



JAPAN

FINANCIAL SECTOR ASSESSMENT PROGRAM

May 2024

TECHNICAL NOTE ON BANKING SUPERVISION AND REGULATION SELECTED ISSUES

This Technical Note on Banking Supervision and Regulation Selected Issues for the Japan FSAP was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on April 16, 2024.

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BANKING SUPERVISION AND REGULATION SELECTED ISSUES

Prepared By
**Monetary and Capital Markets
Department**

This Technical Note was prepared by Katharine Seal (IMF) and Wayne Byres (IMF external expert) in the context of the Financial Sector Assessment Program (FSAP) in Japan, led by Mahvash Qureshi (IMF). It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>

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Glossary

AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
AT1	Additional Tier 1
BCP	Basel Core Principles
BCBS	Basel Committee of Banking Supervision
BHC	Bank Holding Company
BIO	Business Improvement Order
BoJ	Bank of Japan
CCPs	Central Counterparties
CEM	Current Exposure Method
CET1	Common Equity Tier 1
CGC	Corporate Governance Code
CVA	Credit Valuation Adjustment
DAR	Detailed Assessment Report
DICJ	Deposit Insurance Corporation of Japan
D-SIB	Domestic Systemically Important Bank
EVE	Economic Value of Equity
EWS	Early Warning System
FATF	Financial Action Task Force
FSA	Financial Services Agency
FSAP	Financial Sector Assessment Program
Gov	Japanese Government
G-SIB	Global Systemically Important Bank
IMF	International Monetary Fund
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
IRB	Internal Ratings-Based
IRRBB	Interest Rate Risk in the Banking Book
JCGF	Japan Corporate Governance Forum
LBO	Leveraged Buy Out
LCR	Liquidity Coverage Ratio
LEX	Large Exposure standard
LFB	Local Finance Bureau
MoF	Ministry of Finance
NSFR	Net Stable Funding Ratio
RAD	Risk Analysis Division
RCAP	Regulatory Consistency Assessment Program
SG	Supervisory Guidelines
SVB	Silicon Valley Bank

EXECUTIVE SUMMARY

The Financial Sector Assessment Program (FSAP) carried out a targeted evaluation of issues relating to the effectiveness of banking supervision and regulation in Japan. The scope of the work focused on the key findings from the 2017 Basel Core Principles (BCP) Detailed Assessment Report (DAR) and the transformation of the supervisory approach by the Financial Services Agency (FSA) undertaken since the last FSAP. The overall conclusion of the 2017 DAR was that the supervisory framework was generally sound, but some key priority areas were identified as needing to be addressed. This note reviews progress made in these areas as well as examining the fundamental shift to a more risk-focused, principles-based supervisory approach than before.

The FSA has initiated a major transformation of its supervisory approach, moving from checklists to a principles-based, risk-focused engagement. A transformation of this scale is a significant project, and it is to the FSA's great credit that it has brought the industry along with its thinking. The new structure of engagements, supervisory priorities, and expectations have been communicated to and are supported by the industry. The change to the supervisory approach is, in practical terms, still work in progress, as is the supervisory process for all advanced jurisdictions that seek to keep their approaches forward looking and in touch with industry evolution. In this light, the continued development of supervisory guidelines and investment in the joint data project with the Bank of Japan (BOJ) are indicative of the FSA's continued forward momentum and are very welcome.

Since the last FSAP, the FSA has redefined its policy goals, shifting from a narrow focus on "stability" alone to one that balances "stability" and "effective financial intermediation," but its legal mandate needs to confirm the priority of financial safety and stability.¹ While recognizing the wisdom of the FSA's supervisory transformation and the risks of an overly narrow or rigid focus on the FSA's explicit safety mandate, there are risks from having multiple objectives which will, at times, be in conflict. The primary objective of an agency like the FSA should always be the promotion of safety and soundness and, if the agency is assigned broader responsibilities, these should be subordinate to the primary objective. It is important that the FSA operates within the legal frameworks that reflect and require this hierarchy.

The FSA needs to accrue a cadre of staff that is sufficient both in terms of numbers and range of skills. Challenges include budget for headcount, as although it is recognized that headcount has increased marginally over recent year, the complement of staff even for the major banks is not generous. Japan's role as the supervisor to three G-SIBs puts a particular premium on this issue in international terms. Rotation of staff at both senior and junior levels exacerbates concerns that skills, experience, and continuity are not being fully developed or maintained. Even aside from the highly specialist emerging skills, such as cyber resilience, banking supervision is, across the board, a

¹ See also: "FSA's supervisory approaches—Replacing checklists with engagement," June 2018, page 7. The 2018 document set out the reformed regulatory and supervisory manifesto of the FSA.

professional technical discipline and not a generic bureaucratic post. The FSA should be funded and staffed commensurately with the elite technical institution that it needs to be.

The FSA has shifted towards a more modern, risk-based approach to supervision that is better suited to overseeing and responding flexibly to an evolving banking system. Important developments are needed, however. The FSA should explore the development of more forward-looking metrics in the Early Warning System (EWS), especially for credit and liquidity risk. Given the risk that problems at regional or smaller banks may go undetected for some period of time, the FSA should enhance a baseline set of supervision activities to be undertaken to improve a minimum understanding of each bank's risk profile. It is also firmly recommended that the FSA develops a revised and more articulated and risk-based supervisory methodology, as recommended in the 2017 FSAP, which would support the FSA in drawing together a full risk profile of an institution, including governance, business, and strategy risk. It would also support the FSA in allocating supervisory resourcing according to shifting needs, identifying risk trends, and underpinning supervisory consistency and quality control.

Enhanced data analytics are core to the FSA's new supervision approach and require continued investment. Stress testing, improved scenario analysis, and review of major banks' Internal Capital Adequacy Assessment Process (ICAAP) are already benefiting from the increased data focus. Further benefits will accrue as these projects continue to mature and as the FSA expands its data access as part of the joint initiative with the BOJ. It is important, however, that the FSA does not hesitate to request the datasets that it needs from banks and that it obtains the investment necessary to build robust and penetrating analytical capabilities.

Two important, but related, gaps persist in the FSA's powers related to capital adequacy, making Japan an outlier among its peers. The "Pillar 2" powers to calibrate a capital requirement to a bank's risk profile and risk management capability are still missing. A fully articulated Pillar 2 approach, focused on the appropriate capital allocation of risks is unlikely ever to be achieved if the supervisory authority ultimately lacks the formal power to require banks to hold capital in excess of the minimum. In addition, and while acknowledging an enhanced scope to act effectively due to the new EWS, the FSA's ability to proactively intervene to deal with a bank with a deteriorating capital situation is constrained by the inability to order the bank to raise capital until such time as it has already breached the minimum regulatory requirements. Delays to regulatory action in the event of an emerging crisis may well make it harder to deal with the situation and make it more costly to resolve. Notwithstanding the FSA's ability and proven willingness to issue Business Improvement Orders to require banks to de-risk balance sheets by restricting business, direct capital powers are core to any effective supervisory system. Options for the supervisor to intervene directly by requiring more capital on a legal basis should be a minimum expectation, even though the indirect formal options exist.

The FSA should set appropriate minimum liquidity requirements for all banks, not only internationally active banks. Although internationally active banks are subject to the Basel Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) standards, there is no quantitative minimum liquidity requirement for domestic banks. At present, the FSA collects monthly

information about domestic banks' liquidity profiles, using one of two simplified LCR measures. The FSA uses its EWS to identify banks with weak liquidity profiles and subjects those banks to more intensive monitoring. Even allowing for the largely stable, retail deposit base of the domestic banking system, the lack of explicit minimum quantitative or qualitative standards—that of course banks should monitor and manage for themselves in the first instance—creates a potential prudential vulnerability that the FSA and, as needed, the BOJ would have to react to in the event of stress.

The BOJ should update its practices and approach to remain broadly aligned with the FSA given the latter's role as the primary regulator and supervisor of the banking sector.

A distinctive feature of the Japanese system is the role played by the BOJ in examining banks that hold an account with the central bank. While cooperation and coordination between the FSA and BOJ is evident and firms commented that it was now enhanced, the overall supervision of banks will be both more effective and more efficient if supervisory practices are aligned to the maximum extent possible. To that end, the BOJ should ensure that it continually updates and tailors its own approaches to remain aligned with the evolution of practices within the FSA.

The possibility of domestic consolidation and, for mega banks, overseas strategic expansion throw a spotlight onto change of control and major acquisition.

The intent and impact of the legislative easing should be beneficial, for example, in terms of facilitating income stream diversification for banks. Nevertheless, such expansion will introduce new risk management challenges, and enhanced oversight from the parent and the supervisor should be a priority for the relevant banking groups. Change of control and major acquisition of banks and by banks remains a critical gateway to the banking sector that the FSA must protect appropriately and mandatory approval at the 50 percent controlling threshold, as opposed to notification, is warranted for all classes of shareholders.

The introduction of the concept of economic interdependence has improved the Japanese regime in respect of related party risks.

The definition of related parties itself should, however, be broadened to include individuals connected to a bank, keeping in mind that abuses to banks can stem from this quarter. To maintain vigilance, related party supervision, including regular reporting to the FSA, must apply to all banks.

Greater attention is needed on the risks surrounding third party service providers, not least in the light of growing cyber threats.

The industry's need to have access to relevant information in third party service providers may need to be secured on a regulatory or legislative basis. The supervisor needs to further strengthen the analysis of how the banking sector is operationally interconnected, to identify critical nodes, not only in relation to cyber threat, but also with respect to operational risk and resilience.

Table 1. Japan: Recommendations on Banking Supervision and Regulation

Recommendations	Timing ¹	Authorities
Mandate, Supervisory Objectives, Organization and Powers		
Make explicit provision in the law to ensure the priority of financial safety and stability in the mandate of the FSA, in keeping with current policy and practice. (Paragraph 9)	NT	Gov
Provide the FSA with the power to set and adjust individual bank capital ratios (above the minimum requirements) in response to either a bank's heightened risk profile or deteriorating financial position. (Paragraph 11)	NT	Gov
Provide a fixed term for the appointment of the FSA Commissioner. Give the Commissioner the power to organize his staff for an agreed period (e.g., 3-5 years with option to stay on if individual agrees). Ensure longer staff rotations at senior and junior levels in recognition of the specialist nature of the agency and the need for the FSA to retain international standing. (Paragraph 19)	NT	Gov
Review options to pay a "risk" premium to scarce skills that are key for the FSA (e.g., cyber resilience). (Paragraph 17)	I	Gov/FSA
Provide a legal gateway to ensure exchange of confidential supervisory information between the BOJ and FSA (and vice versa) for the purposes of executing the institutions' supervisory and stability mandates, and without the requirement for firms' approval. (Paragraph 23)	NT	Gov
Ensure on-site visit forms part of the licensing approvals as well as close observation in the follow-up monitoring process. (Paragraph 24)	NT	FSA
Strengthen the pre-approval process when a major shareholder obtains a controlling (over 50 percent) interest to ensure an up-to-date view understanding. (Paragraph 27)	I	Gov
Implement a stricter pre-approval for an acquisition as already 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. (Paragraph 28)	I	Gov
Supervisory Approach		
Enhance baseline supervision requirements for all banks to improve the minimum level of supervisory activity (including on-site inspections) over a prescribed period of time. (Paragraph 49)	I	FSA
Continue to develop the EWS, especially for credit and liquidity risk, to ensure more forward-looking metrics, and make more use of non-financial information for supervision. (Paragraph 56)	I	FSA
Establish a periodic cycle to review and update the Supervisory Guidelines (e.g., every five years) to incorporate and/or repeal supplementary material as necessary. (Paragraph 60)	MT	FSA
Continue to invest and prioritize data analytical capabilities. (Paragraph 68/67)	I	FSA/BOJ
¹ I Immediate (within 1 year); NT Near Term (within 1-2 years); MT Medium Term (within 3–5 years).		

Table 1. Japan: Recommendations on Banking Supervision and Regulation (concluded)		
Develop a revised supervisory risk methodology to consolidate and classify the overall risk assessment for each bank. (Paragraph 72)	I	FSA
Maintain alignment of its supervisory practices and approach with the FSA. (Paragraph 39)	NT	BOJ
Raise the thresholds set out in the Prompt Corrective Action regime, i.e., recalibrate the trigger points for action in the Order in relation to Article 26(2) of the Banking Act. (Paragraph 84)	NT	Gov
Amend the Order to <i>Define the Categories Prescribed in Article 26 Paragraph (2) of the Banking Act</i> to permit the FSA to issue a business improvement order to raise capital in a wider range of circumstances than currently prescribed, e.g., if it has reasonable grounds for believing a bank could fall within one of the categories within a short period of time (e.g., 6 months). (Paragraph 84)	NT	Gov
FSA to supplement or amend its Supervisory Guidelines to clarify the principles under which the FSA would reserve the right to move directly to issuing a BIO under Article 26, in order to avoid undue delay in applying appropriate corrective action. (Paragraph 85)	NT	FSA
Prudential Regulations and Requirements		
The definition of related parties should be broadened to include individuals connected to a bank. Related party supervision should apply to all banks and include regular reporting to the FSA. (Paragraph 98)	MT	Gov/FSA
Establish a minimum liquidity requirement for domestic banks. (Paragraph 106)	NT	FSA
Strengthen the ability of banks to access third-party service providers and consider the need to place on a regulatory footing if needed to ensure cyber security and operational resilience in banks. (Paragraph 111)	NT	Gov
Further strengthen the analysis of how the banking sector is operationally interconnected, through developing network analysis of how the banks are connected through common technologies and service providers, allowing the identification of critical nodes, and taking appropriate action accordingly. The analysis should not be limited to cyber-risk but address operational risk and resilience. (Paragraph 111)	I	FSA
Carry out a corporate governance and risk management review of regional and smaller banks in order to identify institutions with deficiencies and target awareness programs. (Paragraph 116)	I	FSA/LFB
Provide the FSA with 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. This will act as a "safety net" provision to ensure that audit firms will be appointed whose skills and resources are commensurate with the firms they are appointed by. (Paragraphs 117-118)	MT	Gov

INTRODUCTION

A. Scope and Approach

1. **This note was prepared in the context of the FSAP mission to Japan from September 19 to October 6, 2023.** It presents the FSAP findings and recommendations on topics focused on banking supervision and regulation, which were selected primarily according to the findings of the full assessment of the 2017 Basel Core Principles (BCP) assessment, the IMF's policy on the matter, and the Japanese authorities' views. In particular, the note considers the supervisory reforms undertaken by the FSA from 2018 to establish a more risk-based, forward-looking approach. This note is not a detailed assessment report and does not give grades on compliance or revise the grades given in the 2017 BCP assessment. A review of the progress achieved in addressing the main recommendations from the 2017 assessment is included (see Appendix I). The note focuses on the prudential supervision of deposit-takers that are supervised by the FSA for prudential matters.²
2. **The analysis in this note forms part of the 2024 FSAP of Japan.** It is based on the regulatory framework in place and the supervisory practices employed as of October 2023.³ The analysis was based on a review of regulations and supervisory guidance, meetings with the Japanese financial regulators, Bank of Japan, and review of their joint responses to questionnaires. The FSAP team also met with representatives from banks, external auditors, consultants, and industry associations.
3. **The FSAP team appreciated the cooperation from the authorities.** In particular, the team would like to thank the FSA, who was the main counterpart, and who responded to the mission requests despite many burdens imposed by hosting the G7 Presidency.

B. Financial Sector Structure

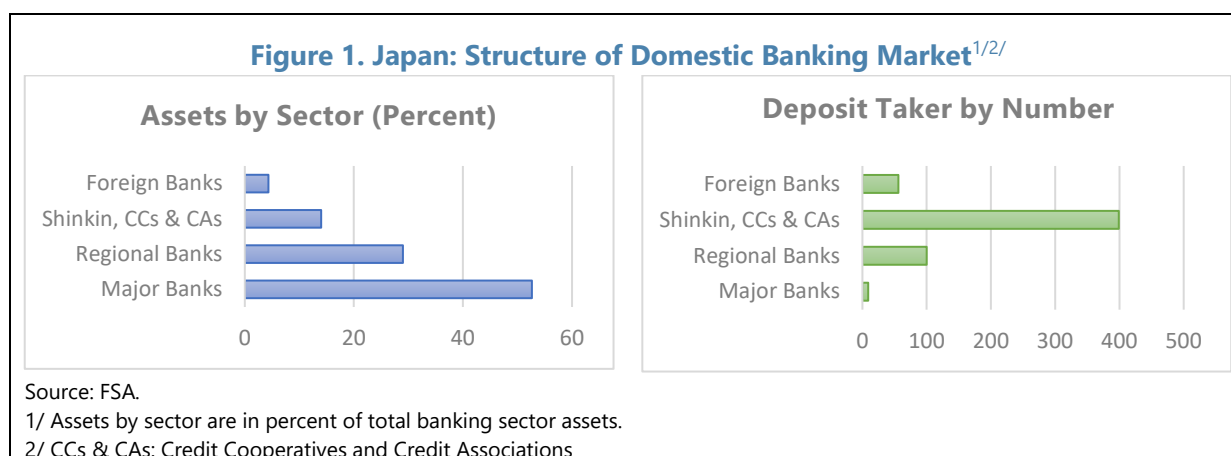
4. **Japan is a significant international financial center with 23 jurisdictions represented in its banking market alone.** The total assets of the Japanese financial sector stood at approximately 6.6 times GDP at end-2022, making it one of the largest global financial systems. The banking sector accounts for about 60 percent of the system, with three Global Systemically Important Banks (G-SIBs) holding about half of the banking system assets and a third of the financial system assets. Japanese insurance and securities sectors are also world ranking. Japan's insurance sector is the third largest in the world, accounting for about 12 percent of the financial system. The Japanese securities market boasts a capitalization of 11 percent of GDP in 2022. Investment funds have grown since the last FSAP and represent the third largest sector of nonbank financial intermediaries (NBFIs). Completing the picture, Japan has three domestic central counterparties (CCPs), including one of the top ten global CCPs.

² The mission did not review the oversight of the agriculture cooperative Norinchukin Bank or Japan Post Bank.

³ This Technical Note is prepared by Katharine Seal (IMF) and Wayne Byres (IMF Expert and former Chair of the Australian Prudential Regulation Authority).

5. The banking sector is home to three “mega banks” with extensive international operations. These banks—Mizuho Bank, MUFG Bank, Sumitomo Mitsui Banking Corporation—have been classified as G-SIBs. Japan also designated four domestically systemically important banks (D-SIBs) in 2015 (Sumitomo Mitsui Trust Holdings, Norinchukin Bank, Daiwa Securities Group, and Nomura Holdings). Norinchukin Bank, a financial institution based on cooperative organizations such as agricultural and fishery cooperatives, as discussed in the 2017 FSAP, is supervised by the FSA together with the Ministry of Agriculture, Forestry, and Fishery under the Norinchukin Bank Act. The FSA retains sole responsibility for setting the soundness standards for the financial institution and conducting on-site inspections related to credit extended to individuals. The Japan Post Group plays an important role in both the banking and life insurance sectors, accounting for about 12 percent and 22 percent of the sectors, respectively.

6. Altogether there are nine “major” banks, including the three G-SIBs (Figure 1). These banks have head offices in major cities such as Tokyo and Osaka and operate nationwide. Regional banks, as the name implies, tend to have operations that are heavily concentrated in a particular regional area, although ten of them also have international establishments. These banks are grouped by two associations: the Regional Banks Association of Japan (Regional banks I) that has 62 member banks, and the Second Association of Regional Banks (Regional banks II) that has 37 members. There is also one regional bank that is a member of neither association. Finally, there are 399 *Shinkin* banks and credit cooperatives of which 247 *Shinkin* banks hold current accounts at the Bank of Japan. While the mega banks are dominant, the domestic Japanese banking market is not as concentrated as in several other jurisdictions with G-SIBs, and, as sub sectors, the regional banks but also the *Shinkin* banks and credit cooperatives, are important.



INSTITUTIONAL SETTING

A. Mandate, Supervisory Objectives, Organization and Powers

Mandate and Objectives

7. Since its establishment, the FSA had sought to achieve three missions, consistent with its mandate under Article 3 of the Act on the Establishment of the Financial Service Agency.

These were: (i) ensuring financial stability, (ii) promoting consumer protection (including safety for bank depositors), and (iii) maintaining market integrity and transparency. These are orthodox objectives for an integrated supervisory agency, but their application within the Japanese system of supervision—seen as quite strict and rigid—had been heavily influenced by the need to restore trust in the system following the banking crisis that had led to the FSA’s creation.

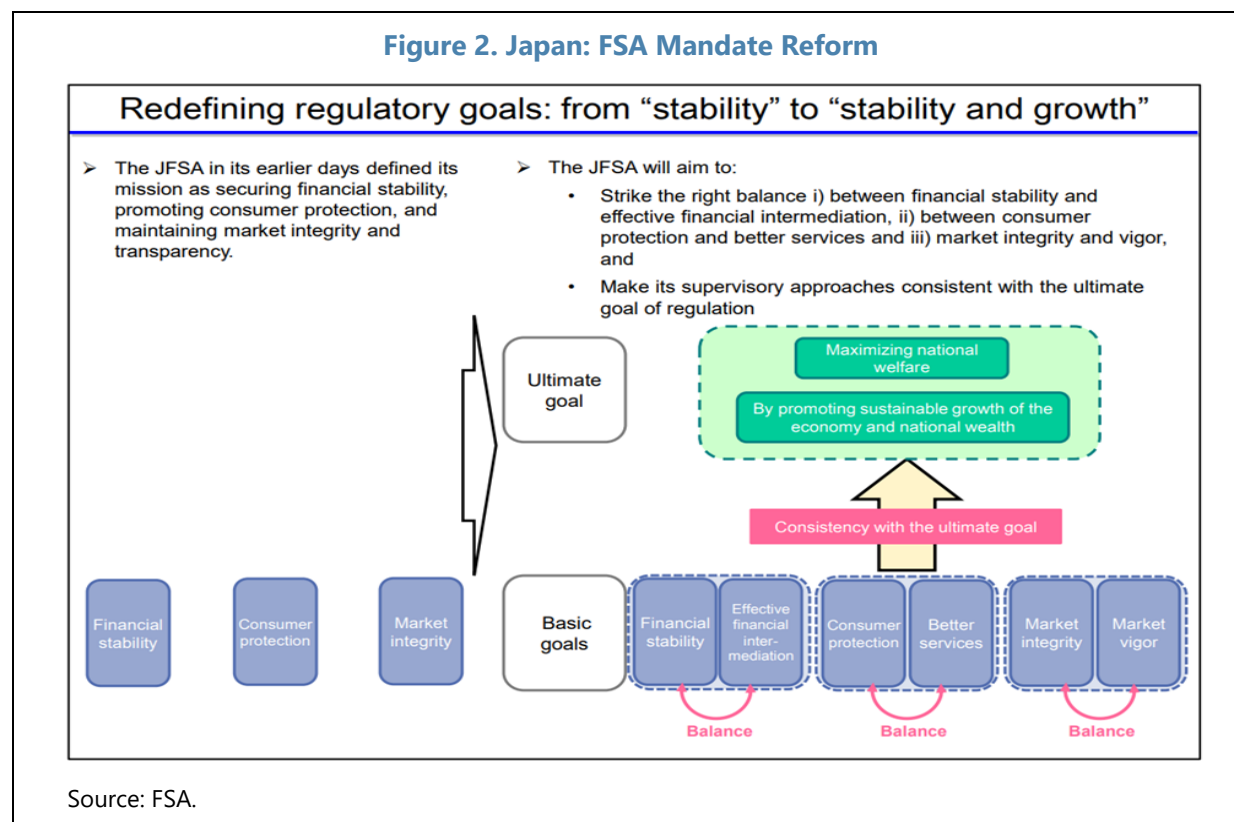
8. In 2018, the FSA announced reforms, consistent with its mandate, which represented more growth-oriented objectives (Figure 2).

Recognizing that the core mandate, if applied narrowly or too rigidly, may not always lead to optimal economic outcomes, the FSA determined that the goals of financial stability, consumer protection, and market integrity should be balanced with the goals of effective intermediation, better services, and market vigor. In other words, to achieve the ultimate goal of enhancing national welfare, and to respond to the evolving challenges of the financial sector, the FSA aims to attain (i) financial stability and effective intermediation, (ii) consumer protection and better services, and (iii) market integrity without stifling vigor and innovation.⁴ The reforms were also intended to underpin a more forward-looking, proactive, and risk-based supervisory approach.

9. The FSA’s revised objectives require a careful balancing to ensure that the primacy of financial safety and stability is not lost within a broader set of government objectives and policies. The new goals are not explicitly stated in law. It is appropriate that an agency such as the FSA should be mindful of the broader agenda of its national government, but financial stability and depositor protection objectives should always, in the event of any conflict, take priority in a financial supervisor’s efforts. As the Global Financial Crisis amply demonstrated, not all growth and financial intermediation is beneficial and compatible with stability. It is fully understood that the FSA itself recognizes the importance of balancing its objectives and has sought to make its position clear in its public statements. Nevertheless, while positive, statements by the FSA are a second-best solution. For the avoidance of doubt, the FSA would be strengthened by making explicit provision in law to confirm the priority of financial safety and stability, in keeping with current policy and practice.

⁴ Source: Financial Service Agency (June 2018), *FSA’s Supervisory Approaches: Replacing Checklists with Engagement*.

Figure 2. Japan: FSA Mandate Reform



Organization and Decision Making

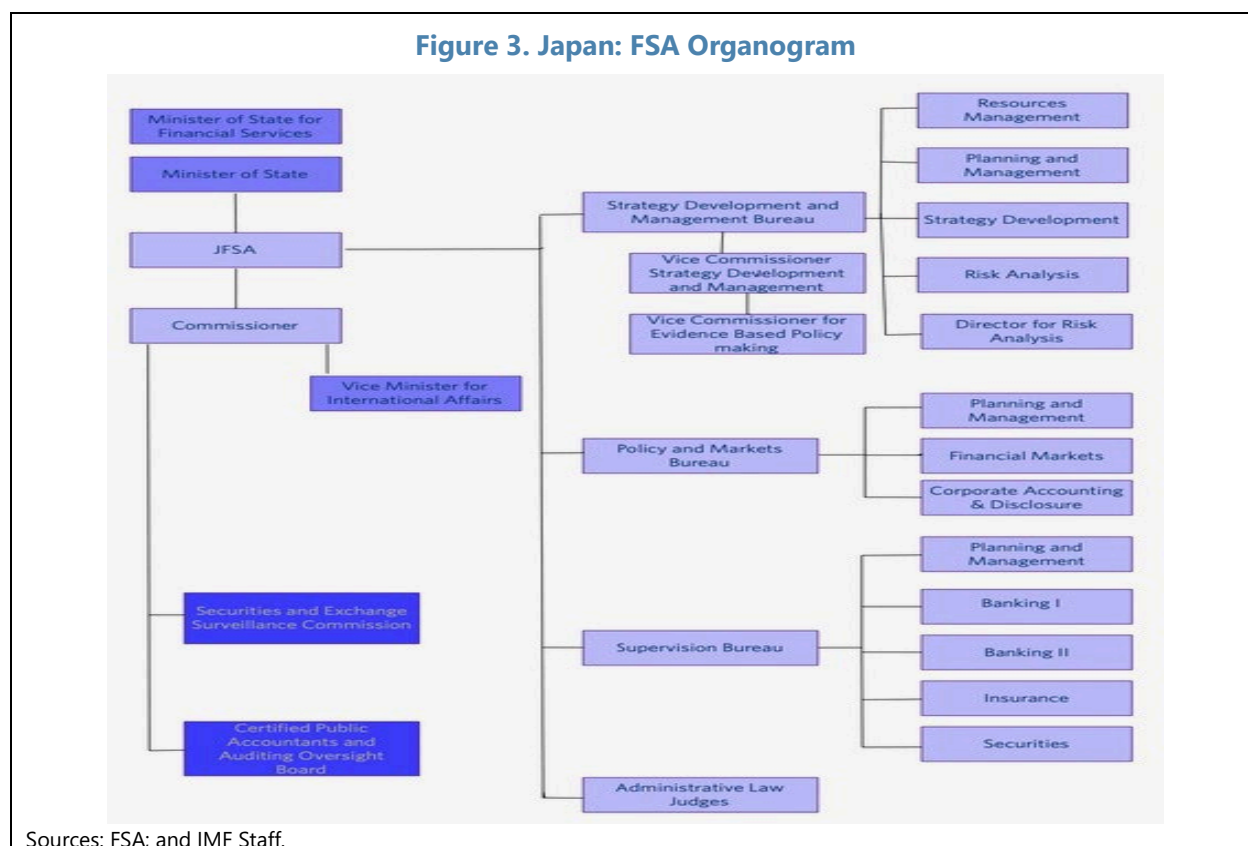
10. Organizational reform has accompanied the retuning of the FSA mandate. To deliver the refocused objectives, the internal structure of the FSA was significantly reorganized into three bureaus: Strategy Development and Management Bureau, Policy and Markets Bureau, and the Supervision Bureau (Figure 3). This restructure is set out in the Cabinet Order for the Organization of the Financial Services Agency (No. 392 of 1998, as most recently amended in 2019). Previously, the three internal bureaus of the FSA consisted of the Planning and Coordination Bureau, Inspection Bureau, and Supervisory Bureau. The organization is publicly disclosed on the FSA website. Internal decision-making is not public information, but the FSA has retained the same internal delegated decision-making system that was in place in the 2017 FSAP.

Powers of the FSA

11. The powers and authorities of the FSA remain substantively unchanged following the reforms. As noted in the 2017 FSAP, the FSA is broadly well equipped with the suite of graduated powers that is necessary for a supervisory agency. However, gaps persist in the area surrounding capital adequacy. This concern is discussed in more detail below, but in brief, the FSA cannot issue a direct order to increase capital until a bank has breached a minimum threshold. In addition, the “Pillar 2” power to calibrate a capital requirement to a bank’s risk profile and risk management capacity is still missing. Given these gaps, Japan is an outlier relative to its peers. The FSA, however,

has no particular concern with the current scope of its powers, and believes that it has the ability to address issues indirectly through supervisory activities.

12. Under the Banking Act, the Prime Minister delegates authority to the Commissioner of the FSA with exceptions specified by Cabinet Order. Within the Banking Act, all powers are granted to the Prime Minister. Delegation of powers is set out under Article 59(1) of the Banking Act and the powers excluded from delegation are confirmed in the Order for Enforcement of the Banking Act (Cabinet Order No. 40 of 1982, Article 17). Six items are iterated in the Cabinet Order and cover the licensing and revocation of a bank and a bank holding company, as well as the publication in the official gazette in relation to revocation of an authorization (and the ending of an authorization held by a foreign bank) and formal notification requirements to the Minister of State for Financial Services regarding revocation and authorizations of bank holding companies. Discussions with the authorities indicated that Cabinet Orders relating to the FSA are drafted by the FSA, which was deemed appropriate not least as such Orders typically contain a level of detail not suitable for primary legislation. It was also noted that issues such as delegation of powers, while stable for many years, could in theory be amended during an annual process. There was no suggestion in any of the mission dialogues that the FSA was treated as anything other than an equal partner in its discussions with the MoF.



13. Banking Act powers that have not been delegated to the FSA Commissioner are exercised by the Minister for Financial Services. Preparation of the authorization and revocation decisions is, however, undertaken by the FSA itself. In practice, the FSA has a de facto veto; although it has no power under the law to veto new entrants to the banking sector as an application for authorization is not put forward unless it is sufficiently robust to recommend approval. In fact, close dialogue with would-be applicants means that applications are not submitted in the first place until they meet the required standard. Such an arrangement implies that there is strong confidence in terms of one aspect of gatekeeping—namely, the entry point to the system. There is less confidence, from a pure legal perspective, in ensuring that that a bad actor will be removed from the sector. That said, there are no grounds to suggest that the FSA’s advice would be set aside, at least in the current cultural context that places a high premium on conformity with law and where there is a high price to pay for loss of reputation.

B. Independence and Resources

14. The FSA is an external agency of the Cabinet Office and staff of the FSA are government officials and its budget allocation comes from the national budget. MoF officials confirmed that the FSA’s funding is part of the national budget debated in the Diet, but not subject to separate parliamentary scrutiny. Despite concerns in the 2017 FSAP that the FSA might not be able to grow or sustain its resources, in fact there has been a modest increase in headcount over the period. The uplift in numbers has been and continues to be directed towards the divisions focused on major banks. Other positive features in respect of adequacy of resourcing include the FSA’s ability to travel to the overseas locations of its major banks, attend the meetings of the international the in which it participates, and embark on a data integration and upgrade program. In particular, the FSA has invested in training resources that are available online and on-demand for its staff.

15. An assessment of resourcing for the prudential supervision of banks in Japan needs to take account of both the FSA’s wide mandate and the other agencies involved in banking supervision. A little over a quarter of the FSA’s staffing (around 450 out of 1,650 in FY 2024) is assigned to the Securities and Exchange Surveillance Commission and the Certified Public Accountants and Auditing Oversight Board. The remaining 1,200 staff are deployed across regulation and supervision—both prudential and conduct—for banking, insurance, and securities firms, with banking assigned the lion’s share. Banking supervision resources are also supplemented by around 340 staff in the BOJ’s Financial System and Bank Examination Department, and staff dedicated to banking supervision (circa 100) in the Local Finance Bureaus.

16. That said, the FSA’s complement of staff, even for major banks, is not generous. The risk-based approach, rightly, prioritizes the G-SIBs and major banks, but the regional banks, as a sector, are a significant player and warrant more resources than the FSA can reasonably devote to them. To date, the FSA has been able to attract risk experts, although it is required to offer government pay scales. Employing staff from the marketplace is not always straightforward as even though such personnel come onto the FSA’s staff, there is a general expectation that they will return to the industry, which can create heightened sensitivities around confidentiality. Furthermore, when staff return to the industry, the FSA does not reap the benefit from a long-term transfer of skills. The

FSA does not supplement its staff's skills by deploying external parties to conduct activities to assist the supervisory function (see paragraph 63) due to confidentiality constraints. Aside from direct resource limitations, the authorities need to find options to manage confidentiality issues that allow them to use resources fully and effectively.

17. The FSA needs to accrue a cadre of staff that is sufficient both in terms of numbers and range of skills. In Japan, as among many advanced countries, specialist but essential skills, are not plentiful in either the public or private sector. Personnel challenges are not unique to Japan but the FSA, in common with its international peers, must identify effective strategies to meet the skills envelope, and the FSA must be given the resource envelope to ensure sufficiency of staffing across all the banking sectors. This may need to include options for providing "risk premiums" for scarce but essential skills, such as cyber resilience, and finding better operational modes to utilize staff who may, at some point, return to private sector practice.

18. Staffing decisions are not wholly within the FSA's purview. The FSA Commissioner has authority over personnel management of staff whose position is equivalent to or lower than Director (Article 55-1, National Public Service Act). It is, of course, important to understand that rotation of staff is a widespread practice in both the public and private sectors in Japan and that the practice broadens the experience of more senior staff to support them in their career. Nevertheless, there are sensitive challenges that must be managed carefully, particularly in a highly technical agency such as the FSA where both technical expertise and institutional memory are vital and cannot be obtained in a short period of time. The mission understood that there may be some growing appetite to extend the periods of rotation. Moreover, rotation is a common practice at the less senior staff levels and firms, with whom the FSAP team met, indicated frustration that the turnover was too rapid, leading to lack of build-up of in-depth experience and a need to "teach" newly arriving staff what the issues were. This frustration is commonly felt by major banks across jurisdictions when their main relationship managers or policy experts move and appears to be more pronounced within Japan.

19. There is no fixed period of appointment for the Commissioner and at the time of the FSAP, the FSA was on its fourth Commissioner since 2020. There are undesirable outcomes that can stem from appointments that are too long, but also from a continual turnover at the head of an agency. The concept of a fixed-term appointment aims to provide a supervisory authority with certainty and stability without becoming overly set in its ways. It is even more undesirable for the agency not to be able to depend on greater stability in its most senior ranks, including its Commissioner. While recent appointees to the Commissioner role have come from within the FSA's senior executive ranks, such rapid turnover (and the consequent changes to other leadership roles) is likely to impede the cohesion and development of the organization. The cost to the FSA and Japan more broadly in this regard could be felt in its status and credibility, including its ability to capitalize on its peer relationships and argue its case in international fora, as well as a deeper and more robust relationship with the major banks, which is essential for the achievement of its mission.

C. Interagency Cooperation

20. The FSA has coordination, collaboration, and information sharing arrangements at domestic and international levels. Supervisory Colleges and Crisis Management Groups are in place for the three G-SIBs and for one D-SIB. Work to enhance crisis preparedness has continued since the last FSAP with the FSA establishing the "Recovery and Resolution Planning Office" in the Supervision Bureau in 2020 that helps to coordinate and centralize interagency information, for example, for crisis readiness efforts.

21. Information sharing between the FSA and BOJ on supervisory matters appears to be effective but could be made stronger. Considerable effort has been undertaken by both organizations in recent years to better coordinate and share information with each other. This was a product of the program of work under the 'Initiatives for Further Strengthening Coordination between the Financial Services Agency and the Bank of Japan,' released in March 2021, which established the Financial Monitoring Council (FMC). The FMC's objective has been to achieve more efficient and effective monitoring by sharing information and coordinating monitoring themes and on-site inspection targets. Feedback from staff in both the FSA and BOJ indicated that a high volume of information flows between the two organizations at multiple levels within their respective authorities about supervised banks, attesting to the fluency of the relationship. Supervisory planning arrangements are discussed in more detail below (see supervision planning under Section III Supervisory Approach).

22. The legal foundations for information sharing are incomplete. The Bank of Japan Act (Clause 3 of Article 44) stipulates that if a request has been made from the Commissioner of the FSA, the BOJ may submit the documents describing the results of the on-site examinations and other related materials to the Commissioner or have officials of the FSA inspect them. In other instances where confidential information about individual banks is to be exchanged (such as the BOJ requesting information from the FSA, or either agency wishing to proactively provide information to the other), such information flow will usually require the consent of banks. Both organizations indicated, however, that consent from banks was not difficult to obtain (e.g., in the case of the BOJ, it is a standard consent in the agreement under which they undertake on-site examination), so in practice this did not present a major barrier to effective information exchange.

23. Nonetheless, it would be preferable if information exchange between the two organizations is put on a stronger footing. This could, for example, involve a legislative amendment to provide a statutory foundation for information to flow between the FSA and BOJ without first needing the consent of banks. Moreover, to reinforce the measures to strengthen the information exchange framework, such a provision could also make it an obligation for each agency to share information with the other if the agency in receipt of information had reasonable grounds for considering that it would be of material interest to the other agency. This would put the FSA and BOJ on a par with their international peers and ensure that in the event of any concerns arising that

there would be no doubt arising on the ability of the two institutions to pool information and coordinate as effectively as possible.⁵

D. Licensing and Change of Control

24. In common with several other global agencies, the FSA has experienced something of a surge in license applications since the last FSAP. The three successful applicants who approached the FSA since 2017 (plus some cases where banks with an existing license changed their business model from a traditional to non-traditional model) represent emerging, innovative, and online business models. Extensive contact between the applicant and the FSA prior to formal application leads to submission packs that essentially already meet the approval criteria. Non-traditional banks require specialist skillsets in the FSA to ensure that the online modality of the new firms will be sufficiently robust. Based on the FSAP team's observations, the FSA has placed significant emphasis on the systems of the new entrant, although had not undertaken any form of independent testing, such as an on-site examination. Nor is there a systematic process of close observation over the first year of operation. The Japanese system for licensing has something of a failsafe built in, to the extent that a bank must achieve profitability within three years. Nevertheless, as the gatekeeper to the financial system the FSA needs to ensure that the skills are in place to operate a new venture safely. Therefore, ensuring that, at a minimum, the FSA conducts an on-site visit prior to granting an authorization and maintains close observation through the follow-up process to confirm that the documentary submissions are substantiated and that the new entrant is sound and orderly is recommended.⁶

25. Measures are in place to support the consolidation of the regional banking sector. As part of a broader drive to improve banking sector efficiency, the act on special measures for the anti-monopoly act for regional banks has provided a 10-year window for a merger or other integration between regional banks. This would exempt the merger from the application of the anti-monopoly act on the condition that the new merged bank was judged to better serve its local communities through leveraging the capacity generated by the merger. There is also a temporary grant scheme for regional banks which are merging or integrating for the purpose of strengthening their business foundations (running for 5 years from 2021) that subsidizes some of the initial merger costs. And there is a 3-year measure introduced by the BOJ in 2021, i.e., the Special Deposit Facility to Enhance the Resilience of the Regional Financial System, in which an additional ("extra") interest rate is paid on BOJ deposits by regional and Shinkin banks who undertake initiatives to strengthen their business foundations (e.g., by reducing overhead ratio).⁷ While the BOJ does not publicly

⁵ In the EU, the Capital Requirement Directive (2013/36/EU, as amended), Articles 24 and 56, ensure that supervisory authorities and authorities with responsibility for financial stability can exchange information. In the U.S., the Federal Banking Agencies have broad statutory powers to share information with other domestic Banking supervisors. See e.g., 12 U.S.C. §§ 1817 (a)(2)(A) and (C).

⁶ For clarity: in Japan the term "on-site inspection" is used to describe an inspection of a bank that is already licensed and under FSA supervision. The pre-license "on-site visit" might be described as an inspection in other jurisdictions.

⁷ <https://www.boj.or.jp/en/finsys/rfs/rel201110a.pdf>

disclose the number of regional banks that meet the requirements, the BOJ does disclose the regional banks that have received the extra interest.

26. The possibility of domestic consolidation and, for mega banks, overseas strategic expansion throw a spotlight onto change of control and major acquisition. Moderate changes have been made to the regulatory framework since the 2017 FSAP, chiefly some broadening to the bank acquisition/investment permissions (see paragraph 29). Notification of shareholding in a bank is triggered by a five percent threshold, as well as any subsequent changes (Banking Act Articles 52-2-11 and 52-3). Approval is required to become a major shareholder (Article 52-9). This threshold is set at 20 percent control of voting rights but is 15 percent under some circumstances. Above 50 percent, notification or approval processes apply depending on whether the change of control and acquisition is triggered by a bank (or bank holding company (BHC), or company seeking to become a BHC). For example, if a bank were to seek to obtain control of another bank (to make the target a subsidiary and raise its holding from 20 percent to over 50 percent), then approval is required (Banking Act Article 16-2 (4)). A post-facto notification requirement applies to all other major shareholders (defined as holding more than 20 percent, who increase their holding to greater than 50 percent; see Banking Act Article 53(2)(ii)). However, the FSA can apply a condition to a major shareholder so that any increase above the 50 percent threshold will require an approval. The conditionality is not mandatory and is not routinely applied and, obviously, needs to be in place before the shareholding crosses the 50 percent threshold.

27. Currently the strength of the change of controls system depends significantly on how rigorously the approvals process is operated at the 20 percent threshold. The FSAP team saw no evidence to suggest that the FSA took the approval process lightly. The ability to raise more capital, integrity, business reputation, and capability are all factors that are considered. However, the potential lapse of time between a shareholder passing the 20 percent mark and seeking to pass the 50 percent threshold, and the changes that might have taken place in the bank in the meantime could be very substantive. In other words, the prior assessment and conclusions on suitability may no longer be valid. If the shareholder were not a bank (or BHC/company seeking to become a BHC) then a controlling interest of a bank could be obtained with no approval and only a retrospective notification. There appears to be no practical or conceptual reason to allow this risk to persist. Mandatory approval at the 50 percent threshold is warranted for all classes of shareholders. Until changes can be made to legislation, and as advocated by the 2017 FSAP, all new major shareholders (between 20 and 50 percent of holdings) should be made subject to the condition of pre-approval in the future event they wish to pass the 50 percent threshold. If it is possible, the same pre-approval condition should also be attached to all current major shareholders.

28. In terms of major acquisition, unless a bank intends to acquire a bank as a subsidiary, the requirements are largely notification. As recorded in the previous BCP assessment, the FSA has the power to ex ante review major acquisitions by a bank, with the exception of acquisitions in ancillary business or banking related business for which pre-approval is not necessary. 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, require prior notification, not prior

approval. Based upon this prior notification, the FSA can require a bank to take measures if it is concerned about the potential impact of this investment.

29. While the Japanese framework provides the authorities with a good degree of awareness of bank shareholders, there are prudential vulnerabilities. Instances of change of control have more than doubled since the last FSAP, compared with the previous period. Similarly, major acquisitions increased more than 15-fold over the same time. The increase of changes suggest that it is timely to address both the change of control and major acquisition frameworks to ensure that both acquiring and target banks are fully assessed at the point where control changes. Further, a 2021 amendment to the Banking Act permitted foreign bank subsidiaries of Japanese banks to directly acquire consumer lending and leasing companies with “out-of-scope business lines.” The amendment also permits more flexible authorization of banks’ subsidiaries and affiliated companies. This will allow for the sale of internally developed IT applications and systems, financial technology-related businesses, data analysis, marketing and advertising. While diversification into such activities may boost income and growth and provide a wider portfolio of services for clients, the risks need to be monitored extremely carefully, both domestically and overseas as banks expand beyond their known traditional competencies.

E. Recommendations

30. In order to ensure that the foundations of supervisory authority cannot be undermined, the authorities are strongly encouraged to act as follows:

- Make explicit provision in the law to ensure the priority of financial safety and stability in the mandate of the FSA, in keeping with current policy and practice.
- Provide the FSA with the power (“Pillar 2” power) to set and adjust individual bank capital ratios (above the minimum requirements) in response to either a bank’s heightened risk profile or deteriorating financial position.
- Raise the thresholds set out in the Prompt Corrective Action regime. That is, recalibrate the trigger points for action in Cabinet Order in relation to Article 26(2) of the Banking Act.
- Amend the Order to Define the Categories Prescribed in Article 26 Paragraph (2) of the Banking Act to permit the FSA to issue a business improvement order to raise capital in a wider range of circumstances than currently prescribed, e.g., if it has reasonable grounds for believing a bank could fall within one of the categories within a short period of time (e.g., 6 months).
- Provide a fixed term for the appointment of the FSA Commissioner. Give the Commissioner the right to organize his staff for an agreed period (e.g., 5 years with option to stay on if individual agrees). Ensure longer staff rotations at senior and junior levels in recognition of the specialist nature of the agency and the need for the FSA to retain international standing. Also ensure that handover of responsibilities are managed effectively to maintain continuity.

- Review options to pay a “risk” premium to scarce skills that are key for the FSA (e.g., cyber resilience).
- Provide a legal gateway to ensure exchange of confidential supervisory information between the BOJ and FSA (and vice versa) for the purposes of executing the institutions’ supervisory and stability mandates, and without the requirement for banks’ approval.
- Ensure on-site inspection forms part of licensing approvals as well as close observation in the follow-up monitoring process.
- Strengthen the pre-approval process when a major shareholder obtains a controlling (over 50 percent) interest to ensure an up-to-date understanding.
- Implement a stricter pre-approval for an acquisition as already 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.

SUPERVISORY APPROACH

A. Transforming the FSA’s Supervisory Approaches

31. In 2018, the FSA announced a comprehensive set of reforms to its supervisory approach. At their most basic level, the reforms sought to shift the FSA’s supervisory approach from one comprising backward-looking, compliance-based check on formal requirements, into a modern supervisory approach based on substantive, forward-looking, and holistic analysis and judgment. The reforms also sought to ensure that the FSA’s regulation, supervision, and enforcement activities were aligned with the ultimate regulatory goal of contributing to national welfare.

32. The reforms to supervision were prompted by a recognition that supervision approaches built on past crises may no longer be fit-for-purpose as economic conditions and the financial system evolved. The long-standing supervisory approach of the FSA had been based on a comprehensive set of checklists and prescriptive requirements. The inspection approach was heavily focused on loan-by-loan review of lending files and compliance checks of internal controls, a legacy of the Japanese banking crisis of the 1990s. There was limited scope for supervisory discretion or tailored approaches, despite the diversity of Japanese banks and the increasingly rapid evolution of the banking system and the risks it was exposed to. While the inspection approach had been thought to have achieved its objective for its time, it was increasingly considered to encourage conformity and stifle innovation within the banking system.

33. For the FSA itself, the extent of change required by the new model of supervision was rightly described as transformational. The reforms required change to almost every aspect of the FSA’s supervisory operations. Not only did supervisory policies and procedures need to be almost completely rewritten, but different types of data also needed to be collected, different forms of engagement with banks needed to be developed, new quality assurance mechanisms needed to be established, and (perhaps most important) FSA supervisory staff needed to be equipped with the skills, knowledge, and culture to apply the new approach. The FSA considers that, five years on, they

have fully implanted the new approach, although specific supervision tools and techniques continue to evolve in response to current events.

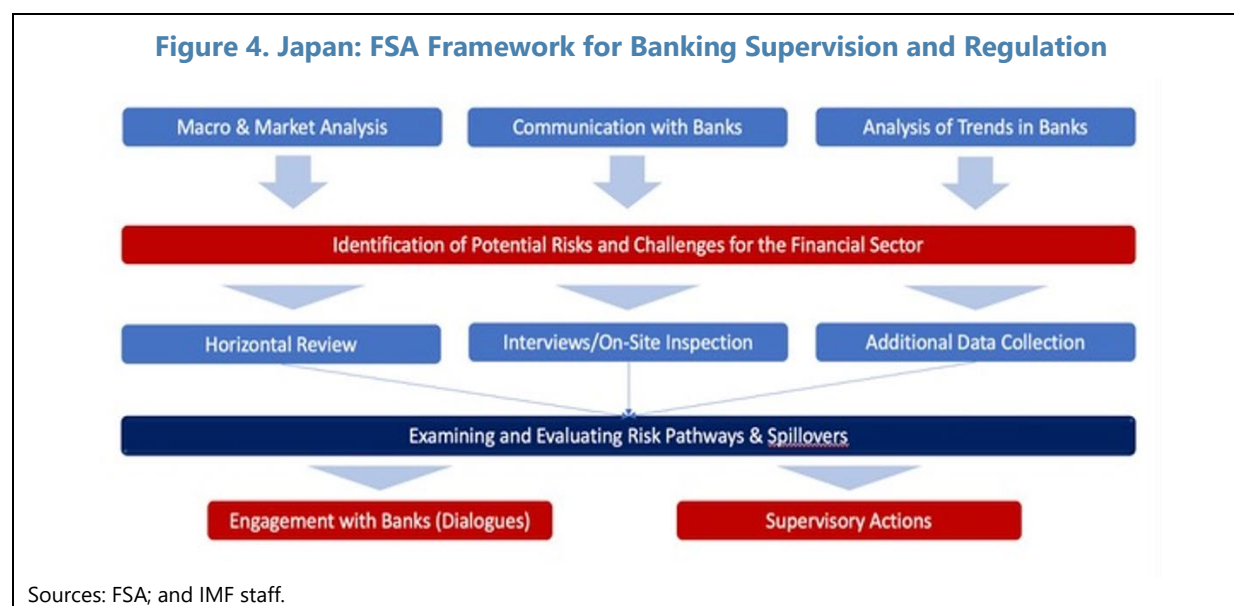
34. The FSA acknowledged that one of the challenges of its new approach was establishing the right supervision mindset. Shifting from a compliance-based approach to one that required a much greater exercise of judgement was a major cultural shift, and FSA staff indicated that this was possibly the hardest component of the transformation to implement. Extensive training and guidance were provided to supervisors to help with the change, although this is something that requires continued investment to ensure the culture change is permanent.

35. The new approach also requires confidence (psychological safety) on the part of regulated banks that the FSA would respond in a balanced manner when banks revealed problems to them. The FSA is clearly alert to this, and routinely seeks feedback from a range of sources (including surveys and interviews conducted by a third-party provider to provide anonymity). The results from these surveys, which are published, indicate a high degree of support from the banking sector for the FSA's new approach.

B. Replacing Checklists with Engagement

New Supervisory Approach

36. Compared to the previous FSAP, the FSA has shifted towards a more modern, risk-based approach to supervision that is better suited to overseeing and responding flexibly to an evolving banking system. The principles on which the framework is built are sound—the supervisory approach has become more forward-looking and risk-focused, and supervision is applied on a differentiated basis to banks of different sizes. Active supervisory judgement is being encouraged, horizontal reviews are being deployed more actively, and investment is being made in data analytics to support these changes (Figure 4).



37. Industry participants and observers acknowledged and were appreciative of the new approach. In all discussions the FSAP team held with selected industry participants and observers, the FSA's emphasis on engagement and dialogue was strongly welcomed. Industry participants felt the FSA was approachable, listened to their concerns, and communicated clearly. Nonetheless, the FSA was still described as 'stringent' in its expectations. Bank management also acknowledged that the new approach made clear that they were primarily accountable for the prudent and sustainable operation of their bank.

38. Notwithstanding the major improvements, there are also a range of areas in which the FSA should continue to strengthen its practices. Certainly, there is room to improve the sophistication of the FSA's supervision approach and toolkit. No supervisor achieves best practice in all that they do, and the FSA should continue to engage with and learn from peer supervisors around the world. Some areas for improvement, such as increasing the intensity of supervision for regional banks and improving its data analytics, will be a challenge without more resources for the FSA. But other suggestions, such as enhancing its EWS and developing a revised supervisory risk methodology, could be implemented without the need for more staff.

39. The BOJ should also ensure that its practices and approach remain broadly aligned with the FSA given the latter's role as the primary regulator and supervisor of the banking sector. Acknowledging that the BOJ is not formally a regulator and conducts its supervision activities with different objectives, there is nevertheless considerable overlap between the interests of the two organizations. When the FSA substantially overhauled its supervisory approaches in 2018, there were no similar reforms to the BOJ's supervisory activities although the existing risk-based structure of the BOJ's own work and long history of cooperation position it well. While cooperation and coordination are evident, supervision of banks will be both more effective and more efficient if supervisory practices are aligned to the maximum extent possible. To that end, the BOJ should ensure that it continually updates and tailors its own approaches to remain broadly aligned with the evolution of practices at the FSA.

Organizational Structure

40. Organizational changes in the FSA since the previous FSAP have produced more integrated oversight of banks. The previous structure created a strong delineation between on-site inspections, which had mainly been conducted by the Inspection Bureau, and interviews and other dialogue with banks, which had mainly been undertaken by the Supervision Bureau. While the new structure still sees supervision activities split between the Supervision Bureau and the Strategy Development and Management Bureau, much greater cooperation and collaboration between the two divisions are now evident. In this regard, the Risk Analysis Division (RAD) of the Strategy Development and Management Bureau plays a central role, both in terms of being an active partner in the supervision of the largest banks, as well as in providing data analytics and risk expertise to the Supervision Bureau to guide supervision activity more generally.

Supervision Planning

- 41. The FSA publishes its supervision priorities annually.** The BOJ also publishes its own list of priorities, so banks have visibility of the matters of interest to both organizations. Although they are published for slightly different time periods (the BOJ's fiscal year beginning April; the FSA's supervisory year beginning July), there is a high degree of coordination in the planning via joint FSA-BOJ committees (notably the biannual meetings of the Financial Monitoring Council and the quarterly Coordination Meeting for on-site inspections and examinations).
- 42. In the case of the BOJ, there is an average examination cycle which can be adjusted if necessary.** Mega banks are inspected every three years (i.e., one mega bank per year); other major banks, regional banks and foreign banks every five years; and Shinkin banks every seven years. Cycles can be shortened and/or the scope of examinations adjusted depending on the BOJ's views of a bank's risk profile and degree of risk taking, its capital adequacy and profitability, and its systemic impact.
- 43. Supervision by the FSA is tailored to banks according to the size and risk of their operations.** Broadly, there are four peer groups, each subject to a slightly different supervisory methodology. Nine major banks are subject to the most highly structured and intensive supervision, while around 100 regional banks, 399 Shinkin and other small banks, and 56 foreign banks are subject to more targeted supervision. The respective shares of banking sector assets for these banking groups are about 50 percent, 30 percent, 15 percent, and 5 percent.
- 44. The largest nine banks are subject to a structured annual supervision cycle.** Consistent with the FSA's published supervisory priorities, the planning cycle runs from July to June each year. In August, each of the major banks is provided with a supervision plan for the year ahead, which has been developed with input from across the various teams within the FSA. It will reflect both the FSA's published organizational priorities (horizontal themes), as well as idiosyncratic issues specific to the bank concerned. It will also have regard to any inspection activities to be conducted by the BoJ. In June the following year, the bank will receive a formal feedback letter containing the results of the supervision program (typically 20-30 pages long). This will be personally delivered at a meeting between a Director-General of the FSA and the CEO of the bank, at which the issues needing action will be highlighted and a commitment to address them will be sought.
- 45. In practice, supervision plans are adjusted as needed to respond to events that may arise mid-year.** For example, the turmoil created by the failure of SVB and Credit Suisse in March 2023 resulted in a range of supervision activities being undertaken at a short notice. Banks also do not need to wait for the feedback letter at the end of the supervisory cycle to hear the FSA's concerns. Feedback is being regularly provided to banks throughout the year, and the FSA seeks to operate on the basis that the feedback letter should not contain any surprises for the bank. During the FSAP mission, banks indicated that this was the case.
- 46. The supervision cycle for regional banks uses a less rigid approach, with more discretion given to supervisors to determine supervision activities in response to each bank's risk profile.** Regional banks do not receive an individual supervision plan, nor an end-of-cycle feedback letter. Instead, regional banks are informed of the FSA's annual strategic priorities, and

supervisors will determine the activities to be undertaken each bank guided by the FSA's priorities, the outputs of the Early Warning System (see further below), and any other pertinent information (e.g., the results from horizontal reviews). Individual supervision activities might be conducted by FSA staff, staff from the relevant Local Finance Bureau (LFB), or both.

47. Day-to-day supervision of Shinkin and other small banks is primarily conducted by Local Finance Bureaus, under delegated authority from the FSA. The supervision cycle is similar to the one for regional banks, except that the 10 LFBs perform the bulk of inspection and day-to-day liaison functions. The FSA provides guidance to the LFBs on its priorities for supervision, as well as assists the LFBs to identify potential targets for supervision activity based on the EWS. The FSA is provided with the results of the LFBs supervisory work and may on occasion conduct joint meetings or inspections if needed.

48. Foreign banks are subject to the lightest supervision reflecting their generally low risk profile and limited systemic importance. Most foreign banks operate in the form of branches and supervision is largely conducted off-site, through data monitoring and the exchange of information with home authorities and participation in supervisory colleges. On-site inspections of foreign banks are relatively few in number; after an extensive horizontal review program in 2014-15, the number of on-site inspections of foreign banks has averaged 1-2 per annum since that time.

49. While the FSA's approach to supervision activity is consistent with its espoused risk-based approach, there remains a risk that problems at a regional or smaller bank may go undetected for some period of time. The FSA has a small set of baseline set of supervision activities that must be undertaken each year to ensure at least a minimum understanding of each bank's risk profile. However, FSA staff indicated that, in considering which banks would be subject to on-site inspection in the year ahead, the period since the last inspection would be a factor taken into consideration, but there is no limit on the length of time that would be acceptable to go without an inspection. The FSA should enhance its baseline supervision requirements for all banks to improve a minimum level of supervision activity (including on-site inspections) is undertaken over a prescribed period of time.

Supervision Intensity and the Early Warning System

50. For the largest banks, there appears to be relatively close and continuous supervision activity by the FSA. The largest banks have dedicated supervisors, who are in regular (usually daily) contact with the banks that they are responsible for. Staff in the Risk Analysis Division (that is, the Division housing the FSA's data and risk management experts) are heavily involved in much of the day-to-day supervision of these banks.

51. Central to the supervision process for regional and smaller banks is the Early Warning System (EWS). The EWS is intended to identify banks with financial metrics that could indicate potential problems in the future, and hence allow the FSA to allocate its supervisory resources to investigate issues early. As a result, the degree of supervisory intensity for these banks varies to a greater degree, depending on whether the banks trigger the EWS or there are other issues of concern that the FSA becomes aware of.

52. There are four sets of metrics that comprise the EWS, covering credit risk, stability (market risk and interest rate risk in the balance sheet), cash flow (liquidity), and profitability.

In each case, a set of metrics and associated trigger points have been established to flag banks that might be at greater risk of future problems.

53. The EWS data is updated at varying frequencies. The liquidity and market risk data is updated monthly. The credit risk data is updated half-yearly. The IRRBB data is updated quarterly. The profitability data is updated annually. This longer cycle is primarily reflective of the nature of the profitability component of the EWS. Unlike the other three components of the EWS framework, the profitability EWS is much more complex and involves forecasting profits over a five-year time horizon under both current trends and (if current trends are adverse) some alternative scenarios.

54. Supervisors use the outputs of the EWS (both the type and number of flags) to guide the type and intensity of their supervisory response. Although supervisors will always conduct a hearing with a bank that triggers the EWS, they will also combine the EWS results with other supervisory information to determine banks in need of the most intensive supervisory attention.

55. The metrics within the EWS are likely to be of varying quality in predicting future problems. The profitability and market risk (IRRBB) indicators are more sophisticated and essentially involve testing the impact of future adverse scenarios. For other types of market risk, simple sensitivity measures are used. For credit and liquidity risks the EWS comprises simple balance sheet ratios (or changes in those ratios). While the latter ratios are undoubtedly sensible metrics to monitor, they are unlikely to be particularly helpful as an early warning signal, as they would signal adverse trends already underway (i.e., they are “lagging indicators”). Notwithstanding other supervisory activities which are in place, there are no metrics within the EWS that attempt to capture non-financial risks (e.g., the risks stemming from poor governance, risk management, or internal controls), although non-financial risk information is captured and assessed elsewhere within the supervisory process.

56. Given the centrality of the EWS to the deployment of supervisory resources for regional and smaller banks, the FSA should explore, especially for credit and liquidity risk, the development of more forward-looking metrics. The inclusion of metrics, for example, on the extent of higher-risk lending, loans in arrears but not yet non-performing, and the adequacy of provisioning coverage, would improve the value of the credit EWS. For liquidity, the EWS could be enhanced through a greater focus on the sources of liquidity and potential future cash flows. Data on customer complaints and operational outages might also be useful non-financial metrics for the FSA to utilize in its supervisory activities, even if the FSA ultimately decides not to add such metrics into the EWS. Although the exact details vary, many other supervisors use early warning systems, and the FSA could examine these to draw from best practice of peer authorities.

Supervisory Tools and Activities

57. The basic supervisory toolkit of the FSA is largely aligned with the modern risk-based approaches used in peer countries. That is, the FSA applies a mix of on-site and off-site supervision in order to identify and rectify supervisory concerns, directed to areas that the FSA considers having the greatest potential to adversely impact its statutory objectives.

58. The FSA seeks to adopt a close and continuous supervision approach, particularly for the largest banks. There will be day-to-day communication with banks, typically occurring through

periodic and occasional interviews, dialogue, and discussions with banks' management, outside directors, internal auditors, and various other officers or employees. This will be supplemented by the collection and analysis of both financial information and other business information of those banks. The FSA describes its supervisory approach as one in which it will closely communicate with banks and gather information on a routine basis, with a sense of moderate and constructive tension between the supervisor and the bank. On-site inspections will be directed to activities that require more intensive examination.

59. The FSA's supervisory guidelines (SGs) are extensive, but not overly prescriptive. In the shift to its new supervision approach, the FSA's old inspection manuals were abolished, and replaced with new SGs. These provide considerable guidance to supervisors (and banks) on the questions the FSA will consider when examining various aspects of a bank's operations. However, while the Guidelines contain a wide range of issues for supervisors to take account of in their assessments, the questions being posed are largely outcomes-focused, and stop short of prescribing how banks should run their businesses.

60. In some areas, the FSA's expectations are supplemented by discussion papers and other materials that have been published subsequent to the most recent version of the Guidelines. This helps ensure banks are aware of the FSA's thinking on new and emerging issues. However, there is a risk that the volume of this supplementary material grows over time, and it becomes difficult for users (supervisors and banks) to be clear as the totality of the FSA's standards and expectations. A commitment to undertake a periodic update of the SGs (e.g., every five years), incorporating and/or repealing supplementary material, would be worthwhile.

61. In recent years, the FSA has made greater use of horizontal (thematic) reviews. These typically focus on the FSA's annual strategic priorities but can also be deployed to respond to an issue that emerges suddenly. The use of horizontal reviews also aids consistency of supervisory assessments by having the same group of experts involved in examining an issue at multiple banks at the same time. Examples in recent years have included: credit risk management of domestic leveraged buy outs (LBOs), internal ratings and provisioning practices, risk-taking investment policy, model risk management, overseas project finance, and foreign currency liquidity management.

62. The FSA (and BOJ) seeks to keep a close eye on the offshore operations of its largest banks. Given the extensive offshore operations of the largest Japanese banks, the FSA is restarting offshore visits that had to be put on hold during the COVID-19 pandemic. Prior to the pandemic, the FSA regularly visited the major offices in the U.S., the U.K., Europe, and Asia. Overseas office management will often meet with the FSA when they periodically return to Tokyo to provide an update on their business, and local Japanese embassy staff in foreign jurisdictions can also be utilized to maintain liaison with Japanese banks between FSA visits. The FSA also collects data specific to the overseas offices of the Japanese banks, enabling them to undertake high-level monitoring of their offshore businesses throughout the year. These activities are supplemented by the BOJ's examination processes, which also cover inspections of the bank's major overseas offices.

63. The FSA does not utilize or outsource any supervisory work to external parties, such as consulting firms or auditors. This is somewhat unusual relative to peers, who quite often seek to employ third-party experts to bolster gaps in the level or depth of supervisory expertise. The FSA

explained this was primarily an issue related to confidentiality: to the extent that the FSA required additional technical expertise on a complex matter, it would seek to directly hire such expertise into the FSA on a short-term contract, effectively making the expert(s) FSA employees for the period of the assignment. As noted previously in relation to resourcing, this is not always easy for the FSA to do.

Data-Driven Planning and Analysis

64. A core component of the FSA's new supervision approach is to make greater use of data analytics. The FSA has established the Macro-financial Stability and Data Strategy Office within the Risk Analysis Division to substantially increase the value it is able to derive from its supervisory data and associated analysis.

65. As part of this initiative, the FSA is developing a comprehensive stress testing program. There are multiple components to this. At the center is the joint, annual stress test conducted with the BOJ, which applies a common economic scenario across a select group of major banks. The fact that the stress test is conducted is public but results are not published, although the BOJ's Financial System Report provides an analysis of its macro stress tests. Banks are also asked to apply the FSA-BOJ common scenario to their own stress testing models, allowing the FSA to compare the results and better understand banks' own stress testing capabilities and assumptions.

66. Complementing the joint FSA-BOJ program are a number of other activities. Under their ICAAPs, large banks conduct annual stress tests, and the FSA is able to review and analyze the results of those. For regional banks, the FSA will review the banks' internal stress tests and encourage them to improve the framework as necessary where the EWS indicates potential problems might be emerging. The FSA is also developing additional scenario analysis capabilities that will test specific risk categories, such as a deterioration in credit risk, or a market risk shock.

67. To enhance its monitoring capabilities, the FSA is working on an initiative to expand its access to data. This includes both collecting more granular datasets from banks, and making greater use of third-party datasets. The FSA is also working with the BOJ to develop a common data platform that allows banks to submit datasets only once to both agencies. This project will also allow for redundant data to be dropped from reporting requirements while at the same time giving both authorities access to more granular, transaction-level data on corporate loans.

68. The FSA must continue to invest in its data analytical capabilities. The FSA has a long-standing public commitment (contained in its SGs) to limit the supervisory burden of information collection. Nevertheless, to successfully deliver on its mission with limited resources, the agency needs to continue to build its data analysis capabilities to enable it to identify potential problems earlier and target its supervisory resources most effectively. This will require expanded access to data along with sufficient budget for investments in up-to-date infrastructure (databases and analytical tools) and advanced data analysis skills amongst its staff. It also needs to continue to foster a culture of data-driven supervision amongst its broader supervisory cadre.

Supervisory Assessment and Rating System

69. Unusual amongst risk-based supervisors, the FSA does not utilize a supervisory rating system to capture its overall supervisory risk assessment for each bank. Ratings are typically

used by supervisors, especially those with a large population of banks to oversee, as a means of providing a common, overarching framework for the supervisory process and for clear communication of overall supervisory assessments, both to supervisory staff and the banks being supervised. The FSA discontinued its former risk ratings system when it reformed its supervisory approach. The 2017 FSAP offered some recommendations on how that former system might be further developed but it is understood that the FSA, reasonably, wishes to move forward with methodologies rather than to look backwards.

70. In practice the FSA effectively uses the EWS as a partial substitute for a rating system.

To some extent, the EWS does the same as a rating system, by distinguishing between banks with lower and higher risk profiles. However, the two are not the same. The EWS is a series of metrics that is used as an *input* to a risk assessment, whereas a supervisory rating is the *output* of a broader assessment. The EWS only covers financial metrics (albeit important ones) and does not capture qualitative items such as the inherent risk of the bank's strategy, the strength of governance and management, the robustness of risk management, or the adequacy of internal controls, all of which would typically be captured in a supervisory rating. And as noted previously, the EWS is not a major input into the supervisory strategies of the major banks.

71. The BOJ, on the other hand, does employ a supervisory rating system. Following an on-site examination, banks are rated. Grades are assigned to several components: financial soundness, profitability, credit risk, market risk, liquidity risk and operational risk. If material management issues are identified through BOJ examinations, banks are required to report progress of improvement to the BOJ.

72. The FSA should consider the development of a revised risk methodology to strengthen its existing supervisory framework.

While the EWS provides a specific and important input into the analytical understanding of the banks, more is needed, in particular a tool to bring together a complete view of a bank, using all information sources, and strengthen the FSA's ability to identify and actively prioritize the most important issues. As the 2017 FSAP noted, and despite the many valuable reforms and enhancements in the interim, an analytical framework to assess the risk profile of banks and banking groups on a more comprehensive and systematic basis is still needed. A forward-looking supervisory analytical system, which takes into account assessments of, at a minimum, governance, business and strategy risk and inherent and mitigated (by management and/or capital) risk level of all material risk types (not limited to EWS risks), will build on the work already achieved by the FSA in understanding the business profiles and risk strategies of the banks. Such a supervisory risk methodology could also be beneficial to help allocate supervisory resourcing according to shifting needs, identify trends in risk over time, bring consistency to supervisory actions, improve quality control, and provide a common language about the outcomes of each bank's supervisory assessment.

Imposing Corrective Action

73. For the most part, the FSA does not need to resort to legal orders to achieve its objectives. It was clear from evidence provided to the FSAP team that the FSA is able to force banks to improve their operations through routine dialogues and hearings with banks. Banks seem

receptive and responsive to the FSA's concerns and preferred actions, and as a result persuasion is sufficient to achieve most supervisory outcomes.

74. Nevertheless, where routine supervision has failed to generate remedial action at a bank, the FSA may mandate a Business Improvement Order (BIO). BIOs may be issued by the FSA under Article 26 of the Banking Act, and provide a general power to direct a bank to improve its business or financial condition (Table 2). Although the Act states that BIOs are to be issued by the Prime Minister, it also states that this power is delegated to the FSA (Article 59(1)) and the FSA itself may delegate part of this authority to Directors-General of Local Finance Bureaus for the purposes of supervising regional and Shinkin banks (Article 59(2)). There have been no instances in which the Prime Minister has been involved in decision-making in relation to BIOs. The issuance of a BIO must be notified to the Minister of Finance (Article 57-6), and the Minister may need to be consulted before the BIO is issued if the FSA considers the maintenance of an orderly credit system could be materially affected (Article 57-5). There have been no recent instances of the latter.

75. In contrast, the BOJ has no formal enforcement powers. The BOJ's supervision activities are undertaken as a condition of the bank having access to the BOJ's current account services. The BOJ's capacity to enforce action on a bank derives from the status of the BOJ, and the potential to lose access to the account services at the BOJ. Where necessary, the BOJ would coordinate with the FSA to ensure corrective action occurred to address its concerns.

76. There are two types of BIOs that the FSA can issue: a general BIO and one specifically addressing capital. Except for when it comes to capital-related matters, BIOs provide the FSA with a broad suite of options to require a bank to improve its operations. The Act provides for a general power such that the FSA may (i) order a bank to submit an improvement plan to address the FSA's concerns, (ii) itself prescribe the actions the bank must take and the timing thereof, (iii) order the bank to suspend all or part of its business activities by a set deadline, (iv) order it to deposit bank assets, or (v) otherwise issue orders with respect to measures that are necessary from a supervisory perspective. The Banking Act contains penalty provisions such a BIO be breached.

77. BIOs may be published if that is deemed to serve the public interest. Where the FSA believes the disclosure of the nature of the order will have a positive impact (e.g., via general deterrence to the rest of the industry, or a means of demonstrating to the public that action is being taken to respond to a concern), both the existence of the BIO and its contents will be published. On the other hand, in instances where publication of the order may add to instability, the FSA may choose to keep the BIO confidential. Data made available to the FSAP team indicated most BIOs made under Article 26 have been made public.

78. There are avenues available to banks to challenge FSA actions. When the FSA proposes to take an administrative action, such as issuing a BIO, it will conduct a hearing or seek written submissions in accordance with the Administrative Procedure Law which gives the bank the opportunity to make the case for why such an order is unnecessary. Should the FSA decide to proceed with the action after the hearing, a bank is also able to make a request for examination based on the Administrative Complaint Review Act or file a lawsuit for revocation of the action under the Administrative Case Litigation Act. The FSA advised that there have been no recent examples of any such appeals.

79. Unlike the broad range of orders that can generally be made by BIO, the FSA’s ability to proactively enforce the ongoing capital sufficiency of banks, via a direct requirement to increase capital, is constrained by law. Not only does the FSA lack the ability to set bank-specific (Pillar 2) capital requirements, but its ability to proactively respond to a bank with a deteriorating capital position is also constrained by a Cabinet Order (Table 2) that effectively prevents the FSA from issuing a formal BIO to improve the bank’s capital position until the bank has breached prescribed triggers. The FSA’s awareness of the need to act at an early moment is not in doubt and its practices are noted below (see paragraph 82).

Table 2. Japan: Corrective Action for Capital Deficiencies

Under Article 26, paragraph 2 of the Banking Act, a business improvement order pertaining to capital must be consistent with the relevant Cabinet Order. The relevant Order (<i>Order to Define the Categories Prescribed in Article 26, Paragraph (2) of the Banking Act</i>) establishes a scale of action of increasing severity. Corrective action is automatically triggered by quantitative thresholds, both on a consolidated and a non-consolidated basis. The table below shows an example with total capital ratio on a consolidated basis, but there are also scaled triggers for the Tier 1 and CET1 capital ratios as well as for the leverage ratio. For domestic (non-internationally active) banks, a separate scale is applied, based on a narrower definition, or “core capital” ratio (broadly, CET1). Regardless of the scale, the actions within the categories are the same	
Capital Ratio	Action
Category 1 Total Capital Ratio of 4% to less than 8%	Order to submit a capital improvement plan that is acceptable to the FSA, and an order to implement the plan.
Category 2 Total Capital Ratio of 2% to less than 4%	Order to pursue some or all of the following measures: (i) submission of acceptable capital enhancement plan; (ii) prohibition on dividends or bonuses, or restraint on amount thereof; (iii) reduction in assets, or limits on asset growth; (iv) prohibition or restriction on acceptance of deposits; (v) reduction in services at some business offices; (vi) elimination of some business offices; (vii) reduction of services incidental to core banking; (viii) reduction in services of subsidiary company, and/or sale of shares in subsidiary company; and/or (ix) other measures deemed necessary by the FSA Commissioner.
Category 2-2 Total Capital Ratio of 0% to less than 2%	Order for drastic reduction in services; merger; discontinuation of banking services.
Category 3 Total Capital Ratio less than 0%	Order to suspend banking services in whole or in part.

Source: FSA.

80. Moreover, the BIO capital triggers, for banks with international business, are set at the level of Basel minimum requirements (and, in broad terms, at equivalent levels for smaller banks). The Order establishes an escalation process as banks fall below minimum requirements, with an intervention of increasing severity as the capital ratio declines. However, critical to the framework of the Cabinet Order is that a BIO cannot require a capital raising unless and until the various triggers are hit (i.e., the bank falls below the minimum requirements).

81. The effect of the Cabinet Order is to delay formal direct action on capital enhancement until a bank’s minimum capital ratio has been breached. This sits at odds with the intent of the Basel capital conservation framework, under which action of increasing severity is initiated to attempt to prevent a breach from occurring in the first place. It is also at odds with the Prompt

Corrective Action regimes used by many other supervisors, which aim to nudge supervisors to act *before* minimum requirements are breached.

82. Without formal powers to formally intervene early and directly with capital-related orders, the FSA relies primarily on its ability to influence and drive corrective action through other, indirect, means. The discussion regarding limitation on powers is separate from any discussion on the FSA's supervisory attentiveness. The FSA is fully aware of the need for early information and the need to act at an early moment to achieve maximum effectiveness. Tools and approaches including the EWS which probes forward-looking capital and ICAAP review, support the FSA in its capital awareness. Should there be indications that a bank might be at risk of breaching any of the capital thresholds, the FSA will require increased reporting (under Article 24 of the Banking Act) and, as necessary, issue a BIO under Article 26 that will restrict the business of the bank in question. Given the stature and authority of the FSA, this will be effective in most cases in generating an appropriate response from the bank concerned and the bank may raise capital on its own initiative.

83. Nevertheless, if the bank's response is slow or inadequate, the FSA can only respond to the problem through indirect, but formal, means if a breach of the capital triggers under the Cabinet Order has not occurred. For example, the FSA could impose other operational constraints, reduce risk limits, or restrict higher risk loan portfolios. In effect, the concerns must be addressed through the actions that impact the denominator of the capital ratio (such as the limiting the amount and risk of assets), rather than directly addressing the numerator. It also means the corrective action is more likely to impact (some) customers of the bank, rather than directly placing the cost of boosting the bank's capital ratio onto shareholders. The intense monitoring and intervention under Article 26(1) is also not well suited to situations that arise more unexpectedly and/or move rapidly as there is not enough time for the measures to take effect and stabilize the bank.

84. The FSA's direct ability to ensure banks' ongoing capital adequacy needs to be strengthened. The supervisor needs to be able to intervene at the earliest moment possible to secure the most stable outcome for the institution, its depositors and the system at large. While the FSA does seek to intervene to ensure capital sufficiency is preserved, it does not have the power to directly require banks to increase capital until they have breached prescribed triggers. Restricting the timing and nature of the supervisors' scope of capital powers creates a needless vulnerability in the system. Legislative amendment is required to ensure the FSA has the full suite of capital powers, to deliver capital proportionate to the scale and nature of risks in banks, has appropriate capital thresholds for action and a suitably broad set of circumstances under which it can mandate capital raising. For completeness these measures are noted also under paragraph 41 (regarding supervisory powers).

85. There are many strengths in the Japanese approach given the new emphasis on understanding banks' businesses, although improvements are needed. The expectation that the bank should take ownership of the identified concern and make remedy is an important foundation for supervisory process. It was clear from the records made available to the FSAP team that the FSA

is able to communicate a clear message and executes an orderly follow up process. Equally, there is a clear escalation process through more intensive supervision, hearings and then use of formal powers. In fact, in cases where an immediate response is required, the FSA can immediately issue a BIO under Article 26(1) of the Banking Act. However, the FSA could be better supported in achieving a timely and intrusive corrective approach. One issue is that while the FSA wishes, sensibly, to emphasize the autonomy of banks where reasonable and conduct a supervisory dialogue to fundamentally resolve problems, this can lead to delay in the issuance of a BIO that may be needed. While supervisory dialogue may assist the FSA in identifying and understanding the cause of a problem in a bank before it issues a BIO through the receipt of reports under Article 24, for example, it can still increase the risk of overall delay.⁸ Valuable time might be lost in terms of rectification of vulnerabilities, especially in instances when time is a priority. Another issue is that resources for supervisory relationships with regional and smaller banks is stretched thin and corrective actions will be more likely to be reactive and less timely than the supervisor might wish. Absent enhanced resourcing, the recommendations on deepening data, the EWS and the revised supervisory risk methodology will assist the FSA in identifying potential concerns sooner rather than later.

C. Recommendations

86. Regarding supervisory practice and approach, the following recommendations are made:

- Given that the Early Warning System does not capture all risks, the FSA should enhance its baseline supervision requirements for all banks to improve a minimum level of supervision activity (including on-site inspections) is undertaken over a prescribed period of time.
- The FSA should be encouraged to continue to invest in its data analytical capabilities.
- The FSA should consider the development of its own supervisory risk methodology to strengthen its existing supervisory framework.
- The FSA should continue to develop the EWS, especially for credit and liquidity risk, to ensure more forward-looking metrics, and make more use of non-financial information for supervision.
- The FSA should establish a periodic cycle to review and update the SGs (e.g., every five years) to incorporate and/or repeal supplementary material as necessary.
- The BOJ should maintain alignment of its supervisory practices and approach with the FSA.
- The FSA's ability to ensure banks' ongoing capital adequacy should be strengthened. The following measures are strongly urged and the first is essential for compliance with the Basel framework:

⁸ The Comprehensive Guidelines for Supervision of Major Banks (June 2021), II-5-1 Basic Workflow for Administrative Action (Adverse Action) sets out the basic workflow for executing major adverse actions such as issuing a BIO under Article 26 and which explains the process for requesting reports under Article 24 prior to issuing a BIO.

- Provide the FSA with the power (“Pillar 2” power) to set and adjust individual bank capital ratios (above the minimum requirements) in response to either a bank’s heightened risk profile or deteriorating financial position.
- Raise the thresholds set out in the Prompt Corrective Action regime. That is, recalibrate the trigger points for action in Cabinet Order in relation to Article 26(2) of the Banking Act.
- Amend the Order in relation to Article 26 Paragraph (2) of the Banking Act to permit the FSA to issue a business improvement order to raise capital in a wider range of circumstances than currently prescribed, e.g., if it has reasonable grounds to believe a bank could fall within one of the categories within a short period of time (e.g., 6 months).
- The FSA should supplement or amend its Supervisory Guidelines to clarify the principles under which would reserve the right to move directly to issuing a BIO under Article 26, in order to avoid undue delay in applying appropriate corrective action.

PRUDENTIAL REGULATIONS AND REQUIREMENTS

87. Unlike the peer-group based approach to supervision, the primary distinguishing feature in the application of regulation is whether a bank is internationally active or not.

Internationally active banks, a group which captures six of the nine major banks and 10 of the 100 regional banks, are subject to the full Basel standards. Domestic banks, even if in the major bank category, are subject to domestic Japanese standards. In some cases, the standards may be similar between the two groups (for example, Japan endeavors to use a largely common approach to the calculation of risk-weighted assets), but in others the standards can be quite different (for example, while the FSA monitors banks’ liquidity positions, there is no minimum liquidity requirement for domestic banks).

A. Capital and Risks

Capital

88. As discussed above, under the current legal framework (Table 3), the FSA does not have complete Pillar 2 powers. That is to say that the supervisor cannot set a minimum capital ratio for a bank that is tailored commensurate to its risk profile. Specifically, it lacks the “ability to require banks to hold capital in excess of the minimum.” In some respects, the FSA is an active Pillar 2 supervisor, in that it requires major and regional banks to submit Internal Capital Adequacy Assessment reports. The FSA assesses the ICAAPs submitted by the major 9 banks, and as needed will enter into a supervisory dialogue with the banks. The risks specifically identified under Pillar 2 in the Basel Framework are placed under scrutiny. However, if the FSA were to consider that the regulatory capital of the bank was insufficient for its risk profile and capability, then additional capital is not an option that can be formally required. The FSA instead must depend on its ability to persuade and encourage, which, on the basis of all findings the mission was able to make, are considerable. Ultimately, however, if a difference of view were to develop between the bank and the FSA, the power of compulsion is missing.

Table 3. Japan: Capital Standards

	Internationally Active Banks	Domestic Banks
Capital	CET1 (common stock, retained reserves, etc.) * Includes other comprehensive income. * Goodwill, other intangible assets, deferred tax assets, and other investments in financial institutions, etc. are deducted from CET1 Other Tier 1 (preferred stock, perpetual subordinated bonds, etc.) Tier 2 (term-limited subordinated bonds, general allowance for loan losses, etc.)	Core capital (common stock, retained earnings, preferred stock with mandatory conversion clause, preferred investment in cooperative organizations, general allowance for loan losses) * Valuation difference on other securities is not included in profit or loss. * "Deduction items" similar to Basel standard are deducted from core capital.
Risk Weighted Assets	Basel Framework National discretion and transitional measures based on international agreements may apply.	Basel Framework. However, some simplified methods can be applied. E.g., risk weighting of real estate exposures in credit risk, current exposure method (CEM) use of counterparty credit risk, simplified method for credit valuation adjustment risks
Minimum Ratio	CET1 Ratio \geq 4.5 percent Tier 1 Ratio \geq 6 percent Total Equity Ratio \geq 8 percent	Core Capital Ratio \geq 4 percent Banks adopting the Internal Ratings-based Approach (IRB) must meet the Basel CET 1 ratio

Source: FSA.

89. Broadly speaking, the supervisory approach to capital is one of conserving the supply rather than requiring fresh stocks. Due to the corrective action system, the FSA cannot require more capital until the minimum capital thresholds have been breached. The FSA has clear powers, which it uses—the FSAP team confirmed—to require banks to suspend business lines, to dispose of high-risk assets and to conserve dividends. In terms of the capital equation, the focus and the powers are on the denominator and not the numerator. The FSA also notes that the EWS system, which is designed to be as forward looking as possible, provides insight into when a bank is starting to experience stress and therefore, the FSA has the ability to deploy its range of powers to protect capital at an early stage. When a bank experiences stress, however, an injection of fresh capital will act more quickly than de-risking the balance sheet. If the FSA is able to use its soft powers of influence to ensure more capital is obtained then this will, almost certainly, be the swiftest remedy. If, though, the bank is reluctant, then fallback powers of legal authority will act more quickly.

90. This FSAP is not the first to recommend that the FSA is furnished with powers to require banks to increase capital or to operate at a higher minimum capital ratio. It is recognized that introducing such powers would be a major change that has given the authorities pause. In introducing such powers, a cautious and phased approach could be considered, focusing first on the G-SIBs, followed by the D-SIBs and other internationally active banks, and then to other institutions. In terms of increasing capital, the corresponding Cabinet Order specifying the corrective action regime for capital-related matters would also need to be amended to allow for this phased

approach. With respect to introduction of Pillar 2 powers, the FSA could also give confidence to the industry regarding the by updating its SGs to explain its philosophy and decision-making framework for use of the powers, and the criteria it would use to judge whether additional capital add-ons were warranted. Introducing such a framework would put the FSA on a par with its peer G-SIB regulatory authorities. The manner in which the legal powers are introduced is obviously important. The FSA will need to be able to make use of both powers fully, using supervisory discretion, but without undue constraint that hinders or in practice prevents the use of these powers. Requiring a bank to raise capital will be an occasional event, but one that, if needed, is likely to be in a tight timeframe. Adjusting minimum capital requirements to the full risk profile of a bank, by contrast, should be a standard practice, employing all the supervisors' skills, analysis and judgement. As in Japan's peer jurisdictions, the law should enable but not constrain the supervisor.

Credit Risk and Provisioning

91. Supervision of credit risk management in banks has experienced perhaps the most profound change since the shift from compliance checking and the abolition of the Inspection Manual. Prior to the reform, the FSA placed a premium on conducting uniform and comprehensive inspections, based on the Inspection Manual, during which inspectors would verify the appropriateness of banks' self-assessments and write-offs and loan loss provisions for individual loans, and verified the adequacy of minimum capital requirements. Now that the Inspection Manual has been abolished, supervisors seek to exercise supervisory judgement in assessing the banks' own ability to assess and manage its credit risk process. Horizontal reviews support the FSA in deepening its monitoring work and allows feedback to the industry in the form of FSA Progress Reports that can highlight specific cases, one recent example being a case of provisioning based on a group of industries affected by the COVID-19 crisis, as well as feedback letters and individual dialogue with firms as necessary.

92. Provisioning under current accounting standards in Japan is still based on the incurred loss approach. The now abolished Inspection Manual had fostered uniform standards for loan loss provisions, but equally had inhibited any forward-looking perspective. The new supervisory approach actively encourages banks to incorporate as much forward-looking perspective as possible and also acknowledges that banks are able to continue to apply the existing accounting practices.⁹ As of March 2022, only around 5 percent of banks were using an Expected Loss provisioning approach. The FSA encourages banks to identify and assess future credit risks in loan classification, write-offs and provisioning and supervision and monitoring.

⁹ The framework divides borrowers into six classes from normal to bankrupt, the first three classes receive a general allowance calculated by multiplying the expected loss rate by the amount of receivables for each borrower classification and the lower three classes, the expected uncollectible amount for each individual borrower. The horizon is one year for the first two classes and three years for the middle two classes.

Large Exposures and Concentration Risk

93. The FSA has implemented the Basel Committee framework for large exposures since the last FSAP. Furthermore, Japan has been assessed under the Basel Regulatory Capital Assessment Program (RCAP) in 2022 and made further amendments to its national implementation. Overall, the implementation was assessed as largely compliant with specific findings under scope of application and value of exposures. In practice both sets of findings were rooted in the fact that supervisory concerns in Japan are focused chiefly on the banking book, which is where risks are mainly located, but this left potential vulnerabilities. For example, in terms of scope, the RCAP findings included that some securities groups (final designated parent companies) were designated as internationally active and as D-SIBs but were not subject to the large exposure (LEX) framework, while being subject to other Japanese regulatory standards including on capital and liquidity. Also, the calculation of exposure values of swaps, futures, forwards, credit derivatives and options in the trading book under the Japanese LEX regulations is not clearly specified. Work due to the RCAP uncovered a greater diversity of behavior than had been expected in banks. The authorities have been amending their regulatory treatment in light of the RCAP, which will come into force in 2024.

94. Particular work has been carried out on connected counterparties and economic interdependence is now recognized. Initially updated in the SGs in 2019, and broadened as a result of the LEX framework, connections between counterparties have expanded from purely capital relationships between groups of connected counterparties to capturing economic interdependence. For example, the SGs will now cover a borrower who was reliant on generating profits from a third party or a third-party guarantee. A borrower in a network that could be subject to a chain of default would also be captured. Importantly, it is for the bank to be able to identify and respond to the stress. The FSA wanted banks to identify and understand the substance of the risks, and to be able to identify and respond in the event of stress. Only internationally active banks are required to identify economic interdependence, on the grounds of the burden it represents, and exposures are reported to the FSA when greater than 10 percent of Tier 1 capital.

95. Other forms of concentration limits are not imposed on banks. The exposure for the top 20 counterparties is also reported to the FSA. In terms of supervisory practice, the FSA were, for example, able to follow up on the potential impact of distress to major creditors by examining the top 100 exposures held by regional banks (data received on a 6 monthly basis). The RAD is considering obtaining the entire exposure list on a quarterly basis as part of the data review project.

Related Party Risks

96. There is a general prohibition on non-arm's length dealings in the law. Article 13-2 of the Banking Act prohibits transactions that are not on an arm's length basis, regardless of whether the counterparty is a related party or not. Any exceptions to this prohibition must receive the FSA's prior approval.

97. The introduction of the concept of economic interdependence has improved the Japanese regime in respect of related party risks. The current framework identifies related parties

mostly but not wholly as corporate entities and establishes requirements for arms' length and conflict of interest provisions.¹⁰ The more principles-based approach in SGs places a clear risk management onus on banks to identify and manage their related party exposures. Banks are expected to have limits in relation to maximum related party exposures, but the FSA does not prescribe any itself.

98. While all the changes are welcome and positive, the definition of related parties needs to be extended to cover individuals and should clearly apply to all banks. At present, the definition of related parties in the Banking Act and related Orders and Ordinances does not allow for the concept of a related party to be a natural person other than major shareholders. The gap in the definition of related parties regarding natural persons means that other entities that would be linked to the bank through the individual will not be captured in any form of reporting or analysis. This creates potential vulnerabilities whether for purposes of ensuring that suitable arms-length controls and limits are in place, as well as for concentration and large exposure purposes. By contrast, the Companies Act (Article 356(1)) acknowledges the need and creates obligations in relation to any conflicting interest transactions by a director (including approval by the Board and disclosure). The FSAP team saw evidence in a new license application of the notification of directors to comply with the related party obligation. However, under current rules, spouses or children of directors are not identified as related parties.

99. Reporting of related party transactions as an exposure class, as opposed to large exposures, is recommended for monitoring purposes and this should apply to all banks. In other jurisdictions it has often been the smaller or smallest banks that have fallen prey to abusive behavior by related parties. Related-party exposures can expose banks to a range of risks and vulnerabilities. These risks are well recognized and articulated in international standards including the BCPs but also in the G20/OECD Principles of Corporate Governance, the International Financial Reporting Standards (IFRS) and the AML/CFT standards set by the Financial Action Task Force (FATF).

Interest Rate Risk in the Banking Book (IRRBB)

100. The FSA applies the Basel standard on interest rate risk to internationally active and (on a simpler basis) to domestic banks. In the case of the former, the standard has been applied since 2018, and in the latter case from 2019. The full suite of Basel interest rate shocks is applied to internationally active banks, and a delta economic value of equity (Δ EVE) in excess of 15 percent of Tier 1 capital is utilized as a threshold for the materiality test. For domestic banks, a narrower set of shocks is applied (parallel up, parallel down and steepening), and a Δ EVE in excess of 20 percent of

¹⁰ The related party framework is established in: the Banking Act (Article 13-2), the Order for Enforcement of the Banking Act (Article 4-2), the Ordinance for Enforcement of the Banking Act (Article 14-8 to 11), and the SG for Major Banks covering Outsourcing (III-3-3-4), Arms' Length Principles ((V-2), Major Shareholders (V-4) and Systems to protect Customers' Interests (V-2).

core capital is utilized as a threshold of the materiality test. Both these thresholds are included in the published Supervisory Guidelines.

101. Data on interest rate risk is collected and monitored on a monthly basis. In addition to the two threshold measures above, the EWS contains a number of additional measures. Hence, a bank may trigger the EWS even if they do not exceed the key measures mentioned above. As with other risks, the FSA will conduct additional dialogue and analysis in instances where the EWS is triggered to ensure the risks are understood, and corrective action is taken if needed. The BOJ also collects and monitors interest rate risk data and engages with banks as necessary.

102. The FSA has a team of around ten staff in the Risk Analysis Division who provide supervisors with expertise and horizontal analysis of market-related risks. This team covers IRRBB, as well as traded market risk and liquidity. As with other specialist teams in the FSA, this is a relatively small team of specialists given the breadth of banks and the nature of the risks being covered.

103. In the wake of the March 2023 banking turmoil in the United States and Europe, the FSA evaluated the impact on the Japanese banking sector. The FSA primarily assessed the impact of credit losses against the Silicon Valley Bank (SVB), and reviewed holdings of AT1 bonds in Credit Suisse. At the same time, the FSA is also mindful of the recent upward pressure on domestic interest rates, and is carrying out analysis of its potential capital impact, noting the various possible channels through which it might affect banks. Regional banks are primarily being monitored through the EWS system, where significant movement in the indicators or expected losses would trigger intensive monitoring. The BOJ reported that it was monitoring bank liquidity, capital and changes in the financing environment, while keeping in close contact with the FSA.

Liquidity Risk

104. For internationally active banks, the FSA applies the Basel LCR and NSFR standards. A minimum LCR requirement has been applied monthly since March 2015, both on an all-currencies basis as well as for major currencies. At the time of its introduction, the minimum LCR was 60 percent, and the requirement was phased in by an additional 10 percentage points annually until reaching 100 percent in 2019. The NSFR has been implemented from September 2021. A bank subject to these requirements must disclose its LCR and NSFR quarterly. The Basel Committee's RCAP program found the implementation of the LCR and NSFR to be compliant overall with the respective Basel standards.

105. For domestic banks, however, there is no quantitative minimum liquidity requirement. The FSA collects monthly information about domestic banks' liquidity profiles (and can collect more frequent information as needed) and uses the metrics within its Early Warning System in order to identify banks with weak liquidity profiles and subject those banks to more intensive monitoring. It also requires banks to report one of the two simplified LCR measures. However, there is no minimum liquidity requirement prescribed within the FSA's regulatory framework.

106. The FSA should consider whether the continued absence of a requirement for a minimum level of liquidity holdings remains warranted. Domestic Japanese banks generally have strong (stable and insured) retail deposit funding coupled with relatively large holdings of liquid assets (cash, central bank deposits, JGBs and municipal bonds). In view of the SVB collapse, the FSA has stated that it does not believe there are any banks with similar business models in Japan. Nonetheless, the absence of any form of prescribed minimum liquidity is unusual and inconsistent with the Basel Core Principles. Especially as some domestic banks are fairly large, and given the limitations of the current EWS in relation to liquidity, a minimum requirement (even if not calibrated to a particularly high level) would provide an important backstop should issues emerge in the future. Indeed, now would be a relatively easy time to introduce such a requirement, given the industry has abundant liquidity and any new requirement would be unlikely to bind.

Operational Risk and Resilience

107. Supervisory expectations for operational risk for major banks are established in the FSA's supervisory guidelines which are in the course of being updated. The provisions on operational risk (SG III-2-3-7-2) are relatively new (not yet translated into the English version available on the FSA website) and are also supported by longer standing sections of the SGs, such as outsourcing and IT risk. These older sections, also found in the SGs for small and regional banks must now bear greater weight in the light of the emergence of cyber threats and risks associated with third party service providers which banks need to manage. The FSA has also issued discussion papers which are keystone references in their dialogues with firms. A paper on IT and Governance was issued in 2019 (updated in 2023) and a paper on Operational Resilience based on international discussions such as the Basel Committee was also issued in 2023. The Supervisory Guidance for major banks has been updated based on the results of a discussion paper on Operational Resilience. A monthly FSA newsletter not only facilitates awareness of these supervisory publications but includes a meaningful precis of the critical content.

108. The FSA is conscious of the need to assess and raise the skills capacity in the sector, particularly among regional banks. The specialist staff with relevant skills for operational risk and resilience, such as the IT Cyber Monitoring Team, are located in the horizontal team in the Risk Analysis Division. While the horizontal risk team, is a resource for the entire FSA, in practice a significant proportion of its time is devoted to the banking sector. Industry-wide questionnaires, such as a recent one on cyber security (Cybersecurity Self-Assessment), and cybersecurity exercises (Delta Wall), have been used to educate and draw attention to areas that banks need to focus upon. Local Finance Bureaus, who share the supervisory responsibility for small and regional banks, are able to contact the FSA to ask for cyber experts. Data on operational and IT failures is submitted to the FSA, according to a format set out in the SGs, and is shared with the cyber team and, in aggregate, made public on an annual basis. An incident must be reported immediately, but full details can be provided in due course. Such information includes the area impacted, damage, cause, response by bank, and action taken to prevent recurrence.

109. Operational Resilience and Operational Risk Management is hard to assess without direct inspection. The FSA is largely reliant on indirect and reactive monitoring techniques, such as

incident reporting or loss data in relation to its oversight of these risks. Should a bank experience a significant incident or fail to meet the FSA's expected standards it may receive a BIO under Article 26 of the Banking Act. Multiple teams from the FSA would be likely to need to follow up to investigate and ensure remedial action was adequate, including, for example the IT/cyber specialist, corporate governance/risk management specialists, and AML/CFT specialists. The formal order would be issued by a division in the Supervision Bureau and all subsequent required reports from the bank would be provided to all the teams.

110. Both the supervisory authorities and the industry face scarcity of skills in the cyber and IT space and as such there is a premium on identifying the most effective supervisory techniques. The FSA has deployed a clear supervisory communication strategy using its discussion papers and supervisory newsletter to raise the profile of operational resilience and to highlight its core elements. This strategy has been supported by the exercises and questionnaires that guide banks to focus on areas they may need to work on more. It is essential for this pressure to continue and even increase.¹¹

111. A number of industry professionals that staff spoke with noted that the foreign banking sector was surprised to find that cyber risk/threat was not seen as a chief priority in Japanese banks. This view was supported by a review of public documents from the banking industry, including annual reports. Concerns were also expressed at the ability of banks to probe and understand the adequacy of the cyber protection in their third-party service providers, notwithstanding the fact that banks ought to have suitable access to information if the SG under Outsourcing (III-3-3-4) were being fully met. It may, however, be necessary to consider stronger measures to ensure access to relevant information from third-party service providers, potentially on a regulatory basis, including monitoring, as some providers may have considerable economic strength and market control and in practice may not be as amenable to providing information as they ought to be. Given the potential for both systemic failure and damage to individuals, a concern that is very clearly expressed in the law and guidance, the need to guard against cyber threat should be treated with the highest urgency. In the meanwhile, the FSA is strongly advised, as in the Cyber Technical Note, to further strengthen the analysis of how the financial sector is operationally interconnected. In the context of the banking sector, this would entail developing network analysis of how the banks are connected through common technologies and service providers, thereby allowing the identification of critical nodes. However, the FSA also needs to consider that, of course, the risk of critical nodes is not limited to cyberspace. The mapping and analysis of outsourcing to service providers in relation to operational risk and resilience should be broader than for cyber interconnectedness alone, even though an overlap is to be expected.

B. Governance and Risk Management

112. Corporate Governance requirements are set out in the Companies Act and the Corporate Governance Code (CGC), the latter being enforced via a comply or explain

¹¹ The voluntary financial industry-wide cybersecurity exercise, Delta Wall has been running for 7 years since 2016 and in 2022 covered 160 financial institutions.

mechanism. Expectations set out in the CGC, drawn up by the Council of experts, are aligned with the most recent Basel Committee discussions, and reflect findings from the last FSAP. National importance is attached to corporate governance reform and the FSA has established the Japan Corporate Governance Forum (JCGF), established by the FSA to gather opinions from a wide range of stakeholders, not limited to financial institutions and including overseas investors. The Council of experts, while taking into account the discussions in the JCGF, reports at regular intervals on progress on the CGC and the Stewardship Code, which, respectively are seen as treating “defensive governance” and “growth oriented governance.”¹² Although initiatives are not focused specifically or exclusively on banks, and aim to serve broader goals of sustainable growth, the themes identified in the last FSAP as warranting greater effort are clearly receiving greater attention and discussion, namely: enhanced board structure, allowing for enhanced challenge by independent non-executive directors; enhanced board oversight of risk appetite and strategy, and enhanced fit and proper (F&P) processes to assess the collective experience and expertise of the board as well as applying the F&P process at senior management level.

113. The FSA sees governance as key to promote business change and meet challenges.

Although the FSA notes that corporate governance development is work in progress, advances can be seen in major banks and the larger regional banks.¹³ The larger banks have established and disclosed Audit, Nomination and Remuneration Committees. Firms listed on the Prime Market are required to have at least one third external, independent directors (two directors if listed on other markets) and some progress is being made towards diversity. More than 60 percent of regional banks have audit and supervisory committees. Banks are also being required to have policies with measurable targets for women in mid management positions and diversity in talent. Banks also disclose the roles and expertise of the directors to ensure the necessary diversity of skills on the board.

114. Discussion with major banks and examination of public reports were consistent with FSA requirements. External directors in banks and their holding companies are not the same people, though there is no requirement to separate the role of chair and chief executive. While a comply or explain mechanism for a non-legally binding code did not appear to be a forceful framework, the principle is that if a bank is not in compliance with the CGC then it is held to a high level of accountability to demonstrate what alternative measures it has put in place. If its response was not acceptable to the FSA, then the supervisor would turn to its powers under Articles 26 and 27 of the Banking Act.

115. The FSA’s contact with the major banks is much closer following its supervisory reforms. Meetings are held with the chairman and chief executive on an annual basis at a minimum. For the megabanks, meetings with external directors are also held. Additionally, there are interviews with the senior executives including the “C suite” (Chief Risk Officer, Chief Auditor) every one to two

¹² The Council of Experts Concerning the Follow-up of Japan’s Stewardship Code and Japan’s Corporate Governance Code Opinion Statement No. 6 (April 2023).

¹³ Action Program for Accelerating Corporate Governance Reform: From Form to Substance (April 2023)

months to deepen engagement and understanding. A key priority has been to understand whether external directors have been active in Board meetings and whether effective discussions have been conducted. In principle, the FSA or LFB interviews with CEOs of all regional banks once a year. In addition, an initiative began in 2022, where the FSA and LFB holds dialogue with regional banks' top management, various other officers, and outside directors on the exercise of governance by shareholders and the board of directors and human resource investment and development initiatives.

116. Governance reforms have been echoed in risk management evolution across the major banks. Risk architecture, including risk committees, risk management committees, risk appetite statements and risk frameworks for the management of risk on an enterprise-wide basis, has been developed across major and regional banks. This push is seen to have been driven by the supervisors. It is supported by jointly conducted annual stress tests by the FSA and BOJ. Hearings with major banks focus on overall risk management in light of risk culture but hearings with regional banks are less common unless thresholds in the EWS have been triggered. Overall, the progress with the major banks is positive, and the FSA needs to build on this with strengthened monitoring of the regional and smaller banks both for corporate governance and risk management. Despite resource limitations, the FSA is advised to design and with the LFBs conduct a review of these banks in order to identify institutions with deficiencies, and towards which awareness programs need to be targeted.

Financial Reporting and External Audit

117. The 2017 FSAP found that the FSA had not yet been granted the breadth of powers in respect of the appointment of external auditors that are set out in the BCPs. Although standards for auditors themselves have been further tightened since 2017, the FSA's powers have not been amended in line with the BCPs.¹⁴ The purpose of the recommendation then, and now, is, for example, to ensure that if the FSA becomes aware that a subpar audit has been carried out, which perhaps does not absolutely violate any regulations, then the FSA can step in and indicate to the bank that the auditor is not acceptable. In other words, the objective is to put in place a "safety net" provision to ensure the FSA can insist, as necessary, that audit firms will be appointed whose skills and resources are commensurate with the firms they are appointed by.

118. It is noted that the Certified Public Accountants and Auditing Oversight Board, established in 2004 as an independent authority under the FSA. However, the disciplinary powers of an auditor oversight board are not those that are envisaged here. It would be more practical, for example, for the supervisor to indicate before the fact that an auditor lacked suitable resources and experience than to have to act as a disciplinary body after the fact.

¹⁴ An amendment to the Certified Public Accountants Act (No 103 of 1948) now requires all Certified Public Accountants to be registered with the Japanese Institute of Certified Public Accountants.

C. Recommendations

119. The regulatory and prudential framework in Japan is generally sound, but the following aspects should be addressed:

- The FSA should establish a minimum liquidity requirement for domestic banks.
- The definition of related parties should be broadened to include individuals connected to a bank beyond board members. Related party supervision should apply to all banks and include regular reporting to the FSA.
- The authorities should strengthen the ability of banks to access third-party service providers and consider the need to place on a regulatory footing, if needed, to ensure cyber security and operational resilience in banks.
- The FSA should further strengthen the analysis of how the banking sector is operationally interconnected, through developing network analysis of how the banks are connected through common technologies and service providers, allowing the identification of critical nodes and taking any appropriate action accordingly. The analysis should not be limited to cyber-risks, but address operational risk and resilience.
- The FSA and LFBs should carry out a corporate governance and risk management review of regional and smaller banks in order to identify institutions with deficiencies, and target awareness programs.
- The authorities should provide the FSA with 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. This will act as a “safety net” provision to ensure that audit firms will be appointed whose skills and resources are commensurate with the firms they are appointed by.

Appendix I. Status of the Recommendations of the 2017 FSAP

CP	Recommendations of 2017 FSAP	Status and IMF Staff View
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.	No change. Nature of funding model less likely to be the critical factor than the overall sufficiency, which remains challenged given new and emerging risks.
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.	Ongoing. New applicants are assessed intensively. Periodic checks on ultimate beneficial ownership of banking groups not yet taking place.
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	No change. Recommendations remain in place.
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.	No change. Recommendations remain in place.
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.	Ongoing. Meaningful progress has been made towards a flexible and risk-focused supervisory process that has regard to each bank's risk, size and scale. However, a fully-fledged risk profiling methodology has not been put in place.
10	Establish clear requirements for governance and risk management arrangements of prudent valuations for data submitted as part of regulatory reporting.	Ongoing. Joint data project between FSA and BoJ will require a refreshing of data requirements.
11	Recalibrate PCA triggers to allow the JFSA to intervene earlier. Consider strengthening inter-agency cooperation for crisis management and preparedness.	No change. Corrective action triggers remain calibrated to minimum capital thresholds. Ongoing. Inter-agency cooperation refocused around the Recovery and Resolution Office of the FSA.
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.	Ongoing. Notable progress with increased appointments of outside directors and establishment of board committees by banks (including risk committees not required by law). FSA highly focused on major banks. The role of internal Audit has been explicitly strengthened in the Corporate Governance Code 2021 and in the FSA's Supervisory Guidance. The scope of F&P assessments has not been broadened yet.

CP	Recommendations of 2017 FSAP	Status and IMF Staff View
	F&P processes should be applied to include all key staff appointments.	
15	Strengthen bank risk management requirements for the risk function that has a reporting line into the Board Risk Committee, via the CRO.	Ongoing. Supervisory Guidance is enhanced, and major banks have established Board Risk Committees. It is not a full requirement and does not apply to all banks.
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.	Some improvements. The FSA does not yet have a Pillar 2 capital power, but does receive ICAAPs and monitors Pillar 2 risks.
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.	Ongoing. The FSA has supported firms with publication of discussion papers and examples of sound provisioning practices.
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	Ongoing. The FSA has developed look-through provisions to apply to investment funds and securitized products and has revised its reporting forms. Additionally, the revised calculation method for measuring exposures related to derivatives in the trading book will come into force in 2024. Broader concentration limits are not in place but enhanced dialogue with banks is increasing.
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.	Some improvements. Related party risk management expectations have been strengthened for related corporate entities and directors, notably with the inclusion of the concept of economic interdependence. The Corporate Governance Code emphasizes governance of related party risk. Definition of related party needs to be broadened to capture other types of individuals beyond directors.
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.	Ongoing. The authorities are still encouraged to strengthen the relationships with external auditors.