



# JAPAN

## FINANCIAL SECTOR ASSESSMENT PROGRAM

### DETAILED ASSESSMENT OF OBSERVANCE ON BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

September 2017

This Detailed Assessment of Observance on the Basel Core Principles for Effective Banking Supervision on Japan was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed on September 2017.

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September 2017

# DETAILED ASSESSMENT OF OBSERVANCE

## BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

Prepared By  
**Monetary and Capital  
Markets Department**

This Detailed Assessment Report was prepared in the context of an IMF Financial Sector Assessment Program (FSAP) mission in Japan during December 2016, led by Mr. Gaston Gelos, IMF and overseen by the Monetary and Capital Markets Department, IMF. Further information on the FSAP program can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>

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## Glossary

AFS	Available for sale
AMA	Advanced Measurement Approach
AML/CFT	Anti-money laundering/Combating the financing of terrorism
APTC	Act on Prevention of Transfer of Criminal Proceeds
BCBS	Basel Committee on Banking Supervision
BCPs	Basel Core Principles for Effective Banking Supervision
BoJ	Bank of Japan
BRC	Board Risk Committee
CDD	Customer Due Diligence
CET1	Common Equity Tier 1
CMG	Crisis management group
CRO	Chief Risk Officer
DICJ	Deposit Insurance Corporation of Japan
D-SIB	Domestic Systemically Important Bank
EIC	Examiner in charge
EoL	Exchange of Letters
EU	European Union
F&P	Fit and Proper
FIU	Financial Intelligence unit
FSAP	Financial Sector Assessment Program
FX	Foreign exchange
GAAP	Japanese Generally Accepted Accounting Principles
GDP	Gross Domestic Product
G-SIB	Global Systemically Important Bank
HQLA	high quality liquid assets
JFSA	Japanese Financial Services Agency
JGB	Japanese Government Bonds
LCR	Liquidity Coverage Ratio
LRM	Liquidity risk management
LE	Large exposure
ICAAP	Internal Capital Adequacy Assessment Program
IFRS	International Financial Reporting Standards
IRB	Internal ratings-based
IRRBB	Interest rate risk in the banking book
IRS	Interest rate swaps
IT	Information technology
KA	Key Attributes
KYC	Know your client
LCR	Liquidity Coverage Ratio
MoF	Ministry of Finance

## JAPAN

MoU	Memorandum of Understanding
NIM	Net interest margin
NIRP	Negative interest rate policy
NPL	Nonperforming Loan
NSFR	Net Stable Funding Ratio
PCA	Prompt Corrective Action
RAF	Risk appetite framework
RAS	Risk appetite statement
RWA	Risk-weighted assets
SME	Small- and Medium-sized Enterprise
SREP	Supervisory Review and Evaluation Program
STRs	Suspicious Transaction Reports
U.S.	United States
VaR	Value at Risk

## SUMMARY AND MAIN FINDINGS<sup>1</sup>

- 1. Banking regulations and supervisory processes have undergone significant improvements since the last Financial Sector Assessment Program (FSAP).** The Japan Financial Services Agency (JFSA) is in the process of reforming its supervisory practices and has been shifting its focus from assessing compliance with prudential requirements to a more sophisticated and forward-looking risk-based approach to supervising banks and bank holding companies. Its prudential requirements have also continued to evolve in line with international trends. Capital, liquidity and disclosure requirements have been updated to incorporate the Basel III reforms agreed by the Basel Committee in accordance with the internationally agreed timelines. Corporate governance expectations have also been strengthened with the implementation of Japan's Stewardship Code and Corporate Governance Code designed to strengthen corporate governance in the corporate and financial sectors. Japanese agencies have also deepened their working relationships among themselves and with their foreign counterparts.
- 2. While the supervisory framework is generally sound, some key priority areas need to be addressed.** The approach to supervision by the JFSA is evolving and it needs to take some steps to further develop its processes so that it can respond nimbly and proactively to emerging issues. A confluence of low rates and slow credit growth in Japan has been accompanied by growing offshore lending, especially by the megabanks, resulting in a greater reliance on wholesale foreign currency funding. Moreover, the long-term sustainability of regional and *Shinkin* bank business models is under pressure. Against this backdrop, there are three main priority areas going forward: (i) enhancing the ability of the JFSA to use capital requirements to promote more robust capital planning and risk management practices; (ii) further strengthening corporate governance and risk management practices at banks; and (iii) introducing a more rigorous risk assessment process and a risk tolerance framework to support a more fully risk-based approach to supervision.
- 3. Capital requirements need to be more tailored to individual bank risk profiles.** The JFSA would benefit from a residual power to set Pillar 2 capital requirements for individual banks on the basis of their specific risk profiles to respond more dynamically to emerging issues confronting individual banks. This would also facilitate a better integration of capital requirements with the Supervisory Review and Evaluation Process (SREP) and the supervisory rating system. The JFSA is also encouraged to work with regional and *Shinkin* banks to ensure that dividends and other capital distributions can be constrained before bank capital ratios fall below minimum requirements.
- 4. Corporate governance and risk management remains an area that needs further work to strengthen independence of boards.** Under the oversight of the Japan Government, much work has been dedicated to improving the corporate governance framework for commercial enterprises including financial institutions. Nevertheless, further work is needed to help embed better practices across the banking sector in an effort to drive cultural change.

<sup>1</sup> This Detailed Assessment Report has been prepared by Christopher Wilson (Monetary and Capital Markets Department, IMF) and Mark Zelmer (IMF external expert and former Deputy Superintendent of Financial Institutions, OSFI Canada).

Importantly, greater attention is needed to help boards of directors effectively oversee management and help ensure appropriate checks and balances are functioning. Further work in the area of risk management is also needed to strengthen the independence of the risk management and internal control functions and provide them with clearer reporting lines to the board.

**5. While supervision processes have been strengthened, internal processes need to be further developed to support the transition to a full risk-based approach.** Designating some banks as systemically important has helped lay the foundation for more risk-based supervision. But the risk rating methodology needs to be further developed so that the risk profile of individual banks can be delineated across the spectrum of risk categories (e.g., credit, market, operational risk and AML/CFT vulnerabilities) while taking into account their financial condition, governance and risk management capacity. The JFSA also needs to flesh out its risk tolerances for failure across different types of banks and calibrate them to bank systemic importance. That way the combination of bank risk ratings and risk tolerances can then be used to guide the supervisory intensity, including an effective allocation of supervisory resources.

**6. A stronger principle-based approach to related party exposures is required to prevent risks from building up.** ‘Exposures to related parties’ are required to be conducted at ‘arms-length’ terms. These exposures by their nature deserve enhanced risk management over and beyond standard credit underwriting processes. However, specific limits have not been set by either banks or the JFSA beyond those that already exist in the context of the large exposure rules. While the JFSA takes them into account in its periodic compliance inspections, the supervision of these activities would benefit from more specific periodic reporting requirements and more proactive investigations that are less reliant on signals received from internal audit.

## A. Main Findings

### Responsibility, Objectives, Powers, Independence, Accountability (CPs 1–2)

**7. The legal framework for banking supervision is well established in Japanese laws, regulations, and supervisory guidance.** The legal framework and supporting regulations and guidance are comprehensive, with clear roles and responsibilities assigned to the different agencies, plus a suite of powers that enables supervisors to effectively oversee the banking system. The three mandates—to promote the stability of the financial system, to protect depositors, policyholders, securities holders, and to facilitate finance—assigned to the JFSA are complementary. Depositor protection and financial stability more generally are most likely to be achieved if the JFSA ensures that banks have capital and risk management practices commensurate with the risks they undertake and the environment in which they operate. In turn, this will promote a strong banking system that can contribute to the economic well-being of Japanese society by facilitating finance in the economy.

**8. Most of the mechanisms are in place to allow banking supervision to be conducted with operational independence.** However, the statutory provisions governing the removal of a JFSA Commissioner from office could be tightened up. In addition, while the JFSA budget has been stable in recent years, looking down the road there is a risk that the funding model for the JFSA may become less robust over time if the financial sector continues to expand in a period of

public sector fiscal restraint. Consequently, the authorities may wish to consider whether a different funding model might make sense over the longer run.

### **Ownership, Licensing, and Structure (CPs 4–7)**

**9. The requirements governing licensing, ownership and major acquisitions are broadly well established.** Some enhancements could be introduced at the margin to tighten up the licensing process, give the JFSA the opportunity to pre-approve majority voting interests in banks beyond the major shareholder threshold, and provide the JFSA with stronger powers to review investments by banks in other institutions.

### **Methods of Ongoing Supervision (CPs 8–10)**

**10. Supervision has been strengthened since the last FSAP, but further development of the risk rating methodology is needed.** While the onsite and offsite supervisory processes are relatively sound, the analytical risk framework needs to be further developed to assess the risk profile of banks and banking groups on a more comprehensive and systematic basis. Importantly, this risk rating methodology would help foster further integration of offsite and onsite processes. While the JFSA has made progress in this regard, such as the establishment of a D-SIB and G-SIB framework, elements remain a work in progress and should be completed to support the move to risk-based supervision.

**11. Planning and coordination for supervisory tasks could be improved further.** The JFSA is in the process of adjusting its mix of offsite and onsite activities. For the megabanks and the two major trading banks this is reflected in the integrated approach to supervision where regular monitoring is complemented with periodic interviews of senior management and the use of thematic reviews. This process is planned to be rolled out to the larger Regional and smaller banks over the next few years. In the meantime, the approach for Regional/*Shinkin* banks has moved away from annual onsite inspections. Greater emphasis on planning is needed to help allocate resources across banks and across supervision activities e.g., onsite and offsite.

### **Corrective and Sanctioning Powers of Supervisors (CP 11)**

**12. While the JFSA has the necessary powers to take measures against banks, greater willingness to exercise these powers is needed.** The JFSA has a range of supervisory tools and powers to take measures against banks that are in violation of laws and regulations, or are engaging in unsafe or unsound business practices. However, in practice, the JFSA generally uses non-binding measures (ex. suasion) to correct bank behavior, which may result in delays in remedial actions if consensus is not quickly forthcoming. Prompt Corrective Action (PCA) triggers should be recalibrated to grant the JFSA sufficient flexibility to intervene and act promptly in response to emerging risks. The authorities may also wish to consider strengthening inter-agency coordination for crisis management and crisis preparedness.

### **Cooperation, Consolidated, and Cross-Border Banking Supervision (CPs 3–12–13)**

**13. Significant progress has been achieved in enhancing the oversight of banking groups on a consolidated basis, and in deepening relationships among domestic agencies and between those agencies and their foreign counterparts.** Japanese authorities have been

able to supervise banks and bank holding companies on both a consolidated and unconsolidated or solo basis. Recent legislative changes have given banking supervisors more powers to review the activities of holding companies and related entities and to evaluate the suitability of senior management and owners of those companies. The Bank of Japan (BoJ) and JFSA have also taken steps to enhance their working relationships to better understand financial sector developments and their implications for banking supervision. Deeper relationships have also been formed with foreign supervisory agencies with the signing of new memorandum of understandings (MoUs) and exchange of letters (EoLs), and especially with the formation of Crisis Management Groups for the three major Japanese banks that have been designated as global systemically-important banks.

### **Corporate Governance (CP 14)**

**14. Initiatives to improve corporate governance standards in Japan have commenced; nonetheless, higher standards are needed for banks given the global importance of Japan’s banking system.** Under the oversight of the Japan Government, much work has been dedicated to improving the framework for corporate governance for commercial enterprises including financial institutions. Nevertheless, further work is needed to help embed better practices across the banking sector in an effort to drive cultural change, and there is scope for reducing disparities in governance practices even across major banks. Importantly, greater attention is needed to ensure that boards of directors, with the help of non-executive directors, effectively oversee management and help establish appropriate checks and balances. Owing to the legacy board structures, there is a lack of separation between board in its oversight role and the executive playing a management role. Equally there is insufficient independent reporting by the internal audit function to the Board Audit Committee; in some instances, the latter reports to executive management, typically the President/CEO.<sup>2</sup>

**15. Greater emphasis on the effective functioning of the committee structure is warranted to boost corporate governance.** Owing to the three structures available to banks, there is always a separate audit committee, yet there is not necessarily a separate remuneration committee which allows a level of oversight and separation between those board members responsible for setting the budget, strategy and targets of the bank from those who are also setting the remuneration strategies for board directors. To encourage more robust governance, the JFSA should increase the frequency and depth of onsite and offsite activities to assess the effective functioning of the board and its committee structure. While the JFSA has stepped up engagement with the boards of megabanks and major trading banks, this approach should be rolled out systematically across a broader range of banks.

### **Prudential Requirements, Regulatory Framework, Accounting and Disclosure (CPs 15–29)**

#### ***Risk management (CP 15)***

**16. Greater emphasis on the independence of the risk function is needed, especially in relation to the reporting line of the Chief Risk Officer (CRO) to the Board Risk Committee**

<sup>2</sup> It is acknowledged that the internal auditors do attend board meetings, which would give them an opportunity to convey views directly if necessary.

**(BRC).** The JFSA and BoJ have sufficient frameworks for identifying and evaluating bank risk management systems and processes and for requiring remedial actions. However, further work in the area of risk management is needed to strengthen the independence of the risk management function with a clear reporting line to the board of directors. A counterbalancing feature is that in some cases bank business models are not overly aggressive and continue to have conservative risk settings. Given the challenging operating conditions (flat yield curve and subdued demand for credit), banks' search for yield requires more robust risk management systems and processes to monitor and detect risks early. Continued supervisory attention is recommended to promote stronger risk governance arrangements, including more independent risk management and internal control functions that have direct reporting relationships to the board of directors.

### ***Capital adequacy (CP 16)***

**17. While capital requirements are closely aligned with the Basel Pillar 1 Framework for internationally-active banks, a Pillar 2 capital framework to tailor capital requirements more closely to individual bank risk profiles is lacking.** This is an important shortcoming that makes it difficult for the authorities to require banks to carry more capital beyond the minimum requirements to address specific risks within a bank that may arise, such as risk concentration or interest rate risk in the banking book (IRRBB). The JFSA's plans to become a more dynamic supervisor will require it to exert more influence and operate more proactively with banks to set capital and adjust risk management practices in anticipation of future events. Relying on the minimum capital framework alone may not be sufficient in those situations. Adding a Pillar 2 capital framework would give the JFSA more influence in both bank capital planning exercises and in discussions with banks about their risk management practices more generally.

**18. While most domestic banks are currently well capitalized, the thresholds for early intervention measures are set too low to support effective early action.** For instance, constraints on dividends and other capital disbursements would only start to kick in when bank capital ratios fall below 4 percent. While increasing the minimum requirements for those banks to include a capital conservation buffer may not be practical given the concerns that have been expressed generally about the usability of Basel buffers in times of stress, the JFSA is encouraged to explore the feasibility of introducing such constraints for capital levels above the official minimum requirements, through bank policies and recovery plans, so that they start to kick-in well before capital ratios fall below the 4 percent threshold.

### ***Credit risk (CP 17)***

**19. In general, there is a sufficient focus by banks as well as the JFSA and BoJ on credit risk management.** Discussions with the banking industry indicated sufficient senior-management attention to the problem areas identified and a willingness to further migrate their credit risk management processes towards best practices. Credit risk is a key focus in JFSA Strategic Directions and Priorities which are also made public. Both routine and targeted ad-hoc work by the supervisory and inspection bureaus of the JFSA include detailed monitoring and in-depth analysis (through file reviews) of credit risks and the adequacy of risk management.

***Problem assets, provisions and reserves (CP 18)***

**20. Policies and practices with respect to problem assets have improved considerably since the Japanese banking crisis.** In particular, the gaps in provisioning of SME and other special measure loans have shrunk in recent years, although some legacy issues remain that should be resolved. Regular detailed reviews of loan classifications and provisioning practices carried out by the Japanese authorities have undoubtedly contributed to the better performance in this regard. However, discussions with local observers suggest some issues remain and that a significant amount of work will need to be conducted by banks and the JFSA in coming years to migrate provisioning practices towards the new expected credit loss framework that is emerging as best practice in international accounting standards and Basel Committee provisioning guidance for supervisors. Looking forward, the JFSA may also want to consider whether there are other ways to continue to obtain satisfaction with respect to loan classifications and provisioning adequacy; for example, by possibly placing more reliance on the reviews carried out by external auditors, provided the scope and prudential rigor of those audits is adequate.

***Concentration risk (CP 19)***

**21. While the JFSA has taken steps to tighten the regulations for large exposures, more attention is needed to expand risk management for risk concentrations.** The JFSA has taken a number of steps to strengthen the large exposure regime including imposing stricter limits for connected counterparties, which have been reduced from 40 percent of capital to 25 percent. In addition, the JFSA will implement the new Basel Committee on Banking Supervision (BCBS) LE guidelines that take effect in 2019. Nonetheless, more attention is needed to expand risk management for risk concentrations other than large exposures such as risk concentrations from market risk and other types of risks. The JFSA focuses on concentration as part of credit risk, and occasionally discusses concentrations in other risk-types when some material risk is detected. However, there is no requirement that all material concentrations be regularly reviewed and reported to banks' supervisory boards. Inclusion of these exposures in stress testing is also limited.

***Related party exposures (CP 20)***

**22. The regulatory and supervisory framework for related party exposures has a number of deficiencies.** Exposures to related parties are required to be conducted at 'arms-length' terms. These exposures by their nature deserve enhanced risk management over and beyond standard credit underwriting processes. However, specific limits have not been set by either banks or the JFSA beyond those that already exist in the context of the large exposure rules. While the JFSA takes them into account in its periodic compliance inspections, supervision of these activities would benefit from more specific periodic reporting requirements and more proactive investigations that are less reliant on signals received from internal audit.

***Country and transfer risks (CP 21)***

**23. The JFSA has been monitoring this area closely with additional regular prudential returns focused on country exposures.** Faced with weak profitability amid sluggish loan

demand locally and a low interest rate environment, Japanese banks, particularly the mega banks are expanding overseas, notably in the US and Asia.

**Market risk (CPs 22–24)**

**24. The obligations in the Supervisory Guidelines are generally sound and establish the requirements for banks to implement effective risk management frameworks to measure and manage market risk.** Supervisors periodically review banks to assess whether their market risk management processes are consistent with bank risk bearing capacity and market risk management frameworks. The city banks, including the three megabanks, are the more active participants in trading activities. Instruments traded in the main asset classes typically include Japanese Government Bonds (JGBs), Interest rate swaps (IRS) and currencies. The JFSA has market risk specialists carrying out onsite inspections in the market risk area. Risk limits established by banks for trading activities are usually low with real time monitoring and daily escalations. Most of the supervisory focus and expertise is directed toward mega bank and trading bank market risk management activities given that the market risk exposures of other banks are not material.

**25. IRRBB has received a significant amount of supervisory attention in the last several years and features as a key supervisory priority.** Banks are required to measure, calculate and report their exposure to IRRBB on a quarterly basis. Banks are also required to conduct regular stress testing using both standardized and bespoke scenarios, especially for those banks with more complex business models and optionality in the portfolio. Supervisors make an assessment of IRRBB through the risk profiling process, and the assessors saw evidence that this risk is featured in the SREP assessment and is a key topic in discussions with bank senior management. Banks generally hold large JGB and equity portfolios. The JFSA has also begun the transition to new guidelines for IRRBB which will closely align with the new BCBS requirements in 2018.

**26. The extent of FX funding is a significant risk facing the megabanks where they have expanded their overseas lending.** The BoJ and JFSA carry out onsite examinations/inspections and offsite monitoring of banks in close coordination and cooperation, the former with detailed coverage of risk management. For internationally active banks (non-consolidated and consolidated), JFSA requires banks to comply with the total Liquidity Coverage Ratio (LCR) minimum requirement on a monthly basis. This was implemented in March 2015 and includes disclosures (quarterly) from the end of June in 2015. Banks also report the LCR by significant currency to the JFSA on a monthly basis in accordance with the BCBS liquidity standard. The transposition of the LCR into local rules closely aligns with the BCBS text and implementation timeline meet the Basel III requirements. Offsite monitoring and onsite inspections by both the JFSA and BoJ appear rigorous. Contingency funding plans and FX Liquidity risk management have been a focus of the authorities.

**Internal control, financial reporting and audits (CPs 26 and 27)**

**27. The oversight of bank internal control frameworks is sound, although the internal audit function could be further strengthened by introducing a more direct reporting relationship to bank boards of directors.** Stronger relationships could also be developed with external auditors so that the JFSA can exercise more influence over the scope of external audits

and be more promptly informed about any financial reporting vulnerabilities. The JFSA has limited powers to have weak external auditors removed except in extreme situations. Moreover, external auditors should also be required to report to the Commissioner of the JFSA all items requiring corrective action, not just those that have not been addressed by the bank within two weeks of notification. Even those issues that have been corrected can often be a harbinger of underlying weaknesses in bank risk management and internal control practices that could be more promptly addressed by the JFSA the sooner it is made aware of them.

### **Disclosure and transparency (CP 28)**

**28. Domestic and internationally-active banks have strong disclosure practices.** For example, they have implemented Basel III Pillar 3 disclosure requirements on both a consolidated and unconsolidated basis in accordance with internationally-agreed timelines. As these requirements become more detailed in the future in the wake of planned revisions to the Basel Pillar 3 Framework, the JFSA may wish to consider the regulatory burden imposed on smaller banks and assess the costs and benefits of imposing the more detailed requirements on those institutions.

### ***Abuse of financial services (CP29)***

**29. Japan had taken a number of steps to strengthen its AML/CFT capabilities but greater onsite attention is needed.** While the assessors noted that there have been some improvements, most notably in the reporting of Suspicious Transaction Reports (STRs), a reduction in focus of onsite inspections for AML/CFT is a shortcoming. While reporting of STRs is an input into offsite monitoring, surveillance should be complemented by routine onsite inspections to verify the effectiveness of risk management and controls e.g., in the area of customer due diligence (CDD) processes, and correspondent banking relationships.

## **INTRODUCTION AND METHODOLOGY**

### **A. Introduction**

**30. This assessment of the current state of the implementation of the Basel Core Principles for Effective Banking Supervision (BCP) in Japan has been completed as a part of the Financial Sector Assessment Program (FSAP) mission undertaken by the International Monetary Fund (IMF) during December of 2016.** It reflects the regulatory and supervisory framework in place as of the date of the completion of the assessment. It is not intended to represent an analysis of the state of the banking sector or crisis management framework, which are addressed in other parts of the FSAP.

**31. An assessment of the effectiveness of banking supervision requires a review of the legal framework, and detailed examination of the policies and practices of the institutions responsible for banking regulation and supervision.** In line with the BCP methodology, the assessment focused on the supervisory activities of the JFSA and BoJ and did not cover the specificities of regulation and supervision of other financial intermediaries.

## B. Information and Methodology Used for Assessment

**32. Japan requested to be assessed according to the Revised BCP Methodology issued by the BCBS (Basel Committee of Banking Supervision) in September 2012.** The current assessment was thus performed according to a revised content and methodological basis as compared with the previous BCP assessment carried out in 2011. It is important to note that the two assessments are not directly comparable, as the revised BCP have a heightened focus on corporate governance and risk management and its practice by supervised institutions and its assessment by the supervisory authority, raising the bar to measure the effectiveness of a supervisory framework (see box for more information on the Revised BCP).

**33. The Japanese authorities chose to be assessed against the highest standards of supervision and regulation, and thus were rated against both the Essential Criteria and the Additional Criteria.** To assess compliance, the BCP Methodology uses a set of essential and additional assessment criteria for each principle. The essential criteria (EC) were usually the only elements on which to gauge full compliance with a Core Principle (CP). The additional criteria (AC) are recommended best practices against which the authorities of some more complex financial systems may agree to be assessed and rated. The assessment of compliance with each principle is made on a qualitative basis. A four-part grading system is used: compliant; largely compliant; materially noncompliant; and noncompliant. This is explained below in the detailed assessment section. The assessment of compliance with each CP is made on a qualitative basis to allow a judgment on whether the criteria are fulfilled in practice. Effective application of relevant laws and regulations is essential to provide indication that the criteria are met.

**34. The assessment team reviewed the framework of laws, rules, and guidance and held extensive meetings with officials of the JFSA, BoJ, Ministry of Finance (MoF), Financial Intelligence Unit (FIU), plus additional meetings with audit firms, credit rating agencies, and banking sector participants.** The authorities provided a self-assessment of the CPs rich in quality and comprehensiveness, as well as detailed responses to additional questionnaires, and facilitated access to supervisory documents and files, staff, and systems.

### Box 1. The 2012 Revised Core Principles

The revised Basel Core Principles for Effective Banking Supervision (BCPs) reflect market and regulatory developments since the last revision, taking account of the lessons learned from the financial crisis in 2008/2009. These have also been informed by the experiences gained from FSAP assessments as well as recommendations issued by the G-20 and FSB, and take into account the importance now attached to: (i) greater supervisory intensity and allocation of adequate resources to deal effectively with systemically important banks; (ii) application of a system-wide, macro perspective to the microprudential supervision of banks to assist in identifying, analyzing and taking pre-emptive action to address systemic risk; (iii) the increasing focus on effective crisis preparation and management, recovery and resolution measures for reducing both the probability and impact of a bank failure; and (iv) fostering robust market discipline through sound supervisory practices in the areas of corporate governance, disclosure and transparency.

The revised BCPs strengthen the requirements for supervisors, the approaches to supervision and supervisors' expectations of banks. The supervisors are now required to assess the risk profile of the banks not only in terms of the risks they run and the efficacy of their risk management, but also the risks they pose to the banking and the financial systems. In addition, supervisors need to consider how the macroeconomic environment, business trends, and the build-up and concentration of risk inside and outside the banking sector may affect the risk to which individual banks are exposed. While the BCP set out the powers that supervisors should have to address safety and soundness concerns, there is a heightened focus on the actual use of the powers, in a forward-looking approach through early intervention.

The number of principles has increased from 25 to 29. The number of essential criteria has expanded from 196 to 231. This includes the amalgamation of previous criteria (which means the contents are the same), and the introduction of 35 new essential criteria. In addition, for countries that may choose to be assessed against the additional criteria, there are 16 additional criteria.

While raising the bar for banking supervision, the Core Principles must be capable of application to a wide range of jurisdictions. The new methodology reinforces the concept of proportionality, both in terms of the expectations on supervisors and in terms of the standards that supervisors impose on banks. The proportionate approach allows assessments of banking supervision that are commensurate with the risk profile and systemic importance of a wide range of banks and banking systems

**35. The team appreciated the excellent cooperation received from the authorities.** The team extends its thanks to staff of the authorities who provided excellent cooperation, including extensive documentation and access, at a time when they were burdened by many initiatives related to global regulatory changes.

**36. The standards were evaluated in the context of the Japanese financial system's structure and complexity.** The CPs must be capable of application to a wide range of jurisdictions, whose banking sectors will inevitably include a broad spectrum of banks. To accommodate this breadth of application, a proportionate approach is adopted within the CP, both in terms of the expectations on supervisors for the discharge of their own functions and in terms of the standards that supervisors impose on banks. An assessment of a country against the CPs must, therefore, recognize that its supervisory practices should be commensurate with the complexity, interconnectedness, size, and risk profile and cross-border operation of the banks being supervised. In other words, the assessment must consider the context in which the supervisory practices are applied. The concept of proportionality underpins all assessment criteria. For these reasons, an assessment of one jurisdiction will not be directly comparable to that of another.

**37. To determine the observation of each principle, the assessment has made use of five categories: compliant, largely compliant, materially noncompliant, noncompliant, and non-applicable.** An assessment of “compliant” is given when all ECs and ACs are met without any significant deficiencies, including instances where the principle 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 principle and there is clear intent to achieve full compliance with the principle within a prescribed period of time (for instance, the regulatory framework is agreed but has not yet been fully implemented). A principle is considered to be “materially noncompliant” in case of severe shortcomings, despite the existence of formal rules and procedures and if 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 authorities’ ability to achieve compliance. A principle is assessed “noncompliant” if it is not substantially implemented, several ECs and ACs are not complied with, or supervision is manifestly ineffective. Finally, a category of “non-applicable” is reserved for those cases that the criteria would not relate the country’s circumstances.

## INSTITUTIONAL AND MARKET STRUCTURE OVERVIEW<sup>3</sup>

**38. The Japanese banking industry mainly consists of the three mega banks (classified as Global Systemically Important Banks —G-SIBs<sup>4</sup>), Japan Post Bank, two trading banks, a large number of regional banks, and many cooperative banks (*Shinkin* banks) including Farmers Bank.** These institutions have combined assets of ¥1,826 trillion (about US\$16 trillion). The system is large by domestic measures and by international comparisons (with assets of 365 percent of Gross Domestic Product (GDP) and is the second largest banking system in the world. While city banks and other large banks have nationwide networks and overseas operations, in some cases quite extensive, the regional banks serve a mainly domestic client base. Though regional banks are individually small, as a group they are systemically important representing approximately 40 percent of banking system assets.

<sup>3</sup> This section draws from other documents produced for the FSAP, some of which at the time of this assessment were not yet finalized. A complete analysis of the macroeconomic framework is contained in Article IV reports.

<sup>4</sup> Three Japanese banks have been deemed to be G-SIBs by the FSB and BCBS including: Mizuho FG, Sumitomo Mitsui FG and Mitsubishi UFJ FG. As published by the Financial Stability Board (FSB) in November 2016. See <http://www.fsb.org/wp-content/uploads/2016-list-of-global-systemically-important-banks-G-SIBs.pdf>

**39. The banking system is characterized by low profitability, sound yen liquidity, low levels of nonperforming loans (NPLs), and sound average capitalization.** A prolonged

period of low economic growth has depressed domestic credit demand with domestic loan growth slowing. The flattening of the yield curve has put pressure on net interest margins (NIM) with NIM on a downward path and the cost to income ratio flat. While return on equity remained broadly static between 2015 and 2016, pre-provisioning income is falling, since net interest income is the main source of revenue. Average capitalization of the sector seems sound. The average nonperforming loan (NPL) ratio for the system is 1.6 percent.

Japanese Banking System: Key Financial Indicators /1				
	(Percent)			
	2013	2014	2015	2016
Return on equity	8.29	7.8	8.82	8.5
Return on assets	0.37	0.33	0.37	0.25
Pre-provision income/RWAs	1.56	1.51	1.64	1.38
Cost-to-income ratio	54.13	52.44	51.26	54.32
CET1 ratio /2	11.15	11.42	11.37	11.75
Leverage ratio /3	5.25	5.31	5.72	5.48
NPLs/gross loans	1.98	1.64	1.37	1.17
Texas Ratio /4	17.7	15.05	11.56	10.15
Domestic loans/domestic assets	39.39	38.7	38.7	38.7

Source: JFSA, ERAs and IMF staff calculations.

1/ All figures as at 31 December, 2015

2/ CET1-ratio - transitional: 2010-2013 Core Tier1-ratio

3/ Calculated as Shareholders equity/Total assets

4/ Calculated as NPLs/Shareholders equity+ loss reserves

**40. Domestic operating conditions are challenging and banks are expanding offshore to take advantage of lending opportunities.**<sup>5</sup> Japanese banks have aggressively expanded in the region, with the country's second-biggest banking conglomerate, Mizuho Financial Group, and two other banks receiving licenses to operate in Myanmar last year; Sumitomo Mitsui Banking buying a stake in Cambodia's Aceda Bank in 2014; and Bank of Tokyo-Mitsubishi UFJ (MUFJ) acquiring Thailand's Bank of Ayudhya in 2013. At Mizuho, overseas business operations account for more than half of income from customers. The overseas expansion of Japanese banks brings opportunities and risks. While a more diversified income base and geographic reach expands lending opportunities, it brings about the need for stronger risk management, as well as potential foreign exchange funding risks.

**41. Banks benefit from a relatively large, stable and growing deposit base yet larger FX liquidity needs create risks.** More than half of domestic savings are held in bank deposits—a much higher proportion than most other developed markets—and Japanese banks have one of the lowest ratios of market-based financing globally, with very little reliance on confidence-sensitive sources of funding. Loan-to-deposit ratios for banks are at historic lows (average of less than 70 percent) with a large part of the excess liquidity invested in JGBs or held on deposit with the BoJ. Banks therefore enjoy favorable liquidity indicators in respect of LCR and Net Stable Funding Ratio in local currency. However, the need to finance overseas loans leaves the banks

<sup>5</sup> Data released at the end of July 2015 from the Bank of International Settlements revealed that Japan's banks became the biggest cross-border lenders at the end of the first quarter of 2015. With \$3.53tn of foreign loans, Japan's banking sector has marginally surpassed its UK counterpart to renew its position as the world's dominant cross-border supplier of loans.

vulnerable to FX liquidity risk as non-yen loan growth is outpacing deposits, a large share of which are wholesale in nature.

**42. Commercial real estate loans and cross-border exposures are potential future sources of credit risk.** The recent growth in real estate loans has surpassed that observed during the real estate boom preceding the Lehman shock. The increase in loans by major banks is mainly attributable to Japanese Real Estate Investment Trusts and banks have continued to respond proactively to demand for funds from large real estate developers as well as from private real estate funds (SPCs) sponsored mainly by foreign affiliated funds. Real estate firms' investment to GDP ratio was rated 'red' according to BoJ's April 2016 heat map of macro risk indicators.<sup>6</sup> Banks' overseas loans have continued to show relatively high growth, particularly loans to advanced economies, such as North America. Loans extended by major banks, measured in United States (U.S.) dollars, have increased by approximately 10 percent in 2015 on a year-on-year basis (an annual increase of approximately US\$80 billion) and those extended by regional banks increased by approximately 20 percent (an annual increase of approximately US\$4 billion). However, domestic credit growth remains weak at about 2 percent (yoy), despite the rapidly growing lending to real estate firms.

**43. The level of cross-shareholdings at the three banks has been deemed risky by the JFSA, and could pose severe problems to their capital levels.** Banks hold large JGB and equity portfolios, about ¼ of total assets. Equity holdings are mainly held to support long-term relationships (and related business) with large corporations, and account for more than half of city banks' Tier 1 capital, well in excess of the less than 10 percent holdings evident among U.S. and European banks. The Nikkei rallied by 57 percent in 2013, by 7.1 percent in 2014 and by almost 18 percent in 2015, which has allowed banks with significant stock holdings to benefit despite the decline in Nikkei since August 2016.

**44. Large exposures to JGBs by Japanese banks continue to be a risk.** Japanese banks have traditionally been the largest buyers of JGBs purchasing about 200 trillion yen of JGBs since 2000. However, the BoJ is now the biggest buyer owing to current monetary policy settings. As of July 2016, JGBs accounted for around 10 percent of the industry's balance sheet, a significant drop from the recent peak of 20 percent as of March 2012. Negative interest rate policy (NIRP) pushed yields on most low risk assets — including Japanese government bonds (JGBs) of most tenors — to near-zero or negative, and substantially flattened the yield curve, reducing banks' profit margins from maturity transformation. However, the yield curve seems to have been stabilized since the introduction of the yield curve control at end-September 2016.

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<sup>6</sup> Although more recently the rating turned "green" in the October 2016 heat map, the level of real estate companies' investment to GDP ratio still remains high. The BoJ includes 14 ratios in its heat map of financial activity indexes from 1980 and includes 7 sectors. See <https://www.boj.or.jp/en/research/brp/fsr/data/fsr160422a.pdf>

## PRECONDITIONS FOR EFFECTIVE BANKING SUPERVISION<sup>7</sup>

### Sound and sustainable macroeconomic policies

**45. The institutional framework supporting the conduct of sound macroeconomic policies in Japan follows the integrated approach.** A single universal regulator (the JFSA)<sup>8</sup> conducts both safety and soundness oversight and conduct-of-business regulation for all the sectors of financial services, while the BoJ conducts onsite examinations and offsite monitoring of its counterparty financial institutions. The MoF also retains an important role. The Deposit Insurance Corporation of Japan (DICJ) 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.

**46. Close domestic coordination among the above agencies is required for effective macro prudential policy making.** The Japanese authorities have made significant progress in strengthening the links between the domestic agencies involved in bank supervision. In June 2014 the Council for Cooperation on Financial Stability was launched. It includes senior officials from the BoJ and JFSA. In addition, senior officials from the JFSA, BoJ and MoF have been holding monthly meetings on international financial and capital market issues since March 2016.

**47. As regards crisis management, the Financial Crisis Response Council (FCRC) is activated by the PM when government intervention in a troubled financial institution is necessary under the “measures against crisis” or “orderly resolution” regimes.** The FCRC consists of the Prime Minister (PM) (chair), the Chief Cabinet Secretary, Minister for Financial Services, the MoF, the Commissioner of Financial Services Agency, and the Governor of the BoJ. It is convened by the PM to advise him on how to handle financial institutions that face serious liquidity or solvency pressures; however, ultimate decisions on how to respond are formally taken by the PM himself. Since its creation, the FCRC has been used only twice, and since the blanket guarantee was lifted, the general bank resolution measure of providing partial depositor

<sup>7</sup> This section draws from other documents produced for the FSAP, some of which at the time of this assessment were not yet finalized.

<sup>8</sup> The JFSA 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 1,600 people. The Securities and Exchange Surveillance Commission (SESC) is placed within the JFSA and conducts market surveillance and onsite inspections of securities companies. However, it is not authorized to take administrative actions such as penalties: the JFSA is responsible for these actions based on the advice of the SESC. The Certified Public Accountants and Auditing Oversight Board (CPA AOB), also within the JFSA, 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 CPA AOB can only recommend sanctions, while the JFSA imposes them.

protection has only been used once. As stipulated in Article 38 of the Bank of Japan Act, the PM,<sup>9</sup> and the MoF may request the 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, the BoJ may undertake the necessary actions, including the provision of uncollateralized loans. The BoJ independently judges the propriety of the necessary actions based on four principles.

**48. As regards the financial system as a whole, the 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 onsite examinations and offsite monitoring, seminars of BoJ's Center for Advanced Financial Technology, and international discussions.

**49. Separately, general advice regarding the financial system is provided via the Financial System Council (FSC) within the JFSA.** The FSC, which comprises different sectional committees and subcommittees in the JFSA, conducts wide-ranging deliberations on the financial system in response to requests from the PM, the Commissioner of the JFSA, or the MoF. 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

**50. 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.

**51. 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 JFSA 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

<sup>9</sup> The PM delegates the above power to request BoJ to take actions to the JFSA Commissioner under Article 61–2 of the Bank of Japan Act.

Act also requires larger audit corporations auditing 100 or more listed companies to follow a five-year rotation rule. The judicial system is well-developed.

**52. 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 U.S., that had adopted legislation mandating central clearing of standardized over the counter (OTC) derivatives by the end of 2012.

### Effective market discipline

**53. 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. The Companies Act 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 JFSA annual financial statements, as set forth in Article 435 of the Companies Act. These statements are to be 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 the "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 JFSA's Supervisory Guidelines and Inspection Manuals, which, while they are not legally binding, are explicit expectations to be complied with by the banks. Should banks fail to comply with these expectations, administrative actions can be taken by the JFSA.

### Public safety nets

**54. 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.

**55. The DICJ contributes to financial stability by managing the deposit insurance system and resolving failed banks.**<sup>10</sup> In cases when a bank fails, the DICJ will make payouts to

<sup>10</sup> DICJ's role in resolution is contingent on its appointment by the JFSA to execute specific resolution actions determined by the JFSA or PM as the case may be.

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 Act on Special Measures for Strengthening Financial Functions. 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.

**56. The Deposit Guarantee Scheme is funded ex ante by periodical contributions from banks.** The 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 JFSA and MoF, and the government may provide guarantee on the DICJ's financing. Currently, ¥69 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

**57. 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 JFSA. The JFSA 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 JFSA has developed and published supervisory guidelines and inspection manuals. In practice, the supervisory guidelines are mostly being used in the assessment of offsite activities of the JFSA staff, whereas the inspection manuals are being used as guiding practice for the onsite activities of the JFSA 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

**58. Both the BoJ and the JFSA conduct day-to-day supervision of banks using both onsite inspections and offsite monitoring, and regular interactions with officials of the supervised entities.** Formally, and based upon Article 44 of the Bank of Japan Act, the BoJ may submit the documents describing the results of the onsite examinations and other related materials to the Commissioner or have officials of the Financial Services Agency inspect them. Regarding offsite analyses and at senior management level, there exists more regular information exchange between the JFSA and BoJ. Staff exchanges between the JFSA and BoJ also take place regularly. In September 2015, the JFSA published "Strategic Directions and Priorities" which indicates clearly what goals the JFSA aims to attain during the period from July 2015 to June 2016 and how. The "Strategic Directions and Priorities," places importance on PDCA cycle, and the JFSA evaluates/publishes its undergoing process and accomplishments. Meanwhile, the JFSA regularly summarizes its performance against objectives in its public annual reports. Both the BoJ and the JFSA determine the frequency, scope, and the number of examiners, using the "risk-based" framework for onsite

examinations/inspections. The BoJ announces its onsite examination policy on an annual basis, including the key issues in the conduct of onsite examinations and major findings in the previous year.

## DETAILED ASSESSMENT

<b>A. Supervisory Powers, Responsibilities and Functions</b>	
<b>Principle 1</b>	<b>Responsibilities, objectives and powers.</b> An effective system of banking supervision has clear responsibilities and objectives for each authority involved in the supervision of banks and banking groups. <sup>11</sup> A suitable legal framework for banking supervision is in place to provide each responsible authority with the necessary legal powers to authorize banks, conduct ongoing supervision, address compliance with laws and undertake timely corrective actions to address safety and soundness concerns. <sup>12</sup>
<b>Essential criteria</b>	
<b>EC1</b>	The responsibilities and objectives of each of the authorities involved in banking supervision <sup>13</sup> are clearly defined in legislation and publicly disclosed. Where more than one authority is responsible for supervising the banking system, a credible and publicly available framework is in place to avoid regulatory and supervisory gaps.
Description and findings re EC1	<p>There are laws for banking and for banking supervision. The legal framework for banking supervision in Japan consists of four levels. The first is the laws that have been approved by 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 JFSA. In practice the JFSA is substantially involved in the drafting of laws, orders and ordinances. The fourth level consists of supervisory guidelines that have been issued by the JFSA. The JFSA has also developed an inspection manual. In practice, the supervisory guidelines frame the offsite assessment activities of JFSA staff, while the inspection manual anchors the onsite activities of JFSA supervisors during their inspections. All pieces of legislation mentioned above plus the JFSA supervisory guidelines and inspection manual are publicly available to promote transparency in the regulatory framework.</p> <p>The most substantive parts of banking regulation are found in the supervisory guidelines and the inspection manual. Banks treat the guidelines and inspection manual as regulations that applies to them and that they need to adhere to, even though the guidelines and</p>

<sup>11</sup> In this document, “banking group” includes the holding company, the bank and its offices, subsidiaries, affiliates and joint ventures, both domestic and foreign. Risks from other entities in the wider group, for example non-bank (including non-financial) entities, may also be relevant. This group-wide approach to supervision goes beyond accounting consolidation.

<sup>12</sup> The activities of authorising banks, ongoing supervision and corrective actions are elaborated in the subsequent Principles.

<sup>13</sup> Such authority is called “the supervisor” throughout this paper, except where the longer form “the banking supervisor” has been necessary for clarification.

inspection manual do not have specific references in law, given their expectations are public and can be reinforced by supervisory interventions if necessary to enforce compliance. In addition, the JFSA issues so-called "No action letters" as an official response to inquiries from banks. The supervisory guidelines and inspection manual are regularly amended where appropriate.

Japanese law also defines the authorities involved in banking supervision. The Japan Financial Services Authority (JFSA) has been established by the Act for Establishment of the Financial Services Agency. In Article 2, the JFSA is established as a government agency. The act stipulates in Article 3 the objectives and responsibilities of the JFSA: 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 and other persons equivalent thereto, while facilitating finance. So the JFSA is the integrated regulator for the banking, securities and insurance sectors. Concerning its responsibilities, Article 4 of the Act for Establishment of the Financial Services Agency mentions that the JFSA 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 include: banks (city banks and regional banks), bank-holding companies, *Shinkin* banks, credit cooperatives, labor credit cooperatives, *Norinchukin* Bank, and private business operators engaged in deposit-taking.

The JFSA has been established as an extra-ministerial bureau of the Cabinet Office. The head of the Cabinet Office is the PM. The powers stipulated in the Banking Act belong to the PM, as the head of the Cabinet Office. Most of these powers have been delegated to the Commissioner of the JFSA 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 JFSA 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.

All banks are stock companies licensed under the Banking Act, and are supervised by the JFSA. As for most of the regional banks, the JFSA has delegated its supervisory powers to Local Finance Bureaus of the MoF. Within the JFSA 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 as well as small deposit-taking institutions. To that end, the JFSA has published the "Comprehensive Guidelines for Supervision of Small- and Medium-Sized and Regional Financial Institutions" for labor banks and the "Comprehensive Guidelines for Supervision of Co-operative Financial Institutions" which serve as reference material for those engaged in day-to-day supervision as well as for the institutions themselves.

Besides city banks and regional banks, there are cooperative-type financial institutions consisting 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 JFSA in the same way as regional banks. So here too, the JFSA 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. As indicated above the regulations applicable to these banks are the same as those for regional banks.

In addition, there exist many small agricultural and fishery cooperatives of financing business as well as labor cooperatives that take saving deposits locally (there are about 700 agricultural cooperatives and about 110 fishery cooperatives). Agricultural cooperatives and fishery cooperatives are supervised by the JFSA, the Ministry of Agriculture, and prefectural governments 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 governments. In so far these cooperatives engage in financing business, upon the request of the local state government, the JFSA performs inspections on their financial soundness. The JFSA together with the Ministry of Agriculture has developed the supervisory guidelines for these cooperatives.

There is one agricultural and fishery cooperative which, given its size, is co-supervised by the JFSA and the Ministry of Agriculture, Forestry and Fishery. This is the central agricultural and fishery cooperative bank named Norinchukin. Although co-supervised, the JFSA has the sole responsibility in setting the soundness standards for the institution. This means that in effect, the Ministry of Agriculture, Forestry and Fishery does not contravene JFSA decisions in this area, for instance in case the JFSA takes 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 JFSA and the Ministry of Agriculture, Forestry and Fishery co- decide. As for labor cooperatives, they are co-supervised by the JFSA and the Ministry of Health, Labor and Welfare. The regulations applied to these labor cooperatives are the same as those applied to cooperative banks.

The JFSA has taken steps to develop closer relationships with Local Finance Bureaus in recent years through the establishment of a Regional Financial Institution Planning Office in 2015 that works closely with Local Finance Bureaus to develop risk profiles for regional banks, *Shinkin* banks and credit cooperatives; and to support Local Finance Bureaus in planning and implementing the requisite supervisory monitoring and intervention activities.

Besides the JFSA, 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 offsite 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 JFSA 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 JFSA and BoJ share information on a wide range of issues and at various levels, including the following. First, the JFSA and BoJ regularly exchange information to adjust the schedules and the lists of the financial institutions they intend to visit, in advance of the inspections/examinations. Additionally, when a request has been made from the JFSA Commissioner, the BoJ may submit the documents describing the results of the onsite examinations and other related materials to the JFSA Commissioner or have officials of the JFSA inspect them (Article 44 of the Bank of Japan Act). Second, on a regular basis, the JFSA and BoJ contact each other through variety of ways, including frequent/informal visits, calls and e-mails at division chief/director levels.

To further enhance cooperation between the JFSA and BoJ, the Council for Cooperation on Financial Stability, which consists of senior officials including the JFSA Commissioner and the BoJ Deputy Governor, was established in 2014 as an inter-agency framework to regularly discuss macroprudential policy and enhance cooperation between the two organizations. The Council holds meetings about once every half year. The establishment of the Council and its recent meeting are published on the website of both organizations. In addition, a meeting to exchange information on international financial and capital markets has been held between the JFSA, MoF, and BoJ on a monthly basis since March 2016. The JFSA and BoJ have also been using project teams to coordinate positions on important domestic and international challenges, with a recent example being Japanese positions on Basel work related to interest rate risk in banking books.

JFSA also serves as the resolution authority in Japan working closely with the BoJ, which as central bank is responsible for maintenance of stability of the financial system, and the Deposit Insurance Corporation of Japan. The latter serves as the receiver in charge of liquidating assets of a failed bank in the case of smaller institutions that need to be closed. For more complex resolution situations where key operating units need to remain open, the DICJ would be the receiver of a failed holding company which absorbed the losses from the operating units and also the shareholder of a bridge bank special purpose vehicle established to manage the recapitalized operating units under a single-point-of-entry scheme. DICJ bridge bank plans would need to be confirmed by the JFSA as the resolution authority. The Financial Crisis Response Council chaired by the PM deliberates on resolution measures and coordinates the activities of the government agencies involved in resolution.

The Financial Crisis Response Council plays a key role in the financial sector safety net. It is chaired by the PM and comprises the MoF, the Minister for Financial Services, the Commissioner of the JFSA, the Governor of the BoJ, and the Chief Cabinet Secretary. It advises the PM on the existence of systemic risks at the point of a financial institution's failure, and on measures to manage financial crises. However, ultimate decisions are formally taken by the PM, who may request the DICJ to take certain measures to help

	protect financial stability. (In the case of a labor bank or federation of labor banks, the PM must consult with the Minister of Health, Labor and Welfare, and with the Ministry of Economy, Trade and Industry in the case of The Shoko Chukin Bank). The FCRC also promotes the implementation of said measures by relevant administrative agencies.
<b>EC 2</b>	The primary objective of banking supervision is to promote the safety and soundness of banks and the banking system. If the banking supervisor is assigned broader responsibilities, these are subordinate to the primary objective and do not conflict with it.
Description and findings re EC2	<p>Article 3 of the Act for Establishment of Financial Services Agency states “the mission of the JFSA is to ensure the stable functioning of the financial system of Japan and to protect depositors, policyholders, securities investors and other persons equivalent thereto, while facilitating finance.”</p> <p>Japanese authorities view the three objectives as complementary to one another. Adequate capital that is commensurate with the risks borne by banks and banking groups is clearly important but the authorities also stressed the need for bank risk management and control practices to be commensurate with the risks that banks are undertaking and the environment in which they operate. That way banks will be better positioned to help facilitate finance and earn profits on a sustainable basis, which will support the protection of depositors and promote the stability of the financial system. They recognize that achieving the three objectives will require banking supervision to become more nimble and proactive in its response to the expected evolution of the financial system over time. To that end closer coordination with the BoJ and MoF is helping the JFSA gain a better understanding of how the financial system and the economy are evolving at a macro level, which helps to inform its own supervisory activities.</p>
<b>EC3</b>	Laws and regulations provide a framework for the supervisor to set and enforce minimum prudential standards for banks and banking groups. The supervisor has the power to increase the prudential requirements for individual banks and banking groups based on their risk profile <sup>14</sup> and systemic importance. <sup>15</sup>
Description and findings re EC3	<p>Articles 14–2 and 52–25 of the Banking Act give the PM the authority to set prudential standards for capital adequacy and the safety and soundness more generally of banks and bank holding companies. In practice these powers have been delegated to the JFSA Commissioner in accordance with Article 59 of the Banking Act and Article 17 of the Order for Enforcement of the Banking Act. Decisions of the JFSA Commissioner cannot be appealed. As in many other jurisdictions, there is a process for aggrieved parties to contest the behavior of the JFSA and obtain compensation if it fails to adhere to proper administrative procedures in formulating its policies and supervisory decisions.</p> <p>The JFSA has established various standards for safety and soundness of bank management such as the Comprehensive Guidelines for Supervision of Major Banks, etc. (hereinafter, Comprehensive Supervisory Guideline), of Small- and Medium-Sized and Regional Financial Institutions, and the Guideline for Financial Conglomerates Supervision to anchor offsite</p>

<sup>14</sup> In this document, “risk profile” refers to the nature and scale of the risk exposures undertaken by a bank.

<sup>15</sup> In this document, “systemic importance” is determined by the size, interconnectedness, substitutability, global or cross-jurisdictional activity (if any), and complexity of the bank, as set out in the BCBS paper on *Global systemically important banks: assessment methodology and the additional loss absorbency requirement*, November 2011.

	<p>supervisory activities, and the Inspection Manual for Deposit-Taking Institutions and for Financial Holding Companies to guide onsite supervisory activities.</p> <p>JFSA powers include the ability to tailor prudential requirements to the risk profile and systemic importance of individual banks and banking groups. For example, in November 2015, it revised the public notice on capital adequacy ratios and Supervisory Guidelines in order to set up a framework to identify and designate G-SIBs and D-SIBs. In December 2015, three financial groups were designated by the JFSA as G-SIBs and seven as D-SIBs. The JFSA has accordingly through public notice applied additional capital requirements to those institutions since March 2016.</p> <p>G-SIBs are designated based on the results of assessment by FSB and are subject to additional capital requirements. D-SIBs are designated based on assessments conducted by the JFSA. Specifically, the JFSA considers not only quantitative factors such as size and interconnectedness but also qualitative factors like systemic importance in the market in order to make designations and decided on capital standard. For example, if a systemic importance in a certain market is high, banks will be designated as D-SIBs and capital standard higher than Basel requirements (more than or equal to 0.5 percent of risk weighted assets—RWA rate needs to be added) will be required.</p>
<b>EC4</b>	Banking laws, regulations and prudential standards are updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices. These are subject to public consultation, as appropriate.
Description and findings re EC4	<p>The JFSA has regularly amended banking laws and regulations in response to changes to the domestic banking environment and international developments. Some recent examples on the domestic front include: the Order to dismiss auditors was implemented (in 2013); large exposure limits were revised in 2013; changes in content of business operations of bank holding companies (in 2016, not yet in force); amending supervisory guidelines in 2015 to implement the provisions of the new Japanese Corporate Governance Code in supervisory expectations for banks and banking groups; and amending the Bank Act in May 2016 to allow banks to have subsidiaries engaged in Fintech activities.</p> <p>As for international developments, the JFSA has been implementing Basel III requirements in accordance with the internationally agreed timeframes and has received compliant overall ratings in this regard in recent Basel Committee RCAPs.</p> <p>Articles 38 to 45 of the Administrative Procedure Act requires administrative ministries and agencies including JFSA to issue proposed regulations for Public Consultation. Based on this article, JFSA has exposed proposed Orders, Ordinances and Supervisory Guidelines approximately for one-month every time they are amended. Moreover, JFSA also publishes its views on comments submitted.</p>
<b>EC5</b>	<p>The supervisor has the power to:</p> <ul style="list-style-type: none"> <li>(a) have full access to banks' and banking groups' boards, management, staff and records in order to review compliance with internal rules and limits as well as external laws and regulations;</li> <li>(b) review the overall activities of a banking group, both domestic and cross-border; and</li> </ul>

	(c) Supervise the activities of foreign banks incorporated in its jurisdiction.
Description and findings re EC5	<p>The JFSA has the power to request all information necessary for the supervision of banks and banking groups (including foreign banks incorporated in Japan and foreign activities of Japanese banks abroad) based on Article 24 of the Banking Act. In practice it will do so via regular or ad-hoc interviews, onsite inspections, and regular reporting. In addition, the JFSA may require banks to submit ad hoc reports and filled-in questionnaires if needed for the execution of its duties. Moreover, the JFSA can 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.</p> <p>The authority of JFSA to issue reporting orders and to conduct inspections is applied not only to a bank itself but also its subsidiaries and subcontractors regardless of whether their operations are conducted in Japan or other jurisdictions. The equivalent authorities also apply to subsidiaries and subcontractors of a bank holding company as well as a bank holding company itself in accordance with 52–31 and 52–32 of Banking Act. With this authority, JFSA reviews the overall activities of a banking group including cross-border operations.</p> <p>The BoJ also collects data and information from financial institutions in accordance with the onsite examination contracts as stipulated in Article 44 of the Bank of Japan Act. In addition, when financial institutions subject to onsite examinations have financial holding companies, the BoJ may request financial holding companies to submit a report or relevant materials, in accordance with its Inquiry Agreements.</p> <p>If there are “justifiable reasons” bank subsidiaries and bank outsourced companies can refuse JFSA investigations. “Justifiable reasons” would be reasons other than necessity to ensure sound and appropriate operation of banks. The authorities confirmed that this is simply a legal safeguard in their laws to ensure that supervisory authorities do not demand information beyond what is needed to carry out their prudential responsibilities. There have not been any cases of any parties relying on this provision to refuse to supply information to the JFSA. Even if they did the JFSA believes it could access the required information in other ways.</p> <p>Effective investigations of bank and subsidiaries is also supported by the fact that a person that falls under one of the following items is subject to punishment by imprisonment with required labor for not more than one year or a fine of not more than three million yen: (1) a person who fails to report/submit a document, or a person who reports/submits document that includes a false statement (2) a person who fails to answer or gives a false answer to a question from an official, or a person who refuses, interferes with, or avoids an inspection (Banking Act Article 63–2,3). (3) Also, the bank that violates will be subject to fine of not more than 200 million yen (Banking Act Article 64).</p>

<b>EC6</b>	<p>When, in a supervisor's judgment, a bank is not complying with laws or regulations, or it is or is likely to be engaging in unsafe or unsound practices or actions that have the potential to jeopardize the bank or the banking system, the supervisor has the power to:</p> <ul style="list-style-type: none"> <li>(a) take (and/or require a bank to take) timely corrective action;</li> <li>(b) impose a range of sanctions;</li> <li>(c) revoke the bank's license; and</li> <li>(d) cooperate and collaborate with relevant authorities to achieve an orderly resolution of the bank, including triggering resolution where appropriate.</li> </ul>
Description and findings re EC6	<p>In case of noncompliance or unsound practices, the JFSA Commissioner has powers to take prompt remedial actions. If a bank license needs to be revoked or orders need to be issued to suspend in whole or in part a banking operation, the PM needs to endorse decisions of the JFSA Commissioner. There have not been any cases where those endorsements have not been granted.</p> <p>Based upon Article 26 of the Banking Act, the JFSA 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.</p> <p>Based upon Article 27 of the banking Act, the JFSA 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 PM "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)".</p> <p>In the case of the BoJ, when, in an examiner's judgment, a bank is considered not complying with laws or regulations, the BoJ will provide the bank with the findings on points that need improvement pursuant to Article 2 of the Onsite Examinations Agreement. In cases where the bank violates the Onsite Examinations Agreement, the BoJ may publicly announce the facts thereof in accordance with Article 13, Paragraph 1 of the Onsite Examinations Agreement. Moreover, the agreement with regard to public announcement shall not prevent the BoJ from exercising its termination right pursuant to the terms in any of the "Current-account Agreement" or other contractual provisions (Article 13, Paragraph 3 of the Onsite Examinations Agreement).</p> <p>The Financial Crisis Response Council deliberates on resolution measures and promotes the implementation of the measures. Further details on its role can be found in EC1. The JFSA is the resolution authority in Japan as well as bank supervisor and works closely with the Deposit Insurance Corporation of Japan (which serves as the receiver in the liquidation</p>

	process). In the event a major bank needs to be resolved the JFSA would continue to supervise the bank operating units that would continue to function while the single-point-of-entry holding company is resolved.
<b>EC7</b>	The supervisor has the power to review the activities of parent companies and of companies affiliated with parent companies to determine their impact on the safety and soundness of the bank and the banking group.
Description and findings re EC7	<p>The JFSA has the power to review the activities of parent companies and affiliates of those companies under Article 52–11 of the Banking Act. Further details can be found in EC6 of CP6.</p> <p>When granting banking licenses, the JFSA will examine whether the applicant is independent from the parent company in the sense that banking business is completely isolated from the risks arising from business activities conducted by the parent company. (Referred in VII-1-6 of the Supervisory Guideline). In addition, major shareholders of banks that wish to hold shares of a bank no less than the major shareholder threshold which is 15 or 20 percent (depending on the influence of the shareholder to the bank) of voting rights, must get pre-approval for the holdings in accordance with Article 52–9 of the Banking Act. The JFSA will review the application based on the criteria stipulated in Article 52–10 of the Banking Act. Major shareholders also include those who have control over parent companies of banks.</p> <p>In assessing the eligibility of the applicant as a major shareholder, Paragraph 1, Article 52–10 of the Banking Act requires the JFSA to check matters on funds for acquisition, financial condition and status of income and expenditure, and personnel structures etc. of the applicant. With regard to personnel structures, JFSA will examine whether the applicant sufficiently understands a public nature of banking business, and that the applicant has sufficient social credibility. VII–2–2–1 of Supervisory Guideline provides detailed checklists when JFSA examines an application for major shareholders from business companies conducting non-financial activities.</p> <p>In the case of the BoJ, when financial institutions subject to onsite examinations have financial holding companies, the BoJ may request financial holding companies to submit a report or relevant materials and conduct onsite inquiries, in accordance with Inquiries Agreement.</p>
<b>Assessment of Principle 1</b>	C
Comments	The legal framework and supporting regulations for banking supervision in Japan are comprehensive with clear roles and responsibilities assigned to the different agencies plus a suite of powers that enable banking supervisors to effectively oversee the banking system. As is the case in many other jurisdictions the JFSA is charged with multiple mandates, in this case to pursue the stability of the financial system, to protect depositors, policyholders, securities holders, and to facilitate finance. The assessors concur with the authorities that the three mandates are complementary in that depositor protection and financial stability more generally are most likely to be achieved if the JFSA ensures that banks have capital and risk management practices commensurate with the risks they undertake and the environment in which they operate. In turn, this will promote a strong

	<p>banking system that can contribute to the economic well-being of Japanese society by facilitating finance in the economy.</p> <p>The Japanese legal framework provides clear provisions on the authorization of banking establishments and adequate information powers, as well as sufficient provisions for the supervisor to set prudential requirements via laws, ordinances guidelines, and inspection manuals. Also, the JFSA has in general substantial powers to undertake remedial action in its day-to-day supervision.</p> <p>As is the case in many jurisdictions some quite important remedial powers, like the powers to issue and revoke a banking license and the power to issue an order to suspend whole or part of the banking business, have not been delegated to the head of the JFSA, but have instead been retained by the PM. In practice the JFSA prepares the analysis for such decision making and offers its recommendations, which need to be endorsed by the PM.</p> <p>The JFSA indicated that while the decisions need to be formally endorsed by the PM the JFSA prepares these decisions and fully manages the decision-making processes. There has not been any situation where a proposed decision was unduly delayed or the substance changed from the JFSA's proposed decision. Thus, the assessors are satisfied that these arrangements work well in practice.</p>
<b>Principle 2</b>	<b>Independence, accountability, resourcing and legal protection for supervisors.</b> The supervisor possesses operational independence, transparent processes, sound governance, budgetary processes that do not undermine autonomy and adequate resources, and is accountable for the discharge of its duties and use of its resources. The legal framework for banking supervision includes legal protection for the supervisor.
<b>Essential criteria</b>	
<b>EC1</b>	The operational independence, accountability and governance of the supervisor are prescribed in legislation and publicly disclosed. There is no government or industry interference that compromises the operational independence of the supervisor. The supervisor has full discretion to take any supervisory actions or decisions on banks and banking groups under its supervision.
Description and findings re EC1	<p>The Act for Establishment of the Financial Services Agency created the JFSA as an external agency of the Cabinet Office. More precisely, the JFSA 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 an independent body from the Cabinet Office.</p> <p>The PM 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 JFSA 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 JFSA are specified in the Banking Act. They are mainly 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. Consequently, the PM would ultimately be responsible for endorsing major supervisory decisions in these areas. Those</p>

would be based upon supervisory information prepared and provided by the JFSA. If the PM should 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.

The JFSA has adequate independence to deploy its own banking supervision resources for the execution of its tasks. For the supervision of regional banks, the JFSA 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 JFSA 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 prudential matters under consideration concerning specific institutions. This is especially true for banks that are under the sole supervision of the JFSA, both in terms of the JFSA's mandate and the deployment of its resources.

The accountability of the JFSA is carried out on an ex post basis, which prevents active and ongoing intervention by the Diet in current cases. The JFSA 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. In September 2015, the JFSA published "Strategic Directions and Priorities" which indicates clearly what goals the JFSA aims to attain during the period from July 2015 to June 2016 and how. The "Strategic Directions and Priorities," places importance on PDCA cycle, and the JFSA evaluates/publishes its undergoing process and accomplishments. Meanwhile, the JFSA regularly summarizes its performance against objectives in its public annual reports.

The organizational structure of the JFSA 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 JFSA. Based upon these legal provisions, there are three internal bureaus in place within the JFSA: 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 respective directors. Quality control activities and peer reviews are undertaken in a rather informal way. There are direct contacts with banks supervised which help guide the work of the bureaus. Any information on banks would be inputted to senior management. There is 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 JFSA to the Local Finance Bureaus which are part of the MoF though increasingly subject to more coordination by the JFSA through its risk profiling program run. Within the JFSA a Regional Financial Institution Planning Office provides guidance to

these Local Finance Bureaus on the direction of their supervision with the help of the risk profiling program. These divisions also manage possible remedial supervisory action. The supervision, undertaken by the Local Finance Bureaus, also includes inspections.

Staffing levels and budgets within the JFSA have been fairly stable in recent years despite fiscal restraint in the public sector. The JFSA officials confirmed that they have not had any significant difficulties in obtaining the resources needed to fulfill their responsibilities and that the government has been willing to fund its priority initiatives. However, there is an issue of whether the funding model for the JFSA will remain robust over the longer term if the financial sector continues to evolve and expand while the public sector remains subject to fiscal restraint.

The JFSA staff is made up of government officials, and the PM has the authority over personnel management of all officials whose position is higher than Director including JFSA Commissioner. The JFSA Commissioner has the authority over personnel management of all staff whose position is equivalent to or lower than Director (National Public Service Act paragraph 1 Article 55). Being government officials, the JFSA staff, including the Commissioner are subject to Articles 75 and 78 of National Public Service Act, which stipulates that government officials shall not, against their will, be demoted, placed on administrative leave or dismissed, unless they come under a clause provided by law or by rules developed by the National Personnel Authority. These clauses are stipulated in Article 78 and include (i) unsatisfactory performance of duties; (ii) mental or physical disorders that leave the individual unable or encountering difficulties in performing their duties; (iii) lacking other qualifications required for the position; or (iv) the individual has become redundant following a reorganization that eliminates the individual's post.

As indicated in BCP 1, the JFSA supervises the Labor Bank under the Labor Bank Act together with Ministry of Health, Labor and Welfare. The JFSA also supervises Norinchukin Bank under the Norinchukin Bank Act together with Ministry of Agriculture, Forestry and Fishery. Supervisory guidelines and inspection manuals relevant for these institutions have been published, which serve as references not only for government officials, but also for each financial institution in creating business plans and internal management frameworks for risk management and customer protection. The Supervisory Guidelines and the Manual are created in consultation with other ministries that supervise together with the JFSA. Criteria for approval and licensing are stipulated in detail in the Supervisory Guidelines, and other ministries assess from the same view points as the JFSA. However, regarding the necessary measure to maintain the stability of the financial system such as the authority to carry out onsite inspection, the JFSA has the sole authorization which ensures the independence of the JFSA.

#### **Accountability of the JFSA**

Regarding dispositions upon applications and adverse dispositions conducted by administrative ministries and agencies against private companies, Administrative Procedure Act requires the ministries and agencies to establish and disclose the standards. Under the Act, Administrative ministries and agencies shall, in cases where they render Dispositions

	<p>refusing the permission, etc. sought by Applications, concurrently show the grounds for the subject Disposition. The same applies to the case where adverse dispositions are taken.</p> <p>The JFSA has also clarified detailed criteria for approvals and licenses in its Supervisory Guideline. As explained in EC3 of Principle 1, the JFSA has also published supervisory basic checklists for its onsite and offsite activities through Comprehensive Guidelines for Supervision of Major Banks, etc., Comprehensive Guidelines for Supervision of Small- and Medium-Sized and Regional Financial Institutions, Guideline for Financial Conglomerates Supervision, Inspection Manual for Deposit-Taking Institutions, and Inspection Manual for Financial Holding Companies. Additionally, the JFSA has published “Criteria for Administrative Actions” and has announced all administrative actions to the public, except in cases where such announcement might hinder managerial improvements in the targeted financial institution. The JFSA has also compiled and published, on a quarterly basis, a Collection of Cases in which administrative action has been taken. In relation to onsite inspections, the JFSA has published a Collection of Findings during onsite inspections which led to low grades as appropriate in order to increase transparency and predictability of the JFSA’s onsite activities. Moreover, upon individual request based on Law Concerning Access to Information held by Administrative Organs, the JFSA has responded to many requests for disclosure of information each year.</p> <p>Furthermore, the JFSA published “Strategic Directions and Priorities” which indicates clearly what goals the JFSA aims to attain during the period from July 2015 to June 2016 and how. The “Strategic Directions and Priorities,” places importance on PDCA cycle, and the JFSA evaluates/publishes its undergoing process and accomplishments. Meanwhile, the JFSA regularly summarizes its performance against objectives in its public annual reports.</p> <p><b>Governance of the JFSA</b></p> <p>The organizational structure of the JFSA is defined and disclosed through the Law on the Establishment of the Cabinet Office and Order and Ordinance for Organization of the JFSA. Three internal bureaus are in place within the JFSA: Planning and Coordination Bureau, Inspection Bureau and Supervisory Bureau. The JFSA does not have any high-level officials, including the Commissioner, from either the financial institutions it supervises or former politicians, which limits interference from the industry and politics in its supervisory activities.</p> <p><b>Supervisory measures</b></p> <p>The JFSA has the authority to take various supervisory measures not only to banks but also bank subsidiaries, bank outsourced companies, bank holding companies, and major shareholders. Examples include requirement for report based on Article 24, Article 52–31, and Article 52–11 of Banking Act, the authority to carry out onsite inspections based on Article 25 and Article 52–32, Article 52–12, business improvement order against major shareholders who hold more than 50 percent of voting rights based on Article 26, Article 52–33, Article 52–14 of the Banking Act.</p>
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	<p><b>Operational Independence of the Bank of Japan</b></p> <p>With regard to the BoJ, it possesses independence to operate its functions, as stipulated in the Bank of Japan Act (e.g., Articles 3, 5, 24, 25, and 51 of the Bank of Japan Act).</p>
<b>EC2</b>	<p>The process for the appointment and removal of the head(s) of the supervisory authority and members of its governing body is transparent. The head(s) of the supervisory authority is (are) appointed for a minimum term and is (are) removed from office during his/her term only for reasons specified in law or if (s)he is not physically or mentally capable of carrying out the role or has been found guilty of misconduct. The reason(s) for removal (are) publicly disclosed.</p>
Description and findings re EC2	<p>The JFSA Commissioner is appointed by the PM. The Commissioner appoints other senior staff. Formally, the Commissioner is appointed for an indefinite term, but in practice he/she tends to hold office for two to three years. Also, the Commissioner as head of the JFSA is a government official and as such cannot be dismissed from his position, except in the limited cases outlined previously in EC1 of this Core Principle. In practice, there have not been any precedent where the Commissioner has been demoted, placed on administrative leave or dismissed by PM. If such a case were to happen, the National Public Service Act requires the reasons to be clearly specified and the Guidance for publication on Disciplinary Action (Notification by the National Public Personnel Authority) requires a summary of the demotion or dismissal to be published. In addition, personnel reshuffles are in practice published in the Official Gazette, media and JFSA's website.</p> <p>In the case of the BoJ, the Bank of Japan Act stipulates the process for the appointment of officers in Article 23 and officers' terms of office in Article 24. The Bank of Japan Act stipulates guarantee of the officers' status in Article 25. Specifically, officers of the BoJ (excluding Executive Directors in this paragraph) shall not be dismissed against their will during their terms of office, except in the following cases: (i) An officer has received a ruling of the commencement of bankruptcy proceedings; (ii) An officer has received punishment under this Act; (iii) An officer has been sentenced to imprisonment without work or a heavier punishment; (iv) An officer has been deemed incapable of carrying out his/her duties due to mental or physical disorder by the board (or by the board and the Cabinet in the case of the Auditors).</p>
<b>EC3</b>	<p>The supervisor publishes its objectives and is accountable through a transparent framework for the discharge of its duties in relation to those objectives.<sup>16</sup></p>
Description and findings re EC3	<p>Discharge of JFSA'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 JFSA generally follows the BCBS recommendations and consults with industry and the public before amending its supervisory guidelines and/or inspection manual. In addition, the public is informed about JFSA's views via monthly newsletters and public presentations and speeches. Starting from 2013-2014, the JFSA has been publishing "Financial Monitoring Policy", which includes policy regarding onsite/offsite monitoring. Furthermore, in September 2015, "Strategic Directions and Priorities" was published, which indicates how and what goals the JFSA aims to attain regarding not only in inspection/supervision but also policy planning and international cooperation.</p>

<sup>16</sup> Please refer to Principle 1, Essential Criterion 1.

	<p>Additionally, in the so-called No Action Letter System, when private companies are about to launch new businesses, or dealings in concrete terms, the JFSA receives and responds to inquiries about whether such concrete activities are subject to unfavorable dispositions. Moreover, to complete the No Action Letter System which deals with the legality of individual cases, the JFSA has introduced “Written Inquiry Procedures for General Legal Interpenetration,” allowing for inquiries about general and abstract legal interpretation. Furthermore, under the Public Comment System, the JFSA has asked comments to the public every time it amends its financial regulations.</p> <p>With regard to the BoJ, it is required to conclude a contract with financial institutions to conduct onsite examinations (Article 44 of the Bank of Japan Act). The contract includes clauses, such as prior notification of the visit, to ensure the transparency of the entire process as well as to reduce the administrative burden of the counterparties.</p> <p>The BoJ also releases many reports and statements on a regular basis concerning its policy actions and operations, findings from its research, and the procedures/guideline, to pursue its function to maintain financial system stability in a transparent manner. The following are some examples:</p> <ul style="list-style-type: none"> <li>✓ Financial System Report (bi-annual);</li> <li>✓ Annual Review;</li> <li>✓ Annual Onsite Examination Policy (which includes the review of the previous fiscal year);</li> <li>✓ Public Statements with respect to Decision concerning Article 38 of the Bank of Japan Act; and</li> <li>✓ Speeches and Materials Presented in Seminars (Hosted by Center for Advanced Financial Technology).</li> </ul>
<b>EC4</b>	<p>The supervisor has effective internal governance and communication processes that enable supervisory decisions to be taken at a level appropriate to the significance of the issue and timely decisions to be taken in the case of an emergency. The governing body is structured so as to avoid any real or perceived conflicts of interest.</p>
Description and findings re EC4	<p>The JFSA and BoJ have formal delegation frameworks in place that govern internal decision-making processes. Approval processes within those organizations ensure that decisions are taken at appropriate levels within the organizations.</p> <p>In order to ensure the continuous operation even in the event of natural and man-made disasters, the JFSA established the “JFSA Emergency Action Plan,” the “JFSA Business Continuity Plan (Earthquake Directly below Tokyo Edition/Outbreak of Pandemic Flu Edition),” and the “JFSA Civil Protection Plan.” In the event of natural and man-made disasters, based on above plans, the JFSA will decide on policies to be taken and set up a “Disaster Management Team” with the Minister for Financial Services as the head.</p> <p>National Public Service Ethics Act and relevant stipulations set out ethical principles that government officials need to follow pertaining to their duties including the following.          (1) Officials shall always execute duties fairly and shall not give unjust and discriminatory treatment to citizens. (2) Officials shall not utilize their duties or positions for their personal interest or for their organizations’ private interest. (3) In exercising the authority granted by</p>

	<p>laws, officials shall not take any actions that may cause suspicion or distrust from the citizens, such as receiving any gifts from person upon whom the officials exercise the authority. In addition, the JFSA staff are precluded from having ownership stakes in regulated entities and need to regularly attest that they are in compliance with the conflict of interest rules.</p> <p><b>Bank of Japan</b></p> <p>In accordance with Article 22 of the Bank of Japan Act, the BoJ makes contingency plans in advance in case the Governor and the Deputy Governors are prevented from attending to their duties. As stipulated in Article 22–3 of the Bank of Japan Act, the Governor or the Deputy Governors shall not have the authority of representation with regard to matters for which their interests and the interest of the BoJ conflict with each other. As stipulated in Article 16(5) of the Bank of Japan Act, the board designates, in advance, a member who shall perform the duties of the chairperson when the chairperson is prevented from attending to his/her duties.</p> <p>As stipulated in Article 26 of the Bank of Japan Act, an officer of the BoJ shall not engage in other work and carry out commercial business. Moreover, the BoJ establishes rules on service for its officers and employees, such as rules on the obligations to devote themselves to their duties and to separate themselves from private enterprises. (the Bank of Japan Act, Article 32).</p>
<b>EC5</b>	<p>The supervisor and its staff have credibility based on their professionalism and integrity. There are rules on how to avoid conflicts of interest and on the appropriate use of information obtained through work, with sanctions in place if these are not followed.</p>
Description and findings re EC5	<p>The JFSA's banking supervision staff has credibility based on their professionalism and integrity in carrying out their duties. All the JFSA 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. Staff tend to rotate every two to three years. This enables them to gain a broader perspective on banking supervisory issues and the knowledge transfer process is to ensure continuity in the quality of supervisory work is adequate. We understand that career paths exist for generalists, but not for specialists.</p> <p><b>Professionalism of the JFSA</b></p> <p>For the supervision of financial institutions, a high level of expertise is required and the JFSA maintains and improves its staff expertise in response to the development of financial technology and financial markets. The JFSA has worked hard to improve professionalism of its staff as follows.</p> <ul style="list-style-type: none"> <li>• The JFSA has seconded some of its staff to international organizations (such as FSB, IOSCO and IAIS), foreign supervisory authorities (such as SEC), foreign Embassies, private companies, local government, and universities.</li> <li>• The JFSA has seconded its staff to graduate schools in and out of Japan (majors include accounting, IT, finance, MBA) in order to support them gain knowledge/skills and develop skills to analyze from specialists' point of view.</li> </ul>

- The JFSA has recruited staff members from the private sector such as banks as well as lawyers and Certified Public Accountants and allocated the staff depending upon need of each department.
- In addition, the JFSA has established a well- organized internal training system (see EC4 of this Core Principle).

#### **Integrity of the JFSA**

The JFSA staff is made up of government officials. All government officials shall ensure fairness and public trust in exercising duties in accordance with National Public Service Ethics Act. Article 99 of that act also provides "no official shall act in such a way as to discredit his/her government position or bring dishonor upon all the government positions," which prohibits acts causing discredit.

Prevention of conflicts of interest and appropriate use of information  
Officials must not divulge any confidential information they gained through their duties. There are standards set for penalties and disciplinary actions to be taken for when an official violates the above.

#### **Professionalism and Integrity of the Bank of Japan**

With regard to the BoJ, as mentioned in the "The Bank of Japan's Strategic Priorities for Fiscal 2014–2018" which was decided by the Policy Board, the BoJ will secure and foster human resources with a high degree of central banking expertise in the execution of business operations and organizational management. Officers and employees shall be deemed to be those engaged in public service pursuant to laws and regulations (the Bank of Japan Act, Article 30). The BoJ has also established its own compliance rules in accordance with Article 32 of the Act.

As stipulated in Article 22–3 of the Bank of Japan Act, the Governor or the Deputy Governors shall not have the authority of representation with regard to matters for which their interests and the interest of the BoJ conflict with each other.

As stipulated in Article 26 of the Bank of Japan Act, an officer of the BoJ shall not engage in other work and carry out commercial business. Those who have violated Article 26 shall be punished by a non-penal fine not exceeding five hundred thousand yen (the Bank of Japan Act, Article 65 (v)).

The BoJ has also established rules on service for its officers and employees, such as rules on the obligations to devote themselves to their duties and to separate themselves from private enterprises. (the Bank of Japan Act, Article 32). Moreover, as stipulated in Article 29 of the Bank of Japan Act, the BoJ's officers and employees shall not leak or misappropriate secrets which they have learned in the course of their duties. Those who have leaked or misappropriated secrets in violation of Article 29 shall be punished by imprisonment with work for not exceeding a year or a fine not exceeding five hundred thousand yen. (the Bank of Japan Act, Article 63).

<b>EC6</b>	<p>The supervisor has adequate resources for the conduct of effective supervision and oversight. It is financed in a manner that does not undermine its autonomy or operational independence. This includes:</p> <ul style="list-style-type: none"> <li>(a) a budget that provides for staff in sufficient numbers and with skills commensurate with the risk profile and systemic importance of the banks and banking groups supervised;</li> <li>(b) salary scales that allow it to attract and retain qualified staff;</li> <li>(c) the ability to commission external experts with the necessary professional skills and independence, and subject to necessary confidentiality restrictions to conduct supervisory tasks;</li> <li>(d) a budget and program for the regular training of staff;</li> <li>(e) a technology budget sufficient to equip its staff with the tools needed to supervise the banking industry and assess individual banks and banking groups; and</li> <li>(f) a travel budget that allows appropriate onsite work, effective cross-border cooperation and participation in domestic and international meetings of significant relevance (e.g., supervisory colleges).</li> </ul>
Description and findings re EC6	<p>The JFSA is funded by the central government budget. The Diet approves the JFSA 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 JFSA has received a relatively high priority in central government budget planning; in recent years its budget and number of staff have been stable while those of other government ministries and agencies have declined due to fiscal restraint within the Japanese government. Also, possible expenses by the JFSA 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 JFSA 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 while still being subject to conflict of interest and confidentiality provisions of government. The JFSA has made extensive use of this facility. This has so far helped to keep staff turnover rates at manageable levels. It also has an extensive internal training program in which staff participates two to four times a year.</p> <p>More specifically, internal training programs have been provided for staff for various levels from basics to advanced, depending on an individual's knowledge, experience and competencies. The training programs were offered in the form of lectures and seminars. (88 programs were provided during the period of April 2015 to March 2016). Through training programs, staff is able to gain knowledge about financial monitoring and recent financial regulations. Training programs also include specific case studies. The lecturers are not only internal staff but also private sector specialists such as scholars, attorneys and CPAs who are invited from outside.</p> <p>Information technology system such as the JFSA IT infrastructure that supports the overall financial supervision and monitoring has been installed in order to restore and utilize data</p>

	<p>and materials submitted from financial institutions in an efficient manner.</p> <p>The JFSA secures adequate budgets for onsite inspections and other business travels every year, which also cover irregular expenditures in response to changes in supervisory priorities.</p> <p>Moreover, in accordance with Paragraph 1, Article 59 and Article 17–2 of Order for Enforcement of the Banking Act, the JFSA Commissioner may, pursuant to the provisions of a Cabinet Order, delegate part of the authority to the Director General of Local Finance Bureaus or Local Finance Branch Bureaus. Based on this provision, the JFSA can also utilize the resources in Local Finance Bureaus for its supervisory activities.</p> <p>The JFSA also secures adequate budgets every year for business travels for participating in meetings in Japan and also international meetings including supervisory college.</p> <p><b>Bank of Japan</b></p> <p>The BoJ prepares a budget for expenses every fiscal year. While securing the necessary budget to perform its role as the central bank of Japan, the BoJ has also thoroughly examined each item of expenditure to achieve more streamlined overall spending. (See the Annual Review 2016) It is financed mainly by interest on own assets such as Japanese government securities, bills, loans and foreign currency assets. Therefore, it is financed in a manner that does not undermine its autonomy or operational independence. See its financial statements available at <a href="http://www.boj.or.jp/en/about/account/index.htm/">www.boj.or.jp/en/about/account/index.htm/</a></p>
<p><b>EC7</b></p>	<p>As part of their annual resource planning exercise, supervisors regularly take stock of existing skills and projected requirements over the short- and medium-term, taking into account relevant emerging supervisory practices. Supervisors review and implement measures to bridge any gaps in numbers and/or skill-sets identified.</p>
<p>Description and findings re EC7</p>	<p>The JFSA regularly reviews its staffing and skills requirements, identifies gaps and training requirements through its corporate planning processes. For example, in 2016 it identified the need for more IT expertise and is now seeking to recruit additional IT staff as well as train existing staff on IT issues.</p> <p><b>Bank of Japan</b></p> <p>The BoJ formulates and releases the "The Bank of Japan's Strategic Priorities" which describes the basic principles for its business operations and organizational management including human resources and budget for expenses. (See "The Bank of Japan's Strategic Priorities" available at <a href="https://www.boj.or.jp/en/about/activities/strategy/data/hoshin14.pdf">https://www.boj.or.jp/en/about/activities/strategy/data/hoshin14.pdf</a>) With a view to (1) steadily carrying out the strategic objectives for business operations and organizational management outlined in the Strategic Priorities for fiscal 2014-2018 and (2) reviewing and revising as necessary the allocation of management resources, the BoJ will conduct and make public performance reviews of measures taken under the Strategic Priorities every fiscal year. In addition, it will conduct a thorough review of the entire contents of the Strategic Priorities. The performance reviews are shown in the Annual Review available at <a href="https://www.boj.or.jp/en/about/activities/act/ar2016.htm/">https://www.boj.or.jp/en/about/activities/act/ar2016.htm/</a></p>

	In addition, the Financial System and Bank Examination Department of the BoJ establishes annual strategic objectives for macro prudential policy, and aims to secure quality human resources in accordance with issues identified and to enhance the expertise through staff training. Center for Advanced Financial Technology provides staff training and development relating to the Department's business operations.
<b>EC8</b>	In determining supervisory programs and allocating resources, supervisors take into account the risk profile and systemic importance of individual banks and banking groups, and the different mitigation approaches available.
Description and findings re EC8	<p>The JFSA has introduced risk profiling of regulated banks and banking groups, which drive monitoring and inspection activities for individual institutions and ultimately the allocation of staff to those activities across regulated institutions. Over time the JFSA has moved away from its NPL focus of the 1990s and has combined on and offsite surveillance activities with technical specialists to focus on specific risk issues within the banking system.</p> <p>In particular, since July 2013, taking into account changes in the environment surrounding the financial system, the JFSA has been reviewing its financial monitoring. In 2013 and 2014, the JFSA published "Financial Monitoring Policy" which integrated the process of onsite monitoring and offsite monitoring. In September 2015, the JFSA published "Strategic Directions and Priorities," which indicates the policy for the entire JFSA, including monitoring policy.</p> <p>With these policies, the Inspection Bureau and the Supervisory Bureau of the JFSA together will interview/request materials (offsite monitoring) and grasp the financial institution's business situation, its issues, risk characteristics, and systemic importance. If necessary, the JFSA will conduct focused onsite inspections in order to monitor/reduce risks (onsite monitoring).</p> <p>The BoJ establishes and publishes the onsite examination policy annually. As the onsite examination policy stipulated, the BoJ examines the risk, while taking into account the risk profile and systemic importance of individual banks and banking groups.  <a href="https://www.boj.or.jp/en/finsys/exam_monit/exampolicy/kpolicy16.pdf">https://www.boj.or.jp/en/finsys/exam_monit/exampolicy/kpolicy16.pdf</a></p>
<b>EC9</b>	Laws provide protection to the supervisor and its staff against lawsuits for actions taken and/or omissions made while discharging their duties in good faith. The supervisor and its staff are adequately protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith.
Description and findings re EC9	An appropriate protection from being liable for actions taken in good faith is assured for the JFSA 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 JFSA nor the JFSA itself could be held liable for this damage. The party which has suffered from the decision by the JFSA 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 JFSA but the Japanese

	<p>Government is subject to litigation if the JFSA is sued for its inappropriate actions. In recent years, no such cases of litigation have been witnessed.</p> <p>Normally the supervisory authority and its staff would be adequately protected against the cost of defending their actions. However, when there is malicious 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. There have not been any cases in recent years.</p>
<p><b>Assessment of Principle 2</b></p>	<p>LC</p>
<p>Comments</p>	<p>The JFSA and BoJ have most of the mechanisms in place that are needed to enable those agencies to conduct their banking supervision work with the requisite operational independence and appropriate legal protection. The two agencies also have sound governance frameworks internally and have been able to obtain the funding and resources they need to discharge their duties. The JFSA recognizes that the introduction of a more dynamic approach to supervision will require organizational changes and extensive staff training to upgrade staff skills and is actively engaged in implementing its plans in this regard.</p> <p>The JFSA does not meet all of the requirements of EC2 as the JFSA Commissioner does not have a fixed term of office, consistent with the practice for most heads of agencies in Japan. (The BoJ Governor post is an exception in this regard). However, in the event that a Commissioner was dismissed, demoted or placed on administrative leave the government is required to articulate the rationale and publicly announce the decision.</p> <p>In addition, the assessors believe the statutory provisions outlining the conditions upon which a Commissioner could be replaced do not provide sufficient protection for the Commissioner to carry out his or her duties without potentially running a risk of being removed from office in the event of a major dispute with the government over prudential matters. Assessing the performance and qualifications of an agency head often requires a fair amount of qualitative judgment, and such judgments could conceivably be influenced by differing views on prudential issues. Thus, the assessors cannot rule out the possibility that at some point in the future a government might be tempted to remove a Commissioner on performance or qualifications grounds in the event of a major dispute on prudential matters. Having said that, the assessors respect the fact that fixed terms of office are not the norm in Japan and that there have not been any cases where a Commissioner has been dismissed, demoted or placed on administrative leave by the PM.</p> <p>The JFSA budget is included as part of the national budget and as such is subject to the examination and approval of the Ministry of Finance. The JFSA budget requests are under the same restriction. Although it could potentially be impacted by political considerations, this has not been an issue in practice. The JFSA budget has remained stable and the JFSA has been able to obtain the funding it needs to carry out its duties. Having said that the assessors believe that this funding model could potentially become gradually less robust</p>

	<p>over the longer term. This could be the case, for example, if the financial sector continues to expand and become more complex over time and the public sector remains subject to a protracted period fiscal restraint. Such pressures are unlikely to emerge all at once; rather the risk is that they may emerge in the form of an accumulation of events over time that gradually erodes the JFSA's capacity to acquire the resources it needs to effectively fulfill its mandate. Consequently, the assessors encourage the authorities to consider whether a different funding model might make sense for the JFSA in the longer run.</p> <p>In addition, when looking at the day-to-day supervisory tasks under the direct control of the JFSA staff, there is sufficient operational independence from government decision-making. However, some major JFSA decisions on individual banks, like the approval and revocation of a license or the suspension of the whole or part of the banking operations need to be formally endorsed by the PM. This is a fairly common practice in many jurisdictions given the importance of such decisions. The assessors are comforted by the fact that in practice these endorsements are granted routinely and there have not been any circumstances where JFSA proposals have been refused or significantly modified.</p> <p>As outlined under CP 1, the supervision of regional and cooperative banks is delegated by the JFSA to Local Finance Bureaus. These bureaus are not part of the JFSA but of the MoF for legacy administrative reasons. The day-to-day supervision of these regional and cooperative banks is conducted by staff within those bureaus under close oversight by the JFSA. The assessors welcome the changes introduced by the JFSA in recent years to strengthen its coordination of the work conducted by, and its provision of more risk profiling technical support to the Local Finance Bureaus.</p>
<b>Principle 3</b>	<b>Cooperation and collaboration.</b> Laws, regulations or other arrangements provide a framework for cooperation and collaboration with relevant domestic authorities and foreign supervisors. These arrangements reflect the need to protect confidential information. <sup>17</sup>
Essential criteria	
<b>EC1</b>	Arrangements, formal or informal, are in place for cooperation, including analysis and sharing of information, and undertaking collaborative work, with all domestic authorities with responsibility for the safety and soundness of banks, other financial institutions and/or the stability of the financial system. There is evidence that these arrangements work in practice, where necessary.
Description and findings re EC1	<p><b>Cooperation among the JFSA, BoJ, and MoF</b></p> <p>Aside from the JFSA, the BoJ conducts a) onsite examinations of financial institutions, as stipulated in Article 44 of the Bank of Japan Act, by dispatching its examiners to the institutions; and b) offsite monitoring, through meetings and telephone interviews with their executives and staff, as well as analyses of various documents and financial data. Findings both from onsite examinations and offsite monitoring help facilitate the smooth settlement of funds and the proper exercise of the lender of last resort function.</p>

<sup>17</sup> Principle 3 is developed further in the Principles dealing with "Consolidated supervision" (12), "Home-host relationships" (13) and "Abuse of financial services" (29).

To conduct inspections and examinations effectively and efficiently, the JFSA and BoJ share information and exchange views in a broad manner:

- 1) The JFSA and BoJ regularly exchange information to adjust the schedules and the lists of the financial institutions they intend to visit, in advance of the inspections/examinations.
- 2) The JFSA coordinates inspection planning with the BoJ examinations.
- 3) On a regular basis, the JFSA and BoJ make contacts through a variety of channels, including frequent/informal visits, calls and e-mails at division chief/director levels.
- 4) Depending on the case or importance, the JFSA/BoJ may set up regular/ad-hoc meetings, or conference calls for information sharing and exchange of views at higher levels. For example, in order to share information and opinions on recent developments in financial system and markets, and strengthen the cooperation between the JFSA and the BoJ, Japan launched the Council for Cooperation on Financial Stability, which consists of senior officials including the Commissioner of the JFSA and a deputy governor of the BoJ was formed in June 2014. In addition to these individual initiatives by the JFSA and the BoJ, a meeting to exchange information on international financial and capital markets, which consists of the JFSA, BoJ, and MoF, has been held on a monthly basis since March 2016. This meeting is held so that three authorities can enhance further cooperation among them.
- 5) Taking into account the abovementioned information sharing, the BoJ may submit the documents describing the results of the onsite examinations and other related materials to the Commissioner or have officials of the JFSA inspect them (Article 44 of the Bank of Japan Act).
- 6) The BoJ and JFSA have enhanced personal exchanges ranging from staff level to senior level. The JFSA host a person from the BoJ as the deputy Commissioner.

#### **Use of External auditors**

The JFSA has its own staff for banking supervision in order to ensure quality, integrity and appropriateness of supervisory activities; therefore, it never outsources any supervisory duties to third parties such as external auditors.

However, based on Article 193–3 of Financial Instruments and Exchange Act (which was introduced through amendment of the Act in 2007), the JFSA can obtain information on significant matters related to management of business of a bank and banking group. Under this article, in case when external auditors find matters through which listed companies or their subsidiaries may violate laws or which may negatively affect appropriateness of financial statements and other Information, they are required to notify the fact to those companies in writing at first, and then in case where even after a certain period of time, the situation has not improved, to notify the matters to the Commissioner of the JFSA.

In addition, in accordance with Article 24 of Banking Act, the JFSA has the power to receive reports via banks with regard to issues found out by external auditors, and the JFSA periodically speaks with external auditors on issues that may negatively affect financial reporting and issues regarding the scope of internal control audit during inspections. Japan Institute of Certified Public Accountant has provided “Guideline for Cooperation between Accounting Audit and Financial Inspection” since 27 July 2000 (which was revised in May

	<p>2011 as “Guideline for Cooperation between Accounting Audit and Internal Control Audit and Financial Inspection) and based on this guideline, external auditors have dialogues with examiners at appropriate timings where necessary.</p> <p><b>Crisis management</b></p> <p>In line with FSB “Key Attributes (KA)”, the JFSA has set up a Crisis Management Group (CMG) with relevant foreign resolution authorities, together with Deposit Insurance Corporation of Japan (DICJ) and the BoJ, and hold the meeting once a year. In this meeting, they discuss and share information on Recovery and Resolution Plan for relevant banks, with host authorities. Japan has also concluded Co-Ag (Cooperation Agreement) among authorities participating in the CMG meeting, in line with the KA. The JFSA and the DICJ have a legal responsibility for resolution of financial institutions, and exchange views frequently with each other, through a variety of channels, including visits, calls and e-mails.</p>
<b>EC2</b>	<p>Arrangements, formal or informal, are in place for cooperation, including analysis and sharing of information, and undertaking collaborative work, with relevant foreign supervisors of banks and banking groups. There is evidence that these arrangements work in practice, where necessary.</p>
Description and findings re EC2	<p>The JFSA periodically meets with foreign supervisory authorities, to exchange views on the current situation of financial sector in each jurisdiction, international market developments and collaborate on important regulatory and supervisory issues. In addition, where necessary, the JFSA has concluded MoUs or EoLs on supervisory cooperation. One of the assessors has many years of personal experience in collaborating closely with the JFSA and BoJ officials on international regulatory issues and can attest that these arrangements work very well in practice.</p> <p>The JFSA has endeavored to cooperate with foreign supervisors either via bilateral dialogues or via Supervisory College or both as necessary. For example, the JFSA has periodically hosted Supervisory College meetings and Crisis Management Group meetings for three Japanese major banking groups, and it has also participated in Supervisory College meetings on foreign banks that have business operation in Japan. In these meetings, qualitative information as well as quantitative data on financial indicators of certain banking groups as a whole are shared and mutual understanding of supervisory issues is promoted. In a situation where supervisory actions are required, such as a change in economic situation, the JFSA has shared supervisory information with foreign counterparts via conference calls on an ad-hoc basis.</p>
<b>EC3</b>	<p>The supervisor may provide confidential information to another domestic authority or foreign supervisor but must take reasonable steps to determine that any confidential information so released will be used only for bank-specific or system-wide supervisory purposes and will be treated as confidential by the receiving party.</p>
Description and findings re EC3	<p>Cooperation with Domestic Authorities</p> <p>The JFSA informally exchanges supervisory information with the BoJ via dialogues, telephones and emails where necessary. The BoJ together with the JFSA participates in Supervisory Colleges for three Japanese major banking groups. In cases where both the JFSA and BoJ participates in the same Supervisory College meetings held by foreign</p>

	<p>supervisors, the JFSA and BoJ will exchange views on the status of business management and operation of foreign banks’ branches in Japan. The BoJ may submit the documents describing the results of the onsite examinations and other related materials to the Commissioner or have officials of the JFSA inspect them (Article 44 of the Bank of Japan Act).</p> <p><b>Cooperation with Foreign Supervisors</b></p> <p>The JFSA and BoJ exchange with foreign supervisors information on banks or banking groups in which both parties have common interests. It is prohibited for the JFSA to exchange information for other than supervisory purposes based on Article 100 of the National Public Service Act and Article 29 of the Bank of Japan Act. When sharing information the Japanese authorities clearly indicate in articles of MoUs and EoLs that foreign counterparts are expected to keep the information confidential and to be used only for supervisory purposes. If the JFSA or BoJ assume that the counterparts use the supervisory information for other than supervisory purposes, the JFSA 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 Bank of Japan Act.</p>
<p><b>EC4</b></p>	<p>The supervisor receiving confidential information from other supervisors uses the confidential information for bank-specific or system-wide supervisory purposes only. The supervisor does not disclose confidential information received to third parties without the permission of the supervisor providing the information and is able to deny any demand (other than a court order or mandate from a legislative body) for confidential information in its possession. In the event that the supervisor is legally compelled to disclose confidential information it has received from another supervisor, the supervisor promptly notifies the originating supervisor, indicating what information it is compelled to release and the circumstances surrounding the release. Where consent to passing on confidential information is not given, the supervisor uses all reasonable means to resist such a demand or protect the confidentiality of the information.</p>
<p>Description and findings re EC4</p>	<p>Staff members of the JFSA 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 JFSA (Paragraph 1 of Article 100 and Article 109 of the National Public Service Act). A staff member that does not abide by these stipulations may, as disciplinary action, be dismissed, suspended from duty, suffer reduction in pay or be admonished, when he/she 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).</p> <p>“Any secret which may have come to their knowledge in the performance of their duties” of Paragraph 1 of Article 100 of the NPSL is interpreted as information which is not disclosed to the public and is deemed to be worth being protected as secret in practice (Precedent, Supreme Court, 19 December 1977).</p> <p>The JFSA has implemented rules on grading and handling of information, and it stipulates that the JFSA officials shall obtain express agreement of the foreign authorities before publishing or providing confidential information received from foreign authorities to a third</p>

	<p>party.</p> <p>The MOU/EOL that the JFSA has concluded with foreign authorities have articles indicating that received information from other authorities should be used only for supervisory purposes and should not be disclosed unless the express content from the other authorities is obtained. It is also mentioned "To the extent permitted by their respective domestic laws and regulations, FSA or another authority should hold confidential any information received, and they will not disclose it without prior consent of the other supervisor. If the JFSA or another authority is legally compelled to disclose confidential information received from the other supervisor, they will, to the extent permitted by applicable laws and regulations, consult with the other supervisor before disclosing it. If there is an objection to the disclosure, they will use all reasonable efforts including those available to them at law, to resist the disclosure of the information at issue."</p> <p>The Rule on the Management of Administrative Documents set by the JFSA defines secret documents (information) and requires the JFSA staff to manage the secret information properly. 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 the matters by the person responsible for the management of documents in the department/office responsible for the matters.</p> <p>As Article 29 of the Bank of Japan Act stipulates "BoJ's officers and employees shall not leak or misappropriate secrets which they have learned in the course of their duties," it is prohibited to disclose secrets which it has learned in the course of their duties to third parties. It is also prohibited to disclose information received from another supervisor to third parties in accordance with Article 29 of the Bank of Japan Act. Based on the interpretation of the Article 29 of the Bank of Japan Act, when the BoJ discloses the information received from another supervisor, it should obtain the prior consent.</p>
<b>EC5</b>	Processes are in place for the supervisor to support resolution authorities (e.g., central banks and finance ministries as appropriate) to undertake recovery and resolution planning and actions.
Description and findings re EC5	In the framework of orderly resolution which was incorporated in the revised Deposit Insurance Act in June 2013, the JFSA has a responsibility of developing resolution plans as a resolution authority as well as a supervisory authority. Both the DICJ as an executive agency of resolution and the BoJ as a central bank responsible for maintaining orderly financial system are CMG members, and they are cooperating with the JFSA in the development of resolution plans.
<b>Assessment of Principle 3</b>	C

Comments	The Japanese authorities have made significant progress in recent years in strengthening the links between the domestic agencies involved in banking supervision and in deepening relationships with foreign supervisory agencies via the introduction of more MoUs, EoIs and especially the introduction of CMGs for major Japanese banks that have been designated as global systemically important.
<b>Principle 4</b>	Permissible activities. The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined and the use of the word “bank” in names is controlled.
<b>Essential criteria</b>	
<b>EC1</b>	The term “bank” is clearly defined in laws or regulations.
Description and findings re EC1	<p>Article 2 of the Banking Act defines a bank as a person who operates a banking business under the license of the PM prescribed under Article 4 of that Act. 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 exchange transactions. In addition, in accordance with Article 3 of the Banking Act, a business involving only acceptance of deposits or installment savings shall also be deemed to be a banking business and the Banking Act shall apply to such business.</p> <p>Unless it has obtained a banking license from the PM, no banking business may be conducted. According to Article 4.2 every bank licensed under the Banking Act, shall be a stock company. The JFSA enforces these requirements by responding to possible complaints and by acting on cases when it becomes aware of situations where users of financial services have been harmed.</p>
<b>EC2</b>	The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined either by supervisors, or in laws or regulations.
Description and findings re EC2	<p>The activities a bank may undertake are specifically mentioned in law. Other activities may not be conducted. The activities are listed in Articles 10 and 11 of the Banking Act. In 2016 the Banking Act was revised to allow banks to own subsidiaries engaged in Fintech activities.</p> <p>Article 10 provides a specific list of banking activities, while Article 11 refers to the requirements for undertaking business pursuant to the provisions of the Secured Bonds Trust Act or other laws. The JFSA has also published details of the permissible activities on its website: <a href="http://www.fsa.go.jp/en/refer/legislation/index.html">http://www.fsa.go.jp/en/refer/legislation/index.html</a></p>
<b>EC3</b>	The use of the word “bank” and any derivations such as “banking” in a name, including domain names, is limited to licensed and supervised institutions in all circumstances where the general public might otherwise be misled.
Description and findings re EC3	Article 6 of the Banking Act prohibits any person other than banks from the use of any term in its corporate name that would suggest the entity is a bank. No other person than a licensed and supervised bank may use in its name or trade name any term that would suggest that the entity is a bank. A bank that intends to change its trade name needs authorization from the PM. Both the police and the Consumer Agency respond to the illegal use of the name “bank.”

	Banks are not prohibited from using a word meaning “bank” in their domain names, but the JFSA alerts the financial service users to fraud cases by publishing them on its website, when many fraud cases using similar methods are identified.
<b>EC4</b>	The taking of deposits from the public is reserved for institutions that are licensed and subject to supervision as banks. <sup>18</sup>
Description and findings re EC4	Only institutions licensed and supervised under the Banking Act or other specific laws (e.g., specific laws for cooperative banks and <i>Shinkin</i> banks per EC1 of CP1) may accept deposits from the public; therefore, any other institution accepting deposits from the public would be in violation of Article 4 of the Banking Act.  Now that Japan Post Bank is a bank under the Banking Act following its privatization, it is subject to JFSA supervision.
<b>EC5</b>	The supervisor or licensing authority publishes or otherwise makes available a current list of licensed banks, including branches of foreign banks, operating within its jurisdiction in a way that is easily accessible to the public.
Description and findings re EC5	The JFSA publishes and updates the list of financial institutions and foreign financial institutions that have licenses for conducting banking businesses in Japan on its website.
<b>Assessment of Principle 4</b>	C
Comments	The definition of a bank and the range of activities that banks and bank holding companies are permitted to engage in is clearly defined.
<b>Principle 5</b>	<b>Licensing criteria.</b> The licensing authority has the power to set criteria and reject applications for establishments that do not meet the criteria. At a minimum, the licensing process consists of an assessment of the ownership structure and governance (including the fitness and propriety of board members and senior management) <sup>19</sup> of the bank and its wider group, and its strategic and operating plan, internal controls, risk management and projected financial condition-(including capital base). Where the proposed owner or parent organization is a foreign bank, the prior consent of its home supervisor is obtained.
Essential criteria	
<b>EC1</b>	The law identifies the authority responsible for granting and withdrawing a banking license. The licensing authority could be the banking supervisor or another competent authority. If the licensing authority and the supervisor are not the same, the supervisor has the right to have its views on each application considered, and its concerns addressed. In addition, the licensing authority provides the supervisor with any information that may be material to

<sup>18</sup> The Committee recognizes the presence in some countries of non-banking financial institutions that take deposits but may be regulated differently from banks. These institutions should be subject to a form of regulation commensurate to the type and size of their business and, collectively, should not hold a significant proportion of deposits in the financial system.

<sup>19</sup> This document refers to a governance structure composed of a board and senior management. The Committee recognizes that there are significant differences in the legislative and regulatory frameworks across countries regarding these functions. Some countries use a two-tier board structure, where the supervisory function of the board is performed by a separate entity known as a supervisory board, which has no executive functions. Other countries, in contrast, use a one-tier board structure in which the board has a broader role. Owing to these differences, this document does not advocate a specific board structure. Consequently, in this document, the terms “board” and “senior management” are only used as a way to refer to the oversight function and the management function in general and should be interpreted throughout the document in accordance with the applicable law within each jurisdiction.

	the supervision of the licensed bank. The supervisor imposes prudential conditions or limitations on the newly licensed bank, where appropriate.
Description and findings re EC1	Article 4 of the Banking Act requires banks to have a license. As indicated in CP 2 EC1, the license is formally obtained from the PM. The actual approval process is managed by the JFSA, whose recommendations are routinely endorsed by the PM; confirmed in the course of reviewing supervisory files. The same process holds when a license needs to be revoked (Article 27). There have not been any cases where the PM has not endorsed the JFSA recommendations to either grant or rescind a license.
<b>EC2</b>	Laws or regulations give the licensing authority the power to set criteria for licensing banks. If the criteria are not fulfilled or if the information provided is inadequate, the licensing authority has the power to reject an application. If the licensing authority or-supervisor determines that the license was based on false information, the license can be revoked.
Description and findings re EC2	<p>Article 4 of Banking Act sets out the criteria for licensing as follows.</p> <ul style="list-style-type: none"> <li>➤ Financial basis to conduct the business of a Bank soundly and efficiently and good prospects for income and expenditure pertaining to the business; and</li> <li>➤ Knowledge and experience to be able to carry out the business of a Bank appropriately, fairly and efficiently and sufficient social credibility in light of personnel and other relevant structures.</li> </ul> <p>The JFSA provides more details on application forms for a bank license and on criteria for licensing in the Ordinance for Enforcement of the Banking Act and Supervisory Guideline. As for the application forms for a bank license, the details are given in paragraph 1 and 2 of Article 1–8 of the Ordinance for Enforcement of the Banking Act and the attachment to the Supervisory Guideline.</p> <p>As for criteria for licensing, the details are given in paragraph 3 of Article 1–8 of the Ordinance for Enforcement of the Banking Act and Chapter VII of Supervisory Guideline which designates how the JFSA will supervise entry banks.</p> <p>In the event a person who files an application for a banking license does not fulfil the licensing criteria or when the information provided by the person is not sufficient, the application will be rejected.</p> <p>When the JFSA finds the bank has filed false information in its application for licensing or has violated conditions on the license, it will order the bank to submit a report on the matter and action to improve the situation already taken by the bank to the JFSA based on Article 24 of the Banking Act. If the JFSA finds it necessary to enforce the bank to improve the situation, the JFSA will consider issuing a business improvement order against the bank in accordance with Article 26 of the Banking Act.</p> <p>In addition, the JFSA will consider asking the PM to endorse a recommendation to revoke a bank license in accordance with Article 27 of the Banking Act if the JFSA finds it inappropriate for the bank to continue due to many material violation of laws or regulations or misconducts that harm the public interest (II–5–1–1 (5) and (6) of the Supervisory Guideline).</p>
<b>EC3</b>	The criteria for issuing licenses are consistent with those applied in ongoing supervision.

Description and findings re EC3	<p>The JFSA requires a bank to have the resources and controls in place before it will seek a license for the bank from the PM. After a license is granted the JFSA continues to check whether the bank meets the criteria for holding the license as part of its ongoing supervision through its offsite monitoring activities. Onsite inspections will be conducted if and when the need arises after that but typically a couple of years after the bank has commenced operation to give it time to build a track record before it is reviewed.</p> <p>In accordance with Article 24 of Banking Act, the JFSA require a bank to report the results of fact-finding research to the JFSA when it finds that the bank's activity may violate the criteria for licensing.</p> <p>In situations where the JFSA finds it necessary to force banks to properly implement the business improvement plan in order to ensure safety and soundness of bank's business management and operation, the JFSA will issue a Business Improvement Order to the bank in accordance with Article 26 of Banking Act.</p>
<b>EC4</b>	<p>The licensing authority determines that the proposed legal, managerial, operational and ownership structures of the bank and its wider group will not hinder effective supervision on both a solo and a consolidated basis.<sup>20</sup> The licensing authority also determines, where appropriate, that these structures will not hinder effective implementation of corrective measures in the future.</p>
Description and findings re EC4	<p>In light of personnel and other relevant structures, the JFSA would examine whether or not the applicant has the knowledge and experience to be able to carry out the business of a bank appropriately, fairly and efficiently and whether or not it has sufficient social credibility in accordance with Article 4, paragraph 2, item 2 of the Banking Act.</p> <p>In addition, a person or company who wishes to become a bank holding company needs to be approved by the PM as a bank holding company based on article 52–17 of the Banking Act; the JFSA checks whether or not the applicant fulfils the criteria regarding personnel and other relevant structures.</p> <p>The JFSA checks the legal, managerial, operational and ownership structures of the applicant to ensure it has an internal control system to be able to conduct banking businesses appropriately and effectively. However, it is unclear how far up the corporate structure the JFSA would probe in practice as it has not granted any new licenses in the past 5 years. The JFSA would try and persuade the banking group to change the structure if it has a concern that the structures may harm effective supervision by the JFSA on both a solo and a consolidated basis.</p>
<b>EC5</b>	<p>The licensing authority identifies and determines the suitability of the bank's major shareholders, including the ultimate beneficial owners, and others that may exert significant influence. It also assesses the transparency of the ownership structure, the sources of initial capital and the ability of shareholders to provide additional financial support, where needed.</p>
Description and findings re EC5	<p>A person or company who wishes to become a holder of voting rights of an applicant for a bank license which amounts to no less than the Major Shareholder threshold of 15 percent or 20 percent depending on the influence on the exercise of the voting rights of the</p>

<sup>20</sup> Therefore, shell banks shall not be licensed. (Reference document: BCBS paper on shell banks, January 2003).

	<p>applicant, must apply for approval to be a Major Shareholder of the bank together with an application for the banking license in accordance with Article 52–9 of the Banking Act. The JFSA examines both applications simultaneously.</p> <p>The scope of holders of voting rights of a bank which is necessary for JFSA approval includes not only direct owners but also indirect owners such as ultimate beneficial owners who can influence the exercise of voting rights of a bank (Article 3-2 of the Banking Act). It also includes a person who indirectly controls a bank through vehicles such as joint holding of shares (item 6, paragraph 1 of the said article), and a settler or beneficiary of a trust who may exercise voting rights (Article 2 of the Banking Act).</p> <p>In order to ensure the eligibility of an applicant as a Major Shareholder, the JFSA examines whether, in accordance with Article 52–10 of the Banking Act, matters on funds for acquisition, financial condition, status of income, expenditure, and personnel structure, etc. (including transparency of ownership structure) may hinder sound and proper operation of banking businesses. The JFSA also evaluates whether or not a shareholder that plans to hold more than 50 percent of voting rights has sufficient financial ability to provide funds to the bank in accordance with VII-2-2-1 (2) of the Supervisory Guideline.</p> <p>Financial support provided by major shareholders of the applicant for a bank license will be considered as one element in assessing soundness of financial conditions in licensing. For example, the JFSA examines whether or not there is a formal or informal agreement between the applicant and its major shareholder stipulating how the major shareholder would react to a situation where the applicant faces a financial difficulty. The JFSA also assesses the ability of a shareholder with more than 50 percent of voting rights to supply additional financial support in accordance with VII–2–2–1 of the Supervisory Guideline.</p>
<b>EC6</b>	A minimum initial capital amount is stipulated for all banks.
Description and findings re EC6	Article 3 of the Order for Enforcement of the Banking Act and Article 5 of the Banking Act stipulate that a minimum amount of capital required for a bank is ¥2 billion.
<b>EC7</b>	The licensing authority, at authorization, evaluates the bank’s proposed board members and senior management as to expertise and integrity (fit and proper—F&P test), and any potential for conflicts of interest. The F&P criteria include: (i) skills and experience in relevant financial operations commensurate with the intended activities of the bank; and (ii) no record of criminal activities or adverse regulatory judgments that make a person unfit to uphold important positions in a bank. <sup>21</sup> The licensing authority determines whether the bank’s board has collective sound knowledge of the material activities the bank intends to pursue, and the associated risks.
Description and findings re EC7	<p>The criteria for a banking license in Article 4 of the Banking Act stipulates “In light of such matters as its personnel structure, the Applicant shall have the knowledge and experience to be able to carry out the business of a bank appropriately, fairly and efficiently and shall have sufficient social credibility.”</p> <p>F&amp;P requirements for individual directors and operating officers are stated in Article 7–2 of the Banking Act as follows; she or he has to have the knowledge and experience to be able</p>

<sup>21</sup> Please refer to Principle 14, Essential Criterion 8.

	<p>to carry out the business of a bank appropriately, fairly and efficiently and with sufficient social credibility. The definition of social credibility is fairly broad, encompassing various checkpoints consistent with a F&amp;P test: no "unsocial acts;" no links to organized crime; no criminal record; no securities law or other regulatory violations; and no involvement in previous bank failures. The JFSA requires an applicant for a bank license to take oaths and submit resumes on directors and company auditors and documents proving that the applicant has personnel with sufficient banking knowledge and meets the social credibility criteria under Article 1–8 of the Ordinance for Enforcement of the Banking Act. However, the JFSA does not regularly independently validate the information contained in resumes or attested to in oaths. In practice this has not been a material issue because in the past most applicants for bank licenses were blue-chip companies and other applicants were treated cautiously. Moreover, there have not been many applicants in recent years and no licenses have been granted in the past five years.</p> <p>Based on the above criteria the JFSA examines whether or not “the applicant is a person who may appropriately, fairly and effectively conduct banking businesses and has sufficient social credibility in terms of status on securing directors, company auditors and staffs with sufficient knowledge and experience for banking businesses,” in accordance with Article 1–8 of the Ordinance for Enforcement of the Banking Act.</p> <p>In the case of an application for a bank license from a company running non-financial businesses, the JFSA checks based on VII–1–6–2(2) of the Supervisory Guideline whether there is a sufficiently strong management system in place to avoid conflicts of interests between the subsidiary and the applicant to prevent the banking subsidiary from providing loans or any other financial assistance to the applicant in case the business condition of the latter deteriorates.</p> <p>Article 4 of the Banking Act requires an applicant for bank 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 sufficient social credibility in light of personnel and relevant structures. Based on this article, the JFSA assesses eligibility of the personnel and relevant structures of a bank.</p>
<b>EC8</b>	<p>The licensing authority reviews the proposed strategic and operating plans of the bank. This includes determining that an appropriate system of corporate governance, risk management and internal controls, including those related to the detection and prevention of criminal activities, as well as the oversight of proposed outsourced functions, will be in place. The operational structure is required to reflect the scope and degree of sophistication of the proposed activities of the bank.<sup>22</sup></p>
Description and findings re EC8	<p>When assessing bank applicants, the JFSA will confirm that an applicant is expected to return to profitability within three years from the start of banking business in accordance with Article 1–8 of the Banking Act.</p> <p>With regard to checkpoints in the review of an application for a bank license and supervisory actions after licensing, the JFSA staff are required to refer to the relevant parts</p>

<sup>22</sup> Please refer to Principle 29.

	<p>of the Supervisory Guideline and Inspection Manual, depending on the bank’s business model in accordance with VII-1-1 of the Supervisory Guideline. Accordingly, the intensive dialogues on business model planned by an applicant forms the basis of JFSA’s assessment of the application for a bank license.</p> <p>The JFSA also examines in the licensing process whether or not “an applicant may appropriately, fairly and effectively conduct banking businesses in terms of the bank’s management systems etc.” in accordance with Article 1-8 of the Banking Act.</p> <p>In addition, Article 12-2 of the Banking Act and Article 13-6-8 of the Ordinance for Enforcement of the Banking Act require a bank that outsources part of its businesses to a third party, to take necessary measures in order to ensure the outsourced business is conducted appropriately. The JFSA has the powers to require the third party which conducts part of the banking business to report the status of its business operation or property to the JFSA under Article 24 of the Banking Act and to conduct onsite inspections of that company under Article 25 of the Banking Act.</p> <p>Chapter III of the Supervisory Guideline explains how and what supervisors in charge of offsite activities should examine with respect to internal controls for risk management and financial reporting, and approaches to tackle with organized crimes. Referring to this section, the JFSA engages in dialogues when reviewing applications.</p>
<p><b>EC9</b></p>	<p>The licensing authority reviews pro forma financial statements and projections of the proposed bank. This includes an assessment of the adequacy of the financial strength to support the proposed strategic plan as well as financial information on the principal shareholders of the bank.</p>
<p>Description and findings re EC9</p>	<p>Article 4 of Banking Act provides the criteria for licensing as follows.</p> <ul style="list-style-type: none"> <li>➤ Financial basis to conduct the business of a Bank soundly and efficiently and good prospects for income and expenditure pertaining to the business; and</li> <li>➤ Knowledge and experience to be able to carry out the business of a bank appropriately, fairly and efficiently and sufficient social credibility in light of personnel and relevant structures.</li> </ul> <p>The JFSA provides details of application forms for a bank license in Article 1-8 of the Ordinance for Enforcement of the Banking Act and the attachment to the Supervisory Guideline, which include a requirement for a pro forma financial condition such as balances and adequacy of bank capital for three business years after commencement of banking businesses.</p> <p>The JFSA explicitly sets out detailed criteria for a bank license in the Ordinance for Enforcement of the Banking Act and the Supervisory Guideline. With regard to financial strength of an applicant, the JFSA examines whether or not “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 Article 1-8 of the Ordinance for Enforcement of the Banking Act.</p> <p>As stated in EC5, the JFSA also examines the financial condition and balances of every</p>

	major shareholder of a bank.
<b>EC10</b>	In the case of foreign banks establishing a branch or subsidiary, before issuing a license, the host supervisor establishes that no objection (or a statement of no objection) from the home supervisor has been received. For cross-border banking operations in its country, the host supervisor determines whether the home supervisor practices global consolidated supervision.
Description and findings re EC10	<p>When a foreign bank intends to establish a branch or a banking subsidiary in Japan, the JFSA assesses whether or not the home country of the foreign bank supervises the bank in a virtually equivalent way to JFSA's supervision in accordance with Article 4 of the Banking Act and Article 9 of the Order for Enforcement of the Banking Act (i.e., consolidated supervision across jurisdictions).</p> <p>In the event the establishment of a branch or a banking subsidiary by a foreign bank requires the approval of the home country of the bank, the JFSA requires the foreign bank to submit a document as attachment to the application showing that the establishment has been approved by the home supervisor under Article 28 of the Ordinance for Enforcement of the Banking Act. In any case, in accordance with the Basel Concordat, the JFSA would only recommend granting a license for a foreign branch or subsidiary of a foreign bank if it receives a no objection letter regarding licensing from the foreign supervisor in advance.</p>
<b>EC11</b>	The licensing authority or supervisor has policies and processes to monitor the progress of new entrants in meeting their business and strategic goals, and to determine that supervisory requirements outlined in the license approval are being met.
Description and findings re EC11	<p>The JFSA regularly examines the status on soundness and appropriateness of banking businesses of a newly licensed bank by means of issuing reporting orders under Article 24 of the Banking Act and conducting onsite inspections under Article 25 of the Banking Act at the bank where necessary in order to ensure its soundness and appropriateness.</p> <p>More specifically, the JFSA examines whether or not the bank has expanded into businesses that were not assumed when licensing; whether the bank maintains enough capital; has implemented the risk management contemplated when it was licensed; earns profits as planned in licensing; and has developed the level of security of its IT system in accordance with VII of the Supervisory Guideline. The JFSA will conduct a follow up hearing with a bank whose business operation and earnings deviate from the original business model.</p>
<b>Assessment of Principle 5</b>	LC
Comments	With banking groups becoming more complex over time the JFSA should consider introducing more intensive probing of ownership structures of banking groups during the licensing process to give it more satisfaction that it truly understands who are the ultimate beneficial owners standing behind a banking group and their capacity to provide capital to the bank in times of stress. The assessors do not believe this is a pressing issue in the short run given the lack of interest in new bank licenses in recent years. However, experience in other jurisdictions has shown that demand for bank licenses can emerge quickly when economic conditions change. Thus, in keeping with JFSA's desire to become a more dynamic supervisor it should consider tightening up its licensing process over the medium term.

<b>Principle 6</b>	<b>Transfer of significant ownership.</b> The supervisor <sup>23</sup> has the power to review, reject and impose prudential conditions on any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.
<b>Essential criteria</b>	
<b>EC1</b>	Laws or regulations contain clear definitions of “significant ownership” and “controlling interest.”
Description and findings re EC1	<p>The concept of significant ownership is defined in Japanese laws and regulations but there are no clear definitions of the concept of controlling interest. In practice the JFSA would consider a shareholder that has more than 50 percent of the shares or voting rights to be a controlling shareholder.</p> <p>A person who wishes to hold shares of a bank no less than the major shareholder threshold prescribed in Article 2 of the Banking Act is regarded as a person who would have an important ownership or influence to the bank. Such a person must be pre-approved by the PM (the power of which is delegated to the JFSA Commissioner) prior to becoming such a major shareholder in accordance with Article 52–9 of the Banking Act. The Banking Act defines such a shareholder as a “Major Shareholder of a Bank.</p> <p>The definition of the major shareholder threshold is 20 percent of all voting rights of all shareholders. In cases where there is a fact that would have an important influence on the financial conditions and management policies of a bank, the threshold is set at 15 percent. Article 8 of the Rule on Financial Statements defines such cases; for example, a case where a shareholder provides an important loan or technology to the bank or banking group.</p> <p>Shareholders, which must report to and be approved by the JFSA Commissioner, include not only direct owners but also indirect owners; e.g., such as ultimate beneficiary owners that can control a bank’s voting rights (Article 3–2 of the Banking Act). They also include a person who indirectly controls a bank such as a person that jointly holds shares with others and a settler or beneficiary of a trust who may be able to exercise voting rights (Article 2 of the Banking Act).</p>
<b>EC2</b>	There are requirements to obtain supervisory approval or provide immediate notification of proposed changes that would result in a change in ownership, including beneficial ownership, or the exercise of voting rights over a particular threshold or change in controlling interest.
Description and findings re EC2	As indicated in EC1 of this CP, Article 52–9 of the Banking Act requires prior approval if a shareholder of a bank seeks to obtain more than 20 percent of the outstanding shares or voting rights. In assessing the application, based on item one, Article 52–10 of the Banking Act, the JFSA 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 JFSA will also assess the adequacy of the applicant in this context. The JFSA considers this confirmation by the applicant especially important as it will require major shareholders that have more than 50 percent of voting rights of a bank to support the bank in the event it experiences problems based on Article 52–14 of the Banking Act.

<sup>23</sup> While the term “supervisor” is used throughout Principle 6, the Committee recognizes that in a few countries these issues might be addressed by a separate licensing authority.

	<p>The JFSA does not have any additional requirements for major shareholders that do not signal any future intent to acquire a majority stake in the bank or banking group but whose stakes expand gradually over time to the point where they cross the 50 percent line and become a majority shareholder. The lack of an approval threshold at the 50 percent level thus prevents the JFSA from being able to assess ahead of time the capacity of those shareholders to provide support to the bank in the event it encountered stress. That said, once a Major Shareholder holds a majority of voting rights, the JFSA does have additional powers under Article 52–14 of the Banking Act that enable it to: (i) request the Major Shareholder to submit an improvement plan for ensuring soundness in Bank management; (ii) order a Major Shareholder to change an improvement plan that has been submitted; and (iii) issue orders with respect to measures that are necessary from a supervisory perspective. Thus, even though the Banking Act does not require the Major Shareholder to apply for another approval to own more than 50 percent of the voting rights, that shareholder is subject to additional obligations once it crosses that threshold as above, and the JFSA believes it can effectively supervise it accordingly.</p> <p>A shareholder with more than 5 percent of voting rights must notify the JFSA within 5 days of crossing that threshold. In addition, both major shareholders and those holding more than 5 percent must notify the JFSA when their holding percentages changes by more than one percent (Article 52–2–21 and 52–3 of the Banking Act).</p> <p>Shareholders that must report or be pre-approved include not only direct owners but also indirect owners such as ultimate beneficial owners who control a bank’s voting rights (Article 3-2 of the Banking Act). It also includes a person who indirectly controls a bank such as a person who jointly holds shares with others (item 6, paragraph 1 of the said article), and a settler or beneficiary of a trust that may be able to exercise voting rights (Article 2 of the Banking Act).</p>
<b>EC3</b>	<p>The supervisor has the power to reject any proposal for a change in significant ownership, including beneficial ownership, or controlling interest, or prevent the exercise of voting rights in respect of such investments to ensure that any change in significant ownership meets criteria comparable to those used for licensing banks. If the supervisor determines that the change in significant ownership was based on false information, the supervisor has the power to reject, modify or reverse the change in significant ownership.</p>
Description and findings re EC3	<p>The JFSA Commissioner may order a “Major Shareholder of a Bank” to take necessary measures or rescind the approval of a “Major Shareholder of a Bank” in cases where the “Major Shareholder of a Bank” violates laws, regulations or dispositions taken by the JFSA Commissioner, or takes actions that damages public interests.</p> <p>If there is a doubt that the approval as “Major Shareholder of a Bank” was given based on false information, the JFSA may request submission of a report based on Article 52 of the Banking Act. If there is a significant problem, the JFSA may issue an order to “Major Shareholder of a Bank” to take actions based on Article 52 of the Banking Act. Also, if there is an issue regarding eligibility as “Major Shareholder of a Bank” due to a substantial violation of laws/regulations or multiple actions that damage the public interests, the JFSA may rescind the approval of a “Major Shareholder of a Bank.”</p>

<b>EC4</b>	The supervisor obtains from banks, through periodic reporting or onsite examinations, the names and holdings of all significant shareholders or those that exert controlling influence, including the identities of beneficial owners of shares being held by nominees, custodians and through vehicles that might be used to disguise ownership.
Description and findings re EC4	<p>Shareholders rather than the banks are required to report their holdings to the JFSA in line with the requirement indicated in EC1 of this CP. The JFSA reviews shareholder data through its onsite inspections to confirm that shareholders are meeting their obligations to the JFSA. An examination of supervisory files confirmed that the JFSA has been validating adherence to the requirements and has taken action against shareholders that try to collude to avoid their reporting obligations.</p> <p>Shareholders that hold 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 to the JFSA in accordance with Article 52–2–11 and Article 52–3 of the Banking Act.</p> <p>As indicated in preceding ECs of this CP, the shareholders that must report or be approved include not only direct owners but also indirect owners such as ultimate beneficial owners who control a bank’s voting rights (Article 3–2 of the Banking Act). It also includes a person who indirectly controls a bank such as a person who jointly holds shares with others (item 6, paragraph 1 of the said article), and a settler or beneficiary of a trust who may carry out voting rights (Article 2 of the Banking Act).</p>
<b>EC5</b>	The supervisor has the power to take appropriate action to modify, reverse or otherwise address a change of control that has taken place without the necessary notification to or approval from the supervisor.
Description and findings re EC5	A “Major Holder of a Bank” that does not report shall be punished a non-criminal fine no more than 1 million yen. In addition, the JFSA shall order, a person who has become a holder of voting rights of a bank which amounts to or exceeds the “major shareholder threshold” (see EC1 of this CP for definition), to take necessary measures so that it would no longer hold voting rights of the bank which amounts to or exceeds the “major shareholder threshold” (Article 52-9 of the Banking Act). The measures could include an action to modify, reverse or otherwise address a change of control.
<b>EC6</b>	Laws or regulations or the supervisor require banks to notify the supervisor as soon as they become aware of any material information which may negatively affect the suitability of a major shareholder or a party that has a controlling interest.
Description and findings re EC6	<p>Currently there is no such a requirement in Japan.</p> <p>However, the JFSA has comprehensive authority to regularly monitor a “Major Shareholder of a Bank” and to order appropriate actions, including: issuing a reporting order or conduct onsite inspection to “Major Shareholder of a Bank” where necessary in order to ensure soundness and appropriateness of banking businesses. (Article 52–11, 52–12 of Banking Act); or the JFSA may require a “Major Shareholder of a Bank” with more than 20 percent voting rights of a bank to submit a business improvement plan in terms of its status of its business or property. The JFSA also may require such a “Major Shareholder of a Bank” to take a necessary action. (Article 52–14 of Banking Act).</p>
<b>Assessment of principle 6</b>	LC

Comments	<p>Supervisory approval is necessary for a shareholder that obtains more than 20 percent of the voting rights for a bank and reporting obligations commence at the 5 percent threshold. However, major changes in the shareholding structures above the 20 percent threshold do not necessarily need supervisory approval ahead of time, although changes of more than one percentage point need to be reported by shareholders to the JFSA. In practice intentions are 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 after the Major Shareholder crosses the 50 percent threshold as indicated in EC2. That said, the assessors believe that authorities are generally better placed to exercise influence before a transaction takes place rather than having to respond by imposing additional obligations after the fact. Thus, 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 bank governance structures and business models and so that the JFSA is able to proactively assess the capacity of a majority shareholder to provide financial support to the bank in times of stress. This could be implemented, for instance, using JFSA's powers to impose a condition on the approval of a major shareholder that a possible future majority holding by that major shareholders would be subject to a pre-approval by the JFSA before their voting interest crosses the 50 percent threshold.</p>
<b>Principle 7</b>	<p><b>Major acquisitions.</b> The supervisor has the power to approve or reject (or recommend to the responsible authority the approval or rejection of), and impose prudential conditions on, major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and to determine that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.</p>
<b>Essential criteria</b>	
<b>EC1</b>	<p>Laws or regulations clearly define:</p> <ul style="list-style-type: none"> <li>(a) what types and amounts (absolute and/or in relation to a bank's capital) of acquisitions and investments need prior supervisory approval; and</li> <li>(b) cases for which notification after the acquisition or investment is sufficient. Such cases are primarily activities closely related to banking and where the investment is small relative to the bank's capital.</li> </ul>
Description and findings re EC1	<p>Approvals necessary for acquisition and investment are defined by the Banking Act as follows.</p> <p>Acquisition and establishment of a branch or subsidiary</p> <p>A bank that intends to merge with another bank must obtain a pre-approval from the JFSA Commissioner in accordance with Article 30 of the Banking Act.</p> <p>A bank that intends to hold a subsidiary either in Japan or other jurisdictions must be pre-approved by the JFSA Commissioner in accordance with Article 16-2 of the Banking Act.</p> <p>Note: Approval by the JFSA is not required in cases where a bank intends to hold a subsidiary that operates mainly ancillary businesses for the bank or which conducts businesses related to banking as stated in the article above. The JFSA currently defines a</p>

business to be ancillary to the bank if it earns more than 1 yen in profits and 90 percent of its revenue is obtained from the bank. The JFSA officials noted that they are actively considering reducing the latter threshold to 50–60 percent in response to suggestions from the banking community.

The scope of businesses that a subsidiary of a bank may conduct is listed in Article 16–2 of the Banking Act in order to strictly prohibit a banking group from conducting other businesses not allowed by the Act. The permitted businesses include those related to banks, securities firms, insurance companies, and any other businesses ancillary to banking. A bank that intends to establish a branch in a foreign country must receive approval ahead of time from the Commissioner of the JFSA.

### **Investments**

Banks may only conduct businesses listed in Articles 10 and 11 of the Banking Act. Article 12 of the Banking Act prohibits banks from conducting businesses other than those listed in Article 10 and 11 to ensure soundness of banks. Article 10 of the Act permits banks to transact in securities and to conduct transactions of securities related derivatives, while other investments such as sales and purchase of real properties that are not ancillary to banking businesses are not included in the banking businesses permitted by the Act.

Article 16–3 of the Banking Act sets a limitation for banks to acquire or hold shares of domestic business companies in order to strictly prevent banks from conducting businesses other than banking businesses. The limitation is stipulated as “5 percent of all voting rights of all shareholders of a domestic company.” Note that the 5 percent limit can be exceeded for one year without pre-approval from the JFSA if the position arose from the bank taking collateral from a defaulting borrower. In addition, the 5 percent limit for domestic investments was removed in the Spring of 2016 for companies engaged in Fintech activities to enable Japanese banks to build relationships with those companies. In computing the 5 percent threshold, the number of voting rights is calculated by aggregating both the bank and its subsidiaries.

Though this article does not apply to investments in foreign companies, V–3–3–3 of Supervisory Guideline limits the scope of businesses of foreign companies that a bank may invest. The scope of these businesses are limited to the businesses that are same as businesses that its subsidiaries may conduct as listed in Article 16–2 of the Banking Act and the JFSA approval is required ahead of time for foreign investments in banking businesses.

In the course of transacting securities, banks may also acquire, without approval from the Commissioner of the JFSA, no more than 5 percent of all voting rights of a company that is permitted to be a bank subsidiary based on Article 16–3 of the Banking Act.

In addition, Japan has set a limitation for banks regarding the aggregate amount they can hold of equities to promote sound management of banking businesses. For example, a banking group is only allowed to hold equities up to the amount of its consolidated Tier 1 capital in accordance with Act on Limitation on Shareholding by Banks and Other Financial

	<p>Institutions. In cases where a bank holds shares more than the limitation due to inevitable reasons such as mergers, the bank must obtain approval from the JFSA Commissioner. In this case, the bank must submit an application with documents describing the compelling reason, the plan to dispose such holdings and the expected time. The JFSA examines whether or not the situation is inevitable in accordance with the Ordinance.</p> <p>Large exposure restrictions apply to investment in publicly offered corporate bonds as well as loans. The regulation sets out a limitation tied to the size of a bank's capital.</p> <p>Where a bank acquires a company that operates mainly ancillary business for the bank or which conducts businesses related to banking, the bank is not required to obtain approval from the JFSA Commissioner. However, the bank must report it to the JFSA in accordance with Articles 16–2 and 53 of the Banking Act.</p> <p>A bank is required to report to the JFSA if the bank acquires or holds more than 5 percent of voting rights of a company in which its businesses are included in Article 35 of the Ordinance of the Enforcement of the Banking Act delegated by Article 53 of the Banking Act.</p> <p>Investments are also included in the large exposure regime and the sum of those investments and loans to a single party or a group of connected parties must not exceed 25 percent of the bank's capital under Article 13 of the Banking Act and Article 4 and 14 of the Ordinance for Enforcement of the Banking Act).</p>
<b>EC2</b>	Laws or regulations provide criteria by which to judge individual proposals
Description and findings re EC2	<p>The criteria for a bank to be approved for a merger with another bank are prescribed in Article 31 of the Banking Act.</p> <p>The criteria for a bank to receive approval hold subsidiaries or change subsidiaries' businesses is provided in Article 17–5 of the Ordinance for Enforcement of the Banking Act.</p> <p>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.</p> <p>There are no formal criteria in place for assessing investment proposals.</p>
<b>EC3</b>	<p>Consistent with the licensing requirements, among the objective criteria that the supervisor uses is that any new acquisitions and investments do not expose the bank to undue risks or hinder effective supervision. The supervisor also determines, where appropriate, that these new acquisitions and investments will not hinder effective implementation of corrective measures in the future.<sup>24</sup> The supervisor can prohibit banks from making major acquisitions/investments (including the establishment of cross-border banking operations) in countries with laws or regulations prohibiting information flows deemed necessary for adequate consolidated supervision. The supervisor takes into consideration the</p>

<sup>24</sup> In the case of major acquisitions, this determination may take into account whether the acquisition or investment creates obstacles to the orderly resolution of the bank.

	effectiveness of supervision in the host country and its own ability to exercise supervision on a consolidated basis.
Description and findings re EC3	<p>The JFSA provides the criteria for approving a bank to hold a subsidiary in the Ordinance for Enforcement of the Banking Act. The criteria are consistent with licensing requirements. For example: (i) the bank must have an appropriate capital adequacy ratio after obtaining approval to hold subsidiaries; (ii) net income should continue to be sufficiently positive; and (iii) the applying bank must be able to take necessary measures to ensure that the subsidiary conducts its businesses soundly and appropriately. A review of supervisory files confirmed the JFSA is diligent in enforcing these criteria.</p> <p>In cases where 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 JFSA may reject the application from the bank, based on the third criteria above.</p> <p>With regard to the establishment of a foreign branch or subsidiary, approval is necessary based on Article 8 of the Banking Act. The criteria for approval are prescribed in Article 9–2 of the Ordinance for Enforcement of the Banking Act. For example, the JFSA will not approve an application where the host country’s legal system prevents the applying bank from fulfilling the criteria. The JFSA assesses effectiveness of consolidated supervision of a host country, in terms of whether: 1) the applying bank will appropriately, fairly and effectively be able to conduct banking businesses considering its management system; and 2) the branch or subsidiary will take necessary measures to prevent crimes and to manage customer’s information properly.</p> <p>Where a bank files an application to the JFSA for acquiring a company, the JFSA examines: (1) whether the subsidiary may appropriately and fairly conduct its businesses; and (2) whether the bank will take appropriate measures to ensure that the subsidiary conducts its businesses appropriately and fairly. Accordingly, when banks hold foreign subsidiaries, the JFSA will check the quality of supervision of a host country through assessing 1 above and also consider if the JFSA is able to take supervisory actions on a consolidated basis by assessing 2 above.</p>
<b>EC4</b>	The supervisor determines that the bank has, from the outset, adequate financial, managerial and organizational resources to handle the acquisition/investment.
Description and findings re EC4	<p>One of the criteria for approval when a bank applies to acquire a subsidiary is concerned with whether or not the bank has from the outset the financial and organizational resources to make such an acquisition (See EC3 of this CP).</p> <p>The criteria for establishing foreign branches are the same as that for subsidiaries (see EC3).</p>
<b>EC5</b>	The supervisor is aware of the risks that non-banking activities can pose to a banking group and has the means to take action to mitigate those risks. The supervisor considers the ability of the bank to manage these risks prior to permitting investment in non-banking activities.
Description and findings re EC5	The JFSA supervises whether or not a banking group recognizes group wide risks including risks arising from businesses other than banking. (Supervisory Guideline provides check points for assessing group wide risk management).

Based on the above, through onsite and offsite integrated monitoring, the JFSA reviews if major acquisition or investment by other companies in the same banking group would expose the bank to undue risks. The JFSA also reviews whether the banks are seeking to bypass requirements that prohibits other businesses not allowed by the Banking Act.

When the JFSA finds it necessary to ensure that a bank is soundly and appropriately conducting its banking businesses, the JFSA may convey concerns to the bank and require improvement through regular or ad-hoc offsite interviews. The JFSA would also deploy various supervisory measures: (i) it may issue a reporting order not only to banks but also to subsidiaries of a bank, the companies to which the bank outsources 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; (ii) the JFSA may conduct onsite inspection to those entities in accordance with Article 25, 52–32 and 52–12 of the Act; (iii) the JFSA may issue a business improvement order to a bank, its bank holding company and its major shareholders in accordance with Article 26, 52–33 and 52–14 of the Banking Act. All those measures are intended to mitigate risks to which the bank is exposed.

In addition, the JFSA has established the Guideline for Financial Conglomerates Supervision which sets out supervisory checkpoints for a banking group that conducts financial service businesses other than banking.

As one of the criteria for approving a bank's application to acquire a subsidiary, the above guideline is used to review if measures have been taken by banks to ensure sound and appropriate businesses of the company subject to acquisition. (See EC3).

The soundness of the businesses of financial institutions is influenced by financial/capital market trends and economic trends inside and out of Japan. On the other hand, given activities of each individual financial institution may also have significant influence on the entire economy and financial/capital market, the JFSA recognizes that it is important to analyze interactions between them on an ongoing basis.

From this perspective, the JFSA has been assessing risks within the entire financial sector with a forward-looking perspective through integrated monitoring by its market analysis division, supervisory division, inspection division, and other relevant divisions. Specifically, the JFSA has been making efforts to assess the trends of global macro economy/financial market, trends of market participants, and flow of funds. The JFSA has also been making efforts to grasp/analyze businesses of financial institutions and a real-time trend of fund lending/operations, mainly for large financial groups. Through these efforts, in order to maintain the soundness of financial system of Japan even when the potential risks actualize, the JFSA holds in-depth discussions with financial institutions and relevant authorities.

#### **Bank of Japan**

The BoJ conducts onsite examinations and offsite monitoring on financial institutions as well as onsite inquiries to their financial holding companies.

	<p>As stipulated in "Onsite Examination Policy for Fiscal 2016," with regard to financial institutions that provide a wide range of financial services through group entities, the BoJ endeavors to grasp their relationships with major group companies and the actual business conditions of the group as a whole.</p>
<b>AC1</b>	<p>The supervisor reviews major acquisitions or investments by other entities in the banking group to determine that these do not expose the bank to any undue risks or hinder effective supervision. The supervisor also determines, where appropriate, that these new acquisitions and investments will not hinder effective implementation of corrective measures in the future.<sup>25</sup> Where necessary, the supervisor is able to effectively address the risks to the bank arising from such acquisitions or investments.</p>
Description and findings re AC1	<p>When a bank subsidiary wants to hold another company as a subsidiary, the bank must apply to the JFSA approval to have that company as a subsidiary.</p> <p>Also, when a bank holding company holds another company as a subsidiary, the bank holding company must apply for the approval like a bank, and Article 34–19 of the Banking Act stipulates criteria for approval. When examining the application, the following points will be considered by the JFSA: 1) whether the consolidated capital adequacy ratio will be at an appropriate level after the approval to hold subsidiary is given to the applicant bank holding company; and 2) whether the consolidated income and expenditures will continue to be at a satisfactory level even after the approval; and 3) whether the bank holding company will be able to ensure proper and fair business of the subsidiary. Based on the above points, the JFSA may reject the approval if it is found that undue risk could be caused.</p> <p><b>Bank of Japan</b></p> <p>The BoJ also conducts reviews as part of its constant surveys (offsite monitoring) as well as visits at regular intervals (onsite examination) as to the risks in various areas and relevant issues (as specified in this Criterion and the other Criteria) of its counterparties.</p> <p>Follow-up reports on improvements in business administration and risk management may be requested when major acquisitions or investments by other entities in the banking group expose the bank to any undue risk.</p>
<b>Assessment of Principle 7</b>	LC
Comments	<p>Japanese banks have been increasing significantly their overseas activities. In addition, given the current structural situation of the Japanese banking sector, more extensive domestic partnerships and mergers could conceivably emerge over time if the banking sector consolidates further. 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 JFSA.</p>

<sup>25</sup> Please refer to Footnote 33 under Principle 7, Essential Criterion 3.

	<p>The JFSA 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>In addition, 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 JFSA, although prior notification would be needed. Based upon this prior notification the JFSA 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 the institution receiving the investment) could have a major influence on the business model and risk profile of the latter when engaging in these business partnerships, a more strict pre-approval is recommended as provided for in the case of subsidiaries, rather than a system based upon prior notification combined with onsite and offsite supervisory action. In addition, the scope for approval of acquisitions could be reconsidered, by expanding it to include the acquisition of ancillary business and banking related business.</p>
<b>Principle 8</b>	<b>Supervisory approach.</b> An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address risks emanating from banks and the banking system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable.
<b>Essential criteria</b>	
<b>EC1</b>	<p>The supervisor uses a methodology for determining and assessing on an ongoing basis the nature, impact and scope of the risks:</p> <ul style="list-style-type: none"> <li>(a) which banks or banking groups are exposed to, including risks posed by entities in the wider group; and</li> <li>(b) which banks or banking groups present to the safety and soundness of the banking system.</li> </ul> <p>The methodology addresses, among other things, the business focus, group structure, risk profile, internal control environment and the resolvability of banks, and permits relevant comparisons between banks. The frequency and intensity of supervision of banks and banking groups reflect the outcome of this analysis.</p>
Description and findings re EC1	<p>The JFSA has introduced risk profiles for regional and mega banks as a way to support the allocation of supervisory resources. The risk profile captures the results of offsite surveillance and onsite inspections. It acts as a comprehensive risk assessment and represents the main methodology to rank the risk profile of the banks to determine the supervisory action plans and allocation of resources. The risk profile is performed at least annually and the results are conveyed to the bank's senior management and is a main input into the supervisory action plan (monitoring program). The risk profile is intended to influence the frequency and intensity of supervisory activities.</p> <p>The majority of regional banks have been assigned a risk rating under the new</p>

methodology. For regional banks the assigned of the risk profile has been centralized under a single team and was previously compiled by separate teams.

The methodology is still a work in progress. For instance, the methodology is currently based on risk and the calibration of size or impact is still being developed. It is in part expert judgment mixed with thresholds—approximately five categories based on total assets.

For the mega banks, there is considerably more focus on international events and developments as inputs into the risk profile and the indicators that influence offsite supervision. It is worth noting that the three major banks have been identified as G-SIBs based on their asset size and market share and more resources have been allocated to those three major banks. By the same token, four other banks have been designated as D-SIBs and have been allocated supervisory resources accordingly.

The risk profile covers a broad range of risk categories and includes the business focus, group structure, risk profile, internal control environment and the resolvability of banks, and permits relevant comparisons between banks. To arrive at the risk profile, the JFSA utilizes various kinds of regular and ad-hoc meetings to determining and assessing on an ongoing basis the nature, importance and scope of the risks to which individual banks or banking groups are exposed. Interviews with banks in meetings are conducted based on the Supervisory Guideline. In order to determine the risk profile of banks, the check points in Supervisory Guidelines cover business management (governance), capital adequacy, profitability, comprehensive risk management, credit risk management, market risk management, liquidity risk management, remuneration system, compliance, disclosure requirements, consumer protection, operational risk, system risk, business control of foreign operations, business continuity management, among others.

As for offsite monitoring data, for example, in accordance with Article 24 of Banking Act, the JFSA collects data from banks regarding profitability, the amount of bad loans, credit risk concentration, market risk (including interest rate risk in banking book), liquidity, etc. Under JFSA's "Early Warning System" explained in the Supervisory Guidelines, the JFSA identifies banks which need supervisory special attention (i.e., red flags) based on prescribed ratios and thresholds.

The JFSA will engage in intensive hearings from those banks about causes for red flags and actions taken already by banks. If necessary, Under Article 24 of Banking Act, the JFSA will formally require a bank to submit report or materials on those causes and how it would tackle the matter concerned. In case the bank does not still tackle the matter appropriately, the JFSA may consider further stronger order in accordance with Article 26 of Banking Act, which requires the banks to submit an improvement plan by designating the matters and the time limit for which measures should be taken. Through these administrative powers, the JFSA will enforce banks to address the issues concerned.

In order to enhance macroprudential monitoring, the Financial Services Agency established the Macroprudential Policy Office in the Planning and Coordination Bureau in July 2015, and constructed a framework to mainly conduct monitoring from a macroprudential

	<p>perspective in coordination with the Inspection Bureau and Supervisory Bureau teams in charge of monitoring. The Office analyzes the daily state of the global market and the macroeconomy, and monitors matters such as potential signs that the stability of the financial system will be threatened based on hearings from financial and risk management departments of financial institutions, data, etc.</p> <p>From a macroprudential perspective, the BoJ also 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. Areas of focus for its onsite examinations would be published in its "Onsite 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. The BoJ strives to conduct its onsite examinations efficiently under the framework of "risk-based onsite examinations" employed since fiscal 2008. Under the "risk-based onsite examination" system, frequency, scope and the number of examiners are prioritized based on a comprehensive assessment from two perspective—the impact that individual financial institutions' latent risks would have on the financial system were they to become manifest, and the actual management conditions of the financial institution concerned, such as its capital strength and risks it carries.</p> <p>With regard to resolution planning, discussion is continuing towards improved resolvability taking account of international discussions on the issue. In addition, the Japanese authorities are working toward enhanced resolvability by considering resolution strategies and impediments to the resolvability in view of the strategies through the information sharing and discussion with the host authorities in the CMG meetings and RAP.</p>
<b>EC2</b>	<p>The supervisor has processes to understand the risk profile of banks and banking groups and employs a well-defined methodology to establish a forward-looking view of the profile. The nature of the supervisory work on each bank is based on the results of this analysis.</p>
Description and findings re EC2	<p>The JFSA uses regular meetings with banks and through offsite activities in conjunction with information from other divisions (e.g., economics, markets etc.) to promptly identify risks, issues and themes in financial markets and the banking sector. In addition, the JFSA's Early Warning System (EWS) contributes to the forward looking view of risk. The EWS is based on offsite data (collected monthly or quarterly etc.) and bank results from onsite inspections. The offsite data that feeds into the EWS are relatively comprehensive, including information on the profitability, NPLs, concentration, credit, liquidity and market risks, among others. The EWS will identify outlier banks via "red flags" based on JFSA's analytical framework for monitoring the condition and performance of banks based on prescribed ratios and standards. In the case of a red flag, a bank would be required to provide additional information to the JFSA on the reasons for the various red flags and plans for possible remedial actions.</p> <p>The assessors saw examples where supervisors identified emerging risks (e.g., Brexit) and</p>

	<p>undertook activities to evaluate the potential risks.</p> <p>In conducting onsite examinations, the BoJ conducts the various stress tests (or income simulations) and establishes a forward-looking view of the risk profile.</p>
<b>EC3</b>	The supervisor assesses banks' and banking groups' compliance with prudential regulations and other legal requirements.
Description and findings re EC3	<p>Through a combination of onsite and offsite activities, the JFSA will confirm compliance with prudential regulations and other legal requirements. As part of routine offsite analysis, supervisors will regularly (and at least annually) review a complete suite of bank policies. Via this process, supervisors will confirm whether policies align with regulations and standards. Equally, when new regulations are implemented, supervisors will systematically review bank policies offsite. Through the onsite process, supervisors will assess whether bank policies are fully implemented and operating effectively. The JFSA conducts inspections in accordance with Article 25 of the Banking Act, which is conducted based on the Inspection Manual requiring inspectors to comprehensively check the "legal compliance" including prudential requirements.</p> <p>In addition, the JFSA will submit to banks a self-assessment that is used as an input into the risk profile. Such as capital policy they get in advance.</p>
<b>EC4</b>	The supervisor takes the macroeconomic environment into account in its risk assessment of banks and banking groups. The supervisor also takes into account cross-sectoral developments, for example in non-bank financial institutions, through frequent contact with their regulators.
Description and findings re EC4	<p>See also EC1. The supervisory process takes into account the results of system-wide assessments of macroeconomic and macro financial risks, domestically and internationally given Japan is a highly connected financial center. The results of this analysis will influence the supervisory priorities, depending upon the size, scale and complexity of the bank.</p> <p>Since the JFSA is an integrated regulator which supervises banks, security companies, insurance companies, money lenders, etc., and supervise these financial institutions in a cross sectoral manner. On at least a quarterly basis, the various departments within the JFSA will convene a round-table discussion of risks and key priorities. The outcome from this meeting will influence the supervisory activities for banks and banking groups. Communication of changes in risks or new emerging issues are communicated at a number of levels. This is both a formal and informal process. The macroprudential department plays an important role in this regard, especially for the mega banks, where, for example, it gathers market data (growth projections for emerging markets) and supervisors use this data as input into the assessment of banks' business models to challenge management projections.</p>
<b>EC5</b>	The supervisor, in conjunction with other relevant authorities, identifies, monitors and assesses the build-up of risks, trends and concentrations within and across the banking system as a whole. This includes, among other things, banks' problem assets and sources of liquidity (such as domestic and foreign currency funding conditions, and costs). The supervisor incorporates this analysis into its assessment of banks and banking groups and addresses proactively any serious threat to the stability of the banking system. The

	<p>supervisor communicates any significant trends or emerging risks identified to banks and to other relevant authorities with responsibilities for financial system stability.</p>
Description and findings re EC5	<p>See also EC1. The JFSA, on a regular basis, monitors the build-up of risks using aggregate data. This analysis is undertaken by a separate division within the JFSA and is disseminated across divisions involved in onsite and offsite supervision. Risks that are identified are incorporated into the offsite analysis. Recent examples include the status of NPLs in the system and costs for funding in foreign currency such as foreign exchange swap rates which are two high profile issues.</p> <p>Examples include regional banks' exposures to commercial real estate which is typically concentrated in regional geographies.</p> <p>The BoJ plays an important role in this regard of sharing analysis of system-wide risk factors that are shared with the JFSA and input into the supervisory plans and offsite supervision. Recent examples include build-up of risk in the energy sector and the major bank's exposure to this asset class.</p> <p>Especially with regard to three mega banks, the JFSA holds discussions in a timely manner to understand their credit management policy for sectors with a growing risk and their liquidity management policy against drastic/rapid change in financial markets. For instance, in light of the recent growth of the exposure to the real estate in the banking sector, the JFSA conducted research into the situation of the real estate markets including land prices and details of bank loans to the real estate.</p> <p>In general, the JFSA holds conversations with the BoJ when markets move drastically. With regard to the major banks, the JFSA identifies the important risks on the basis of the collected information and conduct supervisory activities and inspections with tools including stress tests, horizontal review and interview at onsite visit.</p>
<b>EC6</b>	<p>Drawing on information provided by the bank and other national supervisors, the supervisor, in conjunction with the resolution authority, assesses the bank's resolvability where appropriate, having regard to the bank's risk profile and systemic importance. When bank-specific barriers to orderly resolution are identified, the supervisor requires, where necessary, banks to adopt appropriate measures, such as changes to business strategies, managerial, operational and ownership structures, and internal procedures. Any such measures take into account their effect on the soundness and stability of ongoing business.</p>
Description and findings re EC6	<p>The JFSA is preparing resolution plans for G-SIBs and other systemically important banks in accordance with Key Attributes. With regard to resolution planning, discussion is continuing towards improved resolvability taking account of international discussions on the issue. The JFSA is working toward enhanced resolvability by considering resolution strategies and impediments to resolvability through information sharing and discussions with host authorities in the CMG meetings and RAP.</p> <p>The JFSA may, when the need arises for orderly resolution of assets and liabilities of a financial institution, etc. and it finds that measures necessary for the smooth implementation have not been taken, order the financial institution, etc. to take said measures to the extent necessary, by a specified time. (Deposit Insurance Act Article 137-4).</p>

<b>EC7</b>	The supervisor has a clear framework or process for handling banks in times of stress, such that any decisions to require or undertake recovery or resolution actions are made in a timely manner.
Description and findings re EC7	<p>In accordance with the Deposit Insurance Act Article 102–1, the PM may confirm the necessity of the following actions when s/he confirms that the maintenance of an orderly credit system in Japan or in a certain region where the financial institution conducts its business may be extremely seriously hindered barring the measures against financial crisis. Measures available include, but not limited to:</p> <ul style="list-style-type: none"> <li>➤ The subscription for shares, etc. of said financial institution.</li> <li>➤ The financial assistance for an amount that is expected to exceed the expected costs for the payment of insurance proceeds with respect to an insurable contingency of said financial institution.</li> <li>➤ The purchase of shares of said financial institution by the DICJ.</li> </ul> <p>In the case of a severe disruption of Japan’s financial market, the PM may confirm the necessity of the following actions (Deposit Insurance Act Article 126–2–1):</p> <ul style="list-style-type: none"> <li>• The provision of loans to financial institutions, etc.</li> <li>• The financial assistance to financial institutions, etc.</li> </ul> <p>In addition to the measures for financial crisis, the JFSA operates the Prompt Corrective Action System. Administrative actions are taken based on the bank’s capital adequacy ratios and the possible regulatory actions are prescribed in paragraph 2 of Article 26 of the Banking Act set by the Commissioner of the JFSA. Orders will be issued corresponding to ranges of capital adequacy ratio automatically where the ratio is below the minimum requirement such as:</p> <ul style="list-style-type: none"> <li>✓ Order for prohibition or restraint from bank’s paying remuneration for directors, company auditors and/or executive officers.</li> <li>✓ Order the implementation of optional measures such as raising capital, closing significant part of business, merger with another bank, or getting out of banking business.</li> <li>✓ Order suspension of the whole or part of business.</li> </ul> <p>On the basis of the information collected from a bank in accordance with the Banking Act Article 24, as necessary, the JFSA may order the bank to submit the business improvement plan in accordance with the Banking Act Article 26. Furthermore, the JFSA may, when the need arises for orderly resolution of assets and liabilities of a financial institution, etc. and it finds that measures necessary for the smooth implementation thereof have not been taken, order the financial institution, etc. to take said measures to the extent necessary, by a specified time. (Deposit Insurance Act Article 137–4).</p>
<b>EC8</b>	Where the supervisor becomes aware of bank-like activities being performed fully or partially outside the regulatory perimeter, the supervisor takes appropriate steps to draw the matter to the attention of the responsible authority. Where the supervisor becomes aware of banks restructuring their activities to avoid the regulatory perimeter, the supervisor takes appropriate steps to address this.
Description and findings re EC8	The JFSA conducts regular surveillance of the financial system in conjunction with the activities of other government organizations to identify whether financial services are being

	provided by entities that are not appropriately authorized and licensed by the JFSA.
<b>Assessment of Principle 8</b>	LC
Comments	<p>The JFSA's current supervisory approach is predominantly bottom-up, with supervisory teams responsible for highlighting and following up on supervisory issues and concerns facing each institution. While there is a top-down approach for determining and assessing on an ongoing basis the nature, impact and scope of risks, it is mainly driven by "Strategic Directions and Priorities" published annually. A methodology to assess the risk profile of banks and banking groups was introduced in 2014 (the "risk profiles"). The approach is still in the process of being rolled out and aspects of the methodology are still being refined (e.g., how to balance risk against factors such as size, scale, complexity and systemic importance). While the onsite and offsite supervisory processes are relatively sound, full implementation of an analytical risk framework to assess the risk profile of banks and banking groups on a more comprehensive and systematic basis is needed. Importantly, the full implementation of this methodology will help foster further integration of offsite and onsite processes. The approach to the megabanks has been augmented through the introduction of the GSIB framework, which has helped to direct attention to the megabanks, so that the megabanks are receiving considerably more frequent and intensive supervision.</p> <p>The full roll out of the methodology will enhance planning and the allocation of resources to better differentiate the intensity and scope of supervision and allocate its supervisory resources, especially as Japanese banks expand their activities overseas.</p>
<b>Principle 9</b>	<b>Supervisory techniques and tools.</b> The supervisor uses an appropriate range of techniques and tools to implement the supervisory approach and deploys supervisory resources on a proportionate basis, taking into account the risk profile and systemic importance of banks.
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor employs an appropriate mix of onsite <sup>26</sup> and offsite <sup>27</sup> supervision to evaluate the condition of banks and banking groups, their risk profile, internal control environment and the corrective measures necessary to address supervisory concerns. The specific mix between onsite and offsite supervision may be determined by the particular conditions and circumstances of the country and the bank. The supervisor regularly assesses the quality, effectiveness and integration of its onsite and offsite functions, and amends its approach, as needed.
Description and findings re EC1	Risk assessment of financial institutions is undertaken by both the JFSA and BoJ in a mix of offsite and onsite supervision activities. Corrective actions are generally undertaken by the JFSA, being the lead authority for bank supervision and early intervention, bank

<sup>26</sup> Onsite work is used as a tool to provide independent verification that adequate policies, procedures and controls exist at banks, determine that information reported by banks is reliable, obtain additional information on the bank and its related companies needed for the assessment of the condition of the bank, monitor the bank's follow-up on supervisory concerns, etc.

<sup>27</sup> Offsite work is used as a tool to regularly review and analyze the financial condition of banks, follow up on matters requiring further attention, identify and evaluate developing risks and help identify the priorities, scope of further offsite and onsite work, etc.

	<p>resolution and depositor protection.</p> <p>Regular meetings are held with all levels of bank senior management including business heads and risk functions to identify developments in the financial markets and banking sector and to assess the risk profile, adequacy of governance structures, risk management and strategies of banks, banking subsidiaries and bank holding companies. Article 25 of Banking Act gives the JFSA the power to have its officials enter any business office or any other facility of the bank.</p> <p>The JFSA's supervisory bureau and inspection bureau are responsible for carrying out offsite monitoring and onsite inspections respectively. Onsite inspections of banks, carried out in accordance with the JFSA's Bank Inspection Manual, assess the risk management and controls of banks and the areas inspected are be rated accordingly. Generally, onsite inspections for major banks are conducted annually and for regional financial institutions, every two to three years.</p> <p>The JFSA recently revised its approach to the mix of offsite and onsite activities with greater emphasis allocated to onsite activities. In the past, the JFSA generally conducted a single onsite inspection which covered all risk areas in the one activity. Since 2014 a more targeted approach has been implemented which will focus on a single risk area e.g., credit, or market risk. The introduction of the risk profile methodology is an additional development in overall approach.</p> <p>In the last year, greater attention has been dedicated to onsite activities.</p> <p>Follow-up on issues identified during the onsite inspections, including the need for corrective actions, is 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. form the "Bank Ledger" compiled for each institution. The bank ledger contains a summary of the results of the onsite analysis.</p> <p>There is also a separate risk identification program for major banks which 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 are compared across major peer banks twice a year.</p> <p>The "Bank Ledger" or risk identification program do 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 are generally classified into two categories, namely banks with supervisory concerns, and banks without supervisory concerns.</p> <ul style="list-style-type: none"> <li>• 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 JFSA indicating the supervisory concerns are identified.</li> </ul>
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	<ul style="list-style-type: none"> <li>• 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 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.</li> </ul> <p>JFSA’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 help 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 offsite submissions of rectification statuses obtained from the bank.</p> <p>The JFSA and BoJ collaborate regarding supervision of the banks. To conduct inspections and examinations effectively and efficiently, the JFSA and the BoJ share information and exchange views. The JFSA and the BoJ regularly exchange information to adjust the schedules and the lists of the financial institutions they intend to visit, in advance of the inspections /examinations. On a regular basis, the JFSA and BoJ make contacts through a variety of channels, including frequent/informal visits, calls and e-mails at division chief/director levels. Depending on the case or importance, the JFSA/BoJ may set up regular/ad-hoc meetings, or conference calls for information sharing and exchange of views at higher levels. The JFSA and BoJ exchange lists of contact points at various levels, so that they may be able to reach each other, in and outside of their offices.</p> <p>With respect to the BoJ, it focuses 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. The BoJ conducts onsite examinations and offsite monitoring largely for the purpose of preparing for possible emergency liquidity assistance. Both onsite examinations as well as offsite monitoring of financial institutions are carried out by Financial System and Bank Examination Department and local branches within the BoJ. The BoJ determines the frequency, scope, and the number of examiners of onsite examinations using a risk-based approach. Generally, onsite examinations for major banks are conducted bi-annually, and for regional financial institutions three to five years, while those which needs frequent monitoring, every two to three years.</p>
<b>EC2</b>	The supervisor has a coherent process for planning and executing onsite and offsite activities. There are policies and processes to ensure that such activities are conducted on a thorough and consistent basis with clear responsibilities, objectives and outputs, and that there is effective coordination and information sharing between the onsite and offsite functions.
Description and findings re EC2	The scope of an onsite inspection is guided by the Inspection Manual. Checkpoints for inspection are listed in the Inspection Manuals published by the JFSA. To inform the scope, results from offsite monitoring are incorporated into the planning process.

	<p>In planning its annual onsite inspection schedule, the JFSA 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 offsite review. Regular meetings between onsite and offsite supervision staff at the JFSA are carried out for information sharing on banks under their charge.</p> <p>Prior to each bank inspection, the offsite supervision staff responsible for the bank provides the onsite inspector with all relevant offsite information including meetings minutes, analysis of prudential data, financials, recent events, misconducts if any and share key issues regarding the bank from their offsite activities. Following the inspection, the offsite 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 during the inspection. Generally, onsite inspections for major banks are conducted annually and for regional financial institutions, every two to three years. The process for cooperation between offsite and onsite activities, is set out in the Supervisory Guideline (Section on II-1-3). Staff in Supervisory Bureau (in charge of offsite activities) and in Inspection Bureau (in charge of onsite) hold regular meetings for information sharing in addition to the meeting held at the beginning of the fiscal year. A meeting between the Supervisory Bureau and Inspection Bureau takes place prior to the onsite to share information relevant to the inspection e.g., results of data analysis from offsite monitoring. The onsite plan is determined by the risk profile as well as a view about the economic environment and which banks are most vulnerable to risk.</p> <p>For onsite inspections, the JFSA uses the Financial Inspection Rating System, which assigns grades A to D for following categories:</p> <ul style="list-style-type: none"> <li>• governance framework (basic points);</li> <li>• legal compliance;</li> <li>• customer protection framework;</li> <li>• comprehensive risk management framework;</li> <li>• equity capital management framework;</li> <li>• credit risk management framework;</li> <li>• asset assessment management framework;</li> <li>• market risk management framework;</li> <li>• liquidity risk management framework; and</li> <li>• operational risk management framework.</li> </ul> <p>At the conclusion of the onsite inspection, the JFSA notifies banks the rating results and the inspection findings by feedback letters. In order to further improve the transparency and predictability of regulatory action, the JFSA has published “Criteria for Administrative Actions” and has announced all administrative actions to the public, except in cases where such announcement might hinder managerial improvement in the targeted financial institution.</p> <p>The JFSA has also compiled and published, on a quarterly basis, a collection of cases in</p>
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	<p>which administrative action has been taken. In order to ensure transparency and predictability of JFSA's onsite activities, the JFSA also publishes a collection of findings during onsite inspections in the "Financial Inspection Results Casebook" as appropriate, for financial institutions to use as reference in setting an internal management framework.</p> <p>Regarding major banks supervision, the EIC (examiner in charge) and EIC assistants who are assigned to the same section for multiple years will conduct in-depth analysis beforehand. EIC is also assigned to Supervisory Bureau at the same time to participate in interviews by the Supervisory Bureau, Inspection Follow-up interviews, and dialogues regarding current issues. This helps the EIC grasp the situation of financial group that he/she is in charge of appropriately, look ahead to potential risks for future, and consider targeted inspection that focuses on certain risk and theme. During the bank inspection, inspectors always review if the bank is making efforts to improve the issues pointed out during the last inspection. The inspectors also monitor those issues through offsite monitoring.</p>
<b>EC3</b>	<p>The supervisor uses a variety of information to regularly review and assess the safety and soundness of banks, the evaluation of material risks, and the identification of necessary corrective actions and supervisory actions. This includes information, such as prudential reports, statistical returns, information on a bank's related entities, and publicly available information. The supervisor determines that information provided by banks is reliable<sup>28</sup> and obtains, as necessary, additional information on the banks and their related entities.</p>
Description and findings re EC3	<p>Regular and ad-hoc meetings are 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 offsite monitoring, the banks are assessed for supervisory concerns which are then escalated together with the supervisory action plans.</p> <p>The monitoring of the financial system is conducted through a mix of measures of which the offsite monitoring processes comprises a significant component. JFSA's offsite 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 offsite supervisory teams, which 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 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 small- and medium-sized enterprises (SMEs) and domestic lending strategies. Based on the regulatory data submitted and analysis provided to the assessors by the JFSA, there</p>

<sup>28</sup> Please refer to Principle 10.

	<p>appears to be sufficient coverage and follow-up of the financial indicators offsite by JFSA's offsite monitoring teams.</p> <p>In 2010, the JFSA set up a dedicated team called "Supervisory Planning Office" to analyze the financials and offsite monitoring data of major banks. In 2015, the JFSA reorganized the "Supervisory Planning Office" to the "Macroprudential Policy Office" to conduct in-depth monitoring on macroprudential issues. As mentioned in EC1, the JFSA determines supervisory priority orders among banks based on the results of inspection (grades), offsite interviews and specific events which negatively affect banks. These priorities affect frequency, scope and depth of subsequent activities both in offsite and onsite. Also as stated in EC1 in details, based on the section II-1-3 of Supervisory Guideline, staff in Supervisory Bureau (in charge of offsite activities) and in Inspection Bureau hold regular meetings for information sharing. In addition, before bank inspection, staff in charge of offsite activities shall explain to staff in charge of the bank concerned key issues and analysis results of bank's financials that the staff found from offsite activities and deliver reports or materials, notification and data submitted by the bank. Those inputs by offsite are taken into account when determining priorities and scope in onsite activities.</p>
<p><b>EC4</b></p>	<p>The supervisor uses a variety of tools to regularly review and assess the safety and soundness of banks and the banking system, such as:</p> <ul style="list-style-type: none"> <li>(a) analysis of financial statements and accounts;</li> <li>(b) business model analysis;</li> <li>(c) horizontal peer reviews;</li> <li>(d) review of the outcome of stress tests undertaken by the bank; and</li> <li>(e) analysis of corporate governance, including risk management and internal control systems.</li> </ul> <p>The supervisor communicates its findings to the bank as appropriate and requires the bank to take action to mitigate any particular vulnerability that have the potential to affect its safety and soundness. The supervisor uses its analysis to determine follow-up work required, if any.</p>
<p>Description and findings re EC4</p>	<p>See also EC 1-3. Supervisors perform regular offsite analysis based on a range of qualitative and quantitative information submitted on various frequencies. 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. For example, regarding the larger more complex banks, "hearings" or dialogues are held with banks as frequently as monthly 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 JFSA. This was confirmed in discussions with some of the institutions.</p> <p>The JFSA has also implemented horizontal inspections focusing on specific risk issues. Examples include liquidity for the three megabanks in 2016 (specifically FX funding), and money laundering in 2015.</p>

<b>EC5</b>	The supervisor, in conjunction with other relevant authorities, seeks to identify, assess and mitigate any emerging risks across banks and to the banking system as a whole, potentially including conducting supervisory stress tests (on individual banks or system-wide). The supervisor communicates its findings as appropriate to either banks or the industry and requires banks to take action to mitigate any particular vulnerability that have the potential to affect the stability of the banking system, where appropriate. The supervisor uses its analysis to determine follow-up work required, if any.
Description and findings re EC5	The JFSA analyzes risks within the entire financial sector with a forward looking perspective through integrated monitoring by market analysis division, supervisory division, and inspection division. These divisions review a variety of market data and regulatory reporting to develop analytical notes that are communicated across the organization which are input into planning for supervision activities. Specifically, the JFSA will make efforts to grasp/analyze the trends of global macro economy/financial market, trends of market participants, and flow of funds. The JFSA will also make efforts to grasp/analyze businesses of financial institutions and a real-time trend of fund lending/operations, mainly for large financial groups. Through these efforts, in order to maintain the soundness of financial system of Japan even when the potential risks actualize, the JFSA holds in-depth discussions with financial institutions and relevant authorities.
<b>EC6</b>	The supervisor evaluates the work of the bank's internal audit function, and determines whether, and to what extent, it may rely on the internal auditors' work to identify areas of potential risk.
Description and findings re EC6	<p>The quality and effectiveness of the internal audit function is assessed at least annually by the JFSA. The results of IA are inputs into JFSA's supervisory framework e.g., risk profiles, scope of onsite inspections, etc. During the onsite, inspectors will meet with IA to discuss the results of their work, as well as IA's audit plan for the coming year.</p> <p>As stipulated in "Onsite Examination Policy for Fiscal 2016," the BoJ focuses particularly on ensuring the effectiveness of internal control and proactive improvement of risk management with internal audits.</p>
<b>EC7</b>	The supervisor maintains sufficiently frequent contacts as appropriate with the bank's board, non-executive board members and senior and middle management (including heads of individual business units and control functions) to develop an understanding of and assess matters such as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality, risk management systems and internal controls. Where necessary, the supervisor challenges the bank's board and senior management on the assumptions made in setting strategies and business models.
Description and findings re EC7	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 JFSA 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. 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

	<p>corporate governance function at the bank. The role of the Board of Company Auditors is also regularly assessed by the JFSA both offsite and onsite.</p> <p>The JFSA has many opportunities to interview banks based on the Supervisory Guideline II-1-1-2 and during the interviews, the JFSA lets their directors of a bank know supervisory concerns at an early stage in order for the bank to promptly address the concerns. During bank inspection, the JFSA always creates opportunities to meet with wide classes of employees including the president, directors of a bank, auditors, and working level staff to give an appropriate grading. The results will be reflected in the Inspection results including the grading.</p> <p>Through onsite and offsite integrated monitoring, the JFSA reviews the governance of a bank by having interviews with directors of the bank (including non-executive directors), audit committee, and high- and mid-class management (including head of each business unit and head of control system). The JFSA also reviews the governance by confirming the functions of the board of directors. The results are delivered to the bank managements as necessary, and the JFSA follows up on the improvement. For regional banks, for example, the JFSA reviews the banks' consideration/development of sustainable business models through discussions with bank management, as the population is aging and the birthrate is declining.</p> <p>Contact between the JFSA and bank board of directors is less frequent and depth of discussions is limited. The JFSA does not engage in discussions with the whole board to challenge and verify their oversight of the bank and risk management (see also CPs 14 and 15). The JFSA will, however, meet with board of directors in circumstances where serious concerns are raised about governance. The JFSA has commenced meeting non-executive directors for the three megabanks to discuss risk management.</p>
<b>EC8</b>	<p>The supervisor communicates to the bank the findings of its on- and offsite supervisory analyses in a timely manner by means of written reports or through discussions or meetings with the bank's management. The supervisor meets with the bank's senior management and the board to discuss the results of supervisory examinations and the external audits, as appropriate. The supervisor also meets separately with the bank's independent board members, as necessary.</p>
Description and findings re EC8	<p>The JFSA informs bank directors of supervisory concerns at an early stage in order for the bank to promptly address the concerns. Additionally, when the JFSA inspects a bank in accordance with Article 25 of Banking Act, findings are compiled in the Report on Bank Inspection, which is delivered to the bank after the inspection finishes. During bank inspections, the JFSA always creates opportunity to meet with the president and directors of a bank and exchange views on the findings by the JFSA and external auditors.</p> <p>Results of onsite inspections are submitted to the President of the bank from the Deputy General of the JFSA and shared thereon with the board. Moreover, as part of offsite activities, the JFSA conducts follow-up interviews with banks of which the JFSA has finished inspection. Through the interviews, the JFSA will confirm the adequacy of improvement/countermeasures of findings regarding the report from banks, and encourage banks to develop their improvement plan and ensure steady implementation.</p>

<b>EC9</b>	The supervisor undertakes appropriate and timely follow-up to check that banks have addressed supervisory concerns or implemented requirements communicated to them. This includes early escalation to the appropriate level of the supervisory authority and to the bank's board if action points are not addressed in an adequate or timely manner.
Description and findings re EC9	See also EC1–4. Following an onsite inspection banks will submit progress reports for status of implementation of recommendations and remediation. The JFSA will routinely follow up status of inspection recommendations through offsite monitoring and regular meetings with banks. The JFSA may issue a business improvement order based on Article 26 of the Banking Act if it is found that entrusting the improvement to bank's own efforts will hinder the bank's legal compliance framework or risk management framework.
<b>EC10</b>	The supervisor requires banks to notify it in advance of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal or prudential requirements.
Description and findings re EC10	Article 53 of the Banking Act stipulates the requirement for banks and banking groups to notify the JFSA 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 JFSA had clarified in its published list of administrative actions taken by the JFSA 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 JFSA of all significant matters once they become aware of them. Article 35 of Ordinance for Enforcement of the Banking Act spells out details of the matters, which include changes in bank's and banking group's business operation, organization structure, investment activities, capital management, misconducts by staff, etc.
<b>EC11</b>	The supervisor may make use of independent third parties, such as auditors, provided there is a clear and detailed mandate for the work. However, the supervisor cannot outsource its prudential responsibilities to third parties. When using third parties, the supervisor assesses whether the output can be relied upon to the degree intended and takes into consideration the biases that may influence third parties.
Description and findings re EC11	The JFSA does not use independent third parties such as auditors. Nonetheless, in the past there have been cases where they would ask a bank to select and hire consultants to investigate an issue with the results of the review submitted to the JFSA. The JFSA is also able to determine the scope of such a review. But it is not able to compel a bank to do so directly.
<b>EC12</b>	The supervisor has an adequate information system which facilitates the processing, monitoring and analysis of prudential information. The system aids the identification of areas requiring follow-up action.
Description and findings re EC12	Since 2014, the JFSA commenced use of the JFSA IT infrastructure that supports the overall financial supervision and monitoring. The new IT infrastructure allows the JFSA staff to process regulatory data efficiently. The "Offsite Monitoring Data System" is used to store data submitted by banks upon order of the JFSA under Article 24 of Banking Act. It is utilized for identifying banks which needed supervisory special attention under JFSA's Early Warning System.

<b>Additional criteria</b>	
<b>AC1</b>	The supervisor has a framework for periodic independent review, for example by an internal audit function or third party assessor, of the adequacy and effectiveness of the range of its available supervisory tools and their use, and makes changes as appropriate.
Description and findings re AC1	<p>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 offsite activities generally vests with the head of division.</p> <p>The JFSA creates and publishes “FSA Policy Evaluation Implementation Plan” every fiscal year, based on Government Policy Evaluations Act. The Plan states the objectives of each fiscal year, and the accomplishments are evaluated and published after each planned period ends. In order to ensure objectivity and improve the quality of evaluation, the Policy Evaluation Advisor Council, which consists of outside experts, are held when creating the plan or creating evaluation documents.</p> <p>The JFSA established “the Contact for Financial Policies Monitor,” in which neutral third party external experts receive opinions, suggestions, and criticisms concerning JFSA’s policies and activities, from financial institutions and the public (It started its operation since January 29, 2016). In addition, the JFSA established another “Contact for the JFSA,” in order to receive comments directly at the JFSA.</p> <p>Moreover, the “Advisory Group on Supervisory Approaches” was established by the JFSA in August 2016. It is made up for representatives from outside the JFSA that come together to discuss the concept and potential methods of the supervisory approaches and how to implement them effectively.</p>
<b>Assessment of Principle 9</b>	C
Comments	The JFSA has enhanced the supervisory toolkit through several developments: implementation of risk profiles (see CP8); a more targeted approach to onsite inspections; use of thematic style inspections; and a greater emphasis on onsite inspections in the mix of overall supervisory activities. Part of this new approach is also greater emphasis on engagement with banks’ senior management and boards. The JFSA employs a mix of onsite and offsite activities commensurate with bank’s risk profiles, size, scale, complexity and systemic importance. The introduction of the D-SIB and G-SIB framework has also helped to direct attention to the megabanks. It was evident that the megabanks are receiving considerably more frequent and intensive supervision.
<b>Principle 10</b>	<b>Supervisory reporting.</b> The supervisor collects, reviews and analyses prudential reports and statistical returns <sup>29</sup> from banks on both a solo and a consolidated basis, and

<sup>29</sup> In the context of this Principle, “prudential reports and statistical returns” are distinct from and in addition to required accounting reports. The former are addressed by this Principle, and the latter are addressed in Principle 27.

	independently verifies these reports through either onsite examinations or use of external experts.
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor has the power <sup>30</sup> to require banks to submit information, on both a solo and a consolidated basis, on their financial condition, performance, and risks, on demand and at regular intervals. These reports provide information such as on- and off-balance sheet assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, risk concentrations (including by economic sector, geography and currency), asset quality, loan loss provisioning, related party transactions, interest rate risk, and market risk.
Description and findings re EC1	<p>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 JFSA. These include selected financials including balance sheet and capital ratios and consolidated statements for banking groups with subsidiaries where applicable.</p> <p>In addition, under Article 24 of the Banking Act, banks are also required to submit regular offsite monitoring data to the JFSA regarding on a quarterly frequency covering a full range of data points. The regular quarterly submission of data provides a broad cross-section of information allowing supervisors to perform a comprehensive risk assessment e.g., full balance sheet, profit and loss and risk information. A major part of the JFSA's and BoJ's offsite surveillance comprises the review and analysis of data submitted by banks to the JFSA and BoJ, respectively. Both authorities can require the submission of information from banks, including that on subsidiaries, outsourced entities and overseas operations. The reporting is at both solo and consolidated levels.</p> <p>The JFSA requests banks to submit data regarding Pillar 1 risks. For example, with regard to credit risk, the JFSA requests banks to report the latest updates of non-performing assets, average lending rate, provisions, 100 largest borrowers and entities, large exposures (including related parties), classified by jurisdictions, industry sectors and credit ratings periodically (annually, semi-annually quarterly, or monthly, depending upon each case). As for market risk, banks are required to report mark to market evaluation in terms of interest rate, foreign exchange exposures by various currency, and sensitivity analysis of holding securities. As for liquidity, banks should report large depositors lists as well as deposits composition by terms and depositors' profile on a regular basis (monthly or quarterly or so).</p>
<b>EC2</b>	The supervisor provides reporting instructions that clearly describe the accounting standards to be used in preparing supervisory reports. Such standards are based on accounting principles and rules that are widely accepted internationally.
Description and findings re EC2	<p>The JFSA has published reporting instructions that describe the accounting standards to be used for regulatory reporting. The accounting standards are based on the domestic accounting standards (see also CP26).</p> <p>In relation to the accounting standards, convergence between Japanese GAAP and IFRS has been achieved.</p>

<sup>30</sup> Please refer to Principle 2.

<b>EC3</b>	<p>The supervisor requires banks to have sound governance structures and control processes for methodologies that produce valuations. The measurement of fair values maximizes the use of relevant and reliable inputs and is consistently applied for risk management and reporting purposes. The valuation framework and control procedures are subject to adequate independent validation and verification, either internally or by an external expert. The supervisor assesses whether the valuation used for regulatory purposes is reliable and prudent. Where the supervisor determines that valuations are not sufficiently prudent, the supervisor requires the bank to make adjustments to its reporting for capital adequacy or regulatory reporting purposes.</p>
Description and findings re EC3	<p>The reporting standards do not explicitly set out expectations for governance structures and control procedures for regulatory reporting. Equally there are no explicit references to the valuation framework or control procedures for regulatory reporting.</p> <p>The JFSA will include in its engagements with banks issues regarding the organizational arrangements for fair value measurement and change of rules and market value adjustment method. In terms of offsite analysis, the JFSA receive regular reporting on market value adjustments to low liquidity positions, and thus is monitoring if banks properly measure market value. FSA also examines whether the board of directors is sufficiently involved in the establishment of a verification system and conducts robust internal control. During an onsite inspection, the JFSA will review and assess the adequacy of risk management and control procedures such as the separation between first line and second line.</p> <p>Financial Instruments and Exchange Act requires listed companies including banks to have audit certification by a certified public accountant or audit firm on an internal control report assessing the effectiveness of internal control on financial reports. (it became effective since the settlement of accounts for end-March 2009). However, within the Financial Instruments and Exchange Act there are no explicit instructions for banks regarding the measurement of fair values or expectations regarding the reliability of inputs that are consistently applied for risk management and reporting purposes.</p> <p>The valuation framework and control procedures are subject to validation and verification by Internal Audit but the frequency and scope is not prescribed leaving this up to the discretion of banks. The valuation framework is however subject to independent review by the External Auditor that reviews the control framework for valuations at least annually as part of the financial audit.</p> <p>The JFSA, has the power to require banks to adjust Pillar 1 risk-weighted assets if it finds that the bank is not sufficiently prudent in its valuation of positions. However, there was limited evidence to demonstrate that the JFSA has taken action in relation to valuations that were not sufficiently prudent.</p>
<b>EC4</b>	<p>The supervisor collects and analyses information from banks at a frequency commensurate with the nature of the information requested, and the risk profile and systemic importance of the bank.</p>
Description and findings re EC4	<p>The JFSA collects data via offsite monitoring on the various risks in varying frequencies (weekly, monthly, quarterly, semiannually, or annually) depending on banks' size or</p>

	<p>license type (listed company, cooperative financial institution). Under JFSA's "Early Warning System" provided in the Supervisory Guidelines, banks that are highlighted via "red flags" based on JFSA's analytical framework for monitoring the condition and performance of banks are required to provide additional information to the JFSA on the reasons for the various red flags and plans for possible remedial actions. For those banks requiring supervisory actions, the JFSA 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 JFSA 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.</p> <p>On an ongoing basis, the JFSA uses additional information requests from banks to supplement routine reporting as a way to focus on specific risk issues. Assessors saw evidence of these requests. For example, the JFSA conducted a deep dive into sovereign debt positions requesting additional data from banks and followed up the exercise with interviews with banks.</p>
<b>EC5</b>	In order to make meaningful comparisons between banks and banking groups, the supervisor collects data from all banks and all relevant entities covered by consolidated supervision on a comparable basis and related to the same dates (stock data) and periods (flow data).
Description and findings re EC5	Regulatory data is compiled by a specialist unit within the JFSA which produces statistics and ratios used for offsite analysis. The statistics and reports use aggregate data across multiple time horizons and cohorts for peer group comparison. The data set is sufficiently rich that supervisors can request multiple data series for analysis in addition to standard data templates for offsite monitoring.
<b>EC6</b>	The supervisor has the power to request and receive any relevant information from banks, as well as any entities in the wider group, irrespective of their activities, where the supervisor believes that it is material to the condition of the bank or banking group, or to the assessment of the risks of the bank or banking group or is needed to support resolution planning. This includes internal management information.
Description and findings re EC6	The JFSA is empowered under Article 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 JFSA.
<b>EC7</b>	The supervisor has the power to access <sup>31</sup> all bank records for the furtherance of supervisory work. The supervisor also has similar access to the bank's board, management and staff, when required.
Description and findings re EC7	Article 25 of Banking Act provides the JFSA 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 JFSA is also given the equivalent

<sup>31</sup> Please refer to Principle 1, Essential Criterion 5.

	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.
<b>EC8</b>	The supervisor has a means of enforcing compliance with the requirement that the information be submitted on a timely and accurate basis. The supervisor determines the appropriate level of the bank's senior management is responsible for the accuracy of supervisory returns, imposes sanctions for misreporting and persistent errors, and requires that inaccurate information be amended.
Description and findings re EC8	The JFSA 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. The expectation is that the senior management will review regulatory reporting and in practice this is what is seen as usual practice. Errors or deficiencies in the regulatory returns are typically identified by offsite monitoring and through more rigorous onsite inspections where supervisors assess the accuracy of reporting.  Persistent errors in submissions at banks will trigger a review of controls around a bank's compliance and regulatory reporting systems and processes.
<b>EC9</b>	The supervisor utilizes policies and procedures to determine the validity and integrity of supervisory information. This includes a program for the periodic verification of supervisory returns by means either of the supervisor's own staff or of external experts. <sup>32</sup>
Description and findings re EC9	The JFSA reviews and verifies the accuracy, integrity and validity of regulatory reports and submissions during their onsite inspections and assessors saw examples where the accuracy of regulatory reporting was verified.
<b>EC10</b>	The supervisor clearly defines and documents the roles and responsibilities of external experts, <sup>33</sup> including the scope of the work, when they are appointed to conduct supervisory tasks. The supervisor assesses the suitability of experts for the designated task(s) and the quality of the work and takes into consideration conflicts of interest that could influence the output/recommendations by external experts. External experts may be utilized for routine validation or to examine specific aspects of banks' operations.
Description and findings re EC10	The JFSA does not assign any of its works to the third parties for either onsite or offsite inspection. In the area of IT, however, the JFSA has hired fixed term permanent employees with extensive industry experience as a way to enhance its depth of knowledge in key areas.
<b>EC11</b>	The supervisor requires that external experts bring to its attention promptly any material shortcomings identified during the course of any work undertaken by them for supervisory purposes.

<sup>32</sup> Maybe external auditors or other qualified external parties, commissioned with an appropriate mandate, and subject to appropriate confidentiality restrictions.

<sup>33</sup> Maybe external auditors or other qualified external parties, commissioned with an appropriate mandate, and subject to appropriate confidentiality restrictions. External experts may conduct reviews used by the supervisor, yet it is ultimately the supervisor that must be satisfied with the results of the reviews conducted by such external experts.

Description and findings re EC11	<p>Auditors do not have legal duty to report their findings directly to banking supervisors in Japan, but the JFSA has an authority to ask banks to report if there are any auditor's findings. EA reports are also submitted.</p> <p>If a bank submitted a false report, business improvement order under Article 26 of the Banking act may be taken against the bank. In addition, the bank will be penalized under rules after article 63 of the Banking act, depending upon its materiality. In Japan, Article 193–3 of the Financial Instruments and Exchange Act indicated that audit firms must notify collection of facts findings, remedial actions to violation of laws and regulations, and countermeasures to the company by written notice, when firms discovered violation of laws and regulations or the fact that might put in material danger to maintain appropriateness of financial statements in the company before giving an audit certificate. If such situations are not remedied within two weeks, audit firms have to notify the case to the PM. (Article 194–7 delegates the Commissioner of the JFSA to accept the notification.) Audit firms will not bear the blame for violation of confidentiality for the notification to the Commissioner of the JFSA, according to the article.</p> <p>During the onsite inspection, inspectors have opportunities to meet board members or directors individually and can exchange opinions overall business issues including result of external audit. The JFSA 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.</p>
<b>EC12</b>	The supervisor has a process in place to periodically review the information collected to determine that it satisfies a supervisory need.
Description and findings re EC12	The JFSA reviews at least annually the routine information request for regulatory reporting taking into consideration supervisory needs. Typically, the reporting requirements are updated in line with regulatory developments such as through the Basel III implementation.
<b>Assessment re Principle 10</b>	LC
Comments	<p>The JFSA has the means of collecting, reviewing and analyzing financial institution prudential returns on both a solo and consolidated basis. There are two main areas that need to be addressed.</p> <p>Firstly, in relation to governance requirements for valuations. The reporting standards do not explicitly set out expectations for governance structures and control procedures for regulatory reporting. Equally there are no explicit references to the valuation framework or control procedures for regulatory reporting. The JFSA has the power to require banks to adjust Pillar 1 risk-weighted assets if it finds that the bank is not sufficiently prudent in its valuation of positions; however, there was limited evidence to demonstrate that the JFSA had taken action in relation to valuations that were not sufficiently prudent.</p> <p>Secondly, the supervisor does not require that external experts bring to its attention all material shortcomings identified during the course of any work undertaken by them for supervisory purposes. For example, issues identified by auditors and rectified within 14 days should also be disclosed to the JFSA, currently this is not the practice. To further enhance the integrity of prudential reporting, the JFSA should also require that external</p>

	auditors opine whether or not filings have been accurately made.
<b>Principle 11</b>	<b>Corrective and sanctioning powers of supervisors.</b> The supervisor acts at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system. The supervisor has at its disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability to revoke the banking license or to recommend its revocation.
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor raises supervisory concerns with the bank’s management or, where appropriate, the bank’s board, at an early stage, and requires that these concerns be addressed in a timely manner. Where the supervisor requires the bank to take significant corrective actions, these are addressed in a written document to the bank’s board. The supervisor requires the bank to submit regular written progress reports and checks that corrective actions are completed satisfactorily. The supervisor follows through conclusively and in a timely manner on matters that are identified.
Description and findings re EC1	<p>The JFSA identifies problems via both onsite inspections and offsite monitoring. Banks that are highlighted via “red flags” in JFSA’s offsite early warning system are subject to follow up interviews by the JFSA and may be required to provide additional information regarding root causes and a remedial action plan. Assessors saw evidence of this process working effectively.</p> <p>Issues identified during onsite inspections and informed to the banks via the inspection reports issued by the JFSA 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. Processes surrounding the onsite inspection and submission of findings was demonstrated to be working effectively.</p> <p>The JFSA also has the necessary powers to 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. The JFSA 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 JFSA will also follow up on the actions taken by the bank for business improvement for sufficiency via offsite monitoring or further ad-hoc inspections if required. The JFSA has the equivalent power to bank holding companies.</p> <p>Typical supervisory activities and escalation measures include:</p> <ul style="list-style-type: none"> <li>• Annual meeting regarding bank’s risk management. Through this annual meeting held around in October, the JFSA will check how a bank manages its comprehensive and various types of risks, its challenges with respect to risk management and its approach to address them. The JFSA will also see the attitude of bank’s directors to risk management.</li> <li>• Annual meeting with bank’s internal auditors. Through this meeting held around in April, the JFSA will understand how a bank establishes an "internal control system" for risk management and compliance.</li> </ul>

	<ul style="list-style-type: none"> <li>• Quarterly meetings on bank's financial results (conducted based on the size and nature of banks).</li> <li>• Semi-annual meetings on bank's overall business management. Through these meetings, the JFSA will understand how a bank manages profits, operation, bank's capital planning, etc. Usually, a director of the bank will visit the JFSA to explain those issues in the meeting.</li> <li>• Meetings with the president of a bank. As necessary, the JFSA will directly talk with the president of a bank on his views on management strategy, management policy and risk management.</li> <li>• Frequent interviews when necessary. When the JFSA notices events which may negatively affect bank's sound and appropriate management of the business, the JFSA will interview banks. Such events include changes in bank's performance and strategy, in economic situation such as interest rates and asset prices and in customers' attitude to the bank.</li> <li>• Follow up interviews after inspection. As part of offsite activities, the JFSA will conduct follow up interviews with the bank of which the JFSA has finished inspection. Immediately after the Report on Bank Inspection is delivered to a bank, in accordance with Article 24 of Banking Act, the JFSA will ask the bank to hand in coordinated reports or materials concerning improvement efforts by the bank on the findings during JFSA's onsite inspection within one month. The report must include fact checking, cause analysis etc. of findings during the inspection. The JFSA will confirm the adequacy of remedial measures.</li> </ul> <p>When deterioration in financial strength or a serious flaw in risk management is found at a financial institution, the BoJ conducts follow-up reviews periodically in accordance with the Onsite Examination Contracts as stipulated in Article 44 of the Bank of Japan Act. The findings of such reviews are properly shared with the JFSA through a variety of channels.</p>
<b>EC2</b>	<p>The supervisor has available<sup>34</sup> an appropriate range of supervisory tools for use when, in the supervisor's judgment, a bank is not complying with laws, regulations or supervisory actions, is engaged in unsafe or unsound practices or in activities that could pose risks to the bank or the banking system, or when the interests of depositors are otherwise threatened.</p>
Description and findings re EC2	<p>The JFSA has a range of supervisory tools and powers to take measures against banks which are in violation of laws and regulations, or are engaging in unsafe or unsound business practices. The range of measures taken against banks depends 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.</p> <p>The JFSA 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 JFSA 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</p>

<sup>34</sup> Please refer to Principle 1.

	<p>accordance with Article 26 of the Banking Act. The JFSA 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. Suite of measures include:</p> <ul style="list-style-type: none"> <li>• The Commissioner of the JFSA may request banks to submit an 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 JFSA 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. (Note, Article 27 of the Banking Act refers to “PM, however in practice, it is the Commissioner of the JFSA which is operationally active in relation to the following measures).</li> <li>• The PM may order a bank to suspend the whole or part of its business or to dismiss its director, executive officer, accounting advisor, or company auditor, and rescind the license in accordance with Article 27 of the Act, when a bank has violated any laws, regulations, its articles of incorporation or a disposition by the Commissioner of the JFSA, or the bank has acted to harm the public interest.</li> <li>• The PM may rescind the license in accordance with Article 28 of the Act, when it finds necessary in light of the circumstances in the case where it has ordered a bank to suspend the whole or part of its business pursuant to the provisions of Articles 26 and 27 of the Banking Act.</li> </ul>
<b>EC3</b>	<p>The supervisor has the power to act where a bank falls below established regulatory threshold requirements, including prescribed regulatory ratios or measurements. The supervisor also has the power to intervene at an early stage to require a bank to take action to prevent it from reaching its regulatory threshold requirements. The supervisor has a range of options to address such scenarios.</p>
Description and findings re EC3	<p>Based on paragraph 1, Article 74, of the Deposit Insurance Act, the JFSA Commissioner may order a financial institution to appoint an administrator to control its business operations and assets in certain circumstance e.g., when a bank is unable to repay its debt or is likely to restrict withdrawal of deposits due to its business and financial conditions.</p> <p>In addition, based on paragraph 2, Article 74 of the Deposit Insurance Act, the JFSA Commissioner may order a financial institution to appoint an administrator to control the business operations and assets in certain circumstance e.g. receiving notification from the financial institution that a situation is likely to arise in which the financial institution is unable to repay its debt in full with its assets. In practice, Deposit Insurance Corporation will be appointed as the administrator/receiver. The administrator has the exclusive authority 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). With regard to the BoJ, its main role in bank resolution is limited to temporary loans to the Deposit Insurance Corporation with the government guarantee</p>

	<p>(i.e., it does not bear the cost of failed-bank resolution under the deposit insurance system.</p> <p>Regarding capital, the JFSA operates a Prompt Corrective Action System and capital distributions can be constrained where administrative actions are taken corresponding to bank's capital adequacy ratios prescribed in paragraph 2 of Article 26 of the Banking Act. In addition, the JFSA introduced the capital conservation buffer requirements as per the Basel III framework commencing December 2015. Under the framework banks are required to limit their capital distributions in proportion to the amount of capital buffer below the minimum requirement.</p> <p>While the capital conservation buffer provides a framework for actions to require banks to preserve capital if the buffer is breached, the PCA regime does not provide sufficient flexibility for the JFSA to require banks to raise capital unless prudential minimum capital ratios are breached.</p> <p>While the JFSA has issued orders to banks in the past (e.g., from 2000 to 2005) not all banks adhered to the orders. The Finance and Strengthening Act provides for the Japanese government to inject capital into banks during times of stress.</p>
<b>EC4</b>	<p>The supervisor has available a broad range of possible measures to address, at an early stage, such scenarios as described in essential criterion 2 above. These measures include the ability to require a bank to take timely corrective action or to impose sanctions expeditiously. In practice, the range of measures is applied in accordance with the gravity of a situation. The supervisor provides clear prudential objectives or sets out the actions to be taken, which may include restricting the current activities of the bank, imposing more stringent prudential limits and requirements, withholding approval of new activities or acquisitions, restricting or suspending payments to shareholders or share repurchases, restricting asset transfers, barring individuals from the banking sector, replacing or restricting the powers of managers, board members or controlling owners, facilitating a takeover by or merger with a healthier institution, providing for the interim management of the bank, and revoking or recommending the revocation of the banking license.</p>
Description and findings re EC4	<p>See also EC1–3. The JFSA Commissioner may request banks to submit an 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, if the JFSA finds it necessary for ensuring sound and appropriate management of the business of a bank (in accordance with Article 26 of the Banking Act).</p> <p>The mission saw evidence where the JFSA had issued requests for improvement plans expeditiously to facilitate early intervention.</p> <p>In more extreme circumstances, the Minister for Financial Services may order a bank to suspend the whole or part of its business or to dismiss its director, executive officer, accounting advisor, or company auditor, and rescind the license in accordance with Article 27 of the Act, when a bank has violated any laws, regulations, its articles of incorporation or a disposition by the Commissioner of the JFSA, or the bank has acted to harm the public interest.</p>

	<p>The PM may also rescind a banking license in accordance with Article 28 of the Act, when it finds necessary in light of the circumstances in the case where it has ordered a bank to suspend the whole or part of its business pursuant to the provisions of Articles 26 and 27 of the Banking Act.</p> <p>Measures taken under the Article 26 of the Banking Act (it should be noted that not all powers in the Banking Act have been delegated to the Commissioner of the JFSA, however the assessors are of the view that this does not negatively impact the JFSA's exercise of corrective actions and measures as required in the CP):</p> <ul style="list-style-type: none"> <li>➤ Order for submission of an improvement plan or a change of the improvement plan submitted.</li> <li>➤ Order for temporal suspension of the whole or part of the existing business or new business.</li> <li>➤ Order for deposit property.</li> <li>➤ Other measures necessary for the purpose of supervision.</li> </ul> <p>Measures taken under Article 26–2 of the Banking Act (Prompt corrective actions) Orders will be issued corresponding to ranges of capital adequacy ratio automatically where the ratio is below the minimum requirement:</p> <ul style="list-style-type: none"> <li>➤ Order for prohibition or restraint from bank's paying remuneration for directors, company auditors and/or executive officers.</li> <li>➤ Order the implementation of optional measures such as raising capital, closing significant part of business, merger with another bank, or getting out of banking business.</li> <li>➤ Order suspension of the whole or part of business.</li> </ul> <p>(Please see Order Providing for the Categories, etc. Prescribed in Article 26, Paragraph (2) of the Banking Act for details).</p> <p>Measures taken under the Article 27 of the Banking Act:</p> <ul style="list-style-type: none"> <li>➤ Order suspension of the whole or part of existing or new business.</li> <li>➤ Dismiss directors, executive officers, and company auditors.</li> <li>➤ Revoke licenses.</li> </ul> <p>Measure taken under the Article 28 of the Banking Act:</p> <ul style="list-style-type: none"> <li>➤ Revoke licenses.</li> </ul>
<p><b>EC5</b></p>	<p>The supervisor applies sanctions not only to the bank but, when and if necessary, also to management and/or the board, or individuals therein.</p>
<p>Description and findings re EC5</p>	<p>In circumstances where there is a violation of the Banking Act, penalties can be imposed on bank staff (including directors, executive officers, accounting advisors and auditors) and a bank itself in accordance with Article 61 to 67 of the Banking Act. Over the last three years, the JFSA has applied sanctions in a number of cases to banks for a variety of reasons. The assessors saw examples where the JFSA had applied sanctions effectively. Article 27 of the Act also stipulates that the JFSA may order to dismiss a director, executive officer,</p>

	accounting advisor and auditor when they violate laws, terms of incorporation and administrative orders.
<b>EC6</b>	The supervisor has the power to take corrective actions, including ring-fencing of the bank from the actions of parent companies, subsidiaries, parallel-owned banking structures and other related entities in matters that could impair the safety and soundness of the bank or the banking system.
Description and findings re EC6	<p>The JFSA's range of supervisory measures provided under the Banking Act include orders to ring fence banks against activities which may negatively affect the safety and soundness of banks. Under the Banking Act, the JFSA may issue reporting orders, conduct onsite inspections and issue business improvement orders against a bank, bank's subcontractors including its subsidiaries, a bank holding company and bank's major shareholders. By exercising these authorities, the JFSA will require banks to take remedial actions (including ring fencing banks from activities conducted by parent companies, subsidiaries and other related companies) against the matters which may affect negatively safety and soundness of banks (referred in Articles 24, 25, 26, 52–31, 52–32, 52–11, 52–12 and 52–14 of the Banking Act).</p> <p>The range of measures include:</p> <ul style="list-style-type: none"> <li>• ordering the submission of improvement plans;</li> <li>• temporary or permanent suspension of the whole or part of the existing business or new business;</li> <li>• orders prohibiting or restraining the bank from remunerating directors, company auditors and/or executive officers, dismissing directors, executive officers, and company auditors; and</li> <li>• 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.</li> </ul> <p>Common measures taken by the JFSA are improvement plans to address deficiencies in controls or senior management oversight and the mission saw examples where the JFSA had applied these measures. When a bank's capital adequacy ratios fall below the minimum requirement level, the JFSA may order the bank to undertake actions depending on its capital adequacy ratios in accordance to JFSA' Prompt Corrective Action System (PCA) as provided under Article 26–2 of the Banking Act and corresponding Order.</p> <p>Other PCA actions include:</p> <ul style="list-style-type: none"> <li>• 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; and</li> <li>• 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.</li> </ul>
<b>EC7</b>	The supervisor cooperates and collaborates with relevant authorities in deciding when and how to effect the orderly resolution of a problem bank situation (which could include closure, or assisting in restructuring, or merger with a stronger institution).

Description and findings re EC7	<p>When a bank's capital adequacy ratios fall below the minimum requirement level, the JFSA may order the bank to take far reaching actions to address the issue (e.g., suspend significant part of its business, merge with another bank, close or suspend its business, depending on the categories of capital adequacy ratios stipulated in Order providing for the categories prescribed in Paragraph 2 of Article 26 of the Banking Act set by the Commissioner of the JFSA.) In this circumstance, the JFSA will be deeply involved in bank's making of the plans. The JFSA, as a resolution and supervisory authority, develop resolution plans. The Deposit Insurance Corporation of Japan (DICJ) as an executive agency and the BoJ as a central bank responsible for maintaining orderly financial system are CMG (Crisis Management Group) member, and are cooperating with the JFSA.</p> <p>In addition to the description in EC8–7, Article 74 of the Deposit Insurance Act defines the procedures taken by the Commissioner of the JFSA for orderly resolutions of problem banks as follows. Based on paragraph 1, Article 74, of the Deposit Insurance Act, the Commissioner of the JFSA may order a financial institution to appoint a financial reorganization administrator to control its business operations and assets in the following cases:</p> <ul style="list-style-type: none"> <li>• If the financial institution is unable to repay the debt with its assets;</li> <li>• If the financial institution is likely to restrict withdrawal of deposits due to its business and financial conditions;</li> <li>• If the financial institution halts withdrawal of deposits and falls within each of the following conditions: <ul style="list-style-type: none"> <li>◇ Business operations of the financial institution are significantly inappropriate.</li> <li>◇ If the financial institution terminates it's all business operations or dissolved without merging with other entities, etc., smooth monetary flows and the customers' convenience may be affected seriously in geographical regions or business areas where the financial institution conducts business operations.</li> </ul> </li> </ul> <p>Based on paragraph 2 of Article 74 of the Deposit Insurance Act, the PM may order a financial institution to name a financial reorganization administrator to control its business operations and assets, if the institution provides a notice for being unable to repay the debt with its assets, and the institution meets each of the conditions in the 3<sup>rd</sup> case above. In practice, Deposit Insurance Corporation will be appointed as a financial reorganization administrator, and it is understood that the Commissioner of the JFSA has the power to supervise the administrator.</p> <p>Financial reorganization administrator has the exclusive authorities to represent a financial institution under conservation, execute its businesses and manage or dispose its assets (paragraph1, 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. As mentioned above, the DICJ subject to supervision of FSA has exclusive authorities (closure, supporting reconstruction, business transfer)) for orderly resolution of banks. The JFSA and the DICJ have legal responsibilities on bank resolution, and exchange views and information via wide range of channels including visits, telephone</p>
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	<p>calls and e-mails.</p> <p>In the case of financial institution distress that may pose systemic risk issues the PM has the exclusive authority to trigger resolution in the case of “Measures against Financial Crisis” and “Measures for Orderly Resolution” following deliberation by the Financial Crisis Response Council (which includes the JFSA Commissioner among its members). As indicated in CP1/EC1 the PM authorizes the implementation of various resolution measures by the administrative agencies including the JFSA and DICJ.</p>
<b>Additional criteria</b>	
<b>AC1</b>	Laws or regulations guard against the supervisor unduly delaying appropriate corrective actions.
Description and findings re AC1	II-5-1-1 of the Supervisory Guideline specifies a time period for standard processing where administrative actions are taken. Specifically, 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 be conducted generally within one month after receipt of the reports requested under Article 24 of the Banking Act or reports on misconducts.
<b>AC2</b>	When taking formal corrective action in relation to a bank, the supervisor informs the supervisor of non-bank related financial entities of its actions and, where appropriate, coordinates its actions with them.
Description and findings re AC2	<p>The JFSA supervises not only banks but also other financial sectors; for example, insurance companies, securities companies and moneylenders. Banks supervisory divisions of the JFSA will coordinate with other divisions in charge of other financial sectors before taking administrative actions in accordance with Article 26 and 52-33 of the Banking Act.</p> <p>In addition, Article 57-5 of Banking Act stipulates consultation with Minister of Finance in case when administrative measures such as business improvement orders and revokes of licenses are taken against banks, which will negatively affect stability of financial system.</p>
<b>Assessment re principle 11</b>	LC
Comments	<p>The JFSA has a range of supervisory tools and powers to take measures against banks that are in violation of laws and regulations, or are engaging in unsafe or unsound business practices. However, in practice, it 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 those banks. These would usually take the form of business improvement orders and suspension of businesses. In addition to the existing measures under the Banking Act, regarding capital, the JFSA introduced capital buffer requirements in December 2015 whereby banks are required to limit their capital distributions in proportion to the amount of capital buffer below the minimum requirement. 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.</p> <p>The assessors have some concerns regarding (i) the willingness of the JFSA to exercise its powers at an early stage and (ii) the PCA triggers are set too low and do not grant the JFSA sufficient flexibility to intervene and act early in the event emerging risks eventuate. In</p>

addition, the assessors believe the framework for crisis preparation could be further enhanced by strengthening crisis coordination.

(i) While the powers are evident, there appears to be a lack of willingness to fully utilize them in practice. The PCA regime and capital conservation buffer provides a framework for actions to require banks to raise or preserve capital if the minimum requirement threshold is breached. However, the PCA regime does not provide sufficient flexibility for the JFSA to be able to require banks to raise capital unless prudential minimums are breached. The prudential minimums are 8 percent Common Equity Tier 1 (CET1) capital for internationally active banks and 4 percent Core capital for domestic banks. (ii) PCA triggers are currently set too low although in practice the assessors understand from the JFSA that this may not restrict it from taking other supervisory actions where necessary. For instance, supervisory actions will be taken following triggers from JFSA's offsite early warning system or onsite inspection findings. Nevertheless, the JFSA should review its current PCA and consider introducing earlier triggers points.

The assessors observed that the JFSA is perceived by the industry as a relatively "strict" supervisor, with proactive intervention generally taking place following the activation of various triggers including JFSA'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 JFSA 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 JFSA'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.

Intervention efforts of the JFSA 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.

As for crisis coordination where the JFSA interacts with other agencies on resolution matters, currently information-sharing and interagency coordination is facilitated via various fora, including the Council for Cooperation on Financial Stability—consisting of senior officials of the JFSA and BoJ and tasked with coordination on macroprudential policy—and the Financial Crisis Response Council (FCRC)—mandated to advise the PM on the deployment of resolution measures in situations where the stability of the credit system or the financial market is at risk. Such fora, however, do not operate as contingency planning bodies that, inter alia, (i) periodically review the crisis preparedness efforts of the various financial safety net providers; (ii) prepare a comprehensive overview of possible crisis management measures; (iii) organize multi-agency contingency planning exercises; and (iv) coordinate crisis responses and communication plans. The assessors recommend the authorities consider strengthening inter-agency coordination for crisis management and preparedness.

<b>Principle 12</b>	<b>Consolidated supervision.</b> An essential element of banking supervision is that the supervisor supervises the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential standards to all aspects of the business conducted by the banking group worldwide. <sup>35</sup>
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor understands the overall structure of the banking group and is familiar with all the material activities (including non-banking activities) conducted by entities in the wider group, both domestic and cross-border. The supervisor understands and assesses how group-wide risks are managed and takes action when risks arising from the banking group and other entities in the wider group, in particular contagion and reputation risks, may jeopardize the safety and soundness of the bank and the banking system.
Description and findings re EC1	<p>The JFSA is responsible for the supervision of banks and banking groups on both a solo and consolidated basis. Banks and banking groups are required to provide regulatory reporting to the JFSA on both a solo as well as consolidated level on their solvency, earnings, adequacy of risk management and outsourcing in accordance with Articles 52–31 and 52–32 of the Banking Act. During the licensing stage as well as during ongoing supervision, the JFSA collects relevant information regarding banks and banking groups, to understand and assess the status of their business operations and organizational structures.</p> <p>An assessment of a bank’s integrated risk management system to monitor and control domestic and cross-border operations is undertaken by the JFSA as part of an evaluation of the bank’s corporate governance and internal control functions carried out largely via its onsite inspections. The JFSA also assesses the quality of bank management of foreign branches and subsidiaries via information exchange and communication with foreign supervisors as well as onsite visits in foreign jurisdictions. The JFSA requests inspection reports conducted by foreign supervisors on bank foreign operations and reports on misconducts submitted to foreign supervisors. The JFSA staff also participate in meeting between foreign supervisors and the local affiliates of Japanese banks.</p> <p>The evaluation of a bank and bank group integrated risk management practices across the local and overseas entities is carried out by the JFSA as part of its supervisory oversight and monitoring of banks. These may include onsite inspections and reviewing inspection reports from foreign supervisors.</p> <p>Of note, V–1–1 of the Supervisory Guideline states that “it is appropriate to clarify the border of banking group and conduct risk management on a group basis, taking account of practice of risk management, the status of stakeholders that monitor the banking group, improvement of user convenience and international competition.” Accordingly, banks conduct their risk management on a group basis for all material activities in the wider group. Furthermore, the JFSA documents risk profiles of individual banks and revises them every year at the end of June. They are also revised whenever significant issues are found as a result of monitoring or if there are material changes arising from semi-annual financial results.</p>

<sup>35</sup> Please refer to footnote 19 under Principle 1.

	<p>As an example of recent practice, the JFSA has been paying close attention in its supervisory activities of the impact of exceptionally low interest rates on the relationships between banks and their securities firms and trust affiliates. Low interest rates are thought to have increased the links between banks and those affiliates; the JFSA is particularly interested in how that is affecting the incentives for how customers are treated by the banking group as a whole.</p> <p><b>Bank of Japan</b></p> <p>In addition to onsite examinations and offsite monitoring, when financial institutions subject to onsite examinations have financial holding companies, the BoJ makes onsite inquiry contracts with the companies and conducts onsite inquiries.</p> <p>As stipulated in “Onsite Examination Policy for Fiscal 2016”, the BoJ examines the effectiveness of the group-wide business management of financial institutions, including overseas branches and subsidiaries, which offer a wide range of financial services on a group basis.</p> <p>Depending on the risk profile, the BoJ conducts follow-up reviews in accordance with the onsite examination contracts as stipulated in Article 44 of the Bank of Japan Act. The findings of such reviews are properly shared with the JFSA through a variety of channels.</p>
<b>EC2</b>	<p>The supervisor imposes prudential standards and collects and analyses financial and other information on a consolidated basis for the banking group, covering areas such as capital adequacy, liquidity, large exposures, exposures to related parties, lending limits and group structure.</p>
Description and findings re EC2	<p>The JFSA has set capital adequacy standards and other prudential standards on both a consolidated and solo basis in order to evaluate safety and soundness of banks and bank holding companies based on Article 14–2 and 52–25 of the Banking Act. Also, as confirmed in the review of supervisory files it collects and analyzes information on financial results, risk management and business development of financial institutions, by monitoring financial information, business management, ALM management, and lending stance on both a consolidated and solo basis. Note that Article 13 of the Banking Act provides bank’s lending limits on a solo basis and a consolidated basis.</p> <p>In the case of the BoJ, when financial institutions subject to onsite examinations have financial holding companies, the BoJ makes onsite inquiry contracts with the companies and conducts onsite inquiries. The BoJ also conducts reviews as part of its constant surveys (offsite monitoring). In doing so, it collects information and analyzes financial institutions’ business conditions in group basis</p>
<b>EC3</b>	<p>The supervisor reviews whether the oversight of a bank’s foreign operations by management (of the parent bank or head office and, where relevant, the holding company) is adequate having regard to their risk profile and systemic importance and there is no hindrance in host countries for the parent bank to have access to all the material information from their foreign branches and subsidiaries. The supervisor also determines that banks’ policies and processes require the local management of any cross-border operations to have the necessary expertise to manage those operations in a safe and sound manner, and in compliance with supervisory and regulatory requirements. The home</p>

	<p>supervisor takes into account the effectiveness of supervision conducted in the host countries in which its banks have material operations.</p>
<p>Description and findings re EC3</p>	<p>With regard to bank's management of foreign operation, based on III-3-10 of the Supervisory Guideline, the JFSA examines whether the headquarters of a bank has developed an integrated risk management system to monitor and control businesses conducted by its foreign branches and subsidiaries.</p> <p>The JFSA asks banks to submit the result report of inspections conducted by foreign supervisors into banks' foreign operations and the reports of misconducts submitted to foreign supervisors and will cooperate with foreign supervisors when the JFSA uncovers concerns about a bank's monitoring and management system for foreign branches and subsidiaries. (Referred in III-3-10-3 of the Supervisory Guideline).</p> <p>The JFSA examines the status of a bank's management of foreign branches and subsidiaries via information exchange with foreign supervisors and will share the views on this. When the JFSA finds it necessary, it may require the bank to report on its awareness of the status and actions for improving it based on Article 24 of the Banking Act. The JFSA may issue a business improvement order in accordance with Article 26 of the Banking Act when the JFSA finds material problems with the status of a bank.</p> <p>The Inspection Manual requires examiners to check whether bank's integrated risk management and internal control system has been developed on a consolidated basis and whether the bank adequately controls its foreign operations (II-2-1-1 and II-2-1-3 of Integrated Risk Management System Check List). Examiners will also confirm that banks whose foreign operations have significant risks place internal auditors in the operations (II-1-4-viii of the Business Management System Check List).</p> <p>A bank that intends to hold a foreign subsidiary or establish a foreign branch must be approved by the JFSA based on paragraph 7, Article 16-2 and paragraph 2, Article 8 of the Banking Act. In reviewing the application for holding a foreign subsidiary or a branch, the JFSA will examine whether the host country will hinder the applicant bank from appropriately monitoring the subsidiary or the branch and accessing any information of the subsidiary or the branch in accordance with paragraph 2, Article 17-5 of the Ordinance of Enforcement for the Banking Act.</p> <p><b>Bank of Japan</b></p> <p>As stipulated in "Onsite Examination Policy for Fiscal 2016," the BoJ examines the following aspects.</p> <ul style="list-style-type: none"> <li>➤ the effectiveness of the group-wide business management of financial institutions, including overseas branches and subsidiaries, which offer a wide range of financial services on a group basis.</li> <li>➤ the BoJ is enhancing its onsite examinations of overseas branches through means including more specific field work, given the increased weight of international businesses.</li> </ul>

<p><b>EC4</b></p>	<p>The home supervisor visits the foreign offices periodically, the location and frequency being determined by the risk profile and systemic importance of the foreign operation. The supervisor meets the host supervisors during these visits. The supervisor has a policy for assessing whether it needs to conduct onsite examinations of a bank’s foreign operations, or require additional reporting, and has the power and resources to take those steps as and when appropriate.</p>
<p>Description and findings re EC4</p>	<p>The JFSA deploys its examiners in other jurisdictions where Japanese banks actively conduct business; for example, U.S., United Kingdom, Hong Kong, and Singapore. The examiners will visit foreign branches or subsidiaries of Japanese banks at any time, depending on the risk profile and systemic importance of foreign business, and interviews with host country supervisors. Discussions with banks revealed that the frequency varies in practice, likely depending on whether the JFSA has any issues that would warrant onsite probing and discussions.</p> <p>There is a framework for bilateral economic talks between Japan and major countries and other Asian countries. The JFSA participates in such discussions.</p> <p>The JFSA conducts risk-based supervision. The JFSA will issue reporting orders based on Article 24 and 52–31 of the Banking Act and conducts onsite inspection based on Article 25 and 52–32 of the Banking Act when the JFSA finds it necessary to ensure sound and appropriate banking businesses.</p> <p><b>Bank of Japan</b></p> <p>As stipulated in “Onsite Examination Policy for Fiscal 2016,” the BoJ is enhancing its onsite examinations of overseas branches through means including more specific field work, given the increased weight of international businesses. In addition, the BoJ aims to share its findings and strengthen cooperation with overseas regulators, mainly on issues common to internationally active financial institutions.</p>
<p><b>EC5</b></p>	<p>The supervisor reviews the main activities of parent companies, and of companies affiliated with the parent companies, that have a material impact on the safety and soundness of the bank and the banking group, and takes appropriate supervisory action.</p>
<p>Description and findings re EC5</p>	<p>In the case where the parent company of an applicant for a bank license already conducts nonfinancial businesses, the JFSA will examine whether the applicant is independent from the parent company in the sense that banking business is completely segregated from the risks arising from business activities conducted by the parent company. (Referred in VII–1–6 of the Supervisory Guideline).</p> <p>A major shareholder, who wishes to hold shares of a bank no less than the major shareholder threshold which is 15 or 20 percent (depending on the influence of the shareholder to the bank) of voting rights, must get pre-approved for the holdings in accordance with Article 52–9 of the Banking Act, and the JFSA will review the application based on the criteria stipulated in Article 52–10 of the Banking Act.</p> <p>The JFSA has the power to issue reporting orders and to conduct onsite inspections against major shareholders based on Article 52–11 and Article 52–12 of Banking Act. Where a</p>

	major shareholder of a bank no longer satisfies the requirement listed in each item of Article 52–10 of Banking Act, the JFSA may order that the major shareholder of the bank to take necessary measures for satisfying that requirements in accordance with Article 52–13 of Banking Act.
<b>EC6</b>	<p>The supervisor limits the range of activities the consolidated group may conduct and the locations in which activities can be conducted (including the closing of foreign offices) if it determines that:</p> <ul style="list-style-type: none"> <li>(a) the safety and soundness of the bank and banking group is compromised because the activities expose the bank or banking group to excessive risk and/or are not properly managed;</li> <li>(b) the supervision by other supervisors is not adequate relative to the risks the activities present; and/or</li> <li>(c) the exercise of effective supervision on a consolidated basis is hindered.</li> </ul>
Description and findings re EC6	<p>The 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 JFSA 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 practice, decisions to downsize had been taken by banks themselves based on internal risk and capital adequacy considerations without the JFSA being required to take supervisory actions.</p> <p>Article 26 of the Banking Act empowers the JFSA to require a bank to suspend a part of its businesses including foreign businesses when the JFSA finds it necessary to ensure the safety and soundness of the bank’s business. A situation where the JFSA finds necessary information for consolidated supervision is not forthcoming may result in the JFSA taking a variety of remedial measures under Article 26 of the Banking Act.</p>
<b>EC7</b>	In addition to supervising on a consolidated basis, the responsible supervisor supervises individual banks in the group. The responsible supervisor supervises each bank on a stand-alone basis and understands its relationship with other members of the group. <sup>36</sup>
Description and findings re EC7	<p>Article 14-2 and 52–25 of the Banking Act empowers the JFSA 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 JFSA on both a solo and consolidated basis. Capital adequacy standards are applied on both solo and consolidated basis together with large exposure limits.</p> <p>In addition, the JFSA supervises the governance, safety and soundness, and risk management of individual banks on a solo basis based on Comprehensive Guidelines for Supervision of Major Banks, etc. Also, the JFSA supervises on a consolidated basis in terms of risk management of banking groups, such as arm's length principle in accordance with</p>

<sup>36</sup> Please refer to Principle 16, Additional Criterion 2.

	<p>Section V of the Guideline.</p> <p><b>Bank of Japan</b></p> <p>As stipulated in "Onsite Examination Policy for Fiscal 2016", the BoJ examines the effectiveness of the group-wide business management of financial institutions, including overseas branches and subsidiaries, which offer a wide range of financial services on a group basis.</p>
<b>Additional criteria</b>	
<b>AC1</b>	For countries which allow corporate ownership of banks, the supervisor has the power to establish and enforce F&P standards for owners and senior management of parent companies.
Description and findings re AC1	<p>The JFSA is empowered under Articles 52–33 and 52–34 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 JFSA for the establishment of bank holding companies is required and the JFSA would be able to assess the suitability of the parent company during the approval process.</p> <p>In assessing the eligibility of the applicant as a major shareholder, Paragraph 1, Article 52–10 of the Banking Act requires the JFSA to check matters on funds for acquisition, financial condition and status of income and expenditure, and personnel structures, etc., of the applicant. With regard to personnel structures, the JFSA will examine whether the applicant sufficiently understands a public nature of banking business, and that the applicant has sufficient social credibility. VII–2–2–1 of Supervisory Guideline provides detailed checklists when the JFSA examines an application for major shareholders from business companies conducting nonfinancial activities.</p> <p>The JFSA has the power to issue reporting orders and to conduct onsite inspections against major shareholders based on Article 52–11 and article 52–12 of Banking Act. Where a major shareholder of a bank no longer satisfies the requirement listed in each item of Article 52–10 of Banking Act, the JFSA may order that the major shareholder of the bank to take necessary measures for satisfying that requirements in accordance with Article 52–13 of the Banking Act.</p>
<b>Assessment of Principle 12</b>	C
Comments	The Japanese banking supervision framework enables banks to be supervised on both a consolidated and a solo basis. It also gives the authorities the powers they need to be able to oversee foreign activities of Japanese banks and supervise the shareholders and senior management of parent and affiliated companies including outsourcing companies from a prudential perspective. In this regard the assessors welcome the recent changes to the Banking Act that give the JFSA the power to review the activities of the holding company and affiliated entities and evaluate the suitability of owners and senior management of those companies.

	As indicated in EC5 of CP1, there is a legal clause that enables bank subsidiaries and bank outsourced companies to refuse the JFSA investigations if there are "justifiable reasons." As noted the authorities confirmed that this is simply a legal safeguard in their laws to ensure that supervisory authorities do not demand information beyond what is needed to carry out their prudential responsibilities. There have not been any cases of any parties relying on this provision to refuse to supply information to the JFSA and the JFSA could use other means of obtaining the information if the need arose. Consequently, the assessors are satisfied that this clause is not an impediment to the authorities being able to exercise their prudential oversight responsibilities on both a consolidated and solo basis.
<b>Principle 13</b>	<b>Home-host relationships.</b> Home and host supervisors of cross-border banking groups share information and cooperate for effective supervision of the group and group entities, and effective handling of crisis situations. Supervisors require the local operations of foreign banks to be conducted to the same standards as those required of domestic banks.
<b>Essential criteria</b>	
<b>EC1</b>	The home supervisor establishes bank-specific supervisory colleges for banking groups with material cross-border operations to enhance its effective oversight, taking into account the risk profile and systemic importance of the banking group and the corresponding needs of its supervisors. In its broadest sense, the host supervisor who has a relevant subsidiary or a significant branch in its jurisdiction and who, therefore, has a shared interest in the effective supervisory oversight of the banking group, is included in the college. The structure of the college reflects the nature of the banking group and the needs of its supervisors.
Description and findings re EC1	<p>The JFSA has ongoing contacts with supervisors in other countries in which Japanese banks have material operations. Colleges and Crisis Management Groups have also been established since 2008 for the major Japanese banks that have been designated as G-SIFIs. Those groups include representatives from jurisdictions in which Japanese banks have significant operations. The JFSA has asked some foreign supervisory authorities to join in the colleges, in light of size and significance of the foreign subsidiaries or branches of the bank concerned.</p> <p>The BoJ also participates in supervisory colleges and Crisis Management Groups (CMGs) of Japanese systemically important financial institutions as a home authority and actively shares information on their business conditions with the host authorities.</p>
<b>EC2</b>	Home and host supervisors share appropriate information on a timely basis in line with their respective roles and responsibilities, both bilaterally and through colleges. This includes information both on the material risks and risk management practices of the banking group <sup>37</sup> and on the supervisors' assessments of the safety and soundness of the relevant entity under their jurisdiction. Informal or formal arrangements (such as memoranda of understanding) are in place to enable the exchange of confidential information.
Description and findings re EC2	III-3-10-3 of JFSA's Comprehensive Supervisory Guideline stipulates that the JFSA shall consider coordinated work with foreign counterparts in cases where the JFSA recognizes some concerns on a bank's business monitoring and/or management status to its foreign

<sup>37</sup> See Illustrative example of information exchange in colleges of the October 2010 BCBS Good practice principles on supervisory colleges for further information on the extent of information sharing expected.

<p>branches or subsidiaries, in accordance with the increasing need of strong coordinated work among supervisors and accelerated move toward convergence of rules and standards of each jurisdiction, considering the recent globalization of banking operations and development of financial conglomerates.</p> <p>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 would generally be established then.</p> <p>Information sharing is mainly via informal peer to peer contact arrangements. However, the JFSA has also signed EoL with other supervisors when requested. EoLs vary in the form and format but 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.</p> <p>Supervisory colleges and Crisis Management Groups (CMGs) for its major banks are held annually, to establish a formalized platform for multilateral information sharing among the home and host supervisors for jurisdictions where the Japanese banks have major operations. Information discussed during supervisory colleges and CMGs include sharing of supervisory issues, results of onsite inspections, crisis management plans, business strategies and challenges and other topics of interest regarding the major bank groups. The JFSA has signed institution-specific formal arrangements on information sharing for the Japanese G-SIFI banks in the resolution area, and they facilitate information exchange among authorities.</p> <p>The JFSA also periodically has bilateral dialogues with foreign supervisory authorities to exchange views on the situation of financial sector, international market developments and important issues on regulation as well as supervision. In particular, inspection findings following onsite inspections conducted by the JFSA 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.</p> <p>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 JFSA would inform host supervisors on issues or problems that may have a material effect on the subsidiaries or branches in the</p>
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	<p>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 JFSA.</p> <p>As for the BoJ, as described in the Annual Review and “Onsite Examination Policy for Fiscal 2016,” it actively shares information on business conditions of Japanese systemically important financial institutions with host authorities through participating in supervisory colleges and bilaterally. In addition, the BoJ bilaterally shares its findings and strengthens cooperation with relevant overseas central banks, mainly on issues common to internationally active financial institutions. The BoJ has also signed several agreements on confidentiality and information sharing with overseas authorities both bilaterally and through supervisory colleges.</p>
<b>EC3</b>	Home and host supervisors coordinate and plan supervisory activities or undertake collaborative work if common areas of interest are identified in order to improve the effectiveness and efficiency of supervision of cross-border banking groups.
Description and findings re EC3	<p>The JFSA has worked closely with foreign supervisors since the introduction of colleges in 2008 for the major Japanese banks. Ahead of college meetings the JFSA consults with foreign college members to develop agendas for those meetings and include topics of interest for the attending foreign supervisors; e.g., cyber security. To date there have not been many instances where the need for collaborative work on supervisory issues has been identified. That said the JFSA noted that the colleges have led to some useful collaborative work on coordinating data collection between home and host authorities.</p> <p>The BoJ bilaterally shares its findings and strengthens cooperation with relevant overseas central banks, mainly on issues common to internationally active financial institutions.</p>
<b>EC4</b>	The home supervisor develops an agreed communication strategy with the relevant host supervisors. The scope and nature of the strategy reflects the risk profile and systemic importance of the cross-border operations of the bank or banking group. Home and host supervisors also agree on the communication of views and outcomes of joint activities and college meetings to banks, where appropriate, to ensure consistency of messages on group-wide issues.
Description and findings re EC4	<p>The JFSA establishes its communication strategies with foreign counterparts largely through informal peer to peer conversations, onsite visits as well as through more formal supervisory colleges. The scope and nature of communication strategies reflect the size and complexity of the relevant cross-border operations.</p> <p>It is worth noting that the EoLs with foreign supervisors include articles specifying the need for coordination ahead of time on public messaging. For example, the JFSA worked closely with its foreign supervisory counterparts to discuss and coordinate public messaging ahead of time when sanctions were applied to banks by foreign authorities.</p> <p>The JFSA also shares its supervisory reports with the home supervisors of foreign banks operating in Japan, and has shared exit findings with host authorities when it visits operations of Japanese banks in those jurisdictions. The JFSA also provides the three major Japanese banks with summary of discussions from the relevant supervisory college</p>

	<p>meetings.</p> <p>As described in "Onsite Examination Policy for Fiscal 2016," the BoJ shares its findings and strengthens cooperation with relevant overseas authorities, mainly on issues common to internationally active financial institutions.</p>
<b>EC5</b>	<p>Where appropriate, due to the bank's risk profile and systemic importance, the home supervisor, working with its national resolution authorities, develops a framework for cross-border crisis cooperation and coordination among the relevant home and host authorities. The relevant authorities share information on crisis preparations from an early stage in a way that does not materially compromise the prospect of a successful resolution and subject to the application of rules on confidentiality.</p>
Description and findings re EC5	<p>In accordance with the FSB KA (Key Attributes), the JFSA has established CMGs (Crisis Management Group) with foreign authorities for the Japanese banks designated as G-SIFIs, and holds meetings once a year with the DICJ (Deposit Insurance Corporation of Japan) and the BoJ. In these meetings, the JFSA shares information on bank recovery plans and resolution plans developed by the JFSA, and discusses them with host authorities.</p> <p>In accordance with the KA, the JFSA has also concluded Co-Ag (Cooperation Agreement) among CMG members, in order to achieve smooth orderly resolution of Japanese G-SIFI banks.</p> <p>More generally, when issues arise regarding regulatory or legal violations, the JFSA 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 operating in Japan violates laws or regulations, or has 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 JFSA would invite participation by host supervisors to the its 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 JFSA 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>
<b>EC6</b>	<p>Where appropriate, due to the bank's risk profile and systemic importance, the home supervisor, working with its national resolution authorities and relevant host authorities, develops a group resolution plan. The relevant authorities share any information necessary for the development and maintenance of a credible resolution plan. Supervisors also alert and consult relevant authorities and supervisors (both home and host) promptly when taking any recovery and resolution measures.</p>
Description and findings re EC6	<p>The JFSA has been developing resolution plans for Japanese G-SIFI banks, and other systemically important banks as necessary (Supervisory Guidance III-2-3-6 "development of RRP"). In the annual CMG meetings the JSA exchanges information on group-wide resolution plans and discuss relevant issues. In addition, the JFSA has had put in place the framework for swift information exchange and discussion based on the Co-Ag framework.</p>

<b>EC7</b>	The host supervisor's national laws or regulations require that the cross-border operations of foreign banks are subject to prudential, inspection and regulatory reporting requirements similar to those for domestic banks.
Description and findings re EC7	Foreign banking subsidiaries incorporated and licensed in Japan are subjected to the same prudential requirements as domestic Japanese banks. Branches in Japan (for foreign banks) are also subject to the same reporting and inspection requirements as Japanese banks (in accordance with section 7, paragraph 2 of Article 47, and Article 48 of the Banking Act).
<b>EC8</b>	The home supervisor is given onsite access to local offices and subsidiaries of a banking group in order to facilitate their assessment of the group's safety and soundness and compliance with customer due diligence requirements. The home supervisor informs host supervisors of intended visits to local offices and subsidiaries of banking groups.
Description and findings re EC8	<p>The JFSA 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>By the same token the JFSA has the power to conduct onsite inspections of Japanese bank branches, subsidiaries, representative offices and other units established abroad under Article 25 of the Banking Act. The JFSA visits foreign branches and subsidiaries in order to examine group wide risk management and legal compliance systems. The JFSA conducts onsite visits to their branches and subsidiaries overseas to evaluate their risk management and compliance systems including Know Your Customer (KYC) requirement stipulated in the Act on Prevention of Transfer of Criminal Procedure, Comprehensive Supervisory Guideline and Inspection Manuals. The JFSA sends a letter to its foreign counterparty supervisors in order to notify them ahead of time about such onsite-visits to their jurisdictions.</p> <p>The JFSA notifies the host country's supervisor in advance every time it conducts onsite inspections of the foreign operations of a Japanese bank, and visits the host country's supervisor where necessary or exchanges information with the supervisor and to brief them on the exit findings of onsite visits.</p> <p><b>Bank of Japan</b></p> <p>As described in "Onsite Examination Policy for Fiscal 2016," the BoJ enhances its onsite examinations of overseas branches through means including more specific field work, given the increased weight of international businesses of Japanese banks.</p>
<b>EC9</b>	The host supervisor supervises booking offices in a manner consistent with internationally agreed standards. The supervisor does not permit shell banks or the continued operation of shell banks.
Description and findings re EC9	A foreign bank that intends to start banking businesses must be licensed by the PM (under the Article 47 of the Banking Act). The establishment of shell bank is prohibited, and there are no banks operating as booking offices in Japan.
<b>EC10</b>	A supervisor that takes consequential action on the basis of information received from another supervisor consults with that supervisor, to the extent possible, before taking such action.

Description and findings re EC10	When the JFSA decides to take any supervisory actions against a particular bank, it will attempt to exchange information and/or opinions with the foreign supervisor to the extent it will not interfere the immediate action.
<b>Assessment of Principle 13</b>	C
Comments	Foreign banks operating in Japan are held to the same prudential standards as their domestic counterparts. In addition, the assessors believe the Japanese authorities have made significant progress in deepening home-host relations with foreign supervisors in recent years. More MoUs and EoLs have been negotiated with foreign supervisors since the last Financial Sector Assessment Program (FSAP) review and the designation of several Japanese banks as G-SIFIs has led to the formation of Crisis Management Groups for those banks. In turn, this has enabled the Japanese authorities to engage constructively with their foreign counterparts on recovery and resolution planning for those banks.
<b>B. Prudential Regulations and Requirements</b>	
<b>Principle 14</b>	<b>Corporate governance.</b> The supervisor determines that banks and banking groups have robust corporate governance policies and processes covering, for example, strategic direction, group and organizational structure, control environment, responsibilities of the banks' boards and senior management, <sup>38</sup> and compensation. These policies and processes are commensurate with the risk profile and systemic importance of the bank.
Essential criteria	
<b>EC1</b>	Laws, regulations or the supervisor establish the responsibilities of a bank's board and senior management with respect to corporate governance to ensure there is effective control over the bank's entire business. The supervisor provides guidance to banks and banking groups on expectations for sound corporate governance.
Description and findings re EC1	<p>Corporate governance regulations for banks are supplemented with supervisory guidelines. The Companies Act sets out requirements in relation to all companies in Japan and applies to the banks. The Corporate Governance Code also establishes fundamental principles for effective corporate governance at listed companies in Japan. Specifically, in relation to banks supervised by the JFSA, the Supervisory Guidelines stipulate the expectations of banks' corporate governance and it backed up by the JFSA inspection manual which details what is verified onsite.</p> <p>General Principle 4-3 of the Corporate Governance Code states that the board should establish appropriate internal controls and risk management systems. Supplementary Principle 4-3-2 of the Code states that the establishment of effective internal control and proactive risk management systems for compliance and financial reporting has the potential of supporting sound risk-taking. For those banks not subject to the Code (e.g., <i>Shinkin</i> banks) the Supervisory Guidelines set out the expectation that bank boards and senior management are responsible for the control over the entire business.</p> <p>In Japan, companies (including banks) are able to adopt three types of board and governance structures:</p>

<sup>38</sup> Please refer to footnote 27 under Principle 5.

	<ul style="list-style-type: none"> <li>• “Company with auditors” (a system unique to Japan introduced in 1993),</li> <li>• “Company with nominating committee, etc.” (introduced in 2003); and</li> <li>• “Company with audit and supervisory committee” (introduced in 2015).</li> </ul> <p>The Banking Act permits each type of governance structure (see Article 4–2) and while there is a choice between the three, most banks adopt the first structure—company with auditor. In terms of the distribution of banks under each structure, the split is as follows:</p> <ul style="list-style-type: none"> <li>• Company with auditor—one major bank and most regional and <i>Shinkin</i> banks;</li> <li>• Company with nominating committee—two major banks and a few regional banks; and</li> <li>• Company with audit and supervisory committee—approximately 20 percent of regional banks.</li> </ul> <p>The first structure (company with auditors), is a unified board where the members of the board are made up of executive board members and non-executive board members. This type of the company is not required to separate the supervisory function of the board from management function of senior management, and therefore the board does not have separate committees such as remuneration, risk and audit. All functions are conducted via the board. In relation to audit, however, there is a separate structure “Board of Auditors” that performs the internal audit function and is comprised of bank audit staff and external auditors. In effect there is only one board which discharges both responsibilities of oversight and management. The JFSA has separately stipulated expectations of bank directors and senior management of banks with <i>Kansayaku</i> Board (III-1-2-1) and banks with Committees (III-1-2-2) in the Supervisory Guideline. For example, the JFSA requires a bank which is a Company with Auditors’ board to ensure independence of the Board of Auditors. The JFSA also reviews if the Board of Auditors develops an appropriate internal control system. General Principle 4 of the Corporate Governance Code states that, the board should appropriately fulfill its roles and responsibilities, including:</p> <ol style="list-style-type: none"> <li>(1) Setting the broad direction of corporate strategy;</li> <li>(2) Establishing an environment where appropriate risk-taking by the senior management is supported; and</li> <li>(3) Carrying out effective oversight of directors and the management (including <i>shikkoyaku</i> and so-called <i>shikkoyakuin</i>) from an independent and objective standpoint.</li> </ol> <p>The supervisory guideline encourages G-SIBs (three megabanks) to apply the structure of “Company with nominating committee” as this structure is more conducive to facilitating robust governance. Two of the three G-SIBs banks have adopted the “Company with nominating committee” structure, and the third G-SIB bank is scheduled to adopt that structure in June 2017.</p>
<b>EC2</b>	The supervisor regularly assesses a bank’s corporate governance policies and practices, and their implementation, and determines that the bank has robust corporate governance policies and processes commensurate with its risk profile and systemic importance. The supervisor requires banks and banking groups to correct deficiencies in a timely manner.
Description and findings re EC2	The frequency and intensity of supervisory review of bank corporate governance is determined according to a bank’s size, complexity, systemic interconnectedness and risk profile. The JFSA uses regular interviews as the main tool to assess whether a bank has

	<p>robust corporate governance and that policies and processes are commensurate with its risk profile and systemic importance. In regards to the megabanks and trading banks generally, the JFSA maintains a close and continuous approach to supervision of corporate governance requesting and reviewing board reporting, board minutes and MIS on a regular basis—e.g., monthly or quarterly. Based on analysis of this material the JFSA will assess the quality and adequacy of corporate governance. The JFSA will conduct interviews with senior management on a regular basis to evaluate senior management’s stewardship of the bank. Bank policies and processes are also requested and reviewed on a similar basis. The JFSA has increasingly used thematic reviews for the megabanks to identify good practice and raise standards of governance. Based on the Supervisory Guideline III–1, the JFSA reviews if the banks established governance framework: for example, the JFSA confirms with the bank management their recognition of business strategy and business policy. The JFSA also reviews how the board and Board of Auditors are functioning.</p> <p>In relation to the regional and <i>Shinkin</i> banks, the JFSA will rely upon a mix of regulatory reporting and an annual questionnaire to identify the need for in-depth analysis of governance related material. At least annually, the JFSA will meet with bank senior management to discuss strategy and key risk issues.</p> <p>If there is a doubt regarding the effectiveness of the governance framework as a result of review, the JFSA may conduct an in-depth interview regarding the cause and improvement measures. The JFSA may also request reports as needed based on Article 24 of the Banking Act. Following the application of Corporate Governance Code from June 2015, the Supervisory Guideline was amended to add that the JFSA will review whether appropriate measures are taken in line with the Corporate Governance Code when establishing the governance framework.</p> <p>Discussions with the JFSA staff revealed that the JFSA has conducted a fair amount of work reviewing the challenge function provided by external directors and to encourage them to engage more assertively with bank management. The JFSA staff noted their reviews of bank board minutes indicates that the influence of external directors on banks has grown over the last 3–4 years and has led to revisions to bank strategies and corporate plans.</p>
<b>EC3</b>	<p>The supervisor determines that governance structures and processes for nominating and appointing board members are appropriate for the bank and across the banking group. Board membership includes experienced non-executive members, where appropriate. Commensurate with the risk profile and systemic importance, board structures include audit, risk oversight and remuneration committees with experienced non-executive members.</p>
Description and findings re EC3	<p>Supplemental Principle 4–3–1 of the Corporate Governance Code states that the board should ensure that the appointment and dismissal of the senior management are based on highly transparent and fair procedures and reflect the results of company performance. Principle 3–1 states that in addition to making information disclosure in compliance with relevant laws and regulations, companies should disclose and proactively provide the information including the following in order to enhance transparency and fairness in decision-making and ensure effective corporate governance: (iv) board policies and procedures in the appointment of the senior management and the nomination of directors and <i>kansayaku</i> candidates; and (v) explanations with respect to the individual appointments</p>

and nominations based on (iv).

Principle 4-6 of the Corporate Governance Code states that in order to ensure effective, independent and objective oversight of the management by the board, companies should consider appointing directors who are neither involved in business execution nor have close ties with the management. Principle 4-8 of the Code states that Independent directors should fulfill their roles and responsibilities with the aim of contributing to sustainable growth of companies and increasing corporate value over the mid- to long-term. Banks subject to the Code (that is all stock listed companies) should appoint at least two independent directors with such qualities. In meetings with industry, the assessors confirmed this practice was being implemented by banks and often the non-executive independent directors also made up two of the three members of the Audit committee. Principle 4-7 of the Code also states that companies should make effective use of independent directors, taking into consideration the expectations as follows with respect to their roles and responsibilities: i) Provision of advice on business policies and business improvement based on their knowledge and experience with the aim to promote sustainable corporate growth and increase corporate value over the mid- to long-term; ii) Monitoring of the management through important decision-making at the board including the appointment and dismissal of the senior management; iii) Monitoring of conflicts of interest between the company and the management or controlling shareholders; and iv) Appropriately representing the views of minority shareholders and other stakeholders in the boardroom from a standpoint independent of the management and controlling shareholders. Principle 4-9 of the Code states that boards should establish and disclose independence standards aimed at securing effective independence of independent directors, taking into consideration the independence criteria set by securities exchanges. The board should endeavor to select independent director candidates who are expected to contribute to frank, active and constructive discussions at board meetings.

The Supervisory Guideline III-1-2 (P40) states that the JFSA reviews following points: 1) At least one independent external director is appointed when making decisions on proposal of appointment. Yet the independent directors are in the minority and nominating committees are made up of a majority of executive directors. The assessors also confirmed during industry meetings that for banks not subject to the Code, nominating committees were comprised of all executive directors.

In relation to the requirement for board structures to include audit, risk oversight and remuneration committees with experienced non-executive members, the practice is mixed. The JFSA does not prescribe the board structure and in practice banks do not necessarily have audit, risk oversight and remuneration committees. The representation of non-executive members on the committees is observed in relation to the audit committee structure across all three types of board structures (described in EC1), however, for the Company with Auditors structure executive directors play a more influential role in terms of representation on board committees.

Several regional banks have a committee called "advisory board" or "management assessment committee" composed not only of internal directors but also outside experts,

	where risk management and internal control issues are discussed. In addition, most Japanese banks (including regional banks) have a Risk Management Committee that is chaired by CRO or other board members (e.g., President). Although establishing these committees is not a legal requirement, many banks have voluntarily opted having to create such committees.
<b>EC4</b>	Board members are suitably qualified, effective and exercise their “duty of care” and “duty of loyalty.” <sup>39</sup>
Description and findings re EC 4	<p>The Directors have fiduciary responsibilities, which include performing their duties for the Stock Company in a loyal manner in compliance with laws and regulations, the articles of incorporation, and decisions of shareholder meetings (Article 330 and Article 355, Companies Act).</p> <p>An executive Director (<i>shikkoyaku</i>) must have the knowledge and experience to be able to manage the business of the bank appropriately, fairly, and efficiently. The Director must also have sufficient social credibility (Article 7–2 Item 1, Banking Act).</p> <p>Principle 4–11 of the Corporate Governance Code states that the board should be well balanced in knowledge, experience and skills in order to fulfill its roles and responsibilities, and it should be constituted in a manner to achieve both diversity and appropriate size. Supplementary Principle 4–11–1 states that the board should have a view on the appropriate balance between knowledge, experience and skills of the board as a whole, and also on diversity and appropriate board size. Consistent with its view, the board should establish policies and procedures for nominating directors and disclose them along with its view.</p> <p>Principle 4–5 of the Corporate Governance Code states that with due attention to their fiduciary responsibilities to shareholders, the directors, <i>kansayaku</i> and the management of companies should secure the appropriate cooperation with stakeholders and act in the interest of the company and the common interests of its shareholders.</p>
<b>EC5</b>	The supervisor determines that the bank’s board approves and oversees implementation of the bank’s strategic direction, risk appetite <sup>40</sup> and strategy, and related policies, establishes and communicates corporate culture and values (e.g., through a code of conduct), and establishes conflicts of interest policies and a strong control environment.
Description and findings re EC5	See also EC 1-4.

<sup>39</sup> The OECD (OECD glossary of corporate governance-related terms in “Experiences from the Regional Corporate Governance Roundtables”, 2003, [www.oecd.org/dataoecd/19/26/23742340.pdf](http://www.oecd.org/dataoecd/19/26/23742340.pdf).) defines “duty of care” as “The duty of a board member to act on an informed and prudent basis in decisions with respect to the company. Often interpreted as requiring the board member to approach the affairs of the company in the same way that a ‘prudent man’ would approach their own affairs. Liability under the duty of care is frequently mitigated by the business judgment rule.” The OECD defines “duty of loyalty” as “The duty of the board member to act in the interest of the company and shareholders. The duty of loyalty should prevent individual board members from acting in their own interest, or the interest of another individual or group, at the expense of the company and all shareholders.”

<sup>40</sup> “Risk appetite” reflects the level of aggregate risk that the bank’s board is willing to assume and manage in the pursuit of the bank’s business objectives. Risk appetite may include both quantitative and qualitative elements, as appropriate, and encompass a range of measures. For the purposes of this document, the terms “risk appetite” and “risk tolerance” are treated synonymously.

With regards to culture, Principle 2 of the Corporate Governance Code states that the board and the management should exercise their leadership in establishing a corporate culture where the rights and positions of stakeholders are respected and sound business ethics are ensured. Principle 2–2 states that companies should draft and implement a code of conduct for employees in order to express their values with respect to appropriate cooperation with and serving the interests of stakeholders and carrying out sound and ethical business activities. Therefore, the board is responsible for drafting and revising the code of conduct, and ensures its compliance broadly across the organization, including the front line of domestic and global operations.

Principle 2–2–1 also states that the board should review regularly (or where appropriate) whether or not the code of conduct is being widely implemented. The review should focus on the substantive assessment of whether the company’s corporate culture truly embraces the intent and spirit of the code of conduct, and not solely on the form of implementation and compliance.

With regards to conflicts, Principle 4–3 of the Corporate Governance Code states that the board should appropriately deal with any conflict of interests that may arise between the company and its related parties, including the management and controlling shareholders. Principle 4–7 (iii) of the Principle states monitoring of conflicts of interest between the company and the management or controlling shareholders as one of the expected roles and responsibilities of the independent directors.

In terms of activities by the JFSA, the Supervisory Guideline V-5-2 states that the JFSA will review following points for supervision regarding the conflict of interest: (1) Specification of transactions that has the possibility of conflict of interest; (2) Measures to manage conflict of interest; (3) System to manage conflict of interest; and (4) Creation of policy to manage conflict of interest. Supervisory Guideline V-5-3 (P308) states that if there are any issues with above points, the JFSA may request report based on Article 24 of the Banking Act and issue a business improvement order based on Article 26 of the Banking Act.

In the Strategic Directions and Priorities, the JFSA states that since sufficient financial intermediary function under the stress environment is especially significant for three Major Bank Groups and the trading banks, the JFSA reviews if management ensures sufficient risk governance through establishment of a risk-appetite framework (including precise management of profit and flexible review of business policy/capital policy considering future economy and market stress). The assessors believe that more work is needed to expand this process to cover other institutions in the future.

In terms of risk appetite, the work by the JFSA is most developed in relation to the megabanks where the framework is much more advanced and aligns more closely with international practice. The JFSA obtains the risk appetite statement (RAS) and risk appetite framework and reviews in association with banks’ business plans. Interviews are conducted with the responsible staff to discuss the RAS and culture and risk management. The assessors believe that more work is needed to expand this process to cover other institutions in the future.

	For regional financial institutions, the JFSA reviews establishment of sustainable business model, response to risks from business model, and enhancement of business management framework.
<b>EC6</b>	The supervisor determines that the bank's board, except where required otherwise by laws or regulations, has established F&P standards in selecting senior management, maintains plans for succession, and actively and critically oversees senior management's execution of board strategies, including monitoring senior management's performance against standards established for them.
Description and findings re EC6	<p>Regarding the content of Supplementary Principle 4-3-1 and Principle 3-1 (iv) (v) of the Corporate Governance Code, please refer to Principle 14 EC3. Principle 4-3 of the Corporate Governance Code states that the board should understand that one of its major roles and responsibilities is to effectively supervise the management/ Directors from an independent and objective standpoint. It should appropriately evaluate company performance and reflect the evaluation in its assessment of the senior management.</p> <p>Supervisory Guideline III-1-2-1(2)13 (P44) states that in the process of making decisions on proposal of appointment of board, directors and the board should consider if following aspects are considered sufficiently based on Article 7-2 of the Banking Act. As per the Guidelines, a Director must have the knowledge and experience to be able to manage the business of the bank appropriately, fairly, and efficiently. The Director must also have sufficient social credibility.</p> <p>The application of F&amp;P standards for the board and senior management will depend upon the structure of the board. In terms of a bank with a Company with Auditors, F&amp;P standards are applied to the board of directors and the Board of Auditors but not the layer of senior management beneath the board. For a Company with a Nominating Committee etc., the F&amp;P standards are applied to the entire board and the Executive Officers of the bank (senior management e.g., CRO, CFO, CIO, etc.). In the case of the Company with Audit and Supervisory Committee, the F&amp;P will be applied to the board but not the layer of senior management below.</p>
<b>EC7</b>	The supervisor determines that the bank's board actively oversees the design and operation of the bank's and banking group's compensation system, and that it has appropriate incentives, which are aligned with prudent risk taking. The compensation system, and related performance standards, are consistent with long-term objectives and financial soundness of the bank and is rectified if there are deficiencies.
Description and findings re EC7	Following the finalization of the FSB's work on remuneration, the JFSA updated its supervisory guidelines to reflect expectations of banks' in relation to implementing the main FSB recommendations. The JFSA adopted a principles-based approach to remuneration for key components of the framework (e.g., balance between fixed and variable remuneration; claw-backs; and identification of material risk takers). Supervisory Guideline III-2-3-5-2 states that regarding the remuneration system for executives in the group, the JFSA reviews if there is an appropriate framework including an institution or other organization (for example, remuneration committee) that has a function to check on the executives to ensure appropriate structure/operation of remuneration, such as committee to monitor the status of remuneration.

	<p>For example, from the perspective of consistency between the remuneration system and risk management, the JFSA reviews if the ratio of performance-based pay to the total remuneration is appropriate, considering the financial soundness of the entire group. If there are any issues, the JFSA requests reports based on the Article 24 of the Banking Act as necessary.</p> <p>In practice, the JFSA does not see excessive risk taking in bank remuneration strategies for senior management.</p>
<b>EC8</b>	The supervisor determines that the bank's board and senior management know and understand the bank's and banking group's operational structure and its risks, including those arising from the use of structures that impede transparency (e.g., special-purpose or related structures). The supervisor determines that risks are effectively managed and mitigated, where appropriate.
Description and findings re EC8	See also EC1 and 2. The Guideline for Financial Conglomerates Supervision II-1 states that as one of the items to be evaluated in supervision, the JFSA confirms whether the Directors and the Board of Directors fully understand the increasingly complex structures of organizations and also the necessary governance associated with the formation of financial conglomerates, and develop an appropriate governance framework. Also, the Supervisory Guideline III-2-3-3-2(3)-4 (P112) states that the JFSA reviews whether the financial institutions take into account the possibility that still remains that reputational risk could bring back the risk to underlying asset for their stress tests, even if risks regarding the underlying asset are transferred to the investors through unconsolidated special purpose companies.
<b>EC9</b>	The supervisor has the power to require changes in the composition of the bank's board if it believes that any individuals are not fulfilling their duties related to the satisfaction of these criteria.
Description and findings re EC9	Based on Article 27 of the Banking Act, the JFSA Commissioner may order a bank to dismiss its Director if the bank violates a law or regulation, its articles of incorporation, or a disposition by the JFSA Commissioner, or takes actions that damages the public interest. The Inspection Manual also states that the JFSA reviews if Directors consider effective facilitation of finance, legal compliance, customer protection, and risk management as significant issues of business management. Also, from the perspective of F&P principle regarding the Directors of financial institutions, the JFSA may issue a business improvement order if it is found that the Directors are not fulfilling their responsibilities.
<b>Additional criteria</b>	
<b>AC1</b>	Laws, regulations or the supervisor require banks to notify the supervisor as soon as they become aware of any material and bona fide information that may negatively affect the fitness and propriety of a bank's board member or a member of the senior management.
Description and findings re AC1	Based on Article 35 Item 1 (xxv), in the case where the Director of the bank commits crime such as fraud, embezzlement, and misappropriation in conducting banking business, the bank must submit a notification to the JFSA Commissioner within the 30 days after the matter was brought to light.
<b>Assessment of Principle 14</b>	LC

<p>Comments</p>	<p>Initiatives to improve corporate governance standards in Japan have been in progress with the implementation of the Corporate Governance Code. Expectations of banks have also been revised by the JFSA in its Supervisory Guidelines which largely incorporated the revisions to the BCBS guidance on this topic in 2015. In line with the new Code, inspection activities by the JFSA have placed emphasis on stepping up engagement with senior management and the board in particular for the largest most systemic banks. Nonetheless, further improvements in relation to this Core Principle are needed, especially in light of the changing nature of banks’ business models becoming increasingly internationally focused through offshore expansion, and the prominent role that Japan plays in the global banking system. Given this context, the assessment has set a high bar.</p> <p>First, owing to the legacy board structures, there is need for greater separation between board in its oversight role, and the executive playing a management role. The assessors recognize that there are significant differences in the legislative and regulatory frameworks across countries regarding these functions (e.g. some countries use a two-tier board structure, where the supervisory function of the board is performed by a separate entity known as a supervisory board, which has no executive functions while in other countries, in contrast, use a one-tier board structure in which the board has a broader role).</p> <p>However, in several of the board structures for Japanese banks, there appears to be limited independent challenge by independent non-executive directors. The introduction of non-executive directors as required by the Companies Act and the Code goes some way to introducing more independent reviews by board members, but the effectiveness of their role needs to be improved. In effect, the same board members that are setting the strategy, risk appetite, limits, remuneration etc. are also reviewing these same documents, whilst <i>kansayaku</i> (statutory auditor) plays a role of conducting independent audits of the execution function of the board. To reinforce the independence of <i>kansayaku</i> board (i.e., board of statutory auditors), the Companies Act stipulates that not less than half of the <i>kansayaku</i> board must be composed of outside <i>kansayaku</i>. Assessors also noted cases at some smaller regional banks where there is insufficient independent reporting of the IA function to the board audit committee (see also CP26). It is noted that the JFSA conducts inspections in order to enhance oversight function of the banks’ board and the IA function, and subsequent follow-up interviews will be conducted to confirm the adequacy of improvements of findings. Some of these findings by the JFSA are published so that other banks can learn issues to be addressed.</p> <p>Second, F&amp;P processes to assess the collective experience and expertise of the board should be strengthened as well as applying the F&amp;P process at senior management level for bank structures where it is a Company with Auditor and Company with Remuneration Committee. The F&amp;P assessment should be expanded to cover a broader suite of senior management personnel such as all staff reporting to the CEO, heads of divisions and material risk takers.</p> <p>Third, in relation to compensation, there is scope for the JFSA to enhance its supervision of compensation systems across the industry. While the JFSA does not see excessive risk-taking in bank remuneration strategies at present, assessors are of the view that greater</p>
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	<p>emphasis could be placed on this topic to ensure banks apply appropriate incentives which are aligned with prudent risk-taking and overseen by governance frameworks.</p> <p>Lastly, supervisory processes to assess whether boards are overseeing the implementation of bank strategic direction, risk appetite and strategy needs to be enhanced. While the JFSA is to be commended for paying close attention to the performance of the non-executive directors in challenging bank management by such means as reviewing board minutes, the assessors encourage them to go further and deeper in validating the performance of those directors by enhancing direct interviews with them to gain full satisfaction that those directors are suitably assertive in challenging bank management.</p>
<b>Principle 15</b>	<b>Risk management process.</b> The supervisor determines that banks <sup>41</sup> have a comprehensive risk management process (including effective board and senior management oversight) to identify, measure, evaluate, monitor, report and control or mitigate <sup>42</sup> all material risks on a timely basis and to assess the adequacy of their capital and liquidity in relation to their risk profile and market and macroeconomic conditions. This extends to development and review of contingency arrangements (including robust and credible recovery plans where warranted) that take into account the specific circumstances of the bank. The risk management process is commensurate with the risk profile and systemic importance of the bank. <sup>43</sup>
<b>Essential criteria</b>	
<b>EC1</b>	<p>The supervisor determines that banks have appropriate risk management strategies that have been approved by the banks' boards and that the boards set a suitable risk appetite to define the level of risk the banks are willing to assume or tolerate. The supervisor also determines that the board ensures that:</p> <ul style="list-style-type: none"> <li>(a) a sound risk management culture is established throughout the bank;</li> <li>(b) policies and processes are developed for risk-taking, that are consistent with the risk management strategy and the established risk appetite;</li> <li>(c) uncertainties attached to risk measurement are recognized;</li> <li>(d) appropriate limits are established that are consistent with the bank's risk appetite, risk profile and capital strength, and that are understood by, and regularly communicated to, relevant staff; and</li> <li>(e) senior management takes the steps necessary to monitor and control all material risks consistent with the approved strategies and risk appetite.</li> </ul>
Description and findings re EC1	The JFSA provides supervisory basic checkpoints regarding bank's risk management in III-2-3 of the Comprehensive Supervisory Guideline. For example, the JFSA will check the following:

<sup>41</sup> For the purposes of assessing risk management by banks in the context of Principles 15 to 25, a bank's risk management framework should take an integrated "bank-wide" perspective of the bank's risk exposure, encompassing the bank's individual business lines and business units. Where a bank is a member of a group of companies, the risk management framework should in addition cover the risk exposure across and within the "banking group" (see footnote 19 under Principle 1) and should also take account of risks posed to the bank or members of the banking group through other entities in the wider group.

<sup>42</sup> To some extent, the precise requirements may vary from risk type to risk type (Principles 15 to 25) as reflected by the underlying reference documents.

<sup>43</sup> It should be noted that while, in this and other Principles, the supervisor is required to determine that banks' risk management policies and processes are being adhered to, the responsibility for ensuring adherence remains with a bank's board and senior management.

	<p>(1) whether the board of directors of a bank has developed a risk management policy in line with its strategic goals based upon the business management policy of the banking group;</p> <p>(2) whether the board of directors of a bank has developed a risk management division, and the division has internal check function; and</p> <p>(3) whether each business unit (of the bank) has adequately controlled risk within risk capital limit which has been allocated to each business unit beforehand.</p> <p>The JFSA performs this assessment based on a review of board minutes and interviews with the board and senior management as well as regular reporting of bank MIS and policies and processes. With regard to the three mega banks and large securities companies, etc., the JFSA will verify they are strengthening risk governance at the management level, including the management of profitability and adjustments of business strategy/capital management policy taking into account of the possible future economic situation and stressed period in the market, through establishing risk appetite framework, given that their role as financial intermediaries in the stressed period would be important.</p> <p>The Inspection Manual requires inspectors to confirm that a bank conduct an assessment on the limits of the VaR and other risk measurement framework in capturing the risk the bank faces and the way to overcome the weak points of these frameworks. Onsite inspections verify whether limits are monitored and reporting according to policy strategies and guidelines and whether limits are adhered to.</p> <p>The JFSA policy priorities (published in its Strategic Directions and Priorities) provide the way to establish a scenario for the stress test. It also stipulates that the JFSA plans to check if a bank establishes concrete and implementable action plan on the basis of the result of the stress test and if it provides criteria to implement the action plan. The JFSA may also check if the bank adjusts the capital/distribution policy when necessary. In more concretely, the JFSA checks if the concerned employees appropriately assess the following things and set the appropriate limits on the bank’s activities.</p> <ul style="list-style-type: none"> <li>✓ whether the expected profitability, the risk appetite, the risk profile and the capital level of the bank are appropriately aligned;</li> <li>✓ whether the business model of the bank is sustainable in the stressed period</li> </ul> <p>The Strategic Directions and Priorities also stipulates that the JFSA plans to check whether the management system of a bank works appropriately including the status of discussions among management members (and outside board members) about important business challenges. More concretely, the JFSA will check if upper management members proactively engage in the regular risk monitoring and stress test, and take necessary actions including remedy of the risk-taking strategy, taking into account all the important risks, to make it aligned with bank’s business strategy and risk appetite.</p> <p>At least on an annual basis the JFSA conducts a routine inspection of board minutes and board reporting. The results of the inspection are fed into meetings with the board/senior management. For the megabanks the frequency of these engagements have increased, though with less frequency for regional and <i>Shinkin</i> banks.</p>
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<b>EC2</b>	<p>The supervisor requires banks to have comprehensive risk management policies and processes to identify, measure, evaluate, monitor, report and control or mitigate all material risks. The supervisor determines that these processes are adequate:</p> <ul style="list-style-type: none"> <li>(a) to provide a comprehensive "bank-wide" view of risk across all material risk types;</li> <li>(b) for the risk profile and systemic importance of the bank; and</li> <li>(c) to assess risks arising from the macroeconomic environment affecting the markets in which the bank operates and to incorporate such assessments into the bank's risk management process.</li> </ul>
Description and findings re EC2	<p>The JFSA 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. The assessment is undertaken in a proportionate manner, based upon the nature, size, and complexity of the institution involved.</p> <p>Guiding principles for banks are contained within the Supervisory Guidelines that have been developed for major banks as well as for small and regional financial institutions. The latest global financial crisis proved the limitations and weaknesses of frequently-used risk control methods such as economic capital and value-at-risk (VAR) models. The JFSA has therefore indicated in its Strategic Directions and Priorities 2016–2017 that it will encourage banks to improve their risk management methods as one of its supervisory priorities. In order to make an assessment of whether the bank's risk management framework provides a bank-wide view of all risk, the JFSA uses both offsite and onsite processes. Offsite, the JFSA will conduct a desk review of relevant organizational activities of banks to determine what new products, new business lines are being undertaken and whether new risks are being encountered. Risk policies and risk frameworks are reviewed. During the onsite inspections, the JFSA will validate and verify whether risk management frameworks are appropriate for the risk profile of the business. Currently the JFSA does not have a ratings system which incorporates risks from nonbank subsidiaries in a comprehensive way. At present, risks from subsidiaries are captured in a separate risk rating and not integrated into a single composite rating.</p> <p>Where the JFSA concludes that the bank's risk management processes are inadequate, it issues a business improvement order based on the Article 26 of the Banking Act which requires the bank to improve its risk management. Also the BoJ conducts regular risk management reviews as part of its constant surveys (offsite monitoring) as well as its visits</p>

	<p>at regular intervals (onsite inspection), the findings of which are shared with the JFSA when remedial action would be necessary.</p> <p>When establishing Comprehensive Supervisory Guidelines that describes critical check points in offsite banking supervision, the JFSA has separately compiled “Comprehensive Guidelines for Supervision of Major Banks, etc.” and “Comprehensive Guidelines for Supervision of Small- and Medium-Sized and Regional Financial Institutions,” in order to supervise each bank based on its size and nature (hereinafter, “Comprehensive Guidelines for Supervision of Major Banks, etc.” is called “Comprehensive Supervisory Guidelines”).</p> <p>Relevant sections of the Supervisory Guidelines include:</p> <ul style="list-style-type: none"> <li>• III-2-3-1 of the Comprehensive Supervisory Guideline defines duties and responsibilities of the board of directors and bank’s delegation structures for comprehensive risk management. For instance, the board of directors is required, among other things, to clearly define risk management policy, to establish risk management system/structure and to deploy collected information on risks for risk management.</li> </ul> <p>In the Strategic Directions and Priorities, the JFSA requires banks to prepare risk management policy and establish procedures to recognize measure, analyze, monitor, report, manage and mitigate any of the important risks and risk factors. Such risk factors include situation of implementation of the basic strategy to manage credit concentration, control of credit limitation and establishment of the system/structure to trade marketable securities to satisfy basic trading strategy, especially human resource allocation and recruitment/ cultivation of specialists. The JFSA also conducts onsite and offsite monitoring as a unit to understand and verify the actual situation of risk management in each bank. In addition, in The Strategic Directions and Priorities, the JFSA plans to check if systemically important financial institutions appropriately evaluate potential risks of their failure and their possible impacts on financial/capital markets and macro economy as well as its transmission mechanism. The JFSA requires such financial institutions to conduct a stress test with common scenario, through which they are required to prepare comprehensive risk management policy and establish procedures to recognize, measure, analyze, monitor, report, manage and mitigate any of the important risks and risk factors. The JFSA also requires them to evaluate risks arising from the macroeconomic environment that could give impact on markets including change in liquidity, and to deploy the evaluation to improve their risk management procedures.</p>
<p><b>EC3</b></p>	<p>The supervisor determines that risk management strategies, policies, processes and limits are:</p> <ul style="list-style-type: none"> <li>(a) properly documented;</li> <li>(b) regularly reviewed and appropriately adjusted to reflect changing risk appetites, risk profiles and market and macroeconomic conditions; and</li> <li>(c) communicated within the bank.</li> </ul> <p>The supervisor determines that exceptions to established policies, processes and limits receive the prompt attention of, and authorization by, the appropriate level of management and the bank’s board where necessary.</p>

Description and findings re EC3	<p>See also EC 1–3. The JFSA 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. The Inspection Manual requires inspectors to check if banks establish procedures requiring a division exceeds risk limit to report needed information to the board of directors to let them decide if they need to reduce risks and positions, etc.</p> <p>Pursuant to its Strategic Directions and Priorities, the JFSA plans to deepen the discussion with banks from the view point that it is important for management members to set appropriate risk management policies that are reviewed regularly and adjusted to accommodate the changes in macroeconomic and macro financial conditions. The JFSA plans to verify that globally active banks strengthen their risk governance at the management level though establishing the risk appetite framework. The scope of the risk governance includes management of profitability and preparedness for prompt adjustments of management policy and capital policy taking into consideration of the possible future stressed period in economy and markets.</p> <p>To date, the JFSA has relied upon onsite inspections based upon the routine cycle as opposed to thematic or targeted reviews that are carried out throughout the supervisory cycle. There have been few examples where the JFSA has adapted its activities to accommodate changing conditions.</p>
<b>EC4</b>	<p>The supervisor determines that the bank’s board and senior management obtain sufficient information on, and understand the nature and level of risk being taken by the bank and how this risk relates to adequate levels of capital and liquidity. The supervisor also determines that the board and senior management regularly review and understand the implications and limitations (including the risk measurement uncertainties) of the risk management information that they receive.</p>
Description and findings re EC4	<p>The main supervisory activity to determine that boards obtain sufficient information on, and understand the nature and level of risk being taken by the bank and how this risk relates to adequate levels of capital and liquidity is the review of board minutes (conducted at least annually for all banks) and interviews with the board (again, conducted at least annually for all banks). The supervisory 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 set up a risk management division, whether an adequate internal control function has been developed and whether each business unit has adequately controlled its risk via utilizing risk capital limits which have been allocated to each of these business units beforehand (referred in III-2–3–1–1 of the Comprehensive Supervisory Guideline).</p> <p>Several regional banks have a committee called “advisory board” or “management assessment committee” composed of not only internal directors but also outside professions, where overall issues including risk management and internal control are discussed in an objective manner. Additionally, most Japanese banks (including regional</p>

	<p>banks) have a Risk Management Committee that is chaired by CRO or other board members (e.g., President). Although establishing such committees is not a legal requirement like the Board of Statutory Auditors, the purpose of voluntarily having such a committee is to regularly receive reports and discuss risk management issues at the level of board members and senior management (see also CP14).</p> <p>In conformity with JFSA’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.</p> <p>One of the basic building blocks of 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 management of the banks interviewed by the assessors generally had 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.</p>
<b>EC5</b>	<p>The supervisor determines that banks have an appropriate internal process for assessing their overall capital and liquidity adequacy in relation to their risk appetite and risk profile. The supervisor reviews and evaluates banks’ internal capital and liquidity adequacy assessments and strategies.</p>
Description and findings re EC5	<p>The JFSA 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 (see III-2-1-1-2-2 of the Comprehensive Supervisory Guideline).</p> <p>The JFSA requires banks to conduct stress tests to determine whether capital and liquidity is adequate given extreme but plausible events which it analyzes and evaluates appropriateness of systemically important banks’ internal capital and liquidity management and strategy. It also checks if banks utilize the stress test as one of the internal management procedures for a comprehensive self-evaluation of the appropriateness of their capital and liquidity, taking into consideration of their risk preference and characteristics. As mentioned above, the use of the Internal Capital Adequacy Assessment Program (ICAAP) and risk appetite statement (RAS) is developing and becoming established in JFSA’s processes. The SREP is also not a fully structured process.</p>
<b>EC6</b>	<p>Where banks use models to measure components of risk, the supervisor determines that:</p> <ul style="list-style-type: none"> <li>(a) banks comply with supervisory standards on their use;</li> <li>(b) the banks’ boards and senior management understand the limitations and uncertainties relating to the output of the models and the risk inherent in their use;</li> <li>and</li> </ul>

	<p>(c) banks perform regular and independent validation and testing of the models.</p> <p>The supervisor assesses whether the model outputs appear reasonable as a reflection of the risks assumed.</p>
Description and findings re EC6	<p>Banks use various internal models for measuring risks. From the interviews with banks, the assessors understand that in as far they use models; the adequacy of results is evaluated using back testing exercises. The assessors understand that especially smaller banks use off the shelf products for measuring some type of risks, mostly market risk. During 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.</p> <p>For international ratings-based (IRB) banks (banks approved by the JFSA to use an internal rating based approach), the board of directors and executive officers are required, as one of the minimum requirements for approval, to understand models themselves and every detail of related reports from their staffs. In this regard, the JFSA confirms that they deeply understand the weaknesses of the models and model risks. In addition, IRB banks are required to verify their internal models regularly as one of the minimum requirements. The JFSA checks the result of such verification both at the time of the approval and afterwards.</p> <p>Operational risks; (following is intend to discuss treatment for Advanced Measurement Approach—AMA banks.)</p> <p>(a) The JFSA checks if a bank applied for an approval to use AMA for operational risks meets conditions specified in the Articles 315 and 316 of the Capital Adequacy Notice. In the checking process, the JFSA asks banks to answer a questionnaire, through which it finds out all the conditions that the bank fails to meet, and monitor how a bank treats them afterwards.</p> <p>(b) AMA banks are required to analyze how their internal models work and use its result to understand uniqueness of their models including model risks and their limits/uncertainly in measuring operational risks.</p> <p>In offsite monitoring process conducted every six months, the JFSA checks the result of verification conducted by banks regarding their models. If a bank plans to use further developed models to measure risks, it comes to the JFSA to discuss it and gets approval before it starts using them.</p> <p>For systemically important financial institutions, the JFSA checks if they conduct a stress test with a common scenario and appropriately manage models used for the stress test including regular and independent verification processes for their models. The JFSA also confirms that the board of directors and upper level management members understand the limits/uncertainly of the result of the stress tests, and risks of using the results. The JFSA, furthermore, evaluates if the result of the stress test reflects the risks the bank faces in a rational manner.</p> <p>The discussion with the board regarding internal models and assumptions has not been a common element of these activities. For example, the non-executive directors (or outside</p>

	<p>directors) have not been engaged in terms of discussions on models and their outputs. The mission confirmed this limitation during meetings with industry. It is, however, JFSA's intention to deepen the discussion of technical topics with non-executive directors in the future.</p>
<p><b>EC7</b></p>	<p>The supervisor determines that banks have information systems that are adequate (both under normal circumstances and in periods of stress) for measuring, assessing and reporting on the size, composition and quality of exposures on a bank-wide basis across all risk types, products and counterparties. The supervisor also determines that these reports reflect the bank's risk profile and capital and liquidity needs, and are provided on a timely basis to the bank's board and senior management in a form suitable for their use.</p>
<p>Description and findings re EC7</p>	<p>Other than the points raised in answers to EC 1, through II-2-3-2-1-2 of Supervisory Guideline, the JFSA will focus on the followings with regard to credit risk management;</p> <ul style="list-style-type: none"> <li>✓ whether the board of directors has established the organization for credit administration and credit review through such as establishing dedicated divisions.</li> <li>✓ whether divisions for business promotion and for credit review are separated or properly established.</li> <li>✓ whether auditing divisions properly exercise checks of banking operation including credit risk management;</li> <li>✓ whether the board takes some measures such as utilizing external experts where necessary to ensure the validity and effectiveness of internal rules and organizations regarding credit risk management in establishing and reviewing them.</li> <li>✓ whether staff in divisions for credit review properly understand the financial condition of borrowers, purposes of loans, and financial resources for reimbursement and with the use of these information, they examine the accuracy of credit ratings assigned to borrowers.</li> </ul> <p>(Credit risks)</p> <ul style="list-style-type: none"> <li>➤ The JFSA orders IRB banks to submit quantitative template and SA banks (banks using standardised approach) to submit financial documents to check status of their credit risks.</li> </ul> <p>(Liquidity risks)</p> <ul style="list-style-type: none"> <li>➤ The JFSA requires internationally active banks and some domestic banks to submit monitoring formats related to LCR and complementary monitoring information including information on other assets than high quality liquid assets (HQLA) to all counterparties.</li> </ul> <p>(Operational risks)</p> <ul style="list-style-type: none"> <li>➤ The Capital Adequacy Notice requires not just AMA (advanced measurement approach) banks but also TSA (the standard approach) banks to collect information on losses. In addition, BIA (basic indicator approach) banks are required to collect needed information to improve risk management through analyzing actual loss events.</li> <li>➤ Additionally, with respect to management of NPLs, based on II-2-3-2-3-2 of Supervisory Guideline, the JFSA will check whether banks have clearly established the policy for the management as well as the adequacy and appropriateness of the</li> </ul>

	<p>delegation structures and conducts of internal audits in a timely manner.</p> <p>On the other hand, at inspection, examiners will check the followings in accordance with the “Checklists for confirming the status of credit risk management.”</p> <ul style="list-style-type: none"> <li>• Whether banks have established the organization for credit risk management, for example, whether banks have established the loan evaluation and management systems.</li> <li>• Credit rating systems to evaluate and measure credit risk accurately commensurate with the scale and nature of the businesses and risk profiles of banks.</li> </ul> <p>The JFSA requires systemically important financial institutions to conduct stress tests with common scenarios and checks if they have established appropriate information sharing system that enables them to collect, evaluate and report the information on size, composition and quality of all types of risks related to all products and counterparties within entire organization. The JFSA also checks adequacy of credit risk limits, limit controls and the process for reviewing the limits through inspection. 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.</p>
<b>EC8</b>	<p>The supervisor determines that banks have adequate policies and processes to ensure that the banks’ boards and senior management understand the risks inherent in new products,<sup>44</sup> material modifications to existing products, and major management initiatives (such as changes in systems, processes, business model and major acquisitions). The supervisor determines that the boards and senior management are able to monitor and manage these risks on an ongoing basis. The supervisor also determines that the bank’s policies and processes require the undertaking of any major activities of this nature to be approved by their board or a specific committee of the board.</p>
Description and findings re EC8	<p>The JFSA 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.</p> <p>The assessment of bank’s processes regarding new products is contained in the inspection manual which requires inspectors to check if a bank establish the management system that enables to collect information needed for management including financial facilitation (such as management consulting and advisory), compliance and customer protection,</p> <p>Inspection Manual also provides that the board should develop an internal procedure for prior examination and/or approval regarding investing in new products or undertaking new business in line with its comprehensive risk management policy. Pursuant to The Strategic Directions and Priorities, the JFSA plans to check if board of directors and other management members of domestic deposit-taking financial institutions and other financial</p>

<sup>44</sup> New products include those developed by the bank or by a third party and purchased or distributed by the bank.

	institutions discuss allocation of management resources and review their business models.
<b>EC9</b>	The supervisor determines that banks have risk management functions covering all material risks with sufficient resources, independence, authority and access to the banks' boards to perform their duties effectively. The supervisor determines that their duties are clearly segregated from risk-taking functions in the bank and that they report on risk exposures directly to the board and senior management. The supervisor also determines that the risk management function is subject to regular review by the internal audit function.
Description and findings re EC9	<p>The independence of the risk management function and adequacy of resources is stipulated in III-2-3-1-3(2) of the supervisory guideline requires, across all risk categories, banks to establish arrangements where departments of risk management and front office are able to check with each other without any conflict of interest. Also, the inspection manual on compliance arrangement requires inspectors to check whether board of directors ensures independence of compliance department from front office.</p> <p>The supervisory guideline stipulates that banks' 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 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. III-2-3-1 of the Supervisory Guideline requires bank's management to develop a comprehensive risk management system where it would receive reports on various types of risks from every business unit in charge and control all the risks in a comprehensive way.</p>
<b>EC10</b>	The supervisor requires larger and more complex banks to have a dedicated risk management unit overseen by a Chief Risk Officer (CRO) or equivalent function. If the CRO of a bank is removed from his/her position for any reason, this should be done with the prior approval of the board and generally should be disclosed publicly. The bank should also discuss the reasons for such removal with its supervisor.
Description and findings re EC10	<p>The requirement for a CRO function is contained in the Supervisory Guidelines. Through Supervisory Guidelines, the JFSA requires banks to have an organizational structure which comprehensively monitors and controls all kinds of risks managed by individual risk control unit. In addition, the JFSA pays attention to confirming that bank's internal check function works sufficiently. Furthermore, the JFSA examines whether bank's internal audit function recognizes the risk management status of every business unit, and implements risk based audit in terms of its frequency and depth by taking into account the nature and magnitude of individual risk.</p> <p>Inspection Manual requires inspectors to check if banks, depending on their size and characteristics, establish a division for comprehensive risk management that conducts risk evaluation and monitoring. Inspectors are also required to check if banks conduct internal audit on divisions for comprehensive risk management. For large banks with complicated businesses, the JFSA receives report from banks about the resignation of the CRO (Chief Risk Officer) or other equivalent positions and discusses these with the bank if necessary. Because a resignation from such a position is important, the decision subjects to the vote of the board of directors and publicly announced. If the resignation reveals serious</p>

	<p>deficiencies in bank's governance, the JFSA is allowed to take necessary actions to remedy the situation.</p> <p>There is no stipulation for the board structure to have a dedicated risk committee. As such the direct channel for the CRO to report to the board is via the audit committee in most cases. Thus, in many cases the Audit Committee often serves as a risk committee but this is not required by the JFSA. It was also confirmed that the practice for the CRO accessing the BAC (Board of Auditors) is not well established.</p>
<b>EC11</b>	The supervisor issues standards related to, in particular, credit risk, market risk, liquidity risk, interest rate risk in the banking book and operational risk.
Description and findings re EC11	<p>Via IT guidelines and inspection manual, the JFSA 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. Through Supervisory Guideline and Inspection Manual, the JFSA has provided and publish 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.</p>
<b>EC12</b>	The supervisor requires banks to have appropriate contingency arrangements, as an integral part of their risk management process, to address risks that may materialize and actions to be taken in stress conditions (including those that will pose a serious risk to their viability). If warranted by its risk profile and systemic importance, the contingency arrangements include robust and credible recovery plans that take into account the specific circumstances of the bank. The supervisor, working with resolution authorities as appropriate, assesses the adequacy of banks' contingency arrangements in the light of their risk profile and systemic importance (including reviewing any recovery plans) and their likely feasibility during periods of stress. The supervisor seeks improvements if deficiencies are identified.
Description and findings re EC12	<p>On the risk types not captured within the subsequent CPs, the JFSA 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 in particular, with regard to the ATMs that are operated by banks.</p> <p>Pursuant to the supervisory guidelines, the JFSA requires financial institutions to submit recovery plan once a year in principle. Based on the assessment by the JFSA, etc. those institutions improve their recovery plan each year by advancing their risk management system and reviewing the effectiveness of their recovery option, etc. At the supervisory college management members of the said financial institution explain the executive summary of its recovery plan and, at the CMG, home and host authorities discuss the effectiveness of the plan.</p> <p>In accordance with Article 26-1 of the Banking Act, the JFSA may order a bank to submit a business improvement plan if it confirms the necessity to secure the sound and appropriate</p>

	business conducts of the bank.
<b>EC13</b>	<p>The supervisor requires banks to have forward-looking stress testing programs, commensurate with their risk profile and systemic importance, as an integral part of their risk management process. The supervisor regularly assesses a bank’s stress testing program and determines that it captures material sources of risk and adopts plausible adverse scenarios. The supervisor also determines that the bank integrates the results into its decision-making, risk management processes (including contingency arrangements) and the assessment of its capital and liquidity levels. Where appropriate, the scope of the supervisor’s assessment includes the extent to which the stress testing program:</p> <ul style="list-style-type: none"> <li>(a) promotes risk identification and control, on a bank-wide basis</li> <li>(b) adopts suitably severe assumptions and seeks to address feedback effects and system-wide interaction between risks;</li> <li>(c) benefits from the active involvement of the board and senior management; and</li> <li>(d) is appropriately documented and regularly maintained and updated.</li> </ul> <p>The supervisor requires corrective action if material deficiencies are identified in a bank’s stress testing program or if the results of stress tests are not adequately taken into consideration in the bank’s decision-making process</p>
Description and findings re EC13	<p>(See also EC1 and 2). The JFSA guidelines and inspection manuals requires banks to undertake stress tests. By means of onsite inspections, 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 assessors met with undertake stress testing activities, but with quite different foci (interest rate risk, credit risk, market risk, liquidity risk), level of sophistication and periodicity (monthly to yearly).</p> <p>Pursuant to JFSA’s stated priorities, it plans to verify if banks appropriately evaluate various risks and secure enough capital and liquidity, review their strategic direction and risk management methods, and establish a proper crisis management system in order to enable them to provide sufficient financial facilitation with their management and business sound even in the stressed period in economy and markets. For globally active banks, such verification includes whether they establish a proper management system to implement own stress tests and deploy the results in the discussion within the board of directors and other management members to decide the strategic direction and the capital policy.</p> <p>Inspection Manual requires examiners to confirm that a bank conducts stress tests by assuming appropriate and comprehensive stress scenarios, after considering major risk factors which could make negative impacts on the bank’s financial condition and reflecting future changes in economic situation.</p> <p>In case of the BoJ, business management based on an optimal balance between financial bases and risk taking is one of the key issues in the conduct of onsite examinations. In onsite examinations, with regard to major financial institutions, the BoJ examines the following with regard to stress testing: (1) involvement of the board of directors and control functions of sections in charge; (2) sufficiency of scenarios and coverage of the subjects of the stress testing based on financial institutions’ risk profiles and business</p>

	<p>strategies; (3) verification systems for models and data; and (4) frameworks to reflect test results of business operations and risk management. The BoJ confirms the board of directors' awareness with regard to assessing the sufficiency of quality/quantity of the equity capital and the capital policy based on this assessment, taking into account the results of stress testing and responses to international financial regulations, and provides the necessary recommendations. The BoJ also examines progress with the establishment of the framework for controlling risk taking and management comprehensively based on the institutions' business strategies, including the risk appetite framework.</p> <p>With regard to regional financial institutions, the BoJ runs profit simulations under several scenarios including downside risks for the coming three years or so, to assess the economic value of the institutions' asset holdings and the impact on the asset and liability structure. On this basis, the BoJ confirms the board of directors' awareness of the assessment of the sufficiency of quality/quantity of the equity capital and the capital policy based on this assessment, as well as other issues for business management, and provides the necessary recommendations.</p>
<b>EC14</b>	The supervisor assesses whether banks appropriately account for risks (including liquidity impacts) in their internal pricing, performance measurement and new product approval process for all significant business activities.
Description and findings re EC14	<p>Pursuant to the III-2-3-1-3 of the Supervisory Guideline, the JFSA will check points related to the comprehensive risk management including the following:</p> <ul style="list-style-type: none"> <li>• whether a bank recognizes all the risks and decide the risk category subject to the quantitative comprehensive risk management; and</li> <li>• whether a bank quantifies all the risks subject to the management under the same standard.</li> </ul> <p>The Inspection Manual requires inspectors to verify that a bank establish management system in which the board of directors and other management members have division for comprehensive risk management to identify risks associated with new products and report it to the committee for new product when the new products are reviewed. In addition, through onsite and offsite monitoring as a unit, the JFSA checks if a bank takes risks into consideration when it sets employee evaluation system for incentive and internal price decision mechanism.</p>
<b>Additional criteria</b>	
<b>AC1</b>	The supervisor requires banks to have appropriate policies and processes for assessing other material risks not directly addressed in the subsequent Principles, such as reputational and strategic risks.
Description and findings re AC1	<p>The JFSA 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 practice, however, separate risk management units exist. The JFSA requires that the risk management function be periodically reviewed by internal audit.</p> <p>Pursuant to III-8 of the Supervisory Guideline, the JFSA requires a bank to establish an adequate risk management system, including formulating a crisis management manual in</p>

	<p>preparation for natural disasters and reputational risk events and confirming whether the bank clearly defines tasks and responsibilities in times of a crisis and ensures communications channels among relevant personnel in charge. In addition, the JFSA examines whether a bank has developed a business continuity plan which enables the bank to continue its minimum business operation and recover from even after a huge disaster as early as possible.</p> <p>Inspection Manual requires examiners to check whether a bank appropriately controls operational risks including reputational risks. The Inspection Manual also requires banks to identify and control risks which may not be captured in the calculation of the Capital Adequacy Ratio. The Inspection Manual stipulates that the board should establish a crisis management system to respond to reputational crisis situation. For example, especially concerning the fact that large Japanese banks recently focus on foreign Project Finance, which poses risks related to funding costs of foreign currency including U.S. dollar, the JFSA, thorough onsite and offsite monitoring as a unit, checks risks associated with bank's business strategy.</p>
<p><b>Assessment of Principle 15</b></p>	<p>LC</p>
<p>Comments</p>	<p>The JFSA and BoJ have sufficient frameworks for identifying and evaluating banks' risk management systems and processes and for requiring remedial actions. The principles mentioned in the guidelines and inspection manuals are however of a quite generic nature, which puts a lot of burden on the actual supervisory practices for determining bank's implementation of risk management frameworks. While the assessors understand that the implementation of risk appetite frameworks and the ICAAP has commenced, most importantly with the megabanks, further efforts are needed to fully embed the RAS and ICAAP as a way to make a comprehensive assessment of risk and whether capital and liquidity is adequate. The assessment of group-wide risks could also be better integrated into JFSA's risk rating methodology.</p> <p>The governance arrangements at banks should also 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 that can act independently not only in 'form' but also 'in substance' from the board of directors based upon and which receives information on the implementation of risk management systems. run and of identified breaches directly from internal and external audit, whereby the responsibilities of business and internal control function are sufficiently separate.</p> <p>A counterbalancing feature in our evaluation has been that in some cases bank business models are not overly aggressive and have conservative risk settings. However, given the challenging operating conditions (flat yield curve and subdued demand for credit), banks' search for yield requires robust risk management systems and processes to monitor and detect risks early. Continued supervisory attention to strengthen governance arrangements is thus recommended, which should not only address a more independent risk management and internal control function. It also needs to ensure that audit committees or a board of company auditors can act independently from the board of</p>

	<p>directors, and that those groups receive information on the implementation of risks management systems, of actual risks run and of identified breaches directly from internal and external audit or compliance groups that are suitably independent from front-line business groups.</p> <p>The JFSA has stepped up its engagement with the banks' board, non-executive board members (this approach is most advanced with respect to the city banks. However, the depth of engagement with the independent non-executive directors is not yet at a level where the JFSA challenges their oversight of bank's risk management and detailed areas such as assumptions for risk management techniques (e.g., internal models and stress testing). This is especially important as a way to ensure the appropriate checks and balances are operating effectively. (This issue is also covered in CP 14).</p>
<b>Principle 16</b>	<b>Capital adequacy.</b> <sup>45</sup> The supervisor sets prudent and appropriate capital adequacy requirements for banks that reflect the risks undertaken by, and presented by, a bank in the context of the markets and macroeconomic conditions in which it operates. The supervisor defines the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, capital requirements are not less than the applicable Basel standards.
<b>Essential criteria</b>	
<b>EC 1</b>	Laws, regulations or the supervisor require banks to calculate and consistently observe prescribed capital requirements, including thresholds by reference to which a bank might be subject to supervisory action. Laws, regulations or the supervisor define the qualifying components of capital, ensuring that emphasis is given to those elements of capital permanently available to absorb losses on a going concern basis.
Description and findings re EC1	<p>The Commissioner of the JFSA has the authority to set capital adequacy ratios or any other standards for measuring soundness of a bank with the aim of encouraging sound management of businesses by the bank under Article 14–2 of the Banking Act. In exercising that authority, the JFSA publishes detailed standards for calculating capital adequacy ratios in its Capital Requirements Notice. These requirements define the components of capital in line with Basel III, provide detailed instructions for computing risk-weighted assets, set minimum requirement thresholds, and rules under which capital distributions can be restricted and other supervisory actions taken. 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.</p> <p>Articles 26 and 52–33 of the Banking Act give the JFSA the power to order a bank or bank holding company to improve its businesses or even to suspend its businesses (the latter subject to endorsement by the PM), depending upon where the bank's capital ratios stand relative to minimum requirements. In practice the JFSA confirmed that they can only take such actions when bank capital ratios fall below the public minimum requirements.</p>

<sup>45</sup> The Core Principles do not require a jurisdiction to comply with the capital adequacy regimes of Basel I, Basel II and/or Basel III. The Committee does not consider implementation of the Basel-based framework a prerequisite for compliance with the Core Principles, and compliance with one of the regimes is only required of those jurisdictions that have declared that they have voluntarily implemented it.

	<p>In November 2015 the definition of minimum capital requirements for internationally-active banks was expanded by the JFSA to include the Basel III buffers; i.e., in Japan minimum capital requirements including the capital conservation buffer and the countercyclical buffer plus the GSIB/DSIB buffer requirements for relevant internationally-active banks. Those banks are required to limit their capital distributions in accordance with the capital conservation buffer requirements stipulated in Basel III when bank capital ratios fall below the minimum requirement.</p> <p>Although not part of the capital requirements per se, there is a separate limit on a banking group's holdings of equities (to the amount of its consolidated Tier1 capital) in accordance with the Act on Limitation on Shareholding by Banks and Other Financial Institutions.</p> <p>The JFSA operates an Early Warning System, which allows it to continuously conduct offsite monitoring. It monitors banks whose capital ratios are low but still satisfying the minimum capital adequacy requirement. In the event the JFSA has any concerns it would encourage banks to revisit their capital planning assumptions and/or adjust risk exposures so that various risks would not negatively impact on banking soundness, and supervisory measures may be taken against them.</p> <p>This monitoring is conducted in the way described below per Supervisory Guidance III-2-2-3(3).</p> <ol style="list-style-type: none"> <li>1) Various indicators on profitability, credit risks, market risks, liquidity risks are calculated by the JFSA based on monitoring data periodically collected from each bank. (For example, the amount of IRRBB as agreed in Basel Committee in 2004).</li> <li>2) The JFSA understands these risks based on the indicators mentioned above, and selects banks with risks exceeding a certain threshold (for example, 20 percent of own capitals for IRRBB) or banks that are deemed to have high risks. The JFSA closely monitors banks in accordance with their risk profile.</li> <li>3) The JFSA has dialogues with banks subject to close monitoring in order to highlight the causes of high risks and possible remedial measures, and, as necessary, encourages them to implement these measures. The latter may include improvements to their risk management systems; reduction of risks and review of capital plans, in light of identified problems of banks through the collected data and dialogues as well as severity of problems.</li> <li>4) The JFSA would, as necessary, consider issuing a business improvement order against the bank in accordance with Article 26 of the Banking Act.</li> </ol>
<p><b>EC2</b></p>	<p>At least for internationally active banks,<sup>46</sup> the definition of capital, risk coverage, the method of calculation and thresholds for the prescribed requirements are not lower than those established in the applicable Basel standards.</p>
<p>Description and findings re EC2</p>	<p>In Japan a deposit taking financial institution is considered to be an "internationally active bank" if it operates a branch or subsidiary in a foreign jurisdiction, regardless of its size and</p>

<sup>46</sup> The Basel Capital Accord was designed to apply to internationally active banks, which must calculate and apply capital adequacy ratios on a consolidated basis, including subsidiaries undertaking banking and financial business. Jurisdictions adopting the Basel II and Basel III capital adequacy frameworks would apply such ratios on a fully consolidated basis to all internationally active banks and their holding companies; in addition, supervisors must test that banks are adequately capitalized on a stand-alone basis.

	<p>systemic importance. In those cases, the JFSA applies the Basel III Framework to all of those banks in all respects; including definition of capital, computation of risk weights, ratio calculation and overall capital requirements. The JFSA has also gone beyond the formal Basel requirements by requiring banks adhere to its capital requirements on both a consolidated and a solo basis. The JFSA would take a prompt corrective action for a bank when either its solo-based or consolidated-based capital adequacy ratios falls below the minimum requirement based on Article 26 of the Banking Act. Such actions could include issuing business improvement and business suspension orders.</p> <p>The JFSA has been implementing the Basel III capital framework in accordance with the internationally-agreed schedule for implementation. For example, the leverage ratio disclosure requirements were implemented in March 2015 along with the capital buffer requirements. In November 2015, the JFSA established the G-SIB/D-SIB framework including capital charges via changes in the notice on capital requirements and supervisory guidance. 3 G-SIBs and 7 D-SIBs were designated as systemically important banks effective in March 2016. The JFSA also introduced disclosure requirements on 12 assessment indicators for G-SIBs at the end of March 2014, which is in line with international agreements.</p> <p>JFSA's close adherence to the Basel III capital framework has been confirmed by compliant ratings in the Basel Committee RCAP reports conducted to date for Japan covering capital requirements and the G-SIB framework.. In the follow-up assessment report for the capital requirement RCAP published last year, Japan received a Compliant rating for its implementation of the Basel III loss absorbency and a Largely Compliant rating for that of capital buffer (capital conservation and countercyclical capital buffer) standards. In the case of the capital buffer, four minor deviations were uncovered, two of which will be corrected in forthcoming publications on the process for setting the countercyclical buffer ratio and on revisions to bank disclosure requirements. The other two remaining deviations relate to the treatment of interbank exposures and the geographical allocation of trading book exposures for purposes of computing countercyclical capital buffers for individual banks. The assessors concur that neither of those two deviations is likely to have a material impact on reported capital ratios for Japanese banks.</p>
<b>EC3</b>	<p>The supervisor has the power to impose a specific capital charge and/or limits on all material risk exposures, if warranted, including in respect of risks that the supervisor considers not to have been adequately transferred or mitigated through transactions (e.g., securitization transactions)<sup>47</sup> entered into by the bank. Both on-balance sheet and off-balance sheet risks are included in the calculation of prescribed capital requirements.</p>
Description and findings re EC3	<p>Based on Article 14–2 of the Banking Act, the JFSA has the authority to amend standards for capital adequacy ratios and thus has the power to order banks to include any exposures concerned in calculation of minimum capital adequacy ratios. However, this power only extends to setting the public capital requirements for the banking industry or subsets of the industry (e.g., systemically important banks are required to meet more stringent minimum requirements while purely domestic banks are subject to their own set of public</p>

<sup>47</sup> Reference documents: Enhancements to the Basel II framework, July 2009 and: International convergence of capital measurement and capital standards: a revised framework, comprehensive version, June 2006.

	<p>capital requirements) under what is known as Pillar 1 of the Basel Framework. The JFSA does not have the power to impose specific supplementary capital requirements on individual banks under what is conventionally known as Pillar 2 of the Basel Framework. Instead, it would need to discuss with banks other remedial measures to control the risks in question and encourage banks to voluntarily set aside additional capital to cover those risks in bank capital planning exercises.</p> <p>In the case of the BoJ, it requires financial institutions to perform scenario analyses/stress testing, as appropriate, in the course of onsite examinations to measure and validate the anticipated capital levels. It then exchanges views with the senior management as to the adequacy of capital. In its offsite monitoring, the BoJ conducts research through interviews and information/data gathering to assess the capital adequacy of financial institutions. In this assessment process, the BoJ takes into account their profitability, plans to raise capital, as well as the potential impact of credit risk, market risk (including stockholdings) and other risks they may be taking.</p> <p>As stipulated in “Onsite Examination Policy for Fiscal 2016,” the BoJ examines the following aspects.</p> <ul style="list-style-type: none"> <li>✓ Business Management Based on an Optimal Balance between Financial Bases and Risk Taking; and</li> <li>✓ The board of directors needs to be adequately involved in developing risk-taking policies and risk management frameworks, examining the investment situation. In this regard, it is important to be accurately aware of market risk associated with securities portfolios and off-balance transactions, and to ensure the optimal balance between equity capital and risks.</li> </ul> <p>In onsite examinations, the BoJ examines the following: (1) whether the board of directors has clearly set out risk-taking policies, thereby having investment plans formulated in view of the optimal balance between equity capital and risks; (2) whether the board of directors has developed risk management frameworks in accordance with these policies and plans and reviews the frameworks as appropriate; and (3) whether the board of directors holds discussions and reaches adequate decisions in a timely and appropriate manner based on reports on market developments and risks in the event of abrupt changes in the financial and economic conditions.</p>
<p><b>EC4</b></p>	<p>The prescribed capital requirements reflect the risk profile and systemic importance of banks<sup>48</sup> in the context of the markets and macroeconomic conditions in which they operate and constrain the build-up of leverage in banks and the banking sector. Laws and regulations in a particular jurisdiction may set higher overall capital adequacy standards than the applicable Basel requirements.</p>

<sup>48</sup> In assessing the adequacy of a bank’s capital levels in light of its risk profile, the supervisor critically focuses, among other things, on (a) the potential loss absorbency of the instruments included in the bank’s capital base, (b) the appropriateness of risk weights as a proxy for the risk profile of its exposures, (c) the adequacy of provisions and reserves to cover loss expected on its exposures and (d) the quality of its risk management and controls. Consequently, capital requirements may vary from bank to bank to ensure that each bank is operating with the appropriate level of capital to support the risks it is running and the risks it poses.

Description and findings re EC4	<p>Asides from subjecting the three major banks that has been designated as G-SIBs to the international requirements pertaining to G-SIBs, the JFSA has implemented a D-SIB framework in accordance with the 12 international agreed principles published by the Basel Committee, through the change of notice and supervisory guidance. Seven banks have been designated as D-SIBs which includes the 3 G-SIBs. Additional capital requirements (more than or equal to 0.5 percent of RWA) have been added to those banks' minimum Basel capital requirement. The D-SIBs were designated based on some quantitative indicators of size, interconnectedness as well as qualitative indicators of market significance. For example, if a bank increases leveraged transactions, the score on some indicators including size will be higher. The bank may be designated as a D-SIB and additional capital charge may be imposed. When a bank is systemically important in a specific market (share in the securities market), the bank can also be designated as a D-SIB, and additional capital charges can be imposed.</p> <p>In addition, the JFSA implemented the countercyclical capital buffer framework in March 2016 as part of its capital requirements. that buffer is currently set at zero but could be activated in response to any system-wide developments to constrain the build-up of leverage in banks and the banking sector. The Basel III leverage ratio also became effective in March 2015 for internationally active banks. At this stage this is a disclosure requirement but will become a requirement in accordance with the agreed international timeframe after the Basel Committee finalizes the leverage ratio framework.</p>
<b>EC5</b>	<p>The use of banks' internal assessments of risk as inputs to the calculation of regulatory capital is approved by the supervisor. If the supervisor approves such use:</p> <ul style="list-style-type: none"> <li>(a) such assessments adhere to rigorous qualifying standards;</li> <li>(b) any cessation of such use, or any material modification of the bank's processes and models for producing such internal assessments, are subject to the approval of the supervisor;</li> <li>(c) the supervisor has the capacity to evaluate a bank's internal assessment process in order to determine that the relevant qualifying standards are met and that the bank's internal assessments can be relied upon as a reasonable reflection of the risks undertaken;</li> <li>(d) the supervisor has the power to impose conditions on its approvals if the supervisor considers it prudent to do so; and</li> <li>(e) if a bank does not continue to meet the qualifying standards or the conditions imposed by the supervisor on an ongoing basis, the supervisor has the power to revoke its approval.</li> </ul>
Description and findings re EC5	<p>The Capital Adequacy Notice stipulates that a bank must be approved by the Commissioner of the JFSA to adopt an internal rating model for credit risk (Article 140) and market risk (Article 272) as well as a standardized approach (Article 306) and advanced model approach (Article 312) for operational risk. The JFSA will withdraw approvals if a bank does not fulfill those requirements as stipulated (Articles 145, 279, and 317). Detailed requirements are spelled out by the JFSA in the Notice for models to be approved and the review of supervisory files confirmed that the JFSA has a detailed and thorough model review process.</p> <p>The JFSA also continues to review model performance after approvals are granted. All changes to models need to be approved by the JFSA and the JFSA will intervene with banks</p>

	to discuss changes whenever performance issues with models crop up after the approval has been granted.
<b>EC6</b>	<p>The supervisor has the power to require banks to adopt a forward-looking approach to capital management (including the conduct of appropriate stress testing).<sup>49</sup> The supervisor has the power to require banks:</p> <ul style="list-style-type: none"> <li>(a) to set capital levels and manage available capital in anticipation of possible events or changes in market conditions that could have an adverse effect; and</li> <li>(b) to have in place feasible contingency arrangements to maintain or strengthen capital positions in times of stress, as appropriate in the light of the risk profile and systemic importance of the bank.</li> </ul>
Description and findings re EC6	<p>The JFSA requires banks to conduct capital planning exercises including stress testing. In the course of that work it will engage with banks on the adequacy of their capital plans in anticipation of possible events. Discussions with the banks confirmed, for example, that the JFSA paid close attention to banks' stress tests and capital plan assumptions more generally when oil prices were declining rapidly in 2015 and early 2016. Through this process the JFSA can encourage banks to voluntarily carry more capital when the need arises. As indicated in EC4 of this CP, the JFSA could also activate the countercyclical buffer to require all banks and bank holding companies to carry more capital should it be concerned about the macro-financial environment more generally.</p> <p>When bank capital levels are above the minimum requirements, however, the JFSA does not have the authority to formally insist individual banks carry additional capital from a forward-looking perspective. Nor can it use capital as a lever in those situations to encourage specific banks to enhance their risk management practices.</p> <p>The JFSA conducts bottom up stress testing for 3 major banking group, considering the importance of their financial intermediary function during stress periods. This stress testing is conducted as part of the annual bank capital planning exercises.</p> <p>In the process of the stress testing above, the JFSA confirms the following aspects through the continuous dialogue with wide range of staffs including board members, senior managers and other staffs.</p> <ul style="list-style-type: none"> <li>✓ If robust implementation system of stress testing is established</li> <li>✓ If the results of stress testing and subsequently developed crisis management measures are discussed in board meetings and management meetings and are used to develop management policy and capital policy.</li> </ul> <p>The JFSA also requires banks to prepare recovery plans and reviews them in the course of its supervisory activities. As part of these exercises banks are required to explain how they would conserve or raise capital in times of stress.</p>
<b>AC1</b>	For non-internationally active banks, capital requirements, including the definition of capital, the risk coverage, the method of calculation, the scope of application and the

<sup>49</sup> "Stress testing" comprises a range of activities from simple sensitivity analysis to more complex scenario analyses and reverses stress testing.

	capital required, are broadly consistent with the principles of the applicable Basel standards relevant to internationally active banks.
Description and findings re AC1	<p>Capital requirements for non-internationally active banks are fairly similar to the Basel requirements imposed on internationally active banks, but there are some important differences.</p> <p>Details surrounding the definition of capital for domestic banks have been made more conservative and are now broadly consistent with that applied to internationally active banks. The main differences are: (i) that unrealized gains and losses on Available for Sale securities and the revaluation reserve for land are excluded from capital for domestic banks; and (ii) there is no Tier 2 capital requirement for domestic banks. Instead the JFSA focuses only on what it calls Core capital, which closely resembles Common Equity Tier 1 in practice. The JFSA explained that Tier 2 is excluded because:</p> <ul style="list-style-type: none"> <li>✓ Need to avoid excessively complex regulation for domestic banks including medium-small cooperative financial institutions</li> <li>✓ Need to avoid systemic risks in the situation where subordinated bonds and loan as Tier2 are unlikely to be underwritten</li> <li>✓ Need to prevent moral hazard of investors expecting possible injection of public funds for failed banks.</li> </ul> <p>Calculations of risk-weighted assets for domestic banks use the same rules found in the Basel Framework.</p> <p>The risk-weighted core capital ratio requirements for domestic banks is set at 4 percent compared to the 8 percent CET1 requirement for the internationally-active banks. The JFSA noted the main differences here are that the domestic banks are not subject to the Basel buffer requirements (e.g., capital conservation and SIFI buffers). In addition, the differences in ratios does not necessarily mean that domestic banks carry much less capital in practice given that capital requirements computed using the Basel standardized approaches (used by domestic banks) are generally higher than those computed by internationally-active banks using the model-based frameworks. Note that actual capital ratios for the domestic banks, currently in excess of 10 percent, are well in excess of the official minimum requirements.</p>
<b>AC2</b>	The supervisor requires adequate distribution of capital within different entities of a banking group according to the allocation of risks. <sup>50</sup>
Description and findings re AC2	JFSA's capital requirements are applied to banks and bank holding companies on both a consolidated and unconsolidated basis. Thus capital will be allocated appropriately to each unit of group according to risks it is exposed. In addition, the Inspection Manual for Financial Holding Companies (Checklists for group management) requires the JFSA supervisors to check whether a financial holding company adequately allocates its capital within the group.

<sup>50</sup> Please refer to Principle 12, Essential Criterion 7.

	Even a securities firm within the banking group is required to calculate capital adequacy ratios on a solo basis in accordance with a method similar to the one applicable to banks so that capital is built up commensurate with risks it is exposed.
<b>Assessment of Principle 16</b>	MNC
Comments	<p>The JFSA capital framework is closely aligned with the Basel Pillar 1 capital framework for internationally-active banks. However, an important shortcoming is the lack of powers from a Basel Pillar 2 perspective to be able to require banks to carry more capital beyond the minimum requirements to address specific risks within a bank that may arise, for example, due to risk concentrations or growing reliance on foreign currency wholesale funding; or that are not well captured within the Pillar 1 framework (e.g., interest rate risk in the banking book). Up to now, the JFSA has been able to compensate for this shortcoming through its discussions with banks on assumptions used by banks in their capital planning exercises and also indirectly through discussions with banks on their risk exposures more generally.</p> <p>The assessors believe that this shortcoming could become more acute in the future. JFSA's plans to become a more dynamic supervisor will likely bring it into territory where it may need to exert more influence and operate more proactively with banks to set capital and adjust risk management practices in anticipation of future events such as potential risks arising from major bank growing reliance on foreign currency funding. Relying on the minimum capital framework alone may not be sufficient in those situations. Instead, it could be helpful for the JFSA to have a broader power to set capital requirements above the minimum requirements, which could then serve as a residual power that would add more teeth to JFSA's efforts to exert moral suasion in both bank capital planning exercises and in discussions about bank risk management practices more generally.</p> <p>The assessors are also concerned that the thresholds for early intervention measures such as constraints on dividends and other capital disbursements are set too low for domestic banks given they would only start to kick in when capital ratios for those banks fall below 4 percent (compared to 8 percent for internationally-active banks). The assessors appreciate that capital requirements for those banks have become more stringent over time and that those banks are generally carry capital well above the minimum requirements. They also acknowledge that increasing the minimum requirements for domestic banks to include a capital conservation buffer may not be practical given the concerns that have been expressed generally about the usability of Basel buffers in times of stress. But risks can emerge in the future; hence, the JFSA may wish to explore with domestic banks the feasibility of privately introducing such constraints for capital levels above the official minimum requirements through bank policies and recovery plans so that they kick in well before capital ratios fall below the 4 percent threshold.</p>
<b>Principle 17</b>	<b>Credit risk.</b> <sup>51</sup> The supervisor determines that banks have an adequate credit risk management process that takes into account their risk appetite, risk profile and market and

<sup>51</sup> Principle 17 covers the evaluation of assets in greater detail; Principle 18 covers the management of problem assets.

	macroeconomic conditions. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate credit risk <sup>52</sup> (including counterparty credit risk) <sup>53</sup> on a timely basis. The full credit lifecycle is covered including credit underwriting, credit evaluation, and the ongoing management of the bank's loan and investment portfolios.
<b>Essential criteria</b>	
<b>EC1</b>	Laws, regulations or the supervisor require banks to have appropriate credit risk management processes that provide a comprehensive bank-wide view of credit risk exposures. The supervisor determines that the processes are consistent with the risk appetite, risk profile, systemic importance and capital strength of the bank, take into account market and macroeconomic conditions and result in prudent standards of credit underwriting, evaluation, administration and monitoring.
Description and findings re EC1	<p>Banks and the JFSA place a lot of emphasis on properly controlling credit risk. The supervisor provides detailed guidance for banks which set clear expectations for an adequate credit risk control environment e.g., 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. The JFSA checks whether a bank develops its bank-wide business policy, its medium- and long-term business planning and strategy, and its credit risk management policy that reflect the bank's risk appetite in accordance with III-2-3-2-1-2 of Supervisory Guidance.</p> <p>The expansion by the megabanks has been a focus for the JFSA over the last three years conducting a range of activities to monitor and assess emerging risks and quality of risk management. From the banking industry we understood that the JFSA continues to emphasize credit management. Consequently, both for the banks themselves as well as for the JFSA and BoJ, this is a crucial area of attention.</p> <p>Both the supervisory guidelines and onsite inspections include an extensive assessment of banks' policies, 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 inspections the inspectors will assess such requirements and report in a standardized manner about their findings, based upon which the offsite supervisory department could take remedial action.</p> <p>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</p>

<sup>52</sup> Credit risk may result from the following: on-balance sheet and off-balance sheet exposures, including loans and advances, investments, inter-bank lending, derivative transactions, securities financing transactions and trading activities.

<sup>53</sup> Counterparty credit risk includes credit risk exposures arising from OTC derivative and other financial instruments.

	<p>identifies specified risk areas to be assessed further. As stipulated in “Onsite Examination Policy for Fiscal 2016,” the following are the key issues in this area:</p> <ul style="list-style-type: none"> <li>✓ Appropriate Credit Screening and Monitoring, and Establishment of a Framework Compatible with Lending Strategies;</li> <li>✓ Strengthening the Management of Large Exposures/Concentration Risk; and</li> <li>✓ Strengthening the Management of Credit Exposure with Respect to Overseas Businesses.</li> </ul> <p>Inspection Manual requires examiners to check whether relevant directors appropriately grasp the status of credit risk management of financial institution and develop policies and specific measures to establish appropriate credit risk management system, based on sufficient understanding of allocation of credit risk, types and characteristic of credit risk, methods to identify, evaluate, monitor, and control credit risk, and the importance of credit risk management.</p> <p>Inspectors examine that internal rules on credit risk management includes necessary provisions to manage credit risk that reflect the size and property of business and the risk profile in accordance with Inspection Manual. Also, the JFSA examines, through onsite and offsite monitoring, whether the processes of credit risk management are consistent with the risk appetite, risk profile, systemic importance, and capital strengths of the bank, taking account of market and macroeconomic conditions, and whether it results in prudent standards of credit underwriting, evaluation, administration, and monitoring.</p>
<p><b>EC2</b></p>	<p>The supervisor determines that a bank’s board approves, and regularly reviews, the credit risk management strategy and significant policies and processes for assuming,<sup>54</sup> identifying, measuring, evaluating, monitoring, reporting and controlling or mitigating credit risk (including counterparty credit risk and associated potential future exposure) and that these are consistent with the risk appetite set by the board. The supervisor also determines that senior management implements the credit risk strategy approved by the board and develops the aforementioned policies and processes.</p>
<p>Description and findings re EC2</p>	<p>Based on II-1-1-2 of Supervisory Guideline, the JFSA regularly engages in discussion with bank’s board regarding the status of credit risk management, and the adequacy of reporting to provide an accurate insight into the performance of the portfolio including through forward looking indicators of risk. Specifically, the JFSA will check the followings with respect to credit risk management of holding assets including off-balance sheet items based on II-2-3-2-1-2 of Supervisory Guidelines and Inspection Manual (Checklists for credit risk management).</p> <p>Based on Inspection Manual, the JFSA will examine if bank’s board has set strategic goals of the loan department and established a credit risk management policy for identifying, evaluating and monitoring credit risk. The JFSA also examines if the board periodically or regularly receives the report on the status of overall credit risk management, and reviews the effectiveness of the process. For the megabanks, the JFSA routinely receives board reporting packs and meets regularly with senior management to discuss credit risk. The</p>

<sup>54</sup> “Assuming” includes the assumption of all types of risk that give rise to credit risk, including credit risk or counterparty risk associated with various financial instruments.

	JFSA reviews credit policies on at least an annual basis. Onsite reviews will assess the implementation of the policies and adequacy of the control environment. In relation to regional banks (and other banks), the JFSA conducts a similar set of supervisory activities in a proportional manner.
<b>EC3</b>	<p>The supervisor requires, and regularly determines, that such policies and processes establish an appropriate and properly controlled credit risk environment, including:</p> <ul style="list-style-type: none"> <li>(a) a well-documented and effectively implemented strategy and sound policies and processes for assuming credit risk, without undue reliance on external credit assessments;</li> <li>(b) well defined criteria and policies and processes for approving new exposures (including prudent underwriting standards) as well as for renewing and refinancing existing exposures, and identifying the appropriate approval authority for the size and complexity of the exposures;</li> <li>(c) effective credit administration policies and processes, including continued analysis of a borrower's ability and willingness to repay under the terms of the debt (including review of the performance of underlying assets in the case of securitization exposures); monitoring of documentation, legal covenants, contractual requirements, collateral and other forms of credit risk mitigation; and an appropriate asset grading or classification system;</li> <li>(d) effective information systems for accurate and timely identification, aggregation and reporting of credit risk exposures to the bank's board and senior management on an ongoing basis;</li> <li>(e) prudent and appropriate credit limits, consistent with the bank's risk appetite, risk profile and capital strength, which are understood by, and regularly communicated to, relevant staff;</li> <li>(f) exception tracking and reporting processes that ensure prompt action at the appropriate level of the bank's senior management or board where necessary; and</li> <li>(g) effective controls (including in respect of the quality, reliability and relevancy of data and in respect of validation procedures) around the use of models to identify and measure credit risk and set limits.</li> </ul>
Description and findings re EC3	See also EC1 and EC2. The JFSA, through its onsite and offsite monitoring, requires and examines banks to develop policies and processes that include (a)–(g) to establish an appropriate and properly controlled credit risk environment. Additionally, with respect to management of NPLs, based on II-2-3-2-3-2 of Supervisory Guideline, the JFSA will check whether banks have clearly established the policy for the management as well as the adequacy and appropriateness of the delegation structures and conducts of internal audits in a timely manner. During an inspection, examiners will assess the application of the credit policies and the adequacy of the three lines of defense.
<b>EC4</b>	The supervisor determines that banks have policies and processes to monitor the total indebtedness of entities to which they extend credit and any risk factors that may result in default including significant unhedged foreign exchange risk.
Description and findings re EC4	Supervisory measures and responses include continuous monitoring, ad hoc offsite monitoring, early warning system based on offsite monitoring. Inspectors check the following points in accordance with "Checklists for confirming the status of credit risk management." The policies and processes to monitor credit risk management and market risk management are provided in III-2-3-2 and III-2-3-3 of Supervisory Guideline. As one

	<p>of the main focus of supervision, the Guideline requires, for example, the board to provide the policy of risk management based on strategic objectives that reflect business policy of the bank as a whole. 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> <p>To adequately monitor the financial condition including total indebtedness of obligors, banks conduct regular credit assessments at the portfolio level and by counterparty. Large exposures receive heightened management and board attention. Portfolio reporting is escalated through senior management and to management committees. The JFSA routinely evaluates MIS to monitor changes in portfolio trends and large counterparty loans. The onsite inspection unit assesses the adequacy and timeliness of credit file reviews during onsite inspections and looks at the extent to which files are routinely reviewed. Stress testing results are also a key feature of JFSA's dialogue with senior management and the board.</p>
<b>EC5</b>	The supervisor requires that banks make credit decisions free of conflicts of interest and on an arm's length basis.
Description and findings re EC5	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 JFSA's day-to-day supervision. The JFSA examines at its inspection if banks have taken adequate measures in terms of compliance with the rule. Article 13-3-2 and 52-21-2 of the Banking Act require a bank and banking group to establish organization and delegation structures for avoiding conflicts of interests and during inspection. The JFSA will check the status of compliance with the provisions.
<b>EC6</b>	The supervisor requires that the credit policy prescribes that major credit risk exposures exceeding a certain amount or percentage of the bank's capital are to be decided by the bank's board or senior management. The same applies to credit risk exposures that are especially risky or otherwise not in line with the mainstream of the bank's activities.
Description and findings re EC6	There is no requirement in the regulations that major credit risk exposures exceeding a certain limit/threshold or credits which are especially risky, to approved by senior management or the board. In accordance with III-2-3-2-2-2 of Supervisory Guideline, the JFSA will check whether the bank's board selects borrowers to which a bank has large exposure based on reasonable thresholds and continuously monitors their credibility and financial conditions. The definition of exposures should include not only lending assets but also off-balance sheet items such as derivatives etc. The inspection manual requires examiners to check the adequacy of credit limits set by banks and whether banks conduct credit risk management on an individual counterparty basis for those to which banks have large exposure. Additionally, examiners will confirm that banks manage the exposures to the counterparty on a group basis. Furthermore, examiners will assess whether banks have appropriately managed credit risk by reflecting in internal rules reporting systems, responsibilities and procedures where the exposure exceeds the credit limit.
<b>EC7</b>	The supervisor has full access to information in the credit and investment portfolios and to the bank officers involved in assuming, managing, controlling and reporting on credit risk.

Description and findings re EC7	<p>Based on the Articles 24 and 25 of Banking Act, the JFSA may freely access to any staffs or information held by a bank. Additionally, the JFSA may require a bank, bank's subsidiaries and companies to which the bank has outsourced part of its businesses to report the status of the business and properties to the JFSA. Obviously, the information relating to banks' credit and investment portfolio is not excluded from the scope of JFSA's access. Though the bank's board is responsible for reporting or submitting the necessary documents to the JFSA, the JFSA may contact appropriate staff responsible for underwriting, management and control of bank's credit risk. During onsite inspection, the JFSA may also freely contact Chief Executive Officer, directors and the staffs responsible for underwriting, management and control of bank's credit risk.</p> <p>The JFSA regularly assesses the status of bank's credit portfolios on both solo and consolidated basis by collecting the offsite monitoring data (per quarter), and if necessary, the JFSA will access to the staffs in charge of credit risk management. At inspection, examiners may contact any relevant staff. The JFSA 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 JFSA 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 JFSA.</p> <p>With regard to the supervisory reporting and relevant issues (as specified in this Criterion and the other Criteria), the BoJ may collect and analyze information and financial data of the financial institutions on a regular/ad hoc basis, in accordance with the onsite examination contracts as stipulated in Article 44 of the Bank of Japan Act. Data for credit and investment portfolios are included in the supervisory reporting.</p>
<b>EC8</b>	The supervisor requires banks to include their credit risk exposures into their stress testing programs for risk management purposes.
Description and findings re EC8	<p>In JFSA's Strategic Directions and Priorities, it is stressed that management of financial institutions should be well aware of credit cycle or large changes of economic and market environment in the future. In this respect, the JFSA continues to have dialogue with them and examines whether financial institutions ensure their safety and soundness sufficient to perform the functions of financial Intermediaries even at a stress period. More specifically, for example, the JFSA examines whether internationally active financial institutions appropriately evaluate transmission mechanism and scenario that potential risks materialize, as well as its impact on economy and financial and capital markets, and its impact on the safety and soundness of financial institutions.</p> <p>Based on such evaluations, the JFSA examines whether financial institutions appropriately evaluate relevant risks including credit risk and ensure capital and liquidity sufficient to perform appropriate functions of financial intermediaries; develop and review operational policies and risk management policies in a forward looking manner with appropriate involvement of the board of directors; and establish appropriate crisis management systems.</p>
<b>Assessment of Principle 17</b>	C

Comment	<p>In general, the assessors see a sufficient focus by banks as well as the JFSA and BoJ on credit risk management. Credit risk is a key focus in JFSA's strategic plans which are communicated to the market. Both routine and targeted ad hoc work by the supervisory and inspection bureaus of the JFSA conduct detailed monitoring and in depth analysis (through file reviews) of credit risks and adequacy of risk management. In the discussions with the banking industry the assessors also found sufficient senior-management attention for the problem areas identified and a willingness to further improve their credit risk management processes toward best practices.</p> <p>While there is no requirement in the regulations that major credit risk exposures exceeding a certain limit/threshold or credits which are especially risky, be approved by senior management or the board it is the expectation of the JFSA for these exposures to be reported to the board as a matter of course to allow the board an opportunity to assess the bank's overall risk profile (see also CP19).</p>
<b>Principle 18</b>	<b>Problem assets, provisions, and reserves.</b> <sup>55</sup> The supervisor determines that banks have adequate policies and processes for the early identification and management of problem assets, and the maintenance of adequate provisions and reserves. <sup>56</sup>
<b>Essential criteria</b>	
<b>EC1</b>	Laws, regulations or the supervisor require banks to formulate policies and processes for identifying and managing problem assets. In addition, laws, regulations or the supervisor require regular review by banks of their problem assets (at an individual level or at a portfolio level for assets with homogenous characteristics) and asset classification, provisioning and write-offs.
Description and findings re EC1	<p>Based on Article 6 of the Financial Reconstruction Act, banks are required to assess the quality of their assets (i.e., classify assets) every accounting period. Article 4 of the Ordinance for Enforcement of the Act provides criteria for classifying loans based on borrower financial condition and business performance.</p> <p>In accordance with its Supervisory Guidelines, the JFSA regularly reviews bank self-assessments of their NPLs, write-offs and provisions to ensure that loans are classified appropriately and that write-offs and provisions are prudent. In particular, it examines whether the assignment of internal ratings to individual borrowers are consistent with borrower financial results and adjusted on a timely basis as those results evolve. It also ensures that the ratings take account of any market signals. The JFSA also explores whether banks then conduct adequate classifications of borrowers, write-offs and provisioning for the loans taking into account recent default trends and bankruptcy events.</p> <p>Based on the Inspection Manual, the JFSA also examines if boards of directors of banks require the asset classification divisions to establish standards for self-assessment, loan classifications, write-offs and provisions, and if the banks have established the organization structures to adequately conduct self-assessments and calculate the amounts for write-offs and provisions.</p>

<sup>55</sup> Principle 17 covers the evaluation of assets in greater detail; Principle 18 covers the management of problem assets.

<sup>56</sup> Reserves for the purposes of this Principle are "below the line" non-distributable appropriations of profit required by a supervisor in addition to provisions ("above the line" charges to profit).

	<p>The guidelines and inspection manual thus provide a sufficient basis for an adequate evaluation of the policies and processes in place for identifying and managing problem assets. The assessors review of supervisory files and their visits to banks also confirmed that in practice loan portfolios are reviewed on a sufficiently frequent basis, whereby both individual and portfolio approaches are used. The asset classification methods are generally disclosed in the annual accounts; although some institutions use a more detailed approach in practice.</p> <p>The BoJ also conducts offsite monitoring as well as onsite examinations of bank management of problem assets, provisions and reserves, and other relevant issues in assessing the credit quality of its counterparties. It also examines the accuracy of financial institution self-assessments during its onsite examinations.</p> <p>As stipulated in "Onsite Examination Policy for Fiscal 2016," the BoJ examines the following aspects (See Core Principle 17 for additional details).</p> <ol style="list-style-type: none"> <li>1. Appropriate Credit Screening and Monitoring, and Establishment of a Framework Compatible with Lending Strategies.</li> <li>2. Strengthening the Management of Large Exposures/Concentration Risk.</li> <li>3. Strengthening the Management of Credit Exposure with Respect to Overseas Businesses.</li> </ol>
<b>EC2</b>	<p>The supervisor determines the adequacy of a bank's policies and processes for grading and classifying its assets and establishing appropriate and robust provisioning levels. The reviews supporting the supervisor's opinion may be conducted by external experts, with the supervisor reviewing the work of the external experts to determine the adequacy of the bank's policies and processes</p>
Description and findings re EC2	<p>As noted in EC1, in accordance with the Inspection Manual, the JFSA examines if the directors and managements of banks have established appropriate asset classification systems. In addition, the JFSA directly assesses the accuracy and appropriateness of the results of self-assessment, write-offs and provisions when it inspects the banks and bank holding companies. It does not rely on external experts to conduct those assessments. In addition, it does not have formal channels for discussing these issues with external auditors, although in practice they would have a similar focus.</p> <p>In conducting onsite inspections, the JFSA reviews bank self-assessments against the bank's own policies and samples loans to ensure they have been correctly classified and adequately provisioned. If necessary, the JFSA will instruct the bank to increase provisions accordingly if material gaps are uncovered. Material gaps (defined as 30 percent or more of aggregate provisions) will result in business improvement orders to increase provisions under Article 26 of the Banking Act if the bank does not promptly correct the situation on its own. The review of supervisory files confirmed that the JFSA is diligent in reviewing loan classifications and provisions, and the auditors, rating agencies and banks visited confirmed that the issues surrounding the provisioning of SME loans observed in the past continue to linger but have shrunk significantly in importance. Looking to the future, they also indicated that banks and the JFSA have some significant challenges ahead of them to</p>

	<p>implement the new expected-credit-loss framework for loan loss provisions that is being introduced in international accounting standards.</p> <p>As indicated in EC1, in its onsite examinations the BoJ also checks the accuracy of the financial institution's self-assessment of assets in order to evaluate the appropriateness of write-offs and loan-loss provisions.</p>
<b>EC3</b>	The supervisor determines that the bank's system for classification and provisioning takes into account off-balance sheet exposures. <sup>57</sup>
Description and findings re EC3	Based on the Inspection Manual, banks are required to conduct self-assessment of assets including off-balance sheet items, classify those assets and calculate the amount of provisions for them. The review of supervisory files and the banks visited confirmed that such exposures were also taken into account.
<b>EC4</b>	The supervisor determines that banks have appropriate policies and processes to ensure that provisions and write-offs are timely and reflect realistic repayment and recovery expectations, taking into account market and macroeconomic conditions.
Description and findings re EC4	<p>Through the Inspection Manual, banks are required by the JFSA to establish standards and procedures to adequately and accurately conduct write-offs and provisions on a timely basis, and to have policies/processes to ensure that the write-offs and provisions take into account the prospect of reimbursement by borrowers. For example, in circumstances where market conditions changed markedly as was the case when oil prices declined sharply in 2015, the JFSA confirmed whether the three G-SIFI banks (which have significant exposures to the resources and energy industries) increased provisions or writes off amounts in line with the more adverse market conditions. Discussions with banks confirmed that the JFSA was paying close attention to their provisioning practices during this period. In conducting these reviews the JFSA compared Japanese bank provisioning practices to those of G-SIFI peer banks from the U.S.A. and U.K., and where necessary, required the Japanese banks to review the classification of their exposures and adjust provisions accordingly.</p> <p>Now that the special measures associated with lending to small- and medium-sized enterprises have expired, the issues with respect to the classification and provisioning of these loans continue to linger but are less material than in the past.</p>
<b>EC5</b>	The supervisor determines that banks have appropriate policies and processes, and organizational resources for the early identification of deteriorating assets, for ongoing oversight of problem assets, and for collecting on past due obligations. For portfolios of credit exposures with homogeneous characteristics, the exposures are classified when payments are contractually in arrears for a minimum number of days (e.g., 30, 60, 90 days). The supervisor tests banks' treatment of assets with a view to identifying any material circumvention of the classification and provisioning standards (e.g., rescheduling, refinancing or reclassification of loans).
Description and findings re EC5	Under III-2-3-2-3 of the Supervisory Guideline, banks are required: 1) to establish adequate business management systems which enable them to identify NPLs in a timely manner and to deal with NPLs at early stage such as through write-offs or provisioning;

<sup>57</sup> It is recognized that there are two different types of off-balance sheet exposures: those that can be unilaterally cancelled by the bank (based on contractual arrangements and therefore may not be subject to provisioning), and those that cannot be unilaterally cancelled.

	<p>2) to establish a clear policy for NPL management; 3) to establish the NPL management system in accordance with the policy; and 4) to implement the NPL management adequately by the division in charge.</p> <p>In accordance with the Inspection Manual, the JFSA examines if the division in charge of managing problem assets adequately understands and manages business conditions of troubled borrowers and instructs as necessary the borrowers to implement recovery plans or demands them to repay loans, and if banks have the adequate process and staff in place to collect claims on delinquent loans.</p> <p>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 borrowers who have failed to make payment of principals and interests for three months or more are categorized as “loans with special attention.” In the event new loans are provided to those borrowers for the purpose of repaying original loans, all of those new loans need to be classified as special attention, even if they are nominally not in arrears. This is confirmed by the JFSA when it reviews the classification of loans in the course of its supervisory activities.</p> <p>The JFSA does not actively monitor or require reporting for loans that are in arrears less than ninety days; although the banks themselves may monitor these loans on their own volition.</p> <p>As indicated in EC4, the JFSA directly examines the appropriateness of bank’s self-assessment standards and the accuracy of the results of self-assessment in the course of its onsite inspections and the findings are addressed through onsite and offsite supervision in the event misclassifications are uncovered.</p>
<b>EC6</b>	<p>The supervisor obtains information on a regular basis, and in relevant detail, or has full access to information concerning the classification of assets and provisioning. The supervisor requires banks to have adequate documentation to support their classification and provisioning levels.</p>
Description and findings re EC6	<p>Based on Article 24 of the Banking Act, the JFSA requires banks to submit offsite monitoring data showing the classification of NPLs and amount of provisions on a semi-annual basis. In addition, the JFSA requires banks to submit detailed documents on their credit risk management of large exposures including classification and amounts of provisions at least quarterly when the JFSA conducts dialogues with banks on their financial results.</p> <p>At inspection, the JFSA accesses all necessary information in order to assess the status of a bank’s credit risk management in accordance with Article 25 of Banking Act. In accordance with the Inspection Manual, the JFSA examines whether each department supplies enough data and records for the board meeting or equivalent settings to verify the adequateness of the provisions and write-off amount ex-post, and asks banks to preserve adequate documentation to support their decisions regarding loan-classification and provision amounts.</p>

	<p>With regard to supervisory reporting and relevant issues (as specified in this Criterion and the other Criteria), the BoJ may also collect and analyze information and financial data of the financial institutions on a regular/ad hoc basis, in accordance with the onsite examination contracts as stipulated in Article 44 of the Bank of Japan Act. Data for classification of assets and loan-loss provisions are included in the supervisory reporting.</p>
<b>EC7</b>	<p>The supervisor assesses whether the classification of the assets and the provisioning is adequate for prudential purposes. If asset classifications are inaccurate or provisions are deemed to be inadequate for prudential purposes (e.g., if the supervisor considers existing or anticipated deterioration in asset quality to be of concern or if the provisions do not fully reflect losses expected to be incurred), the supervisor has the power to require the bank to adjust its classifications of individual assets, increase its levels of provisioning, reserves or capital and, if necessary, impose other remedial measures.</p>
Description and findings re EC7	<p>Based on Article 6 of the Financial Reconstruction Act, banks are required to assess the quality of assets 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 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>Furthermore, based on the Inspection Manual, the JFSA examiners will assess "appropriateness of self-assessment standards and accuracy of the result" and "adequacy of the write-off and provisioning standards and the accuracy of their implementation" at inspection.</p> <p>Based on those annexes, if the JFSA believes asset classifications or provisions of a bank are not adequate, it will require the bank to address the situation. The JFSA also examines whether the bank has established the asset classification system.</p> <p>As indicated in EC1, the JFSA sends an inspection report to a bank and within a week issues an order in accordance with Article 24 of the Banking Act to require the bank to report its analysis and improvement measures concerning the findings in the inspection report within a month from the date of the order. The JFSA conducts hearings with a bank when the bank submits the report stated above in order to ensure that the proposed improvement measures will address inspection findings.</p> <p>In case where significant gaps remain unimproved between the result of self-assessment and those of inspection, in accordance with Article 26 of Banking Act, the JFSA may order the bank to take necessary measures; for example, by requiring it to submit an improvement plan, or it may order them to suspend a part of or the whole business to ensure safety and soundness of the banking businesses.</p> <p>In onsite examination, the BoJ checks the accuracy of the financial institution's self-assessment of assets in order to evaluate the appropriateness of write-offs and loan-loss provisions. If the BoJ judges the asset classifications or loan-loss provisions to be inadequate or inaccurate, it will urge the financial institution to revise the classification and increase provisions, reserves or capital.</p>

<b>EC8</b>	The supervisor requires banks to have appropriate mechanisms in place for regularly assessing the value of risk mitigants, including guarantees, credit derivatives and collateral. The valuation of collateral reflects the net realizable value, taking into account prevailing market conditions.
Description and findings re EC8	<p>In accordance with the Inspection Manual, banks are required to have appropriate mechanisms in place for assessing the value of risk mitigants, including guarantees and collateral. The guidance under which they operate is fairly general in this regard and is largely based on accounting standards. It could benefit from more direction to encourage banks to give more consideration to the principle of prudence in computing collateral valuations. The JFSA reviews bank policies and procedures to ensure that valuations are conducted in a consistent manner in accordance with bank policies and procedures.</p> <p>The JFSA also verifies through its onsite inspections whether banks value collateral in accordance with net realizable values by reviewing the fair values of marketable securities relative to prevailing market prices and by ensuring that the valuations for real estate properties pledged as collateral are updated at least annually, and preferably semi-annually for weaker credits. In conducting onsite inspections, the JFSA benefits from having some qualified real estate appraisers on staff who are able to review bank real estate appraisals. In addition, the JFSA assesses if banks have evaluated collateral values from various perspectives such as using comparative analysis of valuations, for example comparing bank valuations to selling prices of similar properties.</p>
<b>EC9</b>	<p>Laws, regulations or the supervisor establish criteria for assets to be:</p> <ul style="list-style-type: none"> <li>(a) identified as a problem asset (e.g., a loan is identified as a problem asset when there is reason to believe that all amounts due, including principal and interest, will not be collected in accordance with the contractual terms of the loan agreement); and</li> <li>(b) reclassified as performing (e.g., a loan is reclassified as performing when all arrears have been cleared and the loan has been brought fully current, repayments have been made in a timely manner over a continuous repayment period and continued collection, in accordance with the contractual terms, is expected).</li> </ul>
Description and findings re EC9	<p>Based on Article 6–2 of the Financial Reconstruction Act, banks are required to assess the quality of assets periodically, and Article 4 of Ordinance for Enforcement of the Act provides classification of assets based on the borrowers’ financial conditions and business performance. For example, in accordance with Article 4 of Ordinance for Enforcement of the Financial Reconstruction Act, loans to borrowers who have failed to make payment of principal and interest for three months or more are categorized as “loans with special attention.” In case new loans are provided to borrowers for the purpose of repaying the original loans, all of those loans must be identified as special attention, even if they are not in arrears nominally.</p> <p>Under III–3–2–4–3(2) of Supervisory Guideline, loans requiring special attention can be reclassified as performing if the loans have been restructured and the new terms and conditions are consistent with prevailing interest rates and the bank can demonstrate that the risks associated with the borrower have declined due to significant improvements in business conditions.</p>

	<p>Having said that, it appears that banks have some flexibility in determining what indicators and factors to use to guide their reclassification decisions as the JFSA has not issued specific guidance on this aspect of the provisioning process. This places more of a burden on bank supervisors to undertake activities to verify that banks are adopting a conservative approach.</p>
<b>EC10</b>	<p>The supervisor determines that the bank's board obtains timely and appropriate information on the condition of the bank's asset portfolio, including classification of assets, the level of provisions and reserves and major problem assets. The information includes, at a minimum, summary results of the latest asset review process, comparative trends in the overall quality of problem assets, and measurements of existing or anticipated deterioration in asset quality and losses expected to be incurred.</p>
Description and findings re EC10	<p>In accordance with the Inspection Manual, the JFSA assesses if credit management department of banks recognize and manage the conditions of loan portfolio adequately, and report to the board meeting periodically. In practice in Japan this means detailed reporting to the board semi-annually with more streamlined reporting on a quarterly basis with major exposures reviewed by Executive Committees of banks on a monthly basis.</p> <p>Through the onsite and offsite supervisory monitoring, the JFSA examines whether directors in charge of credit department have instructed relevant divisions to preserve enough data and records of self-evaluation process, amounts of provisions and write-offs periodically (more than twice a year) to verify them ex-post. The JFSA also examines if banks have established procedures to report material cases that might significant impact their business to the board immediately.</p> <p>Based upon the banks visited, the board is adequately informed about the condition of the bank asset portfolios, 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 JFSA requires banks to calculate provisions using the Discounted Cash Flow Method.</p> <p>In its onsite examinations, the BoJ checks the accuracy of the financial institution's self-assessment of assets in order to evaluate the appropriateness of write-offs and loan-loss provisions. The BoJ also confirms whether the credit management division of a financial institution verifies the condition of loan portfolio including its asset assessment and loan-loss provisions, and reports to the board of directors.</p>
<b>EC11</b>	<p>The supervisor requires that valuation, classification and provisioning, at least for significant exposures, are conducted on an individual item basis. For this purpose, supervisors require banks to set an appropriate threshold for the purpose of identifying significant exposures and to regularly review the level of the threshold.</p>
Description and findings re EC11	<p>Based on the Inspection Manual, with regard to the borrowers to which banks have large exposures, the JFSA examines if banks monitor borrower creditworthiness and financial conditions respectively and continuously. In addition, with regard to "loans with special attention" to largest borrowers [temporary threshold of more than ¥10 billion (roughly equivalent to \$100 million)], banks have been requested to calculate provision of each exposure using the Discounted Cash Flow Method. Having said, the threshold is just a benchmark to distinguish borrowers. Thus, banks can also apply the Discount Cash Flow</p>

	Method to calculate provisions for other large exposures below the threshold, so long as they understand the characteristics of their portfolio and use the method consistently in their internal policies.
<b>EC12</b>	The supervisor regularly assesses any trends and concentrations in risk and risk build-up across the banking sector in relation to banks' problem assets and takes into account any observed concentration in the risk mitigation strategies adopted by banks and the potential effect on the efficacy of the mitigants in reducing loss. The supervisor considers the adequacy of provisions and reserves at the bank and banking system level in the light of this assessment.
Description and findings re EC12	<p>Under III-2-3-2-3-2 of the Supervisory Guideline, banks are required to establish adequate business procedures to enable them to manage problem loans with strict self-evaluation methods and provision / write-off calculation systems, to enable restructuring NPLs to performing loans, to securitize NPLs, to deal with doubtful loans among NPLs.</p> <p>In addition, the JFSA conducts surveys semi-annually with all banks regarding NPLs and publishes the items below;</p> <ul style="list-style-type: none"> <li>• Transition of loans reported (disclosed) pursuant to the Financial Reconstruction Act;</li> <li>• Factors to increase/decrease loans reported (disclosed) pursuant to the Financial Reconstruction Act;</li> <li>• Transition of level of protection of loans reported (disclosed) pursuant to the Financial Reconstruction Act;</li> <li>• Transition of evaluation value of real estate collaterals (estimated disposable amounts) and actual records of selling prices;</li> <li>• Transition of loss occurred by disposing NPLs;</li> <li>• Transition of balances of "loan with special attention"; and</li> <li>• Transition of obligor classifications by self-evaluation.</li> </ul> <p>Since the above public data are available for the last 15 years, it is possible for the JFSA to understand not only the trend in the total balance of NPLs in the banking sector but also the transition of estimated disposable amount and track-record of selling prices of real estate property pledges as collateral (which is the majority of collateral pledged in support of loans). Accordingly, it might be possible to forecast the potential impact and discretion of changes of real estate market and risk reduction effect of real estate collateral.</p> <p>Based on the results of these surveys, the JFSA considers the adequateness of provisions and reserve amounts throughout the banking sector.</p> <p>In addition, the review of supervisory files confirmed that the JFSA regularly collects detailed information on risk concentrations across sectors and industries on a quarterly basis. This information helps to inform its views on credit trends and hence their reviews of bank loans classifications, collateral valuations and provisioning practices.</p> <p>The BoJ publishes its Financial Stability Report twice a year, and evaluates financial institutions' macro risk profiles (comprising the size of risks accumulated, the rate of accumulation, and the distribution of risks as well as its skewness within the system), and then assesses the adequacy of their financial resources (bank capital and funding liquidity)</p>

	relative to risks. The October 2016 edition discusses risk concentrations and their macro stress test exercise.
<b>Assessment of Principle 18</b>	LC
Comments	<p>The policies and practices of banks with regard to problem assets have improved considerably since the Japanese banking crisis. Discussions with some private sector officials suggest some issues remain with respect to the provisioning of some SME loans but they have shrunk in importance in recent years. The regular detailed reviews of loan classifications and provisioning practices carried out by the Japanese authorities have undoubtedly contributed to the better performance in this regard. However, the JFSA is encouraged to work with the banks to eliminate the remaining legacy issues to further boost confidence in bank provisioning practices among external stakeholders.</p> <p>By the same token, given the important role that collateral often plays in setting provisioning requirements, the assessors believe that confidence in provisioning practices could also be further enhanced by the JFSA issuing additional guidance on collateral valuations as necessary. While there are no indications of any pressing issues, the assessors believe that it would be helpful if the JFSA proactively stressed the importance of applying prudence in those valuations over and beyond the valuation principles contained in accounting standards.</p> <p>Looking to the future it is clear that a significant amount of work will need to be conducted by banks and the JFSA in coming years to migrate provisioning practices towards to the new expected credit loss framework that is emerging as best practice in international accounting standards and BCBS provisioning guidance for bank supervisors.</p> <p>Looking forward, the JFSA may also want to consider whether there are other ways to continue to obtain satisfaction with respect to loan classifications and provisioning adequacy; for example, by possibly placing more reliance on the reviews carried out by external auditors if satisfaction can be obtained on the scope and prudential rigor of those audits. If so, it might then be possible for some bank supervisory resources to be redirected to more forward-looking analysis of credit trends and emerging risks and the capacity of bank risk management and internal controls to respond to those trends and risks, in accordance with the vision of the JFSA Commissioner to introduce a more dynamic approach to banking supervision.</p>
<b>Principle 19</b>	<b>Concentration risk and large exposure limits.</b> The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate concentrations of risk on a timely basis. Supervisors set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties. <sup>58</sup>
<b>Essential criteria</b>	

<sup>58</sup> Connected counterparties may include natural persons as well as a group of companies related financially or by common ownership, management or any combination thereof.

<b>EC1</b>	Laws, regulations or the supervisor require banks to have policies and processes that provide a comprehensive bank-wide view of significant sources of concentration risk. <sup>59</sup> Exposures arising from off-balance sheet as well as on-balance sheet items and from contingent liabilities are captured.
Description and findings re EC1	<p>Article 13 of the Banking Act sets out the large exposure limitation to a single counterparty.</p> <p>Article 4–4 of the Order for Enforcement of the Banking Act and Article 14 of the Ordinance for Enforcement of the Banking Act provides the definition of credit, which includes on-balance sheet assets such as loans, guarantee on liabilities, capital subscriptions, deposits, and derivative transactions and off-balance sheet assets. Please note that derivative transactions were once excluded from the definition of credit; however, it was added to the definition when the Banking Act and related regulations were amended in 2014. Exposures arising from off-balance sheet as well as on-balance sheet items and from contingent liabilities are captured. 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. The definition or classification of connected counterparties is based on ownership which potentially narrows the application of the LE regime unless there is effective ownership. Also, the JFSA does not have any discretion in applying the definition on a case by case basis.</p> <p>In addition to the revisions to the banking Act that took place in 2014 to tighten the LE regime, the JFSA plans to implement the revised LE guidelines issued by the BCBS. The new LE standards will take effect from 2019 aligned with the BCBS timeline.</p> <p>Positions are calculated on a gross 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 JFSA has to explicitly agree (Article 14–9–2 of Order for Enforcement of the Banking Act). Quarterly, the JFSA 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>While the JFSA has strengthened the LE framework, further work on risk concentrations other than just credit is needed, such as market risk. Particularly for banks with large bond and traded portfolios, managing concentration risk more broadly than just credit is needed.</p>

<sup>59</sup> This includes credit concentrations through exposure to: single counterparties and groups of connected counterparties both direct and indirect (such as through exposure to collateral or to credit protection provided by a single counterparty), counterparties in the same industry, economic sector or geographic region and counterparties whose financial performance is dependent on the same activity or commodity as well as off-balance sheet exposures (including guarantees and other commitments) and also market and other risk concentrations where a bank is overly exposed to particular asset classes, products, collateral, or currencies.

<b>EC2</b>	The supervisor determines that a bank's information systems identify and aggregate on a timely basis, and facilitate active management of, exposures creating risk concentrations and large exposure <sup>60</sup> to single counterparties or groups of connected counterparties.
Description and findings re EC2	<p>Every bank has to quarterly submit the data on the performance of large exposures to JFSA's offsite monitoring system, and accordingly it is required to have information system in place to identify exposures to a single party and a group in a timely manner and aggregate them. Reporting is designed to capture direct credit exposures by counterparty, by currency, by credit grade, geography and by industry segment.</p> <p>During an inspection, examiners will evaluate the adequacy of bank's information system for credit risk management. Since banks have to submit data on large exposures to the JFSA, 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 systems 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 counterparts. However, given its complexity, they do not have systems available that would capture in more detail the group of connected counterparts, other than via direct and well known ownership structures.</p>
<b>EC3</b>	The supervisor determines that a bank's risk management policies and processes establish thresholds for acceptable concentrations of risk, reflecting the bank's risk appetite, risk profile and capital strength, which are understood by, and regularly communicated to, relevant staff. The supervisor also determines that the bank's policies and processes require all material concentrations to be regularly reviewed and reported to the bank's board.
Description and findings re EC3	<p>In accordance with III-2-3-2-2-2 of Supervisory Guideline, the JFSA examines whether the board of directors selects single parties and groups based on reasonable thresholds and continuously monitor the creditworthiness and financial conditions of those single parties and groups.</p> <p>Additionally, in accordance with the Inspection Manual, inspectors examine whether credit management division establishes credit limits and appropriately manages credit risks by addressing credit risk concentration, and whether the division adequately grasps and controls credit risk concentration to each industry type or specific group and periodically reports it to the board of directors.</p> <p>Greater emphasis on the RAS framework as a way to adequately measure and monitor concentration risk in line with risk appetite would help risk management framework to inform board oversight to determine that the bank is operating within its stated strategy (see also CP15).</p>

<sup>60</sup> The measure of credit exposure, in the context of large exposures to single counterparties and groups of connected counterparties, should reflect the maximum possible loss from their failure (i.e. it should encompass actual claims and potential claims as well as contingent liabilities). The risk weighting concept adopted in the Basel capital standards should not be used in measuring credit exposure for this purpose as the relevant risk weights were devised as a measure of credit risk on a basket basis and their use for measuring credit concentrations could significantly underestimate potential losses (see *"Measuring and controlling large credit exposures"*, January 1991).

<b>EC4</b>	The supervisor regularly obtains information that enables concentrations within a bank's portfolio, including sectoral, geographical and currency exposures, to be reviewed.
Description and findings re EC4	<p>Based on Article 24 of the Banking Act, the JFSA requires banks to periodically submit the performance of large exposures. The data is analyzed by the offsite department. More specifically, the JFSA selects banks which should improve the status of credit risk management based on the data including NPL ratios, credit concentration ratios in terms of aggregated large exposures (more than 10 percent of the Tier 1 capital or top 100 large exposures) and industry type and capital adequacy ratios calculated under the scenarios where large exposure risk materializes.</p> <p>The JFSA undertakes regular dialogues with selected banks on the cause and improvement plans, and where necessary, facilitates those banks to implement the plans by requiring them to submit reports on the plans based on Article 24 of Banking Act.</p> <p>Additionally, if the JFSA finds that the situation of bank's credit risk concentration is serious and it necessary to enforce them to address it through a further stronger measure, the JFSA will issue an order for business improvement based on Article 26 of the Banking Act. Bank are required to periodically report on the breakdown of a bank's credit portfolio into its sectoral, geographical and currency exposures. However, the JFSA expects banks to have such breakdowns internally available and might require the bank to provide the relevant information in the context of its onsite inspections.</p>
<b>EC5</b>	In respect of credit exposure to single counterparties or groups of connected counterparties, laws or regulations explicitly define, or the supervisor has the power to define, a "group of connected counterparties" to reflect actual risk exposure. The supervisor may exercise discretion in applying this definition on a case by case basis.
Description and findings re EC5	<p>The concept of "a single group" corresponding to the "group of connected counterparties" in the large exposure regime in Japan is described on Article 4-1 of Order for Enforcement of the Banking Act delegated from Article 13-1 of the Banking Act.</p> <p>A group of counterparties are deemed to be "related counterparty group" if they meet at least one of the following criteria:</p> <ul style="list-style-type: none"> <li>• Quantitative criteria; one of the counterparties owns 50 percent or more of the voting rights of other(s)</li> <li>• Qualitative criteria; one of the counterparties substantially controls or economically depends on other(s). (In such cases, the counterparty is judged to have a close relationship with others such as parent-child relationship or fraternity.)</li> </ul> <p>A bank is required to judge if there is a close relationship described in the above only for the counterparties required to submit consolidated accounting documents such as listed companies and financial institutions, given that it may not be easy for a bank as a third party to make own judgment whether there is such a relationship.</p> <p>The JFSA does not have the power to define a group of connected counterparties to reflect actual risk exposure.</p>

<p><b>EC6</b></p>	<p>Laws, regulations or the supervisor set prudent and appropriate<sup>61</sup> requirements to control and constrain large credit exposures to a single counterparty or a group of connected counterparties. "Exposures" for this purpose include all claims and transactions (including those giving rise to counterparty credit risk exposure), on-balance sheet as well as off-balance sheet. The supervisor determines that senior management monitors these limits and that they are not exceeded on a solo or consolidated basis.</p>
<p>Description and findings re EC6</p>	<p>See also EC1. Article 13–1 of the Banking Act provides below limits:</p> <ul style="list-style-type: none"> <li>➤ "The total amount of credit provided by a bank to one person (including other persons who has a special relationship specified by a Cabinet Order with that person; hereinafter the same shall apply in this Article) shall not exceed the amount obtained by multiplying the amount of the bank's capital by the ratio specified by a Cabinet Order for each category provided therein, (the amount thus calculated shall be referred to as the "Limit of Granting of Credit" in this Article)."</li> <li>➤ Article 4–8 of Order for Enforcement of the Banking Act (the Cabinet Order) provides the limits of credit granting to a single counterparty including related counterparty group, 25 percent of bank's capital. The same regulation is applied on the consolidated basis based on Article 13–2 of the Banking Act.</li> <li>➤ In addition, Article 4–4 of Order for Enforcement of the Banking Act and Article 14 of Ordinance for Enforcement of the Banking Act provide the definition of credit, which includes both on-balance sheet assets such as loans, securities investments and deposits and off-balance sheet items such as guarantees and derivatives transactions.</li> <li>➤ If the exposure to a single party or a single group exceeds the ratio provided by Order for Enforcement of the Banking Act, banks must be approved by the Commissioner of the JFSA in accordance with Article 13–1 of the Banking Act. In this case, the JFSA examines if there is a compelling reason in accordance with Article 4–9 of Order for Enforcement of the Banking Act.</li> <li>➤ The JFSA checks the compliance with the article using the data of JFSA's offsite monitoring data system. Through the system, JFSA semi-annually collects the data on borrowers to which banks have exposures more than 10 percent of bank's capital or top 100 largest borrowers in size and checks continuously the performance of bank's large exposures.</li> <li>➤ In accordance with the Inspection Manual, JFSA examines at inspection if credit limits have been appropriately set by a bank, if concentration of credit risk exposures is adequately controlled and if any concentration in bank's credit portfolio (i.e., concentration of credit risk exposures to each industry type or specific group) is periodically reported to the bank's board of directors.</li> </ul>
<p><b>EC7</b></p>	<p>The supervisor requires banks to include the impact of significant risk concentrations into their stress testing programs for risk management purposes.</p>
<p>Description and findings re EC7</p>	<p>Included in JFSA's proprieties for 2016 is to check the status of the implementation of the management policy for credit concentration and the limitation of credit of regional banks. It also plans to confirm how banks determine a scenario for stress tests as well as if they set a concrete and implementable action plan. There is no explicit reference to inclusion of risk</p>

<sup>61</sup> Such requirements should, at least for internationally active banks, reflect the applicable Basel standards. As of September 2012, a new Basel standard on large exposures is still under consideration.

	concentrations in stress testing programs, however, in relation to the megabanks, a bottom up approach to stress testing is adopted.
<b>Additional criteria</b>	
<b>AC1</b>	<p>In respect of credit exposure to single counterparties or groups of connected counterparties, banks are required to adhere to the following:</p> <ul style="list-style-type: none"> <li>(a) ten percent or more of a bank's capital is defined as a large exposure; and</li> <li>(b) twenty-five percent of a bank's capital is the limit for an individual large exposure to a private sector non-bank counterparty or a group of connected counterparties.</li> </ul> <p>Minor deviations from these limits may be acceptable, especially if explicitly temporary or related to very small or specialized banks.</p>
Description and findings re AC1	<p>III-2-3-2-6 of the Comprehensive Guidelines for Supervision of Major Banks, etc., defines large exposure as more than 10 percent of bank's Tier 1 capital. As stated in answers to EC6, the regulatory ratios in large exposure regime on a single counterparty stipulated in the Banking Act are 25 percent of the regulatory capital.</p> <p>In offsite supervision, through the early warning system using the offsite monitoring data updated on a regularly basis, the JFSA selects banks which should improve the status of credit risk management based on the data including NPL ratios, credit concentration ratios in terms of aggregated large exposures (more than 10 percent of the Tier 1 capital or top 100 large exposures) and industry type and capital adequacy ratios calculated under the scenarios where large exposure risk materializes. Based on the result, the JFSA will conduct sufficient dialogues with selected banks on the cause and their improvement plans. Where necessary, the JFSA will facilitate them to implement the plans by requiring submission of the reports on the plans for improvement based on Article 24 of Banking Act. In case the JFSA finds a further stronger action is necessary for ensuring safety and soundness of a bank, the JFSA will issue an order for business improvement based on Article 26 of the Banking Act.</p> <p>Additionally, the Inspection Manuals (Checklist for credit risk management) require banks 1) to set credit limits (i.e., limits of amount in granting credit and ratios of credit exposures to bank's capital); and 2) to aggregate exposures to single parties for monitoring if they can form a group. The findings at inspection related to the above are mentioned in the section of "credit risk management" in the inspection report and based on those, a grade from A to D will be assigned to the item under the Financial Inspection Rating System. Within a week after the inspection report is delivered to the bank, the JFSA will generally require the bank to submit the report which must include the bank's awareness of the findings, and the actions for addressing them within a month in accordance with Article 24 of the Banking Act. Where the report is submitted, the JFSA will conduct follow-up dialogues with banks in order to ensure the adequacy of the improvement plans and their implementation.</p>
<b>Assessment of Principle 19</b>	LC
Comments	The JFSA has taken a number of steps to strengthen the large exposure regime including

	<p>imposing stricter limits for connected counterparties, which have been reduced from 40 percent of capital to 25 percent. In addition, the JFSA will implement the LE guidelines that have been revised by the BCBS and will take effect from 2019 (aligned with the BCBS timeline). Nonetheless, more attention is needed by the supervisor to encourage appropriate risk management for risk concentrations that encompass both credit exposures in the banking book as well as large counterparty credit risk exposures emanating from trading activities (e.g. counterparty exposures) and other types of risks.</p> <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.</p> <p>Secondly, 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>Thirdly, the definition or classification of connected counterparties is based on ownership which potentially narrows the application of the LE regime unless there is effective ownership. Also, the JFSA does not have any discretion in applying the definition on a case by case basis. 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.</p>
<b>Principle 20</b>	<b>Transactions with related parties.</b> In order to prevent abuses arising in transactions with related parties <sup>62</sup> and to address the risk of conflict of interest, the supervisor requires banks to enter into any transactions with related parties <sup>63</sup> on an arm's length basis; to monitor these transactions; to take appropriate steps to control or mitigate the risks; and to write off exposures to related parties in accordance with standard policies and processes.
<b>Essential criteria</b>	
<b>EC1</b>	Laws or regulations provide, or the supervisor has the power to prescribe, a comprehensive definition of "related parties". This considers the parties identified in the footnote to the

<sup>62</sup> Related parties can include, among other things, the bank's subsidiaries, affiliates, and any party (including their subsidiaries, affiliates and special purpose entities) that the bank exerts control over or that exerts control over the bank, the bank's major shareholders, board members, senior management and key staff, their direct and related interests, and their close family members as well as corresponding persons in affiliated companies.

<sup>63</sup> Related party transactions include on-balance sheet and off-balance sheet credit exposures and claims, as well as, dealings such as service contracts, asset purchases and sales, construction contracts, lease agreements, derivative transactions, borrowings, and write-offs. The term transaction should be interpreted broadly to incorporate not only transactions that are entered into with related parties but also situations in which an unrelated party (with whom a bank has an existing exposure) subsequently becomes a related party.

	Principle. The supervisor may exercise discretion in applying this definition on a case by case basis.
Description and findings re EC1	<p>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. While the definition of related parties is generally broad, it does not capture close family members as well as corresponding persons in affiliated companies. However 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, such as dispatch of directors or senior management which gives the JFSA the ability to apply discretion to go beyond the definition in the Banking Act and classify relationships as related parties (“specified related persons”)—such as key staff and close family members which are not explicitly named in the Banking Act. While there is this discretion, the JFSA to date has not exercised this discretion. The JFSA predominantly relies on banks to use the definition in the Banking Act and other related parties are potentially omitted from reporting.</p> <p>As a result, the definition of related parties may not be sufficiently broad. In practice, the JFSA will place reliance on banks to conduct due diligence at the time of account origination to collect necessary details to identify related parties.</p>
<b>EC2</b>	Laws, regulations or the supervisor require that transactions with related parties are not undertaken on more favorable terms (e.g., in credit assessment, tenor, interest rates, fees, amortization schedules, requirement for collateral) than corresponding transactions with non-related counterparties. <sup>64</sup>
Description and findings re EC2	Article 13–2 of the Banking Act clearly prohibits a bank from conducting any transactions with specified related persons with preferential terms where a bank may suffer unreasonable losses 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.
<b>EC3</b>	The supervisor requires that transactions with related parties and the write-off of related-party exposures exceeding specified amounts or otherwise posing special risks are subject to prior approval by the bank’s board. The supervisor requires that board members with conflicts of interest are excluded from the approval process of granting and managing related party transactions.
Description and findings re EC3	<p>Based on V–2 of Supervisory Guideline, banks are required to check if they do not violate the “arm-length rule” stipulated in the Banking Act for example, when outsourcing part of their businesses or conducting other transactions with entities of the banking group.</p> <p>With regard to decision made by the bank’s board on granting of credit to directors, Article 369 of the Companies Act (equivalent to Business Law in Japan) provides that a</p>

<sup>64</sup> An exception may be appropriate for beneficial terms that are part of overall remuneration packages (e.g., staff receiving credit at favorable rates).

	<p>director who has any interests may not participate in the decision, and the proportion necessary for granting credits to “specified related person” is at least two-thirds of the board members as stated in Article 14 of the Banking Act. This is higher than the proportion required in the Companies Act.</p> <p>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. This 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. However, loans at “arms-length” terms are permitted.</p> <p>There is no requirement relating to write-offs of exposures to “specified related person” and (ii) there is no requirement for prior board approval of exposures to related parties.</p>
<b>EC4</b>	The supervisor determines that banks have policies and processes to prevent persons benefiting from the transaction and/or persons related to such a person from being part of the process of granting and managing the transaction.
Description and findings re EC4	<p>There are no specific requirements prescribed by the JFSA (or contained in related regulations) that cover the granting and managing of related party transactions. There are requirements in relation to other aspects of related party exposures as discussed above and more generally in relation to credit risk management (see CP 17).</p> <p>The related requirements include the arms-length rule where banks are required to check that they do not violate the “arm-length rule” stipulated in the Banking Act. In addition, 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 JFSA undertakes surprise visits based upon specific concerns identified, for instance coming from whistle blowing.</p> <p>V-5 of Supervisory Guideline titled as “establishment of the business management system for protecting the customers’ interest” requires banks to identify transactions which may cause conflict of interest, and take necessary measures for avoid it. Based on the Inspection Manual, the JFSA will examine at inspection banks’ business management system for avoiding conflict of interest in order to protect the customers’ interest from being unduly damaged by bank’s operation or transactions with the “specified related persons.”</p>
<b>EC5</b>	Laws or regulations set, or the supervisor has the power to set on a general or case by case basis, limits for exposures to related parties, to deduct such exposures from capital when assessing capital adequacy, or to require collateralization of such exposures. When limits

	are set on aggregate exposures to related parties, those are at least as strict as those for single counterparties or groups of connected counterparties.
Description and findings re EC5	<p>The JFSA does not have the full range of powers specified in this EC, mainly in relation to deducting exposures from capital when assessing capital adequacy. In relation to limits, the large exposure framework is applied to related party exposures which limits exposures to 25 percent of capital. Furthermore, paragraph 6, Article 4 of the Order for Enforcement of the Banking Act imposes a stricter limit on banks for exposures to major shareholders of 15 percent.</p> <p>The JFSA sets no requirement for deduction from capital or securing collateral regarding exposures to "specified related person." The JFSA examines both in onsite and offsite supervision whether a bank has developed its own internal rules on large exposures. The JFSA also examines the adequacy of the rule and bank's compliance with it. 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.</p>
<b>EC6</b>	The supervisor determines that banks have policies and processes to identify individual exposures to and transactions with related parties as well as the total amount of exposures, and to monitor and report on them through an independent credit review or audit process. The supervisor determines that exceptions to policies, processes and limits are reported to the appropriate level of the bank's senior management and, if necessary, to the board, for timely action. The supervisor also determines that senior management monitors related party transactions on an ongoing basis, and that the board also provides oversight of these transactions.
Description and findings re EC6	<p>Although the JFSA 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 are classified as large exposures. However, given its principles-based approach, the JFSA 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.</p> <p>Based on Supervisory Guideline, the JFSA will check whether banks have established appropriate credit evaluation and management systems, which provides some comfort for the way exposures to related parties are treated. The JFSA quarterly collects the data on large exposure (more than 10 percent of bank's Tier 1 capital or top 100 parties in size of credit exposures) including those to "specified related person" and monitor bank's major transactions with "specified related persons." It will also examine whether the board of directors accurately grasps the performance of large exposure borrowers and whether the board actively engages in management of credit risk exposures including those to "specified related persons."</p>
<b>EC7</b>	The supervisor obtains and reviews information on aggregate exposures to related parties.
Description and findings re EC7	The JFSA quarterly collects the data on large exposure (more than 10 percent of bank's Tier 1 capital or top 100 parties in size of credit exposures) including those to "specified related persons" and monitor bank's major transactions with "specified related persons" in offsite supervision. Based on the Inspection Manuals (Checklists for "Credit Risk

	<p>Management”), the JFSA examines at inspection whether a bank monitors borrowers including their “specified related persons” where bank’s exposures to them are so large that may significantly affect the bank’s financial condition in case of their default. 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> <p>However, there is no dedicated related party reporting framework, so the aggregation of related party exposures is not included in the routine reporting by banks which makes identification more difficult for supervisors.</p>
<p><b>Assessment of Principle 20</b></p>	<p>MNC</p>
<p>Comments</p>	<p>A stronger principles-based approach to related party exposures is required to prevent risks from building up. ‘Exposures to related parties’ are required to be conducted at “arms” length terms. These exposures by their nature deserve enhanced risk management over and beyond standard credit underwriting processes. However, specific limits have not been set by either banks or the JFSA beyond those that already exist in the context of the large exposure rules. While the JFSA takes them into account in its periodic compliance inspections, its supervision of these activities would benefit from more specific periodic reporting requirements and more proactive investigations that are less reliant on signals received from internal audit.</p> <p>The JFSA has adopted a principles-based approach to related party exposures and while there are various obligations and requirements, in several areas the framework falls short of the expectations in this principle.</p> <p>First, in relation to policies and processes; there are no specific requirements prescribed by the JFSA (or contained in related regulations) that cover the granting and managing of related party transactions. There are requirements in relation to other aspects of related party exposures as discussed above, and more generally in relation to credit risk management. Next, the JFSA does not have the full range of powers specified in this EC, mainly in relation to deducting exposures from capital when assessing capital adequacy under Pillar 2. Lastly, there is no dedicated related party reporting framework, so the aggregation of related party exposures is not included in the routine reporting by banks which makes identification more difficult for supervisors.</p> <p>The law has some 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 JFSA to set specific limits, nor has the JFSA set specific limits itself, besides limits that already exist in the context of JFSA’s large exposure rules. On the enforcement of these provisions, the JFSA would take them into account in the context of its periodic compliance inspections. The JFSA could further strengthen its supervisory activities with regard to this provision, especially via more specific periodic reporting requirements. In addition, some extra assessment criteria could be presented as part of the inspection manual, focusing the inspections ex ante on the exposures to related parties, which now are more based on signals received (for instance from whistle blowing).</p>

<b>Principle 21</b>	<b>Country and transfer risks.</b> The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate country risk <sup>65</sup> and transfer risk <sup>66</sup> in their international lending and investment activities on a timely basis.
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor determines that a bank's policies and processes give due regard to the identification, measurement, evaluation, monitoring, reporting and control or mitigation of country risk and transfer risk. The supervisor also determines that the processes are consistent with the risk profile, systemic importance and risk appetite of the bank, take into account market and macroeconomic conditions and provide a comprehensive bank-wide view of country and transfer risk exposure. Exposures (including, where relevant, intra-group exposures) are identified, monitored and managed on a regional and an individual country basis (in addition to the end-borrower/end-counterparty basis). Banks are required to monitor and evaluate developments in country risk and in transfer risk and apply appropriate countermeasures.
Description and findings re EC1	<p>Country risk is important for Japanese banks because of the megabank's strategies to focus on intensifying their operations abroad, especially in Asia. JFSA's supervisory guidelines (III-2-3-2-4-2) require banks to establish adequate processes to identify monitor and manage country risks. While 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 are assessed by the JFSA inspectors during their onsite inspections. BoJ's onsite examinations would also focus on effective management of overseas credit exposure.</p> <p>Supervisory guideline identifies and defines the following items as part of the onsite inspection:</p> <ul style="list-style-type: none"> <li>✓ whether the board of directors or equivalent bodies understands the importance of country risk, and have established processes to identify accurately risk exposures, and have established a regular monitoring system;</li> <li>✓ whether the board of directors or equivalent bodies have formulated processes for an accurate monitoring system and an adequate response system in order to control country risk exposures, such as establishing internal rules to make adequate changes for global exposures; and</li> <li>✓ whether a bank has constructed processes for quick and flexible responses when the bank finds changing international circumstances (in controlling country risk exposures).</li> </ul>

<sup>65</sup> Country risk is the risk of exposure to loss caused by events in a foreign country. The concept is broader than sovereign risk as all forms of lending or investment activity whether to/with individuals, corporate, banks or governments are covered.

<sup>66</sup> Transfer risk is the risk that a borrower will not be able to convert local currency into foreign exchange and so will be unable to make debt service payments in foreign currency. The risk normally arises from exchange restrictions imposed by the government in the borrower's country. (Reference document: *IMF paper on External Debt Statistics—Guide for compilers and users*, 2003.)

	<p>Having in mind the major banks are expanding their overseas businesses, Strategic Directions and Priorities for this operation year has set the followings as priority measures;</p> <ul style="list-style-type: none"> <li>✓ It is important to improve their group-base business- and risk- management system including their overseas activities.</li> <li>✓ The banks should develop appropriate risk management system as well as increase resilience to the volatility of the market and economy by enhancing their capital in order to ensure their sound management and fully exercise their financial intermediary function even in stressed period.</li> <li>✓ It is important to strengthen the group-wide efforts to prevent abuse of dominant power through lending activities and to avoid conflict of interest among the group companies as the business alignment with group companies progresses.</li> </ul> <p>In addition, the Inspection Manual requires inspectors during onsite inspection to confirm whether a bank has classified loans to foreign governments and PSEs appropriately through analysing financial conditions, economic conditions, and foreign currency cash flow of the governments and by considering riskiness of loan recovery.</p> <p>Inspection manual also indicates that inspectors should confirm, in addition to normal loan assessment similar to domestic loans, whether a bank has reviewed loans to private sector entities incorporate in or loans to affiliate Japanese companies active in the jurisdiction the government of which a bank has classified as ‘risky” in NPL categories.</p> <p>For example, in the case that the sovereign rating of Saudi Arabia had been downgraded due to the recent stagnant oil price, the JFSA investigated through onsite and offsite monitoring, how the banks changed their policies and processes of country risk- and transfer risk- management by incorporating market and macroeconomics such as downgrade of major oil producing countries. FSA also inspects whether the processes are consistent with their risk profile, systemic importance and risk appetite.</p>
<b>EC2</b>	<p>The supervisor determines that banks’ strategies, policies and processes for the management of country and transfer risks have been approved by the banks’ boards and that the boards oversee management in a way that ensures that these policies and processes are implemented effectively and fully integrated into the banks’ overall risk management process.</p>
Description and findings re EC2	<p>See also EC1. The JFSA uses a variety of supervisory activities including: offsite monitoring, interviews with senior management and onsite inspections. Banks are required to report exposures by country and by currency. Banks with international operations also submit to the JFSA credit risk policies and risk appetite statements which allow the JFSA to evaluate risk settings and risk tolerances. As part of the onsite inspection, the JFSA will assess whether the board of directors recognize the importance of country risk management, and establish a system to continually monitor and assess the situation accurately. Through this process, the JFSA verifies whether the board has approved and implemented strategies, policies, and processes of country risk- transfer risk- management.</p>
<b>EC3</b>	<p>The supervisor determines that banks have information systems, risk management systems and internal control systems that accurately aggregate, monitor and report country exposures on a timely basis; and ensure adherence to established country exposure limits.</p>

Description and findings re EC3	<p>See also EC1 and EC2. The Inspection manual (checklists for inspection of credit risk management) requires inspectors to confirm whether:</p> <ul style="list-style-type: none"> <li>- a bank has established a credit risk management system comparable to the bank's size/characteristics and risk profile;</li> <li>- a bank has established an adequate credit risk limit control by credit risk management department; and</li> <li>- the credit risk management department have adequately trash out their methods of specification, evaluation, and measurement. Country risk is considered as part of credit risk in this context.</li> </ul>
<b>EC4</b>	<p>There is supervisory oversight of the setting of appropriate provisions against country risk and transfer risk. There are different international practices that are all acceptable as long as they lead to risk-based results. These include:</p> <ul style="list-style-type: none"> <li>(a) The supervisor (or some other official authority) decides on appropriate minimum provisioning by regularly setting fixed percentages for exposures to each country taking into account prevailing conditions. The supervisor reviews minimum provisioning levels where appropriate.</li> <li>(b) The supervisor (or some other official authority) regularly sets percentage ranges for each country, taking into account prevailing conditions and the banks may decide, within these ranges, which provisioning to apply for the individual exposures. The supervisor reviews percentage ranges for provisioning purposes where appropriate.</li> <li>(c) The bank itself (or some other body such as the national bankers' association) sets percentages or guidelines or even decides for each individual loan on the appropriate provisioning. The adequacy of the provisioning will then be judged by the external auditor and/or by the supervisor.</li> </ul>
Description and findings re EC4	<p>Inspection Manual requires inspectors to examine whether a bank adequately secures "Provisions for Loans to Specific Countries"; for example, inspectors will examine classification of countries, classification of loans and measurement of expected losses. The JFSA has not provided any explicit limitations on exposures to each country, though the JFSA inspectors examine the appropriateness of asset evaluation and provisioning to each country. Then, the JFSA inspectors point out problem areas for improvement such as insufficient provisioning. In cases where a bank does not correct identified problems in spite of our recommendation, the JFSA will consider (a) taking administrative actions or issuing reporting orders based on Article 24 of the Banking Act or if the JFSA finds it necessary to have stronger action against a bank; and (b) issuing business improvement orders based on Article 26 of the Banking Act.</p> <p>The JFSA 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 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 JFSA 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 JFSA 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</p>

	<p>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 JFSA requires banks to report issues identified by external auditors. In addition, the JFSA 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>
<b>EC5</b>	<p>The supervisor requires banks to include appropriate scenarios into their stress testing programs to reflect country and transfer risk analysis for risk management purposes.</p>
Description and findings re EC5	<p>JFSA's strategic priorities highlight the importance of monitoring the credit cycle to manage the bank with sufficient care to the possibility of large environment changes in the future. For example, the JFSA checks whether the global active banks are adequately assessing the credit contagion channels and scenarios, the impact to the economy, financial and capital markets, and the soundness of themselves when potential risk materialized.</p> <p>The JFSA also checks whether the banks adequately evaluate various risks, including country risks and transfer risks, during the normal environment and secure sufficient capital and liquidity so that they can maintain their soundness and provide enough financial intermediary function in the stressed time, whether the managements of the banks are actively reviewing the management policies and risk management policies with forward looking attitude, and have built up a functional crisis management system. For example, learned from the downgrade of Saudi Arabia due to the recent stagnant oil price, the JFSA requires banks to included scenarios of country risk, such as downgrade of major countries, and transfer risk due to overseas law changes in their stress test.</p>
<b>EC6</b>	<p>The supervisor regularly obtains and reviews sufficient information on a timely basis on the country risk and transfer risk of banks. The supervisor also has the power to obtain additional information, as needed (e.g., in crisis situations).</p>
Description and findings re EC6	<p>On a quarterly basis, banks are required to submit information on country credit exposures to the JFSA as part of their regular prudential returns submissions. The JFSA 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 JFSA 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> <p>The JFSA regularly receives data from banks on credit amounts to each country every quarter via Offsite Monitoring Data System. The JFSA also obtains more detailed data and risk information on exposures to a country where necessary. For understanding country risks in a timely manner after the recent sovereign crisis, the JFSA requires each bank to submit data on their exposures to each country which must be categorized into a sovereign, financial institutions and non-financial institutions.</p>
<b>Assessment of Principle 21</b>	C
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</p>

	expand overseas, particularly to Asia. The JFSA has been monitoring this closely with additional regular prudential returns submissions on country exposures.
<b>Principle 22</b>	<b>Market risk.</b> The supervisor determines that banks have an adequate market risk management process that takes into account their risk appetite, risk profile, and market and macroeconomic conditions and the risk of a significant deterioration in market liquidity. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate market risks on a timely basis.
<b>Essential criteria</b>	
<b>EC1</b>	Laws, regulations or the supervisor require banks to have appropriate market risk management processes that provide a comprehensive bank-wide view of market risk exposure. The supervisor determines that these processes are consistent with the risk appetite, risk profile, systemic importance and capital strength of the bank; take into account market and macroeconomic conditions and the risk of a significant deterioration in market liquidity; and clearly articulate the roles and responsibilities for identification, measuring, monitoring and control of market risk.
Description and findings re EC1	<p>JFSA'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 JFSA are provided in JFSA's Supervisory Guidelines. During onsite inspections, the JFSA 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 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 bonds (mainly JGBs), foreign exchange (FX,) and interest rate trading. For the top five banks market risk RWAs is approximately 3–5 percent range and for all other banks generally less than 3 percent. The two main trading banks Nomura and Daiwa, market risk consumes approximately 30 percent and 25 percent respectively. The JFSA has more than 30 onsite inspectors (most with more than 10 years of 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 are deployed for onsite inspections of market risk areas, particularly for the mega banks which are more active in trading activities.</p> <p>The Supervisory Guideline requires that:</p> <ol style="list-style-type: none"> <li>(1) board of directors is responsible for establishing the adequate market risk management policy,</li> <li>(2) internal rules on market risk should clearly define the roles and responsibilities of "front office (market division)," "middle office (risk management division)" and "back office (administrative division)"; and</li> <li>(3) board of directors or equivalent organization has to assess the effectiveness of policy development process on a regular basis and, as necessary, to update its process based on the reports concerning the market risk management activities.</li> </ol> <p>During the inspection, JFSA's inspectors will confirm the adequacy of market risk management in accordance with Inspection Manual. For example, the Britain's referendum</p>

	<p>vote to leave the EU (Brexit) caused a big turmoil in financial markets (foreign exchange, equities, etc.). The JFSA is monitoring, through both on-sight inspection and off-sight monitoring, whether bank’s market risk measurements adequately capture such an extreme market, macro-economic or market liquidity deterioration. In addition, the JFSA determines that the processes are consistent with risk appetite, risk profile, systemic importance and capital strength of the bank.</p> <p>As stipulated in the “Onsite Examination Policy for Fiscal 2016,” the BoJ examines the market risk management frameworks of financial institutions and checks whether financial institutions conduct risk management compatible with investment strategies and methods depending on the risk profile. Specifically, the BoJ examines the following: (1) whether financial institutions appropriately identify and analyze risks, by looking at risk factors involved in their securities and portfolios as a whole, including the risks of individual financial products and transactions such as their credit risk, foreign exchange risk, and stock price risk, in addition to interest rate risk; (2) whether risk management division properly monitors the market prices of securities, the amount of risk associated with securities holdings, and observance of various limits in accordance with the risk characteristics and investment methods; (3) whether the adequacy and limitations of the risk measuring methods are examined regularly through, for example, the conduct of back testing, and necessary measures are taken. In doing so, the BoJ also examines as necessary; and (4) whether frameworks of risk management function effectively in each phase of the stress scenarios.</p>
<b>EC2</b>	<p>The supervisor determines that bank’s strategies, policies and processes for the management of market risk have been approved by the banks’ boards and that the boards oversee management in a way that ensures that these policies and processes are implemented effectively and fully integrated into the banks’ overall risk management process.</p>
Description and findings re EC2	<p>See also EC1. The Supervisory Guidelines contain a number of criteria that assess whether board’s have been sufficiently involved in setting the bank’s market risk strategies, policies and processes. Specifically, the Supervisory Guidelines III–2–3–3–2(2) expect the following in relation to market risk governance and risk management:</p> <ul style="list-style-type: none"> <li>✓ Whether the board of directors has formulated the market risk management policy based on the strategic goals in line with the bank’s overall business policy: whether the board of directors has put in place an appropriate market risk management system in accordance with the bank’s strategic goals and risk management policy and in line with its profit targets.</li> <li>✓ Whether the bank’s market risk management rules have clearly designated the managers of “front office (market division),” “middle office (risk management division)” and “back office (administrative division).”</li> </ul> <p>Assessors saw examples where the board approves policy at least annually the trading strategy and risk management standards. The board sets VaR and other portfolio limits in RAS. boards review results of stress testing and compliance with limits are routinely reported to the board via risk reporting.</p> <p>JFSA’s Supervisory Guidelines details the requirement for banks in establishing market risk exposure limits commensurate with the size and scope of their businesses. Management</p>

	oversight is part of the requirement and these are assessed by the JFSA 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 JFSA 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.
<b>EC3</b>	The supervisor determines that the bank's policies and processes establish an appropriate and properly controlled market risk environment including: <ul style="list-style-type: none"> <li>(a) effective information systems for accurate and timely identification, aggregation, monitoring and reporting of market risk exposure to the bank's board and senior management;</li> <li>(b) appropriate market risk limits consistent with the bank's risk appetite, risk profile and capital strength, and with the management's ability to manage market risk and which are understood by, and regularly communicated to, relevant staff;</li> <li>(c) exception tracking and reporting processes that ensure prompt action at the appropriate level of the bank's senior management or board, where necessary;</li> <li>(d) effective controls around the use of models to identify and measure market risk, and set limits; and</li> <li>(e) sound policies and processes for allocation of exposures to the trading book.</li> </ul>
Description and findings re EC3	<p>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 and limit breaches are reported through senior management. During the onsite inspection, the JFSA verifies that a bank has put in place a system for collecting and analyzing a wide range of information that could affect the prices of its assets, including economic trends at home and abroad, and for reporting material information to the management team in a timely manner so that the management team can decide policies for business operations and risk management properly and promptly.</p> <p>Included in this work is an assessment of whether the risk management division not only allocates risk capital or establishes limits (e.g., loss cut points, warning points) to each business in an automatic manner, but also collects and analyzes various pieces of information that could contribute to risk management and makes independent efforts to capture risks, thereby utilizing the relevant information for daily risk management operations. An important aspect of this work is to verify that the bank has clearly established a system to report to the manager in cases where the position, risk or loss exceeds or is likely to exceed the relevant limits, as well as the manager's authority (including the policy and procedure).</p> <p>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 JFSA examiners during onsite inspections. (See Supervisory Guideline III-2-3-3-2(1) and (2)).</p>
<b>EC4</b>	The supervisor determines that there are systems and controls to ensure that banks marked-to-market positions are revalued frequently. The supervisor also determines that all transactions are captured on a timely basis and that the valuation process uses consistent

	and prudent practices, and reliable market data verified by a function independent of the relevant risk-taking business units (or, in the absence of market prices, internal or industry-accepted models). To the extent that the bank relies on modeling for the purposes of valuation, the bank is required to ensure that the model is validated by a function independent of the relevant risk-taking businesses units. The supervisor requires banks to establish and maintain policies and processes for considering valuation adjustments for positions that otherwise cannot be prudently valued, including concentrated, less liquid, and stale positions.
Description and findings re EC4	<p>Regarding systems, Inspection Manual (“Checklist for Market Risk Management”) requires the bank to maintain a system that enables it to value its position on real-time or at least on a daily basis, and JFSA’s inspectors will review the bank properly values its position on a continuous basis during the inspection. As for the valuation methodologies, Inspection Manual requires the bank to establish and maintain internal procedures for ensuring independence of valuation functions and objectivity of valuation.</p> <p>In cases where the bank calculates theoretical price based on its pricing model, JFSA’s inspectors assess whether the bank makes appropriate valuation adjustments to reflect the illiquidity or structural vulnerability of the position, etc. In relation to the boundary between banking and trading book assets, there is a strict prohibition of transfer of assets between the two books in either direction, in accordance with paragraph (3) of Article 13–6–8 of the Ordinance for Enforcement of the Banking Act. The inspection manual directs supervisors to confirm.</p> <p>As described in Inspection Manual (“Checklist for Market Risk Management”), the board of directors is requested to establish organizational structure which secure independence of market risk management division from market division or sales promotion division, and to enhance their governance function. During the inspection, JFSA’s inspectors confirms whether the market risk management division can ensure accuracy and completeness of position data, and can perform independent model validation. During the inspection, JFSA’s inspectors will also confirm whether internal audit division has performed audit including the above-mentioned points. The JFSA places emphasis on assessing the effectiveness and independence of the risk management functions within banks either via interviews or during onsite inspections.</p>
<b>EC5</b>	The supervisor determines that banks hold appropriate levels of capital against unexpected losses and make appropriate valuation adjustments for uncertainties in determining the fair value of assets and liabilities.
Description and findings re EC5	According to Supervisory Guideline (III–2–3–3–1), the bank is required to develop an internal risk management system associated with market risk regardless of whether the loss arising from market movement directly impact regulatory capital, and to make efforts properly to ensure the soundness of its financials. When the bank values its positions based on pricing model, valuation adjustments should be made as appropriate, for example, to reflect illiquidity of its position or to cover the uncertainty of the model valuation, etc. (III–2–3–3–2).
<b>EC6</b>	The supervisor requires banks to include market risk exposure into their stress testing programs for risk management purposes.
Description and findings re EC6	The JFSA 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

	<p>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 JFSA examiners during their onsite inspections. During onsite inspections, the JFSA inspectors would replicate the bank's value-at-risk (VaR) models and carry out their own stress tests on banks based on JFSA'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 Strategic Directions and Priorities 2016–17, the JFSA further focuses on verification of stress-testing by banks taking into account the current market turmoil.</p> <p>As described in the Strategic Directions and Priorities, the management of the financial institutions is required to pay attention to the "credit cycle," namely, it is important for senior management to develop an awareness of future significant environmental changes in economy and market. From this perspective, the JFSA will deepen the discussion with financial institutions so that the JFSA can ensure the soundness and sustainability of the financial institutions to fully continue their financial intermediary business even in times of economic and market stress. More specifically, for example globally active financial institutions are required to evaluate the impact on the overall financial markets and transmission mechanism to the actual economy in cases where potential risks arise, as well as the impact on the soundness of the individual firms.</p> <p>Furthermore, the financial institution is required to properly evaluate various risks, including market risk, and maintain adequate amount of capital and liquidity during normal times so as to fully continue its financial intermediary business even in times of economic and market stress. Also, the financial institution is required to formulate and revise forward-looking management policy or risk management policy with the involvement of the management team, and to put in place an appropriate crisis management system.</p>
<b>Assessment of Principle 22</b>	C
Comments	<p>The city banks, including the three megabanks, and the two major trading banks are the more active participants in trading activities. Instruments traded in the main asset classes typically include JGBs, IRS, and currencies. The JFSA has market risk specialists, 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. Most focus and expertise is directed toward the mega banks' and the trading banks' market risk management. There was general compliance with this Principle.</p>
<b>Principle 23</b>	<p><b>Interest rate risk in the banking book.</b> The supervisor determines that banks have adequate systems to identify, measure, evaluate, monitor, report and control or mitigate interest rate risk<sup>67</sup> in the banking book on a timely basis. These systems take into account the bank's risk appetite, risk profile and market and macroeconomic conditions.</p>

<sup>67</sup> Wherever "interest rate risk" is used in this principle the term refers to interest rate risk in the banking book. Interest rate risk in the trading book is covered under Principle 22.

<b>Essential criteria</b>	
<b>EC1</b>	<p>Laws, regulations or the supervisor require banks to have an appropriate interest rate risk strategy and interest rate risk management framework that provides a comprehensive bank-wide view of interest rate risk. This includes policies and processes to identify, measure, evaluate, monitor, report and control or mitigate material sources of interest rate risk. The supervisor determines that the bank’s strategy, policies and processes are consistent with the risk appetite, risk profile and systemic importance of the bank, take into account market and macroeconomic conditions, and are regularly reviewed and appropriately adjusted, where necessary, with the bank’s changing risk profile and market developments.</p>
Description and findings re EC1	<p>Interest rate risks are an integral part of market risk management framework required by banks under JFSA’s Supervisory Guidelines. These would include, inter alia, 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 are the JGB holdings which are substantial. 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>Regarding interest rate risks in the banking book, the JFSA requires banks to submit the relevant data to the offsite monitoring data system of the JFSA on a monthly basis. By using the data, the JFSA will identify banks which are categorized in “outliers” and then will engage in intensive dialogues with those banks regarding the cause for the banks’ assuming relatively higher interest rate risks among banks and the remedial actions taken by those banks.</p> <p>When necessary for further encouraging banks to address the risk, the JFSA will issue a reporting order in accordance with Article 24 of the Banking Act. In case the JFSA finds it necessary for enforcing banks to properly implement the business improvement plan in order to mitigate the interest rate risks in the banking book, in accordance with Article 26 of Banking Act, the JFSA shall issue a business improvement order for the banks.</p> <p>“Outliers” are defined in Supervisory Guideline 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 the case either of (i) parallel yield curve shift by 200 basis points; or (ii) one or 99 percent tile event happening to one-year holding assets measured during the observation period of at least five years.</p> <p>Onsite inspections by the JFSA 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 JFSA 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 JFSA examiners during their onsite inspections. In its onsite examinations, the BoJ would also assess the</p>

	<p>appropriateness of management oversight over the interest rate risk management of its counterparties, including oversight over stress testing processes.</p> <p>The Supervisory Guideline and Inspection Manual (checklists for market risk management), the JFSA will check the followings in its supervision (III-2-3-3-2):</p> <ul style="list-style-type: none"> <li>✓ whether the bank's board has developed a market risk management policy in line with strategic goals in its business management plans of the group. The board has also developed appropriate market risk management system, in line with its strategic goal, risk management policies, profit target, etc.;</li> <li>✓ whether the board has actively and quickly determined a policy for business and risk management from a wide perspective; and</li> <li>✓ whether a bank has established a reporting system where material information is reported promptly to bank's management in order for the management to determine an appropriate policy in business and risk management in a timely manner by collecting and analysing a wide range of information including internal and external economic trends which will affects the prices of bank's holding assets.</li> </ul> <p>At inspection, the JFSA will also check the efficacy of the process for implementing those above. Findings at inspection are reflected in the item of the status of bank's market risk management in the inspection report and a grade assigned to the item. The JFSA is beginning the transition to new guidelines for IRRBB which will closely align with the BCBS revisions. The timeline for implementation is 2018.</p>
<b>EC2</b>	<p>The supervisor determines that a bank's strategy, policies and processes for the management of interest rate risk have been approved, and are regularly reviewed, by the bank's board. The supervisor also determines that senior management ensures that the strategy, policies and processes are developed and implemented effectively.</p>
Description and findings re EC2	<p>Regarding interest rate risks in the banking book, based on III-2-3-3-2 of Supervisory Guideline and Inspection Manual (checklists for market risk management), the JFSA will check the followings in its supervision:</p> <ul style="list-style-type: none"> <li>✓ whether the bank's board has developed a market risk management policy in line with strategic goals in its business management plans of the group. The board has also developed appropriate market risk management system, in line with its strategic goal, risk management policies, profit target, etc.;</li> <li>✓ whether the board has actively and quickly determined a policy for business and risk management from a wide perspective; and</li> <li>✓ whether a bank has established a reporting system where material information is reported promptly to bank's management in order for the management to determine an appropriate policy in business and risk management in a timely manner by collecting and analysing a wide range of information including internal and external economic trends which will affects the prices of bank's holding assets.</li> </ul> <p>At inspection, the JFSA will also check the efficacy of the process for implementing those above.</p>
<b>EC3</b>	<p>The supervisor determines that banks' policies and processes establish an appropriate and properly controlled interest rate risk environment including:</p> <p>(a) comprehensive and appropriate interest rate risk measurement systems;</p>

	<p>(b) regular review, and independent (internal or external) validation, of any models used by the functions tasked with managing interest rate risk (including review of key model assumptions);</p> <p>(c) appropriate limits, approved by the banks' boards and senior management, that reflect the banks' risk appetite, risk profile and capital strength, and are understood by, and regularly communicated to, relevant staff;</p> <p>(d) effective exception tracking and reporting processes which ensure prompt action at the appropriate level of the banks' senior management or boards where necessary; and</p> <p>(e) effective information systems for accurate and timely identification, aggregation, monitoring and reporting of interest rate risk exposure to the banks' boards and senior management.</p>
<p>Description and findings re EC3</p>	<p>(See also EC1). The JFSA will check the followings based on III-2-3-3-2 of the Supervisory Guideline.</p> <ul style="list-style-type: none"> <li>✓ whether a bank does research regularly to upgrade and sophisticate the bank's internal models concerning market risks;</li> <li>✓ whether a bank has enhanced its market risk management method including stress tests, and reviewed the assumptions in management risks by taking into account the economic trend;</li> <li>✓ whether a bank's board has developed a basic policy in setting position limits applied to individual staff, section and branch, etc. (i.e., those on the notional amount and interest rate sensitivity), risk limits (i.e., those on unexpected losses such as VaR), limits on loss and assumptions in stress tests; and</li> <li>✓ whether the board on a regular basis (at least once in each period) reviews the setting above reflecting business operation in individual position.</li> </ul> <p>Inspection Manual requires banks to adopt, manage and update the risk measuring system that reflects all material market risks including interest rate risk with appropriate involvement of the board. Additionally, in setting the limits, banks are required to reflect their risk-taking strategies and the status of capital and profitability, and to notify it to the relevant staff in an appropriate manner whenever changing the limits. Furthermore, banks should develop delegation structures where the status of risk management is reported to the board on a regular basis or as necessary.</p>
<p><b>EC4</b></p>	<p>The supervisor requires banks to include appropriate scenarios into their stress testing programs to measure their vulnerability to loss under adverse interest rate movements.</p>
<p>Description and findings re EC4</p>	<p>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 JFSA requires banks to submit on a monthly basis to JFSA's offsite monitoring data system, as well as relevant data regarding interest rates in banking books. From the submitted data, the JFSA identifies banks classified as "outliers." "Outliers" are defined in the JFSA' 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</p>

banking book). Follow-up dialogue with outlier banks for appropriate remedial actions is then taken by the JFSA. Generally, it is JFSA'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. The JFSA 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 offsite review. Monthly data obtained from banks include securities exposures and sensitivities. Please refer to the discussion under EC3 for more details.

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.

The JFSA will check the followings based on III-2-3-2(2) of Supervisory Guideline:

- ✓ whether not only historical data but also assumed stress scenario are used for analysis;
  - ✓ whether assumed stress scenario appropriately reflects the situation where assets are severely affected due to the international and domestic economic developments, and whether several assumed stress scenarios are used; and
  - ✓ whether situation where assumed correlation of assets price is impaired.
- Inspection Manual (checklists for market-related risk management system) requires banks to conduct stress tests by assuming either worst-case scenarios or the situation where some of the assumptions made in the risk measurement methods have collapsed in stress testing. The Manual also requires bank's board to take into account the results of stress tests in developing a market risk management policy and this will be confirmed at inspection.
  - FSA operates the Early Warning System which allows it to continuously conduct offsite monitoring. FSA monitors banks which are still satisfying the minimum capital adequacy requirement so that various risks would not negatively impact on banking soundness, and supervisory measures may be taken against them.
  - This monitoring is conducted in the way described below (Supervisory Guidance III-2-2-3(3)).

The FSA calculates various indicators on profitability, credit risks, market risks, liquidity risks based on monitoring data periodically collected from each bank (For example, the amount of IRRBB as agreed in Basel Committee in 2004).

The JFSA understands these risks base on the indicators mentioned above, and selects banks with risks exceeding a certain threshold (for example, 20 percent of own capitals for IRRBB) or banks which are deemed to have high risks. The JFSA closely monitors banks in accordance with such risk profile. The JFSA has dialogues with banks subject to close monitoring in order to highlight the causes of high risks and possible remedial measures, and, as necessary, encourages them to implement these measures. These measures include

	<p>improvement of risk management system, reduction of risks and review of capital plans, in light of identified problems of banks through the collected data and dialogues as well as severity of problems.</p> <p>The JFSA, as necessary, shall consider issuing a business improvement order against the bank in accordance with Article 26 of the Banking Act.</p>
<p><b>Additional criteria</b></p>	
<p><b>AC1</b></p>	<p>The supervisor obtains from banks the results of their internal interest rate risk measurement systems, expressed in terms of the threat to economic value, including using a standardized interest rate shock on the banking book.</p>
<p>Description and findings re AC1</p>	<p>Regarding interest rate risks in the banking book, the JFSA requires banks to submit the relevant data to the offsite monitoring data system of the JFSA on a monthly basis. By using the data, the JFSA will identify banks which are categorized in “outliers” and then will engage in intensive dialogues with those banks regarding the cause for the banks’ assuming relatively higher interest rate risks among banks and the remedial actions taken by those banks.</p> <p>When necessary for further encouraging banks to address the risk, the JFSA will issue a reporting order in accordance with Article 24 of the Banking Act. In case the JFSA finds it necessary for enforcing banks to properly implement the business improvement plan in order to mitigate the interest rate risks in the banking book, in accordance with Article 26 of the Banking Act, the JFSA shall issue a business improvement order for the banks.</p> <p>“Outliers” are defined in Supervisory Guideline as banks whose impact of interest rate shocks on their bank capital exceeds 20 percent of the sum of Tier 1 and Tier2 capital of the banks. The shocks cover the case either of (i) parallel yield curve shift by 200 basis points; or (ii) one or 99 percent tile event happening to one-year holding assets measured during the observation period of at least five years.</p> <p>The JFSA monitors the market risk situation and its impacts on banks in its supervision and conducts interviews with banks in a timely manner as necessary, especially when market ratios such as interest rates and asset prices fluctuate. (III–2–3–3–3 of Supervisory Guideline).</p> <p>The Early Warning System also allows the JFSA to continuously conduct offsite monitoring. The JFSA monitors banks which are still satisfying the minimum capital adequacy requirement so that various risks would not negatively impact on banking soundness, and supervisory measures may be taken against them.</p> <p>The JFSA conducts meetings with bank senior management in order to highlight the causes of risks and possible remedial measures, and, as necessary, encourages banks to implement measures as necessary. These measures include improvement of risk management system, reduction of risks and review of capital plans, in light of identified problems of banks through the collected data and dialogues as well as severity of problems.</p>

<b>AC2</b>	The supervisor assesses whether the internal capital measurement systems of banks adequately capture interest rate risk in the banking book.
Description and findings re AC2	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 JFSA examiners during onsite inspections. When onsite, the JFSA will check followings based on III-2-3-3-2(2): <ul style="list-style-type: none"> <li>✓ whether banks understand that the amount of IRRBB may significantly change depending on the definition of core deposits, internally define core deposit in an appropriate manner, and examine it by back testing.</li> <li>✓ Inspection Manual requires banks to capture interest rate risks in the banking book in assessing the ICAAP and examiners will check its adequacy at inspection.</li> </ul>
<b>Assessment of Principle 23</b>	C
Comments	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 JFSA 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. The JFSA is beginning the transition to new guidelines for IRRBB which will closely align with the BCBS revisions. The timeline for implementation is 2018.
<b>Principle 24</b>	<b>Liquidity risk.</b> The supervisor sets prudent and appropriate liquidity requirements (which can include either quantitative or qualitative requirements or both) for banks that reflect the liquidity needs of the bank. The supervisor determines that banks have a strategy that enables prudent management of liquidity risk and compliance with liquidity requirements. The strategy takes into account the bank's risk profile as well as market and macroeconomic conditions and includes prudent policies and processes, consistent with the bank's risk appetite, to identify, measure, evaluate, monitor, report and control or mitigate liquidity risk over an appropriate set of time horizons. At least for internationally active banks, liquidity requirements are not lower than the applicable Basel standards.
<b>Essential criteria</b>	
<b>EC1</b>	Laws, regulations or the supervisor require banks to consistently observe prescribed liquidity requirements including thresholds by reference to which a bank is subject to supervisory action. At least for internationally active banks, the prescribed requirements are not lower than, and the supervisor uses a range of liquidity monitoring tools no less extensive than, those prescribed in the applicable Basel standards.
Description and findings re EC1	For internationally active banks (non-consolidated and consolidated), the JFSA requires banks to comply with the minimum requirement of LCR (monthly) which was implemented in March 2015 including disclosures (quarterly) from the end of June in 2015. The level of the minimum requirement was set at 60 percent in 2015 and will rise in equal annual steps to reach 100 percent in 2019 (currently 70 percent in 2016). The implementation timeline aligns with the Basel III requirements. <p>There are only minor deviations from the BCBS LCR framework which has been confirmed by a recent RCAP exercise. The deviations are immaterial and do not impact the quality of liquidity risk management.</p>

	<p>To enhance the effectiveness of LCR, the JFSA separately introduced an approximate indicator (“Approximate LCR”) which prioritizes timely reporting, under which banks are required to calculate Approximate LCR on a daily basis within two business days from the day subject to calculation. In cases where the Approximate LCR goes down lower than the level that is higher than the LCR minimum level by 20 percent, the bank must submit a daily report on Approximate LCR to the JFSA. In addition, for non-internationally active banks, the JFSA applies monitoring approaches to those banks, major banks of which are required to report the liquidity indicator equal to LCR, other banks of which are required to report simplified LCR.</p> <p>To supplement the LCR, the JFSA also introduces the framework of liquidity monitoring, where banks are required to report monthly:</p> <ul style="list-style-type: none"> <li>(i) contractual maturity mismatches;</li> <li>(ii) concentration of funding;</li> <li>(iii) unencumbered liquidity assets; and,</li> <li>(iv) LCR by major currency.</li> </ul> <p>For systemically important financial institutions, in addition to the frameworks mentioned above, the JFSA issued the guidance “Key Matters in Examining Liquidity Risk Management at Large Complex Financial Groups” where more detailed key matters in its supervision are indicated.</p> <p>The BoJ has 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>The BoJ monitors the liquidity conditions of banks on a daily basis. Daily dialogues between the BoJ and the banks were taken when necessary, and were deemed particularly effective during the crisis. BoJ’s offsite 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. The JFSA engages in daily contact with the BoJ to understand any concerns arising from BoJ’s daily monitoring. The BoJ also contacts the JFSA immediately should any issues be noted regarding liquidity risk. In cooperation with the BoJ, the JFSA 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 offsite analysis of monthly returns submitted by banks as well as onsite inspections.</p>
<p><b>EC2</b></p>	<p>The prescribed liquidity requirements reflect the liquidity risk profile of banks (including on- and off-balance sheet risks) in the context of the markets and macroeconomic conditions in which they operate.</p>

Description and findings re EC2	<p>Under the LCR requirement, the run-off rates and haircuts for HQLA are based upon stressed circumstances both idiosyncratic and market-wide occurring simultaneously (e.g., outflows of deposits, downgrades in banks' own credit rating, decline of banks' ability to raise unsecured funding, decline of banks' ability to raise some secured funding, significant declines of collateral values and unexpected draws on credit or liquidity facilities). In addition to the requirement described above, under the Inspection manual, the JFSA requires banks to analyse and assess liquidity risk using multiple scenarios considering both endogenous and exogenous factors (e.g., large-lot fund movements, deterioration in their financial results, a sharp market decline and malfunctioning of the administrative processing computer system).</p> <p>For systemically important financial institutions, in addition to the requirement mentioned above, the JFSA issued the guidance "Key matters in examining Liquidity Risk Management at Large Complex Financial Groups," under which banks are required to develop the system to ensure an appropriateness of liquidity stress testing for their internal management purposes according to "Principles for Sound Liquidity Risk Management and Supervision" issued in September 2008 by the Basel committee on banking supervision.</p>
<b>EC3</b>	<p>The supervisor determines that banks have a robust liquidity management framework that requires the banks to maintain sufficient liquidity to withstand a range of stress events, and includes appropriate policies and processes for managing liquidity risk that have been approved by the banks' boards. The supervisor also determines that these policies and processes provide a comprehensive bank-wide view of liquidity risk and are consistent with the banks' risk profile and systemic importance</p>
Description and findings re EC3	<p>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 JFSA confirm the above during their onsite inspection in accordance with their inspection manual. Key activities to confirm the adequacy of governance arrangements include assessment of board reporting, board minutes, ALCO minutes and interviews with senior personnel with direct responsibility for managing liquidity e.g., Treasurer.</p> <p>JFSA's inspection Manual also specifies requirements on the monitoring conducted by liquidity risk management division of a bank. In addition, the BoJ also verifies the governance structure in place for bank's liquidity risk management and carries out offsite assessment of liquidity risk of financial institutions using multiple indicators. BoJ's assessment includes verification that board and risk managers manage their assets, liabilities and funding profiles according to the stated liquidity risk strategy and risk appetite.</p> <p>For maintenance of liquidity to withstand a range of stress events, under the LCR requirement banks are required to withstand cash outflows during a month liquidity stress period. The guidance "Key Matters in Examining Liquidity Risk Management at Large Complex Financial Groups" applies to financial institutions with large overseas operations,</p>

	<p>which are required to develop higher quality liquidity risk management. Under paragraph (3) of the guidance, banks are required to appropriately identify cash outflows during a stress period.</p> <p>Based on paragraph III–2–3–4–2 of the Supervisory Guideline, the JFSA will check by way of offsite activities whether the manager in a liquidity risk management division categorizes the status of bank’s liquidity according to how tight the liquidity condition of the bank is (for example, in normal situation, the situation of concern and the stress situation) and whether for each situation, she/he establishes rules on liquidity management approaches, reporting system and processes for liquidity management with the authorization of the board.</p> <p>As described in Inspection Manual (checklists for confirming liquidity risk management status), examiners will confirm whether board members have established policies and rules for liquidity risk management, and have considered concrete measures during onsite inspection (P229). Examiners also confirm whether banks have established liquidity strategy consistent with banks’ strategic objective (P229). Those results and findings of onsite inspection will be written in “liquidity risk management status” section of Report on Bank Inspection and will be taken into account in a grade assigned from A to D under the Inspection Rating System of the JFSA. Checklists for confirming liquidity risk management status consist of three chapters, Requirements for board of directors, Requirements for managers in charge and Specific Issues which examiners need attention.</p> <p>When delivering the Report of Bank Inspection, the JFSA always issues a reporting request under the Article 24 of the Banking Act, and asks banks to hand in coordinated reports within one month. The report includes fact checking, cause analysis, betterment/countermeasures, etc., of findings pointed out during the inspection. The JFSA confirms the adequacy of remedial actions to address findings regarding the report from banks, and encourage banks to develop their improvement plan and secure steady implementation by way of offsite monitoring.</p>
<p><b>EC4</b></p>	<p>The supervisor determines that banks’ liquidity strategy, policies and processes establish an appropriate and properly controlled liquidity risk environment including:</p> <ul style="list-style-type: none"> <li>(a) clear articulation of an overall liquidity risk appetite that is appropriate for the banks’ business and their role in the financial system and that is approved by the banks’ boards;</li> <li>(b) sound day-to-day, and where appropriate intraday, liquidity risk management practices;</li> <li>(c) effective information systems to enable active identification, aggregation, monitoring and control of liquidity risk exposures and funding needs (including active management of collateral positions) bank-wide;</li> <li>(d) adequate oversight by the banks’ boards in ensuring that management effectively implements policies and processes for the management of liquidity risk in a manner consistent with the banks’ liquidity risk appetite; and</li> </ul>

	<p>(e) regular review by the banks' boards (at least annually) and appropriate adjustment of the banks' strategy, policies and processes for the management of liquidity risk in the light of the banks' changing risk profile and external developments in the markets and macroeconomic conditions in which they operate.</p>
Description and findings re EC4	<p>See also EC3. 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 JFSA 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 JFSA. These are supplemented by BoJ's analysis, with the 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 among other factors. The BoJ also conducts onsite 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. The BoJ would provide their findings of LRM to the JFSA 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 JFSA and BoJ is necessary.</p> <p>The JFSA had announced via its Strategic Directions and Priorities 2016–2017 and in cooperation with the BoJ, an increased focus via offsite 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 JFSA for offsite analysis including deposit information, liquid assets. Information on adequacy of liquidity buffers would be requested by the JFSA and assessed for banks flagged out for enhanced monitoring either through offsite monitoring or onsite inspections. The majority of banks' exposures are denominated in yen. However, with the more internationally active banks expanding their operations overseas in an attempt to increase profitability, the JFSA 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. The BoJ has also been conducting offsite monitoring on a daily basis with respect to foreign currency.</p> <p>The mission saw evidence of the JFSA and BoJ's work to assess the adequacy of liquidity risk management which also demonstrated a focus on main risk issues. For example, given the current domestic low interest rate environments, etc. where major banks, etc. are expanding loans to overseas borrowers while the funding cost of foreign currency are rising, the authorities were targeting their attention on foreign currency liquidity risk.</p>

<p><b>EC5</b></p>	<p>The supervisor requires banks to establish, and regularly review, funding strategies and policies and processes for the ongoing measurement and monitoring of funding requirements and the effective management of funding risk. The policies and processes include consideration of how other risks (e.g., credit, market, operational and reputation risk) may impact the bank’s overall liquidity strategy, and include:</p> <ul style="list-style-type: none"> <li>(a) an analysis of funding requirements under alternative scenarios;</li> <li>(b) the maintenance of a cushion of high quality, unencumbered, liquid assets that can be used, without impediment, to obtain funding in times of stress;</li> <li>(c) diversification in the sources (including counterparties, instruments, currencies and markets) and tenor of funding, and regular review of concentration limits;</li> <li>(d) regular efforts to establish and maintain relationships with liability holders; and</li> <li>(e) regular assessment of the capacity to sell assets.</li> </ul>
<p>Description and findings re EC5</p>	<p>As part of ongoing monitoring of bank liquidity, the JFSA and BoJ assess bank funding plans taking into account changing market conditions. The range of liquidity indicators that are reported provide a relatively comprehensive picture of bank’s changing liquidity risk profile. Interviews are held with bank senior personnel on a regular basis to discuss funding plans and contingency arrangements in the event conditions in funding markets change quickly. The outcomes of stress testing are also discussed during these interviews. The JFSA does not prescribe a uniform scenario, instead banks conduct stress testing based using parameters in line with their own risk appetite and a risk appetite. Currently there is an emphasis on FX liquidity and the changing assumptions regarding outflows and haircuts.</p> <p>A comprehensive assessment of funding strategies and contingency arrangements is undertaken during onsite inspections where supervisors use the Supervisory Guideline to help make an assessment. In paragraph III–2–3–4–2 of the Supervisory Guideline, the JFSA indicates the following key matters in its inspection.</p> <ul style="list-style-type: none"> <li>✓ Whether the managers of funding management division and risk management division categorize the status of funding according to each funding status (e.g., “normal”, “needs care,” and “crisis”) and develop methods of management, report and approval. etc., for each category based on the approval of the board of directors, etc.</li> <li>✓ Whether funding management division always addresses assets available for outright sale or for collateral (such as JGB), and the timing and the amount of funding through selling, secured funding or using liquidity facilities from the relevant central bank or financial institutions in the market in order to secure funding method for “Crisis.”</li> <li>✓ Whether major banks monitor especially on the market condition for funding and develop a contingency plan considering that they in many cases raise funds from both domestic and international markets.</li> </ul> <p>Specifically, relating to the points in this EC:</p> <ul style="list-style-type: none"> <li>• For (b) described in the essential criteria, the JFSA conducts its monitoring of the status of banks’ holdings of unencumbered assets.</li> <li>• For (c), it requires banks to report information on concentration of funding through its monitoring.</li> <li>• For (e), in its monitoring of the status of banks’ holdings of unencumbered assets, it encourages banks to regularly assess the ability to sale assets by requiring them to</li> </ul>

	<p>identify the assets available for sale (AFS) by location and report information on haircuts to be applied to the assets.</p> <p>As described in Inspection Manual (checklists for inspection confirming liquidity risk management status), examiners will confirm whether banks have established policies and internal rules for measuring and monitoring liquidity gaps and whether they set the appropriate liquidity gap limits. Examiners will also confirm whether banks have identified factors to make influence upon banks' liquidity position, whether they constantly evaluate the status of liquidity concentration, whether they have emergency fundraising measures, and whether they have implemented stress tests in line with the size and characteristics of banks.</p>
<b>EC6</b>	<p>The supervisor determines that banks have robust liquidity contingency funding plans to handle liquidity problems. The supervisor determines that the bank's contingency funding plan is formally articulated, adequately documented and sets out the bank's strategy for addressing liquidity shortfalls in a range of stress environments without placing reliance on lender of last resort support. The supervisor also determines that the bank's contingency funding plan establishes clear lines of responsibility, includes clear communication plans (including communication with the supervisor) and is regularly tested and updated to ensure it is operationally robust. The supervisor assesses whether, in the light of the bank's risk profile and systemic importance, the bank's contingency funding plan is feasible and requires the bank to address any deficiencies.</p>
Description and findings re EC6	<p>See also EC1 and EC 5. 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. Banks are already conducting stress-testing for all other currencies other than yen.</p> <p>Requirements on these areas are laid out in the JFSA's supervisory guidelines and verified during JFSA's interview with banks and during onsite inspections. The JFSA monitors and analyzes liquidity status of banks monthly based on the data collected through "Offsite Monitoring System" and tries to encourage earlier improvement of liquidity position by frequent communication.</p>
<b>EC7</b>	<p>The supervisor requires banks to include a variety of short-term and protracted bank-specific and market-wide liquidity stress scenarios (individually and in combination), using conservative and regularly reviewed assumptions, into their stress testing programs for risk management purposes. The supervisor determines that the results of the stress tests are used by the bank to adjust its liquidity risk management strategies, policies and positions and to develop effective contingency funding plans.</p>
Description and findings re EC7	<p>The JFSA and BoJ have emphasized the importance of liquidity management under changing macro conditions through its publication of "Strategic Directions and Priorities" and as for the BoJ "Onsite Examination Policy" and "Financial System Report". (i.e., management which is sufficiently aware that significant changes in economic and market environments could occur in the future). The mission saw evidence where the authorities had engaged with banks on this topic.</p>

	<p>Specifically, for example for the megabanks, the JFSA and BoJ had engaged on the topics of market liquidity and potential shocks to funding arrangements both domestic and external. Supervisors demonstrated that the assessment looked at: (i) the soundness of liquidity risk management; (ii) appropriately assess various risks in normal times; (iii) maintain a sufficient level of capital and liquidity commensurately to those risks; (iv) conduct forward-looking approaches to developing and reviewing their business policy and their risk management policies, etc. given an appropriate involvement of managements; and (v) develop an appropriate liquidity crisis management system so as to fulfill their financial intermediary function in the stress period of the economy and the market.</p>
<p><b>EC8</b></p>	<p>The supervisor identifies those banks carrying out significant foreign currency liquidity transformation. Where a bank’s foreign currency business is significant, or-the bank has significant exposure in a given currency, the supervisor requires the bank to undertake separate analysis of its strategy and monitor its liquidity needs separately for each such significant currency. This includes the use of stress testing to determine the appropriateness of mismatches in that currency and, where appropriate, the setting and regular review of limits on the size of its cash flow mismatches for foreign currencies in aggregate and for each significant currency individually. In such cases, the supervisor also monitors the bank’s liquidity needs in each significant currency, and evaluates the bank’s ability to transfer liquidity from one currency to another across jurisdictions and legal entities.</p>
<p>Description and findings re EC8</p>	<p>Through “2015–2016 Strategic Directions and Priorities,” the JFSA has announced that it will particularly focus on:</p> <ul style="list-style-type: none"> <li>(i) planning and promotion of banks’ global business strategies;</li> <li>(ii) development of their management system and maintenance and education of their staff commensurate to the expansion of their overseas businesses;</li> <li>(iii) maintenance of stable funding of foreign currency commensurate to the expansion of their overseas businesses and strengthening foreign currency liquidity risk management; and</li> <li>(iv) strengthening of management of their exposures extended to foreign borrowers through an appropriate identification of economic and market trends of the countries where their exposures exist as well as borrowers’ financial results, etc.</li> </ul> <p>The assessors saw examples where supervisors have been focusing their attention on FX funding risks. Specifically, the reporting under the LCR by currency and by liquidity mismatch provided an insight into FX liquidity risk profile for banks. Equally, during the onsite inspections the mission saw evidence where supervisors had assessed FX liquidity risk in detail using the Inspection Manual. Inspections confirmed the analyses and assessment of liquidity risk by taking into account the nature of various currencies handled in and outside Japan taking an office-by-office basis and a currency-by-currency basis, looking at the solo and consolidated reporting. Supervisors looked at limits and scenarios for stress testing to determine whether the parameters had fully captured changes in market conditions and taking a forward-looking view.</p>
<p><b>Additional criteria</b></p>	

<b>AC1</b>	The supervisor determines that banks' levels of encumbered balance-sheet assets are managed within acceptable limits to mitigate the risks posed by excessive levels of encumbrance in terms of the impact on the banks' cost of funding and the implications for the sustainability of their long-term liquidity position. The supervisor requires banks to commit to adequate disclosure and to set appropriate limits to mitigate identified risks.
Description and findings re AC1	In paragraph III-2-3-4-4-1 of the Supervisory Guideline, with regard to its supervision of liquidity coverage ratio (LCR), the JFSA indicates that (i) it is necessary for banks to prepare for liquidity risk in addition to the enhancement of capital to secure prudent financial condition; (ii) it is important for banks to enhance resilience that enables the continuity of operation in cases where there are difficulties for funding by securing efficient HQLA to prepare for short-term liquidity risk; (iii) it is also necessary for the JFSA to address liquidity risk of banks and encourage them to hold sufficient HQLA; and (iv) from these perspectives, Internationally Active Banks shall be required to hold sufficient HQLA based on the objective measure like LCR.
<b>Assessment of Principle 24</b>	C
Comments	<p>For internationally active banks (non-consolidated and consolidated), the JFSA requires banks to comply with the minimum requirement of LCR (monthly) which was implemented in March 2015 including disclosures (quarterly) from the end of June in 2015. The level of the minimum requirement was set at 60 percent in 2015 and will rise in equal annual steps to reach 100 percent in 2019 (currently 70 percent in 2016). The implementation timeline aligns with the Basel III requirements.</p> <p>Offsite monitoring and onsite inspections by both the JFSA and BoJ appear rigorous. The inspection rating system helps identify main risk issues and there was evidence that when issues are identified remedial action is taken. The suite of reporting that accompanies the LCR provides the JFSA with a variety of indicators to analyze liquidity. The BoJ receives regular and frequent reporting of liquidity indicators. Given the strategy of more banks attempting to expand overseas in the search for yield, continued focus by the BoJ and the JFSA 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>
<b>Principle 25</b>	<b>Operational risk.</b> The supervisor determines that banks have an adequate operational risk management framework that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify, assess, evaluate, monitor, report and control or mitigate operational risk <sup>68</sup> on a timely basis.
<b>Essential criteria</b>	
<b>EC1</b>	Law, regulations or the supervisor require banks to have appropriate operational risk management strategies, policies and processes to identify, assess, evaluate, monitor, report and control or mitigate operational risk. The supervisor determines that the bank's strategy, policies and processes are consistent with the bank's risk profile, systemic importance, risk appetite and capital strength, take into account market and macroeconomic conditions,

<sup>68</sup> The Committee has defined operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The definition includes legal risk but excludes strategic and reputational risk.

	and address all major aspects of operational risk prevalent in the businesses of the bank on a bank-wide basis (including periods when operational risk could increase).
Description and findings re EC1	<p>JFSA's supervisory guidelines require banks to develop appropriate operational risk management systems commensurate with their risks profiles which are monitored through offsite supervision and validated by onsite inspections. The 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. JFSA'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. From a governance perspective, bank boards are responsible for understanding, establishing and adjusting these risks and mitigating controls.</p> <p>Supervisors conduct ongoing surveillance of regulatory reporting and factors impacting the business environment and quality of controls to assess whether banks' operational risk management frameworks and strategies respond according to changes in the operating environment. The results of this analysis will inform the stance adopted for individual banks as well as for potential thematic considerations. When reviewing a financial institution's operational risk management system, inspectors examine whether the system is an appropriate commensurate with the size, scale and nature of the institution's business and risk profile.</p>
<b>EC2</b>	The supervisor requires banks' strategies, policies and processes for the management of operational risk (including the banks' risk appetite for operational risk) to be approved and regularly reviewed by the banks' boards. The supervisor also requires that the board oversees management in ensuring that these policies and processes are implemented effectively.
Description and findings re EC2	<p>As per the Supervisory Guidelines, bank boards and senior management are responsible for the effective implementation of operational risk policies and procedures. During the onsite inspection there is an assessment of the board's role in the oversight of this process. The governance dimension of the onsite inspection will typically focus on the effectiveness of bank's implementation of approved strategies and policies, including regular reporting and quality of discussion of operational risk in board minutes.</p> <p>In terms of risk appetite frameworks, the megabanks are making progress at developing tolerances and articulating risk thresholds. To date, the JFSA has focused most of its attention on the megabanks with work on the regional banks and <i>Shinkin</i> banks not yet fully developed.</p>
<b>EC3</b>	The supervisor determines that the approved strategy and significant policies and processes for the management of operational risk are implemented effectively by management and fully integrated into the bank's overall risk management process.
Description and findings re EC3	See also EC 1 and 2. Through offsite activities, supervisors will review policies and processes as well as monitor changes in the business environment while the onsite will verify the implementation of operational risk policies to satisfy the "use" test. Which is a critical feature of a robust framework. III-3-6-2 of Supervisory Guideline states that the bank's

	<p>board should develop an appropriate operational risk management system and implement measures to reduce the risk. As one of the checkpoints in supervising banks' risk management, III-2-3-1-3 of Supervisory Guideline stipulates that the risk-related information that the board of directors oversees the implementation of the framework. Onsite inspections which include a review of board reporting and minutes is one of the activities to verify the board's role. The BoJ also conducts offsite monitoring and onsite examinations to assess the adequacy of risk management policies and processes at banks.</p>
<b>EC4</b>	<p>The supervisor reviews the quality and comprehensiveness of the bank's disaster recovery and business continuity plans to assess their feasibility in scenarios of severe business disruption which might plausibly affect the bank. In so doing, the supervisor determines that the bank is able to operate as a going concern and minimize losses, including those that may arise from disturbances to payment and settlement systems, in the event of severe business disruption.</p>
Description and findings re EC4	<p>Banks are required to establish comprehensive resiliency efforts, crisis management, and business continuity plans to enable prompt and appropriate recovery strategies and measures during crisis to minimize any disruptions to banking operations. The authorities have had considerable experience in this area subsequent to the Great East Japan Earthquake in March 2011 and the experience strengthened bank processes as well as JFSA's supervision techniques. In 2015, the JFSA conducted a horizontal review of banks' BCP to identify outliers and generally raise awareness and quality of risk management.</p> <p>The 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, the 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 offsite checks. For regional financial institutions increased reliance on shared information technology systems, outsourcing risks would be assessed by the BoJ during their visits to the outsourced entities and operation centers. While the 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 the BoJ. The JFSA would have the powers to conduct onsite inspections at outsourced service providers.</p>
<b>EC5</b>	<p>The supervisor determines that banks have established appropriate information technology policies and processes to identify, assess, monitor and manage technology risks. The supervisor also determines that banks have appropriate and sound information technology infrastructure to meet their current and projected business requirements (under normal circumstances and in periods of stress), which ensures data and system integrity, security and availability and supports integrated and comprehensive risk management.</p>
Description and findings re EC5	<p>As per the Supervisory Guidelines, boards need to be cognizant of all inherent information technology risks and to have taken measures to mitigate the risks, including comprehensive</p>

	<p>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 assess the banks' business management strategies and adequacy of investments in IT systems that are required for the size and scope of its operations.</p> <p>JFSA's Supervisory Guidelines require banks to submit reports to the JFSA on information technology system issues including measures taken to address the issues immediately after occurrence. Under Article 24 of the Banking Act, the JFSA 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 JFSA operational risk issues related to fraud, embezzlement, breach of trust and other activities that may pose risks to the safety and soundness of banks.</p> <p>As stipulated in "Onsite Examination Policy for Fiscal 2016, the BoJ focuses on establishment and strengthening of IT risk management frameworks; and establishment and strengthening of cyber security management frameworks in the conduct of onsite examinations.</p>
<b>EC6</b>	<p>The supervisor determines that banks have appropriate and effective information systems to:</p> <ul style="list-style-type: none"> <li>(a) monitor operational risk;</li> <li>(b) compile and analyze operational risk data; and</li> <li>(c) facilitate appropriate reporting mechanisms at the banks' boards, senior management and business line levels that support proactive management of operational risk.</li> </ul>
Description and findings re EC6	<p>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 JFSA's onsite inspections. III-1-2 of Supervisory Guideline stipulates the key issues in supervising banks' governance structures, including the board of directors' efforts in establishing management information systems including operational risk management.</p>
<b>EC7</b>	<p>The supervisor requires that banks have appropriate reporting mechanisms to keep the supervisor apprised of developments affecting operational risk at banks in their jurisdictions.</p>
Description and findings re EC7	<p>There is no specific requirement for banks to advise the JFSA of adverse events which impact the operational risk management system from operating as expected. Nonetheless, in practice, banks keep their supervisor apprised of developments. In this regard, the engagement with the megabanks is frequent (at least quarterly) on an informal basis and semi-annually for AMA banks where changes in the operating conditions will regularly be discussed.</p> <p>Specifically, in relation to IT systems, III-3-7-1-3 of Supervisory Guideline requires banks to submit "report on IT system troubles" immediately after the occurrence. If the JFSA sees a problem with the way a bank controls operational risk, the JFSA may require the bank to</p>

	report the analysis and measures taken on the problem as necessary based on the Article 24 of the Banking Act.
<b>EC8</b>	<p>The supervisor determines that banks have established appropriate policies and processes to assess, manage and monitor outsourced activities. The outsourcing risk management program covers:</p> <ul style="list-style-type: none"> <li>(a) conducting appropriate due diligence for selecting potential service providers;</li> <li>(b) structuring the outsourcing arrangement;</li> <li>(c) managing and monitoring the risks associated with the outsourcing arrangement;</li> <li>(d) ensuring an effective control environment; and</li> <li>(e) establishing viable contingency planning.</li> </ul> <p>Outsourcing policies and processes require the bank to have comprehensive contracts and/or service level agreements with a clear allocation of responsibilities between the outsourcing provider and the bank.</p>
Description and findings re EC8	<p>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 and ensure that outsourced activities do not affect the safety and soundness of the banks' activities. Prior approval of the JFSA is not required for outsourcing activities undertaken by the bank although there is some expectation by the JFSA for the banks to consult with them on planned outsourcing activities during their regular dialogues with the banks. The JFSA 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. The main outsourced providers to banks include NTT Data, Hitachi and IBM. In the last three years the JFSA has conducted onsite inspections of the providers.</p> <p>In accordance with Article 12-2 of Banking Act, and Article 13-6-8 of Ordinance for Enforcement of the Banking Act, when a bank outsources a part of its business to a third party, the bank must take the measures to ensure such operation properly conducted. In order to implement the provisions above effectively, the JFSA has set out general checkpoints when outsourcing takes place in banks' business operation in III-3-3-4 of Supervisory Guideline, requiring banks to develop necessary delegation structures for ensuring customer protection and safety and soundness of business management.</p> <p>In order to ensure safety and soundness of a bank, the JFSA has authorities to require such third parties to which the bank has outsourced part of its businesses to report on the status of their businesses (Article 24 of Banking Act), as well as to conduct onsite inspection to the parties. (Article 25 of the Act). In addition, in deciding which companies banks will outsource part of their business to, Inspection Manual requires banks to assess the quality of their service and sustainability, to identify risk management issues and to confirm sharing of responsibility in arrangement on outsourcing.</p>
<b>Additional criteria</b>	

<b>AC1</b>	The supervisor regularly identifies any common points of exposure to operational risk or potential vulnerability (e.g., outsourcing of key operations by many banks to a common service provider or disruption to outsourcing providers of payment and settlement activities).
Description and findings re AC1	There are a number of arrangements in place (mainly between the regional banks) where share IT services exist. The JFSA are aware of the arrangements and have conducted onsite inspections to assess the effectiveness of risk management such as DR, and BCP.
<b>Assessment of Principle 25</b>	C
Comments	Offsite reporting is generally comprehensive providing supervisors with internal loss data broken down by event type (as well as top 50 loss events) enabling an ability to monitor potential changes in risk profile. AMA banks are subject to heightened reporting requirements e.g., (BEICFs, internal loss data, and external loss data as well as results of scenario analysis). Ongoing model monitoring of AMA banks is rigorous. While IT system risks and the adequacy of integrated risk management for banks expanding overseas remains key risks, the JFSA have acknowledged these risk areas and have intensified its supervision over these areas.
<b>Principle 26</b>	<b>Internal control and audit.</b> The supervisor determines that banks have adequate internal control frameworks to establish and maintain a properly controlled operating environment for the conduct of their business taking into account their risk profile. These 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 <sup>69</sup> internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
Essential criteria	
<b>EC1</b>	Laws, regulations or the supervisor require banks to have internal control frameworks that are adequate to establish a properly controlled operating environment for the conduct of their business, taking into account their risk profile. These controls are the responsibility of the bank’s board and/or senior management and deal with organizational structure, accounting policies and processes, checks and balances, and the safeguarding of assets and investments (including measures for the prevention and early detection and reporting of misuse such as fraud, embezzlement, unauthorized trading and computer intrusion). More specifically, these controls address: <ul style="list-style-type: none"> <li>(a) organizational structure: definitions of duties and responsibilities, including clear delegation of authority (e.g., clear loan approval limits), decision-making policies and processes, separation of critical functions (e.g., business origination, payments, reconciliation, risk management, accounting, audit and compliance);</li> <li>(b) accounting policies and processes: reconciliation of accounts, control lists, information for management;</li> </ul>

<sup>69</sup> In assessing independence, supervisors give due regard to the control systems designed to avoid conflicts of interest in the performance measurement of staff in the compliance, control and internal audit functions. For example, the remuneration of such staff should be determined independently of the business lines that they oversee.

	<p>(c) checks and balances (or "four eyes principle"): segregation of duties, cross-checking, dual control of assets, double signatures; and</p> <p>(d) safeguarding assets and investments: including physical control and computer access.</p>
Description and findings re EC1	<p>Banks and bank holding companies are required under Article 13 of the Banking Act to establish appropriate internal control frameworks. The details of these frameworks are delegated to the boards of directors of banks. In addition, the JFSA conveys its supervisory expectations that require each financial institution to have an appropriate internal control framework consistent with the business and size of the institution in its Supervisory Guidelines for major banks and for small, medium and regional financial institutions. JFSA's Inspection Manual also sets out detailed checklists covering items (a) through (d) of this EC, which are used by supervisory staff in onsite inspections to make sure bank policies and operations are in compliance with those requirements in practice. Given they are part of the Inspection Manual, the checklists themselves are public documents. Many of these issues, notably those in (d) are also captured as part of JFSA's review of bank operational risk management practices.</p> <p>In the case of major banks and banking groups the JFSA conducts monthly offsite reviews of bank internal control environments to ensure they are performing satisfactorily. Targeted onsite reviews are then conducted whenever incidences arise with a focus on probing the root cause of the incidences so that the control framework can be enhanced accordingly. As for smaller institutions, the JFSA reviews their internal control frameworks once or twice per year with more frequent and intrusive investigations when the need arises. Those inspections include interviews with control teams within the banks as well as with the bank's top management and directors responsible for the control frameworks to obtain satisfaction that the control environments are operating satisfactorily. The review of supervisory files confirmed that the JFSA is assiduous in its monitoring of internal control system issues.</p> <p>The JFSA is also seeking to be forward-looking in its assessments of bank internal controls in addition to conducting ex post reviews of performance. For example, it has been comparing the control frameworks of banks of similar size through horizontal peer reviews. And, in the case of the mega banks the JFSA has also been conducting client surveys of Japanese companies to obtain feedback, for example, on the quality of service to obtain some insights into how well decision-making processes are operating in practice and how clients see the coordination between bank head-offices and bank operations in foreign countries.</p> <p>The BoJ also conducts reviews of bank internal control frameworks as part of its ongoing surveys (offsite monitoring) as well as onsite examination as to the internal control and relevant issues (as specified in this Criterion and the other Criteria) of its counterparties.</p> <p>As stipulated in "Onsite Examination Policy for Fiscal 2016," the BoJ examines the following:</p> <ol style="list-style-type: none"> <li>1. Ensuring the Effectiveness of Internal Control. To ensure the effectiveness of risk management, internal control frameworks at financial institutions need to function effectively.</li> </ol>

	<p>In onsite examinations, the BoJ examines the following: (1) whether the board of directors has provided risk management frameworks and oversees the implementation appropriately; (2) whether senior management executes operations in accordance with the risk-taking policy determined by the board of directors and manages risks; and (3) whether senior management provides reports appropriately so that the board of directors can oversee the risk management practice. In doing so, the BoJ will also examine (4) the effectiveness of the group-wide business management of financial institutions, including overseas branches and subsidiaries, which offer a wide range of financial services on a group basis.</p> <p>2. Proactive Improvement of Risk Management with Internal Audits Internal audits provide a basis for ensuring the proper conduct of business operations and play an important role in promoting the proactive improvement of risk management. For this reason, the board of directors needs to be aware of the importance of internal audits and ensure their effectiveness. Also, the internal auditors need to evaluate the effectiveness of risk management and other control functions and report to the board of directors as appropriate from an independent and objective standpoint.</p> <p>3. In onsite examinations, the BoJ examines the following: (1) whether the board of directors appropriately decides the scope of internal audits and allocates audit resources based on the risk assessment; (2) whether the internal auditors adequately audit businesses, including those of overseas entities and subsidiaries; and (3) whether the board of directors makes the most of auditors' recommendations regarding their business management.</p> <p><b>Development of Management Information Systems</b></p> <p>It is important for financial institutions to appropriately set up and employ mechanisms to gather the information necessary to manage business operations and risks. For financial institutions that actively expand their international businesses and offer a wide range of financial services on a group basis, it is important to appropriately assess in a timely manner various risks that extend over regions.</p> <p>In onsite examinations, mainly with regard to major financial institutions, the BoJ examines (1) whether they have appropriately set up mechanisms to gather the necessary information, including those for information infrastructure such as the management information system (MIS); and (2) whether the reliability and timeliness of information are ensured. With regard to major financial institutions, the BoJ will also examine; and (3) the routes by which risk spreads as well as potential effects through fund transactions and credit provision relationships with other major domestic and overseas financial institutions.</p>
<p><b>EC2</b></p>	<p>The supervisor determines that there is an appropriate balance in the skills and resources of the back office, control functions and operational management relative to the business origination units. The supervisor also determines that the staff of the back office and control functions have sufficient expertise and authority within the organization (and,</p>

	where appropriate, in the case of control functions, sufficient access to the bank's board) to be an effective check and balance to the business origination units.
Description and findings re EC2	<p>The JFSA monitors whether or not a bank's board of directors has developed an integrated risk management system that controls risks managed by each risk management unit. It also conducts onsite inspections in accordance with the Inspection Manual. The inspections include examinations of the appropriateness of the management systems for each risk category and of the effectiveness of each section's function.</p> <p>In particular, in accordance with the checklists contained in the Inspection Manual, the JFSA supervisors confirm the independence of the internal audit control function of a bank and ensures the bank has a dedicated executive director responsible for overseeing the control functions within the bank. That said, there are still cases where the internal audit function for even some of the most systemic banks still report to the board or board of auditors via the president or CEO rather than directly. The JFSA supervisors also review the experience and qualifications of internal control function staff, paying particular attention as to whether the internal audit staff have enough experience to oversee the activities that are the focus of bank expansion plans.</p> <p>The JFSA also pays attention to the profile of the internal audit function within the banks. Particular attention is being paid to what happens to the staff of these functions when they are rotated out to other areas within the bank. It noted that in the past the internal audit functions had been considered a backwater in some banks as they are not directly responsible for generating revenue for the bank. However, in recent years some banks have recognized that the internal audit function can be a useful stepping stone for future senior executives given the role the function plays for the bank as a whole, which can be helpful in developing strategic perspectives.</p>
<b>EC3</b>	The supervisor determines that banks have an adequately staffed, permanent and independent compliance function <sup>70</sup> that assists senior management in managing effectively the compliance risks faced by the bank. The supervisor determines that staff within the compliance function is suitably trained, have relevant experience and have sufficient authority within the bank to perform their role effectively. The supervisor determines that the bank's board exercises oversight of the management of the compliance function.
Description and findings re EC3	<p>The JFSA conducts onsite inspections in accordance with the Inspection Manual that assess whether the board of directors:</p> <ul style="list-style-type: none"> <li>✓ allocates a manager with sufficient knowledge and experience in the integrated legal compliance unit in order to implement its assignment;</li> <li>✓ grants power to the manager; and</li> <li>✓ secures the independence of the legal compliance unit from the business operation units and enable it to exercise its diversion function.</li> </ul> <p>The JFSA recognizes that building a global legal compliance system is an urgent necessity as the major banks expand their overseas businesses. With this in mind, it has been</p>

<sup>70</sup> The term "compliance function" does not necessarily denote an organizational unit. Compliance staff may reside in operating business units or local subsidiaries and report up to operating business line management or local management, provided such staff also have a reporting line through to the head of compliance that should be independent from business lines.

	<p>conducting onsite and offsite monitoring and checks to ensure those banks assign well-trained and well-experienced staffs to the legal compliance team so that those teams will be fully functional. This has been supplemented by a horizontal review of the three major banks in 2014 to assess the ability of their compliance functions to support their overseas expansions. The JFSA has also been making comparisons of the three banks against a major U.S. bank in this area to help identify training needs in this area.</p>
<b>EC4</b>	<p>The supervisor determines that banks have an independent, permanent and effective internal audit function<sup>71</sup> charged with:</p> <ul style="list-style-type: none"> <li>(a) assessing whether existing policies, processes and internal controls (including risk management, compliance and corporate governance processes) are effective, appropriate and remain sufficient for the bank’s business; and</li> <li>(b) ensuring that policies and processes are complied with.</li> </ul>
Description and findings re EC4	<p>JFSA’s Inspection Manual stipulates that banks should develop policies for ensuring effectiveness of internal audit, internal rules and management systems. The manual also requires inspectors to examine that banks periodically evaluate effectiveness of internal audit systems and improve it based on the evaluation in a timely manner.</p> <p>The JFSA supervisors confirm in the course of their offsite monitoring and onsite inspections that bank boards have established internal audit units that are commensurate with the size and risk profile of the bank, and that the boards regularly evaluate the appropriateness and effectiveness of internal control environment and that of the internal audit function. Particular attention is paid to ensuring that the internal audit unit is independent from other units.</p> <p>In discussions with the assessors the JFSA noted that some major banks have established hub-spoke systems for internal audit groups within their global operations. The JFSA recognizes the trade-offs that can ensue from on the one hand having internal audit groups embedded locally which can be useful in terms of benefitting from local knowledge and proximity to the business line but on the other hand pose challenges with respect to promoting consistency in internal audit activities across the bank as a whole. The JFSA has been working with banks to make sure the latter understand the potential weakness of the hub-spoke organizations and obtain explanations from them on what steps they are taking to compensate for the potential weakness of this arrangement.</p>
<b>EC5</b>	<p>The supervisor determines that the internal audit function:</p> <ul style="list-style-type: none"> <li>(a) has sufficient resources, and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing;</li> <li>(b) has appropriate independence with reporting lines to the bank’s board or to an audit committee of the board, and has status within the bank to ensure that senior management reacts to and acts upon its recommendations;</li> <li>(c) is kept informed in a timely manner of any material changes made to the bank’s risk management strategy, policies or processes;</li> </ul>

<sup>71</sup> The term “internal audit function” does not necessarily denote an organizational unit. Some countries allow small banks to implement a system of independent reviews, e.g., conducted by external experts, of key internal controls as an alternative.

	<p>(d) has full access to and communication with any member of staff as well as full access to records, files or data of the bank and its affiliates, whenever relevant to the performance of its duties;</p> <p>(e) employs a methodology that identifies the material risks run by the bank;</p> <p>(f) prepares an audit plan, which is reviewed regularly, based on its own risk assessment and allocates its resources accordingly; and</p> <p>(g) has the authority to assess any outsourced functions.</p>
Description and findings re EC5	<p>The JFSA supervisory expectations requiring banks to appoint qualified internal auditors was added to the Supervisory Guidelines in March 2014, III-1-2-1 (5) of the Supervisory Guideline provides supervisory expectations regarding the independence of internal audit units and prompt reporting on findings from an internal audit to the board of directors.</p> <p>The JFSA conducts onsite inspections in accordance with Inspection Manual. The inspection includes criteria on whether or not the board of directors has introduced the following:</p> <ul style="list-style-type: none"> <li>✓ Whether or not an internal audit unit has an appropriate number of staff with necessary knowledge, experience and sufficient specialty to examine businesses, and develops policies in order to strengthen auditors' competencies through training.</li> <li>✓ Whether or not the internal audit unit maintains independence from other units in order to exercise audit functions.</li> <li>✓ Whether or not the internal audit unit retains its independence in order to prevent auditing from being influenced by other units.</li> <li>✓ Whether or not an internal audit unit has the power to access all records, materials, staffs and directors for auditing.</li> </ul> <p>In addition, according the Inspection Manual, the JFSA supervisors will inspect the critical service providers that undertake operations for multiple financial institutions, and probe the extent to which their control environments are being audited by bank internal auditors.</p>
<b>Assessment of Principle 26</b>	C
Comments	<p>The oversight of bank internal control frameworks is sound, and the profile of internal audit groups within banks has improved significantly in recent years. That said, the assessors believe the internal audit function could be further strengthened by introducing a more direct reporting relationship to bank boards of directors or boards of auditors. This does not appear to be a material gap at this time, however, as the review of supervisory files did not reveal any significant shortcomings in internal audit behavior or in that function's ability to have their views conveyed to bank boards in practice.</p>
<b>Principle 27</b>	<p><b>Financial reporting and external audit.</b> The supervisor determines that banks and banking groups maintain adequate and reliable records, prepare financial statements in accordance with accounting policies and practices that are widely accepted internationally and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor's opinion. The supervisor also determines that banks and parent companies of banking groups have adequate governance and oversight of the external audit function.</p>
<b>Essential criteria</b>	

<b>EC1</b>	The supervisor <sup>72</sup> holds the bank's board and management responsible for ensuring that financial statements are prepared in accordance with accounting policies and practices that are widely accepted internationally and that these are supported by recordkeeping systems in order to produce adequate and reliable data.
Description and findings re EC1	<p>Under Article 20 of the Banking Act, Japanese banks and banking groups are required to prepare and publicly disclose non-consolidated and consolidated financial statements. In addition, Article 21 of the Banking Act requires banks and banking groups to publicly disclose annual and interim reports both on non-consolidated and consolidated basis explaining the bank's business and financial condition.</p> <p>The JFSA will issue business improvement order under Article 26 of the Banking Act or imposed penalties under Article 63 of the Banking Act in cases where the bank violates the laws stated above.</p> <p>Japanese banks have the option to prepare their financial statements in accordance with either the Japanese Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS). Japanese GAAP was assessed as equivalent to IFRS by EU in December 2008. In addition, Japanese GAAP auditing standards have been established and are revised by reference to ISA to maintain consistency with international standards.</p> <p>In addition, a bank or banking group subject to Financial Instruments and Exchange Act are required to engage certified public accountants or audit firms and have their financial statements audited. In addition, beginning in March 2009 a listed company is required to obtain an audit certification from certified public accountants or audit firms for internal control reports which assess the effectiveness of internal controls.</p> <p>Bank management and directors have a responsibility to ensure the system that appropriately maintains the bank's financial records and reliability of financial data. This has been reinforced by the JFSA in its Supervisory Guideline III-3-2-2, which requires banks to develop a proper internal control system and regularly test that the system functions and update it as needed. This is validated by bank internal auditors, external auditors and the JFSA itself via its supervisory activities in accordance with its Inspection Manual.</p>
<b>EC2</b>	The supervisor holds the bank's board and management responsible for ensuring that the financial statements issued annually to the public bear an independent external auditor's opinion as a result of an audit conducted in accordance with internationally accepted auditing practices and standards.
Description and findings re EC2	Under Article 4-2 of the Banking Act, banks are required to engage external auditors (certified public accountants or auditing firms) to review and provide a formal opinion on the bank's financial statements. As indicated in EC1, the statements are audited in accordance with Articles 435 and 396 of the Companies Act. External auditors also shall provide accounting audit reports to bank auditors, and board of company auditors shall

<sup>72</sup> In this Essential Criterion, the supervisor is not necessarily limited to the banking supervisor. The responsibility for ensuring that financial statements are prepared in accordance with accounting policies and practices may also be vested with securities and market supervisors.

	<p>produce audit reports (Article 390 of the Companies Act) and provide the report and financial statements to shareholders (Article 437 of the Companies Act).</p> <p>All banks are stock companies, and all cooperative financial institutions are subject to <i>Shinkin</i> Bank Act or Act on Financial Businesses by Cooperatives in which Companies Act is applied mutatis mutandis (See EC 4). Therefore, financial statements are legally required to be audited by certified public auditor. A member of a bank's board of directors also needs to personally confirm the validity of the financial statements in the bank's annual report.</p> <p>Bank board of directors are required to produce annual reports in accordance with Article 21 of the Banking Act. Based on Article 19–2 of the Ordinance for Enforcement of the Banking Act, the annual report shall state that the financial statements have been audited in accordance with Companies Act and Financial Instruments and Exchange Act. Regulatory capital adequacy ratios are also audited by external auditors. The annual report is also required to disclose any material facts arising from the audits and the improvement plans to address them.</p> <p>As indicated in EC1, Japanese GAAS has been established and is revised by reference to ISA to maintain consistency with international standards.</p> <p>External auditors do place some reliance on the work conducted by bank internal auditors, but will conduct more work on their own if there are any issues or gaps with respect to the internal audit work.</p> <p>The JFSA also inspects the financial statements of banks and banking groups in accordance with the requirements of its Inspection Manual. The frequency and intensity of its onsite work has tended to decline over time as it has gained confidence in and is able to rely more on the work of external auditors. The JFSA is also communicating more with external auditors on issues of common interest, which was confirmed in the review of supervisory files.</p>
<b>EC3</b>	<p>The supervisor determines that banks use valuation practices consistent with accounting standards widely accepted internationally. The supervisor also determines that the framework, structure and processes for fair value estimation are subject to independent verification and validation, and that banks document any significant differences between the valuations used for financial reporting purposes and for regulatory purposes.</p>
Description and findings re EC3	<p>As indicated in EC1 of the CP, Japanese GAAP has been assessed as equivalent to IFRS by the European Union (EU) in December 2008. Banks and banking groups are required to submit regulatory data in accordance with Japanese GAAP. Thus, there are no significant differences between the valuations used for financial reporting purposes and those for regulatory purposes.</p> <p>Tradable securities are required to be carried at fair-value in accordance with Japanese GAAP and IFRS accounting standards. The JFSA has held discussions with banks and their auditors on the valuations of these exposures to ensure that prudence is exercised when conducting valuations, notably over the extent to which reliance can be placed on market indices for valuation estimates. In general, the JFSA tries to reach consensus with the banks</p>

	<p>and external auditors on valuation issues. While it has the legal authority to impose its own valuation practices, it would need to have clear grounds upon which to intervene before it could act.</p> <p>Japanese companies have traditionally held substantial amounts of equities of major business partners (cross shareholdings) to help cement long-term business relationships and prevent hostile takeovers. Under the original Japanese GAAP, which was mostly built on historical cost valuations, such practices had 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 been subject to limits on their equity holdings as a share of bank capital.</p>
<b>EC4</b>	Laws or regulations set, or the supervisor has the power to establish the scope of external audits of banks and the standards to be followed in performing such audits. These require the use of a risk and materiality based approach in planning and performing the external audit.
Description and findings re EC4	<p>Banks and banking groups are required to be organized as joint stock companies and engage external auditors in accordance with the Article 4–2 of the Banking Act. A <i>Shinkin</i> bank and Credit cooperative are also required to engage external auditors in accordance with Article 38–3 of the <i>Shinkin</i> Bank Act or Article 5–9 of the Act on Financial Businesses by Cooperatives in which Companies Act is applied mutatis mutandis. Article 396 of the Companies Act provides the scope of the audit (financial statements stipulated in Articles 396 and 435 of the Companies Act).</p> <p>As indicated in EC1, external auditors are expected to determine and report whether a bank's financial statements are presented fairly in accordance with Japanese GAAP (or IFRS). As the JFSA does not formally rely on external auditors to audit financial statements or carry out internal controls assessments apart from those relevant for the fair presentation of financial statements, generally the JFSA would not be able to establish changes in scope of audits although in practice, the JFSA 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>
<b>EC5</b>	Supervisory guidelines or local auditing standards determine that audits cover areas such as the loan portfolio, loan loss provisions, non-performing assets, asset valuations, trading and other securities activities, derivatives, asset securitizations, consolidation of and other involvement with off-balance sheet vehicles and the adequacy of internal controls over financial reporting.
Description and findings re EC5	Given external auditors are required to audit the financial statements of banks in accordance with Japanese auditing standards, the audits will cover the various components of bank 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 or IFRS.

<b>EC6</b>	The supervisor has the power to reject and rescind the appointment of an external auditor who is deemed to have inadequate expertise or independence, or is not subject to or does not adhere to established professional standards.
Description and findings re EC6	<p>In cases where any issue such as severe violations of laws or regulations is identified an external auditor could be dismissed under the Article 27 of the Banking Act. The JFSA may take disciplinary actions (admonition, suspension of the business within two years, etc.) against all certified public accountants and auditing firms, including accounting auditors of banks, in cases where CPAs or auditing firms violate the Certified Public Accountants Act in accordance with the Article 31 and 34–21–2 of the Act.</p> <p>Under Paragraph 2 of Article 30 and Paragraph 2 of Article 34–21 of the Certified Public Accountants Act, the JFSA may take disciplinary actions (suspension of the business within two years or reprimand) against all certified public accountants and auditing firms, including accounting auditors of banks, in cases where certified public accountants or auditing firms negligently verify the appropriateness of materially misrepresented financial statements.</p> <p>Moreover, under Paragraph 1 of Article 30 and Paragraph 2 of Article 34–21 of the Certified Public Accountants Act, the JFSA may take disciplinary actions (e.g., suspension of the business within two years, deregistration against certified public accountants, dissolution order against auditing firms) in cases where certified public accountants or auditing firms knowingly verify the appropriateness of materially misrepresented financial statements.</p> <p>That said, for the JFSA to reject or rescind the appointment of an external auditor of a bank the issue would need to be fairly extreme, and there have not been any recent examples of incidences involving extreme violations. (Note that a separate division of the JFSA oversees external auditors). The most notable example of an issue in this regard was back in 1998 when Daiwa failed and the external auditor was sanctioned.</p>
<b>EC7</b>	The supervisor determines that banks rotate their external auditors (either the firm or individuals within the firm) from time to time.
Description and findings re EC7	III–1–2–1 of Comprehensive Guidelines for Supervision of Major Banks, etc., (or II–1–2 (6) Comprehensive Guidelines for Supervision of Small- and Medium-Sized and Regional Financial Institutions) requires banks to appropriately determine CPA’s tenure involved in external audits. That said, there is a mandatory rotation requirement for auditors of listed and certain large companies every seven years with a cooling off period of two years under the CPA Act and JICPA also requires larger audit firms to follow a five-year rotation rule with a five-year cooling off period for lead engagement partners and quality review partners.
<b>EC8</b>	The supervisor meets periodically with external audit firms to discuss issues of common interest relating to bank operations.
Description and findings re EC8	The JFSA uses its own supervisory personnel resources to ensure the quality, integrity, and adequacy of the supervision. It has not outsourced any supervisory affairs to any third parties. However, it has the authority to receive reports on issues identified by the bank’s external auditor, and as confirmed in the review of supervisory files the JFSA does have meetings with external auditors to discuss matters that may affect financial results of the bank or matters that falls under the scope of audit for internal control system of the bank.

	<p>In addition, JICPA has published “Guidelines for Cooperation between Financial Inspection and Accounting Audit” on July 27, 2000, and accounting auditors have discussions with JFSA’s inspectors where appropriate in accordance with the guideline.</p> <p>With regard to the BoJ, it holds trilateral meetings with the financial institution and its auditor, when necessary, on the occasion of an onsite examination.</p>
<b>EC9</b>	<p>The supervisor requires the external auditor, directly or through the bank, to report to the supervisor matters of material significance, for example failure to comply with the licensing criteria or breaches of banking or other laws, significant deficiencies and control weaknesses in the bank’s financial reporting process or other matters that they believe are likely to be of material significance to the functions of the supervisor. Laws or regulations provide that auditors who make any such reports in good faith cannot be held liable for breach of a duty of confidentiality.</p>
Description and findings re EC9	<p>Although external auditors are not legally required to report to bank supervisors the facts that they uncover during an audit, they are required to report misconducts to company auditors in cases where the accounting auditors found them out (Article 397 of the Company Act). Company auditors also shall report misconducts to directors (Article 382 of the Companies Act). Therefore, the JFSA may require a bank via its directors to report the facts that auditors found out during the audit.</p> <p>A bank or its personnel shall be punished in accordance with Article 63 of the Banking Act in cases where the bank or its personnel intentionally submits false reports to the JFSA. In addition, the JFSA issues business improvement order to the bank in such cases, and it may be punished in accordance with Item 2 of the Article 62 of the Banking Act.</p> <p>However, as described in the EC11 of CP 29, auditors who act in good faith and comply with laws or regulations cannot be held responsible for any liability in breaching confidentiality in this respect.</p> <p>In cases where certified public accountants or auditing firms identify any fact that does not comply with laws or regulations or any fact that may affect the appropriateness of financial statements in their audit procedures of companies subject to Financial Instruments and Exchange Act, they are required to report these facts and to request corrective actions against the audited company in writing. In addition, they are required to report to the Commissioner of the JFSA in cases where the audited company does not correct the fact within two weeks of notification (Article 193–3 of the Financial Instruments and Exchange Act).</p> <p>Certified public accountants and auditing firms are not liable for confidentiality in reporting to the Commissioner of the JFSA in accordance with the Article.</p>
<b>Additional criteria</b>	
<b>AC1</b>	<p>The supervisor has the power to access external auditors’ working papers, where necessary.</p>

Description and findings re AC1	The JFSA has the indirect authority to access external auditor working papers because it can order banks to submit any materials in non-consolidated and consolidated basis in accordance with Article 24 of the Banking Act.
<b>Assessment of Principle 27</b>	LC
Comments	<p>While there are some legislative powers over external auditors vested with the PM (delegated to the Commissioner of the JFSA) 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), the JFSA would not be able to reject or rescind the appointment of an external auditor except in extreme situations.</p> <p>Banking supervisory powers should not only apply in instances when clear malpractice had taken place but should be more wide ranging to allow banking supervisors 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>Many jurisdictions 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 JFSA 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. This should not only be restricted to cases arising from violations of laws and regulations and financial statement misstatements but should also include reporting to the JFSA issues that have been subsequently rectified by the bank. These less egregious issues can often be a harbinger of underlying weaknesses in bank risk management and internal control practices that could be more promptly addressed by the JFSA the sooner it is made aware of them.</p>
<b>Principle 28</b>	<b>Disclosure and transparency.</b> The supervisor determines that banks and banking groups regularly publish information on a consolidated and, where appropriate, solo basis that is easily accessible and fairly reflects their financial condition, performance, risk exposures, risk management strategies and corporate governance policies and processes.
Essential criteria	
<b>EC1</b>	Laws, regulations or the supervisor require periodic public disclosures <sup>73</sup> of information by banks on a consolidated and, where appropriate, solo basis that adequately reflect the bank's true financial condition and performance, and adhere to standards promoting comparability, relevance, reliability and timeliness of the information disclosed.

<sup>73</sup> For the purposes of this Essential Criterion, the disclosure requirement may be found in applicable accounting, stock exchange listing, or other similar rules, instead of or in addition to directives issued by the supervisor.

Description and findings re EC1	<p>As indicated in EC1 of CP27, under Article 20 of the Banking Act, Japanese banks and banking groups are required publicly disclose non-consolidated and consolidated audited financial statements. Article 21 of the Banking Act requires those institutions to publicly disclose annual and interim reports both on non-consolidated and consolidated basis explaining their businesses and financial conditions.</p> <p>Article 21 of the Banking Act provides the JFSA with the authority to stipulate matters to be reported in annual and interim reports. This is expanded upon in Article 19–2 of the Ordinance of the Enforcement of the Banking Act. Paragraph 7 of that Ordinance requires a bank to publicly disclose information useful for the public to understand business and financial condition of the bank and its subsidiaries. Based on Article 19–5 of that Ordinance, the JFSA requires banks to publicly disclose quarterly important matters for reference to depositors and other customers to help them understand the status of the business and assets of the bank and its subsidiaries.</p> <p>Every fiscal year, a company subject to Financial Instruments and Exchange Act is required to disclose consolidated and non-consolidated financial statements. In addition, a listed company is required to disclose consolidated financial statements quarterly. On the other hand, a non-listed company subject to Financial Instruments and Exchange Act is required to disclose consolidated and non-consolidated financial statements semi-annually.</p> <p>Moreover, public companies shall timely disclose their financial status in accordance with rules provided by stock exchanges.</p> <p>The JFSA has gone even further by spelling out its public disclosure requirements for banks and banking groups in a Disclosure Notice that sets out detailed instructions including templates (where appropriate) for banks and banking groups to publicly disclose information required by the Basel Framework on a consolidated and unconsolidated basis. These Pillar 3 public disclosure obligations have been integrated with Japanese bank financial statements and are applied to both internationally-active and domestic banks. Forthcoming new Pillar disclosure requirements under Basel III will be implemented in accordance with the internationally-agreed timelines.</p>
<b>EC2</b>	<p>The supervisor determines that the required disclosures include both qualitative and quantitative information on a bank’s financial performance, financial position, risk management strategies and practices, risk exposures, aggregate exposures to related parties, transactions with related parties, accounting policies, and basic business, management, governance and remuneration. The scope and content of information provided and the level of disaggregation and detail is commensurate with the risk profile and systemic importance of the bank.</p>
Description and findings re EC2	<p>Please see EC1 of this CP. This obligation is met via the general requirements set out in Japanese law and ordinances plus through Disclosure Notice implementing Basel Framework Pillar 3 public disclosure requirements. The JFSA monitors bank adherence to these requirements through its offsite monitoring and as confirmed by a review of supervisory files follows-up on any issues in its onsite inspections. The Basel Framework obligations are imposed on all banks and banking groups.</p>

<b>EC3</b>	Laws, regulations or the supervisor require banks to disclose all material entities in the group structure.
Description and findings re EC3	<p>Banks and a bank-holding companies subject to Financial Instruments and Exchange Act are required to disclose important companies within their groups (parent companies, subsidiaries, affiliated companies, or other related companies) in their public disclosures such as financial statements.</p> <p>Article 19–2 and 19–3 of the Ordinance for the Enforcement of the Banking Act stipulate disclosure requirements regarding banking groups, such as their main stockholders and subsidiaries, as items requiring public disclosure in annual and interim reports in accordance with Article 21 of the Banking Act.</p>
<b>EC4</b>	The supervisor or another government agency effectively reviews and enforces compliance with disclosure standards.
Description and findings re EC4	Disclosures, such as financial statements that banks and bank-holding companies are required to publish under Financial Instruments and Exchange Act, are reviewed by the JFSA in the course of its offsite monitoring and onsite inspections conducted in accordance with its Inspection Manual. Rules and regulations against violators such as administrative actions and criminal responsibilities are stipulated. Business improvement orders would be issued in the event a bank fails to honor the JFSA disclosure requirements or is found to have released incorrect information. A review of supervisory files confirmed that the JFSA actively pursues banks that have mistakenly disclosed incorrect information.
<b>EC5</b>	The supervisor or other relevant bodies regularly publishes information on the banking system in aggregate to facilitate public understanding of the banking system and the exercise of market discipline. Such information includes aggregate data on balance sheet indicators and statistical parameters that reflect the principal aspects of banks' operations (balance sheet structure, capital ratios, income earning capacity, and risk profiles).
Description and findings re EC5	<p>The JFSA and BoJ publish on their websites comprehensive information on the Japanese banking industry such as capital adequacy ratios, net income and its breakdown and nonperforming loan ratios. In addition, the BoJ conducts research and analysis assessing risks in the financial system as a whole, i.e., taking a macroprudential perspective, by making use of insights obtained through its onsite examinations and offsite monitoring and paying due attention to the interconnectedness of the real economy, financial markets, and the behavior of financial institutions. The findings of this research and analysis are published in various forms for example, in its Financial System Report.</p> <p>In addition, banking industry organizations such as the Japanese Bankers Association publish information on the industry; for example, JBA analyzes financial results of the industry and comprehensively publish financial statements of each bank on its website.</p>
<b>Additional criteria</b>	
<b>AC1</b>	The disclosure requirements imposed promote disclosure of information that will help in understanding a bank's risk exposures during a financial reporting period, for example on average exposures or turnover during the reporting period.
Description and findings re AC1	The JFSA Disclosure Notice (Article 2–4–2–(a) of the Pillar 3 Notice) requires banks to disclose average balances in cases where period-ending credit exposure balances differ

	<p>materially from average balances over the reporting period. (The calculation methodology needs to be disclosed if average daily balances are not used).</p> <p>In addition, the three major Japanese banks have been making steady progress in implementing all of the disclosure recommendations of the Financial Stability Board's Enhanced Disclosure Task Force (this includes some information on risk exposures and liquidity condition information during a reporting period as well as end of period information). The 2015 EDTF report from the FSB indicates that the Asian-Pacific banks (which includes Japanese banks among others) had implemented almost two-thirds of the recommendations at the end of 2014, consistent with the average for U.S. banks albeit lagging European and Canadian banks. Mitsubishi UFJ FG was singled out as a best practice example for its disclosure of information related to troubled debt restructurings.</p> <ul style="list-style-type: none"> <li>✓ More detailed disclosures are planned in the future when JFSA's Disclosure notice is revised to implement new enhancements to the Pillar 3 component of the Basel Framework in accordance with the internationally-agreed schedule.</li> </ul>
<b>Assessment of Principle 28</b>	C
Comments	<p>The Japanese authorities are to be commended for their dedication in promoting strong disclosure standards. In addition to good disclosure practices generally domestically, they have required both domestic and internationally-active banks implement Basel III Pillar 3 disclosure requirements on both a consolidated and unconsolidated basis in accordance with internationally-agreed timelines, and have encouraged the most systemic banks to adopt the enhanced disclosure requirements endorsed by the Financial Stability Board. However, as international disclosure requirements become more detailed in the future in the wake of planned revisions to the Basel Pillar 3 Framework, the JFSA may wish to consider the regulatory burden imposed on smaller banks and assess the costs and benefits of imposing the more detailed requirements on those institutions.</p>
<b>Principle 29</b>	<b>Abuse of financial services.</b> The supervisor determines that banks have adequate policies and processes, including strict customer due diligence (CDD) rules to promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities. <sup>74</sup>
Essential criteria	
<b>EC1</b>	Laws or regulations establish the duties, responsibilities and powers of the supervisor related to the supervision of banks' internal controls and enforcement of the relevant laws and regulations regarding criminal activities.
Description and findings re EC1	The JFSA is the supervisory agency responsible for monitoring and enforcing bank's responsibilities in relation to financial crime (AML/CFT). In Japan, the Act on Prevention of Transfer of Criminal Proceeds (hereinafter "APTC") is the main law governing the prevention of criminal proceeds via the banking sector, including the legal framework for customer due diligence. Articles 15 to 18 of the APTC empowers the JFSA to supervise

<sup>74</sup> The Committee is aware that, in some jurisdictions, other authorities, such as a financial intelligence unit (FIU), rather than a banking supervisor, may have primary responsibility for assessing compliance with laws and regulations regarding criminal activities in banks, such as fraud, money laundering and the financing of terrorism. Thus, in the context of this Principle, "the supervisor" might refer to such other authorities, in particular in Essential Criteria 7, 8, and 10. In such jurisdictions, the banking supervisor cooperates with such authorities to achieve adherence with the criteria mentioned in this Principle.

	<p>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 JFSA to develop internal controls to ensure compliance with the APTC.</p> <p>In relation to JFSA's expectations for banks to implement effective controls and policies to prevent financial crime, the Supervisory Guideline contains such provisions. In order to evaluate bank's processes for managing and mitigating ML/TF risk, the JFSA monitors bank's overall risk management framework and compliance on an ongoing basis. The JFSA will then drill down into specific themes associated with AML/CFT using offsite data to guide onsite activity. When onsite the JFSA uses its inspection manual which has explicit provisions which requires a bank to develop an internal control environment to comply with APTC in order to tackle organized crimes, etc.</p> <p>Inspection Manual (Checklist for legal compliance) also explicitly requires inspectors to examine whether a bank has developed an internal control environment to comply with APTC in order to tackle organized crime. The JFSA is explicitly placed as the supervisor with sufficient authorities, and it appropriately supervises financial institutions in accordance with laws, regulations, Supervisory Guidelines and Inspection Manuals. Also, the JFSA, in cooperation with other relevant ministries and agencies, has been working on legislation such as amendment of APTC to prevent abuse of financial services in line with global standards with taking the deficiencies identified by the 2008 FATF Mutual Evaluation into consideration.</p>
<b>EC2</b>	<p>The supervisor determines that banks have adequate policies and processes that promote high ethical and professional standards and prevent the bank from being used, intentionally or unintentionally, for criminal activities. This includes the prevention and detection of criminal activity, and reporting of such suspected activities to the appropriate authorities.</p>
Description and findings re EC2	<p>Article 8 of the APTC requires financial institutions to submit Suspicious Transactions Reports (hereinafter "STRs"), and paragraph 1, Article 53 of the Banking Act (and item 25, paragraph 1, Article 35 of Ordinance of the Banking Act) provides that banks shall submit reporting when there are illegalities notified by its staffs.</p> <p>Article 11 of the APTC requires financial institutions to develop training programs for their staffs and other necessary systems, and Articles 15 to 18 of the APTC enable the JFSA to order reporting, conduct onsite-inspection and issue business improvement order to financial institutions. The JFSA supervises financial intuitions based on these authorities.</p> <p>The JFSA examines whether banks promote high ethical and professional standards, and whether banks establish appropriate policies and processes to prevent themselves from being used, intentionally or unintentionally, for criminal activities in accordance with III-3-1-3-1-2, III-3-1-3-2 and III-3-1-4-2, etc., of the Supervisory Guideline.</p> <p>The Inspection Manual sets out that inspectors examine whether banks assess their processes for evaluating effectiveness of their compliance systems and revise them in a</p>

	timely manner where appropriate. Under the processes, inspectors examine whether the banks develop an internal control environment to promptly submit STRs to the JFSA when their managers determine the transactions should be reported after an immediate investigation whether or not the transaction could be involved with criminal proceeds.
<b>EC3</b>	In addition to reporting to the financial intelligence unit or other designated authorities, banks report to the banking supervisor suspicious activities and incidents of fraud when such activities/incidents are material to the safety, soundness or reputation of the bank. <sup>75</sup>
Description and findings re EC3	(See also EC2). According to the Banking Act, banks report to the JFSA when they notice illegalities in the banks and their subsidiaries (paragraph 1, Article 53 of the Banking Act, and item 25, paragraph 1, Article 35 of the Ordinance of the Banking Act). APTC stipulates that STRs shall be submitted to the JFSA and other banking supervisors (paragraph 1 and 4 of Article 8, and paragraph 5 of Article 22), and then all STRs shall be reported into the Financial Intelligence Unit (paragraph 5 of Article 8). Reporting of STRs has increased dramatically over the last dozen years with 18,768 STRs reported in 2002, rising to 399,508 STRs reported in 2015. Part of this increase is the result of efforts on behalf of the JFSA and NPA increasing focus on bank awareness of AML/CFT requirements e.g., workshops with financial institutions all over Japan, and the JFSA properly supervises financial institutions. Article 8 of the APTC requires financial institutions to submit suspicious transaction reports (STRs) and paragraph 1, Article 53 of the Banking Act and item 25, paragraph 1, Article 35 of Ordinance of the Banking Act require 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 JFSA requires banks to establish and maintain procedures, policies and internal controls to prevent money laundering and financing of terrorism. The JFSA will assess the internal controls framework in place including the STR reporting process during onsite inspections.
<b>EC4</b>	If the supervisor becomes aware of any additional suspicious transactions, it informs the financial intelligence unit and, if applicable, other designated authority of such transactions. In addition, the supervisor, directly or indirectly, shares information related to suspected or actual criminal activities with relevant authorities.
Description and findings re EC4	Paragraph 5, article 8 of APTC requires the JFSA to promptly forward all STRs that the JFSA has received to FIU, which enable the JFSA and FIU to share all STRs. Paragraph 1, Article 13 of APTC requires FIU to provide information concerning STRs to law enforcement agencies, which enable the JFSA and law enforcement agencies to indirectly share STRs. Paragraph 1, Article 53 of the Banking Act requires banks to report to the JFSA when illegalities in banks and their subsidiaries were observed. Article 8 of the APTC also requires all STRs to be submitted to the JFSA and relevant banking supervisors and subsequently reported to the Financial Intelligence Unit (FIU). 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 Paragraph 2, Article 4 of APTC.  Article 8, paragraph 5, of the APTC requires the JFSA to promptly forward all STRs received to the FIU. Article 13, paragraph 1, of APTC requires FIU to provide information concerning

<sup>75</sup> Consistent with international standards, banks are to report suspicious activities involving cases of potential money laundering and the financing of terrorism to the relevant national center, established either as an independent governmental authority or within an existing authority or authorities that serves as an FIU.

	<p>STRs to law enforcement agencies, which enable the JFSA and law enforcement agencies to have relevant information on all submitted STRs. In terms of domestic sharing of STRs, Article 8, paragraph 1, of the APTC requires financial institutions under the joint supervision of the JFSA 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 JFSA and the others ministries. In terms of foreign financial sector sharing of information, under Article 14 of the APTC, the JFSA would be able to share information on STRs with foreign counterparts via the respective jurisdictions' FIUs. The JFSA exchange general information with foreign counterparts via international bodies such as the BCBS, FATF and the Asia Pacific Group on money laundering.</p>
<b>EC5</b>	<p>The supervisor determines that banks establish CDD policies and processes that are well documented and communicated to all relevant staff. The supervisor also determines that such policies and processes are integrated into the bank's overall risk management and there are appropriate steps to identify, assess, monitor, manage and mitigate risks of money laundering and the financing of terrorism with respect to customers, countries and regions, as well as to products, services, transactions and delivery channels on an ongoing basis. The CDD management program, on a group-wide basis, has as its essential elements:</p> <ul style="list-style-type: none"> <li>(a) a customer acceptance policy that identifies business relationships that the bank will not accept based on identified risks;</li> <li>(b) a customer identification, verification and due diligence program on an ongoing basis; this encompasses verification of beneficial ownership, understanding the purpose and nature of the business relationship, and risk-based reviews to ensure that records are updated and relevant;</li> <li>(c) policies and processes to monitor and recognize unusual or potentially suspicious transactions;</li> <li>(d) enhanced due diligence on high-risk accounts (e.g., escalation to the bank's senior management level of decisions on entering into business relationships with these accounts or maintaining such relationships when an existing relationship becomes high-risk);</li> <li>(e) enhanced due diligence on politically exposed persons (including, among other things, escalation to the bank's senior management level of decisions on entering into business relationships with these persons); and</li> <li>(f) clear rules on what records must be kept on CDD and individual transactions and their retention period. Such records have at least a five-year retention period.</li> </ul>
Description and findings re EC5	<p>Financial institutions are required making operational procedures for Customer Due Diligence, Recordkeeping and other obligations regarding AML/CFT, and also providing training to employees. (Article 11 of APTC). APTC requires financial institutions (1) to conduct Customer Due Diligences when opening accounts and other specified transactions; (2) to keep records of CDDs for seven years after the business relationships between customers end; and (3) to keep records for specified transactions for seven years (Articles 4, 6, and 7 of APTC). The JFSA also conducts onsite-inspections to evaluate how banks comply with the requirements stated above, and the JFSA takes necessary actions when financial institutions do not comply with the requirements. APTC shall punish not only natural person who violates the Act but also legal person that does not comply with it (Article 30 of APTC). Also, APTC requires financial institutions to make risk assessment documents which contain research and analysis of the situation of transfer of criminal proceeds and</p>

	<p>assessment of the risk of money laundering. Financial institutions need continuously to scrutinize identification record and transaction record (Article 11 of APTC, Article 32 of Ordinance for Enforcement of APTC).</p> <p>In addition, APTC requires financial institutions to establish internal control systems in order to appropriately (1) identify beneficial owners; (2) obtain information on the purpose and indented nature of the business relationship; (3) conduct ongoing due diligence on the business relationship, and (4) conduct enhanced due diligence on higher risk transactions (Article 4 and 11of APTC). Moreover, item 4, paragraph 1, Article 32 of Ordinance for Enforcement of APTC requires approvals by a general compliance manager in the case of higher risk transactions such as transactions with politically exposed persons and suspicious transactions. CDD measures must be taken in the case of suspicious transactions and potentially suspicious transactions as well as small amount of separated transactions to avoid CDD thresholds (Article 7 of Order for Enforcement of APTC, Article 5 of Ordinance for Enforcement of APTC).</p> <p>II-3-1-3-1-2 (1) of amended Comprehensive Guidelines for Supervision of Major Banks, etc., in line with amended APTC in 2014 requires banks to establish integrated management systems to conduct CDD measures. For example, encircled number 3 requires to set out a customer acceptance policy; encircled number 2 requires to make risk assessment documents which contain research and analysis of the situation of transfer of criminal proceeds, to conduct continuous scrutiny of identification record and transaction record, and to be approved higher risk transactions with politically exposed persons including establishment of business relationships regarding high risk accounts by a general compliance manager, encircled number 5 requires to make operational manual about CDD including identification and verification of customer, to inform it to staff and to train them about it continuously. encircled number 6 requires to set out policies and processes to monitor and recognize unusual or potentially suspicious transactions. Also, III-3-1-3-1-2 (2) of amended Comprehensive Guidelines for Supervision of Major Banks, etc., requires to establish appropriate conditions to implement appropriate CDD to high risk transactions such as identifying beneficial owner and possibility of foreign politically exposed persons as well as enhanced CDD measures to high risk transactions. Furthermore, III-3-1-3-1-2 (2) requires to establish system to detect, monitor and analyze suspicious customer and transactions, and to consider nature of customers and situation of transactions, and also to conduct adequate CDD measures depending on risks.</p> <p>Inspection Manual stipulates that inspectors evaluate whether banks' board of directors, etc., develop their fundamental policies, rules and organizations for compliance and customer protection. In addition, inspectors examine internal rules on CDDs and STRs provided by board of directors stipulates:</p> <ul style="list-style-type: none"> <li>✧ whether or not rules concerning CDDs and STRs are clear and appropriate;</li> <li>✧ whether or not internal control systems for ousting anti-social rogues are developed, and board of directors clearly show the policy for it and inform employees.</li> </ul> <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</p>
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	<p>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 were 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 most 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.</p> <p>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 and 2014 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 JFSA's 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 JFSA during onsite inspections.</p>
<b>EC6</b>	<p>The supervisor determines that banks have in addition to normal due diligence, specific policies and processes regarding correspondent banking. Such policies and processes include:</p> <ul style="list-style-type: none"> <li>(a) gathering sufficient information about their respondent banks to understand fully the nature of their business and customer base, and how they are supervised; and</li> <li>(b) not establishing or continuing correspondent relationships with those that do not have adequate controls against criminal activities or that are not effectively supervised by the relevant authorities, or with those banks that are considered to be shell banks.</li> </ul>
Description and findings re EC6	<p>APTC requires financial institutions, in relation to cross-border correspondent relationships, to gather sufficient information about a respondent institution to understand fully the quality of a respondent institution's AML/CFT measures, actual situation of respondent's business and the quality of supervision. Also, APTC requires to make operational procedures for the assessment process of correspondent relationships based on such gathered information and to identify that respondent bank is not a shell bank (Article 9 of APTC, and paragraph 4, Article 32 of Ordinance for Enforcement of APTC).</p> <p>Supervisory Guidelines require banks to develop internal control environment to properly conduct correspondent banking businesses to comply with APTC. Moreover, Inspection Manual provides that inspectors examine whether banks clearly and properly develop policies on CDDs and STRs. JFSA's Comprehensive Supervisory Guidelines specifies</p>

	<p>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.</p>
<b>EC7</b>	<p>The supervisor determines that banks have sufficient controls and systems to prevent, identify and report potential abuses of financial services, including money laundering and the financing of terrorism.</p>
Description and findings re EC7	<p>APTC requires banks (1) to conduct CDDs when opening account and other specified transactions; and (2) to keep records of CDDs for seven years after the business relationships between customers end, (3) to keep records for specified transactions for seven years (Article 4, 6, and 7 of APTC). The JFSA conducts onsite inspections to evaluate how banks comply with the requirements stated above, and the JFSA takes necessary actions when financial institutions do not comply with the requirements. APTC shall punish not only natural person who violates the Act but also legal person that does not comply with it (Article 30 of APTC).</p> <p>II-1-1-2 (3) of Supervisory Guideline provides that the JFSA yearly conducts "hearing on internal audit" which includes risk management and compliance systems on AML/CFT. The Inspection Manual provides inspectors examine whether or not board of directors, etc., develops fundamental policies, internal rules and organizations for establishing compliance systems in accordance with management policies, and whether or not board of directors, etc., regularly or in a timely manner where appropriate assesses and revises compliance systems based on reporting and examination for improvement on compliance. Basic Inspection Policy of this year also provides that banks should develop legal compliance system to eliminate anti-social groups (e.g., organized crime, gangs, etc.) from financial services.</p> <p>Verification of banks' internal controls are carried out by the JFSA during their onsite inspections. Annually, the JFSA 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.</p>
<b>EC8</b>	<p>The supervisor has adequate powers to take action against a bank that does not comply with its obligations related to relevant laws and regulations regarding criminal activities.</p>
Description and findings re EC8	<p>APTC requires financial institutions to (1) conduct CDDs when opening account and other specified transactions, (2) keep records of CDDs for seven years after the business relationships between customers and (3) keep records for specified transactions for seven years (Articles 4, 6, and 7 of APTC). The JFSA conducts onsite-inspections to evaluate how banks comply with the requirements stated above, and the JFSA takes necessary actions when financial institutions do not comply with the requirements. APTC shall punish not only natural person who violates the act but also legal person that does not comply with it (Article 30 of APTC).</p> <p>The JFSA requires a bank which does not perform duties to tackle criminal activities to report where necessary based on article 24 of the Banking Act, and then the JFSA issues business improvement order where the JFSA finds significant deficiencies based on Article 26 of the Banking Act. The JFSA also orders a bank the internal control environment</p>

	<p>of which is vulnerable to suspend a part of its businesses for a period of time. In addition, the JFSA shall order such a bank to suspend its whole businesses based on Article 27 of the Banking Act.</p> <p>Powers to take regulatory actions against financial institutions for non-compliance with APTC requirements are vested with both the APTC and the JFSA. The JFSA 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 Articles 24 to 26 of the Banking Act. Fines and imprisonment would generally be decided by the court of law.</p>
<b>EC9</b>	<p>The supervisor determines that banks have:</p> <ul style="list-style-type: none"> <li>(a) requirements for internal audit and/or external experts<sup>76</sup> to independently evaluate the relevant risk management policies, processes and controls. The supervisor has access to their reports;</li> <li>(b) established policies and processes to designate compliance officers at the banks' management level, and appoint a relevant dedicated officer to whom potential abuses of the banks' financial services (including suspicious transactions) are reported;</li> <li>(c) adequate screening policies and processes to ensure high ethical and professional standards when hiring staff; or when entering into an agency or outsourcing relationship; and</li> <li>(d) ongoing training programs for their staff, including on CDD and methods to monitor and detect criminal and suspicious activities.</li> </ul>
Description and findings re EC9	<p>APTC requires financial institutions to provide training to employees, to assign general compliance managers and to recruit those who have adequate capability to conduct proper CCD measures and STRs. III-1-2-1 of Supervisory Guideline requires banks' Representative Director and President to develop systems for internal audit unit and Company Auditor which can assess independently risk management policies, processes and controls. The JFSA may freely access to internal audit report based on Articles 24 and 25 of the Banking Act.</p> <p>III-1-2-1 of Supervisory Guideline stipulates that establishing internal control systems is a fiduciary duty of directors, and provides that directors shall have sufficient knowledge and experience on compliance and risk management for soundly and properly managing banking businesses. These measures ensure to establish policies and processes to designate management level compliance officers, which makes sure to appoint professional staffs who receive reporting when the banks' financial services could be abused, including Suspicious Transactions. III-3-1-3-1-2 of Supervisory Guideline stipulates that financial institutions conduct appropriate and ongoing trainings. III-3-3-4-2 of Supervisory Guideline prescribes that banks should identify whether an outsourced service provider can provide satisfactory level of services and is capable of compensating losses incurred from</p>

<sup>76</sup> These could be external auditors or other qualified parties, commissioned with an appropriate mandate, and subject to appropriate confidentiality restrictions.

	<p>the outsourced services, judging from the service provider’s business record and financial soundness, and consider whether there is any adverse impact on their own reputation.</p> <p>JFSA yearly conducts “hearing on internal audit” with regard to items listed above. Law enforcement agencies such as National Police Agency and Public Prosecutors Office shall address criminal activities, though JFSA has staffs with specialty on criminal issues such as ones who has been transferred from law enforcement agencies. JFSA’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 JFSA 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 JFSA may freely access to internal audit report based on Articles 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. JFSA’s 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.</p>
<p><b>EC10</b></p>	<p>The supervisor determines that banks have and follow clear policies and processes for staff to report any problems related to the abuse of the banks’ financial services to either local management or the relevant dedicated officer or to both. The supervisor also determines that banks have and utilize adequate management information systems to provide the banks’ boards, management and the dedicated officers with timely and appropriate information on such activities.</p>
<p>Description and findings re EC10</p>	<p>The Supervisory Guideline stipulates that banks should develop an appropriate reporting system for cases where staffs notice cases that financial services are abused by criminal organizations, and the JFSA evaluates whether or not banks comply with the rule. The JFSA examines whether financial institutions have management framework, including senior managements’ engagement, to properly handle customers and transactions that are exposed to potentially higher AML/CFT risks due to a customer’s attribute, etc., based on III-3-1-1-1-2 (1) encircled number 3 of Supervisory Guideline. The JFSA also examines whether financial institutions assign the role of compliance officer at management level regarding AML/CFT to implement proper CDD measures based on III-3-1-1-1-2 (1) encircled number 4 of Supervisory Guideline.</p> <p>Inspection Manual provides that inspectors examine whether or not banks establish appropriate measures to integrate, manage, analyse and consider all information on compliance within the banks from the view point of developing strict compliance cultures. Inspection Manual also stipulates that inspectors examine whether or not banks regularly evaluate the effectiveness of processes provided above paragraph in order to assess if the internal control environment on compliance effectively work. For the examination on the internal control system, inspectors also examine whether or not banks establish mechanisms to effectively collect compliance information which is dispersed among a lot of sections in a bank. For example, inspectors examine whether or not the bank develops a reporting system such as helpline and compliance hotline.</p>

<b>EC11</b>	Laws provide that a member of a bank's staff who reports suspicious activity in good faith either internally or directly to the relevant authority cannot be held liable.
Description and findings re EC11	<p>Item 1, paragraph 1, Article 23 of Act concerning Protection of Personal Information allows business operators (including financial institutions) to provide personal data to third party without obtaining the prior consent of the person where it is in accordance with laws and regulations (i.e., bank staffs shall not be punished from the view point of data protection because STRs is stipulated in APTC). Article 709 of Civil Code stipulates "[A] person who has intentionally or negligently infringed any right of others, or legally protected interest of others, shall be liable to compensate any damages resulting in consequence," and there is a case law by the Supreme Court (No 1682, March 24 1994) which provides that an act by a person in accordance with laws and regulations shall not be liable for compensation. Thus, bank staffs who submit STRs are also not liable from the view point of Civil Code.</p> <p>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 8 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>
<b>EC12</b>	The supervisor, directly or indirectly, cooperates with the relevant domestic and foreign financial sector supervisory authorities or shares with them information related to suspected or actual criminal activities where this information is for supervisory purposes.
Description and findings re EC12	Paragraph 1, Article 8 of APTC requires financial institutions which is jointly supervised by the JFSA and other ministries (e.g., Ministry of Agriculture, Forestry and Fishery, and Ministry of Health, Labor and Welfare) to submit STRs to both the JFSA and others, therefore the JFSA shares the same information with all other financial supervisors. The JFSA may share information relating to STRs with foreign counterparts via Japanese and the counterparty's FIU based on Article 14 of APTC. In addition, the JFSA exchanges information with foreign counterparts via international bodies such as AMLEG under BCBS, FATF and Asia Pacific Group on money laundering.
<b>EC13</b>	Unless done by another authority, the supervisor has in-house resources with specialist expertise for addressing criminal activities. In this case, the supervisor regularly provides information on risks of money laundering and the financing of terrorism to the banks.
Description and findings re EC13	Law enforcement agencies such as National Police Agency and Public Prosecutors Office shall address criminal activities, though the JFSA has staffs with specialty on criminal issues such as ones who has been transferred from law enforcement agencies. The JFSA notifies to financial institutions the latest information about designated persons/entities of asset freezing measures based on United Nations Security Council's Resolutions such as Taliban, and about jurisdictions with strategic deficiencies designated by FATF. Paragraph 3,

	<p>Article 3 of APTC stipulates that the National Public Safety Commission would publicize National Risk Assessment of Money Laundering and Terrorist Financing that contains typology of transfer of criminal proceeds every year. National Police Agency and the JFSA collaborates to provide financial institutions with the latest examples of arrested case and typology of transfer of criminal proceeds and examples of suspicious transactions every year through workshops.</p> <p>The JFSA 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>
<b>Assessment of Principle 29</b>	LC
Comments	Japan had taken a number of steps to strengthen its AML/CFT capabilities. While the assessors noted that there have been some improvements, most notably in the reporting of STRs, a reduction in focus of onsite inspections for AML/CFT is a shortcoming. While reporting of STRs is an input into offsite monitoring, surveillance should be complemented by routine onsite inspections to verify the effectiveness of risk management and controls e.g., in the area of CDD processes, and correspondent banking relationships.

## SUMMARY COMPLIANCE WITH BASEL CORE PRINCIPLES

Core Principle	Grade	Comments
1. Responsibilities, objectives and powers	C	<p>The legal framework and supporting regulations and guidance are comprehensive with clear roles and responsibilities assigned to the different agencies plus a suite of powers that enables supervisors to effectively oversee the banking system.</p> <p>The three mandates assigned to the JFSA are complementary in that depositor protection and financial stability more generally are most likely to be achieved if the JFSA ensures that banks have capital and risk management practices commensurate with the risks they undertake and the environment in which they operate. In turn, this will promote a strong banking system that can contribute to the economic well-being of Japanese society by facilitating finance in the economy.</p>

Core Principle	Grade	Comments
2. Independence, accountability, resourcing and legal protection for supervisors	LC	Most of the mechanisms are in place to allow banking supervision to be conducted with the requisite operational independence. However, the statutory provisions governing the removal of a JFSA Commissioner from office could be tightened up. In addition, the funding model for the JFSA may become less robust over time if the financial sector continues to expand in a period of public sector fiscal restraint. Consequently, the authorities may wish to consider whether a different funding model might make sense over the longer run.
3. Cooperation and collaboration	C	The Japanese authorities have made significant progress in recent years in strengthening the links between the domestic agencies involved in banking supervision and in deepening relationships with foreign supervisory agencies via the introduction of more MoUs, EoLs and especially the introduction of CMGs for major Japanese banks that have been designated as global systemically important.
4. Permissible activities	C	The definition of a bank and the range of activities that banks and bank holding companies are permitted to engage in is clearly defined.
5. Licensing criteria	LC	In addition, with banking groups becoming more complex over time the JFSA should consider introducing more intensive probing of ownership structures of banking groups to give it satisfaction that it truly understands who are the ultimate beneficial owners standing behind a banking group and their capacity to provide capital to the bank in times of stress.
6. Transfer of significant ownership	LC	Major changes in the shareholding structures above the 20 percent threshold do not necessarily need supervisory approval ahead of time. In practice intentions are 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. The assessors believe that

Core Principle	Grade	Comments
		<p>authorities are generally better placed to exercise influence before a transaction takes place rather than having to respond by imposing additional obligations after the fact. 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 bank governance structures and business models.</p>
7. Major acquisitions	LC	<p>Given that material investments (more specifically investments that would lead to a significant influence of the investing bank on the operations of the institution receiving the investment) could have a major influence on the business model and risk profile of the latter, a stricter pre-approval is recommended as provided for in the case of subsidiaries, rather than a system based upon prior notification combined with onsite and offsite supervisory action.</p> <p>In addition, the scope for approval of acquisitions could be reconsidered, by expanding it to include the acquisition of ancillary business and banking related business.</p>
8. Supervisory approach	LC	<p>Since the last FSAP, a risk rating methodology to assess the risk profile of banks and banking groups has been introduced (2014) referred to as "risk profiles"). The approach is still in the process of being rolled out and aspects of the methodology are still being refined (e.g., how to balance risk against factors such as size, scale, complexity and systemic importance). While the onsite and offsite supervisory processes are relatively sound, the full implementation of an analytical risk framework to assess the risk profile of banks and banking groups on a more comprehensive and systematic basis is needed. Importantly, the full implementation of this methodology will help foster further integration of offsite and onsite processes.</p>

Core Principle	Grade	Comments
		<p>The approach to the megabanks has been augmented through the introduction of the GSIB framework, which has helped to direct attention to the megabanks, so that the megabanks are receiving considerably more frequent and intensive supervision. The full roll out of the methodology will enhance planning and the allocation of resources to better differentiate the intensity and scope of supervision and better allocate its supervisory resources.</p>
9. Supervisory techniques and tools	C	<p>The JFSA has enhanced the supervisory toolkit through several developments: implementation of risk profiles (see CP8); a more targeted approach to onsite inspections; use of thematic style inspections; and a greater emphasis on onsite inspections in the mix of overall supervisory activities. Part of this new approach is also greater emphasis on engagement with banks' senior management and boards. The JFSA employs a mix of onsite and offsite activities commensurate with bank's risk profiles, size, scale, complexity and systemic importance. The introduction of the D-SIB and G-SIB framework has also helped to direct attention to the megabanks. It was evident that the megabanks are receiving considerably more frequent and intensive supervision.</p>
10. Supervisory reporting	LC	<p>The JFSA has the means of collecting, reviewing and analyzing financial institutions' prudential returns on both a solo and consolidated basis. There is potential that the JFSA collects too much information which may obscure what supervisors need to focus on. In relation to governance requirements for valuations, more emphasis could be placed on the internal risk management practices to confirm the prudent valuation of assets as part of regulatory reporting. Currently valuations are determined by the accounting standards, which may not fully capture governance and risk management requirements for valuations.</p>

Core Principle	Grade	Comments
		<p>The reporting standards do not explicitly set out expectations for governance structures and control procedures for regulatory reporting. Equally there is not explicit reference to the valuation framework or control procedures for regulatory reporting.</p>
11. Corrective and sanctioning powers of supervisors	LC	<p>The assessors have some concerns relate to (i) the willingness of the JFSA to exercise its powers at an early stage and (ii) the PCA triggers are set too low and do not grant the JFSA sufficient flexibility to intervene and act early in the event of emerging risks. 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. The assessors also recommend the authorities consider strengthening inter-agency cooperation for crisis management and preparedness.</p>
12. Consolidated supervision	C	<p>The Japanese banking supervision framework enables banks to be supervised on both a consolidated and a solo basis. It also gives the authorities the powers they need to be able to oversee foreign activities of Japanese banks and supervise the shareholders and senior management of parent and affiliated companies including outsourcing companies from a prudential perspective.</p> <p>While there is a legal clause that enables bank subsidiaries and bank outsourced companies to refuse the JFSA investigations if there are "justifiable reasons," this is simply a legal safeguard to ensure that supervisory authorities do not demand information beyond what is needed to carry out their prudential responsibilities.</p>
13. Home-host relationships	C	<p>Foreign banks operating in Japan are held to the same prudential standards as their</p>

Core Principle	Grade	Comments
		domestic counterparts. As noted above in CP3, significant progress has been achieved in deepening home-host relations with foreign supervisors in recent years.
14. Corporate governance	LC	<p>The corporate governance requirements have been strengthened recently through the introduction of the Corporate Governance Code. While implementation of the new Code will take time to be fully adopted, assessors saw a need for greater oversight of management (e.g., President/CEO) by board non-executive directors, especially among regional banks. Overall, there is scope for reducing disparities in governance practices even across major banks in Japan.</p> <p>F&amp;P processes to assess the collective experience and expertise of the board should be strengthened as well as applying the F&amp;P process at senior management level for bank structures where it is a Company with Auditor.</p> <p>To encourage more robust governance, the JFSA should increase the frequency and depth of onsite and offsite activities to assess the effective functioning of the board and its committee structure across a broader range of banks.</p>
15. Risk management process	LC	<p>The JFSA and BoJ have sufficient frameworks for identifying and evaluating bank's risk management systems and processes and for requiring remedial actions. However, independence of the risk management function needs to be given greater attention, especially in relation to the reporting line of the CRO to the board risk committee. While the JFSA has stepped up engagement with non-executive directors for the megabanks this process needs to be rolled out across the sector.</p>
16. Capital adequacy	MNC	<p>Capital requirements are closely aligned with the Basel Pillar 1 Framework for internationally-active banks but an important shortcoming is a lack of a Pillar 2 capital</p>

Core Principle	Grade	Comments
		<p>framework to tailor capital requirements more closely to individual bank risk profiles. This makes it difficult for the authorities to require banks to carry more capital beyond the minimum requirements to address specific risks within a bank. JFSA's plans to become a more dynamic supervisor will likely bring it into territory where it may need to exert more influence and operate more proactively with banks to set capital and adjust risk management practices in anticipation of future events. Relying on the minimum capital framework alone may not be sufficient in those situations. Adding a Pillar 2 capital framework would give the JFSA more influence in both bank capital planning exercises and discussions about bank risk management practices more generally.</p> <p>Although domestic bank capital requirements have been tightened up and those banks are carrying capital well above minimum requirements, the thresholds for early intervention measures such as constraints on dividends and other capital disbursements are set too low for those banks given they would only start to kick in when capital ratios for those banks fall below 4 percent. The feasibility of introducing such constraints for capital levels above the official minimum requirements through bank policies and recovery plans should be explored so that the constraints can start to kick-in well before capital ratios fall below the 4 percent threshold.</p>

Core Principle	Grade	Comments
17. Credit risk	C	<p>In general, we see a sufficient focus by banks as well as the JFSA and BoJ on credit risk management. Credit risk is a key focus in JFSA's strategic plans which are communicated to the market. Both routine and targeted ad hoc work by the supervisory and inspection bureaus of the JFSA conduct detailed monitoring and in depth analysis (through file reviews) of credit risks and adequacy of risk management. In the discussions with the banking industry there is a trend toward more risk-based lending and away from collateral based lending as well as into new product lines (e.g., consumer finance) where the JFSA will need to ensure it keeps apprised of the adequacy of bank risk management.</p>
18. Problem assets, provisions, and reserves	LC	<p>The policies and practices of banks with regard to problem assets have improved considerably since the Japanese banking crisis. Gaps in provisioning of SME and other special measure loans have become less important in recent years now that the relevant government programs have been terminated. However, the lingering issues should be resolved to further increase confidence in bank provisioning practices. Regular detailed reviews of loan classifications and provisioning practices carried out by the Japanese authorities have undoubtedly contributed to the better performance in this regard.</p> <p>Looking forward, more guidance on collateral valuations stressing the need for prudence would be helpful and provisioning practices will need to continue to evolve as the expected credit loss framework is implemented in accordance with international accounting standards. In addition, the JFSA may want to consider whether there are other ways to continue to obtain satisfaction with respect to loan classifications and provisioning adequacy; for</p>

Core Principle	Grade	Comments
		example, by possibly placing more reliance on the reviews carried out by external auditors if satisfaction can be obtained on the scope and prudential rigor of those audits.
19. Concentration risk and large exposure limits	LC	<p>The JFSA has taken a number of steps to strengthen the large exposure regime including imposing stricter limits for connected counterparties which have been reduced from 40 percent of capital to 25 percent. In addition, the JFSA will implement the LE guidelines which have been revised by the BCBS and will take effect from 2019 (aligned with the BCBS timeline). Nonetheless, more attention is needed to expand risk management for risk concentrations that go beyond large exposures such as risk concentrations from market risk and other types of risks. The JFSA focus on concentration as part of credit risk, and occasionally discuss concentration of other types when some material risk is detected. There is no requirement that all material concentrations to be regularly reviewed and reported to the bank's supervisory board. Inclusion in stress testing is limited.</p>
20. Transactions with related parties	MNC	<p>The JFSA has adopted a principles-based approach to related party exposures relying upon the credit risk framework to establish risk management expectations. However, exposures to related parties are inherently prone to higher credit risk and should be subject to enhanced and bespoke risk management standards and necessary governance.</p> <p>While there are various obligations and requirements, there are several areas where the framework falls short of the expectations in this principle e.g., no requirement for bespoke policies and processes covering the</p>

Core Principle	Grade	Comments
		<p>granting and managing of related party transactions; dedicated limits.</p> <p>It is acknowledged that related party exposures have not been a significant source of losses traditionally for the banking sector, however, owing to the unique risks associated with these types of exposures, enhanced due diligence and governance by banks is needed and supported by supervisory expectations.</p>
21. Country and transfer risks	C	<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. The JFSA has been monitoring this closely with additional regular prudential returns submissions on country exposures.</p>
22. Market risk	C	<p>The obligations in the Supervisory Guideline are generally sound and establish the requirements for banks to implement effective risk management frameworks to measure and manage market risk. Supervisors periodically review banks to assess that their market risk management processes are consistent with the risk bearing capacity and the market risk management framework. Most focus and expertise is directed toward the mega banks' market risk management. There was general compliance with this Principle.</p>
23. Interest rate risk in the banking book	C	<p>IRRBB has received a significant amount of the supervisor's attention during the last several years and features as a key supervisory priority. Banks are required to measure, calculate and report their exposure to IRRBB on a quarterly basis. Banks are also required to conduct regular stress testing using both standardized and bespoke scenarios, especially for those banks with more complex business models and optionality in the portfolio. The JFSA is</p>

Core Principle	Grade	Comments
		beginning the transition to new guidelines for IRRBB which will closely align with the BCBS revisions. The timeline for implementation is 2018.
24. Liquidity risk	C	<p>The BoJ and JFSA carry out onsite examinations/inspections and offsite monitoring of banks in close coordination and cooperation, the former with detailed coverage of risk management. For internationally active banks (non-consolidated and consolidated), the JFSA requires banks to comply with the minimum requirement of LCR (monthly) which was implemented in March 2015 including disclosures (quarterly) from the end of June in 2015. The transposition of the LCR into local rules closely aligns with the BCBS text and implementation timeline aligns with the Basel III requirements. Offsite monitoring and onsite inspections by both the JFSA and BoJ appear rigorous.</p> <p>The extent of FX funding is a significant risk facing the megabanks where they have expanded their overseas lending. Contingency funding plans and FX liquidity risk management have been a focus of the authorities.</p>
25. Operational risk	C	<p>The area of operational risk has undergone several enhancements since the time of the last FSAP, most notably in the strengthening of dedicated IT risk specialists. Sound approaches for business continuity and disaster recovery as well as attention to ongoing monitoring of operational risk events.</p>
26. Internal control and audit	C	<p>Supervisory oversight of bank internal control functions is sound and the role of internal audit functions within banks has been strengthened in the wake of enhancements to corporate governance practices. That said the authorities should consider giving internal</p>

Core Principle	Grade	Comments
		audit groups more direct links to boards in line with emerging best practice.
27. Financial reporting and external audit	LC	<p>Stronger relationships could be developed between bank supervisors and external auditors so that the JFSA can exercise more influence over the scope of external audits and be more promptly informed about any financial reporting vulnerabilities.</p> <p>The JFSA has limited powers to be able to have weak external auditors removed except in extreme situations. External auditors should also be required to report to bank supervisors all findings that could significantly impact the bank, including issues that have been subsequently rectified by the bank. Even minor issues that have been rectified can be a harbinger of underlying weaknesses in bank risk management and internal control practices that could be more promptly addressed by the JFSA the sooner it is made aware of them.</p>
28. Disclosure and transparency	C	<p>Domestic and internationally-active banks have implemented Basel III Pillar 3 disclosure requirements on both a consolidated and unconsolidated basis in accordance with internationally-agreed timelines.</p> <p>As these requirements become more detailed in the future in the wake of planned revisions to the Basel Pillar 3 Framework, the JFSA may wish to consider the regulatory burden imposed on small banks and assess the costs and benefits of imposing the more detailed requirements on those institutions.</p>
29. Abuse of financial services	LC	Japan has taken a number of steps to strengthen its AML/CFT capabilities. However, there remain parts of the frameworks to be put in place to align it further with this Principle. While the assessors noted that there have been some improvements, most notably in the reporting of STRs, a significant

Core Principle	Grade	Comments
		reduction in supervisory attention through onsite inspections is a shortcoming. It is recommended that the authorities remain vigilant through rigorous offsite monitoring complemented with regular verification of the effectiveness of policies and processes to control abuse of financial services.

## RECOMMENDED ACTIONS AND AUTHORITIES COMMENTS

### A. Recommended Actions

Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks	
Reference Principle	Recommended Action
Principle 2	The statutory provisions governing the removal of a JFSA Commissioner from office should be strengthened.  Consider whether a different funding model might make sense over the longer run.
Principle 5	The JFSA should introduce more intensive probing of ownership structures of banking groups to ascertain the ultimate beneficial owners and their capacity to provide capital to the bank in times of stress.
Principle 6	Strengthen the pre-approval process when a major shareholder obtains a majority shareholding (controlling interest) to ensure the JFSA is able to proactively assess the capacity of a majority shareholder to provide financial support to the bank in times of stress.
Principle 7	Implement a stricter pre-approval for an acquisition as provided for in the case of subsidiaries. The scope for approval of acquisitions should be expanded to include the acquisition of ancillary business and banking related business.
Principle 8	Complete finalization of the risk rating methodology as a way to support the transition to a more forward-looking and risk-based supervisory approach. Ensure the methodology has due regard to the bank's risk, size, scale and systemic importance in calibrating the rating.

Reference Principle	Recommended Action
Principle 10	Establish clear requirements for governance and risk management arrangements of prudent valuations for data submitted as part of regulatory reporting.
Principle 11	Recalibrate PCA triggers to allow the JFSA to intervene earlier.  Consider strengthening inter-agency cooperation for crisis management and preparedness.
Principle 14	Further encourage involvement of non-executive directors in performing a check and balance of executive directors, especially their role on committees (e.g., remuneration, audit, nomination and risk). For those banks expanding overseas into new markets, greater attention by the JFSA to the effectiveness of corporate governance is needed, such as through onsite and thematic reviews.  Establish the requirements for Internal Audit to report directly to the Board Audit Committee and follow up with necessary supervisory activities to verify new standards have been adopted.  F&P processes should be applied to include all key staff appointments.
Principle 15	Strengthen bank risk management requirements for the risk function that has a reporting line into the Board Risk Committee, via the CRO.
Principle 16	Establish a Pillar 2 capital framework to give the JFSA more influence in both bank capital planning exercises and discussions about bank risk management practices more generally.
Principle 18	Issue more guidance on collateral valuations stressing the need for prudence and provisioning practices to continue to evolve as the expected credit loss framework is implemented in accordance with international accounting standards.
Principle 19	Encourage appropriate risk management for risk concentrations that encompass both credit exposures in the banking book as well as large counterparty credit risk exposures emanating from trading activities (e.g., counterparty exposures) and other types of risks
Principle 20	Strengthen the risk management requirements for related party exposures in terms of bank's policies and processes for assessing, granting and managing these types of exposures.  Enhance reporting requirements to explicitly include related party exposures reported on routine basis.
Principle 27	Strengthen relationships between bank supervisors and external auditors so that the JFSA can exercise more influence over the scope of external audits and be more promptly informed about any financial reporting vulnerabilities.

Principle 29	Increase the frequency and intensity of supervisory activities to verify the effective implementation of bank risk management to control abuse of financial crime.
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## B. Authorities' Response to the Assessment

1. **The Japanese authorities express our sincere gratitude to the IMF mission led by Dr. Gaston R. Gelos for the efforts they have devoted to complete the assessment of compliance with "Basel Core Principles for Effective Banking Supervision" (hereafter, "the BCP").** We greatly appreciate that the assessment was conducted in a fair, thorough and professional manner throughout the process.
2. **The Basel Committee on Banking Supervision published the revised BCP in September 2012, which was right after the completion of the previous Japan FSAP mission in August 2012.** Since the last FSAP, the JFSA has taken various initiatives aiming at improving the quality of banking supervision and regulations in Japan, and the BoJ has taken measures to ensure financial system stability, while taking into consideration international regulatory and supervisory developments after the financial crisis as well as structural changes in the banking sector and the market. This full assessment against 29 principles of the revised 2012 BCP gave us an invaluable opportunity to review the effectiveness of such initiatives in a comprehensive and objective manner.
3. **The Japanese authorities welcome the overall conclusion of the assessment that confirms a high level of compliance with the BCP recognizing significant improvements in our banking regulations and supervisory process.**
4. **From the late 1990's to early 2000's, the JFSA has made tremendous efforts to rebuild the public confidence in the Japanese financial system; this was done by such supervisory tools as rigorous onsite inspections for reviewing banks' asset qualities, and rigid administrative actions against violations of laws and regulations.** While such *ex-post* supervisory approaches had worked well in addressing NPL problems and in ensuring the minimum level of compliance at that time, it is no longer possible and desirable to keep placing a sole reliance on such traditional supervisory models amid the evolution in the financial and economic environment over time. It is important that banks continuously improve their management in order to stably fulfill their financial intermediary functions towards the future in rapidly changing conditions of financial markets and the real economy. The JFSA will continue to develop regulatory and supervisory frameworks that effectively support these efforts by banks.
5. **In addition, the BoJ have continuously strived to reinforce its measures to ensure financial system stability, by analyzing and assessing the risk in the financial system as a whole and presenting the challenges in the *Financial System Report (FSR)*; conducting its onsite examinations and offsite monitoring while utilizing the analysis and assessments; and incorporating the findings obtained from its onsite examinations and offsite monitoring to the next FSR.** The Japanese financial institutions face challenges, including strengthening the ability to respond to risks in areas where they are stepping up their risk taking, and responding to declining core profitability due to decreasing population. The BoJ will

contribute further to ensuring financial system stability with effective use of its function as a central bank such as onsite examinations and offsite monitoring.

**6. As we continue to achieve such developments, this BCP assessment by the IMF will clearly assist our efforts in this direction and shed light on the remaining issues that we should continue to address.**

**7. The Japanese authorities would like to take this opportunity to respond to some important findings that were identified through this BCP assessment as follows:**

**8. The IMF concluded to maintain MNC grade for Principle 16 regarding the capital adequacy framework, likewise previous BCP assessments for Japan FSAP in 2005 and 2012.**

We are of the view that this recommendation does not pose any questions in the power of the JFSA to ensure banks' compliance with the Pillar 1 minimum capital requirement. Rather, this is to recommend that the capital adequacy framework should enable the JFSA to exert more influence and act more proactively on banks with regard to their capital planning and risk management practices at an earlier stage before reaching the minimum level. We share the same view with the IMF on the importance of encouraging banks to improve their business management including capital planning with a forward-looking perspective. Therefore, we are currently reviewing our supervisory approach taking into account "risks outside Pillar 1," "appropriate balance of risks, return and capital", and "sustainability of a bank's business model", so that we would be able to have more effective and constructive dialogues with banks taking into consideration their size and business/risk features.

**9. Additionally, we would like to draw your attention to the fact that after the completion of the previous FSAP in 2012, we have introduced the capital buffer framework above the minimum level of capital in line with the Basel standard for internationally active banks.** We have also revised the definition of capital (Core Capital) for domestic banks, which has now become more conservative and broadly equivalent to the international definition of Common Equity Tier 1 (CET1), with a view to improving the quality of capital for domestic banks. With these developments, we believe that Japanese capital adequacy standards have been strengthened since the previous FSAP.

**10. As to Principle 20 regarding transactions with related parties, the JFSA is aimed at strengthening its onsite and offsite monitoring process in a more integrated manner, and thereby would pursue further effective approaches in this area.**

**11. Japanese authorities appreciate that the IMF has assessed our compliance with the newly introduced Principle 14 on corporate governance in the revised BCP, based on its substance rather than form.** Initiatives to improve corporate governance standards are in progress in Japan, represented by the creation of the Corporate Governance Code and subsequent efforts by banks such as enhanced use of independent non-executive directors, and adoption of the corporate structure with a nominating committee by large banks. We are fully aware that this positive assessment is based on the assumption that these initiatives will keep evolving. Authorities are committed to making further efforts to establish a more robust corporate governance in Japan, by reviewing, for example, whether the board of directors exercise independent and effective oversight of management at small- and medium-sized banks

under the “Company with auditor” structure, or how independent directors actually contribute to activating meetings of the board of directors at banks adopting the structure of “Company with nominating committee, etc.”

**12. Finally, Japanese authorities fully support the important role of the FSAP to enhance the soundness of the global financial system and develop bank supervisory practices.** We expect to continue constructive dialogues with the IMF and other supervisory authorities in accordance with this objective.