

## **Annual Supervisory Policies for Regional Financial Institutions for Program Year 2008**

The Financial Services Agency (FSA) publishes its Annual Supervisory Policies for Regional Financial Institutions for each program year so as to clarify its supervisory priorities. This is prescribed in the “Comprehensive Guidelines for Supervision of Small- and Medium-Sized and Regional Financial Institutions” which show basic approaches for the supervisory process aimed at regional financial institutions.

At the time of establishing the Annual Supervisory Policies for Regional Financial Institutions for Program Year 2008, global financial markets remain tense, triggered by the subprime mortgage problem. Furthermore, the economy is weakening, and is exposed to further downside risks depending on movements in crude oil prices and other such factors<sup>1</sup>.

In such an environment, regional financial institutions<sup>2</sup> are further expected to fully perform their financial function to help smooth financing for small- and medium-sized enterprises (SMEs), and improve security and convenience for users, including depositors. In order to fully perform their financial function, it is important for the regional financial institutions to maintain their own financial soundness at the same time. For this reason, it is important for regional financial institutions to seek the situation in which smooth provision of funds for the SMEs<sup>3</sup> and the maintenance of the soundness of the regional financial institutions’ own financial positions may work in a virtuous cycle under proper corporate governance.

### **1. Smooth Finance for SME through Promotion of Region-Based Relationship Banking, etc.**

The Japanese economy is weakening and there is the risk that movements in crude oil prices and other such factors will drag it down further. SMEs are facing a tough business climate, and there is a need for financial intermediary functions to be demonstrated properly and proactively. Under these circumstances, it is important that regional financial institutions also conduct risk-taking and risk management carefully, in

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<sup>1</sup> Cabinet Office (August 7, 2008): “Monthly Economic Report” (<http://www5.cao.go.jp/keizai3/getsurei.html>).

<sup>2</sup> “Regional financial institutions” refers to regional banks, second-tier regional banks, shinkin banks and credit cooperatives.

<sup>3</sup> “SMEs” include micro enterprises.

a manner suited to the actual conditions and characteristics of borrower companies, and endeavor to ensure the smooth provision of funds for SMEs. Accordingly, it is important for regional financial institutions to endeavor to further promote region-based relationship banking<sup>4</sup>, etc. The FSA will also work on the following priority areas for smooth SME financing.

**( Enhancement of SME Financing Monitoring)**

The FSA will conduct questionnaire surveys on financing trends of financial institutions, and promote the use of the Smooth Finance Hotline, etc. In addition, FSA personnel will go on tours targeted at SME financing in country areas. Through such efforts, the FSA will precisely understand the financing trends of regional financial institutions and the situation of borrower companies, and reflect the findings in its supervisory activities. The FSA will also encourage regional financial institutions to carefully examine loan applications based on the actual business conditions and characteristics of borrower companies, and fully explain their decisions to customers.

**(Promotion of Region-Based Relationship Banking)**

While regional financial institutions have already been making various efforts in region-based relationship banking, some of their specific measures, including their efforts in business turnaround, are still deemed inadequate by customers. The FSA will continually make the following efforts to refine and instill region-based relationship banking, taking customers' opinions into account.

- The FSA will follow up on the progress of regional financial institutions' efforts in region-based relationship banking, and thereby encourage them to proactively make efforts that accurately meet the financial needs of the region. In doing so, the FSA will continue to place emphasis on three areas, namely, (1) enhancing support to client companies according to their lifecycle, (2) strictly implementing financing methods suitable for SMEs, and (3) contributing to a sustainable regional economy.
- The FSA will motivate regional financial institutions to make extensive efforts by introducing examples and giving praise to progressive efforts and efforts that should be practiced broadly.

**2. Security and Convenience for Regional Users**

Regional financial services play a significant role in supporting the economic

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<sup>4</sup> "Region-based relationship banking" refers to a business model in which the financial institution accumulates information on customers by maintaining a close relationship with customers over a long period of time and provides financial services such as loans, etc., based on such information. (Report by the Second Subcommittee of the Sectional Committee on Financial System of the Financial System Council dated March 27, 2003).

activities of a region. It is important that regional financial institutions — the key providers of such services — help improve security and convenience for users in the region by making voluntary efforts based on the regional financial institutions' innovative ideas.

### ***Meeting asset management needs***

The FSA will verify whether regional financial institutions are explaining the risks accurately when selling investment trusts and on other such occasions, without imposing an excessive burden on customers in terms of time and procedures, so that the regional financial institutions are dealing with them adequately<sup>5</sup> and appropriately.

### ***Business continuity***

Considering that regional financial institutions play a key role in the settlement system, the FSA will confirm whether they are properly conducting risk management when integrating and revising systems and in other occasions of daily system operations<sup>6</sup>. The agency will also confirm their business continuity management in the event of earthquakes, pandemic influenza, etc. Furthermore, the FSA will confirm the regional financial institutions' preparedness for smooth shift to a paperless stock certificate system scheduled for January 2009.

### ***Preventing abuse of financial functions***

In order to ensure security for users, the FSA will verify, based on the following perspectives, whether the regional financial institutions' management systems have been developed to prevent financial functions from being abused and to deal with victims properly. In doing so, the FSA will check the management systems to properly confirm customers' identity and to detect transactions that are strongly suspected of being illegal and make appropriate responses (e.g., freezing of the regional financial institutions accounts).

(1) Do the regional financial institutions make efforts to eliminate the *furikome* fraud (e.g., alerting customers of the fraud around ATMs)? Do the regional financial institutions deal with victims properly and promptly in accordance with the *Furikome* Fraud Relief Act<sup>7</sup>?

(2) Do the regional financial institutions make efforts to prevent unauthorized withdrawals from the regional financial institutions accounts by using counterfeit/stolen cash cards, stolen passbooks, and Internet banking? Do the

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<sup>5</sup> FSA (February 21, 2008): "Our Answers to Your Questions about the Financial Instruments and Exchange Act" (<http://www.fsa.go.jp/policy/br/20080221.html>)

<sup>6</sup> FSA (June 3, 2008): "Regarding System Risk Control at Financial Institutions," (Supervisory Bureau No.1515) (<http://www.fsa.go.jp/common/conference/minister/2008a/20080603.html>)

<sup>7</sup> Act on Payments, etc., of Distribution as Relief for the Damage related to Funds in Deposit Accounts, etc., Used for Criminal Activities.

regional financial institutions pay compensation to victims properly according to the Depositor Protection Act<sup>8</sup> and agreements within the industry?

(3) Do the regional financial institutions take actions to prevent money laundering and terrorist financing?

(4) To prevent damage inflicted by antisocial groups, do the regional financial institutions make efforts according to the “Comprehensive Guidelines for Supervision of Small- and Medium-Sized and Regional Financial Institutions” amended in March 2008 in consideration of the guidelines to protect private enterprises from antisocial groups (agreement of secretarial meeting of Ministerial Meeting Concerning Measures Against Crime)?

### **3. Risk Management and Regional Financial System Stabilization**

As tension remains in the global financial markets, triggered by the subprime mortgage problem, it is necessary for the FSA to carefully monitor the markets and the impact on regional financial systems with a high level of vigilance. Also, the economy is weakening, and is exposed to further downside risks depending on movements in crude oil prices and other such factors. As far as the business performance of regional financial institutions is concerned, credit-related expenses are on the increase.

In the midst of such changes in the economic and market environment both at home and abroad, in order for regional financial institutions to continue performing their financial intermediary functions properly, they need to conduct high-quality risk management under proper corporate governance; this, in turn, will help stabilize the financial system in their regions. The FSA will encourage the regional financial institutions to make voluntary efforts by giving consideration to the following:

- The FSA will verify whether risks are properly managed, for example, whether credit risks associated with exposures to large borrowers and new forms of credit are properly managed, and whether market risks are properly managed according to the status of investments in various financial instruments. Furthermore, the FSA has amended the Guidelines for Supervision effective August 6, 2008 to incorporate the lessons on risk management learnt from domestic and foreign financial institutions’ experience of the subprime mortgage problem, including risk management related to securitized products, etc. As necessary, the agency will verify whether such lessons are reflected in risk management at the practical level and the disclosure of risk-related information.

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<sup>8</sup> Act on Protection, etc., of Depositors and Postal Saving Holders from Unauthorized Automated Withdrawal, etc. Using Counterfeit Cards, etc., and Stolen Cards, etc.

- Bearing in mind that profits play an important role in preparing against risks, the FSA will verify the profitability status of regional financial institutions. If they are deemed to be in need of improved profitability, the FSA will identify what kind of strategies are being built and executed by regional financial institutions to enhance their profit base, including the progress of their efforts in region-based relationship banking. The FSA will also identify their efforts to improve the quality of their capital, which is the foundation for proactive risk-taking.

#### **4. Materializing “Better Regulation”**

Financial regulation should place a greater emphasis on voluntary efforts and innovative ideas by financial firms, in light of the current phase of Japan’s financial sector where it should continue and further refine its efforts to stabilize the financial system, protect users, and establish and maintain fair and transparent financial markets.

Under these circumstances, the FSA will continue to be engaged in the efforts to solve supervisory issues in program year 2008 based on “better regulation” which centers on the following four pillars. The agency will have all its supervisory staff, including local financial bureaus, appreciate the concept and materialize it by the following efforts.

In doing so, the FSA will continue to work more closely with inspection departments and bureaus as well as the Securities and Exchange Surveillance Commission (SESC), and will also endeavor to more extensively execute supervisory administration in an integrated manner by sharing our understanding of regional financial institutions’ issues, etc., with local financial bureaus, which are directly in charge of supervising regional financial institutions.

##### ***Optimal combination of rules-based and principles-based supervisory approaches***

The FSA will utilize “The Principles in the Financial Services Industry,”<sup>9</sup> compiled in April 2008, in its financial administration, and interpret and implement the rules as they were originally intended.

##### ***Timely recognition of priority issues and effective response***

The newly-established Office for Market Analysis and Office for Supervisory Policy, Financial Market and Risk Analysis will gather and analyze information on market trends and risks related to the financial system, and promptly reflect such information in supervising regional financial institutions. The FSA will also properly identify the actual business status of regional financial institutions in consideration of their diversity stemming from regional characteristics, size of business, type of business

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<sup>9</sup> <http://www.fsa.go.jp/news/19/20080418-2.html>

and other factors, and endeavor to conduct supervisory administration in an efficient and effective manner according to the circumstances etc., of individual financial institutions.

***Encouraging voluntary efforts by financial firms and placing greater emphasis on providing them with incentives***

In order to share the same recognition about rectifying problems with regional financial institutions, the FSA will endeavor to analyze and unravel the causes extensively through two-way dialogues. The agency will utilize Basel II which places emphasis on providing the regional financial institutions with incentives, and also place importance on Pillars II and III.

***Improving the transparency and predictability of regulatory actions***

The FSA will strive to improve the transparency and predictability of its regulatory actions by enriching dialogues with regional financial institutions and distributing more information to them. The agency will also properly provide feedback on the results of its fact-finding to the regional financial institutions.

For the purpose of enhancing the effectiveness of such efforts, the FSA will endeavor to improve the skills of its staff by such means as cultivating and hiring experts, and enhancing training programs.