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Japan: Financial Sector Stability Assessment Update

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JAPAN

Financial System Stability Assessment Update

Prepared by the Monetary and Capital Markets and Asia and Pacific Department

Approved by José Viñals and Anoop Singh

July 10, 2012

This report summarizes the findings of the Financial Sector Assessment Program (FSAP) Update for Japan. The assessment took place over two main missions, between November 28–December 16, 2011, and March 12–23, 2012. The FSAP team comprised Udaibir S. Das (Mission Chief), Nicolas Blancher (Deputy Mission Chief), Serkan Arslanalp, Ana Carvajal, Patrick Imam, Hiroko Oura, Christine Sampic, and Rodolfo Wehrhahn; Raphael Lam; Jongsoon Shin; Virginia Rutledge; and, Serene Chow, Michael Hafeman, Keith Hall, Martin Kinsky and Arnoud Vossen (external experts). Christopher Towe participated in both missions. The main FSAP findings are as follows:

- *Important progress has been made since the 2003 FSAP assessment to strengthen and stabilize the financial system*. Significant restructuring was encouraged among large banks and insurance companies, nonperforming loans were reduced, capital positions improved, and supervision and oversight improved. This progress and an effective policy response helped the Japanese financial system withstand one of the most severe output contractions experienced among the G-7 during the global financial crisis.

- *However, high public sector indebtedness and slow growth remain two of the central risks to financial stability*. Close monitoring and contingency planning are needed, therefore, especially with regard to risks related to the JGB market, sovereign funding pressures, regional bank vulnerabilities, and credit quality.

- *Further advances in the regulatory and supervisory regime would help to better anticipate and manage systemic risks*. Among all agencies, mechanisms for systemic and macroprudential oversight could be enhanced and more forward-looking cross-sectoral approaches adopted. Cross-border risk monitoring arrangements should also be deepened given the growing activities of Japanese financial institutions overseas.

- *A broad-based financial reform plan could contribute to an enabling environment for private sector growth as the economy recovers and undergoes more ambitious fiscal consolidation*. Key steps could include (i) ensuring more market-based credit allocation to SMEs, including by reducing the role of government in direct lending and guarantees; (ii) improving the framework for new products and capital markets to support growth-enhancing sectors; and (iii) initiating measures to encourage consolidation and streamlining of regional banks.

The main authors of this report are Udaibir S. Das, Nicolas Blancher, and Serkan Arslanalp, with contributions from the FSAP team.

FSAP assessments are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAP assessments do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

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Glossary

AFS	Available for sale
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
BCP	Basel Core Principles
BIS	Bank for International Settlements
BOJ	Bank of Japan
CAR	Capital adequacy ratio
CCP	Central counterparty
CP	Core principle
DGS	Deposit guarantee scheme
DIC	Deposit Insurance Corporation
DICJ	Deposit Insurance Corporation of Japan
EDF	Expected Default frequency
FATF	Financial Action Task Force
FMI	Financial Market Infrastructures
FSA	Financial Services Agency
FSAP	Financial Sector Assessment Program
GFI	Government-affiliated financial institutions
IAIS	International Association of Insurance Supervisors
ICSD	International Central Securities Depository
IOSCO	International Organization of Securities Commissions
HTM	Held to maturity
JGB	Japanese government bond
JGBCC	Japanese Government Bond Clearing Corporation
JIPF	Japan Investors Protection Fund
JPB	Japan Post Bank
JPI	Japan Post Insurance
LCR	Liquidity coverage ratio
MoF	Ministry of Finance
MoU	Memorandum of understanding
MTM	Mark-to-market
NPL	Nonperforming loan
NSFR	Net stable funding ratio
OSBM	Office of Securities Business Monitoring
PCA	Prompt Corrective Action
PPCJ	Policyholders Protection Corporation of Japan
RTGS	Real Time Gross Settlement
RWA	Risk weighted assets
SESC	Securities and Exchange Surveillance Commission
SIFI	Systemically-important financial institutions
SME	Small- and medium-sized enterprise

EXECUTIVE SUMMARY[1]

Japan's financial system is at a critical crossroad. Compared with a decade ago, its stability seems to have been considerably enhanced due to the lessons learnt from the financial crisis of the 1990s, improved institutional and regulatory frameworks, and proactive policies. The financial system has remained resilient to the global financial crisis, helping counterbalance the global deleveraging process. However, deep-rooted macroeconomic and structural vulnerabilities remain, including questions about long-term fiscal sustainability, deflation, the large financial sector exposures to Japanese government bonds (JGBs), and the likelihood that the demographic transition will weigh on growth and begin to erode private savings. These factors pose risks to the financial system's stability. The broader macroeconomic and institutional environment has limited risk-taking and led to bottlenecks in credit channeling, in turn constraining the financial sector's ability to intermediate effectively and support economic growth.

1. **Measurable progress has been made since the 2003 Financial Sector Assessment Program (FSAP) assessment to strengthen the financial system.** Significant restructuring was encouraged among the large banks and insurance companies, nonperforming loans were reduced, and capital positions improved. Moreover, steps were taken to strengthen the financial regulatory and supervisory system, and advances made to further enhance Japan's crisis preparedness and financial safety net. This progress and an effective policy response, including substantial liquidity injections and monetary easing by the BOJ, as well as other stimulus measures by the government, helped the Japanese financial system withstand one of the most severe output contractions experienced among the G-7 during the global financial crisis. Even more impressive was the swift and decisive response to the devastation caused by the Great East Japan Earthquake in order to maintain financial stability.

2. **However, high public sector indebtedness and slow growth raise challenges for the financial system going forward.** FSAP stress tests indicate that, in the near-term, the system would be resilient to severe economic distress and moderate market shocks. However, financial stability is not assured and intensified monitoring and contingency planning is needed in the following areas:

- **JGB and sovereign funding risks:** The financial system's massive holdings of government bonds leave it exposed to a spike in yields. While the large public financing needs have been fully absorbed by the market thus far, the willingness of market participants to continue to do so at low yields is contingent on sustaining confidence in long-term fiscal sustainability and growth, and on corporate and household savings trends.

- **Risk among regional banks:** Due to weak regional economies, several regional banks are afflicted by low core profitability, relatively thin capital positions, and large duration

[1] A prioritized list of key FSAP recommendations needing immediate consideration is presented in Table 1. Recommendations of a more medium-term nature appear in Table 2. Key financial stability risks are outlined in Table 3 (Risk Assessment Matrix).

gaps, making them particularly vulnerable to slow growth and market yield shocks. This suggests that these banks may require better risk management systems, higher capital buffers, and streamlining of their operations.

- **Credit risk:** Credit quality has held up relatively well despite a large output decline and the recent yen appreciation. However, underlying weaknesses may have been masked by crisis-related measures to support lending to small-and medium-sized enterprises (SMEs), and credit risk may build up in the absence of sustained economic growth.

3. **Further advances in the regulatory and supervisory regime would help to better anticipate and manage systemic risks.** The FSA needs additional resources and skills to undertake thematic risk assessments (across types of financial institutions) on a regular basis, and deepen its oversight of nonbanks. Among all agencies, mechanisms for macroprudential oversight could be enhanced and more forward-looking approaches adopted across sectors:

- **Systemic oversight.** Building on existing mechanisms for systemic risk monitoring and arrangements for interagency cooperation, and given the overseas expansion of Japanese financial institutions, consideration should be given to more regular information sharing systems for systemic risk monitoring, micro- and macroprudential policy coordination, and crisis response (e.g., based on early warning systems and bottom-up stress-tests across all systemically-important banks and nonbank financial institutions).

- **Quality of the prudential and supervisory framework.** There is scope in particular for more stringent large exposure limits on banks; higher minimum capital ratio requirements for domestically-active banks (including credit cooperatives); tighter and more risk-sensitive solvency requirements and liability valuation for insurers; and improved registration processes and auditing requirements for securities firms.

- **Crisis management and resolution arrangements.** More formalized, high-level inter-agency arrangements could facilitate pre-emptive planning and engagement on crisis management. The resolution regime for systemically-important nonbank financial firms should be strengthened (and possibly extended to systemically relevant central counterparties (CCPs)).

4. **Besides ensuring financial stability, a broad-based financial reform plan could improve the financial sector's capacity to enable private sector-led growth.** Once the economic recovery is better assured, some of the key steps could include (i) ensuring more market-based credit allocation to SMEs, including by reducing the role of government in direct lending and guarantees (e.g., by phasing out the SME Financing Facilitation Act by end-FY2012 and reducing the role of government-affiliated financial institutions (GFIs) in financial markets), (ii) improving the framework for new products and capital markets to support growth-enhancing sectors; and (iii) initiating measures to encourage consolidation and streamlining of the regional bank segment, consistent with growth strategies for regional economies.

Table 1. Japan FSAP—High Priority Recommendations[1/]

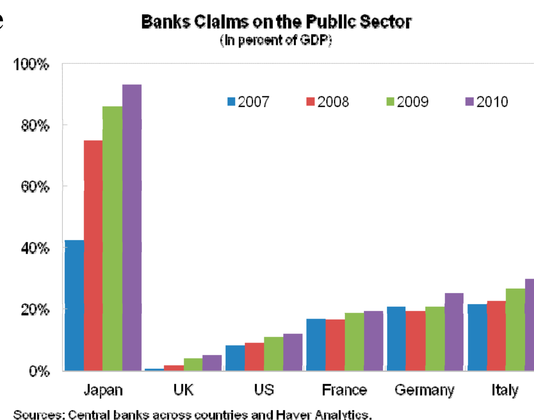
Recommendations	FSSA/RAM
Objective: Bolstering oversight of systemic risk	
Develop the framework for regular thematic risk assessments (across types of financial institutions) and bottom-up stress tests for macroprudential purposes	¶29,36
Intensify monitoring and oversight of systemically relevant financial institutions, markets, and infrastructures	¶36,44
Consider more regular arrangements for more intensive and continuing inter-agency cooperation in systemic risk monitoring and contingency planning	¶30
Monitor closely sovereign-financial stability interlinkages and ensure that risk management frameworks are sufficiently robust to deal with stress situations	¶25,RAM(1)
Objective: Enhancing the quality of prudential and supervisory framework	
Review the FSA's regulatory mandate and evaluate the adequacy of its supervisory skills and resources	¶31,36
Move towards a more formalized risk-based framework for assessing financial institutions' vulnerability and for prioritizing supervisory intensity	¶30,31
Raise minimum capital ratios for domestically-active banks closer to those required of internationally-active banks and align capital buffers with the materiality of risks	¶26,35, RAM(1,2)
Strengthen supervisory requirements on large exposure limits for banks	¶35, RAM(4)
Encourage stronger risk management by financial institutions, including through improved internal governance, and enhanced role for company auditors and audit committees	¶36,37,39
Strengthen securities firm oversight through expanded and more risk-based inspection programs, extended auditing requirements, and improvements to the registration process	¶41,42
Objective: Strengthening crisis management arrangements	
Explore further improvements to ensure the orderly resolution of systemically-important nonbank financial firms	¶49,51,52, RAM(4)
Consider expanding the scope of recovery and resolution plans for all systemically-relevant bank and nonbank financial institutions, consistent with key attributes of an effective resolution regime	¶52
Objective: Supporting private sector growth	
Unwind and better target selected public support measures, including some credit guarantees and SME support measures, as economic recovery takes hold	¶58-60
Develop an effective strategy to establish a stronger regional and cooperative bank sector, including through private sector-led consolidation	¶10,59, RAM(1,2)

[1/] *High Priority* items need immediate attention and implementation *within three years*. These should be read along with Table 2 that lists other *Medium Priority* recommendations where implementation is recommended over a three to five year horizon.

I. Background

5. **Japan confronts a challenging macrofinancial operating environment** (Table 4, Figure 1)**.** On the macroeconomic front, deflationary pressures remain, growth is sluggish, public debt and deficits are large, and the external environment is highly uncertain. The financial system (Figure 2, Annex IV) faces limited credit demand, a flat yield-curve, and weak profitability. At the same time, some policies and market practices in the financial system may have limited risk-taking and posed bottlenecks on credit intermediation, in turn contributing to low growth and structural challenges.

6. **Growing risks to fiscal sustainability have heightened concerns about possible feedback to financial stability.** Gross public debt has grown sharply over the past decade, reaching 220 percent of GDP at end-FY2011, the highest ratio globally. An increasing share of the financial system's balance sheet is invested in JGBs. Fiscal-financial sector linkages have also increased due to crisis-related financial support to the economy through credit guarantees and safety-net lending. However, household and corporate balance sheets appear sound, and continued demand for bank deposits has provided indirect support for government debt markets. BOJ purchases of JGB—through its step-up of existing bond purchases and recent asset purchase program—have also provided support and liquidity for the financial system.

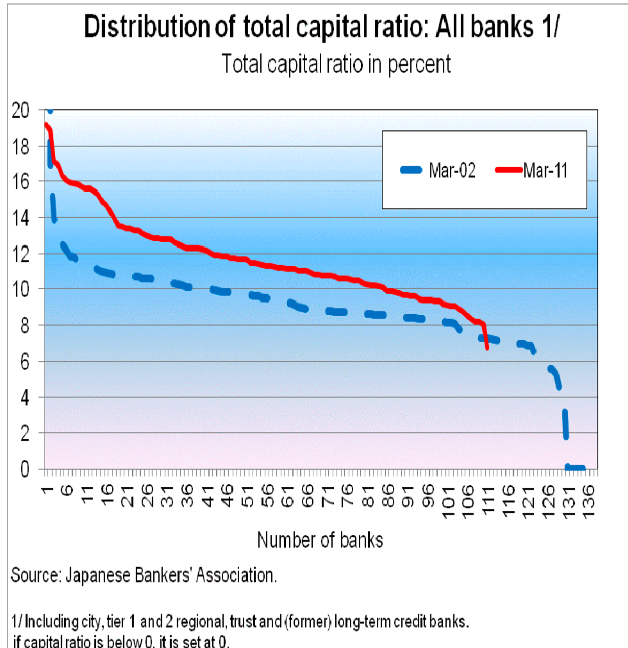


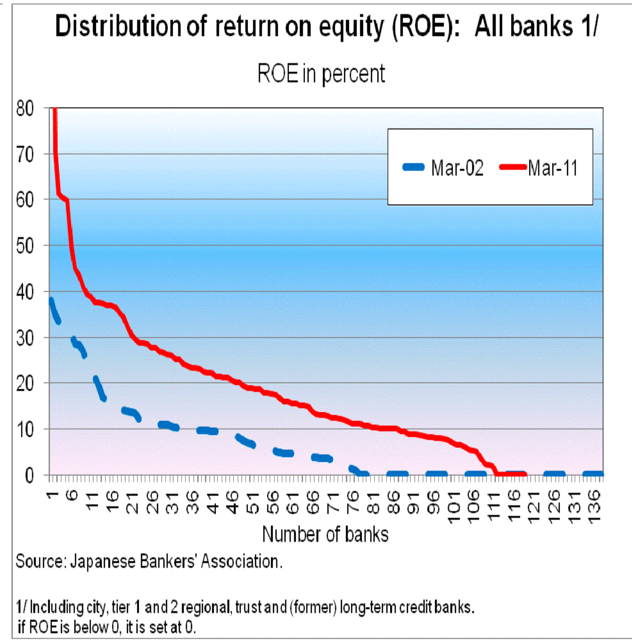
7. **The financial system has remained stable during the global financial crisis and the recent devastating earthquake** (Tables 5–6)**.** Temporary liquidity squeezes in the interbank and corporate debt markets at the peak of post Lehman crisis raised some funding costs, but financing conditions gradually returned to normal, including as a result of action by the authorities to support credit and liquidity. Banks were insulated from the subprime crisis partly due to their limited exposures to complex asset classes and derivative markets. Overall, the payment systems remained well-functioning, despite some short-lived surges in settlement fails. Only some regional banks had concentrated exposures to earthquake-hit areas, and nonlife insurers absorbed losses from the catastrophe by drawing down on their reserves. Specific steps were taken to ease funding conditions and avoid a tightening of financing conditions for SMEs, including U.S. dollar funds-supplying operations and special government credit guarantees.

II. Current State of Financial Stability

A. Financial System—Performance and Soundness

8. **The Japanese banking sector has become much better capitalized over the last decade** (Tables 7–8, Figures 3–4)**.** Since the last FSAP, Japanese banks' capital adequacy ratio (CAR) and Tier 1 capital ratios have improved steadily, including as city banks issued equity in 2009–10. Their liquidity position also remains comfortable, as they hold large amounts of liquid assets as a share of both short-term liabilities (around 50 percent) and total assets (about 20 percent).





9. **Internationally active banks are preparing for Basel III implementation.** The Basel III capital framework will be put in place for internationally active banks from 2013 on, following the medium-term schedule set by the FSA.[2] The FSAP team estimates that applying immediately and in full the Basel III capital definition for the major banks, while keeping the Basel II definition of risk weighted assets (RWA), would reduce their core Tier 1 and Tier 1 capital ratios by about 2 percentage points and total capital adequacy ratios (CARs) by 6 percentage points. In addition, the three mega financial groups estimate that more prudent risk weights (in line with Basel III phase-in as of September 2011) would reduce Tier 1 capital ratios by about an additional 1 percentage point. However, as noted, these financial groups have recently been issuing equity capital, reducing dividend payments, and accumulating retained earnings. Therefore, as of September 2011, they benefit from a solid capital basis of about 14¾ percent CAR, 11⅓ Tier 1 ratio, and 9⅓ core Tier 1 ratio (on a Basel III basis).

[2] As of June 2012, there is no plan to apply the same rule for domestically-active banks.

10. **At the same time, Japanese banks face growing challenges** (Tables 7–8, Figures 3–4)**.** Japanese banks' profitability has improved since the 2003 FSAP, but remains consistently below international norms. Net interest margins (NIM) have been exceptionally weak given the low interest rate domestic environment. This is encouraging banks to increasingly diversify or take on greater risk exposures, including overseas or, for regional banks, through increased JGB portfolio durations. While bank asset quality improved substantially during the past decade, it has recently shown signs of deterioration, and nonperforming loan (NPL) levels may be underestimated due to measures to support SMEs.

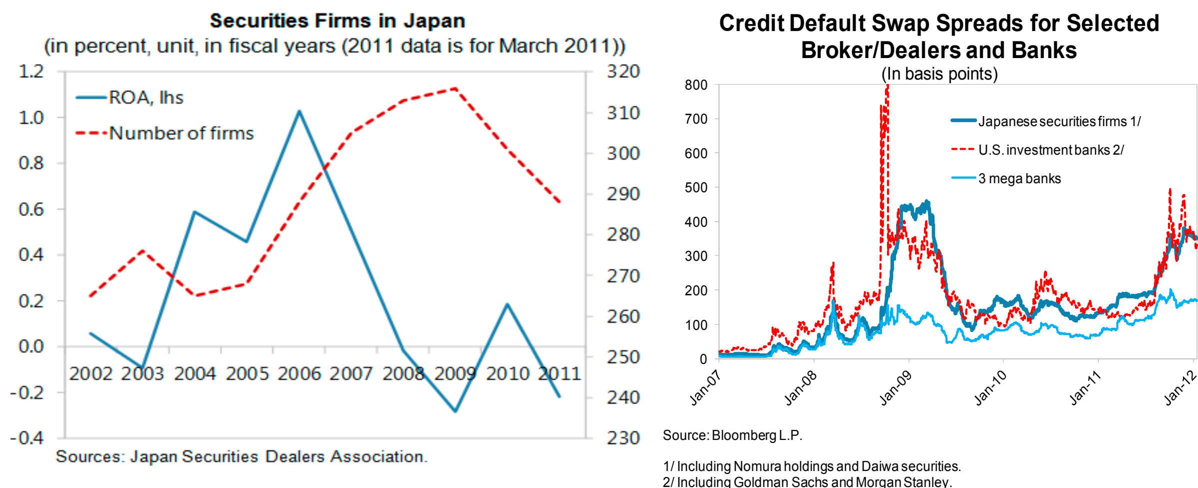
11. **Insurance companies meet their solvency requirements, but these do not reflect a full economic valuation of their assets and liabilities** (Figure 5)**.** Both life and nonlife insurers showed strong regulatory solvency margins under the requirements prior to FY2011. The new solvency requirements that took effect in FY2011 (e.g., as a result of additional risk recognition and new risk calibration) are estimated to have reduced solvency margins by about 20–30 percent, although keeping them still well above the regulatory minimum. Importantly, however, the new requirements still do not incorporate full economic valuation. The profitability of the insurance sector has risen only marginally in recent years, but is expected to improve gradually.

12. **Although substantial reforms were made to Japan's public pensions in 2004, significant challenges to the viability of the system remain**. Key elements of the 2004 reforms, such as macroeconomic indexation of benefits, have yet to be implemented. Also, although some additional changes with regard to indexation are currently under consideration, they do not include what are perhaps the most significant items—raising the retirement age beyond age 65, and harmonizing the system across sectors. The private pension system in Japan has also been evolving and growing, but it still remains small compared to the public pension system.

13. **Major Japanese securities firms appear adequately capitalized and have strong liquidity buffers compared to their foreign peers.** The largest securities companies have Tier 1 capital ratios of 16–24 percent. The sector has been hit hard by global market turbulence since 2007 and core profitability has contracted sharply, reducing equity and raising leverage above comparators. Declining turnovers in equity and bond markets have cut commission income, and net losses were recorded in 2008, 2009, and 2011. Continued pressures on profitability could further push some smaller firms to exit, though the traditional nature of Japanese security firms' business limits the risks of disorderly exits.

	Return on average assets	Share of trading income 1/	Equity/ Total assets	Tier 1 ratio	Liquid asset/ST funding
	2010 (Mar 2011 for Japan), in percent				
Nomura	-0.3	37	5.7	16.4	192
Daiwa	-0.3	29	5.5	24.4	209
Goldman	1.0	61	8.5	16.0	190
JP Morgan	0.8	20	8.3	12.1	52
Morgan Stanley	0.7	56	8.1	15.5	177
Merril Lynch	0.6	46	8.1	…	137
	2006-09 average, in percent				
Nomura	-1.0	24	6.6	…	308
Daiwa	0.1	34	6.9	…	306
Goldman	1.0	75	6.3		145
JP Morgan	0.8	11	8.1	9.8	57
Morgan Stanley	0.3	52	5.2	…	99
Merril Lynch	-0.5	-14	4.5	…	81

Sources: Bankscope, company reports and IMF staff calculation.
1/ Over non-interest operating income



B. Key Risk Factors

14. **JGB market exposures represent one of the central macrofinancial risk factors** (Figure 6)**.** This risk reflects the possible impact on public debt sustainability of changes in yields and related effects on investor confidence; the increased role of the private financial sector in covering government borrowing needs; the prospect that ongoing demographic shifts will reduce private saving; and growing household interest in investing abroad.[3] Interest rate risk sensitivity is especially prevalent in regional banks and insurance companies (JGBs representing about 70 percent of life insurers' securities holdings and 90 percent of insurance cooperatives' securities holdings).[4] In addition, the main public pension scheme, as well as Japan Post and Norinchukin bank, also have large JGB exposures (Box 1).

15. **There are multiple sources of credit risk in the banking system** (Table 8)**.** Historically, domestic corporate loans have been the largest source of credit costs, a risk exacerbated by large and concentrated exposures to a few companies or industries for major banks, or to local industries for regional banks. In addition, SME-related credit costs could rise further if growth slows down or if SMEs that benefited from relaxed regulatory requirements for restructured loans fail to recover once these support measures are removed. Other credit risk exposures, such as those reflecting an acceleration of overseas expansion that may strain underwriting and risk management standards, or mortgage-related exposures (Figure 7), appear modest but require close monitoring.

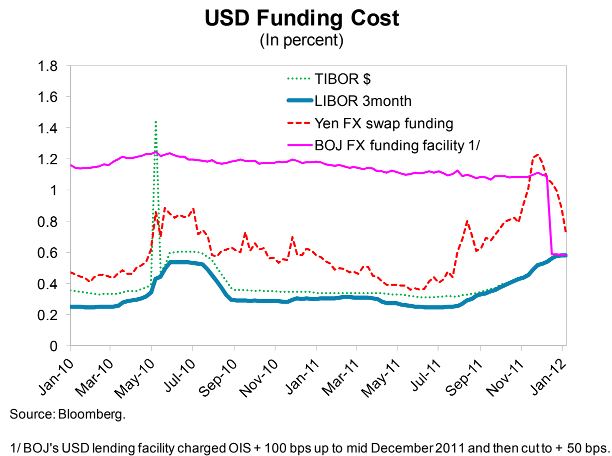
16. **Equity market risk exposures have declined but remain important** (Figure 6, Table 8)**.** City banks' equity holdings still represent around half their capital, but Basel III

[3] Hedging strategies by financial institutions against interest rate shocks typically include holding long-duration liabilities (e.g., pension funds and life insurers) or shortening durations of asset portfolios (as city banks have done recently). Interest rate derivative markets are of relatively small size compared to the JGB market.

[4] According to BOJ estimates, a 100 basis point (parallel) rise in market yields would lead to mark-to-market (MTM) losses of 20 percent of Tier-1 capital for regional banks (not taking into account net unrealized gains on securities), against 10 percent for the major banks.

implementation should incentivize them to further reduce such exposures. Regional banks' equity holdings are smaller but still around 30 percent of capital. Nonlife insurers' equity holdings have decreased to about 20 percent of assets at present, but are twice the level observed in other advanced countries. In the life sector, equity holdings represent only 5½ percent of total assets.

17. **Japanese financial institutions are presently well positioned to deal with potential foreign exchange (FX) market volatility.** The U.S. dollar is the most important currency for yen FX transactions (¾ of total). The net FX positions of Japanese banks are small, limiting potential valuation losses. In addition, Japanese financial institutions actively manage FX liquidity risks by using local repos, interbank loans and certificates of deposit, or cross-currency funding using FX swaps to obtain foreign exchange (mostly U.S. dollar). The cost of some of these funding sources (especially swaps) has been unstable in recent months, and in response, banks have lengthened the term of FX swaps and issued U.S. dollar bonds. Securities firms will also need to manage carefully their day-to-day liquidity due to their reliance on market funding, in particular in FX swaps markets.



Source: Bloomberg.

1/ BOJ's USD lending facility charged OIS + 100 bps up to mid December 2011 and then cut to + 50 bps.

C. Resilience—Stress Tests

18. **The FSAP stress tests were conducted in close collaboration with the BOJ and FSA, building on their existing practices** (Tables 9–11)**.** The top-down bank stress tests were based on the framework used by the BOJ in its Financial System Report (FSR), and bottom-up tests with common assumptions were conducted for major banks and insurers.[5] All calculations were performed by the BOJ (top-down for the banking sector), or by participating banks and insurance companies (bottom-up), based on assumptions and parameters agreed with the FSAP team. The baseline scenario reflects World Economic Outlook projection as of September 2011.[6] Three adverse scenarios capturing the key macrofinancial risks were applied to both the banking and insurance sectors:

- A global double-dip including a significant slowdown in China (*mild*, with a one standard deviation shock to real GDP growth; and *severe*, with a two standard deviations shock);

[5] The stress tests did not cover certain large financial institutions such as Japan Post, Norinchukin bank, and largest securities companies (Box 1).

[6] As of June 2012, deviations from these baseline projections are limited—equity price levels are as projected, JGB yields are lower, and the revised growth outlook is a little stronger.

- A protracted growth slowdown over the medium-to-long-term with further deflationary pressures; and

- A global double-dip mild scenario combined with a 100 bps parallel shift of the yield curve (representing a moderate market yield shock in line with Japan's experience in the past 15 years).

Separately, sensitivity analyses for a larger market yield (single-factor) shock were conducted as part of the top-down tests for banks.[7] Insurance stress tests also examined the impact of some insurance-specific shocks.

Banking sector

19. **The banking sector appears broadly resilient to all of the above scenarios, although some regional banks are vulnerable** (Figures 9–13)**.** Aggregate capital ratios for the whole sector remain well above Basel III requirements. In addition, internationally active banks are also likely to meet Basel III capital requirements on an individual basis, reflecting their high initial capital buffers, and the gradual phase in of Basel III rules that provides time to build capital through retained earnings.[8] However, regional banks, in particular Tier 2 regional banks, are at greater risk. This sub-group, which represents 7 percent of the system's total assets, starts with lower CARs given their less stringent regulatory requirements (4 percent, Basel II-based total CAR), and experiences sharper drops in capital than other groups under the protracted growth and double-dip mild with market yield shock scenarios, due to relatively large credit and JGB-related risk exposures.

20. **As expected, JGB market exposures constitute one of the central macrofinancial risks for the system** (Figure 12)**.** Tests including market yield shocks (i.e., the macro scenario with a 100 bps shock and the sensitivity test for a larger shock) reduce aggregate capital ratios in the first two years more than other scenarios. Other risk factors appear to have less systemic relevance:

- *Credit risk is significant but seems manageable.* While credit cost ratios rise to levels comparable to the early 2000s, especially under the protracted growth scenario, profits and capital levels provide solid buffers for most banks. In line with historical experience, credit costs from the corporate sector are the most important, while risks from household

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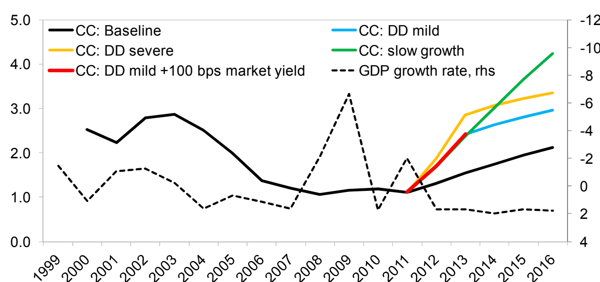
[7] The corresponding shocks to GDP are in line with FSAP practices and more severe than those usually considered by the authorities. The larger market yield shock seemed within the range considered by some Japanese financial institutions for their internal risk management purposes.

[8] The 2.1 percentage points difference in Basel III capital ratios for the three megabanks as of September 2011 between top-down and bottom-up tests (Figure 13) is mostly explained by RWA calculations: top down tests use actual Basel II-based RWA, while bottom-up tests rely on higher RWA in line with the new international standards (Table 9). Other factors (such as different levels of consolidation—Table 9) also contribute to the difference.

and overseas loan exposures are limited.[9] However, these results do not reflect the potential impact of withdrawing SME support measures and large exposure risks.

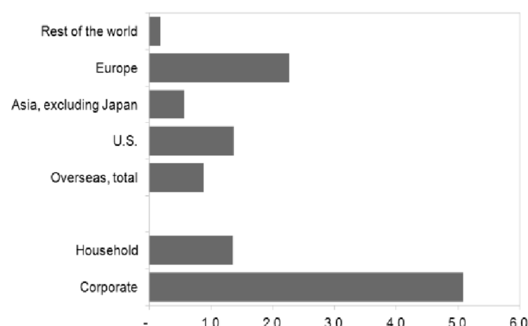
Top-down Cumulative Credit Costs (CC) and Nominal GDP Growth Rate: All Banks 1/
(In percent, March data for the banking sector and calender year for GDP)



Sources: BOJ, CEIC, WEO and IMF staff calculations.

1/ Historical credit cost is defined as stock of provisions/ gross loans. For projection period, stock of provisions are esimated by taking cumulative annual credit costs and adding it to existing stock of provisions as of September 2011, and the ratio is calculated using total gross loan as of September 2011. DD stands for global double dip.

Bottom-up for 3 Mega Banks: Cumulative Credit Costs in Double-dip Severe Scenario (2011, Sep-2014, Mar.) 1/
(In percent of gross loans)



Sources: Banks and FSA, IMF staff calculation.
1/ The scenario give largest credit costs for three mega banks.

- *Equity exposures are another important source of market risk* (other than JGB market exposures). While equity valuation losses under the FSAP stress tests are small, in line with moderate shocks under the scenarios considered, the BOJ estimates in its FSR that a price shock of the order of about 50 percent could reduce Tier 1 capital by about 17 percent and 14 percent for major and regional banks, respectively. Valuation losses from foreign securities are small, including due to very limited exposures to distressed European sovereigns.

- *Yen funding risks* are minimal for Japanese banks, reflecting BOJ's accommodative monetary policy stance, their limited reliance on wholesale market funding, continued deposit inflows, and large holdings of liquid assets (in the form of JGBs, which qualify as collateral for BOJ's standing facilities).

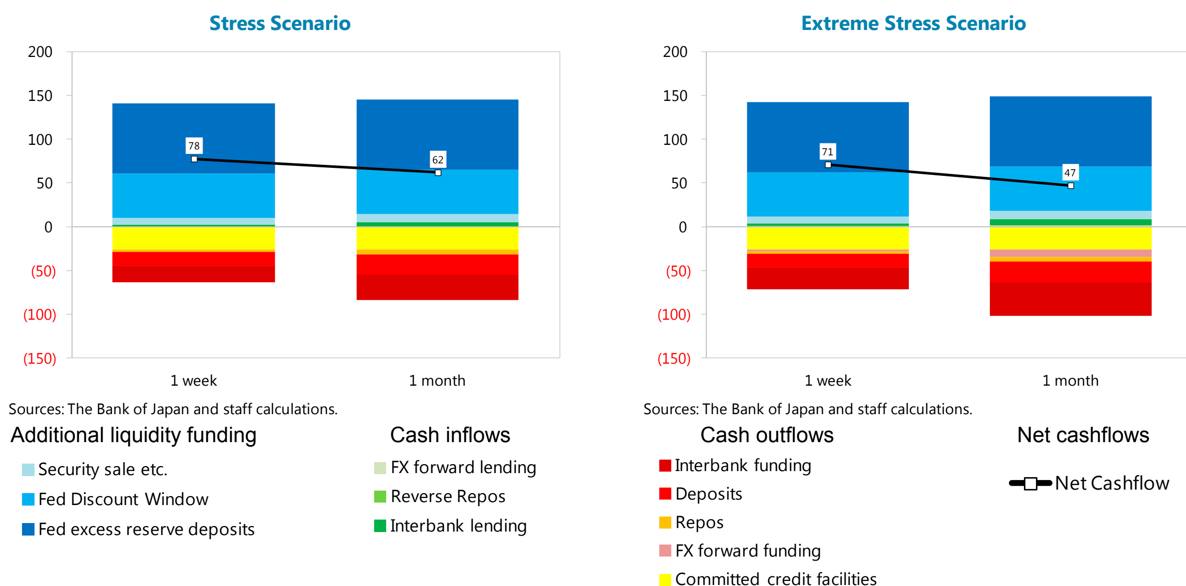
Top-down Yen Liquidity Stress Test Results—Distribution of Liquid Asset Ratios Under Stress Scenarios
(In percent)

	Internationally active banks			Domestic large banks			Domestic small banks		
Deposit runoff rate	0	5	10	0	5	10	0	5	10
Minimum	254	105	78	184	130	102	860	186	133

Sources: BOJ and staff calculations.

- *FX funding risks* are manageable for Japanese banks as a contraction of interbank funding, a disruption in US$-yen swap markets, deposit withdrawals, or realization of contingent liabilities could be met through sales/repos of foreign asset (mostly U.S. treasuries) or, for some of them, through access to various U.S. Federal Reserve System facilities.

[9] Relatively modest exposure to household sector risk reflect a number of factors, including the absence of housing price bubble in the recent past; conservative loan-to-value ratios (85 percent); relatively stable employment conditions; and the use of recourse loans.



Insurance sector

21. **On average, the insurance sector appears resilient, but life insurers' net assets would be affected under stress scenarios** (Figure 14)**.** Although the FSAP team did not have access to individual firm-level results (owing to confidentiality concerns), the FSA confirmed that no insurance company would fall below the solvency margin requirements in any of the scenarios mentioned in paragraph 18. A severe global recession would reduce the solvency margin by a cumulative of 17 percent over two years, while a global double dip with market yield surge would reduce it by 20 percent. Such large losses could be sizeable for individual insurers but the sector, on average, has enough capital level to absorb such shocks. In particular:

- The *life insurance* sector's aggregate solvency margin could withstand adverse scenarios, but net assets would be severely impacted: under a severe global recession or a global recession with market yield surge, they would decline by 30–40 percent over two years (or 40–50 percent if coupled with a pandemic shock).

- The *nonlife insurance* sector also appears on average resilient to stress scenarios (Figure 15). Unlike the life sector, it does not face the risk of major net asset losses, due to the shorter duration of bond holdings. The losses are entirely absorbed by the sizeable unrealized gains on securities.

Box 1. Soundness and Resilience of Other Major Financial Institutions

Complementing the stress test analyses, the Japan FSAP Update separately assessed the soundness and resilience of a few large and potentially systemically-important financial institutions (Japan Post Bank and Insurance, and Norinchukin Bank), based on publicly available data.

Japan Post. *Japan Post Bank* collects large amounts of domestic deposits and is not allowed to make commercial loans (with a few exceptions), nor does it have major equity holdings. As such, its main risk exposure is interest rate risk, with JGBs representing 76 percent of its total assets (70 percent in held to maturity (HTM) account), and resulting in a very high CAR given the zero risk weight assigned to JGBs. It also has a growing portfolio of foreign securities, but the corresponding exchange rate risk exposure is limited, including through hedging. A simple sensitivity analysis suggests that a 100 bps interest rate shock would lead to MTM losses of about 35 percent of Tier 1 capital (taking into account existing unrealized gains, but stressing all JGBs, including in the HTM account). *Japan Post Insurance* faces similar risks (nearly 80 percent of its financial assets are domestic securities, in particular JGBs and local government bonds), and also benefits from buffers to absorb market losses in the form of unrealized gains on its securities portfolio.

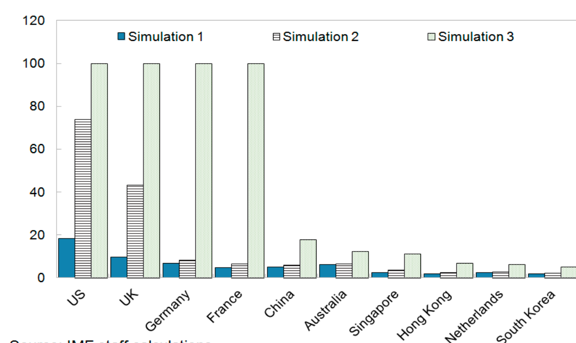
Norinchukin Bank lost in 2009 the equivalent of 20 percent of its Tier 1 capital due to exposures to U.S. mortgage securities. Since then, it has strengthened its capital position by issuing common equity (to member cooperatives) and perpetual subordinated debt. Its Tier 1 capital ratio reached 20.2 percent in September 2011. The bank holds a large JGB portfolio (22 percent of assets), and staff estimates that MTM losses from a 100 bps interest rate shock (including those in the HTM account) would reduce Tier 1 capital by 20 percent. However, its strong capital position, and existing unrealized gains that would raise its Tier 1 capital ratio by about one percentage point, would help maintain its capital above the minimum requirement. It also has a portfolio of foreign bonds, which is of much shorter duration than the JGB portfolio, and it has further decreased its exposures to peripheral European countries in recent years.

D. Financial Spillover Analysis

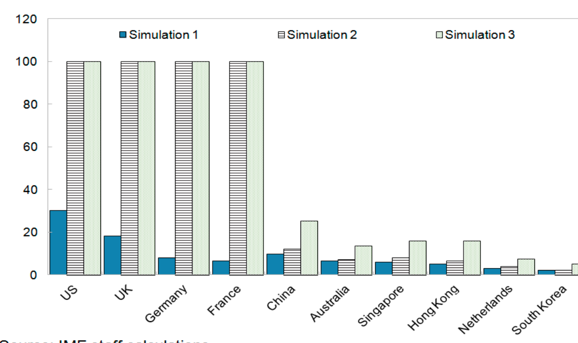
22. **Domestic spillover risks between major banks and regional banks may be high, while spillover risks between banks and insurance or securities companies appear limited.** In particular, rolling-window expected default frequency (EDF) correlations are high between the megabanks and a number of regional banks, as well as among megabanks and regional banks themselves. EDF correlations between megabanks and insurance and securities, on the other hand, are generally low, possibly a reflection of different business models of banks and insurance/securities companies and weaker balance sheet linkages, as the cross-share holdings between these institutions have been declining.

23. **The main potential sources of foreign spillovers into Japan's financial system are the U.S. and core European banking systems, although these risks appear moderate at the moment.** Specifically, EDF correlations suggest that linkages between major Japanese financial institutions and global SIFIs are modest, except in crisis periods. All network simulations of credit and funding shocks indicate that the largest potential losses for Japanese banks would reflect their exposures to the U.S., U.K, Germany, and France (nearly 60 percent of their total

foreign claims).[10] The Japanese banking sector seems able to withstand a range of shocks affecting these four countries, except for the following: (i) if the whole U.S. or U.K. banking sectors fall in distress; (ii) if the German or French banking and corporate or sovereign sectors fall in distress, or (iii) if there are widespread strains in global funding markets (with associated fire sale losses) that lead to more foreign bank failures, resulting in larger credit losses for Japanese banks. No country other than these four can generate impairment above 25 percent of Tier 1 capital for Japan. Among Asian countries, Japan is most at risk from exposures to China, Australia, and Singapore.



Source: IMF staff calculations.



Source: IMF staff calculations.

E. Overall Risk Assessment

24. **In the near term, Japanese banks and insurers seem to have the capacity to withstand a range of adverse macrofinancial scenarios considered in this FSAP.** The stress test results show that the system is favorably positioned to accommodate higher capital requirements under Basel III for major banks. The FSA reported that all insurance companies in the test would maintain a higher solvency margin than the regulatory requirement under all stress scenarios. Spillover effects from global conditions to Japan, including further distress in Europe, seem manageable as well.

25. **JGB market exposures are one of the central sources of macrofinancial risk in the system.** Losses from such exposures could reduce capital ratios (or net assets for insurers) across a range of financial institutions. While the stress tests show that an adverse macroeconomic scenario associated with a 100bps market yield shock would have a manageable impact, these exposures require close monitoring, enhanced risk management, and contingency planning. Indeed, market yield shocks may potentially trigger feedback effects between the public and financial sectors, and the real economy, which are difficult to predict and could have more severe and pervasive impact than measured in the stress tests. In particular:

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[10] The network analysis is based on bilateral exposures of banking systems across 30 countries and their capital level data as at end-September 2011. Three simulations are explored: (i) interbank exposures only (Simulation 1); (ii) potential exposures at default, i.e. outstanding derivative contracts or contingent liabilities (guarantees, credit commitments) vis-à-vis the defaulting banking system (Simulation 2); and (iii) the potential knock-on effects of banking sector distress on the nonbank and sovereign sectors of each country (Simulation 3).

- *Non-linear feedback effects*. The October 2011 FSR indicates that the indirect impact on credit risk of higher interest rates could be highly non-linear: for adjustable rate loans, credit cost ratios from corporate loans could rise by 0.1 percentage points for a 100 bps shock and by 1 percentage points for a 300 bps shock. This reflects the role of complex channels that are not captured in the FSAP stress tests.

- *Compounded risk factors*. In the FSAP stress tests, a market yield shock is assumed to materialize immediately under the mild global double dip scenario. However, a JGB market yield shock may also happen over the medium-term, and in the context of an unfavorable economic path (e.g., a medium-term growth slowdown). Furthermore, Basel III capital requirements will increase gradually, potentially challenging further the resilience of the system.

26. **The FSAP analyses indicate that smaller regional banks constitute the most vulnerable segment**. They are more vulnerable due to their larger duration gap combined with larger credit risk exposures; relatively thin capital positions; lower core profitability; and difficult business prospects in some regions. While they are a small segment of the system and may not seem to represent a direct source of systemic risk, such vulnerabilities do suggest that these banks may need to be subject to higher capital buffers, in line with their risk profile.

27. **Although broadly reassuring, the stress test results need to be interpreted with caution given some data and other limitations affecting the analysis:**

- The FSAP team did not have direct access to supervisory data. The bottom-up results (for both bank and insurance) were communicated to the team only on an aggregate basis due to confidentiality concerns.

- Confidentiality constraints limited the team's ability to assess certain vulnerabilities stemming from cross-border exposures of banks and insurance companies or, in the insurance sector, from the maturity structure of insurance liabilities.

- The banking sector solvency tests did not address risks from large exposures (an area where the Basel Core Principles (BCP) assessment pointed to oversight deficiencies) or the impact of adjusting for support measures to the SME sector (also due to confidentiality constraints).[11]

- Insurance stress tests do not reflect full economic valuations of liabilities (although the results of interest rate sensitivity analyses provide an indication of the potential effects of using such valuations).

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[11] The BOJ estimates a relatively small impact from adjusting for the support measures: if all loans to firms with relaxed requirements for restructured loans become nonperforming, it would increase NPL ratios by about 1 percentage point and credit costs over total loans by about 0.2 percentage points, and reduce Tier I capital ratios by about 0.3 percentage points (April 2012 FSR).

III. Overseeing and Managing Risks to Financial Stability

A. Systemic Risk Perspective

28. **The BOJ's semi-annual FSR represents a key component of the authorities' macrofinancial surveillance.** The FSR casts a wide surveillance net, with extensive reviews of financial and economic developments, both domestic and overseas, and is supported by a relatively deep analytical foundation, including stress tests. The FSR is complemented by an extensive research program within the BOJ, including efforts to establish an Early Warning System (EWS).

29. **Notwithstanding these strengths, the BOJ's macroprudential surveillance could benefit from further enhancements:**

- *Coverage*. There would be merit in assessing longer term structural drivers of systemic risk within the financial system, such as spillovers arising from regional, cross-border, corporate sector and demographic trends.

- *Stress testing*. The existing analyses could be extended to a wider range of financial institutions, including systemically-important nonbank financial institutions. Care is also needed to avoid the results being overly dependent on recent historical relationships, since the stability of some core variables (e.g., interest rates and credit costs) may reflect policy support measures and understate the potential for sharp shifts.

- *Use of market surveys*. BOJ's existing risk analyses could be complemented with other sources of information, such as a systemic risk survey to gauge market participants' risk perceptions.

30. **The current oversight framework operates in the absence of a dedicated financial stability committee or council to assist in macroprudential decision-making and coordination outside crisis periods** (Figure 16–17)**.** Given the existence of strong informal mechanisms, this has, thus far, not posed any impediment to the quality of cooperation and risk monitoring. Cooperation is also simplified since Japan does not have to contend with multiple supervisory agencies (although some supervisory responsibilities on smaller institutions are shared with administrative ministries).

Japan FSAP—G-7 Institutional Models for Financial Stability/Macroprudential Policy

Features of the Model	United Kingdom	European Union	United States	Canada	Japan
1. Existence of a Financial Stability Committee	Yes	Yes	Yes	No formal (created by law) Committee, though formal mechanisms to coordinate and share information (Senior Financial Committee acts as a committee)	No
2. Chair of Financial Stability Committee	Central Bank (Governor)	Central Bank (Governor)	Treasury (Minister of Finance)	Treasury (Department of Finance, not necessarily Minister of Finance)	N/A
3. Decision Taking Power of Financial Stability Committee	Advisory and Compulsive (*)	Advisory	Advisory and Compulsive	Advisory	N/A
4. Degree of institutional integration of central bank and supervisory agencies	Partial (excludes securities)	None (though indirect via national central banks)	Partial (excludes securities and most banks; regulates SIFIs)	None	No
5. Explicit role of MOF/ treasury/government	Part of Financial Stability Committee	Part of Financial Stability Committee (European Commission; Economic and Financial Committee)	Part of Financial Stability Committee	Part of Senior Financial Committee	No

Source: IMF (2010) "Macroprudential Survey."

(*) Decision making power once legislation passed.

31. **Nonetheless, there may be merit in further enhancing coordination and information sharing arrangements among oversight bodies, including in light of the growing international acknowledgment of the benefits from more formalized arrangements for financial stability oversight.** The FSAP focused on the following areas:

- *Policy matters*: There may be additional benefits from formal cooperation arrangements among regulatory institutions that could further define the distribution of responsibilities and roles on systemic issues, including during crises. This could support consistent oversight approaches, minimize the industry's reporting burden, and avoid the risk of supervisory gaps.

- *Information sharing*: The Financial Services Agency (FSA) and BOJ should intensify their cooperation and joint work on systemic risk monitoring via enhanced information sharing and more regular sharing of findings from supervisory activities.

B. Bolstering Financial System Oversight

32. **An assessment of the regulatory and supervisory framework against international standards reveals a large degree of compliance.** The Japanese authorities have implemented various improvements to their supervisory framework since the 2003 FSAP, including the FSA's "better regulation" program which promotes a more risk-focused and forward-looking approach.

33. **However, against the backdrop of the risks outlined in Section II and lessons emerging from the ongoing crisis, there seems to be room for improvement in a number of areas.** A central theme that emerges from the assessment is the need to augment the analytical capacity and risk monitoring capabilities of the FSA, and closer and more formalized interagency coordination on financial stability aspects. Another challenge is to increase supervisory efficacy in the nonbank financial segments and the quality of systemic risk analysis, including the household and corporate sectors. The supervisory arrangements for some cooperative style

institutions could also be clarified. Finally, the FSA's budgetary and operational independence could be enhanced in order to bolster its effectiveness and market standing.[12]

Banking

34. **The banking supervisory framework is largely compliant with the Basel Core Principles** (Annex I)**.** The legal framework for banking supervision, shaped by the banking crisis of the late 1990s, contains elements that position it ahead of many of the ongoing global reform initiatives. The FSA has made strides in improving its framework for regulating and supervising banks since the last FSAP. The FSA implements effectively its principles-based approach based on continuous off-site and effective on-site capabilities.

35. **A key challenge ahead is the need to recalibrate certain prudential requirements.** Japanese banks' traditional business models are coming under pressure as a result of ongoing demographic changes and chronically low margins. As a result, some banks are increasingly seeking to develop new activities, including in foreign markets. Against this background, it will be important to enhance the prudential regime with regard to:

- *Capital requirements.* Capital requirements should reflect banks' actual risk profiles, and higher capital levels may be necessary for certain types of institutions. The distinction between capital requirements for internationally-active banks (8 percent of RWA) and domestically-active banks (4 percent of RWA) could be reconsidered, based on the principle that comparable capital levels are required from banks with similar risk profiles.[13]

- *Sanction powers*. Prompt corrective action (PCA) needs to be reviewed, with triggers allowing for earlier intervention to raise capital.

- *Concentration risk limits*: Large exposure rules need to be revised and strengthened, so that all exposures from an individual client or group of connected clients are taken into account, limits are set as a percentage of Tier 1 or core Tier 1 capital, and all banks properly manage risk concentrations with respect to different regions and industries.

36. **The overall supervisory approach could also be more closely aligned with the profile of systemic risk.** The existing bottom-up supervisory approach works effectively. Complementing this, the FSA could put in place a more formalized top-down framework to identify systemic risk drivers and assess the risk profiles of banks in a more holistic manner—

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[12] The details of the scope and function of the FSA are defined by cabinet order, rather than being in the law. Some supervisory decisions, for instance on licensing, are delegated to the Minister for Financial Services. Day-to-day supervision of regional and Shinkin banks is delegated to regional finance bureaus of the Ministry of Finance, as well as the co-supervision by the FSA and other Ministries on some cooperative-type institutions.

[13] The near-term impact of an increase in capital requirements for domestically-active banks on credit supply could be mitigated by efforts to bring in new capital through equity issuance, lower dividend payouts, or temporary public capital injections. Over the medium term, higher capital would put these institutions in a stronger position to take on risk and extend credit.

including via thematic reviews.[14] A formal criterion to differentiate the more systemically-important financial institutions (SIFIs) could help the FSA further prioritize the allocation of its supervisory resources. While the FSA has powers to effectively supervise banking groups on a consolidated basis, the recent trend towards cross-border lending and investing by banks and insurers also requires that the FSA strengthen its vigilance and oversight of cross-border risks.

Insurance and pension sector

37. **The FSA has been enhancing the framework for insurance oversight, including with regard to solvency requirements** (Annex II)**.** The FSA has revised the risk parameters (resulting in an increase in required capital) and extended the solvency requirements to the holding company level, and it is improving the tools used for supervisory assessment, including stress testing. Steps have been taken to enhance the supervision of insurance holding companies, cooperation with foreign supervisors, and market analysis capabilities. Looking forward, the FSA should build on these efforts and strengthen insurance oversight particularly in the following areas:

- *Supervisory assessment*. The FSA should complete the development of a methodology for risk-rating insurers, adopt a structured system for the internal review of risk assessments, and further increase the level of resources to enable more frequent inspections—especially for the largest insurers.

- *Solvency assessments* should be based on an economic valuation of assets and liabilities, which takes into account future cash flows over the full time horizon.

- *Exercise of supervisory powers*. The formal threshold for supervisory administrative action appears to be high, and the FSA should make greater use of its power to take steps to impose fines on insurers and intermediaries and to develop a more progressive approach to enforcement. The regulation and supervision of reinsurance activities could also be strengthened (exposure to natural catastrophes makes strong reinsurance coverage essential to the Japanese insurance market).

- *Corporate governance* in the industry should also be revised to strengthen independent oversight. This will help reinforce the ongoing supervisory efforts of the FSA.

- *Anticipating crisis situations*, including by taking steps to maximize the value of macroprudential analyses, developing contingency plans, and cooperating more proactively with foreign supervisors—e.g., through the establishment of colleges of supervisors for Japanese insurance groups.

38. **With regard to the public pension system, important objectives have been set but further improvements are needed.** Consideration should be given to incorporating built-in

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[14] Thematic risk assessments will help monitor financial institutions' readiness to manage systemic risk, including the potential impact of risk exposures across categories of financial institutions (not just banks or other financial institutions taken in isolation).

mechanisms to adjust pension parameters, in addition to the macroeconomic indexation of benefits, to support the achievement of both short-term and long-term objectives. Also, a large share of the assets supporting public pensions are invested in domestic fixed-income investments, predominantly JGBs. Alternative, less conservative investment strategies might be encouraged, as a means of improving long-term rates of return and reducing interest rate exposure.

39. **Further steps could also be taken to encourage the growth of the pension system and its contribution to retirement income.** Such steps might include (i) harmonizing the earnings-related contribution limits across various types of pension plans; (ii) allowing the use of higher maximum retirement ages; (iii) promoting financial literacy to encourage participation in defined contribution plans; and (iv) restricting the use of lump-sum and temporary annuity settlements, which can leave retirees with insufficient income in their later years.

Securities firms

40. **The oversight framework for Japanese securities firms shows a high degree of compliance with the International Organization of Securities Commissions (IOSCO) Principles** (Annex III)**.** A robust legal framework provides the FSA with extensive powers to supervise regulated entities, investigate breaches of securities laws and regulations, and cooperate domestically and internationally. In addition, the FSA has made changes in its organizational structure to upgrade its capacity to identify, monitor, and mitigate systemic risk.

41. **However, there is scope for further strengthening the supervision of securities firms in some areas:** (i) the FSA could develop a more robust framework to assess the scale and scope of risk posed by individual firms that could serve as a guide to determine the intensity of regulatory intervention (including onsite inspections); (ii) the Securities Exchange Surveillance Commission (SESC) could intensify the coverage of its inspection program for smaller firms to strengthen investor protection, as conduct issues cannot be easily captured through off-site reporting; (iii) the registration process for securities firms could be improved; and (iv) external auditing requirements could be imposed on regulated entities that can hold clients' assets when necessary.

42. **The FSA should consider reviewing its enforcement program.** This would help ensure a proper balance between different types of regulatory measures at its disposal, from orders for improvement to suspensions and cancellations of registration. Also, the authorities should consider reviewing the current framework for administrative monetary penalties to ensure that the amounts of the penalties act as a sufficient deterrent, and to expand the range of misconducts that can be subject to administrative monetary penalties. Finally, efforts to implement the new principles should continue, in particular in connection with the identification of emerging systemic risks. The creation of the Office of Securities Business Monitoring (OSBM) is a step in the right direction. However, it is important that arrangements be in place to more comprehensively and systematically identify and assess risks and determine the need for regulatory intervention.

Financial market infrastructures (FMIs)

43. **The oversight of the JGB FMIs is effective and the authorities have succeeded in strengthening the robustness and efficiency of FMIs in the past decade.** The law gives the FSA specific powers with regard to FMIs that are consistent with its responsibilities. The BOJ's oversight policy and objectives are decided by its policy board and disclosed on its website, both for private sector-operated Japanese FMIs and for offshore yen payment systems. The authorities conduct onsite inspections and off-site monitoring, and key improvements in recent years have included the implementation of real time gross settlement (RTGS) for all large-value payments, the introduction of liquidity saving features in the RTGS, the development of delivery-versus-payment (DVP) settlement for all types of securities, and the reduction of risks in clearing and settlement of JGBs. Japan has also taken the steps necessary to meet the G-20 commitment to centrally clear all standardized over-the-counter (OTC) derivatives.

44. **Notwithstanding these strengths, steps can be taken to further improve the oversight and supervision framework.** A number of structural improvements planned in response to the Lehman default are awaiting implementation, including contingency funding arrangements for Japan Government Bond Clearing Corporation (JGBCC), and coordinated contingency plans to deal with a CCP failure (in line with the outcome of ongoing international discussions). In addition, the list of systemically-important FMIs could be officially disclosed, and assessments against CPSS-IOSCO standards could be more detailed in a few key areas, such as with regard to the legal basis of settlement finality for fund transfers. Finally, domestic authorities could clarify their cooperation arrangements in order to facilitate the exercise of their respective responsibilities both in normal circumstances and during times of market stress.

IV. Crisis Preparedness and Resolution

45. **Japan has developed a robust and time-tested crisis management framework.** In the 1990s, more than 100 deposit-taking institutions were closed at a substantial fiscal cost. This experience triggered an overhaul of the regulatory architecture, including the establishment of the Financial Reconstruction Commission and the Financial Supervisory Agency in 1998, which were reorganized into the FSA by 2001. Along with the strengthening of the deposit insurance system, these changes contributed to a marked improvement in Japan's crisis management capabilities. Most recently, the ability of the authorities to ensure the functionality and stability of the financial system in response to extreme shocks was displayed in the wake of the Great East Japan Earthquake in March 2011.

A. Crisis Prevention

46. **The BOJ has wide ranging powers to provide liquidity to both bank and nonbank financial institutions.** Standing facilities for the supply of liquidity are available to both banks and those broker/dealers that transact and hold accounts with the central bank. BOJ may also extend collateralized loans to meet the specific needs arising from business operations of individual financial institutions, or to ensure smooth settlement of payments whenever an

institution is experiencing operational difficulties (e.g., in case of natural disasters).[15] In addition, and in exceptional cases as requested by the government, the BOJ is authorized to provide unsecured loans to financial institutions in order to maintain financial stability.[16]

47. **Generous credit support by the government and BOJ has been provided recently to prevent a tightening of financing conditions.** In response to the global financial crisis and the 2011 earthquake, support measures included safety-net lending, expansion of credit guarantees, and BOJ lending to growth sectors and in disaster areas. The team welcomed these steps but cautioned that care would be needed to ensure that these measures do not adversely affect the credit channel and risk-taking incentives for banks. In addition, the credit guarantee program may lead over time to credit and fiscal costs and generate additional concerns about the public sector balance sheet.

B. Crisis Resolution

48. **In times of financial crisis, high level coordination between agencies is provided by the Financial Crisis Management Council (FCMC).** The FCMC is chaired by the Prime Minister and includes the Chief Cabinet Secretary, the Minister for Financial Services, the Ministry of Finance, the Commissioner for Financial Services and the Governor of the Bank of Japan. The FCMC's specific role is to advise the Prime Minister on the resolution of financial institutions whose failure may disrupt financial stability and, where appropriate, to seek a "systemic risk exception" for public injections of capital into the financial system, the establishment of a blanket guarantee, or the nationalization of financial institutions. Since its inception, in 2001, the FCMC has met only twice.[17]

49. **The authorities aim to further refine certain aspects of the resolution regime, taking into account the *Key Attributes for Effective Resolution Regimes for Financial Institutions* recently published by the Financial Stability Board.** The authorities are working closely with other countries to improve arrangements for collectively resolving cross-border problems. They are preparing "recovery and resolution" plans (RRPs) for Japan's three global SIFIs, and examining their extension to a wider range of domestic financial institutions. While Japan's resolution authorities have a full range of powers to resolve deposit-taking institutions, including special measures under the "systemic risk exception" described above, there is no similar institutional arrangement for dealing with the distress or failure of systemic nonbank financial institutions, including CCPs, to guarantee the smooth functioning of the financial system in the event of an unexpected disruption.

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[15] The BOJ may also extend emergency loans on an uncollateralized basis in the case of, for instance, failures in electronic data processing systems caused by natural disaster.

[16] BOJ provision of such loans is subject to well-defined criteria (the Four Principles), which are described on the BOJ website (http://www.boj.or.jp/en/announcements/release_1999/fss9905a.htm/). In support of these responsibilities, the BOJ subjects both banks and nonbanks to regular off-site and on-site monitoring, distinct from the supervisory process that the FSA undertakes for its own prudential purposes.

[17] In addition, a Financial System Council (FSC), largely composed of academics, acts as an advisory board for the government, providing guidance on medium and longer term issues facing the financial system. However, the FSC plays no direct role in agency co-ordination.

50. **Mechanisms that would help contain the potential cost of bank resolution could be introduced.** In the 1990s, despite initial resistance, the authorities eventually accepted the need to expend public money to address the banking crisis as it worsened. The resulting legal framework authorizes the use of Deposit Insurance Corporation of Japan (DICJ) funds in a wide variety of ways, including for crisis management, as well as a government guarantee to DICJ borrowing as backup funding. While such a funding framework is crucial to the credibility of the overall resolution framework, it is also important to ensure that resolutions are carried out in a manner that avoids value destruction, minimizes the public costs, and imposes losses on stakeholders in line with the order of priorities applicable in liquidation.

51. **While the Japanese authorities are well aware of the importance of the above listed goals, some further enhancements could be considered.** Earlier triggers for initiating resolution could help maximize the possibility of an orderly resolution, and minimize loss of value and the costs of resolution. A predominately administrative resolution procedure, in which the roles of the FSA/DICJ and the judiciary are rebalanced so that resolution decisions of the FSA/DICJ are subject to ex post judicial review, could, among other things, help facilitate a transfer of insured deposits and good assets to an acquiring bank immediately upon the initiation of resolution proceedings. Such a transaction is often one of the most cost-effective ways to resolve a bank, and one that best preserves going-concern value. While the merits of, and practices with regard to, depositor preference differ across countries, the benefits of depositor preference could also be re-examined in Japan, especially as it relates to carrying out purchase and assumption transactions. Finally, a more forceful procedure to restructure a bank's balance sheet could be put in place that would not require creditors' consent.

52. **An effective resolution regime also needs to extend to systemically-important nonbank financial institutions as well as banks.** The existing resolution framework for securities firms focuses on the protection of investors through mandatory segregation of client assets and access to compensation from the Investor Protection Fund in the event of failure. This is consistent with the fact that traditionally, the primary business of Japanese securities firms has been brokerage rather than investment banking. However, the largest securities firms have recently been expanding into investment banking activities, and have acquired increasing systemic importance. In this context, improvements to the existing framework should be explored to ensure the orderly resolution of systemically-important securities firms.

C. Financial System Safety Net

53. **The coverage of Japan's financial safety net for depositors, investors and insurance policy holders seems broadly appropriate, but there are some gaps.**[18] The DICJ has been provided with an array of resolution tools, but the fact that its board members currently include representatives of banking associations gives the appearance of conflicts of interest. The Life Insurance Policyholders Protection Corporation of Japan (PPCJ) similar powers as the DICJ, but does not have the same authority to use special measures such as recapitalization or temporary nationalization. The Japan Investor Protection Fund (JIPF) has very limited powers, which are

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[18] The DICJ protects insured deposits for amounts up to ¥10 million in principal plus interest thereon payable until the day of the failure, and unlimited coverage for deposits held for payments and settlement purposes, accounting on total for 90.4 percent of insurable deposits in 2010.

mainly directed at the return of client assets rather than any role in resolving the troubled firm as a "going concern." The authorities recognize that the resolution regime for securities firms may need revisiting in light of international experience during the global financial crisis, which demonstrated the importance of providing for the orderly resolution of large securities firms.

V. FINANCIAL POLICES AND GROWTH

54. **A critical challenge facing Japan's financial system relates to its role in supporting long-term growth.** The current configuration of slow growth, demographic shifts, and fiscal imbalances constitutes a complex set of issues for financial reform. In turn, some policies may have limited risk-taking and introduced bottlenecks in credit intermediation, contributing to low growth.

55. **The government still plays a large role in the credit intermediation process** (Figure 16)**.**[19] While the GFI's share of financial system assets has halved in the past decade (falling to 11 percent at end-FY2010, excluding Japan Post Bank and Insurance), they are still active in implementing policy directives (e.g., to support specific sectors or activities) and facilitating credit to firms with otherwise limited access to commercial bank credit. The public sector's indirect role has also expanded in recent years, with in particular the temporary SME Financing Facilitation Act (that encourages financial institutions to make their best effort in rescheduling loan terms when requested), safety-net lending, the expansion of credit guarantee programs to cover loan values in full, and the BOJ's asset purchase program.

56. **Public support measures and the active role of GFIs have helped avoid an excessive tightening of financing conditions and widespread bankruptcies, especially after the recent earthquake** (Figure 17)**.** Surveys suggest that the SME Financing Facilitation Act improved lending and nearly half of SMEs used counter-cyclical guarantees to bolster liquidity on hand, and more than a fifth have extended guarantee terms. These and other measures (as well as, more broadly, reduced leverage in the corporate sector) helped maintain the overall NPL ratio stable below 3 percent during the global financial crisis, despite a very sharp economic shock. They also partly explain the gradual decline in bankruptcies by an average of 12 percent after the peak of Lehman crisis, and the low corporate exit rate (around 4–5 percent). Efforts were also made to support the financing of startup companies.

57. **Several of these policy measures could entail direct fiscal and other costs that might begin to outweigh their benefits:**

- *Fiscal cost*. Direct fiscal cost through repeated capital injections into GFIs has climbed during the global financial crisis. The government may face further contingent liabilities, such as losses from credit guarantees through fund-provision to JFC reinsurance and subsidies for compensation assets in national and local credit guarantee corporations' funds.

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[19] This section uses a wider definition of GFIs than the authorities: it includes the Japan Housing Finance Agency (JHF), Japan Finance Corporation (JFC), Development Bank of Japan (DBJ), Shoko-Chukin bank (SCB). For the purpose of discussing reform agenda, Japan Post Bank and Insurance are also included.

- *Credit risk*. Loan reclassifications associated with SME support measures are likely to weaken banks' incentives to assess credit risk, especially for regional banks and credit cooperatives (for which about 3–6 percent of total credit has been reclassified under the Act, against 1.7 percent for major banks). The BOJ's 2012 FSR indicates that if firms benefiting from relaxed requirements for restructured loans failed to recover, the NPL ratio of banks would rise about 1 percentage point from the current level.

58. **GFI reforms have slowed down in recent years.** Earlier reform initiatives included commitments to full privatization of several GFIs. However, these plans were delayed following the global financial crisis—e.g., regarding the full privatization of Japan Post and the initiation of the full privatization of SCB and DBJ. Going forward, it will be important to reinvigorate GFI reforms, including in order to ensure a level-playing field in the financial system and to contain contingent fiscal liabilities.

59. **Several financial sector support measures could be better targeted or unwound in a timely manner as the recovery takes hold.** Direct financial support such as safety net loans could be targeted more towards start-ups and growth-enhancing sectors. Temporary support measures, notably the SME Financing Facilitation Act should be allowed to expire as scheduled. Special and counter-cyclical credit guarantees (covering full loan values) could be phased out gradually as the recovery takes hold, taking into account the experience in 2000–2001 in withdrawing special guarantees. Gradually reducing the normal coverage ratio to about 60 percent—in line with international averages—would also help promote market discipline.

60. **Market practices on the use of collaterals and access to credit information could be further improved.** Personal guarantees and collaterals in the form of fixed assets, such as real estate and equipment, are usually required for bank lending. Ongoing efforts to establish an electronic registration system on accounts receivables and other current assets could be advanced in order to further promote asset-backed lending. Also, consideration could be given to extending the coverage of credit registries and incorporating consumer data covering household or personal credit information. Finally, measures to address structural weakness in SMEs, including through the establishment of an asset management company (AMC) tailored to SMEs, could help support startups and facilitate exits of nonviable firms.

There would be merit in taking stock of past successes and failures in promoting capital market development in Japan, and addressing potential obstacles systematically. Potential impediments have included structural and cyclical factors, such as a macroeconomic environment characterized by low interest rates and stagnant economic growth. In contrast with U.S. and European markets, multi-year deleveraging has also contributed to limit the growth of credit markets. "Micro-factors" pertaining to the regulatory, legal, and tax environment, also often play important roles in influencing investor preferences and stimulating the development of financial instruments and markets to meet such preferences. Discussions with market participants may help identify some potential reform areas, including with respect to financial taxation (which, like in many other countries, could be streamlined), the legal and regulatory framework (which is sometimes too complex and fragmented, and hampers new product development), and household financial literacy (which should progress hand in hand with the development of new products).

Table 2. Japan FSAP—Medium Priority Recommendations

Recommendations	FSSA/RAM
Objective: Upgrading Systemic Risk Monitoring	
Deepen cross-border risk monitoring arrangements and make active use of memoranda of understanding with foreign supervisory authorities	¶29,36
Consider expanding the dissemination of the encouraged set of FSIs for banks and, as relevant, for the insurance and securities firms sectors	¶27,29
Strengthen the formal basis for data and information sharing among supervisory agencies given confidentiality provisions in different financial sector-related laws	¶31
Objective: Enhancing Effectiveness of Regulation and Quality of Supervision	
Explore mechanisms to strengthen governance arrangements for the selection of auditors and the protection of their independence	¶35,37,39
Strengthen disclosure requirements for nonbanks, including on assumptions used to measure assets/liabilities and on risk exposures including cross holdings, cross-border, and concentration risks	Annexes II–III
Review the prompt corrective action framework for banks and examine the desirability of raising the trigger points for action	¶35
Provide for explicit supervisory approval of major investments by banks or of changes in their controlling ownership	Annex I
Clarify the co-decision process for institutions co-supervised by FSA and a Ministry, and strengthen FSA supervision of government-owned financial institutions	Annex I
Enforce the existing provisions on exposures to related parties more vigorously	Annex I
Enhance the required solvency margin for insurers to account for all material risks	¶11,37, Annex II
Revise corporate governance and suitability requirements to strengthen independent oversight of banks and insurers	Annexes I–II
Revise the valuation method for insurance liabilities to account for risks over the full time horizon of insurance contracts	¶37, Annex II
Complete the development of a methodology for risk-rating insurers and adopt a more formalized system for the internal review of risk assessments	¶37, Annex II
Establish more comprehensive assessments of individual securities firms (risk scoring or profiling) to guide supervisory intensity and on-site inspections	¶41,42
Further develop and clarify cooperation arrangements among domestic authorities with respect to FMIs in normal circumstances and in times of stress	¶44
Further improve clarity of assessments against the CPSS-IOSCO standards	¶44
Strengthen pension supervision in cooperation with other financial supervisors on risks that could affect both the pension system and financial stability more broadly	¶38,39
Objective: Bolstering Crisis Management	
Refine further the existing bank resolution framework in order minimize its costs (e.g., through earlier triggers and speedier administrative procedures)	¶48-52
Rebalance the roles of the FSA/DICJ and the judiciary so that a range of resolution decisions may be implemented by the FSA/DICJ subject to ex post judicial review	¶50-51
Amend the governance structure of the DIC to make it more independent and to place greater emphasis on minimizing resolution costs	¶50-52
Explore mechanisms to strengthen custody arrangements for collective investment schemes	Annex III
Investigate the need to implement segregation and portability of customers' positions and collateral in JGBCC	¶44
Consider including in the licensing criteria for exchanges a detailed assessment of the robustness of IT systems by independent experts	Annex III

Objective: Supporting Private Sector Growth	
Advance the momentum for full privatization of GFIs (including Japan Post); strengthen GFI supervision, including inspection frequency	¶58
Strengthen credit discipline by introducing a schedule for gradually reducing the coverage of credit guarantees, in line with international norms	¶59
Encourage SME restructuring through wider use of debt-equity swaps and more flexibility in the release of personal guarantees in voluntary workouts and debtor-in-possession bankruptcies procedures	¶60
Encourage further market-based financing (including venture capital) to improve risk assessments and access to capital by start-up companies	¶60-61
Strengthen credit infrastructure by encouraging broader use of collaterals and asset-based lending, and develop a wider coverage and information sharing on current credit registries	¶60-61
Consider further improvements to the framework for new products and capital markets in order to support growth-enhancing sectors	¶61

Notes: These are *Medium Priority* recommendations to be implemented before the next FSAP update. This should be read along with Table 1 on the High Priority recommendations.

Table 3. Japan FSAP—Risk Assessment Matrix

<table>
<tr><th colspan="3">Overall Level of Concern</th></tr>
<tr><th>Main Sources of Risks</th><th>Likelihood
(over next one to three years)</th><th>Impact on Macrofinancial Stability</th></tr>
<tr><td>1. Surge in market yields</td><td>Low
▪ Despite high public debt levels, yields are currently low for various reasons, including safe haven inflows, ample domestic private savings, limited foreign JGB holdings, and room to raise taxes.
▪ However, going forward the risks of a yield surge could increase owing to several factors, including:
o Delays in implementing credible fiscal consolidation plan and continued slow economic growth that undermine confidence in fiscal sustainability.
o A reversal of safe haven inflows once global conditions improve and/or renewed risk appetite by Japanese investors as the domestic or global economies recover, leading to reduced demand for JGBs.
o Demographic changes are expected to reduce private saving, making government financing more dependent on foreign investors at the margin.</td><td>High
▪ Stress tests show a modest effect of a moderate 100 bps shock for banks and insurers, due to solid capital buffers and unrealized gains on JGB holdings.
▪ However, the negative impact from sovereign-financial-real economic linkages and feedback effects could be more severe and pervasive:
o Larger interest rate shocks could result in disproportionally severe impact, for instance through non-linear effects on indirect credit costs, fiscal debt dynamics, and market confidence.
o The impact would be even more severe if it were coupled with less favorable macroeconomic circumstances, e.g., in the context of a protracted growth slowdown.</td></tr>
<tr><td>2. Protracted growth slowdown and deflationary pressures</td><td>Medium
▪ Medium-term economic growth could weaken relative to baseline projections due to several factors:
o Prolonged impact of earthquake-related factors (e.g., energy shortages) may exacerbate “hollowing out” of industrial sectors.
o Continued global economic downturn and sharp and sustained yen appreciation due to safe haven inflows.
o Demographic pressures reducing potential growth rate through combination of reduced labor input and negative wealth effects from falling asset prices.</td><td>Medium
▪ Bank stress test shows that this is one of the key risks for smaller regional banks, due to its impact on credit quality. However, the medium-term nature of the risk provides time to take corrective actions. Also, only a small part of the banking system would undergo severe distress. Larger banks appear better placed, because of their higher earnings and their decision to curb dividend payments to prepare for Basel III capital requirements.
▪ Financial institutions' efforts to seek profits abroad may pose new risks (e.g., due to higher funding costs relative to global competitors and to the taking on of unfamiliar risk exposures).</td></tr>
</table>

	Medium	*Medium*
3.Severe global double dip, reducing Japan's GDP growth	▪ Sovereign distress in Europe and the U.S. may trigger a global double-dip recession, possibly combined with monetary tightening in emerging market (EM) economies. ▪ This may in turn spill over to global financial institutions and/or increase risk aversion, depress asset prices globally and domestically, and tighten global funding conditions. ▪ Such shocks (financial and real) could disrupt Japan's recovery, especially given the limited room for fiscal support.	▪ Global exposures of Japanese financial institutions are, at this moment, small and in less distressed countries (sovereign securities in U.S., Germany, U.K., and France), potentially limiting direct losses. Exposures to from Asia, including China, are also still limited. ▪ Stress tests indicate that the direct impact from overseas exposures (securities and loans, including those to Asia) is likely to be manageable. The main vulnerability stems from the indirect impact through weaker domestic economic growth (raising credit costs from domestic exposures) and domestic asset prices. ▪ Banks appear able to withstand renewed USD funding pressures, including disruption in cross-currency swap markets, but higher funding cost could weigh on their profitability.
	Medium (nonfinancial), Low (financial)	*Medium*
4. Distress of large financial or nonfinancial institutions	▪ Major corporate bankruptcies could materialize if the economy is hit by a severe downturn. ▪ Stress tests and risk profile analysis indicate that large Japanese financial institutions are well capitalized and likely to withstand major shocks.	▪ The BCP assessment pointed out major deficiencies with Japan's regulation on large exposures (Annex I), which raise concerns regarding the potential implications of concentrated credit risk exposures.

Table 4. Japan FSAP—Selected Economic Indicators, 2007–2013

Nominal GDP: US$5,867 billion (2011)
Population: 127.8 million (2011)
GDP per capita: US$45,900 (2011)
Quota: SDR 15,628.5 million

						Projected	
	2007	2008	2009	2010	2011	2012	2013
Growth (percent change) 1/							
Real GDP	2.2	-1.0	-5.5	4.4	-0.7	2.4	1.5
Domestic demand	1.1	-1.3	-4.0	2.7	0.1	3.0	1.5
Private consumption	0.9	-0.9	-0.7	2.6	0.1	2.7	1.7
Residential investment	-9.8	-6.6	-16.6	-4.2	5.4	0.7	1.5
Business investment	4.9	-2.6	-14.3	0.5	1.1	3.2	4.8
Government consumption	1.1	-0.1	2.3	2.1	1.9	2.0	-0.5
Public investment	-5.9	-7.4	7.0	0.4	-3.6	6.3	-12.5
Stockbuilding 2/	0.3	0.2	-1.6	0.8	-0.5	0.2	0.5
Net exports 2/	1.1	0.2	-1.5	1.7	-0.8	-0.5	0.0
Exports of goods and services	8.7	1.4	-24.2	24.2	-0.1	3.1	5.0
Imports of goods and services	2.3	0.3	-15.7	11.1	5.9	7.4	5.7
Inflation (annual average)							
CPI	0.1	1.4	-1.3	-0.7	-0.3	0.2	0.0
GDP deflator	-0.9	-1.3	-0.5	-2.1	-2.1	-0.1	-0.1
Unemployment rate (annual average)	3.8	4.0	5.1	5.1	4.6	4.5	4.4
Government (percent of GDP)							
General government							
Revenue	31.2	31.6	29.6	29.6	30.6	30.9	31.4
Expenditure	33.3	35.7	40.0	39.0	40.7	40.9	39.9
Balance	-2.1	-4.1	-10.4	-9.4	-10.1	-9.9	-8.6
Primary Balance	-2.1	-3.8	-9.9	-8.7	-9.2	-8.8	-7.4
Public Debt, gross	183.0	191.8	210.2	215.3	229.9	234.5	240.0
Money and credit (percent change, end-period)							
Base money	0.4	1.8	5.2	7.0	13.5	...	...
M2 (period average)	2.1	1.8	3.1	2.3	3.2	...	...
Domestic credit	-2.3	1.6	0.4	1.3	0.8	...	...
Bank lending	0.7	4.6	-0.9	-1.8	0.7	...	...
Interest rate							
Overnight call rate, uncollateralized (end-period)	0.46	0.10	0.09	0.1	0.1	...	...
Three-month CD rate (annual average)	0.51	0.51	0.33	0.3	0.3	...	...
Official discount rate (end-period)	0.75	0.30	0.30	0.3	0.3	...	...
Balance of payments (in billions of US$)							
Current account balance	212.2	159.8	146.6	204.0	119.2	130.3	167.0
Percent of GDP	4.9	3.3	2.9	3.7	2.0	2.2	2.7
Trade balance	105.1	38.4	43.4	91.0	-20.5	-10.2	35.1
Percent of GDP	2.4	0.8	0.9	1.7	-0.3	-0.2	0.6
Exports of goods, f.o.b.	678.4	746.5	545.3	730.1	787.2	807.4	830.0
Imports of goods, f.o.b.	573.3	708.0	501.9	639.1	807.7	817.6	795.0
Oil imports (trade basis)	130.1	190.6	99.9	134.3	185.0	227.8	233.7
FDI, net (percent of GDP)	-1.2	-2.2	-1.2	-1.1	-2.0	-1.3	-1.3
Terms of trade (percent change)	-2.1	-9.6	19.5	-3.3	-7.9	3.9	7.0
Change in reserves	36.5	30.8	27.3	44.3	177.0	...	...
Total reserves minus gold (in billions of US$)	952.8	1009.4	1022.2	1096.2	1258.2	...	...
Exchange rates (annual average)							
Yen/dollar rate	117.8	103.4	93.6	87.8	79.8	...	...
Yen/euro rate	161.4	152.1	130.3	116.5	111.0	...	...
Real effective exchange rate 3/	83.6	93.7	110.5	118.2	126.2	...	...
Real effective exchange rate (CPI-based)	83.2	90.1	101.5	102.7	104.4	...	...

Sources: Global Insight, Nomura database; IMF, Competitiveness Indicators System; and Fund staff estimates and projections, as of February 21, 2012.

1/ Annual growth rates and contributions are calculated from seasonally adjusted data.

2/ Contribution to GDP growth.

3/ Based on normalized unit labor costs; 2000=100.

Table 5. Japan FSAP—Key Policy Measures by the FSA During the Global Financial Crisis and After the Great East Japan Earthquake

Key policy measures	Status
Stabilizing equity markets	
Temporarily relaxed market restrictions on listed companies' purchases of own stocks.	Active until end-Oct 2012
Strengthened disclosure and restrictions on short-selling.	Active until end-Oct 2012
Allowed banks' shareholding to exceed their Tier 1 capital with FSA approval.	Active
Resumed activities of the Banks' Shareholdings Purchase Corporation (up to ¥20 trillion).	Active until end-Mar 2017
Reactivating public capital injection schemes to depository institutions	
Ensured smooth financing by boosting capital base of financial institutions.	Active until end-Mar 2017
Expanded the size of public funds available for capital injection.	Implemented for FY2009
Relaxed conditions of capital injection through Act amendments after the Great East Japan Earthquake.	Active until end-Mar 2017
Enhancing bank lending to SMEs	
Encouraged financial institutions on their efforts in smoothing SME financing.	Implemented
Introduced and extended the SME Financing Facilitation Act to allow smooth SME financing by financial institutions.	Active until end-Mar 2013
Temporarily relaxing capital adequacy requirements for banks	
Valuation losses from bonds without credit risks (internationally active banks) and securities (domestically operating banks) are not required in capital adequacy calculations.	Implemented
Improving transparency and reliability of credit rating	
Introduced new registration requirements for credit rating agencies.	Implemented

Sources: FSA, OECD (2009).

Table 6. Japan FSAP—Key Policy Measures by the Bank of Japan During the Global Financial Crisis and After the Great East Japan Earthquake

Date	Policy Measures
Sep-08	Introduction of USD funds-supplying operations.
Oct-08	Extension of the security lending facility; suspension of selling stocks held by the BOJ. Expansion of the JGB purchases with repo agreements.
Oct-08	Introduction of the complementary deposit facility.
Dec-08	Introduction of special funds-supplying operations to facilitate corporate financing.
Dec-08 to Jan 09	Introduction of outright purchases of JGBs and CP, and corporate bonds.
Feb-09	Resumption of stock purchases held by financial institutions.
Mar-09	Provision of subordinated loans to banks.
Dec-09	Enhancement of Easy Monetary Conditions. Introduction of fixed rate funds supplying operations against pooled collateral.
May-10	Reestablishment of U.S. dollar funds-supplying operations.
Jun-10	Funds provisioning measure to support strengthening the foundations for economic growth.
Aug-10	Enhancement of Easy Monetary Conditions. Expansion of fixed rate operation (with a new six month term and expand the size).
Oct-10	Comprehensive Monetary Easing. Virtually zero interest rate policy (VZIRP), clarification of the policy time horizon on medium-term price stability and introduction of asset purchase program.
Apr-11	Provision of funds-supplying operation to support financial institutions in the disaster areas.
Jun-11	Special rules for equity investments and asset-based lending to enhance fund-provisioning measure.

Source: BOJ.

1/ Additional measures involves the relaxation of collateral requirements to include asset-backed CPs, coverage of corporate debts, debt issued by real estate investment corporations, government guaranteed CP, loans on deeds to the public sector, selected foreign government bonds, and standards of corporate debt in disaster areas such as eligible collaterals.

Table 7. Japan FSAP— Banking Sector Soundness: All Banks, 2001–2011

	2001 Mar.	2002 Mar.	2003 Mar	2004 Mar	2005 Mar	2006 Mar	2007 Mar	2008 Mar	2009 Mar	2010 Mar	2011 Mar	2011 Sep
	(In percent)											
Capital adequacy												
Total capital ratio 2/	10.5	10.5	10.9	11.2	11.6	11.5	12.6	12.0	12.6	13.6	14.1	N/A
NPL net of provisions/capital 2/	41	51	43	33	24	18	17	16	16	16	16	N/A
Asset quality												
NPL ratio 2/	6.7	8.7	7.8	6.3	4.6	3.5	3.1	2.9	2.8	2.9	2.9	N/A
Sectoral distribution of loans 3/												
Residents	…	93	94	95	94	94	93	93	94	95	94	94
Deposit-takers	…	6	7	7	7	7	8	7	7	8	8	8
Central bank	…	0	0	0	0	0	0	0	0	0	0	0
Other financial corporations	…	12	13	14	13	12	12	12	11	11	10	11
General government	…	4	4	5	6	6	6	6	7	7	8	8
Nonfinancial corporations	…	41	38	35	34	33	32	33	36	34	33	33
Other domestic sectors	…	31	32	33	35	35	34	34	34	35	35	34
Nonresidents	…	7	6	5	6	6	7	7	6	5	6	6
Earnings and profitability												
ROA	0.0	-0.6	-0.6	-0.1	0.2	0.5	0.4	0.2	-0.2	0.2	0.3	0.3
ROE	-0.8	-12.1	-13.9	-2.1	4.6	13.1	10.1	5.8	-5.2	5.0	6.3	6.7
Interest margin	1.8	1.8	1.9	1.9	1.8	1.8	1.7	1.7	1.7	1.6	1.6	1.5
NII/gross income	73	103	113	76	77	70	70	75	97	76	73	72
Noninterest expenses/gross income	59	80	90	61	62	56	59	64	84	65	65	65
Personnel cost/operating cost	50	49	49	49	46	46	44	43	45	48	48	…
Liquidity												
Liquid assets/total assets	13	14	18	19	20	18	16	16	16	20	21	22
Liquid assets/short-term liabilities	44	37	40	44	44	39	36	36	38	47	48	50
Loan/deposit	71	64	64	66	66	63	64	66	66	69	69	70
Other												
Capital/total assets 4/	4.6	4.2	4.3	4.2	4.4	4.3	4.6	4.2	3.6	4.4	4.7	4.7
RWA/total assets	44	40	39	38	38	37	37	35	29	32	33	N/A
Equity exposures/Capital 4/	105	100	77	83	75	79	75	65	56	49	42	38
Gross derivative asset/capital	35	36	44	34	29	28	28	59	95	61	53	60
Gross derivative liability/capital	33	34	41	30	26	28	28	53	88	56	49	54
Indicators for city and regional (tier 1 and 2) banks												
Total capital ratio	11.1	10.5	9.5	10.5	11.1	11.6	12.2	11.6	11.8	14.1	14.9	15.4
Tier 1 ratio	7.0	6.4	5.8	6.5	7.0	7.3	8.0	8.1	8.1	10.5	11.5	12.0
NPL net of provisions/capital 2/	34	43	35	27	18	13	12	11	12	12	12	11.6
NPL ratio 2/	6.3	8.4	7.4	5.8	4	2.9	2.5	2.4	2.4	2.5	2.4	2.4
ROA	-0.1	-0.6	-0.6	-0.1	0.2	0.5	0.4	0.3	-0.2	0.2	0.3	0.3
ROE	-1.2	-13.9	-16.4	-3.0	4.9	15.1	11.4	6.7	-5.7	5.5	6.9	7.3
Equity exposures/capital 4/	121	117	93	99	88	89	85	74	64	55	48	42.7

Sources: Japanese authorities and IMF staff calculations.

1/ Including city banks, regional banks and shinkin banks (consolidated basis for banking groups).

2/ Aggregated with the unconsolidated basis data.

3/ Include the figures of Credit cooperatives and National Federation.

4/ Capital defined as net asset on the balance sheet.

Table 8. Japan FSAP—Soundness of Banking Sector and Selected Balance Sheet Components, 2001–2011

	2001 March						2011 March						2011 September					
	All	City + region	City	Tier 1 retion	Tier 2 region	Shinkin	All	City + region	City	Tier 1 retion	Tier 2 region	Shinkin	All	City + region	City	Tier 1 retion	Tier 2 region	Shinkin
	(In percent, unless otherwise mentioned)																	
Capital adequacy																		
Total capital ratio 1/	10.5	11.1	11.6	10.1	8.1	10.5	14.1	14.9	17.5	12.0	10.3	14.0	N/A	15.4	18.2	12.4	10.6	N/A
Tier 1 ratio 1/ 2/	…	7.0	6.7	7.5	6.4	…	…	11.5	12.9	9.8	8.0	…	…	12.0	13.6	10.3	8.3	…
NPL net of provisions/capital 1/	41	34	14	10	4	7	16	12	4	5	2	4	N/A	12	4	5	2	N/A
Asset quality																		
NPL ratio 1/	6.7	6.3	8.7	7.0	8.2	9.6	2.9	2.4	1.8	3.1	3.7	6.0	N/A	2.4	1.9	3.1	3.9	N/A
Earnings and profitability																		
ROA	0.0	-0.1	0.0	0.0	-0.9	0.1	0.3	0.3	0.4	0.2	0.1	0.2	0.3	0.3	0.4	0.3	0.2	N/A
ROE	-0.8	-1.2	0.9	-0.6	-25.5	1.7	6.3	6.9	8.8	4.6	2.6	3.0	6.7	7.3	8.4	5.8	5.0	N/A
Interest rate margin	1.8	1.7	1.5	2.1	2.4	2.5	1.6	1.5	1.3	1.7	1.9	2.1	1.5	1.5	1.2	1.6	1.8	N/A
NII/gross income	73	71	61	84	91	90	73	70	61	82	86	89	72	69	59	82	85	N/A
Trading income/total income	…	15	17	8	5	…	…	9	11	5	7	…	…	…	…	…	…	N/A
Noninterest expenses/gross income	59	57	50	66	74	73	65	63	58	68	75	76	65	63	58	69	76	N/A
Personnel cost/operating cost	50	47	42	53	55	61	48	45	39	50	52	59	…	…	…	…	…	N/A
Liquidity																		
Liquid assets/total assets	13	14	14	13	13	7	21	23	27	17	15	9	22	24	27	17	16	N/A
Liquid assets/short-term liabilities	44	45	47	40	51	34	48	50	59	35	38	29	50	52	61	36	41	N/A
Customer loans/deposits	71	64	52	84	90	121	69	61	57	63	75	126	70	62	59	64	75	N/A
Other																		
Capital/total assets 2/	4.6	4.7	4.2	5.2	4.4	4.6	4.7	4.7	4.4	5.1	4.4	4.6	4.7	4.7	4.4	5.1	4.4	N/A
RWA/total assets	44	42	36	51	54	44	33	32	25	43	43	33	N/A	31	24	41	42	N/A
Equity exposures/Capital 2/	105	121	153	58	44	11	42	48	56	34	28	10	38	43	52	30	25	N/A
Gross derivative asset/capital	35	41	62	0	0	0	53	61	97	5	2	0	60	70	110	6	2	N/A
Gross derivative liability/capital	33	39	57	2	2	0	49	57	89	5	2	0	54	63	100	5	2	N/A
Selected components of balance sheet, in percent of total assets 1/																		
Assets																		
Cash	4	5	6	4	3	1	5	5	6	4	4	1	…	…	…	…	…	…
Money market 4/	4	2	2	4	4	17	5	3	4	1	2	21	…	…	…	…	…	…
Securities	22	22	21	22	17	19	30	31	33	27	23	27	…	…	…	…	…	…
JGB+ local gov.bonds	10	10	10	11	8	6	18	19	23	16	13	12	…	…	…	…	…	…
Corporate bond	3	2	1	5	5	8	5	4	2	6	5	11	…	…	…	…	…	…
Equities	5	6	6	3	2	1	2	2	2	2	1	0	…	…	…	…	…	…
Others (incl. foreign)	4	4	3	3	2	5	5	5	6	3	3	4	…	…	…	…	…	…
Loans	59	59	56	66	73	58	53	53	45	65	70	49	…	…	…	…	…	…
Liabilities	0						0											
Customer deposit	67	64	56	87	91	91	75	72	63	88	91	93	…	…	…	…	…	…
Money market 4/	13	15	19	2	1	0	9	10	14	3	2	0	…	…	…	…	…	…
Loans and bonds	3	3	4	1	1	0	6	6	9	2	1	0	…	…	…	…	…	…
Net asset																		
Shareholder's equity 5/	4.2	4.1	3.9	4.3	3.9	5.3	4.5	4.4	4.1	4.6	4.2	5.1	…	…	…	…	…	…
Total assets in trillions of yen	918	804	427	206	61	114	970	841	455	243	63	129	…	…	…	…	…	…
share in the sample	100	88	47	22	7	12	100	87	47	25	7	13	…	…	…	…	…	…

Sources: Japanese authorities, Japanese Bankers Association, CEIC, IMF staff calculations.
1/ Aggregated with the unconsolidated basis data. City + regional bank columns include trust bank data
2/ Capital defined as net asset on the balance sheet.

Table 9. Japan FSAP—Stress Test Matrix (STeM) for the Banking Sector: Solvency Risk

<table>
<tr><th rowspan="2">Domain</th><th colspan="2">Assumptions</th></tr>
<tr><th>Bottom-Up by Banks</th><th>Top-Down by the BOJ</th></tr>
<tr><td>Institutions included</td><td>• Three mega-banks (Mizuho financial group, Mitsubishi UFJ financial group, Sumitomo Mitsui financial group).</td><td>• All major and regional banks (111), 16 internationally active banks (56 percent), 95 domestically-active banks (44. percent). 11 major banks (63 percent); 63 tier 1 regional banks (30 percent), 37 tier 2 regional banks (7 percent). Share in system by assets in parentheses.</td></tr>
<tr><td>Market share</td><td>• 53 percent of commercial banks
• 41 percent of the narrow system and 34 percent of the broad system by assets. 1/ 2/</td><td>• Almost 100 percent of commercial banks
• 77 percent of the narrow system and 64 percent of the broad system by assets. 1/</td></tr>
<tr><td>Data and baseline date</td><td>• Banks internal data as of September 2011
• Financial group consolidated, including nonbank subsidiaries.</td><td>• Bank-by-bank public data and BOJ's internal data as of September 2011
• Bank consolidated, excluding nonbank subsidiaries of a financial group.</td></tr>
<tr><td>Methodology</td><td>• Banks' internal models.</td><td>• BOJ's internal model (built on those used for FSR) modified to include additional exposures.</td></tr>
<tr><td>Stress test horizon</td><td>• Two years (March 2013 and 2014).</td><td>• Five years up to March 2017 (two years for global double-dip +100 bps market yield surge scenario and instantaneous for sensitivity test).</td></tr>
<tr><td rowspan="2">Shocks</td><td colspan="2"><u>Scenario analysis (all are macro scenarios, stressing asset prices and macroeconomic variables, same as the insurance sector scenarios)</u>
• Baseline: September 2011 WEO, real GDP growth rate for the first two years is 4.2 ppt.
• Global double-dip (mild/severe): For the first two years, two-year cumulative GDP growth rate shock of 1 standard deviation (-4½ ppts) for mild scenario and two standard deviation (-9 ppts) for severe scenario based on 1980-2010 data. Differentiated yield shocks on major European sovereigns.
• Protracted slowdown: Real GDP deviating from baseline by 6¾ ppt over five years (about worst 10 percentile shock based on five year cumulative growth rate between 1980 and 2010).
• Global double-dip with surge in market yield: 100 bps (parallel shift) shock (historical record shock since late 1990s) on market yields is added to global double dip mild scenario.</td></tr>
<tr><td></td><td><u>Sensitivity Analysis (Single factor)</u>
• Market yield surge: instantaneous impact of a larger shock.</td></tr>
<tr><td>Risks/factors assessed</td><td>• Credit risk from domestic corporate and retail (housing and consumer loans), and overseas loan exposures.
• Market risks with domestic securities (equity, bonds, incl. own sovereign bonds) in trading, and AFS accounts (excluding HTM (6 percent of total exposures)).
• Market risks with overseas securities in trading, and AFS accounts (excl. HTM (6 percent of total exposures)).
• Exchange rate.</td><td>• Credit risk with domestic corporate and housing, and overseas loans.
• Market risks with domestic securities (equity, bonds, incl. own sovereign bonds) in trading, AFS, and HTM accounts.</td></tr>
<tr><td>Calibration of risk parameters</td><td>• Domestic/overseas credit risk is estimated based on internal rating transition model (linked to macroeconomic variables). Point in time probability of default (PD) and loss-given default (LGD) are calculated to estimate expected loss and unexpected loss for credit risk.</td><td>• Domestic corporate credit cost is estimated based on rating (regulatory loan classification categories) transition model (linked to GDP) Quantile regression model (with 90 percentile estimates) is used for estimation to capture tail-end sensitivity.</td></tr>
</table>

	• **Equity risk** is estimated based on individual stock basis. • **Interest risk** is estimated using Basis Point Value and interest rate scenario by region/countries.	• **Credit cost from housing loan**. PD is projected based on empirical relationship between PD and debt service (linked to disposable income projection). LGD = max loan-to-value ratio (reduced to account for property price declines)-100, 0). Once a loan becomes default, 100 percent provisions are set aside for covering LGD. • **Overseas loan credit cost** is estimated by linking credit cost ratio to global GDP growth rate.
Bank Behavior	• Constant exposures and no management actions (change in RWA in line with PD and LGD changes of existing portfolio). • Assuming fixed dividend amount (across scenarios in line with recent dividend policy of each bank.	• Constant RWA and funding. • Latest actual data for dividend payout ratio and tax rate (bank by bank). • Interest rate passes through upon maturity following bank's historical patterns except for global double-dip + market yield surge scenario, where following is assumed: 100 percent for term deposit, 74 (68) percent for time deposit, 23 (17) percent for loans of major (regional) banks.
Assessment criteria - Hurdle rate	• Basel III ratios including conservation buffer but excluding SIFI charges. Core Tier 1 (Tier 1) requirement without conservation buffer will increase from 3.5 (4.5) percent in 2011 to 4.5 (6) percent in 2017. Conservation buffer will be added by 0.625 every year starting in 2016 for a total of 2.5 by 2019.	• For internationally active banks: same as bottom-up. • For domestically-active banks. Basel II total capital ratio of 4 percent (current regulation) .
- Capital definition	• Basel III capital definitions estimated by banks as per gradual phase in and out schedule following draft national regulation (February 2012).	• Basel III capital definition estimated by BOJ for all banks for impact analysis (Figure 9, 10, 12, and 13). Gradual phase in following draft national regulation (February 2012). • Basel II capital definition for domestically-active banks when judging pass/fail (Figure 11).
-RWA	• September 2011 RWAs incorporates Basel 2.5 and Basel III factors are gradually phased in following draft national regulation (February 2012).	• Basel II (actual as of September 2011) RWA.
Reporting format to the FSAP team	• Aggregate data.	• Aggregate for the total sector and by groups (major, Tier 1 regional, and Tier 2 regional). • Distribution of capital ratios by number and by share in the sector/subgroups by assets.

1/ The narrow banking system includes city, trust, regional (tier 1 and 2), foreign, bridge and internet banks, Shinkin bank and credit cooperatives. The broader system additionally includes J-Post and Norinchukin bank.
2/ The relative size of the bottom-up sample are measured by the size of their banking entities in each financial group (overlapping with top-down sample). However, the actual assets covered by bottom-up exercises are larger as financial group consolidation includes exposures held by nonbank entities in a group (including securities firms and consumer finance companies). Assets (RWA) of three mega banks covered in top-down amount to 88 (96) percent of the bottom-up data for the three mega financial groups.

Table 10. Japan FSAP—Stress Test Matrix (STeM) for the Banking Sector: Liquidity Risk

<table>
<tr><th rowspan="2">Domain</th><th colspan="2">Assumptions</th></tr>
<tr><th>Bottom-Up by Banks</th><th>Top-Down by BOJ</th></tr>
<tr><td>Institutions included</td><td>• Three mega-banks (Mizuho Corporate Bank, Bank of Tokyo Mitsubishi UFJ, Sumitomo Mitsui Bank).</td><td>• All major and regional banks (111) 11 major banks (63 percent); 63 tier 1 regional banks (30 percent), 37 tier 2 regional banks (7 percent).</td></tr>
<tr><td>Market share</td><td>• About 50 percent of top-down sample, (near 40 percent of the narrow system and 30 percent of the broad system) by assets. 1/</td><td>• 77 percent of the narrow system and 62 percent of the broad system by assets.1/</td></tr>
<tr><td>Data and baseline date</td><td>• Banks internal, data as of September 2011.
• Bank consolidated.</td><td>• BOJ data as of September 2011.
• Bank consolidated.</td></tr>
<tr><td>Risk factors</td><td>• US$ funding (withdrawal and market freeze) risk (uniform shock across banks, independent of solvency tests).
• Focus on access to funding (quantity), rather than funding cost.</td><td>• ¥ funding risk (uniform shock across banks, independent of solvency tests).
• Focus on access to funding, rather than funding cost.</td></tr>
<tr><td>Test horizon</td><td>• One week and one month.</td><td>• Three month.</td></tr>
<tr><td>Methodology</td><td>• Cash flow based analysis

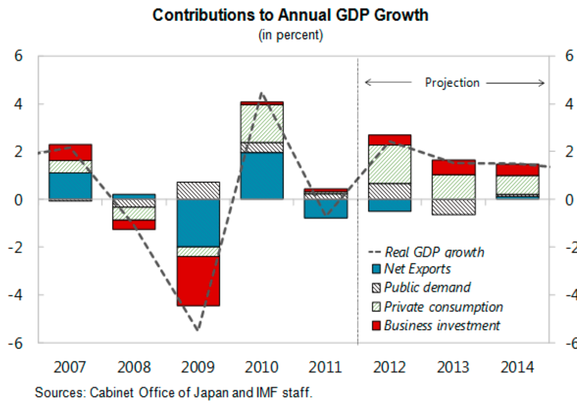
• Shocks on liability side: withdrawal rates are applied for interbank funding (including commercial paper, certificate of deposits, deposits by banks and central banks), deposits by nonbanks, repos (using United States Treasuries, T-bonds, and government guaranteed agency bonds only), yen-US$ cross-currency funding, and committed credit lines.
• Mitigating actions to generate cash: banks can raise additional liquidity by selling unencumbered securities (with haircut according Fed requirements), using Fed excess reserve deposits, Fed Discount Window (amount is determined by the value of unremunerated eligible collateral banks hold) etc.US$ funding through FX spot purchases and BOJ's US$ funds supplying operations are excluded from additional funding tools.</td><td>• Liquidity ratio based analysis.
• Compute post stress liquid asset ratio when (i) wholesale markets freeze; and (ii) deposit are withdrawn.
• No haircut is applied for the liquidity value of JGB, which constitutes a large share of liquid asset.</td></tr>
<tr><td>Shocks</td><td>• Stress scenario: withdrawal upon maturity— interbank funding (30 percent), deposit (20 percent), repos (5 percent). No additional cross-currency funding using swaps beyond the amount they already have. 100 percent of committed asset back commercial paper and 5 percent of other committed credit facilities are incorporated as cash outflows.
• Extreme stress scenario: withdrawal upon maturity— interbank funding (40 percent), deposit (20 percent), repos (5 percent). Cross-currency funding using swaps is reduced by 20 percent upon maturity. 100 percent of committed asset back commercial paper and 5 percent of other committed credit facilities are incorporated as cash outflows.</td><td>• Market freeze scenario: wholesale funding market completely freezes for three months (Liquid asset ratio with 0 runoff rate for deposits).
• Deposit withdrawal scenario: in addition to wholesale market freeze, maturing and liquid deposits will be withdrawn by 5 and 10 percent (runoff rate). The withdrawal rate is severer than historical experiences.</td></tr>
<tr><td>Assessment criteria</td><td>• A bank is considered liquid if it can maintain positive net cash inflow position after taking mitigating actions to generate liquidity.</td><td>• Liquid asset ratio of 100 percent (analytical, not regulatory, criteria).
• Liquid asset ratio = (deposits with the BOJ+cash+JGB)/(net market funding matured within three months+runoff of deposits with a renewal time within three months).</td></tr>
<tr><td colspan="3">1/ The narrow banking system includes as city, trust, regional (tier 1 and 2), foreign, bridge and internet banks, Shinkin bank and credit cooperatives. The broader system additionally includes J-Post bank and Norinchukin bank.</td></tr>
</table>

Table 11. Japan FSAP—Stress Test Matrix (STeM) for the Insurance Sector

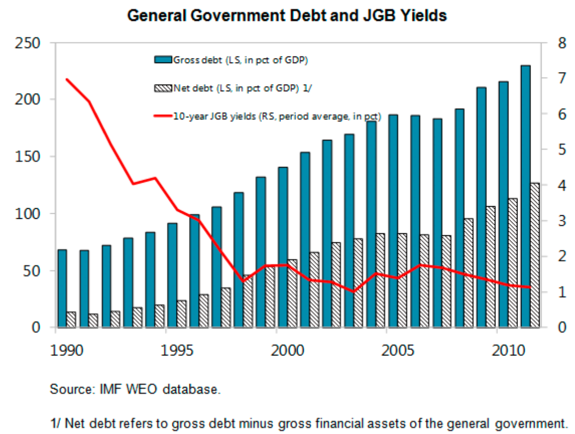
Domain	Bottom-up Stress Test	
	Life insurance companies	**Nonlife insurance companies**
Institutions included	• Four major life insurance companies: Meiji Yasuda life insurance, Dai-ichi life insurance, Sumitomo life insurance, and Nippon life insurance.	• Five major nonlife insurance companies: Tokio Marine & Nichido Fire Insurance Sompo Japan Insurance, Nipponkoa Insurance, Mitsui Sumitomo Insurance, Aioi Nissay Dowa Insurance.
Market share	• 43 percent as of FY2010 by life premium.	• 82 percent as of FY2010 by nonlife premium.
Balance sheet data cutoff date	• Data as of end-September 2011 for all analysis, except for life insurer's interest rate sensitivity analysis using March 2010 data.	
Methodology	• Life insurance internal models.	• Nonlife insurance internal models.
Stress test horizon	• Two years (one-time, cumulative shock applied).	
Shocks	*Scenario analysis (same as the bank solvency test, using accounting based valuation)* • **Baseline:** September 2011 WEO, real GDP growth rate for the first two years is 4.2 ppt. • **Global double-dip (mild/severe):** For the first two years, two-year cumulative GDP growth rate shock of 1 standard deviation (-4½ ppt) for mild and 2 standard deviation (-9 ppts) for severe scenario based on 1980–2010 data. Differentiated yield shocks on major European sovereigns. • **Protracted slowdown:** Real GDP deviating from baseline by 6¾ ppt over five years (about worst 10 percentile shock based on five year cumulative growth rate between 1980 and 2010). • **Global double-dip with surge in market yield:** 100 bps (parallel shift) shock (historical record shock since late 1990s) on market yields is added to global double dip mild scenario. *Sensitivity (single factor) analysis* • **Interest rate sensitivity analysis:** provided an indication of the potential effects of the stresses if an economic-based valuation was adopted. Shocks correspond to the two-year cumulative change in each scenario.	
	• A pandemic event causing a negative deviation of mortality for life insurance sector. The shock on mortality rate is set at 0.13 percent provided by the authorities based on the study by the Ministry of Labor, Health and Welfare.	• A moderate reinsurance failure on nonlife insurance (set as 80–90 percent failures). • No further catastrophic shock is considered given the nonlife insurance sector faced an actual shock from the Great East Japan Earthquake.
Risks/factors assessed	• **Market risk:** Losses/gains from securities holdings, including JGBs, domestic and foreign equities, and holdings of corporate and local government bonds. Securities investments such as equities, real estate, and fixed income assets in AFS account are subject to shocks in the stress test, but debt securities earmarked for policy reserves and held to maturity (about two-thirds of bond holdings) is not subject to a markdown under the accounting basis. • **Interest rate risk:** Interest rate sensitivity provided an indication of the potential effects of the stresses if an economic-based valuation was adopted including JGBs in HTM account and account earmarked for policy reserves amounting to about 2/3 of JGBs. • **Pandemic shocks and reinsurance failures:** Assess the impact of the pandemic shock and reinsurance failures on solvency margin, various reserves position, and change in net assets.	
Reporting basis of results	• All results were reported using the accounting basis, except for the results on interest rate sensitivity that provided an indication of the potential impact of an economic-based valuation. • Results were reported to FSAP team on an aggregate basis.	
Assessment criteria	• Although the stress test did not provide solvency ratios, the impact on solvency was assessed using sector (separate for life and nonlife) aggregate solvency margin (including breakdown); and net assets (including unrealized gains and losses).	

Sources: IMF and FSA.

Figure 1. Japan FSAP—Macroeconomic Developments

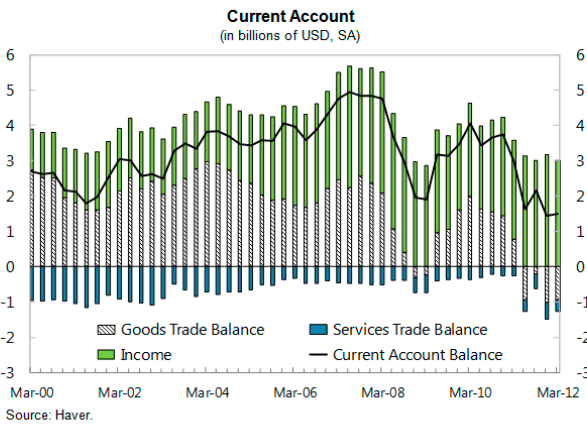


Sources: Cabinet Office of Japan and IMF staff.

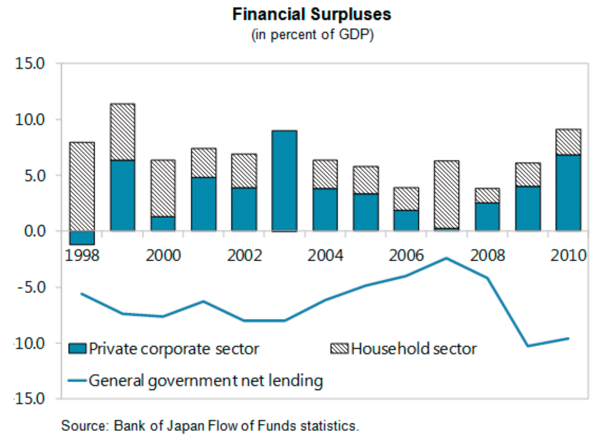


Source: IMF WEO database.

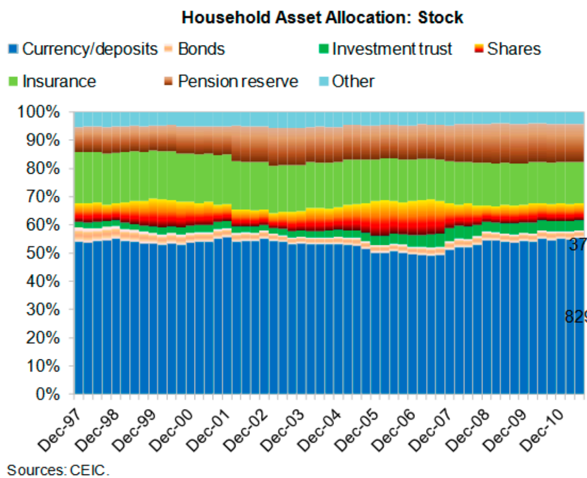
1/ Net debt refers to gross debt minus gross financial assets of the general government.



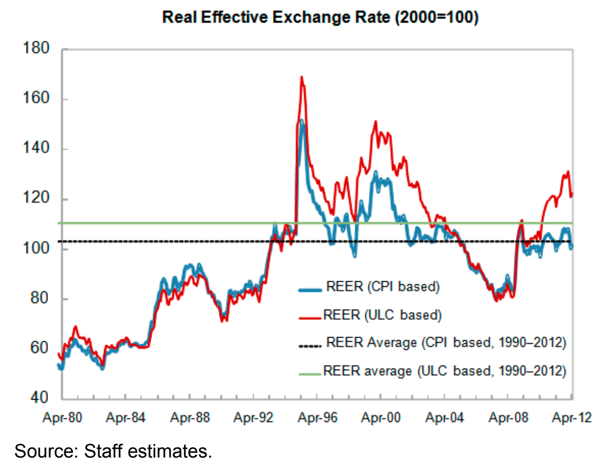
Source: Haver.



Source: Bank of Japan Flow of Funds statistics.

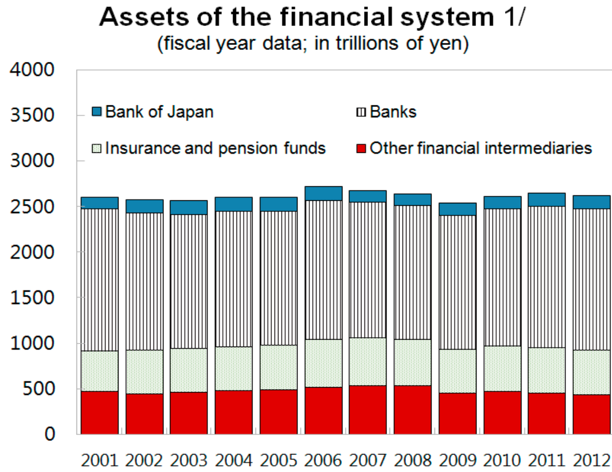


Sources: CEIC.

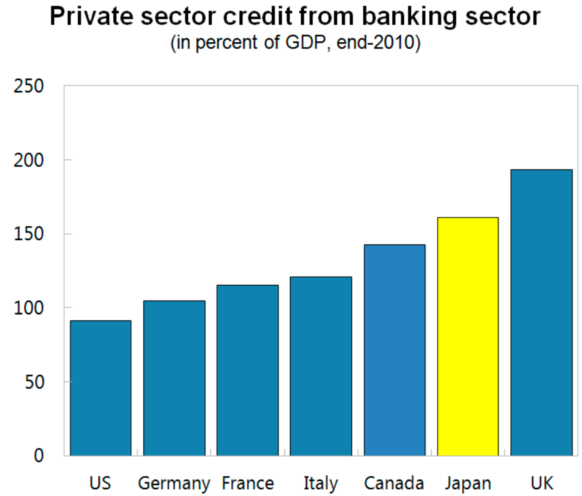


Source: Staff estimates.

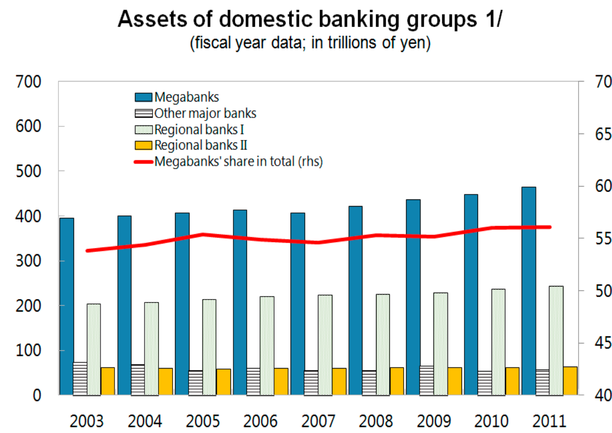
Figure 2. Japan FSAP—Japanese Financial System Structure



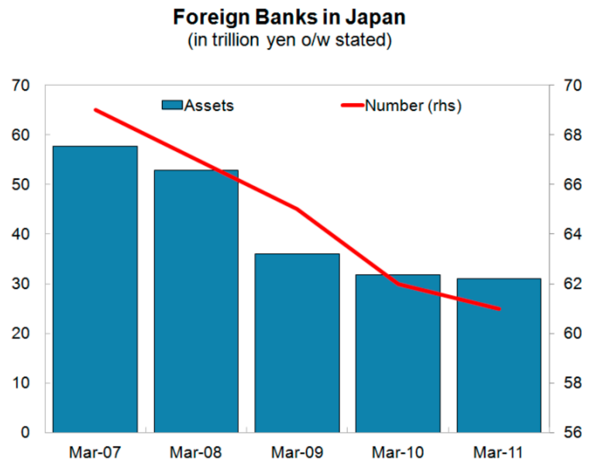
Source: Bank of Japan, Flow of Funds.
1/ Excluding the Fiscal Loan Fund.



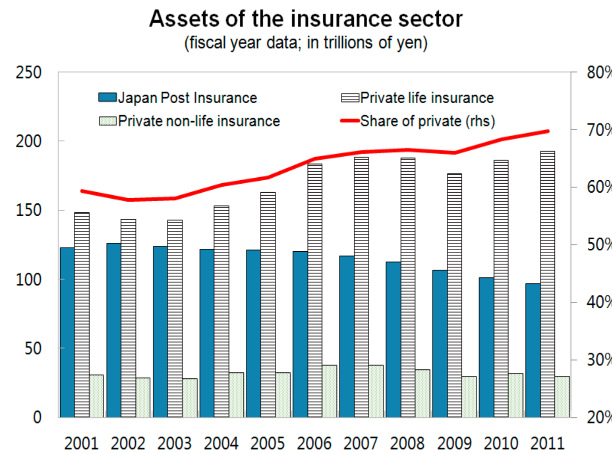
Source: IFS.



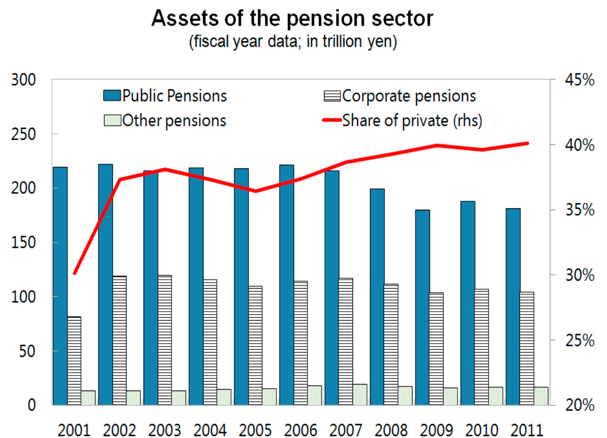
Source: Japanese Bankers Association
1/ Excl. Japan Post Bank and cooperative financial institutions.



Source: FSA.

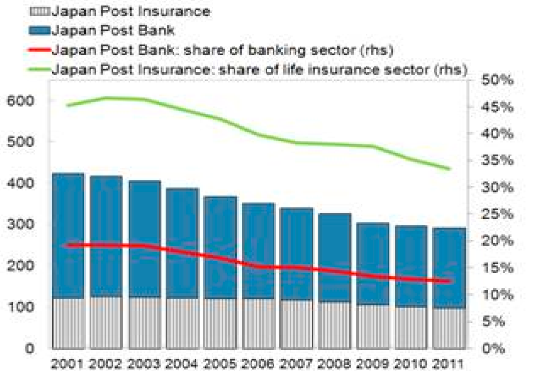


Sources: BOJ - Flows of Funds and Japan Post Insurance

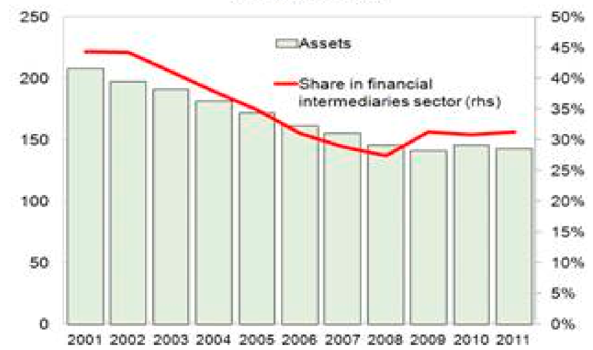


Source: BOJ - Flows of Funds

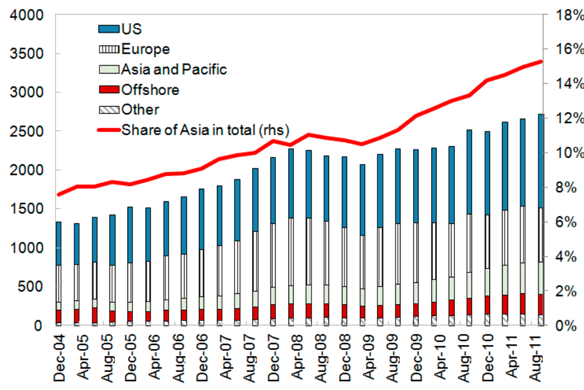
Figure 2. Japan FSAP—Japanese Financial System Structure (continued)



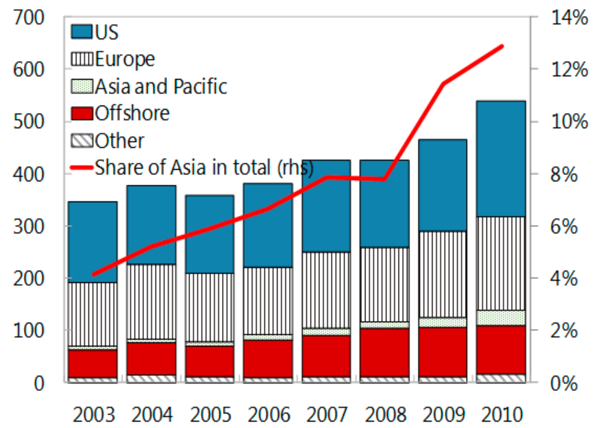
Sources: BOJ Flows of Funds, Japan Post Bank, and Japan Post Insurance.



Source: BOJ Flows of Funds.

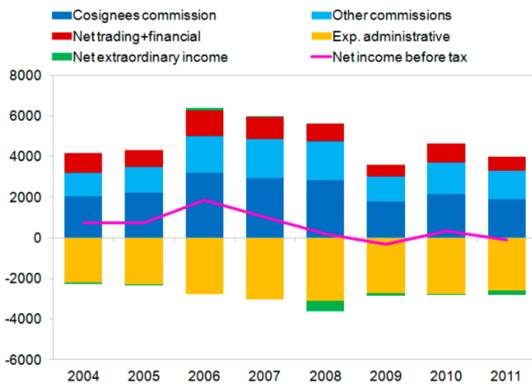


Source: Bank for International Settlements.

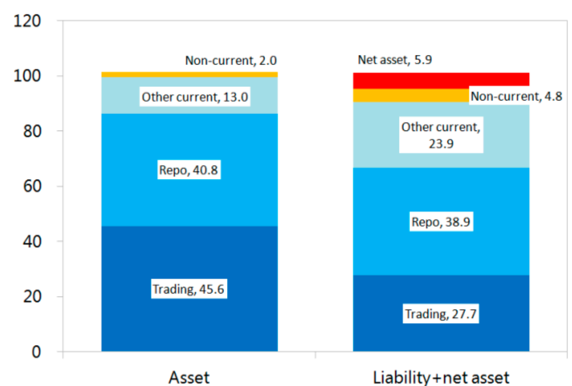


Source: CPIS.

Note: Asia and Pacific includes Australia, Hong Kong SAR, New Zealand, and Singapore.

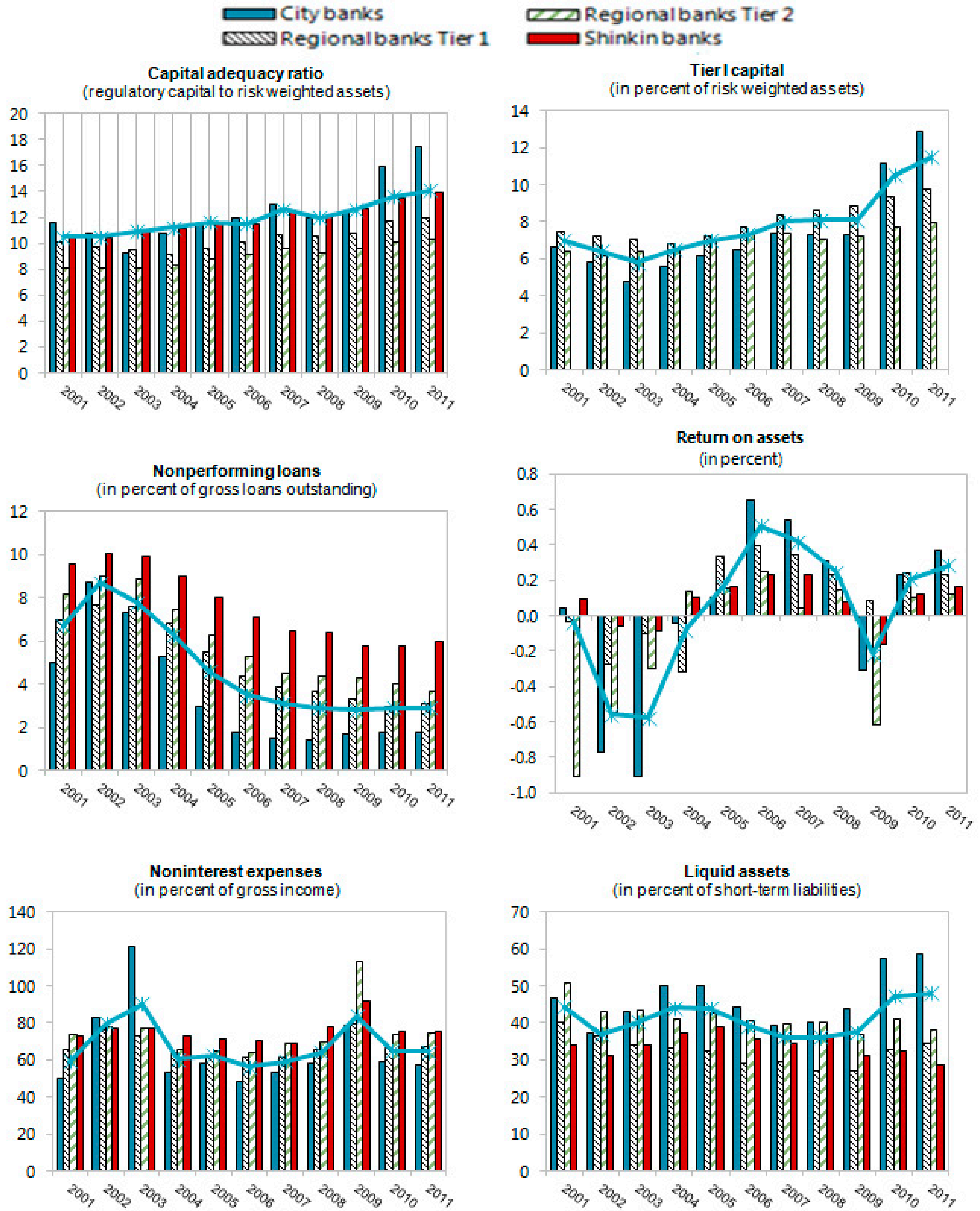


Sources: Japan Securities Dealers Association.



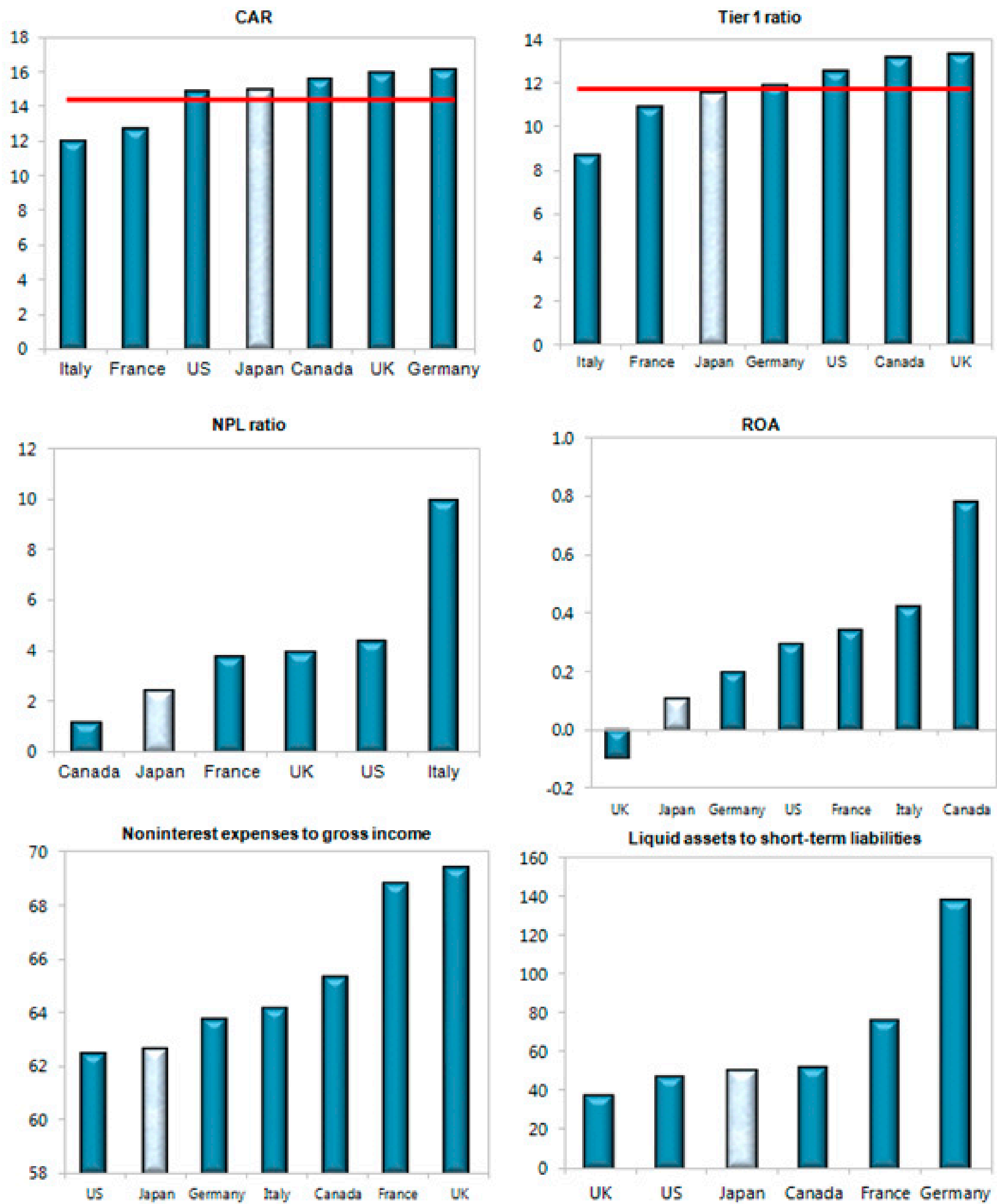
Sources: Japan Securities Dealers Association.

Figure 3. Japan FSAP—Soundness of Banking Sector



Source: FSA.

Figure 4. Japan FSAP—Comparative Soundness of the Banking System

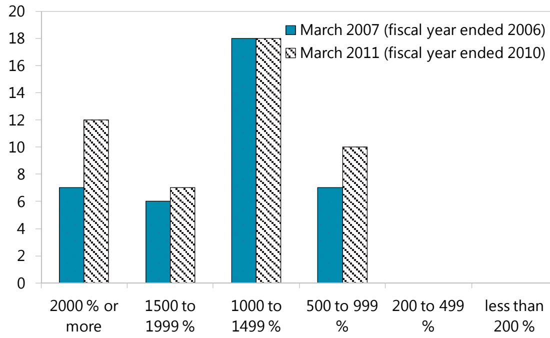


Sources: FSA and IMF FSI website.

Note: All figures are in percent as of end-2010, except for Italy (2010Q2) and Japan (2011Q1). ROA figures are averaged over 2008-10. Figures for Japan include all city and regional banks.

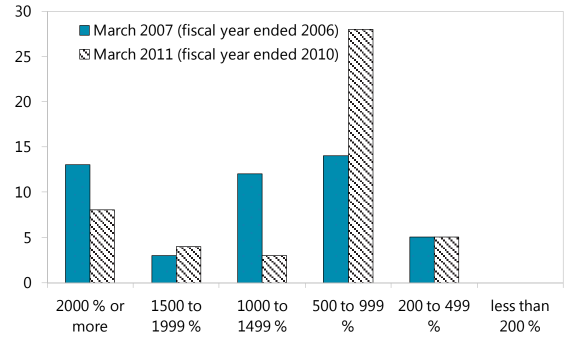
Figure 5. Japan FSAP—Financial Soundness of the Insurance Sector

Distribution of Solvency Margin Ratios - Life Insurance
(number of life insurance companies)



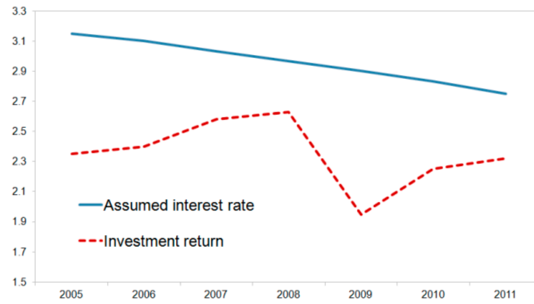
Source: FSA

Distribution of Solvency Margin Ratio - Nonlife Insurance
(number of nonlife insurance companies)



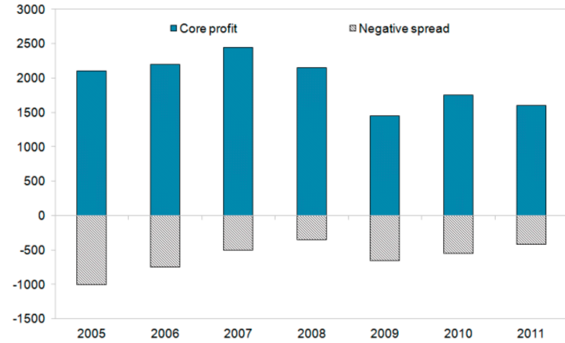
Source: FSA.

Negative Spreads: Gap between assumed interest rate and investment return
(in percent; fiscal year-end)



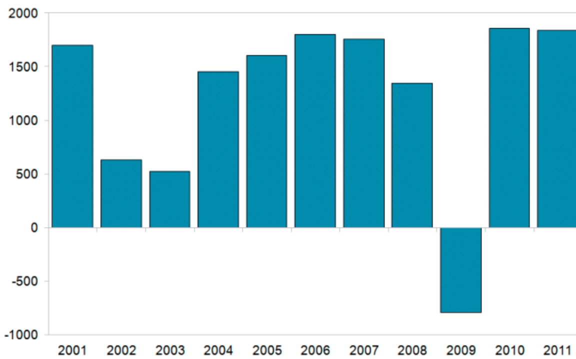
Sources: Fitch and companies reports.

Insurance Companies: Core Profit and Negative Spread
(in billions of yen; fiscal-year end)



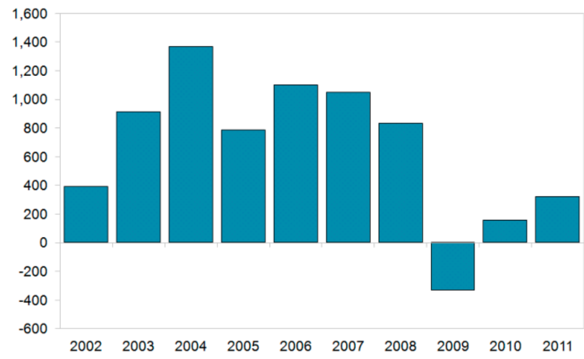
Sources: Fitch and companies report.

Ordinary Profit of Life Insurance
(in billions of yen)



Source: Life Insurance Association of Japan.

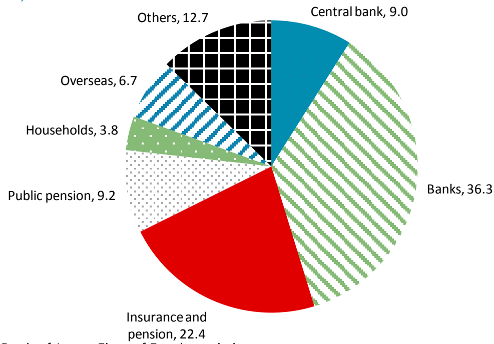
Profitability of Nonlife Insurance
(in billions of yen)



Source: General Insurance Association of Japan.

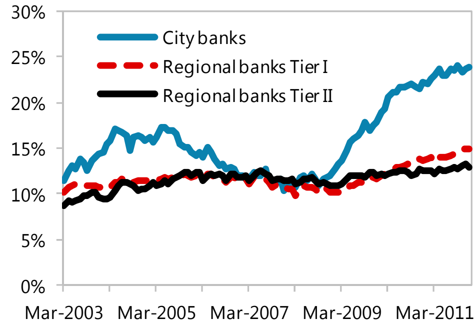
Figure 6. Japan FSAP—Market Risk Exposures in the Financial System

Japan - Shares of JGB Holdings at end-2011
(In percent)



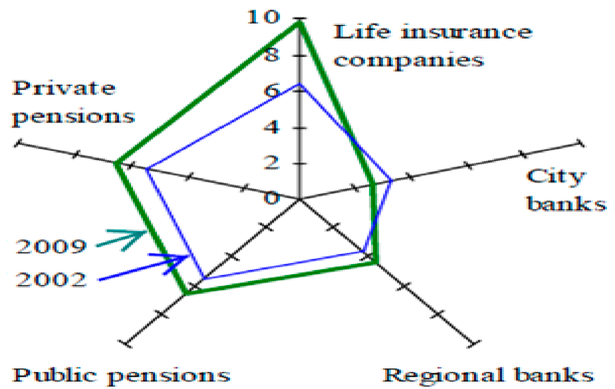
Source: Bank of Japan Flow of Funds statistics

Japanese Banks: JGB Holdings
(in percent of assets)



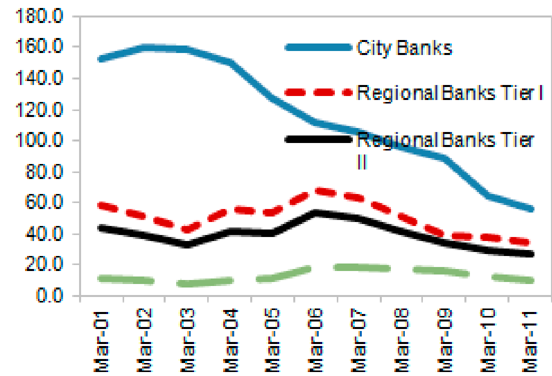
Sources: the Bank of Japan and staff calculation.

Modified duration 1/



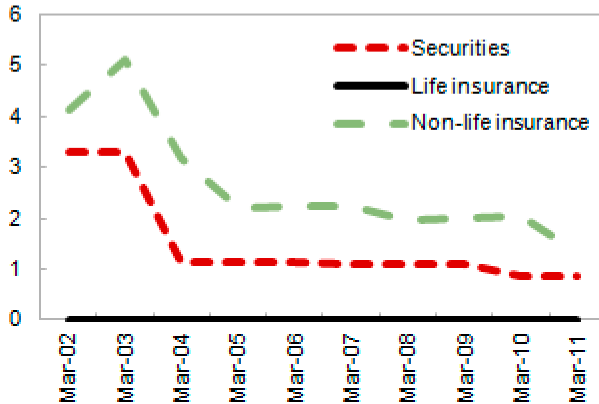
Source: BOJ.

Japanese Banks: Equity Holdings
(percent of capital)



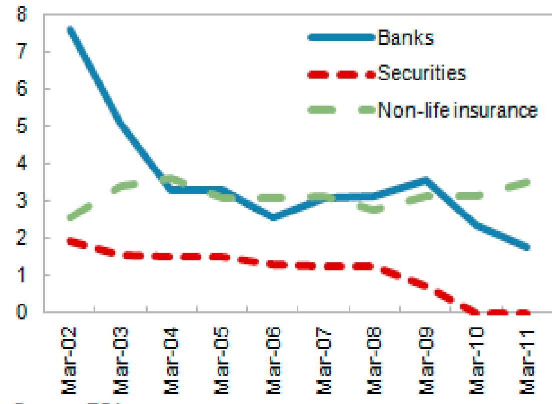
Sources: FSA.

Banks' shareholdings of major financial institutions
(in percent)



Source: FSA.

Life insurance companies share holdings of major financial institutions (in percent)



Source: FSA.

Note: The figures on shareholdings are collected from securities reports based on disclosure of top 10 shareholders.

1/ Modified duration indicates the impact of interest rate changes on bond prices and is proportional to the average maturity. The figure is from the September 2010 FSR.

Figure 7. Japan FSAP—Real Estate Market and Mortgage-Related Exposures

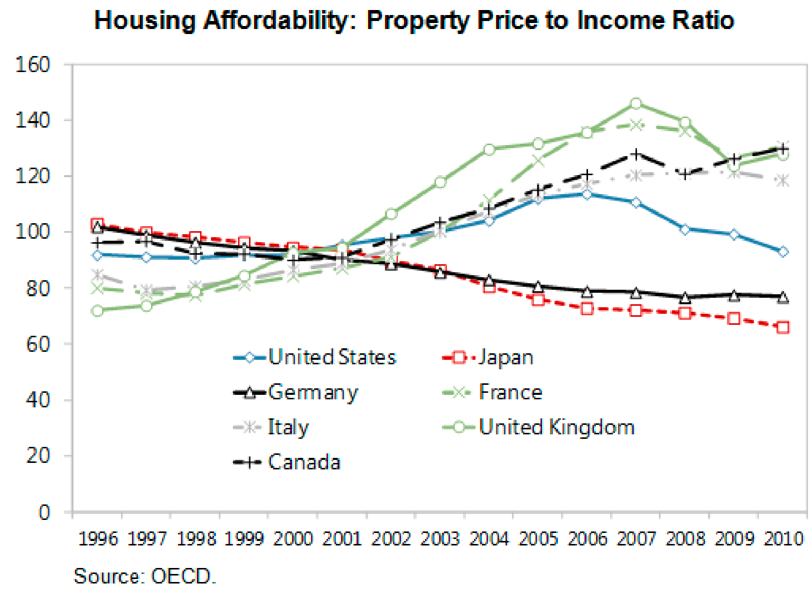
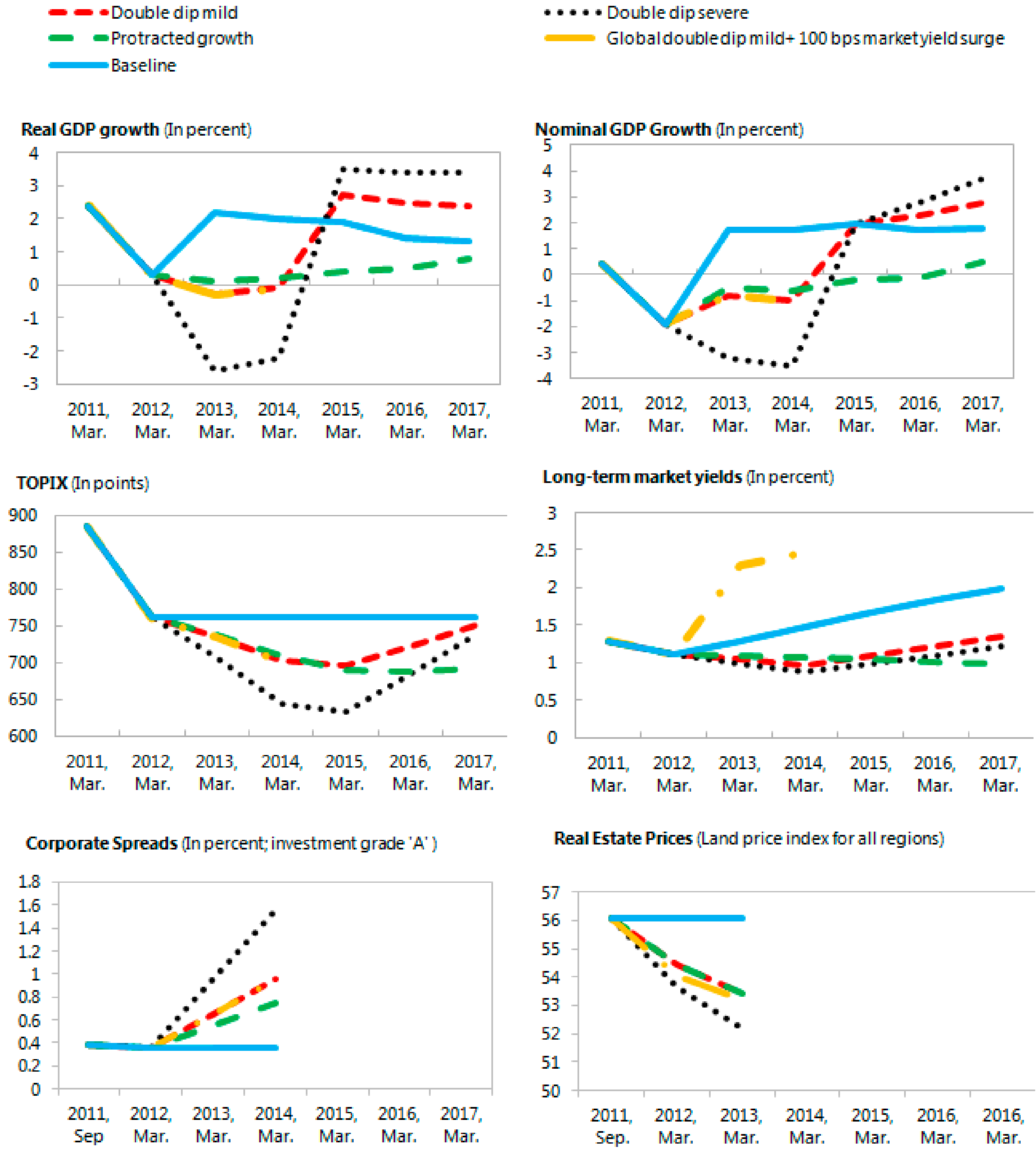
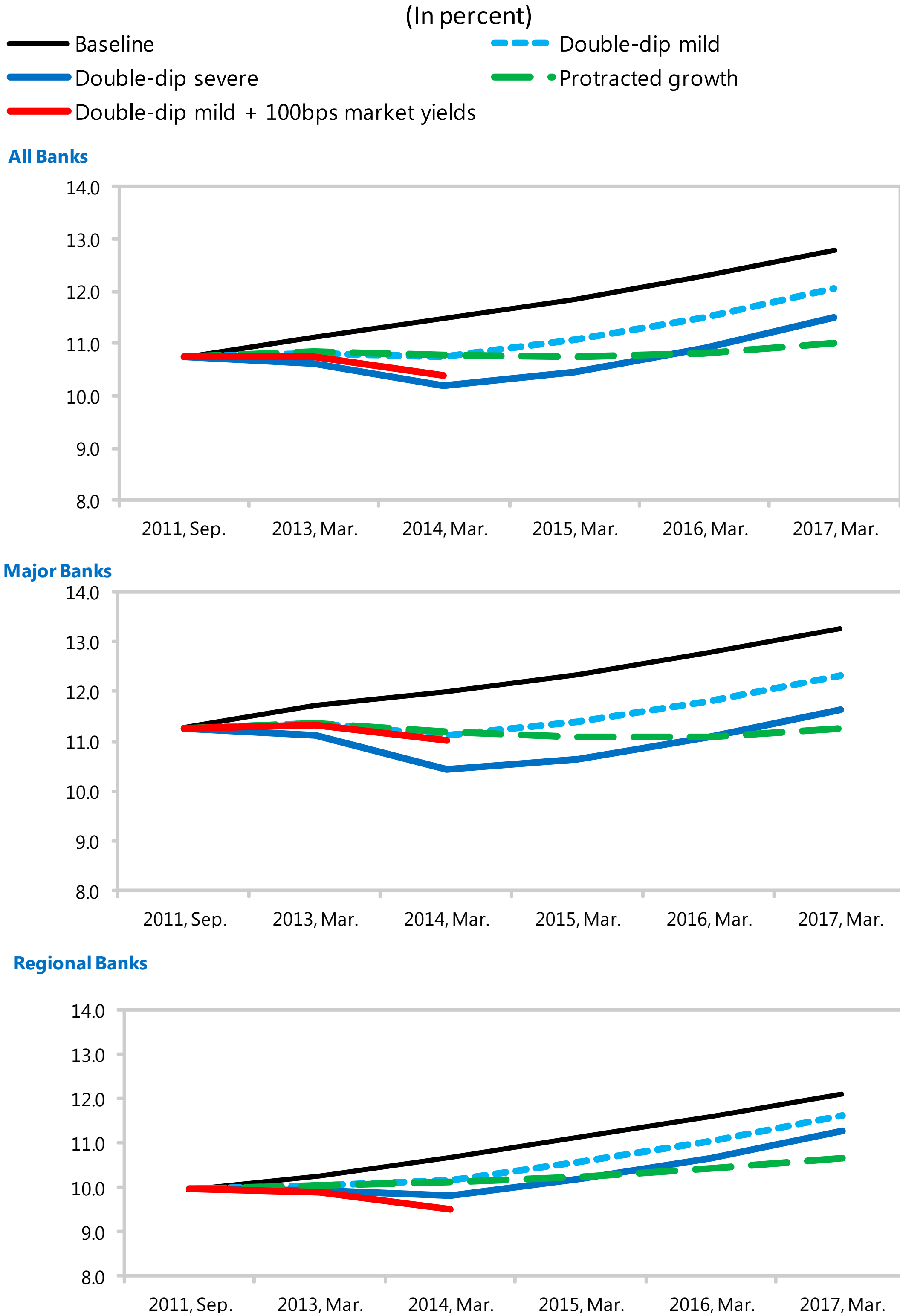


Figure 8. Japan FSAP—Key Macroeconomic Assumptions for Stress Tests



Sources: Bloomberg, FSA, BOJ, and staff estimates.

Figure 9. Japan FSAP—Top-down Bank Solvency: Basel III Core Tier 1 Ratios
All, Major and Regional Banks



Source: Bank of Japan and staff calculations.

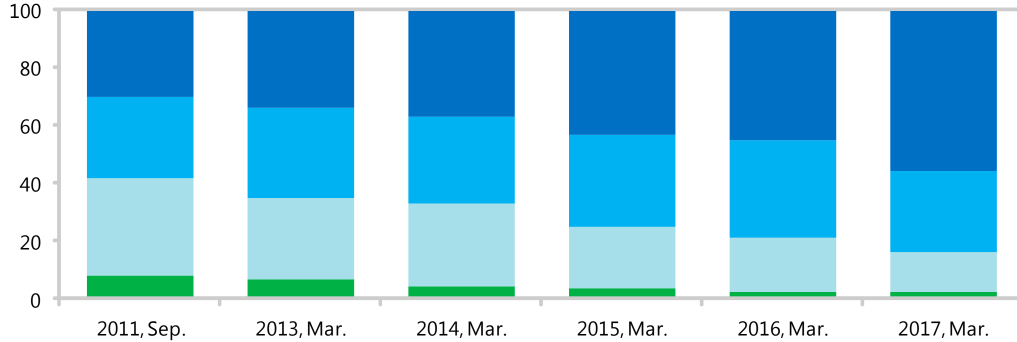
Figure 10. Japan FSAP—Top-down Bank Solvency: Distribution of Basel III Core Tier 1 Ratio: Internationally Active Banks 1/

Sources: The Bank of Japan and staff calculation.

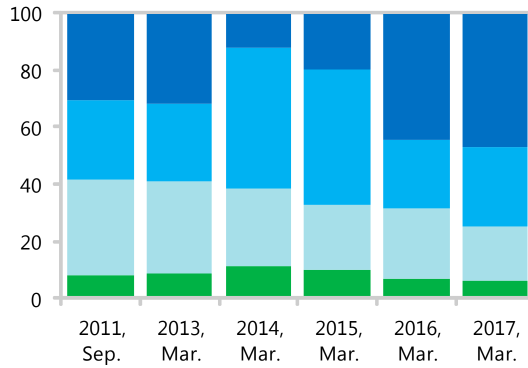
1/ There are 16 internationally active banks holding 56 percent of the system's assets. The Basel III core Tier 1 (Tier 1) requirement without conservation buffer will increase from 3.5 (4.5) percent in 2011 to 4.5 (6) percent in 2017. A conservation buffer of 0.625 ppt per year will be added starting in 2016, for a total of 2.5 ppt by 2019.

Figure 11. Japan FSAP—Top-down Bank Solvency: Distribution of Basel II Total Capital Ratio: Domestically-Active Banks 1/

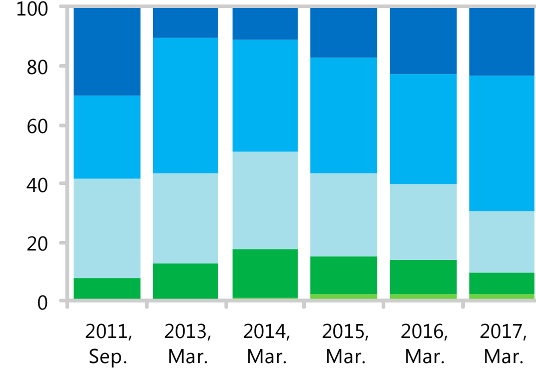
Baseline
(In percent of all domestically active banks by assets)



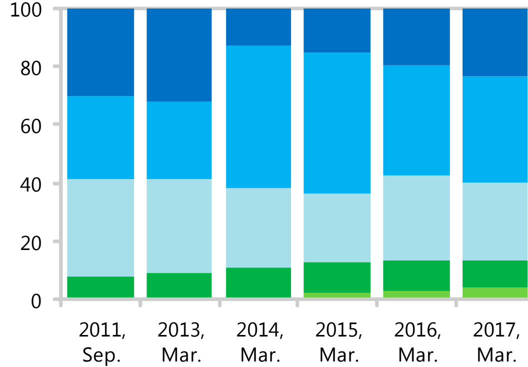
Double dip mild
(In percent of all domestically active banks by assets)



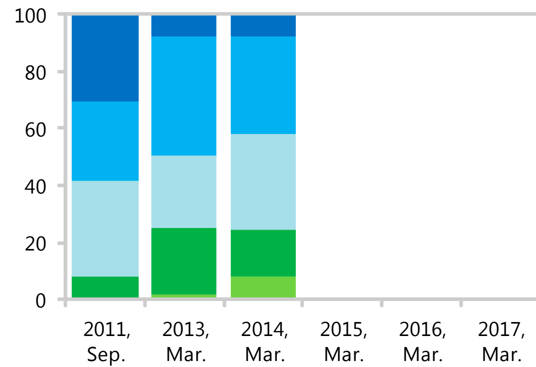
Double dip severe
(In percent of all domestically active banks by assets)



Protracted growth
(In percent of all domestically active banks by assets)



Global double dip + 100 bps surge in market yields
(In percent of all domestically active banks by assets)



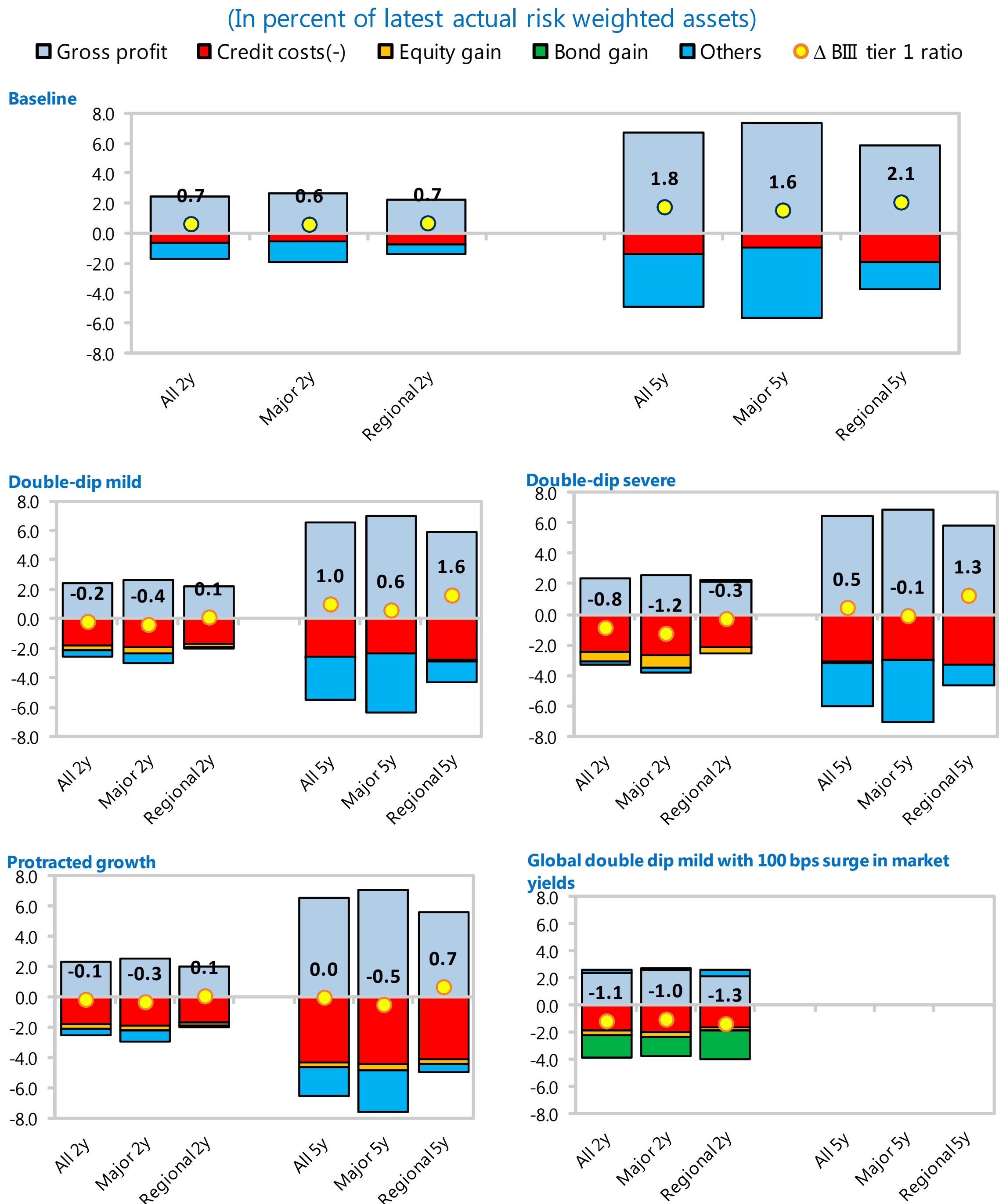
(Total capital ratio in percent)

< 0 | 0-2 | 2--4 | 4--6 | 6--8 | 8--10 | 10--12 | 12--14 | > 14

Sources: Bank of Japan and staff calculation.

1/ As of June 2012, no decision was made on the application of Basel III for domestically-active banks. Therefore, capital adequacy under stress scenario for individual bank in this group is shown using their current requirement of 4 percent total minimum capital requirement based on Basel II capital definition. Applying full Basel III capital definition immediately is expected to reduce total capital ratio for tier 1 regional banks by 3¼ percentage points and for tier 2 regional banks by 1 ½ percentage points. There are 95 domestically-active banks holding 44 percent of the system by asset.

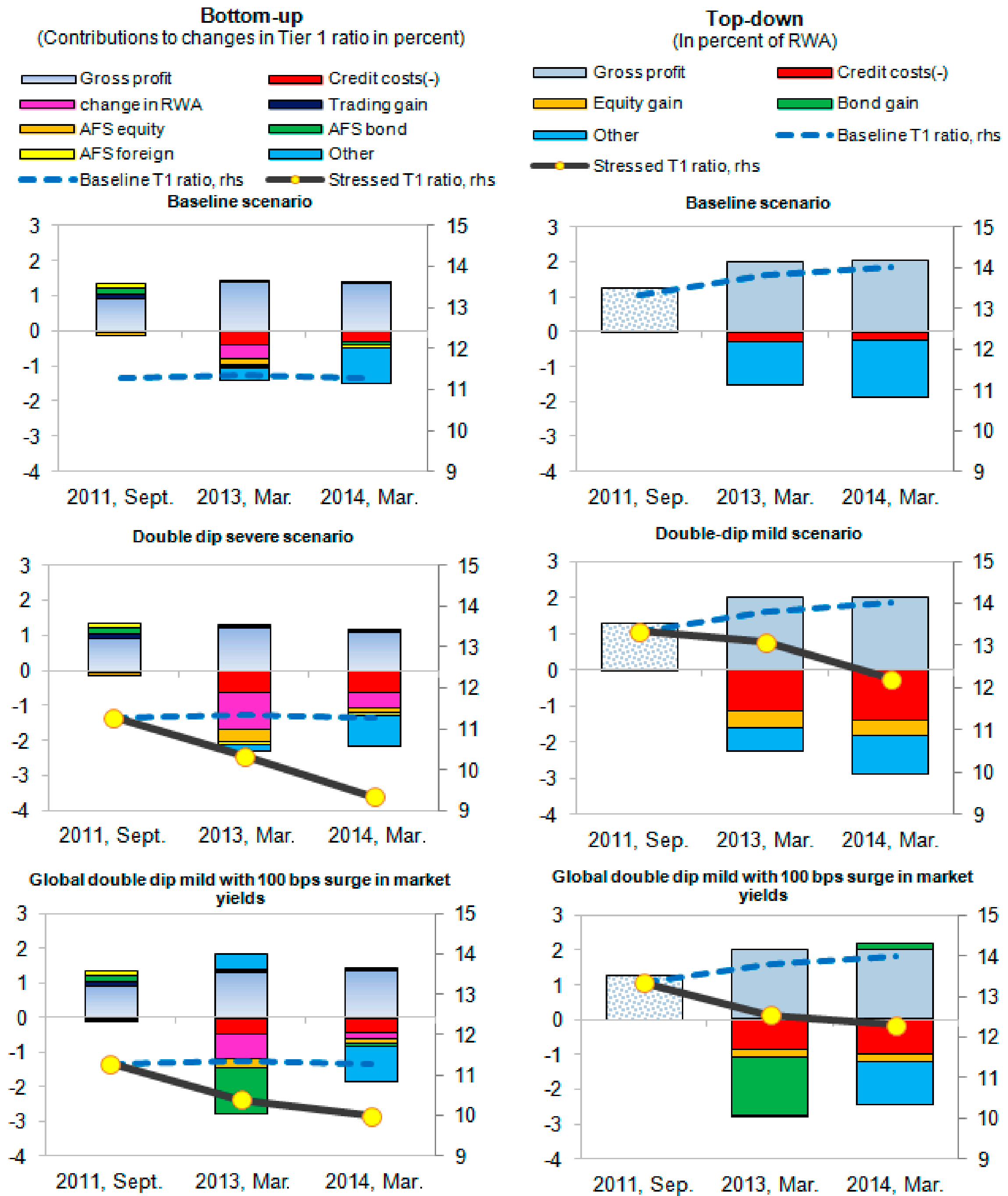
Figure 12. Japan FSAP—Top-down Bank Solvency: Cumulative Impact and Key Contributors 1/



Sources: Bank of Japan and staff calculation.

1/ There are 11 major banks with 63 percent of the system's assets; 100 regional banks with 37 percent of the system's assets (including 63 tier 1 regional (30 percent by assets) and 37 tier 2 regional banks (7 percent of the system). Numbers in the charts indicate changes in Basel III core tier 1 ratio. "Others" include: tax, dividend drawdown of existing unrealized gains, and Basel III transitory effects. Bond portfolio losses are first absorbed by existing buffers in the form of unrealized gains on securities portfolio (mostly JGB related), which amount to 4.3 percent of Tier 1 capital (raising Tier 1 ratio for the whole banking sector by 1/2 percentage points).

Figure 13. Japan FSAP—Three Mega Banks: Bottom-up and Top-down Results 1/

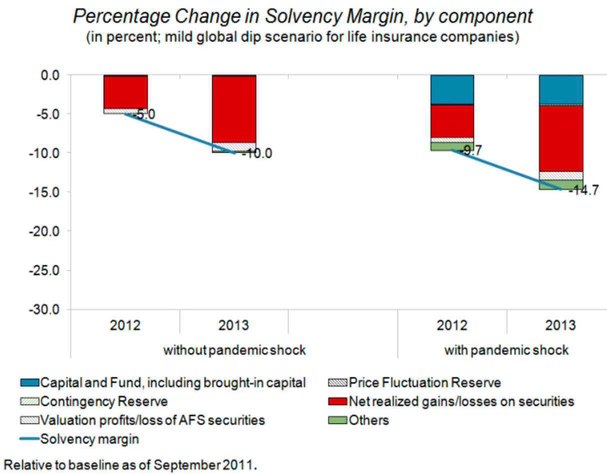


Sources: Bank of Japan (Top-down) and 3-mega banks and FSA (bottom-up), and IMF staff calculations.

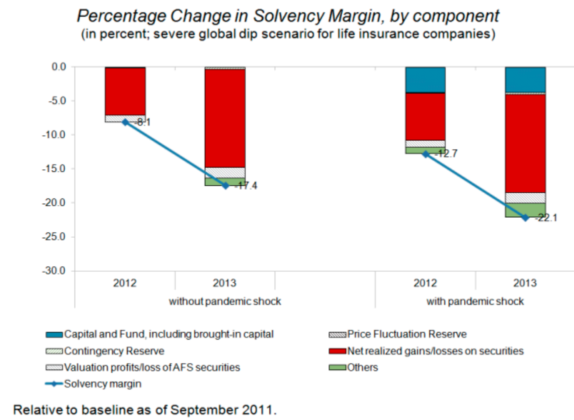
1/ The three mega banks hold 54 percent of the system's assets. T1 stands for Basel III tier 1. "Other" factor includes dividend, tax, and Basel III transitory impacts. The 2.1 percentage points difference of the initial capital ratio mainly reflects the difference between Basel III RWA (for bottom-up) and Basel II RWA (for top-down, Table 9), explaining 2/3 of the difference. Other differences between the two methodologies reflect varying extent of consolidation. While assuming constant RWA tend to underestimate overall impact in top-down tests, it is broadly compensated by larger estimated credit costs as the top-down model picks up more extreme reactions by using quantile regressions. Overall, the top-down credit cost estimate is comparable to bottom-up estimates for the overall Tier 1 impact from credit quality deterioration (credit costs plus deterioration in RWA).

Figure 14. Japan FSAP—Aggregate Stress Test Results—Life Insurance Companies

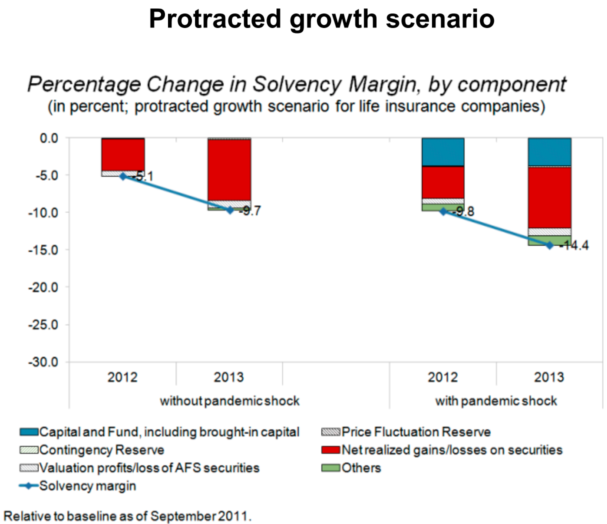
Mild double dip scenario



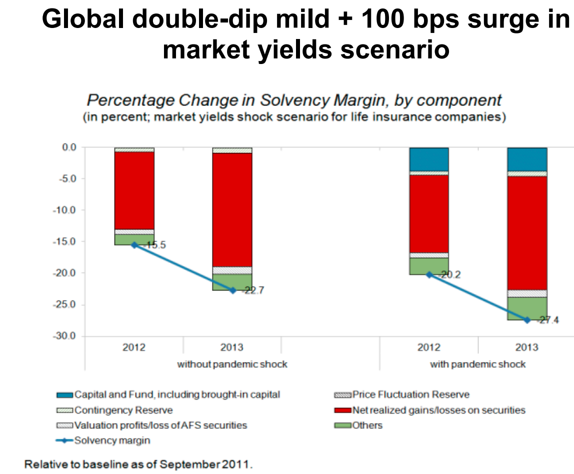
Severe double dip scenario



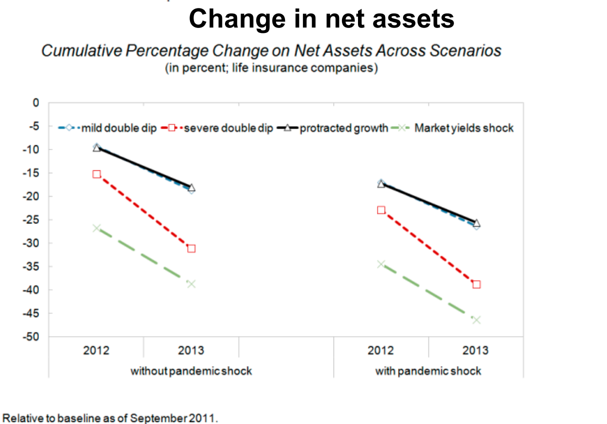
Protracted growth scenario



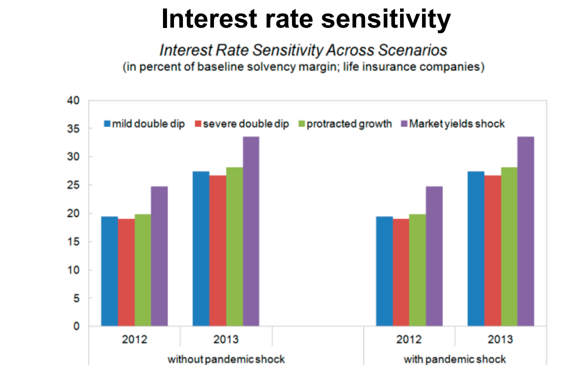
Global double-dip mild + 100 bps surge in market yields scenario



Change in net assets



Interest rate sensitivity



Sources: FSA and staff calculations.

Solvency margin are

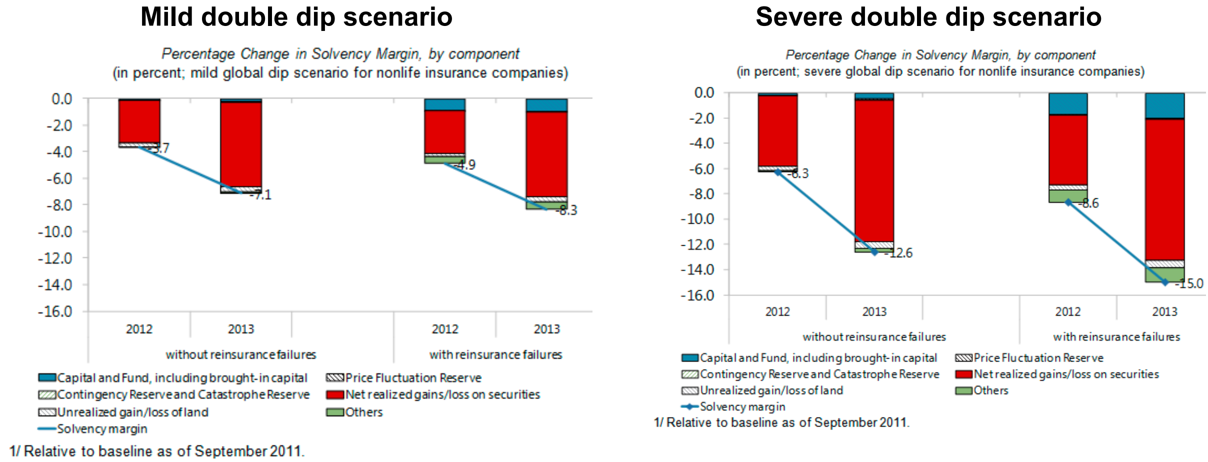
1/ Before tax.

2/ Unrealized gain/loss expect land indicates 90 percent of profits and 100 percent of loss.

3/ Unrealized gain/loss of land indicates 85 percent of profits and 100 percent of loss.

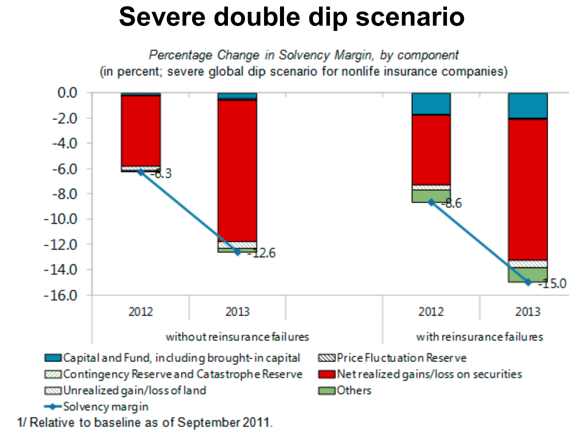
Figure 15. Japan FSAP—Aggregate Stress Test Results—Nonlife Insurance Companies

Mild double dip scenario



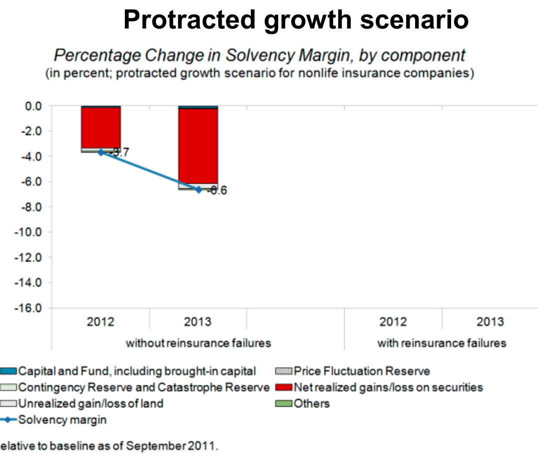
1/ Relative to baseline as of September 2011.

Severe double dip scenario



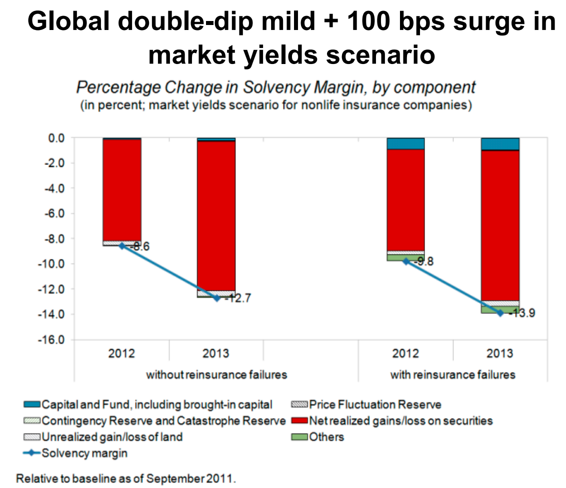
1/ Relative to baseline as of September 2011.

Protracted growth scenario



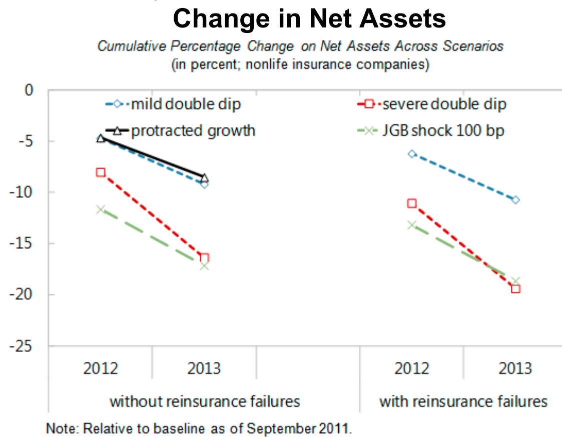
Relative to baseline as of September 2011.

Global double-dip mild + 100 bps surge in market yields scenario



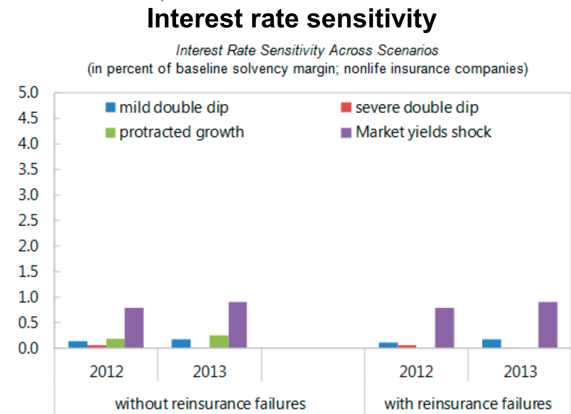
Relative to baseline as of September 2011.

Change in Net Assets



Note: Relative to baseline as of September 2011.

Interest rate sensitivity



Sources: FSA and staff calculations.

Solvency margin are
1/ Before tax
2/ Unrealized gain/loss expect land indicates 90 percent of profits and 100 percent of loss.
3/ Unrealized gain/loss of land indicates 85 percent of profits and 100 percent of loss.
4/ Reinsurance failures are assumed to have recoverable rate of 90 percent in mild double dip and JGB shock scenarios, 80 percent in severe double dip scenario, and 100 percent in protracted growth scenario.

Figure 16. Japan FSAP—Core Financial System Supervisory Architecture

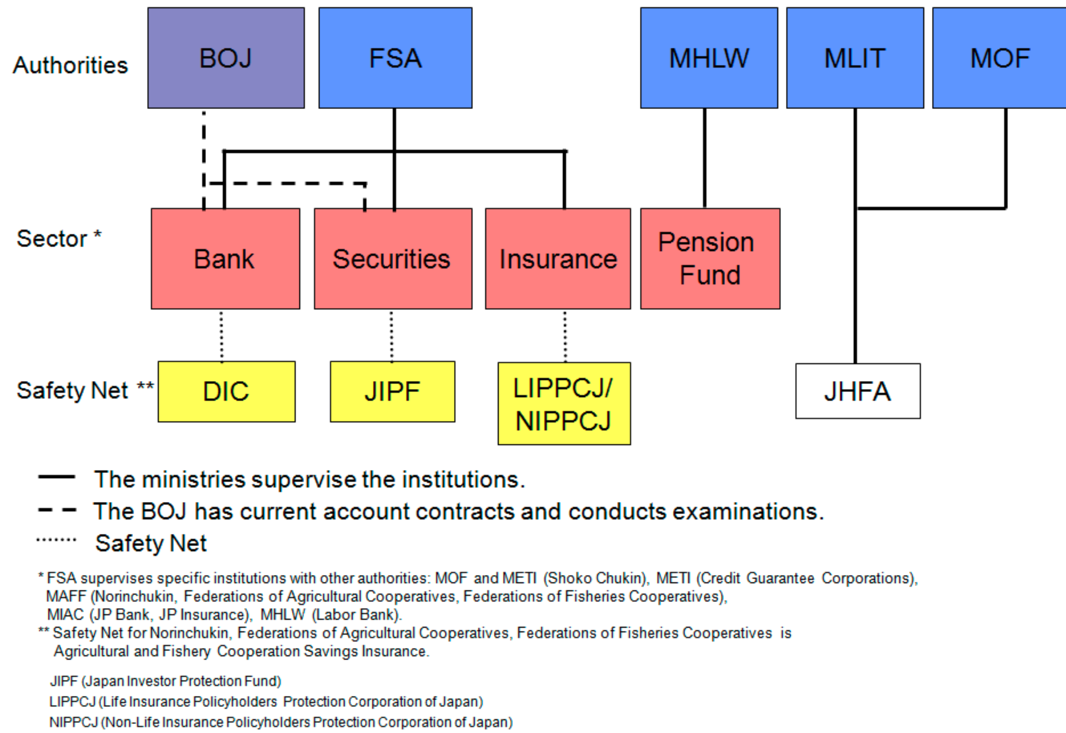


Figure 17. Japan FSAP—Expanded Financial System Supervisory Architecture

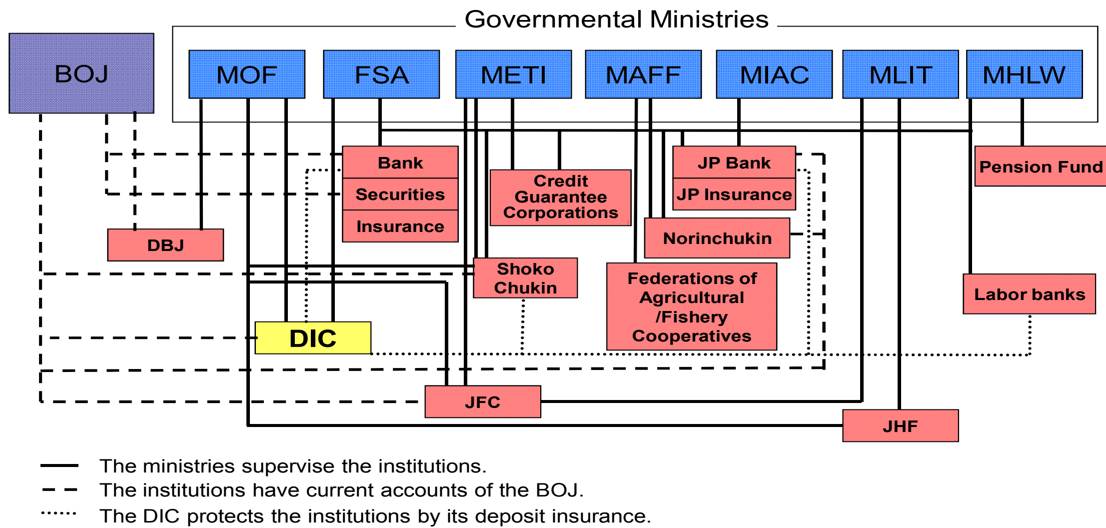
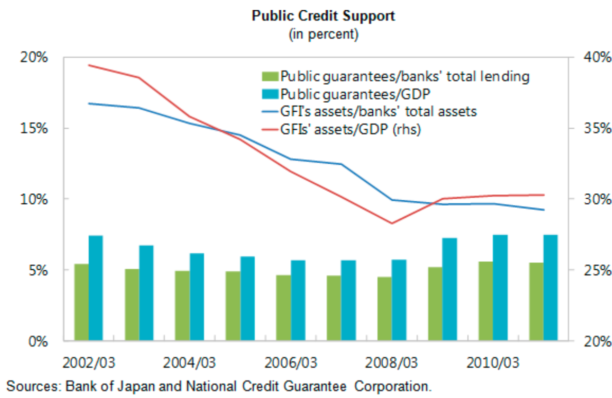
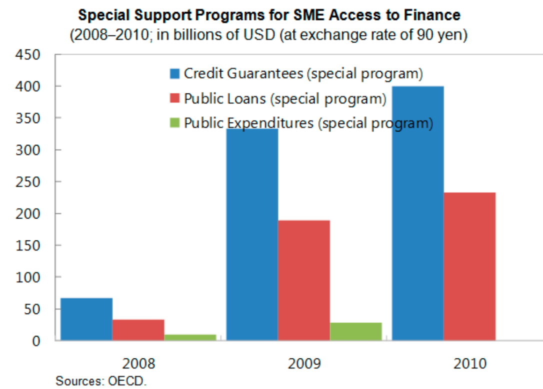


Figure 18. Japan FSAP—Government Credit Support to the Financial System

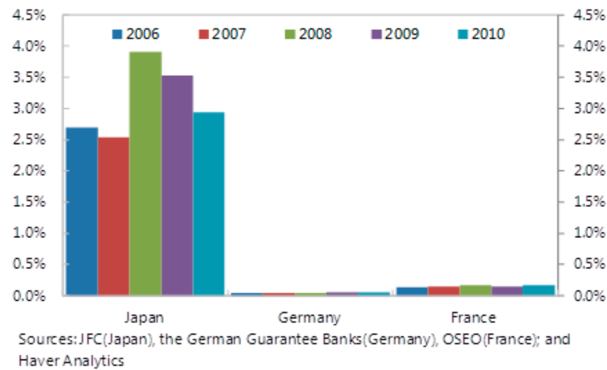
While GFIs' presence declined over the past decade, they still play an active intermediation role.



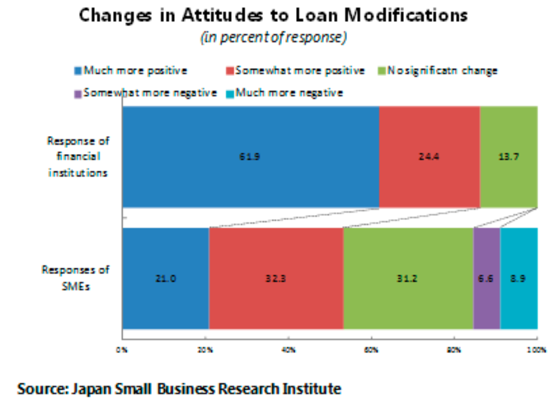
Following the global financial crisis, the government substantially extended support measures to SMEs.



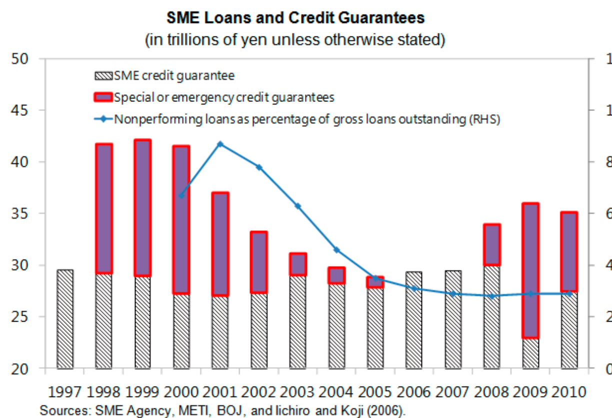
Public support in the form of guarantees appears larger than in other advanced countries.



The SME Financing Facilitation Act has helped improve lending attitudes by financial institutions, although this is not fully perceived by the SMEs.



Sizeable SME guarantees help limit NPL ratios but a shift towards special guarantees is underway…



… and the SME Financing Facilitation Act could also affect banks' credit risk assessment.

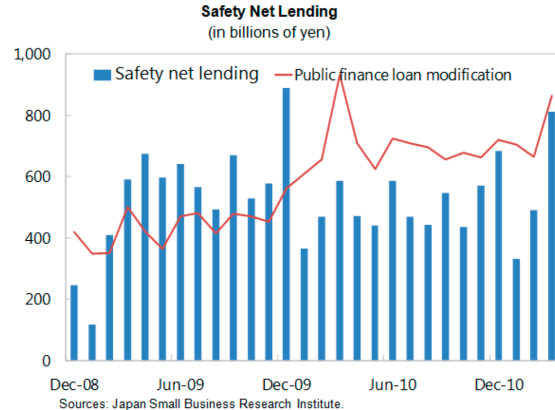
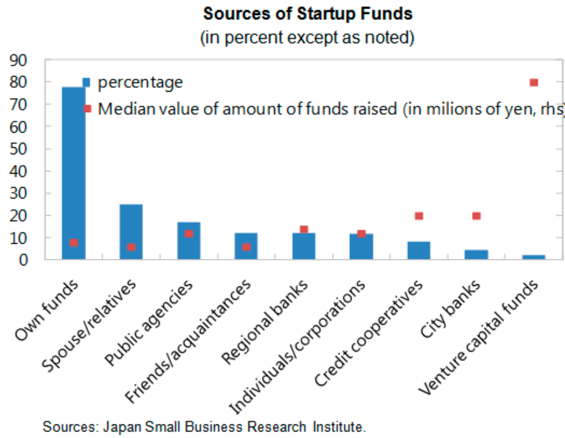


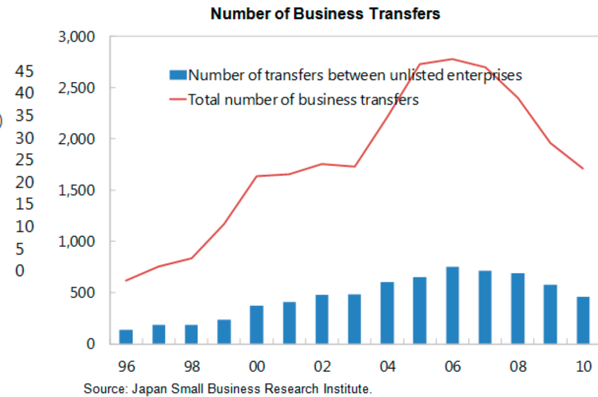
Figure 19. Japan FSAP—Firm Dynamics: Entry and Exits

Start-ups rely predominantly on self-finance, and venture capital funds are uncommon.



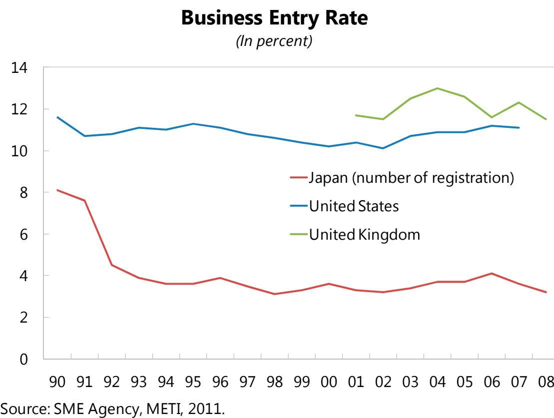
Sources: Japan Small Business Research Institute.

Business transfers are low, possibly hindered by wide uses of personal guarantees.



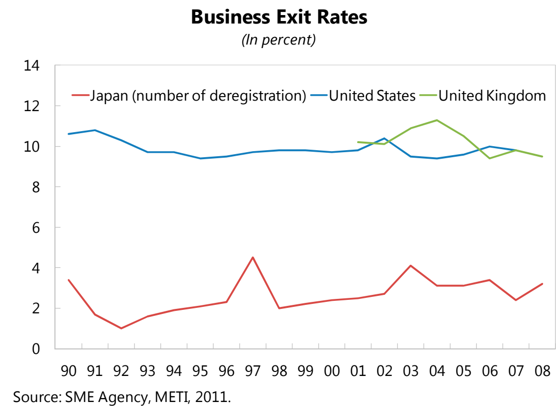
Source: Japan Small Business Research Institute.

Firm dynamics are lackluster, as firms' entry rates…



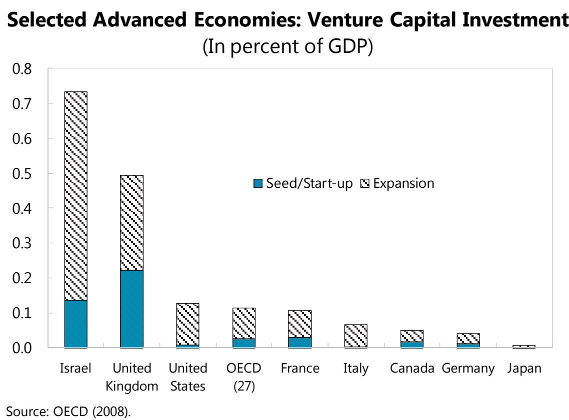
Source: SME Agency, METI, 2011.

… and exit rates are much lower than in other advanced countries.



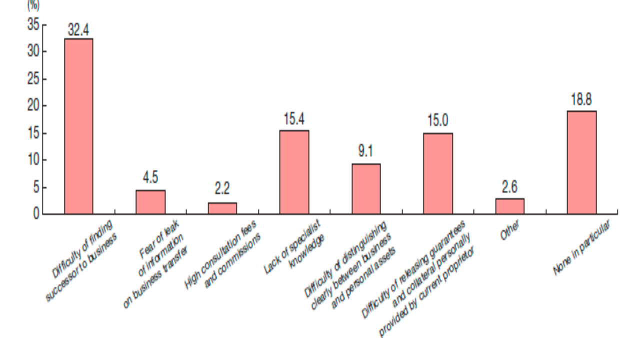
Source: SME Agency, METI, 2011.

Venture capital investment is limited…



Source: OECD (2008).

… partly due to limited exit venues, such as IPOs, mergers and acquisitions.



Source: MRI, *Survey of Business Transfers* (December 2009), commissioned by SME Agency.

Notes: 1. Based on SMEs that responded "want to transfer business to any other enterprise after own retirement" regarding the proprietor's plans for his/her business after retirement.

2. The results were calculated by scoring in order of obstacles: 3 points for first, 2 points for second, and 1 point for third.

ANNEX: Japan FSAP—Observance of Financial Sector Standards: A Summary

This Annex contains summaries of Japan's observance of international standards and codes in the financial sector. The summaries are based on detailed assessments of the following international standards carried out as part of the 2012 FSAP Update:

- *Basel Core Principles for Effective Banking Supervision*—(Assessors: Serene Chow and Arnoud Vossen)
- *IAIS Insurance Core Principles*—(Assessors: Michael Hafeman and Rodolfo Wehrhahn)
- *IOSCO Objectives and Principles of Securities Regulation*—(Assessors: Ana Carvajal and Martin Kinsky)

These assessments identify the main strengths of the regulatory and supervisory framework in managing potential risks and vulnerabilities in the financial system. They also suggest areas where progress is underway and those that would benefit from strengthening and further reform.

ANNEX I. Japan FSAP—ASSESSMENT OF BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION: A SUMMARY[1]

A. Introduction

1. **Japan has made several improvements to its financial regulatory and supervisory framework and practices since the 2003 FSAP.** The framework has allowed successful management of the global financial crisis, and in ensuring business continuity in the face of natural catastrophes including the March 2011 tsunami and earthquake. Amongst others, a more risk focused and a forward looking approach is being promoted and Japan is committed at introducing and implementing the global regulatory reform agenda. In general, the legislative and operational framework for banking supervision largely conforms to the Basel Core Principles (BCPs).

B. Information and Methodology Used for the Assessment

2. **The assessment team reviewed the legal and institutional framework for banking supervision.** It held discussions with staff from the FSA, BOJ, the Japan Bankers Association, as well as representatives of the financial industry. The assessors examined current practices for onsite and off-site supervision, implementation of past FSAP recommendations, and the recent regulatory reforms undertaken by the Japanese authorities.

[1] This is based on a detailed assessment of Japan's observance of the BCPs conducted during November 28–December 16, 2011. It follows up on the first assessment of Japan's banking supervision framework conducted by the IMF as part of the 2003 FSAP.

3. **A good quality assessment of compliance with the BCPs relies on the assessment methodology provided by the Basel Committee as well as the judgment of the assessment team**. Banking systems differ from one country to another, as do domestic circumstances. Also, banking activities are changing rapidly around the world after the crisis, and regulatory approaches and supervisory policies, and best practices are rapidly evolving. Nevertheless, by adhering to a commonly agreed Basel Committee methodology this FSAP assessment provides the Japanese authorities with an internationally consistent evaluation of the quality of their banking supervision in relation to the BCP (2006) which are regarded as a minimum standard. The assessment process enjoyed excellent cooperation from the counterparts in Japan.

C. Institutional and Macroeconomic Setting and Market Structure

4. **Japan's financial system remains the second largest in the world.** Despite policy efforts since 1996 to reduce the economy's reliance on the banking sector, the Japanese financial system remains bank-dominated. Benefiting from strong deposit bases, banks remain the main source of lending, in particular for small-to medium sized enterprises (SMEs).

5. **The domestic banking market is large with about 2,000 deposit-taking institutions.** The three megabanks are large by global standards and active internationally, and there are many smaller-size banks that service local and regional clients. Overseas expansion has been limited to the larger city banks. Since the early 2000s, consolidation within the sector has been and is expected to remain gradual.

6. **The banking industry has been characterised by the following:**

- **High concentration.** Japan Post Bank continues to hold a quarter of total deposits and city banks hold approximately forty percent of total deposits.
- **Low core profitability.** Japanese banks suffer from weak profitability due to low and declining net interest margins amid sluggish borrowing demand of firms and households. In seeking new sources of profit, megabanks are increasingly shifting their lending and other activities abroad, particularly to Asia. However, this business strategy poses challenges to their corporate governance, local funding costs, and risk management.
- **Asset structure.** Loans represent over half of total bank assets and securities about a quarter. Banks' JGB holdings have increased in the past few years, which have increased the banks' exposure to market risks.
- **Loan quality challenges ahead.** Loan quality improved significantly since the early 2000s, but concerns regarding loan quality going forward remain due to weak growth and rising bankruptcy, in particular for regional banks.

- **Securities holdings and market risks.** Banks hold large JGB and equity portfolios. JGB exposures in the banking system have continued to grow thus increasing bank exposures to interest rate risk.

- **Favorable liquidity situation.** Banks benefit from a relatively large and stable corporate and household deposit base.

- **Bank capital.** Reflecting market pressures and expectations of Basel III, major banks have raised around ¥4½ trillion of capital in 2009–10 of which a portion remains as hybrid capital, particularly for the mega banks.

7. **The banking sector remains exposed to important vulnerabilities.** These include the large concentration to JGB exposures, quality of capital at megabanks and adequacy of capital at the non-megabanks in the face of low profitability and reducing loan demands. Operational, funding and governance risks faced by banks expanding overseas are also areas of concern.

D. Preconditions for Effective Banking Supervision

8. **Japan's institutional framework follows the integrated approach.** The FSA as a single universal regulator (the FSA) conducts both safety and soundness oversight, and carries out conduct-of-business regulation for all the sectors of financial services (other than pension funds). The BOJ conducts on-site examinations and off-site monitoring of its counterparty financial institutions. The Ministry of Finance (MOF) also retains an important role. The Deposit Insurance Corporation of Japan (DICJ) is responsible for implementing measures such as the reimbursement of insured deposits and financial assistance to reorganize failed banks. The reform of the previous supervisory system that established an integrated system in the late 1990s was a response to perceived weaknesses in the traditional inspection and supervisory practices of the MOF, which emphasized consultation and administrative guidance. The FSA, MOF, and BOJ frequently exchange information at multiple levels and there are also several councils covering various aspects of financial system policies.

9. **The Financial System Management Council (FSMC) is activated when government intervention in a troubled financial institution is necessary.** The FSMC consists of the Prime Minister (chair), the Chief Cabinet Secretary, Minister for Financial Services, the Minister of Finance, the Commissioner of Financial Services, and the Governor of the BOJ. It is convened by the Prime Minister to deal with financial institutions that face serious liquidity or solvency pressures. Since its creation, the FSMC has been used only twice, and since the blanket guarantee was lifted, the general bank resolution measure of providing partial depositor protection has only been used once. The Prime Minister and the Minister of Finance may request BOJ to take actions, when they find it especially necessary

for the maintenance of stability of the financial system. When the request is made, BOJ may undertake the necessary actions, including the provision of uncollateralized loans.

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

11. **The financial infrastructure supporting effective banking supervision in Japan is well-developed.** The accounting standards in Japan have been extensively developed over the last 10–15 years. Banks are subject to the Japanese generally accepted accounting principles (GAAP) for regulatory reporting. Movements towards convergence between Japanese GAAP and international financial reporting standards (IFRS) started in March 2005. Industry opinion is that Japan is at the final stages of convergence to IFRS. At the moment, Japanese GAAP allows for certain assets and liabilities to be reported as historical cost while the application of fair value accounting requires the reporting at the lower of historical cost or fair value under certain circumstances.

12. **The payment and settlement system is reliable and efficient.** There have been several structural improvements for the past decade with the implementation of Real Time Gross Settlement (RTGS) for all large-value payments, the introduction of liquidity saving features in the RTGS, and the development of delivery-versus-payment (DVP) for all types of securities resulting in the reduction of risks in clearing and settlement of JGBs. Japan is the only jurisdiction, apart from the U.S., that had adopted legislation mandating central clearing of standardized over the counter (OTC) derivatives by the end of 2012.

13. **The Deposit Insurance Act defines the deposits that are protected in the case of a bank failure.** "Payment and Settlement deposits," namely current deposits or non-interest bearing ordinary deposits that satisfy the three conditions of (1) bearing no interest; (2) being redeemable on demand; and (3) providing normally required payment and settlement services, are fully protected. The other remaining deposits, such as time deposits, are protected up to a maximum principle of ¥10 million including interest, per depositor, per financial institution.

E. Main Findings

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

14. **In general, the mandates for banking supervision are sufficiently clear and unambiguous.** The FSA is the integrated supervisory authority for banking, insurance, and securities sector. City banks, regional banks, and shinkin banks are directly supervised by the FSA. The day-to-day supervision of the regional and shinkin banks is delegated to Local Finance Bureaus of the Ministry of Finance (MOF). Some cooperative style institutions are co-supervised by the FSA and the Ministry of Agriculture respectively the Ministry of Labor, based upon different arrangements. Co-supervision by the FSA and a Ministry on supervisory matters may lead to less clear decision making processes. Further, agricultural and fishery cooperatives are supervised under the Agricultural Cooperatives Act and the Fishery Cooperatives Act under which they are allowed to take deposits, whereby daily supervision is conducted by local state government. However, the FSA together with the responsible Ministry of Agriculture has developed supervisory guidelines for these cooperatives and the FSA could, upon request, undertake on-site examinations. BOJ also conducts on-site examinations and off-site monitoring with regard to its counterparties (banks, major securities firms, and other financial institutions) in the context of its central banking function. Its supervisory activities are based upon contracts formulated in accordance with Articles 1 and 44 of the Bank of Japan Act.

15. **The institutional framework for supervision in Japan provides sufficient safeguards for the supervisor's independence in day-to-day supervision.** Nonetheless, in order to enhance the independence in decision-making by the FSA concerning some cooperative style institutions, the FSA could clarify in detail and be transparent on the way co-decision effectively takes place on labor cooperatives and Nurin-Chukin, which should not jeopardize FSAs supervisory responsibilities. The FSA could also consider strengthening the governance arrangements towards the Ministry of Finance's Local Finance Bureaus, to which the day-to-day supervision of regional and Shinkin banks has been delegated, by increasing the staff to oversee these activities and by improving the review processes

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

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

18. **Predominantly informal arrangements exist for the cooperation between the FSA and BOJ, and with foreign supervisory authorities.** A more formalized and systematic basis for interagency information exchange and decision making should be further intensified. Given the bank's strategies to extend their overseas business the arrangements with foreign authorities should be further enhanced as well.

Licensing and structure (CPs 2–5)

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

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

21. **The FSA does not require an ex ante approval of investments by a bank in another bank, in an ancillary business or a related banking business.** A prior notification of such investments is, however, required. Acquisitions would need prior approval, except when it would be in an ancillary business. Investments in non-banking activities are limited by law and may not lead to a significant ownership or a controlling interest of the bank in question.

Prudential regulation and requirements (CPs 6–18)

22. **The FSA requires all institutions to calculate and maintain a minimum capital adequacy ratio.** It has the power to impose higher capital requirements above the minimum on individual banks. However, the FSA's implementation of Pillar 2 of Basel II does not provide for setting extra capital charges in case the supervisory review process would indicate that not all material risks would have been captured. Also, for domestic and internationally active banks, different minimum capital levels and a different definition of capital are used, although a similar capital adequacy framework applies. Triggers for early intervention measures due to a shortfall in minimum capital levels are set at a too low level,

especially for domestic banks. In addition, the assessors noticed some (temporary) measures taken by the Japanese government towards the end of 2008 which include a partial relaxation of the capital adequacy requirement for banks. The authorities should seek to enhance the standards for capital adequacy, and to streamline the rules applicable for domestically and internationally operating banks.

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

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

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

26. **The Japanese regulations contain the basic provisions with regard to 'exposures to related parties,' including that these should be subject to the arms' length rule.** However, the FSA should ensure the enforcement of these provisions via regular off-site monitoring as well as focused on-site inspections.

27. **The FSA had stepped up its reporting requirement for banks on individual country exposures on both frequency and granularity to better monitor country and transfer risks, and related exposures.** Further consideration could be given on the actual quality of monitoring of country exposures and having in place a more forward-looking approach for evaluating risks.

28. **The current supervisory framework with regard to liquidity risk complies with the assessment criteria laid down under the relevant core principle.** Continued focus by both the FSA and the BOJ on the foreign currency funding profile of banks expanding

overseas would be important given the banks' reliance on wholesale funding in these markets and higher costs of funding overseas compared to their domestic funding profiles.

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

30. **The current supervisory framework with regard to interest rate risk in the banking book complies with the criteria of the relevant core principle.** Nonetheless, the assessors support the envisaged change of the FSA's internal policy to undertake a more intrusive capital adequacy management for "outlier" banks following the results of the predefined (potential) parallel interest rate shift stress tests. While the framework for internal audit and control is largely in-line with the CP, corporate governance functions at individual banks could be further improved through strengthening the independence of the internal audit function and Board of Company Auditors.

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

Methods of ongoing banking supervision (CPs 19–21)

32. **The FSA's current bottom up supervisory approach of having supervisory teams responsible for highlighting and following up on supervisory issues and concerns facing financial institutions enables the FSA to promptly identify and deal with issues of supervisory concerns.** However, the FSA should have a more formalized, analytical risk framework that could be used to assess the risk profile of an institution in a holistic manner. In addition, it is recommended that a more formalized criterion be defined for the identification of systemically important financial institutions. This could take into consideration the probability and potential impact of a financial institution on the financial system. Such an approach could also help the FSA to better prioritize its supervisory resources and intensity.

Accounting and disclosure (CP 22)

33. **While the accounting and disclosure practices in Japan comply with the relevant CP to a large extent, there is a risk that temporary government measures in place could**

lead to valuation practices differing from international standards. These government measures could also result in some differing accounting and disclosure practices from international standards. The supervisory authorities may want to take steps to promote the prompt standardization of valuation, accounting and disclosure standards with international standards in all areas. The FSA may also wish to strengthen its authority over external auditors.

Corrective and remedial powers of supervisors (CP 23)

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

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

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

36. **Progress has been made in deepening the cooperation and information sharing between the FSA and other home and host supervisors.** This has been achieved through various channels such as the Exchange of Letters with overseas supervisors and the holding of regular supervisory colleges for the major bank groups. The FSA should continue to further strengthen home/host cooperation through engaging in more proactive cooperation with foreign supervisors by ensuring that relevant information is shared swiftly and effectively to strengthen the FSA's ability to anticipate and deal with crisis situations and potentially any bank resolution situations.

Table A1. Japan—Summary of Compliance with the Basel Core Principles

Basel Core Principle	Comments
1. Objectives, independence, powers, transparency, and cooperation	See below
1.1 Responsibilities and objectives	The mandate for the FSA with respect to the supervision of stock-issuing banks is clear and publicly disclosed. Also the BOJ's role in undertaking supervisory activities is clear and disclosed. However, different types of co-operative style deposit-taking institutions are supervised via different arrangements between the FSA and the Ministries of Labor and Agriculture. Greater clarity and transparency is suggested for the decision making process between FSA and other Ministries where they co-supervise an institution. Further, agricultural and fishery cooperatives are supervised by local state government. Given the limited size and the nature of their main business, the fact that the FSA together with the responsible Ministry of Agriculture has developed supervisory guidelines for these cooperatives and that FSA could, upon request, undertake on-site examinations, we view that a sufficient basis for prudential supervision exists.
1.2 Independence, accountability and transparency	The Banking Act and its delegation Order as well as the actual resources available for banking supervision, contain important safeguards against government and political interference in the FSA's day-to-day bank supervisory practice. Nonetheless, some major decisions concerning individual institutions are formally taken by the Minister for Financial Services, who has been assigned by the Prime Minister, not by the supervisor. In practice, such decisions are prepared and managed by the staff in the FSA, but need approval by the Minister for Financial Services. In addition, some institutions are co-supervised by the FSA and Ministries. Also the FSA could consider strengthening its governance arrangements towards the MOF's Local Finance Bureaus, to which the day-to-day supervision of regional and Shinkin banks has been delegated.
1.3 Legal framework	The Japanese legal framework includes clear provisions on the authorization of banking establishments and adequate information gathering powers. Prudential regulations are mainly set via standards, guidelines and inspection manuals which are publicly disclosed and adequately consulted upon.
1.4 Legal powers	The legal framework, especially the Banking Act, includes sufficient powers to address compliance with laws as well as safety and soundness concerns.
1.5 Legal protection	In general, the legal protection for banking supervisors, being civil servants, is sufficiently safeguarded.
1.6 Cooperation	Predominantly informal arrangements for information sharing exist between the FSA and BOJ and with

	foreign authorities. The arrangements between the Japanese authorities should be intensified further and arrangements with foreign authorities could be enhanced. Appropriate arrangements for the protection of the confidentiality of such information are in place.
2. Permissible activities	In Japan the permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined
3. Licensing criteria	Appropriate provisions for the licensing of banks are in place.
4. Transfer of significant ownership	The FSA has the power to review and reject any proposal to transfer significant ownership held directly or indirectly in existing banks to other parties. However, such powers for ex-ante approval do not explicitly exist for controlling interests.
5. Major acquisitions	The FSA has the power to ex ante review major acquisitions by a bank, with the exception of acquisitions in ancillary business for which a pre-approval is not necessary. Also investments by a bank in another bank, in ancillary business or related banking business other than the acquisition of a subsidiary, either domestically or abroad, do not need prior approval of the FSA, although prior notification would be needed, Based upon this prior notification the FSA may require a bank to take measures if it is concerned about the potential impact this investment might have.
6. Capital adequacy	Although the FSA has the legal power to impose higher capital requirements on individual banks that are commensurate with their risk profiles, the FSA's implementation of Pillar 2 of Basel II does not provide for setting extra capital charges in case the supervisory review process would indicate that not all material risks would have been captured. For domestic and internationally active banks different minimum capital levels are used, although a similar capital adequacy framework is used whereby similar risks lead to similar loss levels for which comparable capital levels should be available to absorb these losses. Moreover, triggers for early intervention measures due to a shortfall in minimum capital levels, are set too low, especially for domestic banks. Also in case a bank falls below its minimum level, it should no longer be allowed to pay dividends or executive compensation. On the quality of capital, domestic banks are still allowed to use deferred tax assets without a cap as part of capital, whereas for internationally active banks this has been capped at 20 percent. In addition, we have noticed some (temporary) measures taken by the Japanese government end 2008 for stabilizing the financial markets and facilitating finance, which includes a partial relaxation of the capital adequacy requirement for banks. In addition, accounting practices in Japan could in a number of cases lead to late recognition of losses together with capital adequacy requirements.
7. Risk management process	The FSA and BOJ have sufficient frameworks for identifying and evaluating bank's risk management

	systems and processes and for requiring remedial actions. They also perform sufficient inspections and monitoring to assess the processes at banks. However, especially the role of the external audit function should be strengthened, and further focus should be put on banks' stress testing practices and banks' integrated risk management. The FSA's priorities (2011) are to be underlined, which are on enterprise wide risk management systems and the enhanced coverage and capture of risks by the bank's internal models. Also, the governance arrangements at banks should be strengthened, promoting not only a more independent risk management and internal control function, but also an audit committee or a board of company auditors that can act independently from the board of directors, not only in 'form' but also in 'substance', and which receives information on the implementation of risks management systems, of actual risks run and of identified breaches directly from internal and external audit or compliance, whereby the responsibilities of the business and internal control function are sufficiently kept separately.
8. Credit risk	The comprehensive work undertaken by the FSA in its on- and off-site supervision as well as BOJ work in this area provides a sound basis for the supervision of credit risks. In general, the banks we visited had a sufficient credit risk management system in place.
9. Problem assets, provisions, and reserves	The policies and practices of banks with regard to problem assets have improved considerably over the last ten years. In the assessor's view, problem loans are adequately identified and classified. However, in the subsequent evaluation for extra provisions and reserves, banks are expected to take a more prudent stance, in taking into account possible factors such as possible changes in their business environment and government measures that are aimed at providing enhanced financing and support to their clients, including the restructuring of their loans.
10. Large exposure limits	The current large exposure rules are not sufficient. The current group concept does not sufficiently capture groups of related counterparties in as far they have a similar counterparty risk. Also, in calculating the exposures, not all exposures on a single counterparty or group of related counterparties are taken into account. Also, for domestic banks the same large exposure limits are applied as for internationally active banks, whereas their minimum level of capital is half of the level of an internationally active bank. And although we understand that the international discussions are still ongoing, the assessor's view is that in as far the limits should capture the event risk of a default of a single counterparty or group of connected counterparties, one should not solely rely on risk weighted exposures or exclude exposures, which in the current practice take place, which might be especially relevant under the current global market conditions. And lastly, limits should be set in such a way that after an event has occurred, a

	sufficient level of capital remains to absorb losses on going concern, which might be challenging, especially for domestically operating banks. With respect to bank's risk management systems, the assessors in their interviews with banks have heard of different systems to manage risk concentrations which might be further strengthened.
11. Exposure to related parties	The law has basic provisions with regard to 'exposures to related parties,' including granting these exposures at arms' length. The FSA however does not actively enforce these provisions via regular off-site monitoring in combination with focused onsite inspections.
12. Country and transfer risks	While the FSA's approach in managing country and transfer risks are largely in-line with this criterion, more consideration should be given to the actual quality of country exposures and a more forward looking approach to asset evaluation and provisions.
13. Market risks	Megabanks are the more active participants in trading activities. The FSA has adequate market risk specialists. On-site inspections are carried out on the market risk area. Risk limits established by banks for trading activities were usually low with real time monitoring and daily escalations.
14. Liquidity risk	Liquidity risk supervision is performed by both BOJ and the FSA, with both authorities carrying out onsite inspections and off-site monitoring of banks in close coordination and cooperation.
15. Operational risk	Operational risk and crisis management framework is well established and in compliance with this Principle. Recent trends suggest that continued focus is needed on key risk areas such as information technology and the adequacy of integrated risk management for banks expanding overseas.
16. Interest rate risk in the banking book	The awareness, measurement, monitoring, and stress testing tools are in place to qualify for compliant grading under this principle. However, the FSA should note the comments on valuation and capital impact as further discussed under CP 22 and CP 6.
17. Internal control and audit	Corporate governance functions at banks should be improved by strengthening the independence of the internal audit function and fit-and-proper requirements for the company auditors.
18. Abuse of financial services	The weaknesses identified by the 2008 FATF evaluation have still not been addressed by changes to banking laws in Japan.
19. Supervisory approach	Supervisory resources are not fully allocated according to the risk assessment results of banks as there is currently no formalized, analytical risk framework used to assess the overall risk profile of an institution, with the exception of regional banks. However, SIBs have been allocated more resources than other banks. There was also no formalized definition of systemically important banks factoring probability and potential impact analysis both from the financial stability and consumer protection dimensions.

20. Supervisory techniques	The off-site and onsite supervisory processes in place are generally in compliance with this Principle.
21. Supervisory reporting	The FSA has the means of collecting, reviewing, and analyzing financial institutions' prudential returns on both a solo and consolidated basis.
22. Accounting and disclosure	The FSA does not have power to reject or rescind the appointment of an external auditor (EC 6). Temporary government measures including those taken to facilitate financing for small and medium-sized enterprises, relaxing the capital adequacy requirement for banks where MTM on "available for sale securities" in the banking book are required to be realized only when a loss of 50 percent was suffered, would affect the accounting representations, loan classifications, provisioning, valuations and capital adequacy.
23. Corrective and remedial powers of supervisors	Trigger levels for the PCA system are set too low (EC 5). Intervention procedures of the FSA could be strengthened to ensure that remedial actions are taken by banks promptly.
24. Consolidated supervision	Element of legal uncertainty under Articles 24-3, 52-31(3), 25-5 and 52-32(5) of the Banking Act that allows subsidiaries of the bank and banking holding company to refuse to submit report or materials requested by the FSA which might be an impediment to effective supervision.
25. Home-host relationships	There is room to further strengthen home/host cooperation through proactive engagement and coordinated, effective and timely sharing of relevant information with foreign regulators.

Table A2. Japan—Recommended Action Plan to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
Responsibilities and objectives (CP 1.1)	Where licensed institutions are co-supervised with the FSA, the arrangement should be clarified and made transparent. The areas where joint decisions are taken and how should be structured in such a manner that the FSAs supervisory responsibilities are not compromised.
Independence, Accountability, transparency (CP 1.2)	See recommended action under 1.1. In addition; the FSA could consider further strengthening its governance arrangements with respect to the day-to-day supervisory activities of the Local Finance Bureaus. Additional staff resources could be deployed to oversee these activities and by improving the review processes
Cooperation (CP 1.6)	The FSA and BOJ should further intensify their cooperation via more enhanced knowledge sharing, joint activities, and more regular sharing of supervisory findings. Japanese authorities should engage in bilateral and/or multilateral memoranda of understanding with the most relevant foreign supervisory authorities.
Permissible activities (CP 2)	The FSA could more pro-actively engage in monitoring of the credit markets, in order to actively enforce that only institutions with a banking license undertake business of a banking nature.
Licensing (CP 3)	Concerning the fit and properness of directors, senior managers and company auditors, regulations should reflect in substance that the person in question should not have a record of criminal activities or have any adverse regulatory judgment that would make him/her unfit for a senior position in a bank.
Transfer of significant ownerships (CP 4)	Japanese regulations should provide for an explicit supervisory approval of changes in ownership that would result in a controlling interest, for instance by utilizing FSA's powers to impose the condition on the approval of a major shareholder that a possible future majority holding by the major shareholder should be subject to a pre-approval by the FSA.
Major acquisitions (CP 5)	Japanese regulations should provide for an explicit supervisory approval of major investments. Also the scope for approval of acquisitions could be considered by inclusion of acquisitions of ancillary business and business related to banking business.
Capital adequacy (CP6)	The FSA should, as a supervisory instrument, also use its powers to set higher capital levels than the minimum depending upon the actual risk profile of the bank concerned.

Reference Principle	Recommended Action
	The capital standards for domestically operating banks should be aligned with those for internationally active banks, whereby similar risks will lead to similar loss levels for which comparable capital levels should be available to absorb these losses. The triggers for early intervention measures due to a shortfall in minimum capital levels should be set at higher levels and should for domestic banks be as much as possible aligned on the lines of internationally active banks, so that earlier more intrusive measures can be taken. In case a bank falls below its minimum level, it should no longer be allowed to pay dividends or executive compensation. For domestic banks, the elements of capital and the deductions, and possible limits used, should in as far as possible be in-line with those for the internationally active banks. Japanese authorities should ensure that their capital adequacy standards do not discourage the use of internal models and improved risk management techniques.
Risk management process (CP 7)	It is recommended that the FSA has arrangements with external auditors on a regular exchange of information on audit findings and a direct notification of exceptions in case unusual transactions identified at the bank. The FSA and BOJ should have a continued focus in their inspections on improving the governance structures at the banks, including risk management, internal audit, and the independent role in substance of the company auditors and possibly an audit committee. The FSA should also encourage a separation between the business line and control functions at senior levels commensurate with the size and complexity of individual banks. The FSA and BOJ should have a continued focus in their inspections on the quality of enterprise risk management and stress testing as a regular risk assessment tool used by banks.
Credit risk (CP 8)	More supervisory attention could be given to the further integration of concentration risk rules within the overall context of credit risk management. More focus could be put on identifying and measuring counterparty credit risk of securities and related derivatives products, and integrating it into the day-to-day risk management practices.

Reference Principle	Recommended Action
	A continued and focused attention by both the FSA and BOJ on the credit management processes of banks is warranted.
Problem assets, provisions and reserves (CP 9)	The FSA should investigate more actively the evaluation of the need for extra provisions and reserves and ensure that the banks take a more prudent stance on possible government measures that are aimed at providing enhanced financing and support to their clients, including in the restructuring of their loans.
Large exposure limits (CP 10)	The group concept of connected counterparties should be extended. The definition of exposure should be changed so that all exposures from an individual client or group of connected clients are taken into account. The large exposure limit set should be commensurate with the minimum capital adequacy ratio applied and should take into account the expected buffer capital that should be kept after an event has occurred. Japanese authorities should consider setting limits as a percentage of Tier 1 or core Tier 1 capital rather than as a percentage of bank capital. The FSA is encouraged to examine the risk management systems of banks with a view to increasing bank's management of risk concentrations in their loan portfolios with respect to different regions and industries.
Exposures to related parties (CP 11)	The FSA should enforce the existing provisions more vigorously by introducing off-site monitoring for these exposures on a regular basis. In its onsite examinations the FSA should undertake focused inspections on related party exposures.
Liquidity risk (CP 14)	The risk assessment standards for assessing liquidity risks following the onsite examinations and offsite monitoring carried out by both the FSA and BOJ could be further enhanced for consistency in approaches and risk rating assessments of banks, with due regard to BOJ's and FSA's own objectives.
Operational risk (CP 15)	Continue with the current focus on IT system risks and the adequacy of banks' integrated risk management.
Interest Rate Risk in the Banking Book (CP 16)	A more intensified capital adequacy management process for "outlier" banks following the results of the predefined (potential) parallel interest rate shift stress tests should be adopted by the FSA. Ensure the standardization of valuation rules with international standards for supervisory purposes
Internal Control and Audit (CP 17)	Strengthen the independence and effectiveness of the independent oversight functions within banks.

Reference Principle	Recommended Action
Abuse of Financial Services (CP 18)	Expedite the remediation of weaknesses identified through the 2008 FATF Mutual Evaluation.
Supervisory Approach (CP 19)	Develop a holistic risk rating assessment framework for individual financial institutions. Define criteria for identifying systemically important financial institutions that could better drive the allocation of supervisory resources and prioritization of supervisory intensity based on the risk and impact of financial institutions to the financial system.
Supervisory reporting (CP21)	To further enhance the integrity of prudential reporting, the FSA may wish to consider requiring that external auditors opine whether or not filings have been accurately made The FSA may wish also to explicitly require external auditors to immediately report any material shortcomings noted directly to the FSA.
Accounting and Disclosure (CP22)	The FSA should be empowered to reject or rescind the appointment of an external auditor, and should promote the prompt alignment of valuation, accounting, and disclosure standards with international standards in all areas.
Supervisors' Corrective and Remedial Powers (CP23)	Rectify deficiencies in the current PCA framework. Use a wider range of intervention tools to avoid delays in remedial actions.
Consolidated Supervision (CP24)	Ensure powers to supervise all entities within a group are not constrained by legal provisions. Continue to enhance the effectiveness of its cross-border supervision, including strengthening potential resolution tools.
Home-Host relationships (CP25)	Engage more proactively in coordinated, effective and timely sharing of relevant information with foreign supervisors on a regular basis to strengthen ability to anticipate and deal with crisis situations and meet industry expectations. Continue efforts to sign more formalized arrangements including bilateral or multilateral agreements with foreign supervisors.

Authorities' response to the assessment

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

42. **The authorities welcome the overall assessment by the IMF that they have achieved a high level of compliance with the Basel Core Principles**. They also appreciate the IMF's assessment that significant progress has been made since the last FSAP. The

recommendations made by the IMF to further improve regulation and supervision in accordance with the BCPs are well received. While some initiatives towards reform are already taken since the time of the assessment, the authorities will thoroughly take into account these recommendations in their continuous efforts to strengthen their capacities for better regulation and supervision.

43. **In two areas where the authority's compliance could improve, initiatives are already underway**.

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

- Concerning CP 10, the Financial System Council, which has been established as an advisory body to the Prime Minister, the Commissioner of the FSA and Finance Minister, is now requested to review the large exposure regime in Japan.

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

Annex II. Insurance Core Principles (ICPs): A Summary[1]

F. Introduction

1. **The summary is based on a full assessment of Japan's compliance with the Insurance Core Principles (ICPs) of the International Association of Insurance Supervisors (IAIS) as adopted in October 2011.** The review was based on the regulatory framework in place, the supervisory practices employed, and other conditions as they existed in December 2011.

2. **Regulation and supervision of the insurance industry in Japan is largely the responsibility of the Financial Services Agency (FSA).** The FSA is an external organ of the Cabinet Office, headed by a Commissioner, and accountable to the Minister for Financial Services.

3. **The assessment is based solely on the laws, regulations, and other supervisory requirements and practices that were in place at the time of assessment.** Ongoing regulatory initiatives are noted by way of additional comments. Assessors had access to a complete self-assessment on the ICPs and responses to a detailed questionnaire that had been provided by the FSA prior to the commencement of the exercise.

4. **The assessment has been informed by discussions with regulators and market participants.** The assessors met with staff from the FSA and various government ministries, insurers, industry associations, professional bodies and firms, and rating agencies. The assessors are grateful for the full cooperation extended by all.

5. **Japan is the first jurisdiction to be assessed under the 2011 version of the ICPs.** The efforts required by the FSA to prepare the self-assessment, even while final changes to the ICPs were being deliberated, as well as its excellent support during the mission, are especially appreciated.

G. Institutional, Macroeconomic Setting and Market Structure

6. **Low interest rates and declining equity prices have placed considerable pressure on the insurance market, influencing both its structure and regulation.** The failures of seven mid-size companies in the late 1990s and early 2000s resulted in mergers and acquisitions, creating larger players but also opening the market for more foreign participants. The 2010 mega mergers marked another milestone in the streamlining of the market. As a result, in the nonlife sector three groups control over 90 percent of the market and four companies over 65 percent of the life market, excluding the JPI. Regulatory valuation and solvency requirements were revised to include elements that allow for a long

[1] This is based on a detailed assessment of Japan's observance of the ICPs conducted during November 28–December 16, 2011.

term recovery of deficits. Rules governing the winding up of companies also allow for the amendment of existing contracts, for example, in the form of a lower guaranteed interest rate.

7. **The Law on the Establishment of the Financial Services Agency (LEFSA) defines the FSA as the authority generally responsible for supervision of the insurance business.** The Insurance Business Act (IBA), the primary legislation through which the insurance business is regulated, identifies some insurance activities as being outside its scope and therefore not supervised by the FSA. They include captives and business transacted by certain closed groups such as labor unions with their members, neither of which is subject to supervision. They also include insurance activities that are subject to other acts; the insurance activities of cooperatives (Kyosai) are subject to other acts and are supervised by the government ministries responsible for the relevant sectors. This assessment focuses on the insurance activities that are regulated by the IBA and supervised by the FSA.

8. **The insurance industry in Japan is an important part of the financial sector.** At the end of 2010, the total assets of the insurance sector amounted to 78 percent of GDP or ¥373 trillion. The life sector has assets of around ¥291 trillion, of which ¥96 trillion correspond to JPI; ¥46 trillion relates to the Zenkyoren, which is the largest federation of cooperatives; and ¥36 trillion to the nonlife sector. In terms of aggregate insurance premiums, Japan is the second largest market in the world, with a share of 13 percent or ¥41.5 trillion in 2010: around 17.5 percent of the global life insurance premium and around 6.5 percent of the global nonlife insurance premium.

9. **The sector is highly concentrated.** The Japanese life insurance market consists of only 47 companies, and only 52 insurers operate in the Japanese nonlife sector. JPI accounts for 21 percent of the life premium and the next four largest life insurers for another 43 percent. The five largest nonlife insurers, belonging to three insurance groups, account for 82 percent of the nonlife premium. About one-half of the insurers operating in the Japanese insurance market are now foreign-owned, with a 20 percent market share in the life sector and a less than 10 percent share in the nonlife sector. There are also 6,921 cooperatives, whose services include life and nonlife insurance. Premiums in both the life and nonlife sectors have stagnated in recent years.

10. **Life products are mainly traditional individual endowments, whole life, and term insurance.** The large sales force of agents dominates as a distribution channel, and focuses mainly on simple life protection and saving products, which account for 87 percent of the sales. Financial institutions, particularly banks, distribute saving products, including variable annuities, and are now distributing around 13 percent of the individual life products. Every third policy sold in 2010 was related to the "third sector," which includes products such as private medical, hospitalization, disability, cancer and long-term care insurance.

11. **The nonlife sector is dominated by motor insurance.** Voluntary and mandatory motor insurance together account for 64 percent of the market, down from 68 percent in 2002. Fire insurance follows, with a 17 percent share. All other types of nonlife insurance are offered. Here again, the main distribution channels are the large sales forces controlled by the insurers. Brokers play a minor role, placing less than 5 percent of the premium. International

reinsurance ceded in the fiscal year 2010 was ¥310 billion and inwards reinsurance was ¥200 billion, about the same level as in the previous three years.

12. **The insurance sector responded positively to the Great East Japan Earthquake.** Both life and nonlife insurers, as well as the cooperative insurers, set up disaster response headquarters within hours of the earthquake. Large numbers of agents and company employees were deployed to the affected area, providing support in claims identification and payment. The earthquake exclusion clause was waived and, with the agreement of the FSA, the formal requirements for payment were relaxed. Close collaboration with the police allowed for fast settlement of life benefits and the simple form of the standard earthquake policy covering residential properties allowed for 80 percent of the claims to be paid within 10 weeks. As of September 2011, the homeowners' earthquake insurance had paid ¥1,145 billion in benefits.

13. **Profitability levels of the life sector have fully recovered from the 2008 global financial crisis and showed two years of record profits.** Life insurers were affected by the 2008 crisis mainly through the depreciation of assets, but their portfolio mix, having a significant position in JGB and local equity, allowed for a fast recovery. The profitability of life insurers is expected to further improve as the negative spread existing in several portfolios is reduced.

14. **Life insurers show a strong regulatory solvency margin.** Under current regulatory solvency requirements the life insurance sector is well-capitalized. With current solvency margin ratios of 500 percent or more, all insurers have sufficient capital to avoid regulatory action (which is triggered at the 200 percent level). Under the newly-established solvency requirements that take effect at the end of the current fiscal year, a reduction of 20 to 30 percent in the margin is expected.

15. **Nonlife insurers affected by the 2008 global financial crisis are in the process of recovery.** The high exposure to equities resulted in a 150 percent loss for the nonlife insurers in FY2008. The recovery was slowed by the occurrence of the severe Great East Japan Earthquake at the end of the FY2011, resulting in additional claims under commercial earthquake insurance in the order of ¥600 billion, of which reinsurance is expected to assume ¥400 billion, and losses to life insurers are modest.

16. **The expected profits for the nonlife sector during the coming years are moderately positive.** Planned increments of the motor insurance rates are expected to accelerate recovery, but exposure to global natural catastrophes has increased as the international expansion of Japanese insurers continues. With a presence in over 50 countries and the strengthening of the Japanese yen, volatility in the profits generated outside Japan remains a challenge. Competition in a stagnant local market has resulted in an increase in the combined ratio, which has exceeded 100 percent for three consecutive years, thus putting pressure on insurers to reduce expenses while maintaining service levels and complying with regulatory requirements. The recent mega mergers in the sector respond to such conditions.

17. **Nonlife insurers show a strong regulatory solvency margin, with a few exceptions.** With 43 of the nonlife insurers having solvency margin ratios of 500 percent or

more, the industry remains above the 200 percent solvency control level. In the case of nonlife insurers, the absence of economic valuation of the liabilities appears to be of less importance than for life insurers. However, the liabilities related to return-of-premium nonlife business would be affected by the adoption of such a valuation approach. Quantitative impact analysis will be necessary to evaluate such a possibility. Other financial indicators of the nonlife insurance sector suggest resilience. The ratio of net premium written to capital and surplus (the risk ratio) is 234.6 percent and capital and surplus of 10 percent of total assets are both within international norms for sound companies. Foreign currency assets are less than 100 percent of capital and surplus, and the exposures are largely hedged. The relatively large equity holdings of nonlife insurers affect their liquidity, but overall liquidity remains at a reasonable level.

H. Main Findings

18. **The review suggests that there is a high degree of compliance with the IAIS Core Principles.** Areas where further strengthening is needed relate to ICPs on the supervisor, valuation, macroprudential surveillance and insurance supervision, and cross-border cooperation and coordination on crisis management.

19. **The FSA has been strengthening its insurance regulatory framework, including the solvency requirements applicable to insurers and insurance holding companies.** It has revised the risk parameters, resulting in an increase in required capital, has extended the solvency requirements to the holding company level and is improving the tools used for supervisory assessment, including stress testing. The FSA should build on this by completing the development of a methodology for risk-rating insurers, adopting a structured system for the internal review of risk assessments, and further increasing the level of resources to enable inspections to be performed more frequently—particularly for the largest insurers.

20. **The FSA has developed a good foundation for dealing with group-wide and macroprudential issues, including the supervision of Japanese insurance holding companies, cooperation with foreign supervisors, and market analysis capabilities.** The FSA should continue to improve its ability to anticipate and deal with crisis situations by taking steps to maximize the value of its macroprudential analyses, developing contingency plans, and cooperating more proactively with foreign supervisors—including through the establishment of colleges of supervisors for Japanese insurance groups.

21. **While currently there are no indications of political or other undue interference in the supervision of insurers, the legal framework governing the FSA contains elements that could undermine the independence and capacity of the supervisor.** For example, the annual budget of the FSA must be approved by the Diet, after first being approved by the Minister for Financial Services and the Ministry of Finance. In recent years, the budget and staffing levels of the FSA have been increasing, while those of other government departments have been reduced. Nevertheless, the budget approved by the Diet has sometimes been less than requested by the FSA. Financing the FSA in a manner that does not involve negotiation of its budget, such as through legally-enforceable levies, could be useful in strengthening both its independence and its resources.

22. **Solvency assessment should be based on a transparent economic valuation of assets and liabilities, which takes into account future cash flows over the full time horizon.** The current methods of valuing insurance liabilities do not meet these criteria, which creates the risk that liabilities are not being fully recognized. The FSA should revise its valuation approach to take fuller account of emerging experience and anticipated future experience.

23. **A few additional areas where improvement would be particularly desirable are summarized below:**

- **The FSA requires insurers to take steps to deal with identified weaknesses, but its intervention efforts could be enhanced.** The FSA prefers to deal with minor regulatory violations through dialogue and moral suasion. Minor sanctions are not being applied. At the same time, the formal supervisory administrative action threshold appears to be high, based on the limited number of such actions taken in the last 10 years. The FSA should make greater use of the tools available to it, such as the power to impose fines on insurers and intermediaries, to develop a more progressive approach to enforcement.

- **Corporate governance has made improvements but independence remains weak.** While a few insurers have a board structure with a clear segregation between board members and senior management in place, the majority of the insurers and insurance holding companies maintain the traditional structure of a board largely comprised of senior management overseen by an audit board. However, the board of corporate auditors has limited powers; for example, it cannot dismiss directors or call for a shareholders meeting, which could compromise the timeliness and effectiveness of its interventions. Its work is largely performed by full-time members who were previously part of management, and fit and proper requirements under the IBA do not apply to corporate auditors and apply only to a limited extent to part-time directors. The corporate governance and suitability requirements should be revised to strengthen independent oversight, which will reinforce the supervisory efforts of the FSA.

- **Exposure to natural catastrophes makes strong reinsurance coverage essential to the Japanese insurance market and overall economy.** The FSA reviews the reinsurance strategies and programs of insurers, but the regulation and supervision of reinsurance could be strengthened. The FSA should consider measures such as stronger documentation requirements (including the prohibition of side letters) and a more formal assessment of the manner in which foreign reinsurers are supervised. The exclusion of the cooperatives' insurance programs from the national earthquake pool might be reconsidered, as it could affect the solvency of those cooperatives in case of a major event or the failure of reinsurers.

- **Stress testing is at an early stage of use and sophistication.** The FSA performs top-down stress testing of the insurance sector each quarter with respect to equity-price, exchange-rate, and credit risks. Insurers are expected to perform stress tests and they

generally submit the results of such tests to the FSA. However, the FSA does not prescribe specific stress scenarios that insurers are required to test.

I. Summary of Observance of the Insurance Core Principles

Table A3. Japan—Summary of Observance of the Insurance Core Principles

Insurance Core Principle	Overall Comments
1 - Objectives, Powers and Responsibilities of the Supervisor	As a consolidated supervisor, the FSA has been able to take advantage of economies of scale. However, the large part of the insurance market served by cooperatives is supervised by independent departments within several ministries. This could potentially cause challenges of resourcing and might make it difficult to achieve consistency of supervision.
2 - Supervisor	While currently there are no indications of political interference in the supervision of insurers, the legal framework governing the FSA contains elements that could undermine the independence and capacity of the supervisor. For example, the budget must be approved by appointed and elected government officials, which leaves it exposed to cutbacks for financial or political reasons. The FSA has been strengthening its insurance regulatory framework and is improving the tools used for supervisory assessment. Industry participants appreciate the proactive manner in which the FSA consults on regulatory and supervisory changes. The FSA expects industry participants to act in accordance with the guidance provided by both the Supervisory Guideline and the Inspection Manuals. However, the manner which the expectations are expressed could affect both their enforceability and their transparency. It is important that the public have ready access to financial and statistical information about insurers and intermediaries. Japanese industry associations publish industry-wide information and information about individual insurers and insurance groups is available on their respective websites. However, it would be better for the public to be able to obtain both industry-wide and entity-specific information from a single, reliable, and consistent source of information. This would not only facilitate the ability of others to perform analyses and contribute to market discipline. Many supervisors make use of outside experts to improve their effectiveness, for example, by contracting with persons having specialized expertise in an emerging area of industry activity.
3 - Information Exchange and Confidentiality Requirements	The positive response to specific requests from foreign supervisors could be enhanced by a more proactive exchange of information with all relevant supervisors. The exchange of information with a foreign supervisor could be delayed if the FSA has not previously checked the confidentiality regime of the foreign jurisdiction.
4 - Licensing	Although it is clear that an insurer is licensed for either life insurance or nonlife insurance, the specific classes of insurance that the FSA has approved the insurer to underwrite are not publicly disclosed. Such

	information can be useful to consumers and intermediaries.
5 - Suitability of Persons	Suitability requirements should formally apply to all persons who hold have key roles in the governance and operation of an insurer. This reinforces the need for insurers to select suitable persons for such roles. It also strengthens the supervisor's ability to take corrective action. Currently, there are some gaps in the scope of suitability requirements. In some jurisdictions, legislation permanently prohibits persons who have been convicted of financial crimes from holding key roles in the governance and operation of an insurer. This strengthens the ability of the supervisor to declare such persons to be unfit.
6 - Changes in Control and Portfolio Transfers	The experience gained through the significant number of portfolio transfers in the late 1990s and early 2000s has been reflected both in the legal framework and in practice.
7 - Corporate Governance	Corporate governance in Japan has improved, but independence remains weak. While a few insurers have a board structure with a clear segregation between board members and senior management in place, the majority of the insurers and insurance holding companies maintain the traditional structure of a board largely comprised of senior management overseen by an audit board. However, the board of corporate auditors has limited powers; for example, it cannot dismiss directors or call for a shareholders meeting, which could compromise the timeliness and effectiveness of its interventions. Its work is largely performed by full-time members who were previously part of management, and fit and proper requirements under the IBA do not apply to corporate auditors and apply only to a limited extent to part-time directors. Also, many insurers—even those with a monitoring board structure—have few outside directors on their boards. As well as improving oversight, a larger proportion of outside directors could be useful in providing management with additional, independent views on business matters. Furthermore, the definition of "outside" is less restrictive than it might be; for example, it does not exclude the spouse of a senior executive. Many important aspects of corporate governance are dealt with in the Supervisory Guideline, rather than in legislation.
8 - Risk Management and Internal Controls	In recent years, the FSA has more strongly emphasized the importance of risk management and internal controls, and some insurers have sophisticated systems in place. Listed companies are required to provide additional assurance on the adequacy of their internal controls, under "J-SOX."
9 - Supervisory Review and Reporting	The FSA has been improving the tools used for supervisory assessment. As mentioned under ICP 2, the FSA should build on this by completing the development of a methodology for risk-rating insurers and adopting a structured system for the internal review of risk assessments. Legislation does not require foreign branches to have the financial information that they submit audited. The FSA has made this a condition of licensing, and individually informs applicants for foreign branch licenses of the requirement. However, this requirement should

	be both strong and transparent. The external auditors of an insurer can be a valuable source of information for supervisors. In some jurisdictions, the legal framework includes provisions that enable supervisors to place greater reliance on the work of external auditors. They include giving external auditors the right to provide information to the supervisor without being subject to lawsuit for breaching confidentiality, requiring external auditors to report to the supervisor significant adverse information that has come to their attention in the course of an audit, enabling the supervisor to review the working papers of the external auditors, and empowering the supervisor to require the external auditor to increase the scope of their audit or to perform a special audit at the expense of the company. The FSA's inspections of insurers appear to be comprehensive and industry representatives have indicated that the findings have been useful to them in improving their operations. However, the time between inspections is longer than it should be.
10 - Preventive and Corrective Measures	The FSA requires insurers to take steps to deal with identified weaknesses, but its intervention efforts could be enhanced. The adoption of a risk-rating system (see ICP 2) and the revision of solvency margin control levels (see ICP 17) would support the FSA's ability to take early preventive and corrective measures. The FSA prefers to deal with minor regulatory violations through dialogue and moral suasion, which it has found effective in securing corrective actions. Minor sanctions are not being applied. At the same time, the formal supervisory administrative action threshold appears to be high, based on the limited number of such actions taken in the last 10 years.
11 - Enforcement	In many jurisdictions, the supervisory authority has the power to impose monetary penalties through administrative means for clearly-defined and less significant breaches of legislation, such as the late or erroneous submission of required information. This power supplements its ability to seek court action to deal with major breaches.
12 - Winding-up and Exit from the Market	The possibility of amending insurance contract conditions where it is highly probable that the continuation of an insurer's business will be difficult is a useful tool in dealing with a failed insurer. Such amendments are subject to various conditions, which are designed to protect consumers.
13 - Reinsurance and Other Forms of Risk Transfer	Japan's exposure to natural catastrophes makes strong reinsurance coverage essential to the Japanese insurance market and overall economy. The FSA reviews the reinsurance strategies and programs of insurers, but the regulation and supervision of reinsurance could be strengthened.
14 - Valuation	Solvency assessment should be based on a transparent economic valuation of assets and liabilities, which takes into account future cash flows over the full time horizon. The current methods of valuing insurance liabilities do not meet these criteria (standards 14.8 and 14.9), which creates the risk that liabilities are not being fully recognized. The combination of basic amortized-cost valuations using conservative assumptions, additional provisions based on the testing of cash flows, and supplemental reserves is difficult to understand.

	Although future cash flows over the full time horizon are taken into account in the initial valuation of liabilities, this is not necessarily the case in the subsequent testing of their sufficiency, for which only cash flows during the next 10 years are required to be considered. The approach to cash flow testing in respect of the negative spread, as well as the absence of an explicit valuation of some options and guarantees, create the possibility that liabilities might be understated. The FSA is currently considering the possibility of moving to a valuation approach that is more closely related to economic value. In addition, the FSA is considering that costs regarding options and guarantees will be taken into account when insurance liabilities are calculated.
15 - Investment	The FSA is considering changes to the investment regulations to give insurers more flexibility in their investment strategies. For example, such changes might include eliminating the quantitative limit on equity investments, which is increasingly affecting some nonlife insurers as their long-term, premium-refund business declines. At the same time, some insurers are actively reducing their exposure to equities in order to reduce market risk and improve returns (in the case of equities purchased as a way to attract insurance business from the issuers). Some jurisdictions supplement quantitative investment limitations with an overriding requirement that insurers invest in the manner of a prudent person. Such a requirement can be particularly useful—both in reinforcing the need for good behavior and empowering supervisory intervention—if quantitative investment limitations are being relaxed.
16 - Enterprise Risk Management for Solvency Purposes	Enterprise risk management is an evolving field, both in Japan and internationally. Some Japanese insurers have sophisticated enterprise risk management systems, while others are at earlier stages of development. The Supervisory Guideline was revised to deal more extensively with risk management in response to the global financial crisis, while the Inspection Manual was updated in 2011 to include a section explicitly on this topic. Through interviews, the FSA has done a thematic review of the enterprise risk management processes of selected insurers.
17 - Capital Adequacy	It is important that solvency requirements be sufficiently strong, while not being onerous. There are various steps that can be taken to achieve this balance, such as requiring insurers to model risks internally and reviewing the results, and comparing the requirements with those of other jurisdictions with similarly sophisticated insurance markets. For the most recent revisions, the risk parameters were calculated by the FSA, based on historical experience. It has been at least 10 years since any insurer has fallen below the 200 percent solvency control level—including an insurer that failed. Even with the recent strengthening of the risk weights, most insurers are likely to remain well above the control levels. In order to serve as an effective supervisory tool, the highest solvency control level should be closer to the level of that insurers typically maintain in order to be considered strong internally and by market participants. The FSA does not impose variations to the solvency margin requirements on individual insurers. The supervisors in some jurisdictions do so, for example, to take account of risk characteristics

	of an insurer that is not fully captured by the standardized formulas. Very few insurers are using internal models for solvency margin calculations. However, the requests to do so are likely to increase in the future, as insurers build their enterprise risk management capabilities and gain comfort in using the related models.
18 - Intermediaries	Onsite inspection is an important tool in the supervision of both insurers and insurance intermediaries.
19 - Conduct of Business	Some supervisors have created units responsible for taking the lead on customer protection, which helps to ensure that such issues are identified in a timely manner and dealt with appropriately.
20 - Public Disclosure	Currently, few insurers are using internal models to calculate the solvency requirements for catastrophe risks. However, those that do so are not required to disclose information about such models. Insurers disclose a significant amount of information, some of which goes beyond the legally-required disclosures. However, there are some areas that should be strengthened. Insurers disclose their exposures to reinsurers by ratings category. This is useful information, but it does not enable users to assess the possible effects of reinsurance concentrations.
21 - Countering Fraud in Insurance	Fraud in insurance has not been a significant problem in Japan. Relatively few cases of fraud have been reported, but there are no statistics on the extent of fraud or its cost to insurers—and ultimately, to consumers. This situation might change, for example, as insurers develop new products that provide different types of living benefits than traditional products. In some jurisdictions, insurers cooperate in a formal manner to share information that supports the detection of fraud.
22 - Anti-Money Laundering and Combating the Financing of Terrorism	The AML/CFT efforts of insurers and intermediaries should be inspected regularly.
23 - Group-wide Supervision	Group-wide solvency requirements have been adopted, which insurance holding companies must meet by March 2012 (the end of the fiscal year).
24 - Macroprudential Surveillance and Insurance Supervision	The IAIS and other international organizations are currently considering how to define and deal with global systemically-important financial institutions. Such considerations are quite relevant to Japan, in light of the size and concentration of its insurance sector.
25 - Supervisory Cooperation and Coordination	The FSA serves as the group-wide supervisor of Japanese insurance groups, but in some cases does not regularly communicate with foreign host supervisors.
26 - Cross-border Cooperation and Coordination on Crisis Management	Cross-border cooperation and coordination specifically related to crisis management of Japanese insurers is in its initial stages.

J. Recommendations and the Authorities' Responses

Table A4. Japan—Recommendations to Improve Observance of ICPs

Insurance Core Principle	Recommendations
1 - Objectives, Powers and Responsibilities of the Supervisor	To help ensure that the objectives of insurance supervision are pursued in a consistent manner with respect to all parts of the Japanese insurance sector, the FSA and the responsible ministries should consider establishing a process that would facilitate the regular exchange of views on the objectives of insurance supervision and the manner in which those objectives might be achieved. Alternatively, the government might consider centralizing insurance supervision with the FSA.
2 - Supervisor	Consideration should be given to having the FSA financed in a manner that does not involve negotiation of its budget, such as by legally-enforceable levies on the industry, which could be useful in strengthening both its independence and its resources. The FSA should complete the development of a methodology for risk-rating insurers, adopting a structured system for the internal review of risk assessments, and further increasing the level of resources to enable inspections to be performed more frequently—particularly for the largest insurers. The FSA should consider making some expectations into requirements within the IBA or secondary legislation and communicate important expectations through the Supervisory Guideline rather than the Inspection Manuals. The FSA should make information about the industry, individual insurers, insurance groups, and intermediaries available on its website. The FSA should consider the possibility of using outside experts to supplement its staff resources.
3 - Information Exchange and Confidentiality Requirements	The FSA should consider expanding its distribution list of relevant supervisors that might be interested in various types of information. To minimize the risk of delays and facilitate proactive, two-way exchanges of information, the FSA should check the confidentiality regimes of all relevant home and host jurisdictions before a specific need arises.
4 - Licensing	The FSA should consider publishing information regarding the classes of insurance each insurer has been approved to underwrite. As commented under ICP 9, the legislation should be amended to require foreign branches to submit audited financial information, so that this requirement will be both strengthened and published.
5 - Suitability of Persons	The legislation should be revised to extend the application of suitability requirements to part-time directors, corporate

	auditors, and all executive officers. The FSA should consider seeking an amendment to legislation to strengthen its ability to disqualify persons who have been convicted of financial crimes from holding key roles in the governance and operation of an insurer.
6 - Changes in Control and Portfolio Transfers	None.
7 - Corporate Governance	The corporate governance and suitability requirements should be revised to strengthen independent oversight, which will reinforce the supervisory efforts of the FSA. As indicated under ICP 2, the FSA should consider making some of its expectations regarding corporate governance into legally-binding requirements under the IBA or secondary legislation.
8 - Risk Management and Internal Controls	The FSA should consider whether all insurers should be subject to the internal control requirements currently applicable to listed companies.
9 - Supervisory Review and Reporting	The FSA should complete the development of a methodology for risk-rating insurers and adopt a structured system for the internal review of risk assessments. The legislation should be amended to require foreign branches to submit audited financial information. The arrangements for communication with the external auditors should be enhanced, for example, by meeting regularly with the external auditors and revising the legal framework to include measures that would enable the FSA to place greater reliance on their work. The FSA should increase the frequency of its inspections. For example, it might inspect all large insurers at least once every two years, high-risk insurers at least annually, and other insurers at least once every three years.
10 - Preventive and Corrective Measures	The FSA should make greater use of the tools available to it, such as the power to impose fines on insurers and intermediaries, to develop a more progressive approach to enforcement.
11 - Enforcement	The FSA might consider the applicability of administrative monetary penalties in Japan and, if appropriate, the legislation should be revised accordingly.
12 - Winding-up and Exit from the Market	The FSA should consider seeking an amendment to the IBA to further protect the rights and entitlements of nonlife insurance policyholders, by extending to them the same preference on winding-up currently provided to life insurance policyholders.
13 - Reinsurance and Other Forms of Risk Transfer	The FSA should consider measures such as stronger documentation requirements (including the prohibition of side letters) and a more formal assessment of the manner in which foreign reinsurers are supervised. 24. The exclusion of the cooperatives' insurance programs from the national earthquake pool might be

	reconsidered, as it could affect the solvency of those cooperatives in case of a major event or the failure of reinsurers.
14 - Valuation	The FSA should revise its valuation approach to take fuller account of emerging experience and anticipated future experience.
15 - Investment	The FSA might consider whether the inclusion of a prudent person requirement in the IBA would be useful in Japan.
16 - Enterprise Risk Management for Solvency Purposes	The FSA should enhance its guidance on enterprise risk management to indicate that insurers should explicitly describe the relationship between their risk tolerance limits, regulatory capital requirements, economic capital, and the processes and methods for monitoring risk. It should also provide more explicit guidance regarding the performance of own risk and solvency assessment. The FSA should encourage insurers to include the target asset mix as part of their investment policies. It should also consider incorporating basic requirements to perform enterprise risk management in the legislation, and communicate more specific expectations through the Supervisory Guideline. The FSA should actively supervise the efforts of insurers in this area, to help ensure that their capabilities are evolving at an appropriate pace.
17 - Capital Adequacy	The required solvency margin should include risk margins for any mismatching of assets and liabilities, not just a risk margin for interest-rate risk. The required solvency margin should also be enhanced to consider the ratings of reinsurers in the risk weights applied to reinsurance credit exposures. In the future, the FSA should consider enhancing the process of revising solvency requirements by asking insurers to model risk scenarios and making detailed comparisons to the solvency regimes of other jurisdictions. The FSA should consider increasing the solvency control levels. The FSA should consider imposing variations to the solvency margin requirements in cases where the risk characteristics of individual insurers are not fully captured by the standardized formulas. The FSA should update its model approval standards to conform to current best practices.
18 - Intermediaries	The FSA should perform periodic onsite inspections of brokers, even though they account for a small share of the market in Japan. Consideration should also be given to making it a legal requirement that all insurance intermediaries pass examinations as a condition of registration.
19 - Conduct of Business	The FSA might consider creating a customer protection unit.
20 - Public Disclosure	The disclosure requirements should be revised to require the

	public disclosure of information about the internal models used to calculate the solvency requirements for catastrophe risks. The FSA should enhance the requirements to include the disclosure of information such as: • the level of sensitivity of investment values to market variables; • the methodology used and the key assumptions employed in measuring assets and liabilities for ALM purposes; • a quantitative analysis of sources of earnings; • quantitative information about material risk exposures, including concentrations; and • the nature of stress testing being performed. The FSA should consider requiring the disclosure of reinsurance premium concentration ratios.
21 - Countering Fraud in Insurance	The FSA should encourage the industry associations to maintain industry-wide data bases to help detect fraud.
22 - Anti-Money Laundering and Combating the Financing of Terrorism	The FSA should reinforce its supervision of AML/CFT through more frequent onsite inspections of insurers and intermediaries (see ICPs 9 and 18).
23 - Group-wide Supervision	None.
24 - Macroprudential Surveillance and Insurance Supervision	The FSA should not only remain actively engaged in the international discussions, but also deal with the issue of systemically-important insurers for its own market. Some steps should be taken to enhance the macroprudential value of the information currently being prepared by the FSA. The FSA should develop a comprehensive process for bringing together the various pieces of information, identifying issues of possible macroprudential importance to the insurance sector (and the financial sector more broadly), formulating adverse scenarios for further consideration, and communicating the results of this analysis internally and with other Japanese supervisory authorities. The effects of the adverse scenarios should be assessed quantitatively, through either top-down stress testing by the FSA or bottom-up stress testing of prescribed scenarios by the insurers. The FSA should also contribute to the ability of others to analyze the industry by making market data publicly available.
25 - Supervisory Cooperation and Coordination	The FSA should establish supervisory colleges for Japanese insurers with material foreign operations, supported by adequate staff and financial resources, and use the colleges to enhance cooperation and coordination.
26 - Cross-border Cooperation and Coordination on Crisis Management	The FSA should develop comprehensive plans for dealing with insurers in crisis and ensure that it has the tools needed to carry out such plans. It should ensure that the plans are internationally-coordinated by working with foreign supervisors, for example, through supervisory colleges.

	Insurers should be required to prepare contingency plans, which should include specific procedures for use in a gone-concern situation.

Authorities' response to the assessment

25. **The Japanese authorities welcome the opportunity to be assessed as the first jurisdiction under the newly revised version of the Insurance Core Principles (ICPs), which was published in October 2011.** The authorities also wish to express their sincere appreciation to the IMF and its experienced assessors for the dedication, time and resources committed to this assessment. It provided the authorities with the opportunity to comprehensively review their regulatory and supervisory framework through their self-assessments and dialogue with the IMF.

26. **The authorities also welcome the overall assessment by the IMF that they have achieved a high level of compliance with the ICPs.** The recommendations made by the IMF are generally well received. While some initiatives towards reform are already taken since the time of the assessment, the authorities will thoroughly take into account these recommendations in the course of their continuous efforts to strengthen their capacities for better regulation and supervision.

27. **However, it should also be noted that there were some differences of views between the IMF and the authorities in interpreting the 2011 version of the ICPs.** For example, ICP 14 contains a passage based on a compromise among the IAIS members in the form of employing a broader interpretation of "economic valuation" while the relevant accounting standards are still very much being developed by accounting standard-setters, particularly IFRS 4.

28. **More broadly, full and immediate compliance with newly developed standards is a major challenge for all.** One example is ICP 24; it requires a macroprudential surveillance framework in the insurance sector, which is still being designed and developed in most jurisdictions, and it will take some time for the best practices in this area to be established.

29. **The authorities aim to pursue their approach of "better regulation" through creating incentives for enhancing effective management on the part of insurers, while the IMF appears to place more emphasis on a rules-based approach, combined with the imposition of strict penalties including fines when the rules are breached.** The authorities believe that encouraging insurers to enhance the effectiveness of their management through close monitoring by and communication with the authorities is a key element of effective regulation and supervision. The authorities also believe that proper regulation and appropriate supervision should incentivize insurers to identify the issues themselves and take corrective measures on their own, and fines and other penalties should play only a complementary role. The authorities would maintain that such an approach improves the quality of the insurance sector more effectively, and should be an integral part of the "better regulation" they aim to pursue.

Annex III. IOSCO Objectives and Principles of Securities Regulation: A Summary[1]

VI. Introduction

1. **The legal and regulatory framework for the securities market in Japan exhibits a high level of implementation of the IOSCO Principles.** In particular there is a robust legal framework that provides extensive powers to the FSA to supervise regulated entities, to investigate breaches of securities laws and regulations, as well as to cooperate both domestically and internationally. In addition, the FSA has made changes in its organizational structure to upgrade its capacity to identify, monitor and mitigate systemic risk.

2. **However, ongoing supervision of securities firms should be strengthened.** First, the FSA should develop a more robust framework to identify and assess the scale and scope of risk posed by individual firms that could also serve as a tool to determine the intensity of regulatory intervention (including on-site inspections). Vis-a-vis investor protection, the SESC should intensify the coverage of its inspection program for smaller firms, as conduct issues cannot be easily captured through off-site reporting. This could be accomplished through a combination of additional institution-based inspections, thematic reviews and/or random inspections.

3. **In addition, the FSA should consider reviewing its enforcement program** to ensure proper balance between different type of regulatory measures at its disposal, from orders for improvement to suspensions and cancellations of registration. Also, the authorities should consider reviewing the current framework for money penalties to (i) ensure that the amount of the penalties is sufficient to ensure a deterrent effect, as well as (ii) to expand the type of misconducts to which administrative money penalties could be applied.

4. **From an organizational perspective, FSA governance arrangements and resources should continue to be strengthened.** Mechanisms should be explored to ensure that the FSA can hire and retain expert staff across the different departments of the organization, including for example by reviewing the salary scale. In this context, the FSA should review whether current resources are sufficient to ensure the robustness of its supervisory program. The authorities should also explore ways to enhance FSA legal independence.

5. **Finally, efforts to implement the new principles should continue, in particular in connection with the identification of emerging and systemic risk.** The creation of the

[1] This is based on a detailed assessment of Japan's observance of the IOSCO Objectives and Principles conducted during November 28–December 16, 2011. An initial IOSCO assessment was conducted in 2003. Since then significant changes have taken place in the Japanese market, in terms of market development and upgrading of the regulatory framework. In addition, IOSCO approved a new set of Principles in 2010 and a revised Methodology in 2011.

OSBM is a step in the right direction. However it is important that some type of arrangement be in place to more comprehensively and systematically identify and assess risks and determine the need for regulatory intervention.

VII. Scope and Methodology

6. **The assessment was conducted based on the IOSCO Principles and Objectives of Securities Regulation approved in 2010 and the Methodology adopted in 2011**. As has been the standard practice, Principle 38 was not assessed due to the existence of a separate standard for securities settlement systems. The assessment did not cover commodities derivatives exchanges or other derivatives exchanges where the underlying asset is not a security.

7. **The IOSCO methodology requires that assessors not only look at the legal and regulatory framework in place, but at how it has been implemented in practice.** The recent global financial crisis has reinforced the need for assessors to take a critical look at make a judgment about supervisory practices, and determine whether they are effective enough. Among others, such a judgment involves a review of the inspection programs for different types of intermediaries, the cycle, scope and quality of inspections as well as how the agency follows-up on findings, including the use of enforcement actions.

8. **The assessors relied on:** (i) a self-assessment developed by the Financial Services Agency (FSA); (ii) the review of relevant laws and reports available in English; (iii) meetings with staff from the FSA, the SESC, the CPAAOB, and the Bank of Japan (BoJ); as well as (iv) meetings with market participants, including issuers, securities firms, fund managers, exchanges, external auditors, credit rating agencies, the Japanese Securities Dealers Association (JSDA), the Investment Trust Association of Japan (ITAJ), the Japanese Institute of Certified Public Accountants (JICPA) and law firms. The limited availability of information in English was a challenge; however to some extent gaps were filed through the discussions with the authorities and market participants, although review of supervisory files could not be conducted in an optimal manner.

9. **The assessors want to thank the FSA and the BOJ for their full cooperation as well as their willingness to engage in very candid conversations regarding the regulatory and supervisory framework in Japan.** The assessors also want to extend their appreciation to all other public authorities and market participants with whom they met.

VIII. Institutional and Market Structure

10. **The regulation and supervision of the Japanese securities markets are responsibilities of the Financial Services Agency (FSA), the Securities Exchange Surveillance Commission (SESC), and the CPAAOB.** The nature of these entities differs: the FSA is an agency within the Cabinet, while the SESC and the CPAAOB are boards

within the FSA, but to which the Financial Instruments Exchange Act (FIEA) afforded a high degree of independence vis-à-vis the FSA.

11. **These agencies exercise delegated authority, as the responsibility for regulation and supervision of securities markets is assigned to the Prime Minister by the FIEA.** Such Act delegates all authority and functions in connection with the regulation and supervision of securities markets to the FSA except functions excluded by a Cabinet Ordinance. Current exceptions are limited, mostly circumscribed to the licensing of exchanges and the authorization of associations. The FIEA prescribes a second level of delegation, in this case of the authority of the FSA in the SESC, to which it entrusts the authority to request reports from regulated entities and conduct on-site inspections and investigations. Finally, the CPA Act delegates to the CPAAOB the oversight of auditors. From an operational perspective, responsibilities are distributed as follows: the FSA is responsible for policy, off-site monitoring, and imposition of enforcement actions; while the SESC carries out onsite inspections and investigations. Based on the results, the SESC may make a recommendation on enforcement actions to the FSA. The CPAAOB oversees the quality control program developed by JICPA, carries out inspections on auditors, and as a result of such inspections, the CPAAOB may make a recommendation for enforcement actions to the FSA.

12. **A third level of delegation is to the local finance bureaus.** The FIEA authorizes the FSA and the SESC to delegate their monitoring and inspection functions to the local finance bureaus. In practice, the FSA and the SESC entrust to the local finance bureaus the review of prospectus and periodic information of issuers; the review of tender offer documents; the registration of financial instruments business operators (FIBOs); and the off-site monitoring and on-site inspections of FIBOs whose capital is less than 12 billion yen. Several types of self regulatory organizations (SROs) coexist and perform important self regulatory functions. Pursuant to the FIEA, three different types of entities can perform self regulatory functions: the exchanges, associations and SROs, which are entities that can only be constituted by exchanges. In practice, in addition to the exchanges, there are several more entities performing important SRO functions: The Tokyo Stock Exchange SRO, the JSDA and the ITAJ. There are two more associations: the Japan Securities Investment Advisers Association (JSIAA) and the Type II Financial Instruments Firms Association (Type II FIA). The JSIAA has some rulemaking functions in connection with investment advisers, and has subject them to off-site reporting; however it does not conduct on-site inspections on them nor exercise enforcement functions –although it can withdraw membership. Finally the Type II FIA has self regulatory functions in connection with Type II FIBOs; but is of very recent creation. Therefore this assessment has not covered these two associations.

Basic legal framework for market participants

13. **The main laws applicable to securities markets are the Financial Instruments Exchange Act (FIEA) and the Investment Trust and Investment Corporations Act (ITIC).**

14. **Issuers of securities that are offered to the public are required to notify the FSA and file a registration statement.** They are also required to submit an annual report, and either a quarterly report (for listed issuers) or a semiannual report (for non-listed issuers). Issuers are also required to notify a list of corporate events to the FSA. In addition the TSE has established a principle of timely disclosure of corporate actions which requires disclosure to the exchange of any event that could have a material effect on investors' decisions.

15. **CIS that are offered to the public are also required to file their offering documents with the FSA.** CIS can be constituted as trusts or corporations, in both cases the law requires that they be managed by a financial instruments business operator (FIBO) registered as an investment management business operator (IMBO).

16. **The provision of securities activities in Japan requires registration as a FIBO.** There are four main types of FIBOs: Type I, which is essentially a broker dealer which can trade in a wide array of securities including stocks, bonds, shares of CIS, derivatives, etc; Type II, which is a broker-dealer that can only trade in a very limited category of securities (those not included in the list of authorized securities for Type I and which are commonly referred to as "illiquid" securities); IMBO which is an asset manager; and an investment advisory firm, which can provide investment advisory services. Registered financial institutions (such as banks, cooperatives and insurance companies) can also provide a limit number of securities markets services to retail investors, mainly related to the distribution of government debt and CIS. The FSA has established a system of consolidated supervision for securities firms with assets equal or above ¥1 trillion.

17. **Two different types of regulated markets coexist: exchanges and proprietary trading facilities (PTS).** Exchanges require a license which is granted by the MoFS on behalf of the PM while PTS must be registered as a Type I FIBO. A trading volume limit of 10 percent is set up on PTS (Article 1 of the Cabinet Order for Enforcement of the FIEA.

Market structure

Equity markets

18. **A total of 2,900 companies are listed on any of the six exchanges that operate in Japan.** Out of such number, 2,280 were listed on the Tokyo Stock Exchange (TSE). The TSE is the main equity exchange in Japan, with a market capitalization of roughly US$ 3,634,790 million as of March 31, 2011. Publicly listed companies are dominated by industrial (including telecommunication and services) and consumer goods companies. Large

caps account for 85 percent of market capitalization, though they amount to only one third of the number of listed companies. There are currently 12 foreign companies listed in Japan. The number of new listed companies had decreased overtime but increased in 2011. In 2010 26 new companies were listed in the TSE, while 68 delisted.

	Listed companies	Listed in one exchange	Listed in multiple exchanges	Five stock exchanges	Four stock exchanges	Three stock exchanges	Two stock exchanges
Tokyo	2,280	1,552	728	24	12	81	611
Osaka	1,745	1,188	557	24	12	78	443
Nagoya	341	101	240	24	11	62	143
Fukuoka	129	38	91	24	10	17	40
Sapporo	76	21	55	24	3	5	23
Total	3,647	2,900	747	24	12	81	630

19. **The TSE and the London Stock Exchange recently established a joint venture called Tokyo AIM, a new Tokyo equity based market for growing companies that is only open to professional investors.** The market is still at an early stage. Tokyo AIM is also considering a debt securities market for professional investors only.

- Note: The TSE plans to integrate TOKYO AIM into the Tokyo Stock Exchange effective July 1, 2012, and re-brand the TOKYO AIM market as ‘TOKYO PRO Market.’

Bond markets

20. **In recent years, Japanese companies have issued increasing amounts of corporate bonds, even though the size of this market remains small** compared to other advanced economies. For 2010 the total amount of bond issuance was 198,439 billion yen, out of which only 4.8 percent were corporate bonds, municipal bonds amount to 3.9 percent, while JGBs make up for 83.6 percent.

21. **Trading of debt is mostly conducted in the over the counter (OTC) markets.** Outside of OTC, the TSE is the main securities exchange in Japan, though the number of companies with listed debt is small compared to equities. No straight bonds are listed on the TSE, except for certain government debt bonds. Some convertible bonds are currently listed (as of November 30, 2010 the number of issuers was 37, the number of listed securities was 39 and the total amount was ¥1,239 billion).

Collective investment schemes

22. **As of end 2010 the total amount of assets under management (AUM) held by investment trusts amounted to ¥98 trillion yen.** Of this amount ¥63 trillion were invested in publicly offered investment trusts, roughly ¥4 trillion in real estate investment trusts and ¥31 trillion in privately placed investment trusts. Of the assets invested in publicly offered investment trusts, ¥52 trillion were invested in stock investment trusts, ¥9 trillion in bond investment trusts and ¥2 trillion in MMF. The major securities firms as well as most of the major banks are the largest CIS managers.

Securities intermediaries

23. **There are currently 322 Type I FIBOs operating in Japan, out of which 22 are foreign firms (not incorporated).** The majority of them are small firms with simple business models, and still retail oriented. However, there are a few large firms with complex business models (e.g. including proprietary trading and derivatives portfolios). There are currently 16 securities companies subject to consolidated supervision. A subgroup of them is subject to more intense monitoring and supervision, based on an assessment of their business models and potential systemic implications. In their case supervision (off and onsite) is assigned to a dedicated unit, the OSBM. Currently 19 firms have presence overseas. The main overseas cities where they operate are New York, London, Singapore, and Hong Kong.

24. **There are other intermediaries providing services in the market.** In addition to Type I FIBOs, there are 1,293 Type II, 1,122 Investment Advisory and Agency Business and 322 IMBOs, as of November 2011.

Trading platforms

25. **There are six exchanges operating in Japan**: the TSE, the Osaka Stock Exchange (OSE), the Nagoya Stock Exchange, the Fukuoka Stock Exchange, the Sapporo Stock Exchange and the Tokyo AIM. However, only the TSE and the OSE have significant trading volumes. On the cash side, the TSE accounts for roughly 90 percent of trading volumes, while the OSE is the main market in connection with derivatives. A merger between these two exchanges has recently been agreed, with completion expected by 2013. In addition, there are five PTS that trade equity, government debt, and corporate debt; but their trading volumes are not significant.

IX. PRECONDITIONS FOR EFFECTIVE SECURITIES REGULATION

26. **Market participants highlighted the need to further strengthen corporate governance. This is** through the inclusion of additional independent directors and the constitution of strong and independent bodies (such as a system of committees) to support the oversight function of the board. All other preconditions appear to be largely in place. In

particular, foreign issuers can tap the markets under similar conditions to domestic issuers. Foreign corporations can register as financial instruments business operators, with the same requirements than domestic corporations and there are no barriers for foreign investors to invest in the domestic market.

27. **The company law is modern and it is easy to constitute a corporation in Japan —incorporation typically takes less than a week**. The insolvency framework includes rehabilitation procedures. Out of court proceedings can be worked out, and guidelines exist in this regard. The judiciary system is perceived as impartial. The prosecution office has created specialized offices in Tokyo and Osaka to deal with financial crime, but participants commented that courts might lack expertise. Accounting and auditing standards do not have major differences from international standards.

X. MAIN FINDINGS

28. **Principles for the regulator:** Responsibilities for the supervision of securities markets lies in the FSA, the SESC and the CPAAOB. Certain features of the legal framework raise concerns in regard to their independence, however in practice there is no evidence of day-to-day interference from the Government. In the areas of their competencies, such agencies have been provided with broad powers vis-à-vis regulated entities, although the FSA cannot impose money penalties except in connection with a limited number of misconducts. The FSA has taken important steps to strengthen its capacity to identify and monitor emerging and systemic risk.

29. **Principles for SROs:** There are a number of SROs currently active and most have a long history of operation. They are subject to "authorization" and must meet criteria that address issues such as capacity, management of conflict of interest, fair treatment of members, and confidentiality. The FSA has enforcement powers over them. The FSA has developed a system of oversight tailored to each SRO that appears to be working well.

30. **Principles for enforcement:** Supervision of securities firms requires further strengthening. First, the FSA has not yet developed a framework to identify and determine the scale and scope of risks of individual firms and determine the intensity of regulatory intervention (including on-site inspections). In addition, the coverage of the on-site inspection program is limited, especially for smaller Type I and IMBOs as well as for Type II and investment advisors —most of which are inspected only by cause. In connection with enforcement, the assessors observed that the FSA is making more use of stronger measures, such as suspensions, in addition to orders for improvement on which it has traditionally relied. In such context, it is important that the FSA periodically reviews its strategy towards enforcement. Criminal convictions have been secured, but commuted sentences can limit the effect of deterrence.

31. **Principles for issuers:** Issuers of public offering are subject to disclosure obligations at the moment of registration and on a periodic and on-going basis that are in line with the

IOSCO Principles. The FSA and the SESC have a system to review offering documents as well as periodic reports, which helps to ensure compliance by issuers with their disclosure obligations. Basic rights of shareholders are imbedded in company law. Certain additional protections are provided by the FIEA, in particular the requirement for a mandatory tender offer under certain conditions. There are notification obligations for substantial holdings. Holdings of insiders must be included in the disclosure documents but a system of timely notification of transactions carried out by them is not in place. Financial statements must be prepared according to local GAAPs, which are broadly consistent with IFRS.

32. **Principles for auditors, credit rating agencies and other information service providers:** A system of quality control for auditors is in place, which involves reviews by JICPA (the professional body) under the oversight of the CPAAOB. Such system is also complemented with direct examinations by the CPAAOB. Auditors are required to be independent of the entities they audit. Issuers' mechanisms to monitor auditors' independence require strengthening. Credit rating agencies are registered by the FSA, and are subject to ongoing supervision through reporting and on-site inspections. There is a framework in place for sell-side analysts to address conflicts of interest, which is based on disclosure.

33. **Principles for collective investment schemes:** Managers and distributors of CIS are required to register with the FSA. Registration requirements for managers (who must register as IMBOs) include capital requirements, fit and proper requirements and organizational requirements or deposits for operation. The SESC does not have a policy to inspect newly registered CIS managers within a short timeframe after registration. The current risk-based approach ensures regular on-site inspections for CIS managers, although the SESC should further strengthen the inspection program for CIS managers especially if the managed CIS is offered to the public and is subject to similar disclosure obligations to an issuer. Assets must be entrusted to a separate custodian. There is no obligation that the custodian be independent; however custodians (trust banks) are subject to regulation and supervision by the FSA. Assets must be valued at fair value. ITAJ has developed guidance on valuation of assets, including illiquid assets. Conditions of suspensions of redemptions must be disclosed in the offering documents. Suspensions of redemptions are notified to the FSA.

34. **Principles for securities intermediaries:** Financial instruments business may only be carried on in Japan by entities registered by the FSA and that comply with registration requirements, which include minimum capital, fit and proper and organizational requirements. The SESC does not have a policy to inspect newly registered FIBOs within a short timeframe after registration. Ongoing capital requirements apply only to Type I FIBOs, which must comply and report a capital ratio similar to Basel II. Reporting requirements are extensive for Type I FIBOs. Smaller intermediaries are not necessarily subject to external audit. The current risk-based approach ensures regular inspection of larger Type I FIBOs and IMBOs by the FSA, which is complemented by JSDA/TSE inspections and ITAJ inspections. Longer cycles apply to smaller Type I and IMBOs, Type II and investment advisors are

inspected mainly by cause. The FSA has not developed a plan to deal with the failure of a securities firm, but experiences of how past failures were handled have been documented.

35. **Principles for secondary markets:** Exchanges and PTS are the only secondary markets that can trade securities and each must comply with criteria set down by FSA. The SROs are responsible for ensuring orderly trading, while the SESC is responsible for market surveillance for purposes of detecting unfair trading practices—in such function it is supported by the exchanges. There has been active enforcement of the requirements prohibiting unfair trading practices. CCPs manage exposures on a daily basis and have powers to request members to post additional margin. Default procedures are known to members. Price limits apply in both the cash and derivatives and circuit breakers apply to derivatives trading if there is excessive volatility. Naked short selling is prohibited.

Table A5. Japan—Summary Implementation of the IOSCO Principles

Principle	Findings
Principle 1. The responsibilities of the Regulator should be clear and objectively stated.	The mandate of the FSA, the SESC and the CPAAOB are established by law. A cabinet ordinance defines the functions that are still retained by the Prime Minister (PM). From an operational perspective the structure is complex as several functions are delegated into the local finance bureaus. There do not appear to be major gaps; however certain functions are still retained by the PM. Mechanisms for cooperation in particular between the FSA and the SESC have improved fostered by informal arrangements such as rotation, and more formal arrangements such as meetings at a senior level.
Principle 2. The Regulator should be operationally independent and accountable in the exercise of its functions and powers.	Certain features of the legal framework might pose a risk to the independence of the FSA (including the SESC, CPAAOB), in particular (i) the legal nature of the FSA and the fact that the scope of its functions is defined by cabinet order, rather than by law, (ii) the fact that its budget can (and has) been adjusted by the MoF; and (iii) the involvement in important matters of the MoFS. However, there is no evidence of interference in day-to-day functions by the MoFS. By practice there is a "term limit" for the Commissioner as he/she steps down every 2-3 years and, at the same time, there is a strong framework of accountability vis-à-vis the Government and the public. The FSA and the SESC prepare annual reports, and the accounts of the FSA have to be audited by the Audit Board of Japan.
Principle 3. The Regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.	The civil service rotation system poses challenges to the retention of experts. The level of resources allocated to securities markets might be affecting the coverage of the inspection program and can have an impact on the overall effectiveness of enforcement. The FSA conducts strategic planning and has basic mechanisms to ensure that functions are adequately discharged. The FSA is active on promoting investor education.

Principle 4. The Regulator should adopt clear and consistent regulatory processes.	The FSA has adopted a public consultation process for the development of regulations. Requirements for registration are established by Law and Cabinet Ordinance, and are published on the website. A broad set of information including supervisory and enforcement policies and annual reports are also available in the website. Recommendations on enforcement and sanctions imposed (except those related to financial soundness) are public. Individuals can seek redress in the judicial tribunals against acts of the FSA. In the cases of denial of a license, cancellation of a license, or the imposition of enforcement actions, a due process has to be followed.
Principle 5. The staff of the Regulator should observe the highest professional standards, including appropriate standards of confidentiality.	The FSA staff is subject to the duties of loyalty, fairness and confidentiality. The FSA has issued detailed guidance in connection with securities transactions. An internal office monitors compliance with such obligations. In the past, administrative actions have been imposed on staff that have violated such obligations. Cooling off periods exist.
Principle 6. The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate.	The FSA has created two offices to better monitor systemic risk: the Office of Market Analysis and the Office of Securities Business Monitoring. In particular the latter engages in active monitoring of large complex firms. A framework to comprehensively and systematically identify systemic risk is needed. Continuation of cooperation between the FSA and the BOJ in the context of crisis management and resolution of weak firms is encouraged.
Principle 7. The Regulator should have or contribute to a process to review the perimeter of regulation regularly.	The FSA has not singled out a specific office to deal with emerging risks and review of the perimeter of regulation. However, the offices mentioned in Principle 6 contribute to such function, as well as the off and on-site monitoring of FIBOs, CIS and market infrastructure. Other informal mechanisms such as meetings of senior officials help to identify sources of risk. Usually on an annual basis the FSA makes proposals to the Diet for changes to the FIEA to address weaknesses identified through all the mechanisms described above.

Principle 8. The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed.	The legal and regulatory framework in place requires regulated entities (FIBOs, IMBOs, auditors, and sell side analysts) to establish policies, procedures, and internal controls to properly address conflict of interest. Such obligations are monitored via onsite inspections. Issuers are required to provide disclosure to the market, which is monitored via the system of review of periodic information. In particular, in connection with structured products the FSA introduced changes to its regulatory framework to address potential misalignment of incentives.
Principle 9. Where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.	Several entities perform self-regulatory functions, including the JSDA, the ITAJ, the TSE SRO and the exchanges. They all require "approval" based on requirements concerning their capacity to operate, their rules, the management of conflicts of interest and confidential information. The FSA has appropriate powers to oversee the SROs. All of the SROs are subject to reporting obligations tailored to their functions. Frequent onsite inspections of TSE/OSE are carried out but less so for ITAJ/JSDA. On-site inspections are complemented by regular communication such as calls and periodic meetings at different levels of the organizations.
Principle 10. The Regulator should have comprehensive inspection, investigation and surveillance powers.	The FSA has comprehensive powers to request reports and conduct inspections on regulated entities.
Principle 11. The Regulator should have comprehensive enforcement powers.	The FSA has been given the power to impose enforcement actions on regulated entities including orders for improvement, suspensions for not more than six months and cancellations of registrations. It can also seek imposition of cease-and- desist order from a district court on a person who has violated the FIEA. Administrative penalties, however, can only be imposed for limited categories of misconduct. In addition, in some cases the level of penalties is low and therefore casts doubts on their deterrent effects.

Principle 12. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.	The coverage of the inspection program (including inspections by the JSDA and ITAJ) is robust for larger Type I FIBOs and IMBOs. The coverage for smaller Type I and IMBOs is more limited, and Type II and Investment Advisors are inspected mainly by cause. The SESC does not make substantive use of horizontal reviews, nor random inspections, and there are no inspections associated with the registration process. As a result small firms might go uninspected for long periods of time, which could pose risks to investor protection. The FSA seeks to balance such risk via off-site monitoring, mainly through annual reporting, and other ad-hoc reporting obligations (notifications). However, the findings from the inspections carried out by the SESC show that material problems are found in this segment of small firms. The FSA is showing more use of stronger measures such as suspensions, in addition to the "traditional" orders for improvement. Enforcement in connection with unfair trading practices appears to be active, as money penalties have been imposed. Criminal convictions have been secured, but commuted sentences are common.
Principle 13. The Regulator should have authority to share both public and non-public information with domestic and foreign counterparts.	The FSA is empowered by law to share public and non-public information with domestic and foreign regulators. Domestic regulators must have equivalent confidentiality obligations to the FSA. Foreign regulators must be able to share information with the FSA. The information can only be used for regulatory purposes although for criminal trials a special procedure can be used to enable release. Staff is bound by law to observe confidentiality.
Principle 14. Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.	Informal arrangements to share information apply domestically particularly with the BoJ, and intensive cooperation takes place in connection with large complex securities firms. By law the FSA can share information with overseas regulators and is a signatory to the IOSCO MMoU. Bilateral arrangements (by way of exchange of letters) to share information have been signed with numerous overseas regulators. Special arrangements for a supervisory college for one large regulated entity are operating.
Principle 15. The regulatory system should allow for assistance to be provided to foreign Regulators who need to make inquiries in the discharge of their functions and exercise of their powers.	FSA regularly assists foreign regulators in obtaining information for regulatory purposes. Under the IOSCO MMoU no request for assistance has been refused.

Principle 16. There should be full, accurate and timely disclosure of financial results, risk and other information that is material to investors' decisions.	Issuers of public offerings must submit a registration statement to the FSA. They are also required to submit periodic reports on a semi-annual or quarterly basis (the latter if they are also listed). They must report material events. The FSA reviews all registration statements, and has developed mechanisms to review periodic reports, which include both off-site reviews as well as on-site inspections. However, municipal bonds that are offered to the public are not subject to such disclosure obligations.
Principle 17. Holders of securities in a company should be treated in a fair and equitable manner.	The Company Act provides a general framework for shareholders' rights. A mandatory tender offer must be launched if after the acquisition the offeror would acquire more than one-third (five in certain situations) of the securities of a listed company. Substantial holdings must be disclosed, as well as changes in holdings. Insiders' holdings must be disclosed in the disclosure documents (registration statement, annual and semiannual or quarterly report), but there is no system of timely notification of their transactions.
Principle 18. Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality.	Annual financial statements of issuers of public offerings must be audited according to local GAAPs. There are currently no material differences between Japanese GAAPs and IFRS. The FSA has developed mechanisms that seek to ensure compliance by issuers with accounting standards, including mandatory audit as well as its own program of off-site and on-site monitoring of periodic information submitted by issuers.
Principle 19. Auditors should be subject to adequate levels of oversight.	There are qualifications for auditors. JICPA undertakes quality control reviews of auditors on a three year cycle (every two years for the four largest firms). Auditors that do not satisfy the quality control are included in an unsatisfactory list and cannot conduct audits of listed companies. The CPAAOB oversees the work carried out by JICPA, and undertakes its own inspections of auditors. The FSA has the power to impose regulatory measures on JICPA as well as on auditors.
Principle 20. Auditors should be independent of the issuing entity that they audit.	Independence of external auditors is required by law. Non audit services are restricted. Rotation every seven years (and cooling off for two years) of the lead engagement team for large and listed companies is required by law. Five year rotation (and five years cooling off) applies where an audit firm has 100 or more listed company clients. Governance arrangements to monitor auditors' independence require strengthening.

Principle 21. Audit standards should be of a high and internationally acceptable quality.	Financial statements in public offering and listing documents must be prepared based on local auditing standards. These are the auditing standards set by the BAC (advisory body within the FSA) supplemented by JICPA's Implementation guidelines (both not finalized until after public comments considered). There are no material differences between local standards and IAS.
Principle 22. Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision.	CRAs whose ratings are to be used for regulatory purposes require recognition by the FSA as an external credit assessment institution (ECAI). Recognition criteria are in line with the IOSCO Principles. There is a separate registration process under the FIEA for any CRA, whether its ratings are to be used for regulatory purposes or not. Registration requirements are in line with the IOSCO principles. In practice, all CRAs used for regulatory purposes have registered with the FSA under the FIEA. The FSA subjects them to periodic reporting and the SESC carries out inspections on them.
Principle 23. Other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them.	The JSDA has developed a specific framework in connection with sell-side analysts, which is based on disclosure in the corresponding research of potential conflict of interests.
Principle 24. The regulatory system should set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme.	CIS managers must register as IMBOs with the FSA and distributors of CIS must register as FIBOs. Requirements are described under Principle 29. The FSA does not have the policy to inspect newly registered CIS managers within a short timeframe after registration. IMBOs that manage CIS are subject to periodic inspections, although the supervisory approach should be strengthened.
Principle 25. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.	The ITIC authorizes two legal forms for CIS: trust and corporations. For CIS of public offering registration documents as well as the prospectus must include detailed information on the legal form and rights of investors. The ITIC requires that assets be entrusted to a separate custodian –usually a trust bank. There is no requirement that the custodian be of a different group, although general obligations for appropriate management of conflict of interest apply and custodians (trust banks) are subject to supervision by the FSA. Resolution of CIS requires investors' approval.

Principle 26. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.	CIS of public offering must submit an "offering" document to the FSA for registration. The local finance bureaus conduct review of the registration documents. ITAJ has developed detailed rules concerning the content of the prospectus which are aimed to ensure the comparability of information available to investors. Material changes have to be approved by investors.
Principle 27. Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.	The FIEA requires fair valuation. ITAJ regulations require mark- to- market valuation for liquid assets and independent valuation for illiquid assets. NAV has to be calculated on a daily basis, and subscription and redemption prices have to be available to investors in the website of ITAJ. Pursuant to regulations from ITAJ pricing errors must be covered by the IMBO. Suspensions of redemptions are notified immediately to the FSA which would have the power to ask for additional information and ask for lifting of suspension.
Principle 28. Regulation should ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight.	The FIEA requires registration as an IMBO of any entity who manages CIS regardless of their nature. As a result managers of HFs must register with the FSA. Registration requirements are the same as for any other FIBO. Currently the FSA does not require specific information on the HFs themselves beyond the annual fund monitoring; however it would have the powers to do so according to the FIEA as well as to share this information with other regulators in the same conditions described in Principle 13.
Principle 29. Regulation should provide for minimum entry standards for market intermediaries.	Only firms registered as a FIBO with the FSA can conduct financial instruments business. Minimum entry requirements apply including minimum capital/deposits, "fit and proper" officers, adequate internal controls and risk management and sufficiency of resources. Registration is done by the local Finance Bureau in accordance with FIEA and FSA guidelines. The SESC does not have the policy to conduct on-site inspections on newly registered FIBOs within a short time frame after registration.
Principle 30. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.	Initial minimum net assets or deposits for operations apply to FIBOs. On an ongoing basis only Type I must maintain a capital ratio formula (similar to Basel II) with monthly/quarterly/annual reporting to the FSA. Other FIBOs are only required to maintain the minimum capital at registration, and submit an annual business report, which includes financial statements. External audit of financial statements is only required for large companies. Type I FIBOs are required to submit a report from an external auditor on segregation of assets of clients to the JSDA.

Principle 31. Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters.	By law, a FIBO must have internal controls, legal and compliance functions (independent from sales or asset management) and risk management procedures. However, in practice the independence of such functions requires strengthening in particular in smaller firms. FIBOs have information obligations vis-à-vis clients, and suitability requirements apply. Clients' assets must be segregated and Type I FIBOs must have this control externally audited on an annual basis. On-site inspections are concentrated in the larger Type I FIBOs and IMBOs. The coverage for smaller Type I and IMBOs is limited, and Type II FIBOs and Investment Advisors are inspected mainly by cause. The SESC does not make substantive use of horizontal reviews, nor random inspections.
Principle 32. There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.	Early warning applies for Type I FIBOs, along with prompt corrective action. Large complex securities firms are under closer monitoring through the OSBM. Resolution of securities firms is governed by the general regime for corporations, including for large complex firms. Under rehabilitation procedures the FSA can request the appointment of an administrator. The FSA has not developed a general procedure manual to deal with the insolvency of a large complex firm, but experience of dealing with previous (significant) failures has been fully documented by FSA, which is functioning as a guiding document. Stress testing by CCPs has been undertaken at FSA request.
Principle 33. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.	Exchanges and PTS require minimum capital, appropriate technology systems and their rules must be vetted before approval. PTS can only be established by Type I FIBOs and require an independent expert IT report.
Principle 34.There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.	The SESC, exchanges, and the FIBOs in their condition of operators of PTS conduct market surveillance. The FSA authorizes changes to rules and maintains close supervision of operations by way of reports, ongoing dialogue and inspections. PTS provide monthly and annual reports to the FSA, as well as on an ad-hoc basis if they detect evidence of market manipulation.

Principle 35. Regulation should promote transparency of trading.	Bids, offers, and trade information are made publicly available for exchanges (95 percent of all trading) and PTS. Electronic platforms for dark pools do not appear to be a cause of concern. Internalization and block trades are permitted and must be reported to exchanges.
Principle 36. Regulation should be designed to detect and deter manipulation and other unfair trading practices.	Administrative and criminal penalties apply for unfair trading practices, including market manipulation, false rumors and insider dealing. There is active market surveillance by the SESC and the exchanges. Administrative penalties have been imposed and criminal convictions have been secured.
Principle 37. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.	Exposures of the larger complex firms are under intense monitoring by the OSBM. The CCPs monitor clearing members' positions on a daily basis. If a participant's exposure becomes a concern, the CCP has the power to request additional collateral. Further transactions will be prohibited and outstanding positions will closed out if this does not occur. There are clear procedures in the event of default which are available to members. Price limits apply to both the cash and derivatives and circuit breakers apply to derivatives trading if there is excessive volatility. Naked short selling is prohibited.
Principle 38. Securities settlement systems and central counterparties should be subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.	N/A

Table A6. Recommended Action Plan to Improve Implementation of the IOSCO Principles

Principle	Recommended Action
Principle 1	The FSA and the SESC are encouraged to continue exploring mechanisms to strengthen cooperation at the operational level and work towards seamless functioning of off-site monitoring and on-site inspections.
Principle 2	The authorities should strengthen the independence of the FSA by such initiatives as: (i) assigning all functions related to securities markets to it via law, and (ii) exploring mechanisms to secure sufficient funding. In addition, vis-à-vis accountability the authorities should assess the benefits of formalizing the current practice of term limits for the Commissioner.
Principle 3	1) The authorities should explore mechanisms to ensure that the organization can retain sufficient experts across the organization, including by reviewing salary conditions. 2) The FSA should review resources allocated to securities markets, in particular to on-site inspections. 3) The FSA is encouraged to continue strengthening internal control mechanisms to ensure that functions are adequately discharged
Principles 6 and 7	The FSA should consider developing arrangements that allow it to more systematically identify, prioritize and determine the scale and scope of risks coming from different entities/activities/products of the financial markets that could serve as the basis for determining whether and what type of regulatory intervention is needed.
Principle 11	The authorities should consider reviewing the administrative money penalty system to (i) ensure that the amount of the penalties provide a deterrent effect and (ii) to expand its coverage to any violation of the FIEA or the ITIC.
Principle 12	1) The FSA and SESC should consider complementing the current system of expert judgment with a framework that allows them to better determine the risks posed by individual firms, which could serve as an input to determine the intensity of regulatory intervention, including on-site inspections. 2) The SESC should review and expand the coverage of the inspection program in particular for smaller firms, Type II and investment advisors (e.g. through more institution based inspections, more use of horizontal reviews, and/or more use of random inspections). 3) The FSA should consider periodically reviewing the strategy towards enforcement to ensure proper balance between different types of measures.
Principle 16	Legal reform should be pursued to subject municipal bonds that are offered to the public to the disclosure regime set forth in the FIEA. Alternatively more clarity as to the existence of a government guarantee is encouraged.

Principle	Recommended Action
Principle 17	1) A legal reform should be pursued to require “insiders” to notify to the FSA and disclose to the public transactions made, in addition to the current mechanism of disclosure through periodic reports. 2) The FSA should consider extending tender offer provisions to on the market transactions.
Principle 19	1) The CPAAOB should continue to keep under review the sufficiency of JICPA’s resources. 2) Ensuring robust enforcement should also be continuously monitored.
Principle 20	The authorities should explore mechanisms to strengthen issuers’ governance arrangements for the selection of auditors, and monitoring of auditors’ independence, by for example requiring special reports from auditors on their actions to ensure independence and requiring an independent body of the issuer to review such reports, and follow up with auditing firms when necessary.
Principle 24	Refer to the recommended actions of Principle 12 (1)(2) and Principle 29.
Principle 25	The FSA should consider the imposition of additional safeguards in connection with custody carried out by entities of the same group.
Principle 29	The FSA/SESC should consider enhancing the registration process for FIBOs for example, by including a policy of on-site inspection of newly registered entities
Principle 30	1) The FSA should consider more frequent reporting for FIBOs other than Type I in connection with their capital position and activities. 2) The FSA should expand external auditing requirements to all securities firms that hold clients assets.
Principle 31	1) The authorities should consider strengthening the requirements for “independence” of the internal control and audit functions in securities intermediaries, especially the smaller ones. 2) Refer to the recommended actions of Principle 12 (2).
Principle 32	1) The authorities should document a contingency plan to be followed in the event of an intermediary’s failure. The plan should include the type of regulatory actions necessary to protect investors from loss and manage the situation. 2) The authorities should continue discussing with other domestic authorities, such as the BOJ, how to cooperate in the case of financial crisis management, including the management of weak financial institutions. In such context the authorities could consider to elaborate contingency plans further. In addition, the authorities are encouraged to develop a resolution plan for large complex securities firms.
Principle 33	The authorities should consider including as part of the licensing criteria for exchanges a detailed IT systems assessment on the robustness of the systems, either by internal expert staff or by an independent external expert with the appropriate knowledge and experience on exchange electronic trading systems.

Principle	Recommended Action
Principle 35	The FSA should consider the development of regulations concerning the treatment of dark pools.
Principle 37	The FSA should consider the introduction of a large traders report.

Authorities' response

36. **The Japanese authorities welcome the opportunity to be assessed as the first jurisdiction under the new IOSCO Principles and Objectives published in 2010 and the Methodologies published in September 2011.** The authorities also wish to express their sincere appreciation to the IMF and its experienced assessors for the dedication, time and resources committed to this assessment. It provided the authorities with an opportunity to comprehensively review their regulatory and supervisory framework through their self-assessments and dialogue with the IMF.

37. **The authorities welcome the overall assessment by the IMF that they have achieved a high level of compliance with the IOSCO Principles.** The recommendations made by the IMF are generally well received. While some initiatives toward reform have already been taken since the time of the assessment, the authorities will thoroughly take into account these recommendations in their continuous efforts to strengthen their capacities for better regulation and supervision.

38. **However, the authorities find that the Methodologies need to be improved further to enable more risk-based assessments with more emphasis on the outcome, not on the form of policy action.** Presently, the Methodologies provide only a single set of policy actions to be in compliance with each principle, irrespective of a country's risk profile or differences in the effectiveness of the policies depending on the country's circumstances. For example, full compliance with Principle 30 would not be achieved until all market intermediaries holding client assets are subject to external audit, regardless of their risk profile. The authorities maintain that, although external audit would be useful, other measures could also achieve the same objectives. The authorities believe that an excessive emphasis on the form of regulation and supervision could lead to a box-ticking approach which does not lead to the desired outcomes of enhancing market integrity and efficient markets, as well as to ensure financial stability. The authorities will continue to work with the IOSCO and the IMF for further improvement of the methodologies.

Annex IV. Japan FSAP—Financial System Structure

1. **The financial system remains predominantly bank-oriented.** Banks hold 60 percent of all financial sector assets (Figure 2), and relative to GDP, the banking sector is larger than other G-7 countries, except for France and the U.K. Japan is also the second largest insurance market in the world in terms of aggregate insurance premiums.

2. **A small number of large institutions dominate the banking and insurance sectors.** There are about 2,000 deposit-taking institutions but a few banks dominate the sector. The six city banks are large commercial banks, four of which belong to the three major banking groups ("megabanks"), holding about 51 percent of Japan's banking sector assets.[1] These banks have close ties with large industry groups but also lend to SMEs. Six trust banks focus on both commercial and trust banking, including asset management services for large (often export-oriented) corporations. Regional banks are typically based in the principal city of prefectures and fund mainly local enterprises and governments. Since the early 2000s, consolidation within the sector has been limited.[2] Foreign banks have traditionally played a minor role in the domestic market—they focus mainly on investment and private banking and derivatives trading, and their share of industry assets fell to only 3.5 percent in FY2010 from 7 percent in FY2006. Japan Post Bank represents 12 percent of all deposit taking institutions' assets (including banks and cooperative financial institutions), and is the largest deposit-taker in the world. In the insurance sector, low interest rates and declining equity prices in the late 1990s and early 2000s put considerable pressures on the industry and led to consolidation. As of end-2010, the total assets of the insurance sector represented 78 percent of GDP, and a large majority of these assets (close to 80 percent) are in the life insurance sector. About one-third of assets in the life insurance sector are held by Japan Post Insurance, the largest life insurer in the world, and most of the rest among a few large insurance companies. The nonlife sector is dominated by motor insurance (nearly two-thirds of the market). About 6 percent of nonlife business and less than 2 percent of the life business is reinsured, primarily in the local market, and the large insurers have capacity to retain most risks. Overall, less than 1 percent of the insurance business is reinsured abroad and less than 1 percent of the premiums of Japanese insurers relate to reinsurance of foreign risks.

3. **The government's direct involvement in the financial system has declined over the last decade but remains significant.** The government retains full ownership of key government-affiliated financial institutions, including, through a holding company, Japan Post Bank (JPB) and Insurance (JPI), whose market shares have declined but remain sizeable. In addition, public credit guarantees have expanded in recent years, and their outstanding amount is equivalent to about 8 percent of GDP.

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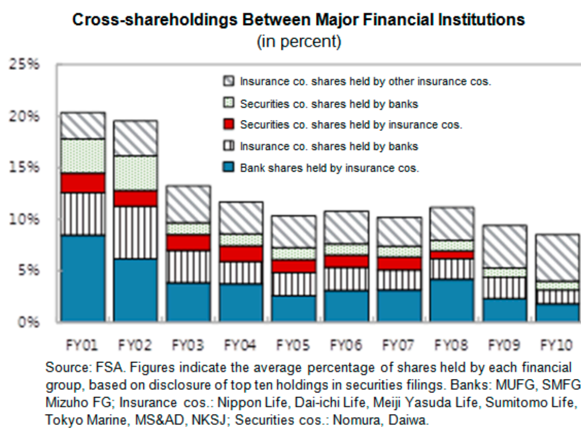
[1] The banking sector includes city banks, regional banks, trust banks, foreign banks, and other banks. As of end-March 2011, assets of these banks amounted to ¥455, ¥306, ¥66, ¥31 and ¥31 trillion, respectively.

[2] Over 2002–10, the number of major banks (city and trust banks) decreased from 15 to 12, while the number of regional banks declined from 117 to 105.

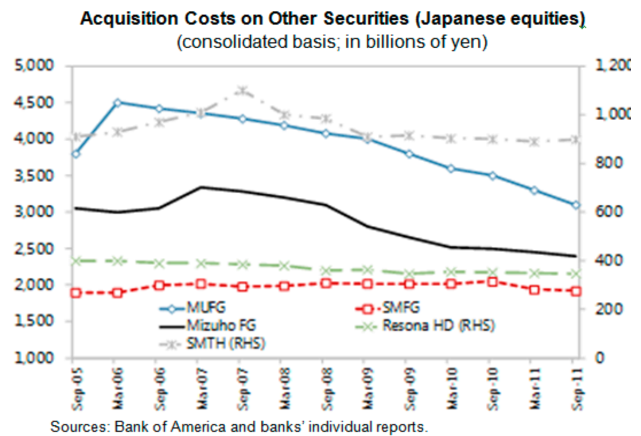
4. **Facing low growth and weak credit demand domestically, Japanese financial institutions' have increasingly expanded their overseas operations, albeit from a low base, and especially in Asia.** Consolidated foreign claims of Japanese banks doubled from US$1.3 trillion to US$2.7 trillion between 2004 and 2010. The U.S. remains the main destination, but Asia's share has grown to about 15 percent of overseas exposures. Continued yen appreciation and weak domestic activity could spur further overseas expansion, making the Japanese financial institutions more interconnected to global and regional financial markets.

5. **Cross-share holdings between all financial groups, except among insurance companies, are declining.** For example, insurance companies collectively held about 8 percent of bank shares in FY01, while they now hold about 2 percent. The only exception is the increase in cross-share holdings among insurance companies. Other balance sheet exposures among financial institutions exist, including via lending operations, but are not taken into account here due to data limitations.

Japan FSAP—Cross Share-Holdings and Acquisition Costs of Securities Among Major Financial Institutions

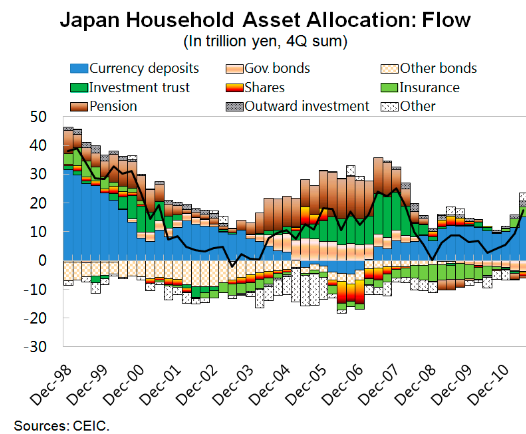


Source: FSA. Figures indicate the average percentage of shares held by each financial group, based on disclosure of top ten holdings in securities filings. Banks: MUFG, SMFG, Mizuho FG; Insurance cos.: Nippon Life, Dai-ichi Life, Meiji Yasuda Life, Sumitomo Life, Tokyo Marine, MS&AD, NKSJ; Securities cos.: Nomura, Daiwa.



Sources: Bank of America and banks' individual reports.

6. **The securities firms sector is relatively small, and low profitability has led to consolidation.** Overall, Japanese securities firms pursue conservative business models and income stems mainly from commissions (about 70 percent of net operating revenue) rather than proprietary trading, the latter being mostly for purposes of managing clients' order flows and market making. This contrasts with other non-Japanese global investment banks, for which trading income represents 46–60 percent or more of total income. Financial innovation in the retail segment has been sustained in the past decade, but has room for



Sources: CEIC.

further development.[1] Japan FMIs are very large and relevant to domestic financial stability.[2]

7. **The pension sector, including both public and private pensions, is an important part of the financial system.**[3] Pension funds hold large pools of assets—totaling about ¥287 trillion as of end-2011, including significant investments in JGBs.

8. **Apart from the JGB market, capital markets in Japan are small compared to other G-7 countries**. Japan's public debt market is the largest in the world, both in absolute size and relative to GDP. In 2011, the amount of Japanese government securities stood at about US$12 trillion, exceeding total domestic bank credit. Activity in short-term funding markets remains limited given the abundance of domestic liquidity. Markets for wholesale funding by financial institutions and cross-border financing—two key drivers of capital market development in other G-7 countries—are small in Japan. Yen-denominated international bond financing has declined from 6 percent of global bond financing in 2001 to 2½ percent in 2011. Financial innovation, especially securitization, started to develop in the mid-2000s, but market turbulence and economic contraction since 2008 led to a reversal of that trend. Equity market capitalization has remained broadly unchanged since the early 1990s.

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[1] While continuing to keep more than 50 percent of their financial assets in deposits, Japanese households have gradually sought higher returns by diversifying into investment trusts (Toushin funds), Japanese real estate investment trusts (J-REITs)-ETFs/ETNs-, and retail FX trading accounts. However, the number of funds is still modest compared to other developed markets.

[2] These include: (i) BOJ-NET Funds Transfer System (BOJ-NET FTS), the Japanese Real Time Gross Settlement System belonging to the top four large value payment systems worldwide settling about 22 percent of GDP daily; (ii) BOJ-NET JGB Services, the JGB securities settlement system belonging to the top five securities settlement systems globally with daily transaction equivalent to about 16 percent of GDP in 2010; and (iii) Japan Government Bond Clearing Corporation, the central counterparty for JGB transactions and ranking among the top 10 CCPs in the world with daily transactions of about 8 percent of GDP in 2010.

[3] "Public pensions" include National Pension, Employees' Pension Insurance, Mutual Aid Associations, and National Pension Fund. "Private pensions" include Employees' Pension Funds, Corporate Defined Benefit, Corporate Defined Contribution, and Individual-type Defined Contribution. They also include Tax Qualified Pensions, which have been phased out as of the end of March 2012.

Annex V. Japan FSAP—Are Internationally Active Japanese Banks Ready for Basel III?

1. **The Basel III framework will begin to enter into force at end-March 2013.** In Japan, new regulations have been finalized and issued in March 2012, following a consultation that took place in the beginning of 2012. Japan has chosen an implementation strategy whereby it will finalize different parts of the Basel III framework by 2019, and typically *one year ahead of the internationally agreed implementation* dates. The first part being introduced includes changes in the definition of capital and risk coverage under Basel III. The next amendments would be on the capital conservation buffer and on the liquidity coverage ratio, for which the exact timeline will depend upon the outcome of the international discussions.

2. **As of end-2011, Basel II.5 applied only to internationally active banks.**[1] Whether Basel III will also have the same limited application is still under discussion. If Basel III were to be applied to other banks, it might be in whole or only in part.

3. **The authorities' intention is to implement Basel III regulation as much as possible with the same level of detail as agreed upon internationally.** Only where national discretion is allowed or where the text may be insufficiently clear, would the FSA provide extra guidance. The FSA, which is the agency principally responsible for Basel III implementation, does not intend to introduce any form of gold plating or set super equivalent rules. The BOJ is also preparing for Basel III, given its role in onsite and off-site bank supervision, and plans to adapt its reporting framework, including on liquidity, to Basel III concepts. Banks have been preparing for some time for Basel III rules, focusing mainly on the new capital requirements. The banks that are currently covered by Basel II.5 have indicated that they would be able to meet the revised capital requirements according to the Basel III timetable. This view was confirmed in discussions with other stakeholders and by the FSAP stress tests, which indicate that major banks can achieve medium-term levels of higher required capital under adverse scenarios, including a slow medium-term growth scenario.

4. **Major Japanese banks seem well positioned to meet the new capital requirements because of already issued equity capital in 2008–2010, the scope to rely on retained earnings, and the ability to access other sources (such as the mandatory conversion of preferred stocks into equity capital).** Also, the banks indicated that they did not expect to have difficulties in meeting the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), scheduled to be introduced in 2015 and 2018 respectively. However,

[1] Basel II and II.5 are also applied to non-internationally active banks, but their minimum capital ratio is set at 4 percent instead of 8 percent. However, those banks are not allowed to include unrealized gains of available-for-sale securities into their Tier 2 capital.

their ability to meet liquidity requirements in foreign currency should be monitored, especially given their ongoing expansion overseas. The possible impact of the leverage ratio, once agreed upon, is still being examined, given that the international discussions are still ongoing and banks are in the process of developing internal mechanisms for balancing adequately this ratio in relation to the Basel III capital requirements and the LCR and NSFR.