authority with the BOJ having a specific role in the context of lender of last resort.

The following provides a summarized overview of some characteristics of both Authorities with respect to their inspections and examinations:

	FSA's inspections	BOJ's examinations
Legal basis	Banking Act, and other acts for corresponding institutions	Bank of Japan Act, Articles 1 and 44, as well as contracts with correspondent financial institutions
Objective	To ensure the soundness and the appropriate management of business of banks and institutions while facilitating finance.	To ensure smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of an orderly financial system
Main focus	Ensuring the appropriateness of compliance, capital adequacy, risk management etc	Assessing various risks, management structure, capital adequacy etc
Financial institutions	Banks, cooperative banks, credit cooperatives, securities companies, investment trust companies, insurance companies, investment-advisory companies, etc.	Banks, cooperative banks, Japanese branches of foreign banks, securities companies, etc
Penalty for refusal	Legal penalty according to Banking Act, Article 63, Section 3 and Article 64.	No legal penalty. However, should an institution refuse to accept examination or to provide information with no justifiable reason, BOJ may take the fact public and/or cancel the current account transaction

EC 2—The framework for the minimum prudential standards for banks is provided by the Banking Act and subsequent regulation. The main components are the standard set by the FSA on the CAR, the supervisory guidelines for major banks, for small and regional institutions and for financial conglomerates and the inspection manual. Article 26 of the Banking Act enables the FSA to take steps for an orderly resolution of problem banks.

EC 3—The FSA is member of the BCBS and the Financial Stability Board (FSB). As such it is committed to implement new BCBS and FSB standards in its regulatory framework. An overview has been provided with respect to the implementation of new

	<p>BCBS regulation by the FSA in the last three years. In general, the FSA has adequately implemented these new standards into its regulatory framework.</p> <p>EC4—The FSA provides some information with regard to the financial soundness of the institutions under its supervision. Also the BOJ publishes financial soundness information about the banking sector. Additionally, the Japanese Bankers Association publishes information on the performance of its member banks. In as far banks are listed, information is also published by rating agencies and investment analysts.</p> <p>AC 1—Since 2007 the FSA applies a “better regulation” program that is focused on improving the quality of financial regulations. Amongst others, this program promotes a more risk-focused and forward-looking approach in new regulation. The banks interviewed appreciated this program, which in their view has improved in focusing the FSA on the most relevant topics. Also, the FSA publishes its annual prudential policy plan for onsite examinations and off-site analyses, which guide, although informally, the allocation of supervisory resources within the FSA.</p>
Assessment	Compliant
Comments	<p>The objectives of the FSA are both linked to micro-prudential supervision and to ensuring the stable functioning of the financial system of Japan. Consequently, the assessors have discussed a number of policies that are aimed at both objectives. An example is the FSA’s role in assessing the institutions efforts ‘in providing enhanced financing and support for the business improvement of SME’s’. For these policies, striking the balance between micro prudential and policy objectives aimed at promoting the financial system of Japan are embedded in day-to-day supervision and are not externalized by applying different bodies. As a result, in practice a large burden is put on supervisors to make the right decisions and balance these objectives on a micro level. From the interviews we held we understood that although this is not an easy task, it works in practice. For instance for the above mentioned policy for SME’s, we did not see an overreliance on one of the two objectives.</p> <p>Labor cooperatives are co-supervised by the FSA and the Ministry of Labor and the Norin-Chukin is co-supervised by the FSA and the Ministry of Agriculture. In addition, for its soundness Norin-Chukin is solely supervised by the FSA. This is different from city and regional banks, which are solely supervised by the FSA. The FSA is the integrated banking regulator in Japan. Co-supervision by the FSA and a Ministry on certain supervisory matters, may lead to less clear decision making processes. The FSA provided the assessors with an overview of the main areas in which supervisory decisions are to be taken by the FSA and the Ministry of Agriculture respectively the Ministry of Welfare. In a number of areas decisions could be taken by both the FSA and another Ministry. It is recommended to clarify and make transparent exactly how the decision making process takes place between the FSA and the other Ministries, whereby these decision making processes should be structured in such a manner that the FSAs supervisory responsibilities should not be jeopardized.</p> <p>Further, the assessors observed that agricultural and fishery cooperatives are supervised under the Agricultural Cooperatives Act and the Fishery Cooperatives Act under which they are allowed to take deposits, whereby daily supervision is conducted by local state government. Given 1) the limited size and the nature of their main business; 2) the fact that the FSA together with the responsible Ministry of Agriculture has developed supervisory guidelines for these cooperatives; and 3) the FSA could, upon request, undertake on-site examinations, the assessors view that in general a sufficient basis for prudential supervision exists for these cooperatives.</p>
Principle 1(2).	Independence, accountability, and transparency. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.

Description	<p>EC 1—The FSA Establishment Act created the FSA as an external agency of the Cabinet Office. More precisely, the FSA is described as, “a government agency other than a Cabinet ministry” and is established as such pursuant to the Law to Establish the Cabinet Office, meaning that it is technically independent body from the Cabinet Office.</p> <p>The Prime Minister as Head of the Cabinet Office has the powers as stipulated in the Banking Act for the execution of supervision. Based upon legal provisions, most of these powers are delegated to the Commissioner of the FSA in accordance with Paragraph 1 of Article 59 of Banking Act and Article 17 of the Order for Enforcement of the Banking Act. However, some powers are not delegated. The powers not delegated to the Commissioner of the FSA are specified in the Banking Act. Major examples are the approval and revocation of the banking license, orders for suspension of the whole or a part of banking operation, and approval for establishment of bank holding companies. As a consequence, the Minister for Financial Services would on a regular basis be informed about problem situations at a bank and would be ultimately responsible for major supervisory decisions. This would normally be based upon individual supervisory information prepared and provided by the FSA. If the Minister for Finance Services would make an inappropriate decision, such as for instance revoking a license without a sufficient reason, the party which has suffered from the decision is allowed to challenge it under the Administrative Appeal Act or to file an administrative suit in order to have the decision cancelled against the Japanese Government under the Administrative Case Litigation Act.</p> <p>The FSA has in general adequate independence to deploy its own banking supervision resources for the execution of its tasks. For the supervision of regional banks, the FSA deploys staff of the local financial bureaus. These bureaus form part of the MOF and execute not only supervisory tasks but also tasks related to the economic policies of the region. The FSA reports to the cabinet and to the Diet and is not subordinated to any other executive institution of the state. This prevents an active and ongoing intervention by the Diet or governmental bodies in matters under consideration concerning specific institutions. This holds especially for banks that are under the sole supervision of the FSA, both in terms of the FSA’s mandate and the deployment of its resources.</p> <p>The accountability of the FSA is performed on an ex post basis, which prevents active and ongoing intervention by the Diet in current cases. The FSA is accountable in various ways. The Commissioner and his staff may be required to appear before the Diet or any of its committees. It is subject to the Administrative Procedure Law, under which it must explain the reasons why any disadvantageous administrative measures were taken; to the Law concerning Access to Information held by Administrative Organs; to the Cabinet Decision relating to a Public Comment Procedure for Formulating, Amending, or Repealing Regulatory Regulation, which requires a consultation process for formulating, amending, or repealing regulations. Furthermore, since 2007 the FSA undertakes a “Better Regulation” program in which it sets out goals such as enhancing dialogues with financial institutions, strengthening cooperation with foreign supervisors, enhancing its research function, and improving quality of employees. To that end, every year the FSA has published on its website how it has achieved the goals listed in this program.</p> <p>The organizational structure of the FSA is defined and disclosed by the Law on the Establishment of the Cabinet Office and by the Order and Ordinance for the Organization of the FSA. Based upon these legal provisions, there are three internal bureaus in place within the FSA: a Planning and Coordination Bureau, an Inspection Bureau and a Supervisory Bureau. In order to prevent supervisory capture within the bureaus, the inspection and supervisory bureaus report independently to their</p>
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respective directors. Quality control activities and peer reviews are undertaken in a rather informal way. There are direct contacts with banks supervised, so one directly receives possible signals that could guide the work of the bureaus. Any information on banks would be inputted to senior management. There's no formalized overview at senior management level of the status of all individual banks, except for regional banks. The day-to-day supervision of regional and Shinkin banks has been delegated by the FSA to the Local Finance Bureaus which are part of the MOF. Within the FSA there are supervisory divisions in the Supervisory Bureau of the FSA that provide guidance to these Local Finance Bureaus on the direction of their supervision. These divisions also manage possible remedial supervisory action. The supervision, undertaken by the Local Finance Bureaus, also includes inspections. The two divisions guiding the work of the Local Finance Bureaus consist of about 50 persons. There are about 600 staff active in the off-site supervision at the local finance bureaus and 500 staff on-site.

Coordination is upheld by means of the FSA's supervisory guidelines and annual supervisory policies that are applied to the supervision of these banks by the Local Finance Bureaus, via seconding staff from the FSA to the Local Finance Bureaus and having some senior management level staff from the FSA hold key positions at the Local Finance Bureaus, by organizing trainings and by regularly holding meetings. Also the FSA, together with the MOFs Local Finance Bureaus develops an annual supervisory plan for each individual bank, which includes schedules for supervisory actions, with reference to the risk factors and risk profile of the bank as assessed by the Local Finance Bureau. Based upon these schedules, the FSA asks Local Finance Bureaus to report major issues for specific banks to the FSA. The FSA assesses the adequacy of the reports made by the Local Finance Bureau and will guide the follow-up work the Bureaus undertake towards the bank. In addition, the FSA will analyze data submitted by the institutions independently from the Local Finance Bureaus and will request the Local Finance Bureaus to undertake certain supervisory actions based upon the outcome thereof. In addition, it conducts on-site inspections jointly with Local Finance Bureaus' staff at regional banks. There also exists a Japanese Ombudsman, but up to now no complaints have been lodged by individuals via this channel about the FSA.

EC 2—The FSA publishes on an annual basis its objectives with respect to banking supervision. A distinction has been made in objectives for off-site and onsite. The objectives provide a general orientation for the execution of supervision. Concerning onsite supervision, the policy also indicates the planned number of examinations and their focus. Discharge of the FSA's duties takes place via publication of its annual report in which it informs the public of the activities undertaken. Concerning its specific regulatory objectives, the FSA would in general follow the BCBS recommendations and consult with the industry and public before amending its supervisory guidelines and/or inspection manual. In addition, the public is informed about the FSA's views via monthly newsletters and public presentations and speeches. The BOJ publishes its focus areas especially by means of its financial stability review and its own annual onsite examination policy. Ex-post information concerning the review of the previous fiscal year is provided as well.

EC 3—The FSA's banking supervision staff has credibility based on their professionalism and integrity. The present supervisory strength of the FSA in banking supervision is around 450 staff, excluding about 1110 staff in Local Finance Bureaus responsible for inspection and supervision of regional financial institutions. The number of staff in banking supervision at the FSA responsible for off-site monitoring is about 110 and in onsite inspections is about 340. Staff would rotate every two to three years from position, with the exception of some specialist staff. Staff rotation mainly takes place within the FSA. Given the number of banks to be supervised, the current

	<p>staffing levels at the FSA seem to be adequate. The ratio of generalists compared to specialists at the FSA is about 3:1. In total about 150 people supervise the major banking groups (all from the FSA), 600 the regional banks (about 30 percent from the FSA and 70 percent from the Local Finance Bureaus) and about 700 the cooperative banks (about 5 percent from the FSA and 95 percent from the Local Finance bureaus). In addition, the FSA has assigned a certain number of specialists in the areas of credit, market, operational, interest rate and liquidity risks to each of the off-site and on-site bureaus. Of all specialists, about 37 percent work in the area of credit risk, 26 percent in the area of operational risk, and 37 percent in the areas of liquidity risk, market risk and interest rate risk.</p> <p>We understand that career paths exist for generalists, but not for specialists. Concerning integrity, all the FSA staff needs to fulfill the basic requirements for government officials as stated in relevant legislation, indicating that they need to ensure fairness and public trust in exercising their duties and which prohibit acts by individuals causing discredit to the national public service. In addition, about 140 staff is employed by the BOJ to perform oversight activities. It is understood that both the FSA and BOJ are able to easily hire graduates.</p> <p>EC 4—The FSA is part of the expense calculation of the central government’s budget. The Diet approves the FSAs budget every fiscal year. This budget provides for staff training, computers, and costs of other facilities as well as travel for onsite work. In practice, the FSA has received a comparative high priority in the central government’s budget planning; in the last ten years the FSA’s budget and number of staffs have increased every year while those of other government ministries and agencies have decreased due to the fiscal deficit of Japanese government. Also possible expenses by the FSA that might be directly allocated to supervised firms, are covered by the budget provided for by the Diet and not by fees charged to institutions in question. The salary-levels of the FSAs staff are those of a government official, and comparable with those of officials working in other ministries. An exemption is made for specialists; since 2000, there is an act based upon which experienced specialists can be hired at better salary-conditions. The FSA has made extensive use of this facility. The FSA has an extensive internal training program in which staff participates two to four times a year.</p> <p>AC 1—The Commissioner of the FSA is appointed and removed by the Prime Minister. The Commissioner appoints other senior staff. Formally, the Commissioner is appointed for an indefinite term, but in practice he/she will hold office for two to three years. Also the Commissioner as head of the FSA is a government official and as such cannot be dismissed from his position, except in the case where, “his performance on duty is obviously unsatisfactory though necessary measures such as giving guidance for improvement are taken” or where, “he is diagnosed as a mental or physical disorder by two doctors.” In practice, there has been no precedent where the Commissioner has been demoted, placed on administrative leave or dismissed by the Prime Minister. If such a case would happen, the National Public Service Act requires the reasons to be clarified.</p>
Assessment	Largely compliant
Comments	<p>Although formally the FSA’s budget is approved yearly by the Diet and could therefore be impacted by political considerations, we assessed that in practice sufficient resources are available to the FSA to undertake its tasks in banking supervision and the FSA can allocate these resources in the way it deems necessary for the execution of its supervisory tasks.</p> <p>Also when looking at the day-to-day supervisory tasks which are under the direct control of the FSA staff, we assessed a sufficient operational independence from</p>

	<p>government decision-making. However, we understand that some major decisions on individual banks, like the approval and revocation of a license or the suspension of the whole or part of the banking operations, are formally taken by the Minister of Financial Services who has been assigned by the Prime Minister, although prepared by the FSA. As the Minister for Financial Services, who has been assigned by the Prime Minister, has these delegated powers, the FSA's proposed decisions may be influenced by more political considerations and may lead to anticipatory behavior by the FSA in order to arrive at decisions that could be approved by the Minister for Financial Services.</p> <p>The FSA indicated that although the ultimate decisions are taken by the Minister, the FSA prepares these decisions and manages the decision-making processes by enhancing their transparency in the supervisory guidelines. The FSA also indicated that it is not aware of any situation where the Minister has unduly delayed such decisions or changed the substance of the FSA's proposed decisions.</p> <p>As already outlined under BCP 1(1), the supervision of regional and cooperative banks is delegated by the FSA to Local Finance Bureaus. These bureaus are not part of the FSA but of the MOF. The day-to-day supervision of these regional and cooperative banks (in total about 370) is done by about 600 off-site staff within these bureaus. In addition, about 500 on-site staff is employed at the Local Finance Bureaus. At the FSA, about 50 staff is involved in the off-site supervision of these institutions. The assessors are of the opinion that the FSA could consider to strengthen the governance-arrangements towards the Local Finance Bureaus, by increasing the staff to oversee these activities and by improving the review processes.</p> <p>For the labor and agricultural cooperatives and Norin-Chukin, Ministries and FSA co-supervise and co-decide on certain supervisory matters. This might impact the operational independence by the FSA concerning these institutions. As already mentioned under BCP 1(1), we recommend to clarify and make transparent the decision making process between FSA and other Ministries where they co-supervise an institution.</p> <p>Besides these more institutional considerations, the FSA is also tasked with the execution of some regulations in which it needs to balance the interests of its micro prudential objectives with those of the central government concerning its decision making on macroeconomic policies and measures. An example is the measure taken by the FSA in 2008 for stabilizing the financial markets and for facilitating finance. For our assessment, we refer to the comments as provided under BCP 1(1).</p> <p>Given these observations, the assessors are of the opinion that the operational independence of and governance arrangements surrounding the FSA should be improved as follows. First the recommendation as already stipulated under BCP 1(1) should be executed and in addition the FSA could consider strengthening the governance arrangements as stipulated above.</p>
Principle 1(3).	Legal framework. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
Description	EC 1—Licensing (based on Paragraph 1, Article 4 of Banking Act) and revocation of licenses (based on Article 27 and 28 of the Act) is the responsibility of the Prime Minister, a function which is delegated to the Minister for Financial Services. Based on Paragraph 2, Article 4 of Banking Act, the FSA has clarified more detailed application forms and criteria for licensing in Article 1-8 of the Ordinance for Enforcement of the

	<p>Banking Act and Supervisory Guideline. As such the FSA has set detailed criteria and based on those criteria it reviews the applications and considers revocation of licenses. There is one deposit-taking institution, Japan Post Bank, which is supervised by the FSA and indirectly owned by the government. For this institution a privatization scheme has been set up, the details of which are under discussion in the Diet. The government does not own any other bank licensed under the Banking Law.</p> <p>EC 2—Based upon the Banking Act and derived delegation orders, the FSA has the power to set prudential rules. An example is the standard it has set for the Capital Adequacy Ratio in accordance with Article 14-2. In addition, it has set various other prudential rules via its supervisory guidelines and inspection manuals, although these instruments are not directly based upon provisions in the Banking Act. There is a legal requirement for the FSA to consult new regulations. Legally, such requirement does not exist for its guidelines and inspection manuals, but it would still consult with the public, based upon its better regulation agenda.</p> <p>EC 3—The FSA has the power to request all information necessary for its supervision of banks. The basis thereof is in Article 24 of the Banking Act. In practice it will do so via regular or ad-hoc interviews, onsite examinations, and regular reporting. In addition, the FSA may require the banks to submit ad hoc reports and filled-in questionnaires, if this would be necessary in the execution of its duties. Moreover, the FSA may require subsidiaries of a bank, outsourced companies (in accordance with Paragraph 2, Article 24 of Banking Act), foreign bank branches (in accordance with Paragraph 2, Article 47 of the Act), major shareholders of a bank (in accordance with Article 52-11 of the Act) and a bank holding company (in accordance with Article 52-31 of the Act) to submit reports or materials. The BOJ may collect data and information from financial institutions in accordance with the onsite examination contracts as stipulated in Article 44 of the Bank of Japan Act.</p>
Assessment	Compliant
Comments	
Principle 1(4).	Legal powers. A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.
Description	<p>EC 1—There are laws and regulations that enable the Japanese supervisor to address compliance with laws and the soundness of the banks under its supervision and that permit the supervisor to apply qualitative judgment. Both the Act for the Establishment of the Financial Services Agency and the Banking Act provide the FSA with such powers, with a view to ensuring a sound and appropriate management of the business of a bank concerned. Under Article 24 of the Banking Act, the FSA has the power to formally require a bank, its subsidiaries and its outsourced companies to submit reports or materials concerning the status of the bank. FSA has stronger powers under Article 26 of the Banking Act. This Article provides the FSA with the power to require a bank to submit an improvement plan by designating the matters and the time limit for which measures should be taken. Through these administrative powers, the FSA can enforce banks to address the issues concerned. Orders issued under such as Article 24 and 26 of Banking Act are examples of “administrative actions.” When the FSA considers the necessity for taking such administrative action, it is able to apply qualitative judgment. No specific conditions exist that could narrow the powers of the supervisor as mentioned under the Articles 24 and 26. However the FSA has identified the basic criteria it will take into account when applying said Articles, in order to be transparent about its application.</p> <p>EC 2—The Japanese authorities have adequate powers to access banks’ Board, management, staff and records for executing their respective role. The FSA may</p>

	<p>require a bank, its subsidiaries (the definition of which is consistent with accounting rules), and its outsourced companies to submit reports or materials concerning the status of its business or property based on Article 24 of Banking Act. It may also have his/her officials enter a business office or any other facility of a bank, its subsidiaries (the definition of which is consistent with accounting rules), and its outsourced companies and ask questions on the status of its business or property or inspect relevant books and documents or other objects based on Article 25 of the Act. In general, the FSA would have unlimited access to the licensed bank. The FSA would normally also have access to (information related to) a subsidiary, with the exception of access other than for prudential reasons. Although in the Banking Act it is stipulated that a subsidiary could refuse access on reasoned grounds, we understand that the FSA would always have full access to information from a subsidiary in as far this information is used for prudential purposes. An example where a subsidiary could refuse access to information is when it could assume that information about its clients' accounts would be used for tax reasons. Access of information or onsite access to an outsourced entity would normally not be limited, since the continuation of having these access powers would be part of the criteria for the outsourcing. With regard to BOJ, it may collect data and information from financial institutions in accordance with the onsite examination contracts as stipulated in Article 44 of the Bank of Japan Act.</p> <p>EC-3—In case of noncompliance or unsound practices, the Commissioner of the FSA has powers to take prompt remedial actions. In some instances, it's not the Commissioner of the FSA but the Minister of Financial Services that has the power to take certain remedial action, although the decision is based upon a proposal from the staff of the FSA. Major examples are the revocation of the banking license or orders for suspension of the whole or a part of banking operation. Based upon Article 26 of the Banking Act, the FSA has the power to request a bank to submit an improvement plan for ensuring soundness in management of that bank or to order a change to the submitted improvement plan by designating the matters and the time limit for which measures should be taken, or, within the limit necessary, order suspension of the whole or part of the business of that bank by setting a time limit or order deposit of property of that Bank or other measures necessary for the purpose of supervision. Based upon Article 27 of the banking Act, the FSA may, when a Bank has violated any laws and regulations, its Articles of incorporation or a disposition based on any laws and regulations or has committed an act that harms the public interest, order the Bank to suspend the whole or part of its business or to dismiss its director, executive officer, accounting advisor, or company auditor.” In accordance with Article 28 of the Banking Act, the Prime Minister “may, in the case where he/she has ordered a bank to suspend the whole or part of its business..., when he/she finds it necessary in light of the circumstances of such arrangement, rescind the license set forth in Article 4(1).” In practice, these powers lie with the Minister for Financial Services, who has been assigned by the Prime Minister.</p>
Assessment	Compliant
Comments	<p>The Japanese legal framework provides for clear provisions on the authorization of banking establishments and adequate information powers, as well as sufficient provisions for the supervisor to set prudential regulations via standards, guidelines, and inspection manuals. Also the supervisor has in general substantial powers to undertake remedial action in its day-to-day supervision.</p> <p>Some quite important remedial powers, like the powers to revoke the banking license or the power to issue an order to suspend whole or part of the banking business, have not been delegated to the head of the FSA, but have been delegated to the Minister for Financial Services, who has been assigned by the Prime Minister. In practice the FSA would prepare the basis for such decision making, but it would need approval by</p>

	<p>the Minister for Financial Services.</p> <p>The FSA indicated that although the decisions are formally taken by the Minister for Financial Services, the FSA prepares these decisions and fully manages the decision making processes. The FSA also indicated that it is not aware of any situation where a proposed decision has unduly been delayed or the substance has been changed of an FSA's proposed decision.</p>
Principle 1(5).	Legal protection. A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
Description	<p>EC 1—An appropriate protection from being liable for actions taken in good faith is assured for the FSA staff, as stipulated in the National Public Service Act and rules made by the National Personnel Authority. Specifically, when a public official, who exercises the public authority in the course of his/her duties, unlawfully inflicted damage on another person intentionally or negligently, the Government shall assume the responsibility to compensate therefore (Paragraph 1 of Article 1 of the State Redress Act). In this context, a supervised institution is included in the scope of 'another person'. In cases where damage would be inflicted against such a person, neither individual members of the FSA nor the FSA itself could be held liable for this damage. The party which has suffered from the decision by the FSA is allowed to challenge it under the Administrative Appeal Act or to file an administrative suit in order to have the decision cancelled against the Japanese Government under the Administrative Case Litigation Act. So not the FSA but the Japanese Government is subject to litigation if the FSA is sued for its inappropriate actions. In recent years, no such cases of litigation have been witnessed.</p> <p>EC 2—Normally the supervisory authority and its staff would be adequately protected against the cost of defending their actions. However, when there is intent or gross negligence on the part of the public officer, the Government has the right to obtain reimbursement from that public officer (Paragraph 2 of Article 1 of the State Redress Act). Possible actions against a public officer in case of intent or gross negligence would be dismissal, suspension from work, a pay cut or a reprimand. In practice, there have been very few such cases in the previous years. Based upon information received, this amounted to seven such cases from 2007 onwards.</p>
Assessment	Compliant
Comments	
Principle 1(6).	Cooperation. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	<p>EC 1—Both the FSA and the BOJ interact on a continuous basis with the banks under supervision. And both authorities undertake off-site analyses and onsite examinations and have interactions with officials of the supervised entities on a regular basis. This intensity of activities towards supervised institutions asks for a high degree of cooperation. The current arrangements are mostly informal. Especially with regard to onsite inspections and examinations, there is an agreement between the FSA and BOJ that they plan their activities in a coordinated manner and adjust where necessary their schedules and the list of institutions to visit. The detailed reports of the inspections and examinations would only be shared in exceptional circumstances between the two authorities. The basic findings and follow-up actions might however be shared, especially in cases where further mitigation actions would be warranted. Formally and based upon Article 44 of the Bank of Japan Act, the FSA may request BOJ to submit the documents describing the results of the onsite examinations and other related materials with respect to concerned financial institutions. Such a provision does not exist for the BOJ, asking information from the FSA. With regard to off-site analyses and at senior management level, there exists more regular information exchange between the FSA and BOJ, although not formalized. Staff</p>

exchanges between FSA and BOJ take place regularly. On crisis resolution, the FSA cooperates with the MOF and the Deposit Insurance Corporation, which take administrative responsibility for the resolution of individual failed financial institutions. In this regard, formal arrangements have been put in place. As for training, the FSA invites BOJ staff as lecturers at training seminars for FSA examiners.

EC 2—No formal arrangements (for instance bilateral or multilateral Memoranda of Understanding) exist on the cooperation and exchange of information between the FSA and BOJ and foreign supervisors. In practice, such activities do however take place, either via bilateral dialogues or via participation in supervisory colleges. In addition to these informal peer-to-peer or multilateral contact arrangements, the FSA would also sign EOLs with other supervisors when requested. EOLs could vary in form and substance but would generally be with one foreign supervisory authority and include provisions on their exchange of information and the confidentiality thereof and would be based upon their domestic laws. At the moment, about six of such EOLs exist. Based upon article 100 of the National Public Services Act, the FSA is prohibited under law to exchange information for other than supervisory purposes. For its three global systemically important institutions, the FSA has decided to sign institution specific formal arrangements. Please refer as well to BCP 25 (EC 2).

EC 3—The extent, to which supervisory information could be exchanged by the Japanese authorities amongst themselves and with foreign authorities, is dependent upon an individual assessment by the FSA and BOJ. More specifically, it is prohibited for the FSA and BOJ to exchange information except in cases where there are legitimate reasons (e.g., supervisory purposes) based on Article 100 of the National Public Service Act and Article 29 of the Bank of Japan Act. So if the FSA or BOJ would assume that the foreign counterparts use the supervisory information for other than supervisory purposes or other legitimate reasons, the FSA or BOJ shall determine not to provide the information to the foreign counterparts based on Article 100 of the National Public Service Act and Article 29 of BOJ Act. In practice, supervisory information might be exchanged, based upon an EOL. Looking at the exchange of confidential information between the FSA and BOJ, the FSA may require BOJ to provide confidential supervisory information about the results of BOJ's on-site examinations and related materials, based upon Article 44 of the Bank of Japan Act. Reversely, no such legislation exists.

EC 4—In general, supervisory staff in Japan is able to deny any demand for confidential information. Both the FSA and the BOJ have rules on this. The FSA staff members are government officials, who shall not divulge any secret which may have come to their knowledge in the course of their duties. This shall also be applied after he/she left the FSA (Article 100 and 109 of the National Public Service Act). The FSA may, as disciplinary action, be dismissed, suspended from duty, suffer reduction in pay or be admonished, when its staff fails to comply with the confidentiality rule (Article 82 of the National Public Service Act). A person who fails to comply with Article 100 of the National Public Service Act is subject to imprisonment with work for not more than one year or a fine of not more than thirty thousand yen (Article 109 of the National Public Service Act). On the scope of information that might be held confidential the supreme court in 1977 stated that this relates to, "Any secret which may have come to their knowledge in the performance of their duties." In addition, secret documents are defined as those which are considered to contain information which is allowed not to be disclosed to the public under Act on Access to Information Held by Administrative Organs (Paragraph 5), those whose confidentiality is necessary to be protected and those regarding which (i) it is identified that the disclosure thereof may cause harm to the national security or legitimate interest of the Head of the Bureau responsible for the matters; and/or (ii) it is identified that matters contained therein must not be accessible to any persons other than those who are deemed as being concerned with

	<p>the matters by the person responsible for the management of documents in the department/office responsible for the matters. With regard to BOJ, its officers and employees shall not leak or misappropriate secrets which they have learned in the course of their duties (Article 29 of the Bank of Japan Act).</p>
Assessment	Largely compliant
Comments	<p>The FSA is the integrated supervisory authority in Japan; BOJ is the central bank which also undertakes supervisory activities. In practice, cooperation and information exchange between both authorities exist and takes place, however mostly on a need-to-know basis and dependent upon the situation at hand.</p> <p>The current global economic situation asks for very intense cooperation between the supervisory authority and central bank, moreover when the central bank also undertakes supervisory activities. We recommend to further intensify the cooperation, whereby for instance the integrated supervisory authority could channel the outcomes of its bottom up assessments of the financial soundness of individual firms on a more ongoing basis to the central banking function, and the central bank function could more frequently provide signals on rapidly developing macroeconomic risks and distortions such as those identified in its financial stability report to the integrated supervisor that could use this in its day-to-day supervision. In addition, we recommend undertaking more joint activities, as both institutions could benefit to a larger extent from each other's knowledge and experiences than now is the case, enabling positive synergies between both organizations. Examples could be common trainings and staff exchanges. Also information from inspections could be exchanged more regularly, and not be primarily restricted to areas where supervisory concerns exist. Besides descriptions of the areas inspected and the approaches taken, this could for instance also be on normal and critical findings identified and on common themes for future remedial actions.</p> <p>With respect to cooperation with foreign supervisory authorities, we understand that in practice the Japanese authorities coordinate activities and exchange information, ranging from bilateral meetings with foreign supervisors to organizing supervisory core college meetings for the major Japanese banks. It might be beneficial to start engaging in bilateral and/or multilateral memoranda of understanding with the most relevant foreign supervisory authorities, also given the increased presence of Japanese banks in especially the Asian region, albeit via branches, subsidiaries or some type of cross border services. Via these MOUs, the basic expectations between the different parties involved on their cooperation could be made explicit, as well as their respective expectations for confidential and institution specific information exchange.</p>
Principle 2.	<p>Permissible activities. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible.</p>
Description	<p>EC 1—The Japanese Banking Act defines the institutions that are licensed and supervised as banks and lists their permissible activities. According to the Article 2 of the Banking Act a bank is a person who operates banking business under the license of the Prime Minister. Banking business in this context means (i) both the acceptance of deposits or savings, and loans of funds or discounting of bills and notes; or (ii) conducting of exchange transactions. Without having obtained a license from the Prime Minister, no banking business may be conducted. According to Article 4.2 every bank under the Banking act, shall be a stock company. The FSA enforces these requirements by responding to possible complaints and by acting on cases she has become aware of where users of financial services have been harmed.</p> <p>EC 2—The activities a bank may undertake are specifically mentioned in law. Other</p>

	<p>activities may not be conducted. The activities are mentioned in the Articles 10 and 11 of the Banking Act. Article 10 lists refers to a specific list of banking activities, Article 11 refers to the requirements for undertaking business pursuant to the provisions of the Secured Bonds Trust Act or other laws. The FSA has also published details of the permissible activities on its website (http://www.fsa.go.jp/en/refer/legislation/index.html).</p> <p>EC 3—For banks, the use of the word 'bank' is prescribed in their name. Banks may also use a trade name. No other person than a licensed and supervised bank may use in its name or trade name any term that would indicate that the person is a bank. A bank that intends to change its trade name needs authorization from the Prime Minister. Both the police and the Consumer Agency respond to the illegal use of the name 'bank'.</p> <p>EC 4—Only institutions that are licensed and supervised under the Banking Act or other specific laws may accept deposits from the public; therefore, any other institution who accepts deposits from the public will violate paragraph1, Article 4 of the Banking Act. After privatization in 2007, also Japan Post Bank became a licensed bank under the Banking Act.</p> <p>EC 5—The FSA publishes and updates the list of financial institutions and foreign institutions that have licenses for conducting banking business in Japan on its website.</p>
Assessment	Compliant
Comments	<p>In case the FSA becomes aware that an institution operates as a bank without a license, it will undertake enforcement action. It also responds to claims and to cases it has become aware of where users of financial services have been harmed. In addition, the FSA may consider engaging more proactively in monitoring of credit markets, in order to enforce more intrusively that only institutions that have a banking license, undertake banking business.</p>
Principle 3.	<p>Licensing criteria. The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.</p>
Description	<p>EC 1—Based upon Article 4 of the Banking Act, each entity that wants to undertake banking business in Japan, is obliged to have a license. In total about 20 licenses have been granted in the last 10 years. The license is obtained from the Prime Minister, who has delegated this power to the Minister of Financial Services. The actual approval process is undertaken by the FSA, who will provide a proposal on the approval process to the Minister of Financial Services who would ultimately sign the license. The submission of the application take place in two steps: firstly there is an informal process, followed by a formal application.</p> <p>EC 2—The basic criteria for obtaining a license are specified in Article 4 of Banking Act, which are financial soundness and having sufficient knowledge and experience to be able to carry out the banking business appropriately, fairly and efficiently and having sufficient social credibility in light of personnel and other relevant structures. More details on the application to obtain a license are provided for in application forms for a bank license (based upon paragraph 1 and 2 of Article 1-8 of the Ordinance for Enforcement of the Banking Act and the attachment to the Supervisory</p>

	<p>Guideline). In addition, paragraph 3 of Article 1-8 of the Ordinance for Enforcement of the Banking Act and Chapter VII of Supervisory Guideline designates how the FSA will supervise entry banks.</p> <p>EC 3—The regulations governing the acquisition of an existing bank basically parallel those governing its initial establishment, since the supervisory requirements with respect to financial soundness and the knowledge and experience to undertake the banking business in an efficient, effective and socially responsible manner continue to exist under ongoing supervision, be it worded in a slightly different manner (safety and soundness of bank's business management and operation), though materially equivalent.</p> <p>EC 4—The FSA has the right to reject applications if the criteria are not fulfilled or if the information provided is inadequate.</p> <p>EC 5—The Banking Law, read in conjunction with the Ordinance, enables the FSA to determine that the proposed legal and managerial structures of the bank will not hinder effective supervision. The examination conducted with respect to an application for a banking license under the provisions of Article 4 of the Banking Act include a check on appropriateness of administrative structures that do not hinder effective supervision, both on a solo and consolidated level. The FSA will check the legal, managerial, operational, and ownership structures of the applicant to ensure that the applicant will operate an internal control system that will be able to conduct the banking businesses appropriately and effectively. The FSA would persuade them to change the structures if the FSA has a concern that the structures may harm effective supervision of the FSA on both a solo and a consolidated basis. In case the bank is part of a larger group, the FSA's approach is that this bank should be able to operate quite independently from the rest of the group and that risks borne by other parts of the group do not unduly influence the bank in the group. Also when setting up a bank holding company, this company needs prior approval by the Prime Minister, based upon Article 52-17 of the Banking Act.</p> <p>EC 6—A person or company who wishes to become a holder of voting rights of an applicant for a bank license which amounts to more than normally 20 percent, would need to have prior approval from the FSA to hold such amount of shares and thus become major shareholder (Article 52-9 of the Banking Act). The FSA would simultaneously examine both applications. The calculation of the threshold of 20 percent does not only take into account direct owners but also indirect owners such as ultimate beneficial owners who can influence the exercise of voting rights of a bank (item 2 to 5, paragraph 1, Article 3-2 of the Banking Act). In its examination of the major shareholder of the proposed bank, the FSA will (in accordance with paragraph 1, Article 52-10 of the Banking Act) take into account matters like the origin of the funds for acquisition, the financial condition of the major shareholder, the status of its income, its expenditure, and its personnel structure (including transparency of its ownership structure).</p> <p>EC 7—Article 3 of the Order for the enforcement of the Banking Act and Article 5 paragraph 1 of the Banking Act stipulate that a bank is required to have a minimum amount of paid-in capital of at least ¥2 billion. Paragraph 3 of the same Article requires approval of the Prime Minister in cases when the bank seeks to reduce the amount of capital.</p> <p>EC 8—The FSA does not employ a specific pre-approval process for prospective directors and senior managers. However, the expertise and integrity of future directors and senior managers are examined during the application process. Such an examination takes place in the context of the requirement in paragraph 2, Article 4 of</p>
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the Banking Act for the banking license. Fit and proper requirements for individual directors and operating officers are stated in item 1, Article 7-2 of the Banking Act. Special emphasis is to be given on item 3 of Article 7-2 of the banking act that states that, 'a person who has been sentenced to a penalty for having violated the provisions of the Banking Act or other laws, and for whom two years have not elapsed since the day on which the execution of the sentence was completed or the sentence no longer applied may not become a director, senior management or company auditor of a bank. The FSA also requires an applicant for a bank license to submit resumes on directors and company auditors and documents which demonstrate that the applicant has personnel with sufficient knowledge in place regarding its future banking businesses under paragraph 1, Article 1-8 of the Ordinance for Enforcement of the Banking Act which will be considered in the application process.

EC 9—The FSA requires the submission of documentation stating a three-year forecast of cash flows and capital adequacy at the time of application. The FSA will assess that an applicant can return to profitability within three years from the start of banking business in accordance with item 2, paragraph 3, Article 1-8 of the Banking Act. With regard to assessment criteria in the review of an application for a bank license, the FSA will assess the governance structure, risk management processes, and internal controls, based upon the relevant requirements as mentioned in the supervisory guideline and inspection manual. This also includes an evaluation of bank's business model, in accordance with VII-1-1 of the supervisory guideline. As part of the evaluation, the FSA will also evaluate possible outsourcing structures, in-line with paragraph 2, Article 12-2 of the Banking Act and Article 13-6-8 of the Ordinance for Enforcement of the Banking Act.

EC 10—The documents provided by the applicant also includes pro forma financial statements, information about its planned capital adequacy and financial soundness information about major shareholders. With regard to financial strength of an applicant, the FSA will assess prior to providing authorization whether, "an applicant's stated capital amount is more than ¥2 billion, and the amount is sufficient for conducting banking businesses soundly and effectively" in accordance with item 1, paragraph 3, Article 1-8 of the Ordinance for Enforcement of the Banking Act.

EC 11—Where a foreign bank intends to establish a branch or a banking subsidiary in Japan, the FSA will assess whether or not the home country of the foreign bank supervises the bank in a virtually equivalent way to the FSA's supervision in accordance with paragraph 3, Article 4 of the Banking Act and Article 9 of the Order for Enforcement of the Banking Act. In case the establishment of a branch or a banking subsidiary by a foreign bank requires the approval of the home country of the bank, the FSA requires the foreign bank to submit written proof that the establishment has been approved by its home supervisor (item 10, Article 28 of the Ordinance for Enforcement of the Banking Act). In accordance with the Basel Concordat, the FSA will give a license for a foreign branch or a Japanese subsidiary of a foreign parent bank only if it receives in advance a no objection letter from the foreign home supervisor (Article 47 and 47-2 of the banking Act). If a financial conglomerate or banking group owns the foreign bank, a declaration of the home-country authority that it supervises the conglomerate/group on a consolidated basis is needed.

EC 12—When the FSA finds the bank has filed false information in application for licensing or has violated conditions on the license, the FSA will order the bank to submit the report on the matter and action to improve the situation already taken by the bank to the FSA based on Article 24 of the Banking Act. If the FSA finds it necessary to enforce the bank to improve the situation, the FSA shall consider issuing a business improvement order against the bank in accordance with Article 26 of the Banking Act. In addition, the FSA shall consider revoking the license of the bank in

	<p>accordance with Article 27 of the Banking Act where the FSA finds it inappropriate for the bank to continue banking business in case it has provided a major amount of material violations of laws or regulations or misconducts which will harm the public interests (II-5-1-1 (5) and (6) of the Supervisory Guideline).</p> <p>EC 13—Paragraph 2, Article 4 of the Banking Act requires an applicant for a banking license to have knowledge and experience as a whole to be able to carry out the business of a Bank appropriately, fairly and efficiently and with sufficient social credibility in light of personnel and relevant structures. Based on this Article, the FSA will assess the eligibility of the personnel and relevant structures of a bank, including the collective knowledge of the board with regard to banking activities.</p> <p>AC 1—Not for all shareholders but for the majority shareholders, the FSA evaluates whether or not it has sufficient financial ability to provide funds to the bank in accordance with VII-2-2-1 (2) of the Supervisory Guideline.</p> <p>AC 2—The FSA regularly examines the status on the soundness and appropriateness of banking businesses of a newly licensed bank by way of its onsite examinations and off-site monitoring. More specifically, the FSA will examine whether or not the bank expands business which was not assumed when licensing, maintains enough capital, develops appropriate risk management systems, earns profits as planned and develops the level of IT security in accordance with VII of the Supervisory Guideline. The FSA will conduct a follow up hearing with a bank whose business operation and earnings deviate from the original business model.</p>
Assessment	Compliant
Comments	Concerning the fit and properness of directors, senior managers and company auditors we recommend to strengthen the requirement in substance with respect to integrity to make it more in-line with good practices, which state that the person in question should not have a record of criminal activities or have any adverse regulatory judgment that would make him unfit for a senior position in a bank.
Principle 4.	Transfer of significant ownership. The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.
Description	<p>EC 1—A shareholding in a bank which represents 20 percent or more of the share capital or voting shares in the bank, or commands a significant influence in the bank's business activities in any other manner, is deemed to be a qualifying holding. In cases where a shareholder would have an important influence to the financial conditions and business operations of the bank, the threshold is lowered to 15 percent. This would for example be in cases where the shareholder would provide an important loan or technology. The determination of a major shareholding is not only based upon direct ownership but also indirect ownership such as the ultimate beneficial owners who can control a bank's voting rights (item 2 to 5, paragraph 1, Article 3-2 of the Banking Act).</p> <p>EC 2—Article 52-9 of the Banking Act requires prior authorization, if a shareholder of a bank seeks to obtain more than 20 percent of the outstanding shares. In assessing the application of the holding, based on item one, Article 52-10 of the Banking Act, the FSA confirms the purpose for the applicant of the holding. If the applicant intends to hold more than 50 percent of the voting rights in the future, the FSA will assess the adequacy of the applicant in this context. The FSA considers this confirmation by the applicant specifically important as the FSA will require major shareholders which has more than 50 percent of all voting rights of a bank to support the bank in case it would get into problems based on the paragraph 1, Article 52-14 of the Banking Act.</p> <p>FSA has the power to impose the condition on the approval of a major shareholder that the future majority holding by the major shareholder should be subject to an</p>

	<p>approval by the FSA under the Paragraph one of the Article 54 of the Banking Act. When assessing an application of a major shareholder according to the purpose of the shareholdings, the FSA will consider the necessity of imposing the condition above on the approval in order to reassess the qualification of the major shareholder as a majority shareholder and the impact of the holding on the bank in light of its governance structures and business model, especially in the case where the major shareholder has committed that it does not intend to subsidize the bank.</p> <p>A shareholder with more than 5 percent of voting rights must notify the FSA within 5 days when the shareholder becomes a major holder of bank's voting rights, or when the holding percentage changes by more than one percent (Article 52-2-21 and 52-3 of the Banking Act). Through this process, the FSA monitors the changes in shareholdings of a bank in its ongoing supervision. In case where a major shareholder is likely to hold more than 50 percent of all voting shares contrary to the FSA's confirmation of the original purpose of the holding by the major shareholder, the FSA may issue a reporting order or conduct an on-site inspection at the major shareholder. When the FSA finds the major shareholder has not qualified as a majority shareholder as a result of the investigation, the FSA will take necessary measures based on Article 52-13 of the Banking Act, which may eventually lead to canceling the approval of being 'major shareholder' based on Article 52-15 of the Banking Act.</p> <p>A major shareholder needs to file a report to the FSA in accordance with item 2, paragraph 2, Article 53 of the Banking Act, in cases where it has got more than 50 percent of all voting rights of a bank.</p> <p>EC 3—Article 52-9 of the Banking Law provides for authorization based on an examination of potential major shareholders that hold more than 20 percent. The FSA can order a major shareholder to take necessary measures or rescind the approval of such a shareholder in cases where this shareholder violates laws, regulations or actions taken by the Commissioner or damages public interests.</p> <p>EC 4—Shareholders themselves who holds more than 5 percent of the voting rights of all shares must report their name, domicile, types of businesses and the holding number of voting rights in accordance with Article 52-2-11 and paragraph 1, Article 52-3 of the Banking Act.</p> <p>EC 5—A shareholder who does not report its shareholdings where appropriate based upon the banking Act, shall be punished an administrative fine of no more than 1 million yen. The FSA shall order a shareholder who has become a major shareholder to take the necessary measures so that it would no longer be a majority shareholder (paragraph 4, Article 52-9 of the Banking Act).</p> <p>AC 1—Currently there is no requirement in Japan that banks must notify the FSA as soon as they become aware of any material information which may negatively affect the suitability of a major shareholder.</p>
Assessment	Largely compliant
Comments	<p>Supervisory approval is necessary for a shareholder that obtains more than 20 percent of the shares of a bank. However, major changes in the shareholding structures above this 20 percent limit, do not necessarily need supervisory approval, although increases need to be reported and in practice intentions need to be clarified with respect to possible future majority shareholdings as soon as a shareholder becomes a 'major shareholder' and extra conditions could then be set on future increases. Especially when a major shareholder obtains a majority shareholding (controlling interest), this should in the assessors' view be subject to a pre-approval process given the changes this might entail for the bank's governance structures and business model, for instance by utilizing FSA's powers to impose the condition on the approval of a major</p>

	shareholder that a possible future majority holding by the major shareholder should be subject to a pre-approval by the FSA.
Principle 5.	Major acquisitions. The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
Description	<p>EC 1—Supervisory approval by the FSA is necessary in case a bank intends to merge with another bank (Article 30, paragraph 1 of the banking Act), to hold a subsidiary in Japan or abroad (Article 16-2, paragraph 4 of the banking Act) or when it wants to establish a branch abroad. There is an exception which applies to cases where a bank intends to hold a subsidiary that operates mainly ancillary business for the bank or that conducts businesses related to banking. In that case, approval is not necessary. Effectively these are cases whereby a bank intends to have part of its permissible activities operated by another legal entity than the bank itself. In practice this would be for reasons of operational efficiency. This exception also holds for having a subsidiary whose business is close and similar to banking business and operates within the list of permissible activities, which would exclude for instance operational lease business for which a separate pre-approval would be necessary. In case of an investment by a bank in another bank, the bank will be assessed as a major shareholder of the other bank. For these instances the description under CP 4 applies.</p> <p>The scope of businesses that a subsidiary of a bank may conduct is listed in paragraph 1, Article 16-2 of the Banking Act. This Article strictly prohibits a banking group to conduct other businesses than allowed by the Act (see Articles 10 and 11 of the Banking Act). The permitted business include those relate with banks, securities firms, insurance companies, and any other businesses ancillary to banking. Article 10, paragraph 2 permits banks to undertake prop-trading in securities and in securities related derivatives, but trading or investments in real properties are not allowed.</p> <p>Paragraph 1, Article 16-3 of the Banking Act sets a 5 percent limit for banks to acquire or hold shares in domestic business companies other than banking or securities business (see Article 16-3 of the banking act). The limitation is stipulated as 5 percent of all voting rights of all shareholders of a domestic company. The number of voting rights is calculated by aggregating both the bank's and its subsidiaries voting rights. The FSA indicated that the reason why holding shares in foreign business companies is excluded from the scope of this limit is because applying the limit to shares in foreign business companies may hinder acquisition of foreign banks by Japanese banks which would further expand their business abroad, given the fact that there are a variety of treatment of holding shares in business companies across countries. In addition, investments in these types of shares are within the scope of the large exposure rules as stipulated in article 13-2 of the banking act, which limits bank's investments in shares of such a company to 25% of bank capital. Moreover, limits have been set to banks with regard to the aggregated amount for holding stock in another company. In accordance with the act on the limitation on shareholding by banks and other financial institutions, a banking group is only allowed to hold stocks by the amount of its consolidated Tier 1 capital. In cases where a bank intends to hold more shares because of special considerations such as a merger, an approval by the FSA is necessary. In this case, the bank must submit an application with documents which describe the compelling reason, the plan to dispose such holdings and the expected time to take. The FSA examines whether or not the situation is inevitable in accordance with the act.</p> <p>EC 2—The criteria for a bank to get approved for a merger with another bank is prescribed in item 3, Article 31 of the Banking Act, the criteria for a bank to obtain</p>

approval to hold subsidiaries or change subsidiaries' businesses is provided in paragraph 2, Article 17-5 of the Ordinance for Enforcement of the Banking Act and paragraph 2, Article 9 of the Ordinance for Enforcement of the Banking Act stipulates the criteria for approval for a bank to set up a foreign branch.

EC 3—The criteria the FSA uses to approve a bank's holding in a domestic subsidiary are provided for in the Ordinance for Enforcement of the Banking Act. The criteria are consistent with the licensing requirements and are as follows: (i) the bank must have an appropriate capital adequacy ratio after approval of holding subsidiaries, (ii) net income should continue to be sufficiently positive, and (iii) the applicant bank must be able to take all necessary measures to ensure that the subsidiary conducts its businesses soundly and appropriately. In case when a bank intends to hold a subsidiary in a jurisdiction where the legislation related to confidentiality obligation may prevent the bank from controlling the subsidiary in an appropriate manner, the FSA may reject the application from the bank, based on the third criterion mentioned above.

The criteria for approval of a holding in a foreign subsidiary or branch is prescribed in paragraph 2, Article 9-2 of the Ordinance for Enforcement of the Banking Act. Based upon this Article, the FSA will assess the effectiveness of consolidated supervision of a host country, and whether the applying bank will appropriately, fairly and effectively be able to conduct banking businesses considering its risk management system, and whether the branch or subsidiary will take necessary measures to prevent crimes and will manage customer information properly.

EC 4—One of the criteria for approving the acquisition of a subsidiary is whether or not the bank has sufficient financial and organizational resources to make such an acquisition. The criteria for establishing a foreign branch are equivalent to those of a subsidiary.

EC 5—Where a bank acquires a company which operates mainly ancillary business for the bank or which conducts businesses related to banking, the bank is not required to get approval by the Commissioner of the FSA but the bank must report it to the FSA in accordance with paragraph 4, Article 16-2 of the Banking Act and item 2, paragraph 1, Article 53 of the Banking Act.

A bank is required to report to the FSA where it intends to acquire or hold more than 5 percent of the voting rights of a company the businesses of which is defined by item 12, paragraph 1, Article 35 of the Ordinance of the Enforcement of the Banking Act delegated by item 8, paragraph 1, Article 53 of the Banking Act. Based upon the notification of the intention received, the FSA may require a bank to take necessary measures if it is concerned with the potential impact on the bank with respect to the bank's safety and soundness. In case a bank would not take the necessary measures in spite of the FSA's guidance, remedial action might take place, based upon the articles 24 and 26 of the Banking Act.

EC 6—The FSA's supervisory practices take into account the risks that non-banking activities can pose to a banking group. In its Annual Supervisory Policy for 2011, the FSA has for instance announced that it will focus on enhancing group wide risk management and governance structures, including risks arising from subsidiaries conducting businesses other than banking services by taking into account different business models or cultures. When the FSA finds it necessary to ensure sound banking businesses, it may issue a reporting order not only to banks but also to subsidiaries of a bank, the companies to which the bank has outsourced part of its businesses, its bank holding companies and its major shareholders in accordance with Article 24, 52-31 and 52-11 of the Banking Act. In addition, the FSA has established a supervisory guideline for financial conglomerates which sets out supervisory

	<p>checkpoints for a banking group which conducts financial service businesses other than banking.</p> <p>AC 1—When examining the proposed acquisition of a foreign company, the FSA will examine amongst other whether the subsidiary may appropriately and fairly conduct its businesses and in this context will examine the FSA's own capacity to take supervisory actions on a consolidated basis.</p>
Assessment	Largely Compliant
Comments	<p>Japanese banks have indicated that in a search for yield they plan to substantially increase their overseas activities. In addition, given the current structural situation of the Japanese banking sector, more extensively domestic partnerships and mergers might take place. Investments by a bank in another bank or related banking business other than the acquisition of a subsidiary, either domestically or abroad, do not need prior approval of the FSA.</p> <p>The FSA has the power to ex ante review major acquisitions by a bank, with the exception of acquisitions in ancillary business or banking related business for which a pre-approval is not necessary.</p> <p>Also investments by a bank in another bank, in ancillary business or related banking business other than the acquisition of a subsidiary, either domestically or abroad, do not need prior approval of the FSA, although prior notification would be needed, Based upon this prior notification the FSA may require a bank to take measures if it is concerned about the potential impact this investment might have. Given that material investments (more specifically investments that would lead to a significant influence of the investing bank on the operations of that company) could have a major influence on the business model of the bank and on its risk profile when engaging in these business partnerships, a more strict pre-approval is needed as provided for in the case of subsidiaries, rather than a system based upon prior notification combined with on-site and off-site supervisory action. In addition, the scope for approval of acquisitions could be considered, by inclusion of acquisition of ancillary business and banking related business.</p>
Principle 6.	Capital adequacy. Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.
Description	<p>EC 1—The Japanese Banking Law establishes the authority to the FSA to set capital adequacy ratios (or any other standards). By exercise of that authority, the FSA has published detailed standards for calculating capital adequacy ratios. These standards apply to all banks both on a solo basis and on a consolidated basis and all bank holding companies on a consolidated basis. There is also a legal framework for corrective action, as defined in paragraph 2, Article 26 and paragraph 2, Article 52-33 of the Banking Act. The components of capital in the calculation of capital adequacy ratios are consistent with the currently applicable Basel standards. Given the extra emphasis on the importance of capital available to absorb losses, the FSA has restricted the unlimited use of deferred tax assets as part of capital: in the past few years banks have been confronted with accelerating amounts of nonperforming loans (NPLs), as a result of which banks accumulated large amounts of deferred tax assets. The loss absorbance of deferred tax assets is of a less certain nature. Consequently, the FSA has amended the standard for the capital adequacy ratio. The amendment has required major banks (not domestic banks) to deduct deferred tax assets from capital where it exceeds 20 percent of Tier 1 capital.</p>

EC 2—For Japanese banks which are ‘internationally active,’ the definition of capital, the method of calculation, and the minimum ratio required of 8 percent are equivalent to those established in the Basel requirement. The FSA determines a deposit-taking financial institution as an ‘internationally active bank’ if that deposit-taking financial institution operates a branch or subsidiary in a foreign jurisdiction, regardless of its size and systemic importance. To these banks, the FSA applies Basel II with respect to definition of capital, ratio calculation, and overall capital requirements. So in case a major bank would not be internationally active, in principle it need not comply with the 8 percent minimum requirement. However, in case such a non-internationally active bank would adopt an advanced model such as the Internal Rating Based Approach for credit risk, the Internal Models Approach for market risk and the Advanced Measurement Approach for operational risk, also the 8 percent minimum requirement will apply (Article 238, Item 8, Paragraph 3 of Article 274 and item 10, Paragraph 3 of Article 315 of standards for Capital Adequacy Ratio)

EC 3—The FSA has the authority to amend standards for CARs. It also has the power to impose a specific capital charge in addition to the 8 percent minimum to an individual bank. However the FSA’s implementation of Pillar 2 of Basel II does not provide for setting extra capital charges in case the supervisory review process would indicate that not all material risks would have been captured. In such situations it would rather ask for other remedial action to mitigate the risk.

Also the BOJ would not directly impose a specific capital charge but in approving counterparties, BOJ considers the capital adequacy ratio of the counterparties amongst its other specific judgmental factors prior to approving a financial institution becoming a counterparty of BOI—i.e., to hold BOJ current accounts and has similar criteria when approving a counterparty for the provision of complementary lending and/or for market operations. When financial institutions are judged not to meet the requirements, BOJ will take measures such as canceling the approval at the time of approval renewal, regular selection, or on an ad-hoc basis. In order to determine such ratio of a certain level or more, BOJ will undertake on-site examinations and off-site monitoring. Within the scope of its on-site examinations, BOJ requires the financial institutions to perform scenario analyses and stress testing, measure and validate the anticipated capital levels, and exchange views with the senior management as to the adequacy of them. In its off-site monitoring, BOJ conducts researches through interviews and via reporting to assess the capital adequacy of financial institutions, taking into account their profitability, plans to raise capital, as well as the potential impact of credit risk, market risk and other risks they may be taking.

EC 4—For ‘internationally active banks’ as well as for other banks and for holding companies, both on- and off-balance sheet risks are taken into account. In implementing Pillar II under Basel II, the FSA encourages each bank to develop an integrated risk management system depending upon its size and complexity and to establish a process to evaluate the adequacy of its capital in comparison with risks to which it is exposed.

EC 5—In practice, FSA does not apply individual capital ratios above the applicable minimum Basel Pillar 1 requirement.

EC 6—The supervisor will take measures should a bank fall below the minimum capital ratio. The corrective actions that can take place depend upon the ratio at which it stands relative to the minimum requirement which is 8 percent for internationally active banks. More specifically in case of an internationally active bank, when the ratio falls below 8 percent but remains above 4 percent, the FSA will require the bank to submit and implement a restructuring plan that is aimed at bringing the capital levels within one year to a level above 8 percent. In this situation, the bank could still pay out

dividends and executive compensation; as long as these plans are part of the approved restructuring plan. In cases where the capital fall below 4 percent but stay above 2 percent, additional restrictions could be put on dividends and executive compensation, on the amount of total assets, and on interests and other terms of deposits. In addition, branches could be closed, business activities could be curtailed and 'other' necessary actions could be taken. When the capital adequacy ratio falls below 2 percent but above 0 percent, extra measures that could be taken include an increase of capital, a substantial curtailment of business, a merger or discontinuance of banking business. Below 0 percent, additional measure is suspension of all or part of the business.

EC 7—The standards for the capital adequacy ratio stipulate that a bank must get approved by the FSA in adopting an internal rating model for credit risk and market risk as well as a standardized approach and advanced model approach for operational risk. The FSA has the power to withdraw such approval if a bank does not fulfill those requirements any longer. (Stipulated in Article 145, 279 and 317).

AC 1—For non-internationally active banks, the definition of capital, the method of calculation and the required capital calculation are broadly consistent.

AC 2—Through the standards for Capital Adequacy Ratio (CAR), the FSA requires non-internationally active banks and bank holding companies to calculate regulatory capital in a consistent manner with the Basel accord framework, although the required level of total capital for those banks and bank holding companies is set at half of that for internationally active banks. So instead of 8 percent minimum, a 4 percent minimum capital requirement applies.

The policy reasons mentioned for this lower requirement are (i) that these non-internationally active banks undertake relationship-based banking in the regions, (ii) are expected to fully take the role of financial intermediations especially in the suburbs against the current severe conditions of the Japanese economy, (iii) almost all of them are small-to-medium sized, (iv) their asset compositions and business models are highly straightforward and simple, and (v) there will be no global impact of their bankruptcies and, if any, it will be effectively contained by the authorities.

In practice, nearly all the non-internationally active banks maintain levels above 8 percent of the capital adequacy ratio (as of end of March 2011).

The FSA can take a corrective action based on paragraph 2, Article 26 of the Banking Act where a non-internationally active bank falls short of the minimum requirement. The corrective actions that can take place depending upon the ratio at which it stands relative to the minimum requirement which is 4 percent for non-internationally active banks. More specifically, in case the ratio falls below 4 percent but remains above 2 percent, the FSA will require the bank to submit and implement a restructuring plan that is aimed at bringing the capital levels within one year to a level above 4 percent. In this situation, the bank could still pay out dividend and executive compensation, as long as these plans are part of the approved restructuring plan. In cases where the capital ratio fall below 2 percent but stay above 0 percent, further restrictions could be put on dividends and executive compensation, on the amount of total assets, and on interests and other terms of deposits. Also branches could be closed, business activities could be curtailed and 'other' necessary actions could be taken, like an increase of capital, a substantial curtailment of business, a merger or discontinuance of banking business. Below 0 percent, an extra measure is suspension of all or part of the business.

In addition, the FSA undertakes off-site monitoring whereby it also takes into account

	<p>the capital levels of the banks. In this regard, the FSA collects off-site capital adequacy data, and it undertakes quarterly interviews on financial results, comprehensive interviews every half year on all material risks of a bank, including an interview with senior management. The FSA could require a bank to report its remedial measures based on Article 24 of the Banking Act. In addition, the FSA could issue a business improvement order based on paragraph 1, Article 26 of the Banking Act which might include corrective measures taken by the bank concerning its capital management system.</p> <p>AC 3—Effectively the FSA does not have the power to set capital levels in anticipation of possible events or changes in market conditions that could have an adverse effect. Rather, the FSA will require banks to set their adequate level of capital, for instance by requiring them to conduct stress testing on credit risk and market risk, a prioritized area for FSA’s examinations in 2011.</p> <p>AC 4—The allocation of capital within a group mainly takes place based upon the regulatory requirements for the different group components. In addition, based upon the FSA’s inspection manual a banking group should have an adequate allocation of capital within the group, to be assessed by the FSA. More specifically, the minimum requirement for capital adequacy applies to the group level and to individual banks within the group (i.e., both on a consolidated basis and on a solo basis). Also a securities firm within the banking group is required to calculate capital adequacy ratios on a solo basis in accordance with the method similar to the one applicable to banks.</p> <p>AC 5—The FSA has direct powers to require an individual bank or banking group to maintain capital above the minimum. However, it would normally not apply them in the context of the FSA’s implementation of Pillar 2 of Basel II and would rather apply in this respect a principles based approach, based upon the bank’s internal assessment of the adequacy of its capital levels linked to its risk profile.</p>
Assessment	Materially non-compliant
Comments	<p>The FSA only applies a fixed minimum capital requirement. In case other material risks that are not captured by the capital ratio would be identified, the ratio would still remain the minimum ratio for that type of institution. So for instance for losses due to interest rate risk in the banking book, no extra capital requirement would be set and consequently no bigger cushion to absorb possible losses would be put in place to address the materialization of risk exposures that have not been captured under Pillar 1. The FSA should also use as a supervisory instrument its possibility to set higher capital levels than the minimum, depending upon the actual risk profile of the bank concerned.</p> <p>Also, the 4 percent minimum level of capital for non-internationally banks is not consistent with the 8 percent minimum which applies for the internationally active banks. In both cases a similar capital adequacy framework is used whereby similar risks will lead to similar loss levels for which comparable capital levels should be available to absorb these losses. At the moment this is not the case and should be remedied.</p> <p>In addition, the triggers for early intervention measures due to a shortfall in minimum capital levels are set at a too low level, especially for domestic banks. These triggers should be put at a higher level. Also in case a bank falls below its minimum level, it should no longer be allowed to pay dividends or executive compensation in-line with international good practices.</p> <p>On the quality of capital we appreciate that for internationally active banks the amount of lower quality capital components via deferred tax assets have been capped</p>

	<p>to 20 percent. However, since the same criterion for good quality capital applies to non-internationally active banks, the same definition of capital should be used for all banks.</p> <p>In addition, measures have been taken by the Japanese government at end 2008 to stabilize the financial markets and facilitate finance. These measures include a partial relaxation of the capital adequacy requirement for banks. More specifically: (i) deposit-taking institutions to which domestic standards are applied are not required to recognize valuation losses from available for sale securities deducted from Tier 1 capital; deposit-taking institutions to which international standards are applied, will have the option not to recognize both valuation profits and valuation losses specifically on securities without credit risks in the capital calculation.</p> <p>Also, accounting practices in Japan might in a number of cases lead to a fairly late moment of recognition of losses. This would for instance be the case on the timing of the recognition of losses of banks using Japanese GAAP held in their banking book (losses would only be recognized in case they would exceed 50 percent of its historic cost) or on the timing of provisions for assets in the loan portfolio that deteriorate in value.</p> <p>Currently, when a regional bank intends to apply an internal model, its minimum capital level is raised to 8 percent. Given this rule, domestic banks operating under the 4 percent requirement might be discouraged to use internal models, given that the use of a model would double their minimum capital requirement, thereby penalizing banks that apply more advanced risk management techniques.</p>
Principle 7.	<p>Risk management process. Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.</p>
Description	<p>EC 1—The FSA requires individual banks and banking groups to have comprehensive risk management policies and processes in place to identify, evaluate, and where appropriate mitigate material risks. This will be undertaken in a proportionate manner, based upon the nature, size, and complexity of the institution involved. Guiding principles for banks will be the respective guidelines that have been developed for major banks as well as for small and regional financial institutions. The latest global financial crisis has proved the limitations and weaknesses of frequently-used risk control methods such as economic capital and value-at-risk (VAR) models. The FSA has therefore indicated in its Annual Supervisory Policy 2011 that it will encourage banks to improve their risk management methods as one of its supervisory priorities. Where the FSA would conclude that the bank's risk management process would be insufficient, it may issue a business improvement order based on the Article 26 of the Banking Act which requires the bank to improve its risk management. Also BOJ conducts regular risk management reviews as part of its constant surveys (off-site monitoring) as well as its visits at regular intervals (onsite examination), the findings of which are shared with the FSA when remedial action would be necessary.</p> <p>EC 2—The guidelines provide sufficient assessment criteria regarding bank's risk management, more specifically whether the board of directors has developed a risk management policy in-line with its strategic goals based upon the business profile of the banking group, whether the board of directors of a bank has setup a risk management division, whether an adequate internal control function has been developed and whether each business unit has adequately controlled its risk via</p>

utilizing risk capital limits which have been allocated to each of these business units beforehand. In conformity with FSA's inspection manual, the examiners will subsequently confirm that these processes and functions for risk management exist and function adequately. In as far necessary, the board is required to establish an appropriate internal risk control function for comprehensive risk management, to evaluate how effectively it works, and to consider necessary improvement actions.

EC 3—The FSA requires a board to set rules within the organization for an adequate internal control of the business functions and requires management to effectively communicate this with all relevant staff. The inspectional manual refers to the treatment of exceptions in implementing the risk management policy, process and risk limits, and requires examiners to assess whether the process for such exceptional treatments are appropriate.

EC 4—One of the basic building blocks of adequate risk management processes is that senior management understands the nature and level of risks taken by the bank and how this relates to adequate capital levels. The senior managers of the banks we interviewed had in general a sufficient understanding of the risks taken and how this is translated into risk capital limits. In addition there was also sufficient understanding about possible improvements of risk capital employed, for instance by utilizing stress testing on capital as an additional tool, although this method might be further utilized on a more regular basis within the sector.

EC 5—The FSA guidelines identify the assessment criteria for bank's internal capital adequacy assessments and strategies. A bank should have a policy and procedure for identifying, measuring, evaluating and reporting risks; a process for reviewing the adequacy of bank capital in comparison with these risks; and a process for determining the adequacy of its capital levels, in-line with its strategic goals and business profile, which is being assessed during onsite inspections.

EC 6—Banks use various internal models for measuring risks. From the interviews with banks, we understand that in as far they use models; the adequacy of results is assessed via back testing mechanisms. We understand that especially smaller banks use off the shelf products for measuring some type of risks, mostly market risk. Question is whether they then fully understand the models used. At onsite inspections, examiners will assess whether the risk management division of a bank reviews the appropriateness of assumptions and methods for quantifying risks. Examiners will also assess whether an independent internal audit unit examines the risk models (in particular their limitation and weaknesses) and undertakes an audit on the information systems used for the data-input of these models.

EC 7—The adequacy of the information systems that are used for measuring, assessing and reporting on the size, nature and quality of the exposures is being assessed as part of the overall assessment of the risk management process in place.

EC 8—The FSA expects that for new products and major risk management initiatives the board has put in place an adequate internal procedure as well as possible criteria to consider in approving new products, including those related to customer protection, that will be assessed by its examiners during onsite inspections. There are no other specific requirements for an active involvement of the Board in the approval of new products.

EC 9—The supervisory guideline stipulates that bank's management should develop a comprehensive risk management system where it would receive reports on various types of risks from every business unit and should control these risks in a comprehensive way. Moreover, the inspection manual requires banks to have a risk

	<p>management function which works independently from front office. This risk management division should report about the risk profile to the board. Indeed, the interview held with banks confirmed that there was senior risk management staff that operated independently from business line staff.</p> <p>EC 10—Via IT guidelines and inspection manual, the FSA has provided detailed prudential standards relating to credit risk management (including large exposure management and country risk management), market risk management (including interest rate risk in banking book and volatility risk of stock prices), liquidity risk management, and operational risk management. From the interviews with banks, we understand that most solutions developed are for the different risk areas separately, with less of an assessment of the risks in an interrelated fashion.</p> <p>AC 1—The FSA requires banks to have an organizational structure that comprehensively monitors and controls all kinds of risks managed by individual risk control unit, but does not prescribe the presence of a separate risk management unit for the more complex banks. In general such separate units would however exist. The FSA would require that the risk management function is periodically reviewed by internal audit.</p> <p>AC 2—The FSA guideline and inspection manuals requires banks to undertake stress tests. By mean of on-site examinations, bank’s stress testing practices have been assessed and a horizontal review of the results has taken place, whereby the BCBS principles for sound stress testing techniques have been guiding principles. Indeed, all banks we visited undertake stress testing activities, but with quite different focus (interest rate risk, credit risk, market risk, liquidity risk), level of sophistication and periodicity (monthly to yearly). We challenged them for instance on reverse stress testing, which was not a well known technique.</p> <p>AC 3— On the risk types not captured within the subsequent CPs, the FSA focuses especially on contingency risks as a result of a crisis event given its recent experiences with the major earthquake and power outages and on reputational risk given the expectations of Japanese customers for the continued availability of standard banking operations—e.g., with regard to the ATMs that are operated by banks.</p>
Assessment	Largely Compliant
Comments	<p>The FSA and BOJ have sufficient frameworks for identifying and evaluating bank’s risk management systems and processes and for requiring remedial actions. The principles mentioned in the guidelines and investment manuals are however of a quite generic nature, which puts a lot of burden on the actual supervisory practices for determining bank’s actual implementations. Besides the FSA and BOJ, also the internal and external audit function would assess the adequacy of the risk management and internal control processes of a bank. Especially the role with the external audit function should be strengthened, whereby signals coming out of their examinations, should be fed into the FSA’s and BOJ’s own assessments.</p> <p>During interviews with banks and other stakeholders we received a broad overview of bank’s risk management processes and practices. Japanese banks have relevant systems and processes in place, although with a varying degree of sophistication. We also understand that for most banks their stress testing practices are not fully integrated into their risk processes. An additional topic identified was that most risks are being handled by banks without having a holistic risk view, whereby also interdependences or changes in behavior of customers, lenders and other bank related parties are taken into account when certain stress scenarios would occur. We therefore underline the FSA’s focus for 2011 on enterprise wide risk management</p>

	<p>systems and the enhanced coverage and capture of risks by the bank's internal models.</p> <p>Also, the governance arrangements at banks should be strengthened. This not only relates to a more independent risk management and internal control function, but also an audit committee or a board of company auditors which can act independently not only in 'form' but also in substance' from the board of directors and which receives information on the implementation of risks management systems, of actual risks run and of identified breaches directly from internal and external audit, whereby the responsibilities of business and internal control function are sufficiently kept separately.</p> <p>A counterbalancing feature in our evaluation has been that in most cases bank's business models are quite straight forward, with some banks having quite a conservative stance on risk taking. However given the further challenging macroeconomic developments which might lead to sudden shocks to the Japanese banking sector and individual banks, a further improvement of their risk management processes and systems, including especially their surrounding governance arrangements, is a high priority.</p> <p>We recommend continued supervisory attention to the focused areas of strengthening bank's group wide risk management processes, improving their stress testing practices and enhancing their governance structures. The strengthened governance arrangements should not only address a more independent risk management and internal control function, but also an audit committee or a board of company auditors which can act independently from the board of directors and which receives information on the implementation of risks management systems, of actual risks run and of identified breaches directly from internal and external audit or compliance, whereby the responsibilities of the business and internal control function are sufficiently kept separately.</p>
Principle 8.	<p>Credit risk. Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk—including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.</p>
Description	<p>Adequate credit risk management processes at banks are of the utmost importance. We identified that most banks have very large loan and bond portfolios and in the context of trade finance provide a considerable number of guarantees, etc. From the banking industry we understood that a continued emphasis is put on the credit management of these portfolios, given the continued severe situation for small and medium sized entities, the pressure on the competitive position of corporates that heavily rely upon exports and the sluggish economic situation which negatively impacts the purchasing power and financial situation of individuals. Consequently, both for the banks themselves as well as for the FSA and BOJ, this is a crucial area of attention.</p> <p>EC 1—Both the supervisory guideline and inspection manual provide quite extensive assessment criteria for bank's polices, practices and procedures regarding the identification, measurement and control of credit risk, including counterparty risk, both on-balance and off-balance, for instance on the establishment of a credit granting policy, on the presence of adequate risk management processes and on risk information to be provided to the board on the credit risk situation. During onsite examinations the inspectors will assess such requirements and report in a</p>

standardized manner about their findings, based upon which the off-site supervisory department could take remedial action.

Also the BOJ undertakes assessments of the bank's credit risk management strategy, policies and processes especially as part of its onsite examinations, whereby it also identifies specified risk areas to be assessed further. The BOJ does not have any specific supervisory responsibilities. However, the Bank of Japan Act (Article 1, paragraph 2) stipulates that the Bank's objective is to ensure a smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of financial system stability. Article 44 of the Bank of Japan Act stipulates that the BOJ may, for the purpose of appropriately conducting or preparing to conduct business prescribed by the Articles 37 to 39, enter into contracts with certain financial institutions with which it undertakes business. Based upon these contracts the BOJ may undertake onsite examinations in the context of its function as lender of last resort for financial institutions. In practice the BOJ has signed such agreements with most Japanese banks. Besides onsite examinations, the BOJ also undertakes off-site analysis, amongst others for credit risk management. For instance for 2011, the BOJs focus will be on the adequate capture of the corporate businesses turn-around plans, especially those for SMEs, the adequate capture of credit risk in the residential mortgage portfolios, the adequacy of the management of overseas credit exposures and the quality of bank's internal credit ratings systems, the findings of which will be shared with the JFA, especially when remedial action would be warranted.

EC 2—Given that Japanese banks went through a deep credit crisis about 10 years ago, banks gained a lot of experience in recent years in assessing credit risk and properly controlling it. Also the supervisor provides in its guidelines sufficient assessment criteria which guide banks in maintaining an adequate credit risk control environment. Focus areas for the FSA in its onsite examinations will for instance be: the establishment of an organization for credit administration and credit review through dedicated divisions, a separation of duties between business line and credit review staff; a proper involvement of the audit function; sufficient knowledge by credit review staff to undertake an adequate assessment of the credits granted. In general we understand that also the FSA prioritizes this area in its onsite examinations.

EC 3—The Japanese authorities have implemented the “arm's length rule” for providing credit in their Banking Act as stipulated in Article 13-2. This provision prohibits a bank to perform transactions with its group entities or their customers under a term which may harm the safety and soundness of the bank, which will be assessed in the context of the FSA's day-to-day supervision.

EC 4—The FSA has full access to information on the credit and investment portfolios and to the bank officers involved in the credit risk management processes, based on the Articles 24 and 25 of the banking act. More specifically, the FSA may require not only the bank, but also the bank's subsidiaries and companies to which the bank has outsourced part of its businesses, to report about the status of the business and about its assets and liabilities to the FSA.

AC 1—There is no specific prescription that major credit risk exposures exceeding a certain limit or credits which are especially risky or otherwise unusual should be decided upon by senior management. However, the FSA will assess whether in its view reasonable thresholds have been identified and sufficiently monitored at the appropriate level.

AC 2—The guidelines provide sufficient assessment criteria for the management of counterparty credit risk exposures. Based upon the discussions with the banking industry, the actual practices in this regard might be quite different. The guidelines or

	<p>the supervisory manual provide no specific guidance on capturing the material risks inherent in individual products of transactions.</p> <p>AC 3—Both Supervisory Guideline and Inspection Manual require bank's credit review division to properly understand the financial conditions of borrowers and the purposes and financial resources for reimbursement of loans in order to appropriately grant credits by taking into account the risk profiles of borrowers.</p>
Assessment	Compliant
Comments	<p>In general we see a sufficient focus by banks as well as the FSA and BOJ on credit risk management. In the discussions with the banking industry we also found sufficient senior-management attention for the problem areas identified and a willingness to further improve their credit risk management processes towards best practices. One area of attention would be the further integration of concentration risk rules within the context of credit risk management, which will be discussed in a subsequent BCP. Also more focus could be put on identifying and measuring counterparty credit risk of securities and related derivatives products, and integrating it into the day-to-day risk management practices. A continued and focused attention by both the FSA and BOJ on the credit management processes of banks is certainly warranted and we would therefore welcome the attention given in the annual supervisory policies 2011.</p>
Principle 9.	Problem assets, provisions and reserves. Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.
Description	<p>Managing problem assets and evaluating the adequacy of provisions and reserves are key features for Japanese banks in the current economic situation. In general, the banks visited had adequate procedures and processes in place for the identification of problem assets. The bank's practices on the evaluation of the adequacy of provisions and reserves however varied quite extensively, most importantly with respect to the effects on the provisioning levels of problem assets that are covered by certain government measures.</p> <p>EC 1—The guidelines and inspection manual provide a sufficient basis for an adequate evaluation of the policies and processes in place for identifying and managing problem assets. During our visits to banks, we also acknowledged that in practice the loan portfolios are reviewed on a sufficiently frequent basis, whereby both individual and portfolios approaches are used. The asset classification method is normally disclosed in the annual accounts, although some institutions use a far more detailed approach in practice.</p> <p>EC 2—Via its onsite examinations, the FSA assesses the adequacy of the classification system used as well the implementation of the provisioning policies and processes. It does not have a direct communication on these aspects with the external auditor, although in practice they would have a similar focus.</p> <p>EC 3—Banks are required to have a system in place for classification and provisioning that also includes off-balance sheet items. The banks we visited confirmed that such assets were also taken into account.</p> <p>EC 4—Via its onsite examinations, the FSA assesses the adequacy of standards established by the banks to adequately and accurately conduct write-offs and provisions, and to have policies/processes to ensure that the write-offs and provisions are made with reflecting the prospect of reimbursement by borrowers. In general we witnessed varying policies with respect to write-offs and provisions made, especially with regard to the in- or exclusion of the effects of targeted government support</p>

	<p>measures.</p> <p>EC 5—Banks should have systems in place which enable them to identify NPLs in a timely manner and to deal with NPLs at early stages through write-offs or provisioning, and whereby it establishes a clear policy for NPL management that should be adequately implemented and effectively applied by the staff concerned. Indeed, the banks visited indicated to have such systems in place. Given recent public measures (like the ones on providing enhanced financing and support for the business improvement of SMEs), banks have effectively taken the lead in developing together with problem clients restructuring plans which would alleviate the client's burden and /or assess the possibility for receiving government guarantees on their loans as part of the temporary government measures taken.</p> <p>EC 6—On a semi-annual basis, the FSA receives individual bank data which shows the classification of nonperforming loans and amount of provisions. In addition, the FSA also uses the quarterly information it receives on large exposures including the classification and amount of provisions.</p> <p>EC 7—The FSA has direct powers to require a bank to increase its levels of provisions and reserves. In practice however, the FSA would rather rely on engaging in intensive dialogues with the bank on their recognition of the deterioration of the status of their credit portfolio and will if necessary require an improvement plan. If the FSA considers it necessary to enforce banks to implement a more severe improvement plan, the FSA will issue an order for business improvement based on Paragraph 1, Article 26 of the Banking Act and might require an increase of its levels of provisions and /or reserves.</p> <p>EC 8—The FSA has the powers to directly impose additional provisions to banks for prudential purposes. In practice it would however preferably undertake other remedial measures, especially to require a business improvement plan when necessary. Based on Article 6 of the Financial Reconstruction Act, banks shall assess the quality of assets within every accounting period. And Article 4 of Ordinance for Enforcement of the Act provides classification of assets based on the borrowers' financial conditions and business performance. In addition, based on item 1, paragraph 2 of Article 19 of Ordinance for Enforcement of the Banking Act; banks are required to classify the loans in the same way required in Article 4 of Ordinance for Enforcement of the Financial Reconstruction Act.</p> <p>EC 9—Based upon its inspection manual, banks should have appropriate mechanisms in place for assessing their value at risk mitigants, including guarantees and collateral</p> <p>EC 10—Banks are required to conduct write-offs or make provisioning reflecting the risk for collection or the risk of devaluation based on the banks' internal standards in accordance with the Inspection Manual as well as Practical Guidance published by JICPA.</p> <p>EC 11—Based upon the banks we visited, the board would be adequately informed about the condition of the bank's asset portfolio, albeit that this might be especially focused on major and special attention loans and less about the whole asset portfolio of the bank and its different components. With regard to "special attention loans" to largest borrowers, the FSA requires banks to calculate provisions using the Discounted Cash Flow Method. We understand that not yet in all instances this would be the case in practice.</p> <p>AC 1—Based on Article 6-2 of the Financial Reconstruction Act, banks are required to assess the quality of their assets (i.e., classify their assets). In accordance with Item 4, Article 4 of Ordinance for Enforcement of the Financial Reconstruction Act, loans to</p>
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	<p>borrowers who have failed to make payment of principals and interests for three months or more are categorized as “special attention loans”. In case new loans are provided to borrowers for the purpose of repaying original loans, all of those loans must be identified as special attention, even if they are not in arrears nominally. In Japan, FSA directly examines the appropriateness of bank’s self-assessment standards and the accuracy of the results of self-assessment at inspection and the findings are addressed through onsite and off-site supervision.</p>
Assessment	Largely compliant
Comments	<p>The policies and practices of banks with regard to problem assets have improved considerably over the last ten years. In our view, problem loans are adequately identified and classified. However, in the subsequent evaluation for extra provisions and reserves, banks should take a more prudent stance in taking into account government measures that are aimed at providing enhanced financing and support to their clients, including the restructuring of their loans. The FSA should inspect this more intrusively, for instance by asking more intense regular reporting on problem loans.</p>
Principle 10.	<p>Large exposure limits. Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.</p>
Description	<p>EC 1—The concept of a single group or of a group of connected counterparties in the Japanese large exposure regime is described in Article 4-1 of Order for Enforcement of the Banking Act, and is for the group of connected counterparties based on ownership structures, not necessarily on connected counterparty credit risk. Also, the FSA does not have any discretion in applying the definition on a case by case basis.</p> <p>EC 2—The limits set for exposures are 25 percent for a single party and 40 percent for a single group, both in term of bank’s capital (Article 13-2 of the Banking Act). These limits are quite high, given that the exposures taken into account include both on-balance and off balance items, but exclude derivatives positions. Said positions are calculated on a net basis, so after possible collateral and guarantees have been taken into account (Article 4-4 of the Order for Enforcement of the Banking Act and Article 14 of Ordinance for Enforcement of the Banking Act). Higher limits are not accepted, unless there would be compelling reasons, in which case the FSA has to explicitly agree (Article 14-9-2 of Order for Enforcement of the Banking Act). Semi-annually, the FSA collects the data on borrowers to which banks have exposures more than 10 percent of bank’s Tier1 capital or the top 100 largest borrowers in size.</p> <p>EC 3—Since banks have to submit data on large exposures to the FSA, they are also required to have information systems in place to identify exposures to a single party and a group in a timely manner and be able to aggregate them. At inspections, examiners will evaluate the adequacy of bank’s information system for credit risk management, including their large exposures. From the interviews done with banks, we understand that normally they would have sufficiently advanced systems in use to assess the large exposures on individual counterparties. However, given its complexity, they do not have systems available that would capture in more detail the group of connected counterparties, other than via direct and well known ownership structures.</p> <p>EC 4—Banks visited had some basic systems in place that took into account concentrations in credit risk, for instance for certain industrial sectors or for certain geographical areas. Certainly these concentrations are measured, but we haven’t been informed about specific systems in place to manage these risks in a more advanced manner, albeit via the allocation of risk capital or by utilizing more advanced</p>

	<p>risk limit systems for certain concentrations. In its guidelines, the FSA has some basic assessment criteria with respect to concentration risks.</p> <p>EC 5—Bank are required to periodically report on the breakdown of a bank’s credit portfolio into its sectoral, geographical and currency exposures. However, the FSA expects banks to have such breakdowns internally available and might require the bank to provide the relevant information in the context of its onsite examinations.</p> <p>AC 1—The FSA uses as thresholds 25 percent for an individual client and 40 percent instead of 25 percent for a group of connected clients.</p>
Assessment	Materially non-compliant
Comments	<p>The rules for capturing and limiting large exposures on single counterparties or related group of counterparties should be strengthened. First of all, the group concept should not only capture a group of connected counterparties based on share-ownerships, but also other groups of related counterparties in as far they have a similar counterparty risk. Also, in calculating the exposures, all exposures should be taken into account, including exposures from derivatives positions. Thirdly, in as far different capital ratios apply for different groups of banks, the large exposure limits should be adapted accordingly for these groups of banks. At the moment the same large exposure limits apply for banks that have a minimum capital adequacy ratio of 8 percent and 4 percent, which for banks to which the 4 percent minimum applies, seems to be very high from a risk perspective. Also limits should be set in such a way that after an event has occurred, a sufficient level of capital should remain to absorb losses on going concern.</p> <p>Also we understand from banks that some type of exposures could be excluded from the calculations and/or could be risk weighted. Although we understand the international discussions are still ongoing, the assessor’s view is that in as far the large exposure limit should capture the event risk of a default of a single counterparty or group of connected counterparties, one should not solely rely on risk weighted exposures or exclude exposures, which might be especially relevant under the current global market conditions.</p> <p>Given these observations, we recommend to strengthen the group concept of connected counterparties, to assure that all exposures from an individual client or group of connected clients are taken into account and that the large exposure limit that is set is commensurate with the minimum capital adequacy ratio applied.</p> <p>In addition, best practice is that the limits would be set as a percentage of Tier 1 or core Tier 1 capital rather than as a percentage of bank capital, which might also be considered by the FSA.</p> <p>Concerning related concentration limits set by banks: the banks that we visited had some systems in place to identify concentrations in their loan portfolios with respect to different regions and industries, however in varying degrees of sophistication. The FSA might further examine the adequacy of such systems, for instance in the context of bank’s risk management processes and enterprise wide risk management.</p> <p>We understand that the current rules limits are more generous than the maximum group limits applied by banks themselves. The banks we visited would see 10–15 percent as the appropriate regulatory limit.</p>
Principle 11.	Exposures to related parties. In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict

	<p>of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.</p>
Description	<p>EC 1—In Japanese law there are sufficiently comprehensive definitions of 'related parties'. Article 13-2 of the Banking Act together with Article 4-2 of Order for Enforcement of the Banking Act provides the definition of "specified related person" which includes subsidiaries, major shareholders and a holding company of a bank, subsidiaries of the bank holding company excluding the bank itself, bank's agents or any other person having a special relationship (such as related legal entities of the bank) specified by Article 4-2 of Order for Enforcement of the Banking Act. In addition, Paragraph 2, Article 14-7 of the Ordinance for Enforcement of the Banking Act states that the definition of related legal entities should reflect not only the form of relationship but also the real influence due to such as dispatch of directors or senior managements. Furthermore, based on the item 2, Article 13-2 of the Banking Act, item 3, Article 14-11 of Ordinance for Enforcement of the Banking Act prohibits banks from doing transactions which avoid application of the regulation under Article 13-2 of the Banking Act by changing names. Therefore, the party who has mutual interests with the "specific related person" or related parties, close relatives and affiliates may be regarded the same as specified related person.</p> <p>EC 2—Article 13-2 of the Banking Act clearly prohibits a bank from conducting any transactions with specified related persons "at unfavorable terms from the banks' perspective in comparison with ordinary terms". Article 14-1 of the Banking Act also prohibits a bank from granting credit to its directors or senior managements with preferential terms where a bank may suffer unreasonable losses in comparison with ordinary terms.</p> <p>EC 3—Based upon the supervisory guideline, banks are required to check if they do not violate the "arm-length rule" stipulated in the Banking Act. With regard to a decision by the bank's board on granting a credit to a director, Article 369 of the Companies Act provides that a director who has any interests may not participate in the decision, and the proportion necessary for granting credits to "a specified related person" should at least be two-thirds of the board members as stated in Article 14 of the Banking Act. So other than loans to board members in the context of the company act, no other pre-approval by the board is necessary. There is also no requirement relating to write-offs of exposures to "specified related person."</p> <p>EC 4—There are requirements set by law that prevent individuals benefiting from lending to related parties. These are specified in Article 3 of the Act Regulating the Receipt of Contributions, Receipt of Deposits and Interest Rates. This article specifies that no officer, employee or any other person working for a financial institution (including the banks within the scope of these BCPs) shall lend money to other persons, mediate in loans or guarantee obligations utilizing his position for the purpose of promoting his own interest or the interest of a third party other than the financial institution concerned. In addition, there are similar provisions for prohibiting banks' related parties benefiting from the banks' transactions. Banks are required under applicable law to report any breaches. The FSA would undertake surprise visits based upon specific concerns identified, for instance coming from whistle blowing.</p> <p>EC 5—No specific limits have been set for exposures to related parties. Effectively, the limits applied are those for other large exposures, which is set at 25 percent. An exception is the exposure to bank's major shareholders, which based upon item 4, Paragraph 6; Article 4 of the Order is subject to a limit of 15 percent. The FSA sets no requirement for deduction from capital or securing collateral regarding exposures to a</p>

	<p>“specified related person.”</p> <p>EC 6—Although the FSA will assess during its inspections whether banks in general have established appropriate credit evaluation and management systems, no specific assessment criteria have been developed for identifying, monitoring and reporting on individual exposures to related parties. The exception is when these exposures to related parties would be captured by exposures in the context of the large exposure regime. However, given its principles based approach, the FSA would expect banks to have adequate internal control systems in place that would prevent banks from breaches of laws, including the ones described above, and would also observe that such systems are in place by means of its periodic inspections. In case irregularities would be identified, the FSA would investigate them and would consider issuing a business improvement order. As an example in 2007 the FSA issued such orders against Sahara Sin-kin Bank and Mishima-Shin-kin Bank.</p> <p>EC 7—Specified related parties are only reported by a bank in as far they would be captured as part of the large exposure regime or would be included in the top 100 credit exposures of a bank.</p>
Assessment	Largely Compliant
Comments	The law has sufficient provisions with regard to ‘exposures to related parties’, including requiring banks for granting all the exposures under the arms’ length rule. However, banks have not been encouraged by the FSA to set specific limits, nor has the FSA set specific limits itself, besides limits that already exist in the context of the FSA’s large exposure rules. On the enforcement of these provisions, the FSA would take them into account in the context of its periodic compliance inspections. The FSA could further strengthen its supervisory activities with regard to this provision, especially via more specific periodic reporting requirements. Also some extra assessment criteria could be presented as part of the inspection manual, focusing the inspections ex ante on the exposures to <i>related parties</i> , which now are more based on signals received (for instance from whistle blowing).
Principle 12.	Country and transfer risks. Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.
Description	<p>An adequate management of country risk is very important for Japanese banks, not only because of the major uncertainties following the global crisis and bank’s direct and indirect exposures on certain problem countries, but also because of bank’s strategies to focus on intensifying their operations abroad, especially in Asia.</p> <p>EC 1, EC 2—The FSA’s supervisory guidelines require banks to establish adequate processes to identify monitor and manage country risks. Although the supervisory guidelines are not specific as to the processes each institution has to put in place, institutions are expected to have in place sufficient processes to allow for flexible and prompt actions in response to observed increase in country and transfer risks. Adequacy and appropriateness of the risk management practices put in place by the banks and valuations of country related exposures would be assessed by the FSA inspectors during their onsite inspections. In addition, the FSA had also announced through their annual supervisory policy for this year that there would be focus on inspecting banks’ control of their cross border risks in cooperation with host supervisors. BOJ’s onsite examinations would also focus on effective management of overseas credit exposure.</p> <p>EC 3—The FSA does not impose explicit provisioning amounts or risk limits per country or region but has the powers to do so if deemed necessary under Article 26 of</p>

	<p>the Banking Act. Banks are expected to put in place procedures to ensure appropriate basis for credit exposure computations and credit loss provisions, including country risk provisions. The FSA inspectors would assess if provisions are adequate and also assess the appropriateness of loans classifications and expected losses measurements. For direct and indirect exposures of banks to regions or countries that are significant and of concern, the FSA would carry out assessments of banks' loan classifications and provisioning via <i>Special Inspections</i>. Peering of classifications and provisioning of large exposures across banks with similar exposures are also carried out via off site monitoring. Adequacy of provisioning are also subject to external audit reviews as part of the annual audit cycle and the FSA requires banks to report issues identified by external auditors. In addition, the FSA would communicate with external auditors on issues relating to financial reporting and internal controls, any issues arising would also be discussed during that forum.</p> <p>EC 4—On a quarterly basis, banks are required to submit information on country credit exposures to the FSA as part of their regular prudential returns submissions. The FSA which would request for more details where warranted, including transaction details on a gross and net basis as well as provisions made to cover for credit and country risks. Arising from the recent financial crisis, the FSA has additionally required banks to report on a monthly basis, all exposures to countries in the Europe, with the breakdown of each individual country exposure into the various categories such as sovereign, financial institutions and non-financial institutions and including details such as maturity for more granular analysis.</p>
Assessment	Compliant
Comments	<p>Faced with weak profitability amid sluggish loan demand locally and a low interest rate environment, Japanese banks, particularly the mega banks have increasingly attempted to expand overseas, particularly to Asia. However, the Japanese banks' direct exposures to European peripheral countries have remained relatively limited at present although any indirect impact of the debt crisis in Europe could further impair economic recovery in Japan and quality of loans at Japanese banks. The FSA has been monitoring this closely with additional regular prudential returns submissions on country exposures. Past experiences with the Japanese banks' exposures to the Middle East and supervisory actions taken by the FSA had been largely bank specific and targeted but the assessors have observed that the FSA has been strict in terms of onsite credit provisioning assessment and would have the supervisory powers to impose explicit provisioning amounts on banks if required. However, more consideration might be given on the actual quality of the exposures, due to a possible materialization of the country risks identified. In general in the discussion undertaken with the industry we understand that no specific provisions are normally taken until the risks have materialized. We would recommend the authorities to have a more forward looking approach to the asset evaluation of these risks and where necessary provide for them.</p>
Principle 13.	<p>Market risk. Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.</p>
Description	<p>EC 1—The FSA's Supervisory Guidelines require that banks have in place an appropriate risk management system to measure, monitor and manage market risk. The Boards of the banks are responsible for understanding, establishing and adjusting these risks and mitigating controls. These expectations by the FSA are provided in the FSA' Supervisory Guidelines. During onsite inspections, the FSA examiners will confirm the adequacy of market risk management. These include ensuring that market risks are identified, trading activities are carried out in-line within established risk</p>

	<p>tolerances, and strategies with appropriate market risks controls are in place and implemented effectively. Trading book portfolios of Japanese banks are generally small, even in the case of mega banks, engaging mainly in foreign exchange and interest rate trading and some minor CDS trading. AFS portfolios would generally be classified under the banking book and these are generally more significant for Japanese banks (please refer also to discussion under Principle 16). The FSA has more than 30 onsite inspectors (most with more than 10 year experience) specializing in market risk and with prior experiences as traders, market risk managers, and internal auditors in charge of market risk in the banking sector and these specialists would be deployed for onsite inspections of market risk areas, particularly for the mega banks which are more active in trading activities.</p> <p>EC 2—The FSA’s Supervisory Guidelines details the requirement for banks in establishing market risk exposure limits commensurate with the size and scope of their businesses. Management oversight is part of the requirement and these are assessed by the FSA examiners during their onsite inspections. The use of appropriate limits for the bank’s trading, held to maturity and available for sale portfolios are part of the expectations by the FSA in banks’ establishing and implementing an effective risk management system. Limit excesses for major banks are reported to the board of directors on a daily basis.</p> <p>EC 3—Banks are required to monitor their market risk positions on a real time or at a minimum daily basis. Profit and loss, limit excesses, and overall positions for each bank are to be reported to senior management daily for major banks. Internal policies and procedures are required to be in place to provide for independent valuations and ensure that the objectivity of these valuations. These are evaluated by the FSA examiners during onsite inspections.</p> <p>EC 4—The FSA requires stress testing to be conducted regularly by banks in-line with the nature and size of their banking activities. These should take into account market stresses and worst case scenarios and results of the stress tests are to be reported to senior management. Contingency plans developed as responses to the stress test results are expected and its effectiveness to be demonstrated to the FSA examiners during their onsite inspections. During onsite inspections, the FSA inspectors would replicate the bank’s value-at-risk (VaR) models and carry out their own stress tests on banks’ based on the FSA’s own scenarios. A comparison of the stress test results would be made against the banks’ own stress test results and inspectors would ensure that bank management was aware of the risks identified by the results and taking appropriate steps to address those risks. Inspectors would also identify and inform banks’ of any weaknesses in the banks’ models noted. As announced in their Annual Supervisory Policy this year, the FSA further focuses on verification of stress-testing by banks taking into account the current market turmoil.</p> <p>AC 1—Banks are required to ensure clear separation of functions between the market risk department, settlements/operations and front office for the market risk department to exercise an adequate check and balance function. Independence in pricing of marks is expected and these are validated by the FSA examiners during onsite inspections.</p>
Assessment	Compliant
Comments	<p>Megabanks are the more active participants in trading activities which would generally include foreign exchange and interest rate trading and some minor CDS trading. AFS portfolios of Japanese banks, which are generally significantly larger than their trading books, are usually classified under the banking book and subject to more generous accounting loss recognition arising from government measures (please refer to discussion under Principle 16). The FSA has adequate market risk specialists, most</p>

	<p>with more than 10 years of relevant experience, carrying out onsite inspections on the market risk area and risk limits established by banks for trading activities were usually low with real time monitoring and daily escalations. More focus and expertise would be diverted by the FSA to the supervision of the mega banks' market risk management. There was general compliance with this Principle. The other main market risks facing the Japanese banks would arise from its interest rate risk in the banking book from extensive JGB holdings (arising from limited credit demand and increasing deposits) and equity holdings (also discussed under Principle 16).</p>
Principle 14.	<p>Liquidity risk. Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.</p>
Description	<p>EC 1—BOJ had, in 2009 and 2010, issued policy papers providing guidelines on liquidity risk management (LRM). BOJ's framework for liquidity monitoring was introduced in detail in "The Bank of Japan's Approach to Liquidity Risk Management in Financial Institutions" issued in June 2009. The July 2010 paper had built on the requirements of the 2009 paper and introduced new requirements following lessons learnt from the global financial crisis.</p> <p>BOJ monitors the liquidity conditions of banks on a daily basis. Daily dialogues between BOJ and the banks were taken when necessary, and were deemed particularly effective during the crisis. BOJ's off-site monitoring was also strengthened through more detailed and more frequent information collected and analyzed. While still focusing on banks establishing robust institution specific liquidity risk management systems, emphasis is now on stress testing, strengthening resilience under stress, adequacy of liquidity buffers, impediments on intra-group and cross-border funding. Banks have been required to take into consideration both on and off-balance sheet liabilities.</p> <p>The FSA engages in daily contact with BOJ to understand any concerns arising from BOJ's daily monitoring. BOJ also contacts the FSA immediately should any issues be noted regarding liquidity risk. Please refer to further discussions under Principle 1(6). In cooperation with BOJ, the FSA has been assessing if banks have established appropriate liquidity management systems and the adequacy of cross-entity liquidity management within a group, foreign currency liquidity management and adequacy of liquid assets via off-site analysis of monthly returns submitted by banks as well as onsite inspections. Such information exchange has been intensified since the recent global financial crisis.</p> <p>EC 2/3—Board members are responsible for ensuring that policies and procedures to manage the liquidity risk of the bank are in place and liquidity strategies are in-line with the overall bank's strategy. With the authorization of the board, managers responsible for liquidity risk are expected to establish appropriate policies and procedures to manage liquidity risk at the bank based on various levels of liquidity stress. The FSA would confirm the above during their onsite inspection in accordance with their inspection manual. The FSA's inspection Manual also specifies requirements on the monitoring conducted by liquidity risk management division of a bank. In addition, BOJ would also check on the governance structure in place for bank's liquidity risk management and carries out off-site assessment of liquidity risk of financial institutions using multiple factor indicators. It would also ensure that board and risk managers are cognizant of the liquidity risk profiles of their individual institutions and manage their assets, liabilities and funding profiles accordingly taking into account factors such as market illiquidity, concentration and unwinding risks.</p>

	<p>EC 4—The standards and sophistication of liquidity risk management tools and frameworks varies greatly depending on the size and nature of the institution's business and also the local, regional vis-à-vis more international focus of each institution's business. Onsite inspections are carried out by the FSA to determine bank's adherence to their established policies and processes for the ongoing measurement and monitoring of liquidity and impact of other risks on the bank's overall liquidity strategy. These will include assessment of appropriate liquidity gap limits, continuous monitoring of concentration risk, contingency funding plans and stress testing commensurate with the size and scope of its businesses. The findings from onsite inspections will be graded under the Inspection Rating System of the FSA. These are supplemented by BOJ's analysis, with BOJ having the benefit of observing the daily cash management information of banks, which include ensuring that banks are appropriately managing their sources and uses of funds taking into account their funding capacity and concentration in funding sources amongst other factors. BOJ also conducts on-site examinations to assess the domestic/global liquidity risk management of its counterparties, including senior management's involvement, framework for institution-wide information sharing and actual risk communication as well as capability to respond to stress situation. BOJ would provide their findings of LRM to the FSA after the end of each examination period (where a series of examinations would be carried out) as well as on a more frequent "needs-to" basis when the exchange of information and views between the FSA and BOJ is necessary.</p> <p>EC 5—The FSA had announced via its Annual Supervisory Policy and in cooperation with BOJ, an increased focus via off-site monitoring on banks' liquidity risk management on a group basis, in particular on cross-border funds flow, integrated liquidity risk management, adequacy of foreign currency liquidity management (both within and outside Japan) and liquidity buffers. Monthly information on LRM is obtained by the FSA for off-site analysis including deposit information, liquid assets. Information on adequacy of liquidity buffers would be requested by the FSA and assessed for banks flagged out for enhanced monitoring either through off-site monitoring or onsite inspections. The majority of banks' exposures are largely denominated in Yen, with banks having already decreased their exposures to other currencies several years back. However, with the more internationally active banks expanding their operations overseas in an attempt to increase profitability, the FSA had also required banks to submit on a regular basis, consolidated LRM data for supervisory analysis and review. Best practices are also communicated to banks through inspection reports following onsite inspections. BOJ has also been conducting off-site monitoring on a daily basis with respect to foreign currency</p> <p>EC 6—Banks are required to establish appropriate contingency plans commensurate with the size, nature and scope of their business activities. These contingency plans are expected to be regularly reviewed for their effectiveness through the conduct of crisis simulation exercises and revised regularly where warranted.</p> <p>AC 1—The FSA had included in their Annual Inspection Policy and Planning document published in 2011, a new requirement for onsite examiners to ascertain whether banks have established an adequate risk management system with regards to foreign currency liquidity management. Banks are already conducting stress-testing for all other currencies other than Yen.</p> <p>AC 2—Requirements on these areas are laid out in FSA's supervisory guidelines and verified during the FSA's interview with banks and during onsite inspections.</p>
Assessment	Compliant

Comments	<p>While the onsite inspections by both the FSA and BOJ appear rigorous and there is in place inspection rating systems, the benchmarking of approaches and assessment standards for liquidity risk supervision carried out by both the FSA and BOJ could be further enhanced for consistency in approaches and risk rating assessments of banks, with due regard of the FSA's and BOJ's own objectives. It has been observed from the banking industry that efforts had been successfully made to gradually reduce the regulatory burden to the banks in the coordination of onsite inspections by the FSA and BOJ. These efforts are commendable and similar processes including but not limited to the submission of data to the authorities could also be further streamlined to minimize the regulatory burdens on banks. In addition, given the strategy of more banks attempting to expand overseas in the search for yield, continued focus by the BOJ and the FSA on the liquidity risks arising from these banks' foreign currency funding profiles is important given the banks' reliance on wholesale funding in these markets and higher costs of funding overseas compared to its domestic funding profiles.</p>
Principle 15.	<p>Operational risk. Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.</p>
Description	<p>EC 1—The FSA's supervisory guidelines requires banks to develop appropriate operational risk management systems commensurate with their risks profiles and ensure that the effectiveness of these risk management systems through regular risk management reporting. These are validated by the FSA via onsite inspections. BOJ also ensures that institutions are effectively managing their operational risks with focus on changes in business environment and impact on operations and information technology systems, including operational risk issues such as frauds, accidents, errors and system failures. Please refer to EC4 for more details of operational risk assessment of key participants in the Japan payments and settlement systems. The findings by BOJ are also shared with the FSA through a variety of channels.</p> <p>EC 2—The FSA's Supervisory Guidelines require banks to have in place appropriate risk management systems to manage operational risks in-line with its strategic goals, including changes in business environments that require changes in business operations and operational risk management. The Boards of the banks are responsible for understanding, establishing and adjusting these risks and mitigating controls. During onsite inspections, the FSA examiners will confirm the adequacy of operational risk management. BOJ also conducts off-site monitoring and onsite examinations to assess the adequacy of risk management policies and processes at banks.</p> <p>EC 3—Board and senior management of banks are clearly responsible under the FSA's Supervisory Guidelines for the effective implementation of policies and procedures for operational risks that are commensurate with the size and scope of their businesses. The FSA examiner during onsite inspections will assess the effectiveness of bank's implementation of approved strategies and policies, including regular reporting to the board and periodic reviews to be carried out when necessary. In the March 2011 Japan earthquake, the authorities had informed the assessors that no major outages were observed at the banks apart from one major bank. Following the incident, the FSA had requested that related financial institutions carry out comprehensive self assessments of their IT system risks and submit the results to the FSA. The authorities were still in the process of obtaining the full self assessments from each bank and carrying out peer reviews amongst the banks.</p> <p>EC 4—Banks are required to establish comprehensive resiliency efforts, crisis management and business continuity plans to enable prompt and appropriate recovery</p>

strategies and measures during crisis to minimize any disruptions to banking operations. Effectiveness of business continuity plans in light of the Great East Japan Earthquake in March 2011 was a focus of the FSA's 2011 Inspection Plan and major black out assumptions and recovery measures put in place by banks were assessed for adequacy by the FSA, both via reviews of the banks' own self assessments of their IT risks, peer reviews as well as onsite inspection by the IT specialists. Another recent operational risk area recognized by the FSA includes risks arising from the integration of IT systems, both for the major banks and regional banks. Onsite inspections at major banks would generally include IT in the scope of inspections.

BOJ also conducts onsite examinations to assess the operational risk management framework and processes of financial institutions. In addition, for institutions which are key participants in the payment and settlement systems, BOJ conducts surveys on the business continuity management at financial institutions related to payments and settlement activities to ensure the smooth functioning of the payment and settlement systems in Japan. In particular, senior management awareness, oversight and sufficiency and regular review of banks' operational risk management frameworks and business continuity plans, taking into account risks and changes in the business environments, payment and settlement risks and effectiveness of business continuity plans, particularly for critical information technology systems, are the focus of BOJ's onsite and off-site checks. For regional financial institutions increased reliance on shared information technology systems, outsourcing risks would be assessed by BOJ during their visits to the outsourced entities and operation centers. While BOJ has to obtain the permission of outsourced service providers to inspect the outsourced operations, it was communicated to the assessors that no resistance or issues on this front had been faced by BOJ. The FSA would have the powers to conduct onsite inspections at outsourced service providers.

EC 5—Banks are required to ensure that bank boards are cognizant of all inherent information technology risks and to have taken measures to mitigate the risks, including comprehensive information technology strategies and contingency plans that are sufficiently flexible to cater for external events that could impact the smooth functioning of the banks' information technology systems. Onsite examiners will assess the banks' business management strategy and adequacy of its investments in IT systems that are required for the size and scope of its operations. IT related issues, if any arising would also result in additional supervisory scrutiny both by onsite and off-site supervision teams at the FSA and potentially administrative actions against the banks as well.

EC 6—The FSA's Supervisory Guidelines require banks to submit reports to the FSA on information technology system issues including measures taken to address the issues immediately after occurrence. Under Article 24 of the Banking Act, the FSA has powers to require banks to report their analysis on operational risk deficiencies and measures taken to address these deficiencies to the authorities. In addition, Article 53 of the Banking Act and Article 35 of the Ordinance for Enforcement of the Banking Act required banks to report to the FSA operational risk issues related to fraud, embezzlement, breach of trust and other activities that may pose risks to the safety and soundness of banks.

EC 7—Legal risk management is included as part of the operational risk management framework under the FSA requirements.

EC 8—Article 12 of the Banking Act requires banks to take adequate and appropriate measures to ensure appropriate outsourcing management when outsourcing processes or businesses to a third party. Banks are required to assess the quality of outsourced service providers, ensure sustainability, identify risk management issues

	<p>and ensure that outsourced activities do not affect the safety and soundness of the banks' activities. Prior approval of the FSA is not required for outsourcing activities undertaken by the bank although there is some expectation by the FSA for the banks to consult with them on planned outsourcing activities during their regular dialogues with the banks. The FSA has powers under Article 24 of the Banking Act to require third party service providers to report the status of their activities and are also empowered to conduct onsite inspections at these outsourced service providers.</p> <p>AC 1—Banking groups are required to identify operational risks inherent in all banking activities and develop appropriate operational risk management systems commensurate with size and scope of its activities on a group-wide basis. Effectiveness of banking group's operational risk management framework will be assessed during the FSA's onsite inspections.</p>
Assessment	Compliant
Comments	While IT system risks and the adequacy of integrated risk management for banks expanding overseas remains key risks, the FSA have acknowledged these risk areas and have intensified its supervision over these areas. Japanese banks' business continuity planning processes had been tested in the Great Eastern Earthquake in March 2011. While there were still gaps to be filled, for some banks in the case of IT system risks, overall the Japanese banks' operational risk and crisis management framework is well established and widely seen as robust.
Principle 16.	Interest rate risk in the banking book. Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.
Description	<p>EC 1—Interest rate risks are an integral part of market risk management framework required by banks under the FSA Supervisory Guidelines. These would include adequate and appropriate control systems and processes to monitor and measure all material market risks, including interest rate risks. When establishing limits, banks are required to reflect their risk taking strategies taking into account capital impact and profitability. For banks in Japan, the major risks arising from their banking book portfolios would be the JGB holdings. Equity holding have been reducing over the years. Banks are required to ensure that risks undertaken are in-line with strategies approved by the Board and exceptions are escalated to management on a timely basis. Senior management oversight is part of the requirement.</p> <p>EC 2—Onsite inspections by the FSA determine if risk management systems and controls are commensurate with the size and nature of its businesses and whether internal models have been reviewed and validated regularly. The FSA also requires stress testing to be conducted regularly by banks and take into account market stresses and changes in the business environment. Contingency plans developed as responses to the stress test results are expected and its effectiveness are demonstrated to the FSA examiners during their onsite inspections. In its onsite examinations, BOJ would also assess the appropriateness of management oversight over the interest rate risk management of its counterparties, including oversight over stress testing processes.</p> <p>EC 3—Banks are required to carry out appropriate stress testing regularly using their own stress scenarios. Scenarios and stress results would be assessed by onsite inspectors as discussed under Principle 13. Specifically for interest rate risks in the banking book, the FSA requires banks to submit on a monthly basis to the FSA's off-site monitoring data system, as well as relevant data regarding interest rates in</p>

	<p>banking books. From the submitted data, the FSA identifies banks classified as “outliers.” “Outliers” are defined in the FSA’ Supervisory Guidelines as banks whose impact of interest rate shocks on their bank capital exceeds 20 percent of the sum of Tier 1 and Tier 2 capital of the banks. The shocks cover cases of (i) parallel yield curve shift by 200 basis points, or (ii) 1st or 99th percentile of observed interest rate changes using a one-year holding period and minimum five years of observations (in-line with BCBS guidance for standardized interest rate shocks on the banking book). Follow-up dialogue with outlier banks for appropriate remedial actions is then taken by the FSA. Generally, it is the FSA’s policy not to impose remedial actions on outlier banks in the form of increased capital requirements. Instead, banks are expected to take other actions such as shortening the maturities of their securities holdings by replacing longer term JGBs with shorter term JGBs.</p> <p>AC 1—The FSA has the authority to require the results of their stress tests and would also carry out their own stress testing on the banks’ securities portfolios both during onsite inspections and off-site review. Monthly data obtained from banks include securities exposures and sensitivities. Please refer to the discussion under EC3 for more details.</p> <p>AC 2—Banks are required to include interest rate risks in the banking books when assessing their internal capital adequacy assessment program (ICAAP) and this would be validated by the FSA examiners during onsite inspections.</p> <p>AC 3—Stress tests should be based on worst case scenarios as well as hypothetical, exceptional but plausible stress scenarios. Assumptions should also be reviewed and stressed in the various stress scenarios. Results of stress testing and measures taken as a result are to be reported to senior management on a regular basis. The level and sophistication of stress tests that is expected of banks differs based on the size and risk profiles of the banks.</p> <p>AC 4—Banks are required to have clear segregation of duties between the front office, risk control and back office functions.</p>
Assessment	Compliant
Comments	<p>Banks generally hold large JGB and equity portfolios. JGB exposures in the banking system have grown over the years, increasing banks’ exposures to interest rate risks substantially. Both the banks and the FSA have acknowledged this risk and generally the awareness, measurement, monitoring, and stress testing tools are in place to qualify for compliant assessment under this principle. However, the assessors have observed valuation issues and the potential impact on capital as detailed below and further discussed under Principle 22 and Principle 6 respectively.</p> <p>As part of the "Economic Policy Package: Measures to Support People's Daily Lives," decided by the government and the ruling parties on October 30, 2008, the capital adequacy requirement for banks were partially relaxed and will remain in effect until March 2012 (currently under discussion for extension after March 2012). Under the new rule, valuation profits or losses on the holdings of “available for sale securities”, such as bonds with a zero risk weighting (e.g., government bonds) need not be reflected in the calculation of the CAR of banks in Japan. In addition, impairment arising from MTM valuation of “available for sale securities” such as bonds and equity holdings in the banking book are required to be realized under local accounting rules only when a loss of 50 percent is reached. Banks do have the option of realizing the MTM losses when a 30 percent threshold was reached.</p> <p>While the FSA, via its offsite monitoring team, carries out independent stress testing to identify and follows-up with outlier banks as discussed in EC 3, the assessors were</p>

	<p>informed that it is generally not the FSA's policy to impose remedial actions on outlier banks in the form of increased capital requirements. As these temporary government measures currently in place could affect the actual level of CAR at banks should significant valuation losses be observed on the AFS portfolios of the banks, stress analysis of the outlier banks and remedial actions taken by the FSA should also be assessed concurrently with the considerations of capital impact as well as potentially additional capital requirements, in-line with BCBS guidance, particularly given the significant size of the interest rate risks in the Japanese banks' banking books. For their own internal risk management purposes, banks should also be required to carry out stress testing and analysis of risks in the banking books taking into account the potential capital impact without the "measures" in place (particularly given that the measures would be expiring soon in March 2012.)</p>
<p>Principle 17.</p>	<p>Internal control and audit. Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.</p>
<p>Description</p>	<p>EC 1, 3—The legal and regulatory frameworks govern the functions of the Board and senior management with respect to corporate governance places full responsibility for oversight and quality of the bank's control environment squarely in the hands of the board of directors. Article 7-2 of the Banking Act requires senior management to have the knowledge and experience to be able to manage and control a bank appropriately, fairly and efficiently. Banks are required under the FSA guidelines to ensure independence of the internal auditors who would be responsible for testing and assessing the adequacy of the bank's corporate governance functions. Quality of board and senior management is assessed on a continuous basis by the FSA through dialogue with bank management responsible for risk management and governance. The adequacy of the corporate governance functions at banks would also be assessed for compliance by the FSA during their onsite inspections.</p> <p>The practice in Japan is for banks to have a Board of Company Auditors (comprising a minimum three Company Auditors) which, apart from attending the meetings of the board of directors, are responsible for ensuring the effectiveness of the corporate governance function at the bank. The Company Auditors are responsible for correcting or preventing significant misconducts or illegalities by means of audits and are given the authority to access all materials, documents and persons at the bank in the course of their audits. The Board of Company Auditors have a reporting line is to the Annual General Meeting (AGM). However, the Board of Company Auditors has limited powers; for example, it cannot dismiss directors or call for a shareholders meeting, which could compromise the timeliness and effectiveness of its interventions. From our observations, the work of the Company Auditors is largely performed by members who were previously part of management, and fit and proper requirements do not apply to the Company Auditors.</p> <p>EC 2—Banks and banking groups are expected to establish a risk management framework commensurate with the nature and size of their businesses. Separate supervisory guidelines for major banks and for small and medium sized regional financial institutions have been issued by the FSA to cater for differences in expectations of the internal control systems for the entities based on the scale and nature of their businesses. Oversight is undertaken by both the FSA and BOJ in a mix of off-site and onsite supervision activities. Expectations of bank management and</p>

their oversight over areas such as delegated roles and authorities, internal control and accounting policies and processes, segregation of duties etc are also detailed in the bank inspection manual and assessed by inspectors during their onsite inspections. Findings on adequacy of oversight and governance during inspection would impact both overall governance assessment as well as the individual inspected areas.

EC 4—The FSA is empowered under Article 27 of the Banking Act to require banks to dismiss their directors, executive officers, company auditors for violations of laws and regulations or actions that harm public interest. In addition, Article 24 and 26 of the Banking Act empowers the FSA to issue reporting orders and take administration actions against banks arising from prudential concerns, including requiring the banks to assess if certain directors or executive were suitable for their posts or positions. The assessors have received details of the supervisory measures taken against banks over the past 10 years. No formal actions have been taken against bank managers or board member as in practice, these officers would voluntarily resign from their positions before such actions are taken and made public.

EC 5—Banks are required via the FSA's Supervisory guidelines to develop an integrated risk management system with sufficient and appropriate control functions to manage the risks of each business within the bank and banking group. Effectiveness of these control functions would be assessed by the FSA during their onsite inspections.

EC 6—Banks are expected to establish an integrated independent legal compliance unit to manage compliance issues. In cases of shared operational duties by the legal compliance unit, controls should be in place to ensure its independence of its compliance functions. Board of directors are responsible for assessing and evaluating the effectiveness of the bank's legal compliance system based on results of internal audit findings, external audit results, reports from business units and are required take steps for improvements where necessary, to ensure the overall effectiveness of the legal compliance function.

EC 7—Banks are required to have an independent and effective internal audit function responsible for examining, assessing and providing independent assurance of the effectiveness of, and adherence to, the bank's risk management, control, and governance processes. The auditors are also responsible for examining and ensuring the bank's compliance to regulatory and supervisory guidelines and other prudential requirements.

EC 8—Internal auditors would be assessed by the FSA at least annually through meetings which would cover assessment of its methodology, scope, rigorousness of its audits and follow-up on rectifications by banks and banking groups. All internal audit reports of banks would be submitted to the FSA during the annual meetings for the FSA's review. In addition, during onsite inspections, the FSA examiners would assess the adequacy of staffing with the appropriate knowledge, experience and expertise for the business functions they are responsible for covering, independence of the internal audit function and internal auditors' access to all records, material, staff and directors of the bank and banking groups (including outsourced functions) for their audits.

AC 1— Article 7 of the Banking Act stipulates the fit and proper rules for directors and senior management, amongst which are the requirements to have sufficient knowledge and experience and prohibits board members from serving in other posts while appointed as a director of a bank.

AC 2—The FSA Supervisory Guidelines requires all important issues to be reported by

	<p>the internal audit unit directly to the executive director and Board without delay particularly if the issues impact corporate governance or any other issues that could affect customer interests. For issues impacting corporate governance which may be challenging for the internal audit unit to handle on their own, Board of Directors are required to take appropriate measures to facilitate internal audit's follow up on the issues, assessing the status of rectifications and to report on inadequate improvements. The FSA has no explicit requirement for the internal audit unit to report to the Board of Company Auditors.</p> <p>AC 3—In Japan, the practice is for banks to have a Board of Company Auditors responsible for ensuring the effectiveness of corporate governance at the banks. The FSA requires banks to ensure independency of the Board of Company Auditors specifying that Company Auditors must not be a director or a senior management of a bank or its subsidiaries who shall independently audit the directors' satisfactory execution of their duties and responsibilities.</p> <p>AC 4—The FSA requires Company Auditors to audit and assess the satisfactory execution of duties and responsibilities by the Board of directors. While there is no explicit regulation requiring banks to notify the FSA on information regarding the fitness and propriety of a Board member or a senior management, the FSA expects the banks to notify them on such matters when aware. Banks are required to report to the FSA all misconducts committed.</p>
Assessment	Largely compliant
Comments	<p>The role of the Board of Company Auditors is to provide reasonable assurance that the corporate governance at the bank is functioning effectively. However, the Board of Company Auditors has limited powers; for example, it cannot dismiss directors or call for a shareholders meeting, which could compromise the timeliness and effectiveness of its interventions. From our observations, the work of the Board of Company Auditors is largely performed by members who were previously part of management, and fit and proper requirements do not apply to Company Auditors. In addition, the internal audit units at the bank are not required to have an independent reporting line to the Board of Company Auditors or an independent Audit Committee, although the banks the assessors visited all had such reporting lines from internal audit to an independent audit committee (usually comprised of the President, the director in charge of internal audit and an external board member) whereby the internal audit results would subsequently be passed to the Company Auditors.</p> <p>Corporate governance functions at banks could be improved through strengthening the independence and effectiveness of the internal audit function which could take place in a variety of forms including having requirements for the internal audit unit to establish a direct reporting line to an independent Audit Committee or (possibly via this Audit Committee where it exists) to the Board of Company Auditors. This could also help alleviate any resource constraints faced by the Board of Company Auditors (comprising only a regulatory minimum of three Company Auditors) in their audits of the corporate governance of the banks. In addition, for issues impacting corporate governance which may be challenging for the internal audit unit to handle on their own, escalation to the Audit Committee or Board of Company Auditors could also ensure a more independent and satisfactory follow-up and rectification of the issue. The FSA might want to consider explicitly requiring the Board of Company Auditors to notify the FSA of significant findings including but not limited to issues relating to the fitness and propriety of a Board member or senior management for prompt supervisory attention and action where required. The FSA should also consider the merits of imposing fit and proper requirements on Company Auditors. These set of recommendations would enhance the independence of the internal audit units at the banks, provide the Company Auditors with sufficient resources to discharge their responsibilities as well</p>

	as provide the FSA with timely and independent information on issues that may be of supervisory concern to enable prompt and appropriate actions to be taken where necessary.
Principle 18.	Abuse of financial services. Supervisors must be satisfied that banks have adequate policies and processes in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.
Description	<p>EC 1—In Japan, the Act on Prevention of Transfer of Criminal Proceeds (APTC) is the main law governing the prevention of criminal proceeds via the banking sector, including the legal framework for customer due diligence. Article 13 to 16 of the APTC empowers the FSA to supervise financial institutions for compliance with the APTC. This would include conducting inspections, obtaining access to all information, documents and records, ordering the submission of reports or issuance of business improvement orders to financial institutions. Banks are required by the FSA to develop internal controls to ensure compliance with the APTC.</p> <p>EC 2— Article 9 of the APTC requires financial institutions to submit suspicious transaction reports (STRs) and Article 53 of the Banking Act requires banks to submit reports on illegal activities noted by the bank. In accordance with III-3-1-3-1-2 (1) of the Comprehensive Supervisory Guidelines, the FSA requires banks to establish and maintain procedures, policies and internal controls to prevent money laundering and financing of terrorism. The FSA will assess the internal controls framework in place including the STR reporting process during onsite inspections.</p> <p>The report on the Observance of Standards and Codes for the FATF 40 +9 Recommendations for Anti-Money Laundering and Combating the Financing of Terrorism prepared by the FATF for Japan in March 2008 provides detailed analysis on the AML/CFT measures in place in Japan. The evaluation concluded that the financial institutions in Japan are adequately regulated and supervised. However, there were exceptions to the FATF standards in several key areas including gaps in CDD obligations, identification of beneficial owners, no requirements to obtain information on purpose and intended nature of business relationships, ongoing due diligence, some gaps in record keeping requirements as well as the lack of provisions mandating enhanced due diligence for higher risk customers and transactions. The amended APTC (2011) following the 2008 FATF evaluation had since been improved to address much of the identified areas, including requiring financial institutions to establish policies and procedures to identify beneficial owners, obtain information on the purpose and intended nature of the business relationship, conduct ongoing due diligence on the business relationship and conduct enhanced due diligence on higher risk transactions. The next amendment to the APTC planned for 2013 would include the recommendations pertaining to cross border correspondent banking. Meanwhile, the Supervisory Guidelines had been amended to require banks to put in place processes to deal with the risks arising from these two areas.</p> <p>EC 3—Article 53 of the Banking Act requires banks to report to the FSA when illegalities in banks and their subsidiaries were observed. Article 9 of the APTC also requires all STRs to be submitted to the FSA and relevant banking supervisors and subsequently reported to the Financial Intelligence Unit (FIU). The STRs reported had increased substantially over the years, from approximately 18,000 in 2002 to almost 300,000 in 2010, due in part to training conducted by the FSA and the National Police Agency that had increased AML/CFT awareness amongst the financial institutions. Financial institutions have also been required to implement counter-measures to mitigate risks associated with jurisdictions that do not or insufficiently apply the FATF Recommendations via the FSA’s Comprehensive Supervisory Guidelines. While the</p>

APTC has not been amended to reflect this requirement legally, the assessors had been informed that the APTC amendment, planned for 2013, would incorporate these requirements on counter-measures to deal with jurisdictions that insufficiently apply FATF recommendations.

EC 4—The APTC requires financial institutions to identify and verify the customer's identification data. Standards for conducting customer due diligence and record keeping (seven years for CDDs after end of business relationships and seven years for specified transactions) are also specified in the APTC. As mentioned in EC 2, as a follow-up to the 2008 FATF evaluation, the APTC was amended in 2011 with more specifics on the "know-your-customer" (KYC) requirements by financial institutions, including identification of business relationships, beneficial ownership, enhanced due diligence and ongoing due diligence. The requirements for integrated risk management policies and procedures to conduct CDDs and STRs are provided in the FSA's comprehensive Supervisory Guidelines. Policies, procedures and control standards, including escalation processes in place to comply with APTC requirements and adequacy of board oversight would be assessed by the FSA during onsite inspections.

EC 5—Following the 2008 FATF evaluation, the FSA's Comprehensive Supervisory Guidelines now specifies requirements for financial institutions to establish internal control processes to address correspondent banking risks. These would include processes which allow banks to examine and assess respondent banks' AML/CFT frameworks and the policies and processes in place to prohibit banks from entering into correspondent banking relationships with shell banks. The amendments to the APTC planned for 2013 would make this a legal requirement as well.

EC 6—Verification of banks' internal controls are carried out by the FSA during their onsite inspections. Annually, the FSA also carries out dialogues with bank's internal auditors on risk management and compliance which would also encompass AML/CFT controls and deficiencies, if any.

EC 7—Powers to take regulatory actions against financial institutions for non compliance with APTC requirements are vested with both the APTC and the FSA. The FSA is empowered under the Banking Act to issue business improvement orders or even the suspension of businesses. APTC has powers to order banks to provide reporting, carry out onsite inspections and order banks to correct any non compliance with laws and regulations, similar to Article 24 to 26 of the Banking Act. Fines and imprisonment would generally be decided by the court of law.

EC 8—As mentioned earlier, the FSA's requirements for adequate and appropriate risk management framework include independent assurance of the effectiveness of, and adherence to approved control and governance processes. These would include internal audit unit which would be assessed by the FSA at least annually through meetings which would cover assessment of its methodology, scope, rigorousness of its audits and follow-up on rectifications by banks and banking groups. The FSA may freely access to internal audit report based on Article 24 and 25 of the Banking Act. In addition, requirements are in place to adopt screening procedures to ensure high ethical and professional standards when hiring employees, including ensuring the competency and independence of officers responsible for reviewing and escalating suspicious transactions. The FSA Comprehensive Supervisory Guidelines also stipulate that financial institutions conduct ongoing training for staff on KYC, AML/CFT to enable them to detect and escalate criminal and suspicious transactions and potential abuses of the bank's financial services. The 2008 FATF evaluation had assessed that "the supervisory authorities are, in general, properly resourced, staffed and trained in relation to AML/CFT. They have adequate powers to monitor and

	<p>ensure compliance by financial institutions with laws and regulations, including conducting inspections and obtaining access to all information, documents and records.”</p> <p>EC 9—The FSA’s Comprehensive Supervisory Guidelines require banks to develop appropriate reporting policies and processes for cases of abuses of banks’ financial services. This FSA would assess during onsite inspections whether banks comply with this requirement and would also assess if management information systems to consolidate and disseminate such information is working effectively to enable responsible officers to obtain the relevant information on a timely basis.</p> <p>EC 10—Article 134 of the Criminal Law in Japan regarding the unlawful disclosure of confidential information would not apply to staff, senior management, directors and company auditors of banks. As Article 35 of the Penal Code provides that acts performed in accordance with laws and regulations or in the pursuit of lawful business is not punishable, persons who reports suspicious transactions in accordance with Article 9 of APTC will not liable for criminal acts. Article 23 of the Protection of Personal Information Act allows financial institutions to provide personal data to third parties without the prior consent of the person involved when the situation is carried out in accordance with laws and regulations (i.e., APCT). In addition, Article 709 of Civil Code provides that an act by a person in accordance with laws and regulations shall not be liable for compensation. This effectively exempts bank staff responsible for STRs from any compensation from the viewpoint of the Japan Civil Code. Effectively, legislations are in place to protect bank staff in terms of criminal, civil or personal information protection from any potential liabilities.</p> <p>EC 11—Article 9, paragraph 4, of the APTC requires the FSA to promptly forward all STRs received to the FIU. Article 11, paragraph 1, of APTC requires FIU to provide information concerning STRs to law enforcement agencies, which enable the FSA and law enforcement agencies to have relevant information on all submitted STRs.</p> <p>EC 12—In terms of domestic sharing of STRs, Article 9, paragraph 1, of the APTC requires financial institutions under the joint supervision of the FSA and other ministries, such as the. Ministry of Agriculture, Forestry and Fishery, and Ministry of Health, Labor and Welfare, to submit STRs to both the FSA and the others ministries. In terms of foreign financial sector sharing of information, under Article 12 of the APTC, the FSA would be able to share information on STRs with foreign counterparts via the respective jurisdictions’ FIUs. The FSA would exchange general information with foreign counterparts via international bodies such as BCBS, FATF and the Asia Pacific Group on money laundering.</p> <p>AC 1—JFS has staff with expertise to handle criminal issues, mainly from transfers from law enforcement agencies such as the National Police Agency and Public Prosecutor’s Office which are the main agencies to handle reported criminal activities in Japan.</p>
Assessment	Largely Compliant
Comments	<p>Following the FAFT Mutual Evaluation performed in 2008, Japan had taken a number of steps to strengthen its AML/CFT capabilities. However, there remain several frameworks to be put in place to align it further with the FATF recommendations. While the assessors noted that these remaining recommendations have been incorporated into the Comprehensive Supervisory Guidelines of the FSA for banks, pending further changes to the APTC planned for April 2013, the outstanding weaknesses identified by the FATF including dealing with politically exposed persons, cross border correspondent banking and the implementation of counter-measures to mitigate risks associated with jurisdictions that do not or insufficiently apply FATF recommendations</p>

	<p>are still not legal requirements for banks in Japan. It is recommended that the authorities ensure that all identified weaknesses are addressed as quickly as reasonably possible to further ensuring a sound and effective AML/CFT framework in Japan. Enforcement efforts could also be enhanced through the greater use of supervisory tools, such as the power to impose fines on banks, to develop a more progressive approach to enforcement.</p>
<p>Principle 19.</p>	<p>Supervisory approach. An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.</p>
<p>Description</p>	<p>EC1—Risk assessment of financial institutions is undertaken by both the FSA and BOJ in a mix of off-site and onsite supervision activities. Corrective actions are generally undertaken by the FSA, being the lead authority for bank supervision and early intervention, bank resolution and depositor protection. Supervisory guidelines for banks have been issued for the major banks and regional banks. Meetings are held regularly with banks, their internal auditors, presidents of banks to identify developments in the financial markets and banking sector as well as enable the FSA to assess the risk profile, adequacy of governance structures, risk management and strategies of banks, banking subsidiaries and bank holding companies.</p> <p>Article 25 of Banking Act also provides the FSA with the power to have its officials enter any business office or any other facility of the bank, ask questions on the status of its business or property, or inspect books and other documents. The FSA is also given the equivalent power against subsidiaries of a bank, companies to which the bank outsources part of its business and bank holding companies.</p> <p>The FSA’s supervisory bureau and inspection bureau are responsible for carrying out off-site monitoring and onsite inspections respectively. Onsite inspections of banks, carried out in accordance with the FSA’s Bank Inspection Manual, would assess the risk management and controls of banks and the areas inspected would be rated accordingly. These inspection ratings would drive the frequency, scope and depth of subsequent inspections. Generally, onsite inspections for major banks would be conducted annually and for regional financial institutions, every two to three years.</p> <p>Follow-up on issues identified during the onsite inspections, including the need for corrective actions, would then be the responsibility of the supervisory bureau. The inspection findings, together with other information on the financial institution such as internal audit findings, analysis results of financials of the bank and banking group, head office information, etc. would form the “Bank Ledger” compiled for each institution. There would also be a separate risk identification program for major banks which would cover detailed analysis of financial indicators such as capital policy, growth strategy, profit structure, lending volume, status of lending to SMEs, domestic lending strategy for the major banks. These financial indicators would be compared across major peer banks twice a year. The “Bank Ledger” or risk identification program would however not include assessments of the major risk categories such as liquidity, market, credit or operational risk or overall risk profiling of the institution. Instead, banks would generally be classified into two categories, namely banks with supervisory concerns, and banks without supervisory concerns. For banks with supervisory concerns, the officer at the supervisory bureau responsible for the institution would provide descriptions of the concerns and action plans to address the issues. These documents are escalated to the Commissioner of the FSA indicating the supervisory concerns are identified. Banks without supervisory concerns would not necessitate any such explicit descriptions of supervisory plans or risk profiling and assessment apart from regional banks and credit cooperatives which has in place a</p>

“risk assessment sheet” and “individual supervision program.” It was noted that there was also no individual risk rating or overall score for each regional bank that would apply for individual regional banks.

With respect to BOJ, it would focus on systemic issues within the banking sector to facilitate to ensure “smooth settlement of funds” and thereby contributing to the “maintenance of stability of the financial system” as stipulated in Article 1 of the Bank of Japan Act. Being the lender of last resort, BOJ would conduct on-site examinations and off-site monitoring largely for the purpose of preparing for possible emergency liquidity assistance. Both on-site examinations as well as off-site monitoring of financial institutions are carried out by Financial System and Bank Examination Department and local branches within the BOJ. BOJ determines the frequency, scope, and the number of examiners of on-site examinations using a risk-based approach. Generally, on-site examinations for major banks would be conducted bi-annually, and for regional financial institutions three to five years, while those which needs frequent monitoring, every two to three years.

EC 2—Supervisory resources are currently not fully allocated according to the risk assessment results of banks as there is currently no formal risk rating methodology for the overall risks of individual financial institutions, apart from regional banks. While it is noted that the three major banks have been identified as systemically important based on their asset size and market share and more resources have been allocated to these three major banks, the FSA intends to implement the international proposals regarding D-SIFIs, including assessment methodologies for systemically important financial institutions, when the proposals are finalized. The assessors do observe that the FSA had categorized its banks into several categories such as mega banks, regional banks and cooperative banks which have partly reflected the risk of these different categories of banks and drives supervisory intensity and resource allocation to some extent. The current two tiered minimum capital requirements in Japan also provides some indication of the difference between banks’ risk profiles, for instance banks that were internationally active and use internal models (minimum 8 percent) and non-internationally active (minimum 4 percent). However, even banks that are subject to lower capital requirements could be systemically important to the financial system. In addition, while it was noted that the supervisors do consider factors such as interconnectedness, and the size of banks’ market share in certain prefectures, to determine the risks of banks and resource allocation, this is done informally and the FSA did not have the formal consistent upfront criteria in place for identifying and differentiating the more systemically important financial institutions apart from the three major banks.

In terms of a formalized, analytical risk framework that might be used to assess the risk profile of an institution on a holistic basis, it was noted that a risk rating framework was in place for onsite inspections. However, this framework would be applicable only for the specific onsite inspection within the scope of the inspection conducted and would not apply to the overall risk profiles of the institution incorporating both the onsite and off-site elements.

The FSA’s Supervisory Coordination Division within the Supervisory Bureau monitors and evaluates the trends, development and risks for the financial system as a whole. This division gathers off-site information on various sectors including banks, security companies, insurance companies, money lenders and uses this information in conjunction with information from in-house analysts to arrive at their conclusions on the risks to the financial system. Results are communicated to the relevant supervisors responsible for each industry segment as appropriate. In addition, the FSA’s Market Analysis Office (established in February 2008) monitors economics and markets and obtains information on the strategies and activities of financial institutions through

discussions with external market analysts. These would provide the basis for the FSA's Annual Supervisory Policy and Inspection Policy which are published annually with key supervisory themes of focus for banking supervisors.

From a macro prudential perspective, BOJ analyzes and assesses the risks in the entire financial system and releases its findings in the FSR semi-annually. The FSR aims to gauge risks in and challenges for Japan's financial system and to share recognition of the risks with a broad range of concerned parties, including financial institutions, so as to ensure stability of the financial system. In October 2011, BOJ integrated the FSR and Financial Markets Report, and published the revised FSR to provide more detailed analysis from the macro prudential perspective.

BOJ's analysis and assessment of the financial system from the macro prudential perspective are reflected in its on-site examinations, off-site monitoring and other activities undertaken by BOJ. Areas of focus for its on-site examinations would be published in its "On-site examination policy" released every fiscal year, taking into account issues concerning individual financial institutions' business conditions and risk management and analysis of the financial system.

EC3—In accordance with Article 24 of Banking Act, banks are required to submit financial information and prudential returns to the FSA such as its profitability, non performing loans, concentration, credit, liquidity and market risks. Under the FSA's "Early Warning System" provided in the Supervisory Guidelines, banks that are highlighted via "red flags" based on the FSA's analytical framework for monitoring the condition and performance of banks based on prescribed ratios and standards would be required to provide additional information to the FSA on the reasons for the various red flags and plans for possible remedial actions.

Regular and ad-hoc meetings are also held with banks to determine and assess the adequacy of risk management and strategies of banks. Interviews are generally conducted in-line with the issued Supervisory Guidelines over inter alia, areas such as corporate governance, capital adequacy, profitability, comprehensive risk management, credit risk management, market risk management, liquidity risk management, remuneration, compliance, disclosure requirements, consumer protection, operational risk, overseas operations and business continuity management. Together with market developments, the results of onsite inspection and off-site monitoring, the banks are assessed for supervisory concerns which are then escalated together with the supervisory action plans to the Commission of the FSA as appropriate.

EC 4—The FSA confirms banks and banking groups' compliance with prudential regulations and other legal requirements through reports submitted regularly to the FSA and also during the meetings carried out with the banks. In addition, the FSA inspectors also check on bank's compliance with prudential regulations and legal requirements during their onsite inspections at the banks.

EC 5—Article 53 of the Banking Act stipulates the requirement for banks and banking groups to notify the FSA on material changes and issues affecting its health and stability and also include items such as changes in business operations, organization structures, investment activities, capital management, and misconduct by staff. In addition, the FSA had clarified in its published list of administrative actions taken by the FSA in the financial sector that when taking administrative actions on banks, it would consider whether banks had attempted to cover up identified problems. This publication of actions taken serve as a future deterrent to banks and reinforce the requirement to notify the FSA of all significant matters once they become aware of them.

	<p>EC 6—The FSA currently utilizes two separate systems, namely the “Off-Site Monitoring Data System” and “Financial Data System for Supervisors” to store data on banks. The former stores the regular prudential returns submitted by banks and this data is used for identifying banks which need additional supervisory attention under the FSA’s Early Warning System. The latter stores the financial information and results of onsite inspections on banks. Data from both systems are used in conjunction for analysis and identification of areas requiring follow-up action. Currently the two systems are not fully integrated which poses some burdens for bank supervisors responsible for specific financial institutions to obtain a full picture of the risks profiles of the individual institution on an overall basis. There is no formal risk rating methodology to assess and rate the overall risks of individual financial institutions apart from regional banks. The FSA had recognized that the two systems could be further integrated to allow for more effective and efficient analysis and monitoring of prudential information and had initiated the development of a more integrated system, targeted to be in place by January 2013. For BOJ, it mainly utilizes two data base management systems, “Financial Data Base” and “Off-site Monitoring System” to store and analyze data on financial institutions.</p> <p>AC 1—Banks and banking groups are expected to establish a risk management framework commensurate with the nature and size of their businesses. Oversight is undertaken by both the FSA and BOJ in a mix of off-site and onsite supervision activities. In addition, dialogues with banks, analysis of trends from off-site monitoring and results from the FSA’s early warning system enables the supervisors to identify trends, emerging risks and challenges for the financial system and take appropriate supervisory actions when necessary.</p>
Assessment	Largely compliant
Comments	<p>The purpose of Principle 19 is to identify whether the supervisor adequately develops a thorough understanding of the individual banks, banking groups and the system as a whole.</p> <p>The FSA’s current supervisory approach is a bottom-up approach, with supervisory teams responsible for highlighting and following up on supervisory issues and concerns facing each institution. The FSA’s top-down approach is driven by the annual supervisory policy and inspection policy published annually. In reviewing the work performed by the supervisory teams at the FSA, the assessors are satisfied that the separate onsite and off-site supervisory processes are relatively sound. However, the FSA could strengthen further its top-down approach. For instance through the establishment of a formalized, analytical risk framework that might be used to assess the risk profile of an institution on a more holistic basis (the assessors note that this was already in place for the regional banks). It was noted that the FSA intends to implement the international proposals regarding D-SIFIs and G-SIFIs, including assessment methodologies for systemically important financial institutions, when the proposals are finalized. While the assessors do observe that more resources had been placed on the mega banks which were subject to continuous offsite monitoring and surveillance, the identification of the other systemically important financial institutions (apart from the three mega banks) and considerations of factors in terms of both probability and potential impact on the financial system both from the financial stability and consumer protection dimensions could further strengthen the FSA’s understanding of the system and its risks from a top down perspective. This could also assist the FSA’s prioritization in terms of supervisory activities and intensity.</p> <p>Establishing a methodology to determine the overall risk profile assessments of each individual institution would provide supervisors with the tool to better determine and assess on an ongoing basis the nature, scope, risk objectives, supervisory action</p>

	<p>plans, and overall risk profile of each bank on a more holistic basis. The methodology, which should cover the business focus, inherent risk profiles, and internal controls at the banks for the various risks areas, would facilitate comparisons between peer banks as well. In addition, upfront criteria enabling the identification of the systemically important financial institutions and on the analysis of individual institutions' risk profile and importance from a system wide perspective would allow the FSA to identify and differentiate banks with higher potential impact on the financial system. The development of these two frameworks, both a formalized analytical risk framework to assess the overall risk profile of an institution and the risk identification of financial institutions at a system-wide level, taking into consideration factors such as probability and potential impact on the financial system, would enable supervisors to have a better macro view of the overall risks of each individual institution in the system as well as identify institutions that would pose to higher risks to the financial stability of the system. Supervisors would also be able to better differentiate the intensity and scope of supervision and better allocate its supervisory resources.</p>
Principle 20.	<p>Supervisory techniques. An effective banking supervisory system should consist of onsite and off-site supervision and regular contacts with bank management.</p>
Description	<p>EC 1—There are processes in place for quality assurance of onsite inspections via the onsite quality evaluation division known as the “review division” that is responsible for the evaluation and finalization of all onsite assessment reports. Quality assurance for off-site activities generally vests with the head of divisions. See also discussions under Principle 19 EC3. Both the BOJ and the FSA carry out off-site monitoring and onsite inspections of financial institutions. While both BOJ and the FSA conduct onsite inspections of financial institutions, BOJ’s onsite examinations and requests for data are based on bilateral agreements between BOJ and the financial institutions that have current accounts with it as stipulated in Article 44 of the Bank of Japan Act. The FSA is empowered under the Banking Act. FSA is empowered to request BOJ to submit documents describing the results of its on-site examinations and other related materials based on Article 44 of the Bank of Japan Act but generally would not need to do so as in practice, BOJ would always inform the FSA of its findings if they were significant for a particular financial institution. There are information sharing and exchanges of views at higher levels between the FSA and BOJ. In addition, BOJ and the FSA have been coordinating their onsite inspection schedules to attempt to reduce overlaps and avoid clashes in timings. Areas of supervisory concerns are identified by both authorities based on results of onsite inspections, off-site monitoring, regular and ad-hoc dialogues with the banks and taking into account market developments and emerging risks. However, administration actions, if any, to be taken on banks would be taken by the FSA.</p> <p>EC 2—See also discussion under Principle CP19. Every year, the FSA outlines its supervisory focus for the year via its “Annual Supervisory Policy” and “Annual Inspection Policy and Plan.” The latter specifies the number of banks and the category of banks planned for onsite inspection in the coming year. In planning its annual onsite inspection schedule, the FSA would assess factors such as the size of the financial institution, time that has elapsed since the previous inspection, results of the previous inspections and incorporate supervisory concerns or developments of the financial institutions arising from off-site review. Regular meetings between onsite and off-site supervision staff at the FSA are carried out for information sharing on banks under their charge. Prior to each bank inspection, the off-site supervision staff responsible for the bank provides the onsite inspector with all relevant off-site information including meetings minutes, analysis of prudential data, financials, recent events, misconducts if any and share key issues regarding the bank from their off-site activities. Following the inspection, the off-site team would be responsible for administrative actions, if any required to be taken on the bank, as well as the follow up on rectifications of findings</p>

during the inspection. Generally, onsite inspections for major banks would be conducted annually and for regional financial institutions, every two to three years. Based on discussions with the onsite inspectors, documentation provided by the FSA as well as discussions with industry participants regarding the FSA's onsite inspections, which while relatively check-list based, appear to be sufficiently intrusive and detailed.

EC 3—The FSA's bank inspection manual specifies areas of focus during onsite inspections including Corporate Governance, Compliance, Capital Management, Credit, Liquidity, Operational and Market Risk Management. Guidelines and checklists are specified in the manual to aid inspectors and also serve as guide for banks to ensure the requisite standards are in place. During each inspection, verification of the completeness and accuracy of regulatory submissions by banks are carried out and findings reported to bank management. Status of rectification of past inspection findings are also verified onsite following earlier off-site submissions of rectification statuses obtained from the bank. As earlier described, the FSA is empowered under Article 25 of the Banking Act to access all relevant information on the bank and banking group. From the documents provided to the assessors as well as descriptions of the FSA' onsite process, the assessors were satisfied that the onsite inspection processes were relatively robust.

EC 4—The monitoring of the financial system is conducted through a mix of measures of which the off-site monitoring processes comprises a significant component. The FSA's off-site monitoring teams regularly analyses the more institution specific and micro prudential aspects based on financials and prudential returns submitted by banks. The data is collected from banks and other relevant entities within a banking organization on comparable dates and periods allowing for comparable analysis and follow-up where necessary. Follow up and remedial actions on all onsite findings would be the responsibility of the off-site supervisory teams, which would conduct interviews and follow-up on the adequacy of rectifications by banks. Onsite inspectors would also join in these follow up meetings to ensure proper rectifications of findings. The offsite team would also, on a semiannual basis, carry out peer analysis of specific risk indicators for the major banks which would include analysis of capital policy, growth strategy, profit structure, lending volume, status of lending to SMEs and domestic lending strategies. Based on the regulatory data submitted and analysis provided to the assessors by the FSA, there appears to be sufficient coverage and follow-up of the financial indicators offsite by the FSA's offsite monitoring teams.

EC 5—As mentioned in Principle 19, meetings are held regularly with banks, banking groups and their internal auditors. In particular for the larger and more complex institutions, discussions between the supervisors and the banks take place at many levels of the organization and take place almost continuously throughout the year. On a monthly basis, "hearings" or dialogues are held with banks to discuss and obtain updates on their various risk management framework in place to manage the various risks such as credit, market, liquidity and operational risks and changes in risk profiles. Supervisors at the local financial bureaus responsible for supervising the regional institutions also hold dialogue as necessary with the regional institutions and provide feedback to the FSA. This was confirmed in discussions with some of the institutions.

EC 6—Quality of board and management is assessed on a continuous basis through dialogue with bank management responsible for risk management and governance. Expectations of bank management and their oversight over delegated roles are also detailed in the bank inspection manual and assessed by inspectors when onsite. Findings on adequacy of oversight and governance during inspection would impact both overall governance assessment as well as the individual inspected areas. The FSA is empowered under Article 27 of the Banking Act to require banks to dismiss

	<p>their directors, executive officers, company auditors for violations of laws and regulations or actions that harm public interest. The practice in Japan is for banks to have a Board of Company Auditors (comprising a minimum three Company Auditors) responsible for ensuring the effectiveness of the corporate governance function at the bank. The role of the Board of Company Auditors is also regularly assessed by the FSA both off-site and onsite.</p> <p>EC 7—The quality and effectiveness of the internal audit function are emphasized by the FSA as it serves to provide independent assurance of the effectiveness of, and adherence to, the bank’s risk management, control, and governance processes. Internal auditors are assessed by the FSA at least annually through meetings which would cover assessment of its methodology, scope, rigorousness of its audits and follow-up on rectifications by banks and banking groups. Internal audit reports would also be provided to the FSA during this time for review.</p> <p>EC 8—Supervisory concerns are generally communicated to bank management at an early stage to enable them to address the concerns promptly. In addition, following the completion of onsite inspections, and inspection report detailing the findings from the inspections are provided to the banks for rectifications and follow up. Best practices are also communicated to banks through inspection reports. The off-site supervisory teams would be responsible for the regular follow up with banks on rectification of supervisory concerns and inspection findings until these were rectified.</p> <p>AC 1—In addition to the meetings with senior management and bank board of directors, findings by external auditors are discussed with the directors of the banks where necessary following the annual submission of financials and findings related to financial controls by external auditors.</p>
Assessment	Compliant
Comments	<p>The regular meetings held by the FSA with the banks to obtain updates on their risks and risk management processes is a positive development in their supervisory practice in recent years. These included the regular annual meetings on the banks’ risk management processes, quarterly meetings on financial results, semi annual meetings on business strategy and performance as well as other ad-hoc meetings called for by the FSA when necessary. These enable the FSA to have constant contact with the bank and be kept abreast of developments at the banks. As discussed in Principle 17, corporate governance functions at banks could be improved through strengthening the independence of the internal audit function at banks and fit and proper requirements for the company auditors.</p>
Principle 21.	<p>Supervisory reporting. Supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either onsite examinations or use of external experts.</p>
Description	<p>EC1—Article 19 of the Banking Act requires banks to submit an interim business report pertaining to the interim business year (period 1 April through to 30 Sep of that business year) as well as at year end (audited) to the FSA. These would include selected financials including their balance sheet and capital ratios and consolidated statements for banking groups with subsidiaries where applicable. In addition, under Article 24 of the Banking Act, banks are also required to submit regular off-site monitoring data to the FSA regarding its various risks, including market risk, liquidity risk and credit risks. Submissions are made electronically for all banks. These would include detailed information on asset quality, loan loss provisioning for its 100 largest borrowers, market risk information, interest rate sensitivity details and depositor information and profiles. A major part of the FSA’s and BOJ’s off-site surveillance comprises the review and analysis of data submitted by banks and counterparts to the</p>

FSA and BOJ respectively. Both authorities can require the submission of information from banks (for the FSA) and counterparts (for BOJ) including that on subsidiaries, outsourced entities and overseas operations. and would included data on integrated

EC 2/3—Accounting standards in Japan have been extensively developed over the last 10-15 years. Banks are subject to the Japan GAAP for regulatory reporting. Movements towards convergence between Japanese GAAP and IFRS started in March 2005. Under the August 2007 'Tokyo Agreement,' Japan established the timeline of end 2008 to eliminate the 26 major differences between Japanese GAAP and IFRS, with the remaining differences being removed by June 2011. Industry opinion is that Japan is at the final stages of convergence to IFRS. At the moment, Japan GAAP allows for certain assets and liabilities to be reported as historical cost while the application of fair value accounting requires the part the lower of cost of fair value under certain circumstances. For example, reporting of investment properties is at amortized cost under Japan GAAP but is at the lower of cost or fair value under IFRS. In addition, please refer to discussion under Principle 22 regarding government measures in place to relax the capital adequacy requirement of banks through delayed recognition of MTM losses on “available for sale securities” in the banking book that is not in-line with international prudential standards.

EC 4—The FSA collects data via off-site monitoring on the various risks in varying frequencies (weekly, monthly, quarterly, semiannually, or annually) depending on banks' size or license type (listed company, cooperative financial institution). Under FSA's “Early Warning System” provided in the Supervisory Guidelines, banks that are highlighted via “red flags” based on the FSA's analytical framework for monitoring the condition and performance of banks based on prescribed ratios and standards would be required to provide additional information to the FSA on the reasons for the various red flags and plans for possible remedial actions. For those banks requiring supervisory actions, the FSA is empowered under Article 24 of Banking Act to request any relevant information from banks and their related companies including their action plans to address the highlighted “red flags”. Should the action plans still prove to be unsatisfactory, the FSA may, in accordance with Article 26 of Banking Act, order the relevant banks to submit business improvements plans with specified timelines to address the affected areas.

On an ongoing basis, the FSA would also initiate additional information requests from banks to analyze and assess their risk profiles and trends. Taking recent sovereign crisis situation as an example, the FSA had conducted interviews with banks regarding their holdings of sovereign debts and had required more frequent reporting of their holdings and exposures.

In addition, megabanks would have the FSA onsite examiners regularly at each mega bank. Based on the results of the onsite inspections, the FSA would be able to assess the risk management and controls of banks and may request for additional information from the banks when necessary.

EC 5—The FSA collects data from banks and other relevant entities within a banking organization using comparable dates and periods allowing for comparability of reported data, analysis and follow-up where necessary. As mentioned in EC4, frequencies of reported information may vary depending on type of information, banks' size or license type.

EC 6—The FSA is empowered under Articles 24 and 52-31 of the Banking Act to request a bank, bank holding company, or its subsidiaries to submit reports or material data regarding its business and property as deemed necessary for supervisory purposes in order to secure sound and proper business operations of the bank and

banking group. Article 24-3, 25-5 and 52-31(3), 52-32(5) of the Banking Act allows subsidiaries of a bank or subsidiaries of the banking holding company to refuse to submit report or materials requested by the FSA if there are justifiable grounds. The FSA indicated that justifiable grounds assume a situation where the FSA requests them for other than supervisory purposes. The provisions may hamper effectiveness of consolidated supervision if the subsidiaries were to take advantage of such a provision. The FSA has indicated that subsidiaries have never made use of this provision to refuse submitting information. It also put forward that in case such a situation would occur, the FSA would continue to access the entity and impose penalties on it based on item 2 of Article 63 of the Banking Act. Please also refer to BCP 24.

EC 7—Article 25 of Banking Act provides the FSA with the power to have its officials enter any business office or any other facility of the bank, ask questions on the status of its business or property, or inspect books and other documents. The FSA is also given the equivalent power over subsidiaries of a bank, companies to which the bank outsources part of its business and bank holding companies. These would also include access to the banks or holding company's board, management and staff to discuss supervisory matters.

EC 8—The FSA has adequate authority to enforce compliance with regards to the timeliness, accuracy and type of information submitted as supervisory returns. Banks and bank holding companies are required to establish adequate and appropriate internal control systems to ensure that regulatory submissions are timely, accurate and valid. These would be the responsibility of the Board and senior management of the bank. Errors or deficiencies in the regulatory returns by banks and picked up by the FSA during their analysis of the returns would require resubmissions by the banks. Persistent errors in submissions at banks would trigger a review of controls around their compliance and regulatory reporting systems and processes and would entail a report to the FSA of the bank's review, analysis and rectification actions taken. In addition, the FSA has imposed penalties for misreporting or persistent errors in case they were made intentionally. More serious or persistent errors could result in business improvement orders by the FSA as provided under Article 26 of the Banking Act. .

EC 9—The FSA reviews and verifies the accuracy, integrity and validity of regulatory reports and submissions during their onsite inspections. As mentioned in EC8, errors or deficiencies in information submitted picked up by the FSA during their analysis of the returns would require resubmissions by the banks. Persistent errors in submissions at banks would trigger a review of controls around their compliance and regulatory reporting systems and processes and would entail a report to the FSA of their review, analysis and rectification actions taken. While external auditors are not required to review and assess the validity and integrity of regulatory reports in their usual scope of work, it would be the responsibility of the internal auditors to do so. Deficiencies if any would be informed to the FSA during their annual discussions with internal auditors. When internal audit reports have been compiled, the FSA asks banks to submit them so that they can be checked.

EC 10—The FSA does not rely on external experts to perform supervisory tasks, as these are all performed in-house by their own staff which would include professionals and experienced personnel in the various fields to provide the in-house expertise. While there could be secondment of staff from agencies such as BOJ to the FSA, they would be very much considered FSA staff during their term at the FSA and any findings would be promptly reported to the relevant staff within the FSA. The roles of external auditors are limited very much only to statutory audits as well as control processes surrounding financial reporting.

	<p>EC 11—External auditors are not required under law to report their findings to banking authorities in Japan. However, the FSA would be able to obtain that information indirectly through the banks as banks are required to report if there are any significant findings by external auditors. Findings that are in relation to violation of laws and regulations or which would result in material misstatements in the financial statements by banks would have to be rectified within two weeks after which external auditors would be required under Article 193-3 of the Financial Instruments and Exchange Act to report the issue to the FSA. See discussion under Principle 22.</p>
Assessment	Compliant
Comments	<p>The FSA has the means of collecting, reviewing and analyzing financial institutions' prudential returns on both a solo and consolidated basis. To further enhance the integrity of prudential reporting, the FSA may wish to consider requiring that external auditors opine whether or not filings have been accurately made. With regards to the reporting of findings by external auditors to the banking authorities in Japan, the FSA may wish to explicitly require external auditors to immediately report any material shortcomings noted directly to the FSA. Sole reliance on bank management to report significant findings of external auditors may be insufficient as situations involving bank management may result in avoidance or delay in such notifications.</p>
Principle 22.	<p>Accounting and disclosure. Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.</p>
Description	<p>EC 1—Banks and banking groups are expected to maintain adequate financial record keeping systems to ensure accuracy and integrity of financial data. The FSA's supervisory guidelines clearly states that bank board and senior management are responsible for banks developing an adequate and effective internal control system to ensure the establishment of systems that could adequately maintain the bank's financial records and financial data. Article 21 of the Banking Act requires a bank to publicly disclose an annual report both on solo and consolidated basis which details the banks' business and financial condition. The guidelines and Banking Act stipulates the requirements of accounting and disclosure. Banks which fail to comply would be issued with a business improvement order under Article 26 of the Banking Act or penalties under Article 63 of the Banking Act in more severe cases of violations.</p> <p>EC 2—In accordance with Article 396 of the Companies Act and Article 21 of the Banking Act, banks' board of directors are required to publicly disclose and submit to the FSA, annual financial statements, as set forth in Article 435 of the Companies Act, which had been audited by external auditors in accordance with Companies Act and Financial Instruments and Exchange Act. The financial statements should be accompanied by explanatory documents on the business and property and be made available to the public by placing them in branches. Items that shall be included in the explanatory documents are stated in Article 19-2 and 34-26 of the Ordinance for Enforcement of the Banking Act. The external auditors, as appointed by the bank, are responsible for auditing the financial statements of the bank and providing their audit report and audit opinion to the shareholders of the bank. Failure to comply with the timely filing of the annual report and accompanying audit report would be considered a violation of the Banking Act and be subject to administrative orders or other actions taken by the FSA.</p> <p>EC 3—Banks in Japan are subject to the accounting principles and provision requirements as laid out in the Japanese GAAP and guidelines provided by supervisors. As mentioned in CP21, the FSA had commenced the convergence of the Japanese GAAP with the IFRS since March 2005 and had established the timeline of end 2008 to eliminate the 26 major differences between Japanese GAAP and IFRS,</p>

	<p>with the remaining differences being removed by June 2011. It is the responsibility of the bank board to establish appropriate policies, procedures and control functions to ensure the independence and reliability of pricing and valuations and to put in place measures to ensure prudent provisioning and write-off policies.</p> <p>Japanese companies hold substantial amounts of equities of major business partners (cross shareholdings) in order to ensure long-term business relationships and prevent hostile takeovers. Under the original Japanese GAAP, which is mostly built on historical cost valuation, such practices have been used by financial institutions to build up capital buffers through unrealized capital gains that are not distributed to shareholders. However, accounting and regulatory frameworks have been increasingly based on mark-to-market approaches, revealing banks' exposures to market risks through cross-shareholdings. Since 2002, banks have been required to report on their equity portfolios valued at market prices for regulatory purposes and from 2006, banks have also new requirement also limits equity holdings as a share of bank capital. The regulatory financial reporting standards require the reporting of profits net of provisions for loan losses. However, recent government measures taken to facilitate financing for small and medium sized enterprises (SMEs), have required banks to endeavor to restructure loan terms to facilitate financing and ease the debt burdens for SMEs when requested by the SMEs. The FSA has been required, since the announcement of this measure, to assess the efforts of financial institutions in providing enhanced financing and support for the business improvement of SMEs. This requires careful balancing with the FSA's prudential objective to ensure appropriateness of classifications and provisioning of these restructured loans. Banks are required to submit a quarterly summary report to the FSA of overall loan migration details following restructuring. However, the assessors have noted that the actual practices for the classifications and provisioning for such restructured loans would vary much from bank to bank.</p> <p>EC 4—Article 396 and 435 of the Companies Act provides the scope of the audit to be carried out by external auditors on the financial statement of banks. Auditors are expected to determine and report whether banks' financial statements are presented fairly in accordance with Japanese GAAP. As the FSA does not rely on external auditors to carry out internal controls assessments apart from those relevant for the fair presentation of financial statements, generally the FSA would not be able to establish changes in scope of audits although in practice, the FSA could communicate to the external auditors during their meetings the focal points for checks and assessments but these would only be related to components of banks' financial statements.</p> <p>EC 5—External auditors are required to audit the financial statements of banks in accordance with Japanese auditing standards. Financial statement audits should cover the various components of banks' financial statements and notes to the financial statements including loan portfolios, loan loss reserves, bad loans, asset evaluation, trading and other securities business, derivatives and securitizations to enable auditors to provide an opinion whether the financial statements as a whole are presented fairly in accordance to Japan GAAP.</p> <p>EC 6—The FSA have powers to take disciplinary actions, including admonition or ordering the suspension of the business for two years, in cases where external audit firms breach the requirements of the Certified Public Accountants Act ("CPA Act") including knowingly or negligently certifying financial statements that have been materially misrepresented. However, apart from the limited instances described above, current legislation do not empower the authorities to take any other action against the external auditors or audit firms in situations unrelated to financial statements misstatements or other clear malpractices unless as provided under the CPA Act.</p>
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	<p>Banking authorities have no powers to reject or rescind the appointment of an external auditor although they could make suggestions to the bank.</p> <p>EC 7—Article 20 and 21 of the Banking Act and Article 435 and 396 of the Companies Act requires a bank to disclose publicly an annual set of audited financial statements on both a bank level and consolidated basis. Disclosure requirements are specified in Article 20 of the Banking Act. The Japanese Institute of Certified Public Accountants (“JICPA”) and the Business Accounting Council in the FSA have made revisions to auditing standards in the light of international developments over expectations of quality of audit, in-line with the International Standards on Auditing (“ISA”). Recent government measures to relax the capital adequacy requirements for banks through changes in local accounting rules for the valuation of available for sale securities in the banking book had resulted in some deviations from international accounting standards.</p> <p>EC 8—The Banking Act requires the public disclosure of solo and consolidated balance sheet, annual and interim business report to enable the public to understand business and financial condition of the bank and its subsidiaries. These disclosures are subject to uniform submission deadlines and reporting requirements to ensure the comparability and timeliness of information. Quarterly disclosure of all important matters relevant to depositor and other customers is also required under Article 19-5 of the Ordinance of the Enforcement of the Banking Act. Publicly listed banking groups are also required to disclose their financial statements on a timely basis in accordance with rules provided by stock exchanges. The accuracy and reliability of the information are the result of adequate and appropriate record keeping systems to be established by the banks. The FSA is empowered to take the appropriate remedial consequences when banks do not adhere to these requirements.</p> <p>EC 9—The annual and interim report to be disclosed in accordance with Article 21 of the Banking Act, and Article 19-2 of the Ordinance for the Enforcement of the Banking Act stipulates the information to be stated the annual and interim report. These would include financial results such as the balance sheet and income statement, risk management framework and practices, indicators on lending, organization of management and the bank’s legal compliance system. Paragraph 7 of Article 21 of the Banking Act also requires banks to endeavor to disclose information which is useful for depositors and other customers to understand business and financial conditions of the bank and its subsidiaries which could include both quantitative and qualitative information.</p> <p>EC 10—The FSA through their onsite inspections, off site review of the financial disclosures and via the CPAAOB which is the body within the FSA that conducts inspections for the quality of auditing procedures by the external auditors would monitor for compliance with disclosure standards. Failures to comply would result in enforcements actions taken by the FSA and exchanges (where applicable).</p> <p>EC 11—Both the FSA and BOJ publish information regarding the Japanese banking industry which is made available to the public via their websites. These include various indicators and ratios such as capital adequacy ratios, net income information, and nonperforming loan ratios, amongst others. The Japanese Bankers Association would also publish industry information following analysis of the financial results of the industry.</p> <p>AC 1—The FSA relies on its own supervisory personnel to carry onsite and off-site supervision of banks. The FSA has the authority to receive reports on issues identified by the external auditors via banks. The FSA would also engage the external auditors for dialogue to discuss matters relating to the financial results of the bank and adequacy of banks’ internal control systems for financial reporting which is within the</p>
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	<p>scope of audit by the external auditors for listed firms. In addition, the CPAAOB division within the FSA would also conduct regular inspections on the quality of auditing carried out by the audit firms of listed companies. This would mean access to all working papers and documents of the audit firms.</p> <p>AC 2—While external auditors are not legally required to report to bank supervisors their findings during their audits, external auditors are required under Article 397 and 382 of the Companies Act to report misconducts discovered by external auditors to the bank’s internal auditors who would then report these misconducts to directors of the bank. External auditors of banks are required to report misrepresentations in financial statements or breaches in legislations to the FSA if management fails to take remedial actions within two weeks. The FSA has powers to require a bank, via its directors to report these findings discovered during the external auditors’ audits to the FSA. As mentioned in the CP 18, EC 10, auditors who act in good faith and comply with laws or regulations shall not be held liable for breach of duty of confidentiality.</p> <p>AC 3—Tenures of external auditors are determined by the banks. The FSA has some supervisory authority over the external auditors but they are not empowered to require banks to rotate their external auditors or partners responsible for auditing their banks. However, there is a mandatory rotation requirement for auditors of listed and certain large companies every 7 years with a cooling off period of 2 years under the CPA Act and JICPA also requires larger audit firms to follow a 5 year rotation rule with a five year cooling off period for lead engagement partners and quality review partners.</p> <p>AC 4—There is no explicit requirement for unlisted banks to have a formal disclosure policy. More broadly, the FSA Supervisory Guidelines are required to have in place proper policies, procedures and systems over financial reporting and disclosures that are in-line with Japan GAAP and regulatory requirements.</p> <p>AC 5—The FSA is empowered to access the external auditor’s working papers via orders to the banks for submission of materials provided under Article 24 of the Banking Act. In addition, the CPAAOB within the FSA would have access to all working papers of audit firms through making administrative requests when necessary or during their inspections of the audit firms.</p>
Assessment	Largely Compliant
Comments	<p>While there are some legislative powers over external auditors vested with the Prime Minister (delegated to the Commissioner of the FSA) these powers only apply in the limited cases of breaches of the CPA Act or negligence in certifying material misstatements in the financial statements. While there is a mandatory requirement for auditors of listed firms to rotate every seven years (or every five years for larger audit firms), banking authorities have no direct powers to reject or rescind the appointment of an external auditor although they could make suggestions to the bank to do so. Banking authorities’ supervisory powers should not only apply in instances when clear malpractice had taken place but should be more wide ranging to allow banking authorities to take all necessary supervisory actions against external auditors on a timely basis including prompt rotation of auditors should there be issues over the independence or quality of auditing standards by a specific audit firm or audit partner in charge of specific bank audits.</p> <p>The regulatory financial reporting standards require the reporting of profits net of provisions for loan losses. However, recent government measures taken to facilitate financing for small and medium-sized enterprises (SMEs), have required banks to endeavor to restructure loan terms to facilitate financing and ease the debt burdens for SMEs when requested by the SMEs. The FSA has been required, since the announcement of this measure, to assess the efforts of financial institutions in</p>

	<p>providing enhanced financing and support for the business improvement of SMEs. This requires careful balancing with the FSA’s prudential objective of ensuring the appropriateness of classifications and provisioning of these restructured loans. Banks are required to submit a quarterly summary report to the FSA of overall loan migration following restructuring. However, the assessors have noted that the actual practices for classifications and provisioning for such restructured loans vary much from bank to bank. These issues on appropriate loan classifications, provisioning and disclosures may have a significant potential impact on bank’s loan portfolios.</p> <p>In addition, as discussed under Principle 6 and 16, the government measure to relax the capital adequacy requirement for banks where for accounting purposes, MTM on “available for sale securities” such as bonds and equity holdings in the banking book under local accounting rules are required to be realized only when a loss of 50 percent suffered, could distort the true value of CAR at banks. While the assessors have noted that banks disclose the unrealized MTM gains or losses in their publication of financial statements, the deferred realization of losses based on a 50 percent threshold is not in-line with international accounting standards.</p> <p>Many countries provide for a statutory obligation on the external auditors of banks to promptly inform the bank supervisor should they encounter any issues during the course of the audit work which could potentially represent a risk to the safety and soundness of the bank. While Article 193-3 of the Financial Instruments and Exchange Act requires external auditors to report findings to the FSA that are in relation to violation of laws and regulations or which would result in material misstatements in the financial statements by banks in cases where these violations were not rectified after two weeks, the authorities should consider the merits of introducing a more prompt reporting regime for the reporting of external auditors directly to bank supervisors of all significant findings that could significantly impact the bank and not only restricted to cases arising from violations of laws and regulations and financial statement misstatements and should also include reporting to the FSA issues that had been subsequently rectified by the bank.</p>
Principle 23.	Corrective and remedial powers of supervisors. Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking license or to recommend its revocation.
Description	<p>EC 1—The FSA identifies problems via both onsite inspections and off-site monitoring. Banks that are highlighted via “red flags” in the FSA’s off-site early warning system would be subject to follow up interviews by the FSA and may be required to provide additional information to the FSA on the reasons for the various red flags and plans for possible remedial actions. Bank management could also be requested to promptly address supervisory concerns at an early stage through dialogues held with the FSA in accordance with the Supervisory Guidelines. In addition, issues identified during onsite inspections and informed to the banks via the inspection reports issued by the FSA would require formal responses from the bank on analysis, improvement and rectification efforts undertaken by the banks within a month of the issuance of the report. The FSA also has the powers to and may require a bank or its subsidiaries or outsourced entities to submit reports or materials concerning the status of the business or property of the bank based on Article 24 of the Banking Act, when the FSA finds it necessary for ensuring sound and appropriate management of the business of the bank. The FSA may also request banks to submit or amend its business improvement plan for ensuring soundness of bank’s management in accordance with Article 26 of the Banking Act. The FSA will also follow up on the actions taken by the bank for business improvement for sufficiency via off-site monitoring or further ad-hoc inspections if required. The FSA has the equivalent power to bank holding companies</p>

as referred in the descriptions on Principle 24.

EC 2—Based on paragraph 1, Article 74, of the Deposit Insurance Act, the FSA may order a financial institution to appoint a financial reorganization administrator to control its business operations and assets in certain circumstance such as when a bank is unable to repay its debt or is likely to restrict withdrawal of deposits due to its business and financial conditions. Based on Article 74-2 of the Deposit Insurance Act, the Prime Minister may order a financial institution to name a financial reorganization administrator to control its business operations and assets. In practice, Deposit Insurance Corporation will be appointed as a financial reorganization administrator, and it is understood that the Commissioner of the FSA has the power to supervise the administrator. Generally, the financial reorganization administrator has the exclusive authorities to represent a financial institution under conservation, execute its businesses and manage or dispose its assets (as provided under paragraph 1, Article 77 of the Deposit Insurance Act). A financial institution under conservation may transfer all or a significant portion of its businesses, reduce the amount of its capital or dissolve itself without a resolution of the shareholders meeting when it is permitted by the court. With regard to BOJ, its main role in bank resolution is limited to temporary loans to Deposit Insurance Corporation with the government guarantee (i.e., it does not bear the cost of failed-bank resolution under the deposit insurance system.

EC 3—The FSA has a range of supervisory tools and powers to take measures against banks which are in violation of laws, regulations and supervisory guidelines or are engaging in unsafe or unsound business practices. The range of measures taken against banks would depend on the severity and gravity of the situations and could include an order to the banks to submit additional reports or material, carry out onsite inspections. The FSA may request banks to submit a business improvement plan for ensuring soundness in management of the bank and order the change of the improvement plan submitted or order suspension of all or part of the bank's business, when the FSA finds it necessary for ensuring sound and appropriate management of the business of a bank in light of status of the business or properties of the bank and its subsidiary companies, etc. in accordance with Article 26 of the Banking Act. The FSA may also order a bank to suspend the whole or part of its business or to dismiss its director, executive officer, accounting advisor, or company auditor, or rescind the license in accordance with Article 27 of the Banking Act, when a bank has violated any laws, regulations, its Articles of incorporation or has acted to harm the public interest.

EC 4—Possible measures include ordering the submission of improvement plans, temporary or permanent suspension of the whole or part of the existing business or new business, orders prohibiting or restraining the bank from remunerating directors, company auditors and/or executive officers, dismissing directors, executive officers, and company auditors, orders for the implementation of measures such as raising capital, closing significant part of business, merger with another bank, exiting from the banking business or revoking bank licenses. Common measures taken by the FSA are improvement plans to address deficiencies in controls or senior management oversight.

EC 5—When a bank's capital adequacy ratios falls below the minimum requirement level, the FSA may order the bank to undertake actions depending on its capital adequacy ratios in accordance to the FSA' Prompt Corrective Action System (PCA) as provided under Article 26-2 of the Banking Act and corresponding Order. Actions could include an order prohibiting or restraining banks from remunerating directors, company auditors and/or executive officers, an order for the implementation of optional measures such as raising capital, closing significant part of business, merger with another bank, or exiting the banking business or in more severe cases, an order to suspend the whole or part of the business. However, the effectiveness of the current

PCA system based on its current threshold levels of capital adequacy is questionable. Specifically, in case of an internationally active bank, if the ratio falls below minimum 8 percent but remains above 4 percent, the FSA will require the bank to submit and implement a restructuring plan that is aimed at bringing the capital levels within one year to a level above 8 percent. Banks with capital ratios between 4 percent to less than 8 percent could still pay out dividend and executive compensation, as long as this a capital restructuring plan is submitted and assessed by the FSA on its viability. In case the capital level falls below 4 percent above 2 percent, the PCA allows for additional measures to be taken including restrictions on dividends and executive compensation, on the amount of total assets, and on interests and other terms of deposits. Branches could also be closed, business activities could be curtailed and 'other' necessary actions could be taken. When the capital adequacy ratio fall below 2 percent but above 0 percent, additional measures that could be taken include an increase of capital, a substantial curtailment of business, a merger or discontinuance of banking business. Below 0 percent, the additional measure provided for under the PCA is suspension of all or part of the business. Please also refer to discussion under Principle 6 on the current PCA system and impact on capital adequacy requirements. However, the assessors were provided with statistics on the FSA's discussions with regional banks arising from supervisory concerns that had resulted in decisions taken by regional banks such as capital raisings since April 2011 as evidence of proactive intervention notwithstanding the low PCA triggers currently in place.

EC 6—Violations or breaches of the Banking Act could result in penalties and actions taken against bank staff (including directors, executive officers, accounting advisors and company auditors) and a bank itself in accordance with Article 61 to 67 of the Banking Act. These could include imprisonments, fines or both depending on the severity of the violations or breaches. Article 27 of the Banking Act also empowers the FSA to order the dismissal of a director, executive officer, accounting advisor and auditor when they violate laws, terms of incorporation and administrative orders. It was noted that the enforceability of the Supervisory Guidelines and Inspection Manual, which are not legally binding on banks but which banks are expected to adhere to, would be via administrative actions issued by the FSA under, especially Article 24 and 26 of the Banking Act. Business improvement orders issued by the FSA under Article 26 of the Banking Act and not adequately addressed by the bank would be considered a breach of the Banking Act and could subject the bank to non-criminal offence such as fines. In practice, the FSA would generally rely on the issuance of improvement orders and suspension of businesses via Article 26 of the Banking Act to enforce supervisory requirements and not frequently impose penalties such as fines. Criminal offences related to violations of the Banking Act would result in criminal proceedings and potentially enforcement actions such as fines, imprisonments or both.

AC 1—The FSA's Supervisory Guideline specifies the standard processing period for administrative actions. Business improvement orders or temporal suspension orders under paragraph 1, Article 26 of Banking Act, and business suspension orders or revokes of licenses under Article 27 of the Act should generally be carried out within one month after receipt of the reports requested under Article 24 of the Banking Act or receipt of reports on misconducts from banks.

AC 2—The FSA's range of supervisory measures provided under the Banking Act would naturally include orders to ring fence banks against activities which may negatively affect the safety and soundness of banks.

AC 3—Banking supervisory divisions of the FSA will coordinate with other divisions in charge of other financial sectors including securities, insurance and moneylenders before taking administrative actions in accordance with Article 26 and 52-33 of the Banking Act. For administrative measures that could negatively affect the stability of the financial system, Article 57-5 of Banking Act stipulates consultation with Minister of

	Finance prior to the administrative measures being taken.
Assessment	Largely Compliant
Comments	<p>PCA triggers are currently set too low although in practice the assessors understand from the FSA that this may not restrict the FSA from taking other supervisory actions where necessary. For instance supervisory actions will be taken following triggers from the FSA's offsite early warning system or onsite inspection findings. Nevertheless, the FSA should review its current PCA to reflect more realistic triggers points.</p> <p>The FSA has a range of supervisory tools and powers to take measures against banks which are in violation of laws, regulations or are engaging in unsafe or unsound business practices. However in practice, the FSA would generally rely on the powers under Articles 24 and 26 of the Banking Act, which are known as "administrative actions" when taking action against banks which are in violation of laws, regulations or are engaging in unsafe or unsound business practices. These would usually take the form of business improvement orders and suspension of businesses. While there are no specific conditions existing that could narrow the powers of the supervisor mentioned under the Articles 24 and 26, such administrative actions could potentially result in delays in remedial actions. In addition, as discussed under Principle 6, Principle 16 and Principle 22, the government measures in place to relax the capital adequacy requirement for banks relating to the delayed realization of MTM losses on "available for sale securities" in the banking book, further raises concerns over the overall effectiveness of the FSA's enforcement approach.</p> <p>The assessors have observed that the FSA was perceived by the industry as a relatively "strict" supervisor, with proactive intervention generally taking place following the activation of various triggers including the FSA's offsite early warning indicators or findings from onsite inspections that could result in discussions with banks, and pressure to correct risk management practices, exposures or increase capital without the use of formal remedial and corrective actions. The assessors were also provided with the list of administrative actions taken by the FSA on banks for the past years and have noted that these were relatively considerable. In terms of proactive intervention, the assessors were also provided with statistics on the FSA's discussions with regional banks arising from supervisory concerns that had resulted in decisions taken by regional banks on especially capital raisings since April 2011.</p> <p>Intervention efforts of the FSA could be further enhanced through the greater use of more direct supervisory tools such as its powers to directly impose prudential limits, thresholds on banks or across the banking sector, which were seldom or never used. From the perspective of a penalty framework, the FSA could also consider establishing a more comprehensive and granular penalty framework commensurate with severity of offences could also enable the FSA to streamline the process of dealing with offences committed by banks, serve as a deterrent measure for future offences by banks and enable the FSA to adopt a more progressive approach to enforcement in-line with current best practices.</p>
Principle 24.	Consolidated supervision. An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.
Description	EC 1—The FSA is responsible for the consolidated supervision of banks and banking groups. Banks and banking groups are required to provide regulatory reporting to the FSA on both a solo as well as consolidated level on their solvency, earnings, adequacy of risk management and outsourcing. During the licensing stage as well as during ongoing supervision, the FSA would collect all relevant information regarding

banks and banking groups, to understand and assess the status of their business operations and organizational structures.

EC 2—Article 24 and 25 of the Banking Act empowers the FSA to issue orders for submission of information and conduct inspections on both banks and its subsidiaries both locally and cross border. Article 52-31 and 52-32 of the Banking Act provides the FSA with similar powers over subsidiaries of a bank holding company and the bank holding company itself. The FSA cooperates with other authorities such as BOJ and exchanges information on onsite and off-site risk assessments to carry out effective supervision. However Article 24-3, 25-5, 52-31(3) and 52-32(5), provide that subsidiaries of the bank or subsidiaries of the banking holding company may refuse to submit report or materials requested by the FSA if there are justifiable grounds. The FSA indicated that justifiable grounds assume a situation where the FSA requests them for other than supervisory purposes. The provisions may hamper effectiveness of consolidated supervision if the subsidiaries were to take advantage of such provisions. The FSA has indicated that subsidiaries have never made use of this provision to refuse submitting information. It also put forward that in case such a situation would occur, the FSA would continue to access the entity and impose penalties on it.

EC 3—The FSA requires banks and banking groups to establish effective and appropriate risk management frameworks on both solo and consolidated basis and must take into account all material risks including those of non-banking businesses within the group that are significant to the bank and banking groups. The activities a bank may undertake are specifically mentioned in law. Other activities may not be conducted. Generally the FSA is strict about banking groups conducting only permissible activities. However, the authorities have also recognized that major financial groups are engaging in active expansion of their operations to non-banking activities and overseas businesses to increase profitability given the slow economic growth in Japan. The FSA established the “Supervisory Planning Room” two years ago with dedicated FSA staff responsible for supervising group wide risks in the three mega banking groups. These would include attendance at quarterly meetings with the groups’ non-banking entities supervised by other divisions in the FSA as well as meetings organized by the offsite review teams. Analysis of financial, strategic, risk and governance impact of non-banking businesses on the group (including changes such as subsidiarization) would also be the responsibility of this team. Risk management systems of banks and banking groups would have to be adjusted correspondingly to recognize the new risks and mitigate them accordingly. The FSA’s focus in the current year had therefore been on the adequacy of corporate governance and comprehensiveness of the enterprise wide risk management systems, particularly when addressing new and emerging risks from subsidiaries with different business models, across different cultures and new industries. The authorities are attempting to and will have to remain vigilant to cross-institutional spillovers, and the possibility that conglomerates adopt legal forms that hinder effective supervision and resolution.

EC 4—Article 14-2 and 52-25 of the Banking Act empowers the FSA to impose prudential standards to ensure the safety and soundness of banks and banking holding companies. These are monitored via regular regulatory returns submitted to the FSA on both a solo and consolidated basis. Capital adequacy standards are applied on both solo and consolidated basis together with large exposure limits.

EC 5—Information sharing with foreign banking supervisors are generally carried out via Supervisory Colleges hosted by the FSA (together with BOJ) for the three major banking groups as well as at bilateral, international meetings or visits by foreign supervisors. Exchanges on areas of supervisory focus would be carried out during the FSA’s visit to branches or subsidiaries of Japanese banks located outside Japan. The FSA had signed EOL with several supervisors which provide an understanding on the

exchange of information between two supervisors for supervisory purposes and in accordance with domestic laws.

Domestically, the FSA cooperates with BOJ in a variety of ways including the regular exchange of information regarding plans to conduct onsite inspections, regular and ad-hoc communication at staff and senior levels (ranging from division chief and directors to executive directors), and exchange of contact details at several levels within the two organizations to allow for contact during exigencies. The FSA is also empowered to request BOJ to submit documents describing the results of BOJ's on-site examinations and other related materials (Article 44 of the Bank of Japan Act). The FSA is not prohibited from sharing information it gathers from BOJ's onsite and off-site activities with foreign regulators for supervisory purposes or other legitimate reasons. Information sharing with foreign supervisors could be initiated by either BOJ or the FSA.

EC 6—Banking Act stipulates the list of permissible activities that banks, bank holding companies and subsidiaries may conduct to avoid contagion exposures arising from non financial activities carried out within the bank group. (Article 10, 11, 12, 16-2, 52-21, 52-23 of Banking Act). Approvals to establish a foreign branch or subsidiary requires approval under Article 16-2 and 8 of the Banking Act. In addition, as mentioned in Principles 3, 23, and 25, the FSA is empowered to undertake remedial measures to limit the activities that the bank may conduct as well as the locations where these activities may be conducted. These include powers to order a bank to downsize activities conducted by subsidiaries or sell shares of the subsidiaries when banks fall short of the minimum required capital ratios prescribed by the authorities. In reality, decisions to downsize had been taken by banks themselves based on internal risk and capital adequacy considerations without the FSA being required to take supervisory actions.

EC 7—An assessment of the bank's integrated risk management system to monitor and control domestic and cross border operations is undertaken by the FSA as a fundamental evaluation of the bank's corporate governance and internal control functions carried out largely via its onsite inspections. The FSA will also assess the quality of bank's management of their foreign branches and subsidiaries via information exchange and communication with foreign supervisors. The FSA will request for inspection reports conducted by foreign supervisors on the bank's foreign operations and reports on misconducts submitted to foreign supervisors.

EC 8—Banks and holding companies intending to establish a new foreign branch or subsidiary must be approved by the FSA. In reviewing the application, the FSA will assess to determine no hindrance by the host country in allowing the applicant bank from accessing any information of the subsidiary or the branch and carry out appropriate monitoring where necessary. Banks and holding companies are also required to provide the FSA with information regarding their foreign operations and other information that supervisors deem necessary to determine compliance with relevant laws and regulations. The FSA would evaluate the quality and effectiveness of the bank and bank group's integrated risk management system in monitoring and controlling domestic and cross border operations.

EC 9—Article 26 of the Banking Act empowers the FSA to require a bank to suspend a part of its businesses including foreign businesses when the FSA finds it necessary to ensure the safety and soundness of the bank's business. A situation where the FSA necessary information for consolidated supervision is not forthcoming may result in the FSA taking a variety of remedial measures under Article 26 of the Banking Act.

EC 10—The evaluation of a bank and bank group's integrated risk management

	<p>practices across the local and overseas entities is carried out by the FSA as part of its supervisory oversight and monitoring of banks. These may include onsite inspections and reviewing inspection reports from foreign supervisors.</p> <p>AC 1—The FSA is empowered to review the activities of the holding company and affiliated entities and evaluate the suitability of owners and senior management of these companies. Approval from the FSA for the establishment of bank holding companies is required and the FSA would be able to assess the suitability of the parent company during the approval process.</p> <p>AC 2—When processing the application by banks to establish a new foreign bank branch or subsidiary, the FSA will assess the quality of the host country’s supervision in accordance with paragraph 2, Article 17-5 and paragraph 2, Article 9-2 of the Ordinance of Enforcement for the Banking Act. Once operations are established, informal evaluation is carried out through ongoing communications with the foreign supervisors, onsite and off-site evaluation of the foreign operations.</p> <p>AC 3—The FSA deploys its inspectors to jurisdictions with major operations by Japanese banks including U.S., U.K., Hong Kong, and Singapore. Those examiners will visit foreign branches or subsidiaries of Japanese banks in an appropriate frequency and engage with the host country’s supervisors for information sharing and exchange of supervisory views and issues.</p>
Assessment	Largely Compliant
Comments	<p>Articles 24-3, 52-31(3), 25-5 and 52-32 (5) of the Banking Act state that subsidiaries of the bank or subsidiaries of the banking holding company may refuse to submit report or materials requested by the FSA or to allow on-site investigation if there are justifiable grounds. However, the FSA explained to the assessors that the background to this Article was based on the nature of the Japanese administrative investigation system to ensure that access to information by the FSA at nonbank entities was for the purpose of banking supervision and not for investigations of other nature such as tax evasion. While the FSA has never had such a request refused, the provisions may hamper effectiveness of consolidated supervision in the future if the subsidiaries take advantage of such provisions. It is therefore recommended to reduce the legal uncertainty that may arise due to the provision in question, for instance by providing a legal opinion.</p>
Principle 25.	<p>Home-host relationships. Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.</p>
Description	<p>EC 1—The FSA have ongoing contact with supervisors in other countries in which Japanese banks have material operations, including periodic visits to foreign supervisory authorities to discuss supervisory issues. Information sharing between home and host supervisors involves sharing significant supervisory concerns during bilateral meetings, participating in regional and international meetings; discussing and coordinating supervisory issues and actions and participating in supervisory colleges. The FSA’s Comprehensive Supervisory Guideline recognizes the increasing need of strong coordinated work among supervisors considering the increased globalization of banking operations and development of financial conglomerates.</p> <p>EC 2—Identification of relevant supervisors is carried out when approving the banks’ applications to establish an overseas branch or subsidiary. Arrangements for the sharing of information regarding the banks’ operations in the home and host countries</p>

would generally be established then. While these would consist mostly via informal peer to peer contact arrangements, the FSA would also sign EOL with other supervisors when requested. Currently Japan has signed more than six EOL with various regulators. EOLs could vary in the form and format but would generally provide an understanding allowing the exchange of information between two supervisors for supervisory purposes in accordance with domestic laws. For instance, an EOL would generally include the agreement to cooperate on the supervision of financial institutions operating in each others' jurisdiction, allowing the sharing of information with host supervisors to the full extent reasonable and subject to statutory provisions, agreement to inform the respective supervisors of examinations, and confirm that the information obtained in the course of examinations on banks or meetings between the authorities shall be treated as confidential and used solely for supervisory purposes. The FSA is prohibited under law to exchange information for other than supervisory purposes under Article 100 of the National Public Service Act. Japan has recently, following the discussion at FSB, decided to sign institution specific formal arrangements on information sharing for the global systemically important financial institutions (G-SIFIs) in Japan by end of 2012 but has not signed any other agreements on an institution specific basis to date. Instead it has stepped up on its hosting of supervisory colleges for its major banks, held annually, to establish a formalized platform for multilateral information sharing amongst the home and host supervisors for jurisdictions where the Japanese banks have major operations. Information discussed during supervisory colleges include sharing of supervisory issues, results of on-site inspections, crisis management plans, business strategies and challenges and other topics of interest regarding the major bank groups. Information sharing via peer-to-peer contact is the most commonly used form of ongoing dialogue currently used.

EC 3—The FSA provides the necessary information to host supervisors. Inspection findings following onsite inspections conducted by FSA in the host jurisdictions would be shared, generally verbally with host supervisors, although if requested, reports in writing would also be provided to the host supervisors. Information such as overall supervisory frameworks, supervisory issues are shared with host supervisors during supervisory colleges. As appropriate, there is also cooperation during the licensing process, in the supervision of ongoing supervision and when dealing with enforcement issues or other problems occurring in both the home jurisdictions or at the foreign operations of the bank. Apart from the instances above, in practice, information sharing would generally arise more often based on requests from the host supervisors. The FSA would inform host supervisors on issues or problems which may have a material effect on the subsidiaries or branches in the host country if requested or asked by the host supervisors. For instance, during the March 2011 earthquake, formal letters which provided some general information about the banking sector in Japan were provided to foreign supervisors. More bank specific information was provided verbally during calls from foreign supervisors to the FSA.

EC 4—The FSA identifies all other relevant supervisors and provides/exchanges information when necessary. These include providing information to the home country supervisor in cases where a foreign bank which operates in Japan violates laws or regulations, or engaged in undesirable business practices, and share the result and findings of the onsite inspections of a foreign bank operating in Japan. As home supervisor, the FSA would invite participation by host supervisors to the FSA's hosted supervisory colleges held for the large Japanese banking groups and would also attend supervisory colleges of foreign banking groups whose operations in Japan is significant. The FSA would also attempt to inform the home country's supervisor of details or violation of laws or regulations by foreign banks operating in Japan and provide the home country supervisors with a copy of the press release prior to its publication.

	<p>EC 5—Article 47 and 48 of the Banking Act subject branches and banking subsidiaries of foreign banks operating in Japan to the same reporting and inspection requirements as Japanese banks.</p> <p>EC 6—The FSA requires a no objection letter issued by the foreign supervisor to the FSA before an approval of a banking license can be issued to the applicant bank. For foreign banks, the FSA must be satisfied that the bank and its foreign parent is subject to global consolidated supervision by its home country supervision. This is assessed at application stage as well as on an ongoing basis via calls and meetings with the major foreign supervisors as well as off site assessment of inspection and overall quality of supervision.</p> <p>EC 7—The FSA does not prohibit or restrict the access of home country supervisors to conduct onsite inspections at local offices and subsidiaries of foreign banking groups but would require advance notification from the home country supervisor. Access to client accounts would also not be restricted.</p> <p>EC 8—The establishment of any “shell bank” is prohibited in Japan and the assessors were informed that there are no banks operating as “booking offices” in Japan.</p> <p>EC 9—When supervisory action is planned for a specific bank, the FSA will attempt to exchange the necessary information and views with the foreign supervisor prior to taking action. However, this is generally carried out to the extent that the foreign supervisor will not interfere with the immediate action planned to be taken by the FSA on the bank.</p> <p>AC 1—The FSA establishes its communication strategies with foreign counterparts largely through informal peer to peer sharing, onsite visits as well as the more formal supervisory colleges. The scope and nature of these communication strategies reflect the size and complexity of the relevant cross-border operations.</p>
Assessment	Largely Compliant
Comments	<p>From our discussions with industry participants, there is an increasing expectation by the industry for the FSA to have close and regular contact with all overseas supervisors to ensure consistency in practices globally and facilitate the resolution of cross border issues.</p> <p>Some progress in the cooperation and information sharing between the FSA and other home and host supervisors had been observed through various channels such as the EOL with overseas supervisors and the holding of annual supervisory colleges for the major bank groups. Frequency of supervisory colleges held and quality of information shared during these colleges appear to be sufficient although there is room to continue enhancing coordination and cooperation with regards to cross border crisis and resolution situations. There also exists sufficient informal channels for sharing of necessary information on urgent or necessary basis although it was noted that during the March earthquake these were more responses by the FSA to requests from host supervisors likely attributable to the FSA being busy handling the unprecedented crisis. The assessors were also informed that Japan has decided to sign institution specific formal arrangements on information sharing for the G-SIFIs by the end of 2012 following the discussion at FSB. Based on feedback from banks as well as other host and home supervisors, there is a room for the FSA continue enhancing its home/host relationships with foreign supervisors in terms of more proactive sharing of information on an ongoing basis. This could take place through the proactive sharing of information with foreign supervisors on issues or problems which may have a material effect on the subsidiaries or branches in the host country and engage</p>

	<p>proactively in coordinated, effective and timely sharing of other relevant information on a regular basis (and not only on a needs to basis). This will strengthen the FSA's ability to anticipate and deal with crisis situations and potentially any bank resolution situations through gaining timely insights into head office, branches and subsidiaries profiles and crisis management/resolution plans. In addition, the FSA should continue in its efforts to sign more formalized arrangements including bilateral or multilateral MOUs with more foreign supervisors.</p>
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