

Outline of JFSA's Approach to Compliance Risk Management

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Financial Services Agency, the Japanese Government (JFSA)

Summary of JFSA's Approach to Compliance Risk Management

Outline

Underlying Issues

- Financial Institutions (FIs) saw 1) **rule-based approaches**, such as compliance check with literal requirements of regulations and superficial prevention measures without root-cause analysis, 2) **backward-looking responses** to the problems which have already materialised, and 3) **ad-hoc and one-by-one measures** mainly taken by the compliance division, but not considered as the entire management issues.
- JFSA's **nitpicking onsite monitoring** on minor flaws may have contributed to these practices and impeded the effectiveness and efficiency of the internal control by financial institutions.
- Need to enhance compliance risk management, including the management attitudes, business model/strategy and corporate culture.

Roles of Management

- Take firm initiatives to develop and implement its internal control system, bearing in mind that **compliance risk is closely related to business model/strategy and corporate culture**.
- Review its perspectives, internal control system and corporate culture in an objective manner and develop corporate governance by which **feedback from the outside of the FI can be obtained**.

Framework for Risk Management

- Put in place **forward-looking and risk-based** management system focused on identifying and mitigating potential and significant issues inherent in its business model/strategy.
- Develop the risk management system which enables each of front divisions, compliance divisions and internal audit divisions to properly manage compliance risk.

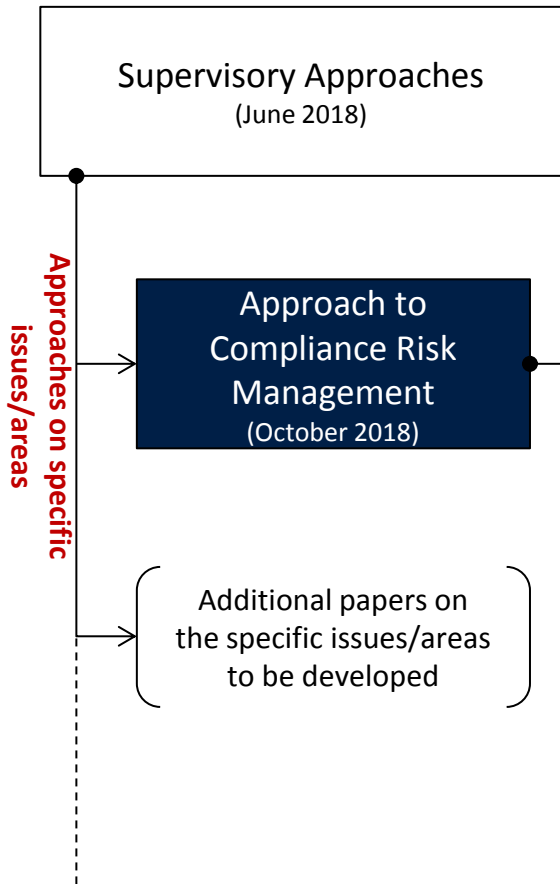
JFSA's Approach

- Engage in constructive dialogues with the management of FIs to **evaluate actions taken by the management**.
- Ensure **risk-based monitoring**, focusing on the significant issues.
- Take into **due consideration the burden** on FIs, reflecting their size, complexity and risk profiles.

JFSA's Approach to Compliance Risk Management in the Monitoring Process

- ✓ Developed this Approach to point out the fundamental concepts for better practices in compliance risk management.

Relation to the Other Papers



Approach in the Monitoring Process

How to Use

- It proposes the **fundamental concepts** so that both FIs and JFSA can pursue the better practices in compliance risk management.
- JFSA will further **study FIs' practices and common challenges** in compliance risk management and then **provide them with the necessary feedback and publish major findings**.
- JFSA shall **not superficially refer to individual issues in this paper** when monitoring individual FIs.

Inspection Manual

- Will repeal JFSA's Inspection Manual after April 2019.
- This does not mean to deny FIs' established practices, but support them to enhance their own risk management taking into account their current practices.

Underlying Issues of JFSA's Approach to Compliance Risk Management

- ✓ Traditional compliance risk management, including superficial, backward-looking and partial measures, needs to be improved.

Current Practices

FIS

- **Too detailed and strict** internal rules, compliance check with **literal requirements** of regulations and **superficial** prevention measures, causing 'compliance fatigue'.
- **Backward-looking** and ad-hoc, one-by-one responses to the problems which have already materialised (limited root-cause analysis).
- Problems addressed mainly by compliance divisions, but **not considered as the entire management issues** (limited leadership by management and/or ownership by front divisions).



May have contributed to these practices

JFSA

- **Nitpicking inspection** on minor flaws.
- **Backward-looking and one-by-one** monitoring on individual cases.

Changes in Circumstances

- The rapid change in the business circumstances, such as innovation and globalisation, may breed new forms of financial products, services and/or transactions which could bring **new types of risks**.
- Expanding cross-border activities.

Serious Misconduct

- Some FIs saw inappropriate conduct in terms of customer protection, market fairness and transparency and their social responsibility, leading to **significantly negative effects on their business** and confidence.

Need to enhance compliance risk management system, including the management attitudes, business model/strategy and corporate culture.

Compliance Risk Management as the Core of Business (Roles of Management)

- ✓ Management needs to develop the proper internal control, corporate culture and governance, bearing in mind that compliance risk is closely related to the business strategy.

Expected Roles

Management

- Top-level risk management with the perspective that **compliance risk is inherent in the business model/strategy**.
- Develop business model/strategy, taking into account a broad range of sources of compliance risk (i.e. tone at the top, which affects the corporate culture).

Internal Control

- Management's views on compliance risk management should be penetrated throughout the firm.
- Middle level should **obtain in-depth understanding** on the management attitudes to compliance risk management and **break them down into actions**.
- Put in place **incentive policies** consistent with the management attitudes and the corporate culture.

Corporate Culture

- Corporate culture is the key for compliance risk management, which affects attitudes of management and middle levels, and the entire structure of the internal control system.
- **Management should clarify** their corporate values, philosophy and codes of conduct, and **make officers and employees assimilate them**.

Governance

- Take an objective view of management attitudes, internal control system and corporate culture (i.e. bridge the gap between the common sense of the FI and society).
- Develop the **governance structure which allows to properly control management's activities**, with the initiatives of the board of directors (including external directors), audit committee, etc.

Framework for Risk Management

✓ Each division is expected to develop its own compliance risk management system.

* The functions of each division could be different among FIs, reflecting their own corporate structures and risk management system.

Self-control by Front Divisions (1st line of defence)

Roles

- Could be major sources of compliance risk related to the business activities.
- Primarily responsible for compliance risk management.

Control by Compliance Divisions (2nd line of defence)

- Independently control and support the risk management by front divisions.
- Manage firm-wide risks on an integrated basis.

Review by Audit Divisions (3rd line of defence)

- Review the efficacy of compliance risk management system independently from both front and compliance divisions.

Expected Functions

- Each officer and employee in front divisions should have the **ownership** in compliance risk management, with the understanding that they are **primarily responsible** for compliance risk management.

- Need the knowledge and expertise on risk management, operation of front divisions and its inherent risks.
- **Management** should grant compliance divisions the **adequate power, position**, independency from front divisions and **human resources**.

- Set the scope of audit following the assessment on the business model and its inherent risks.
- Audit to **properly control the management** (e.g. calling management for improvement).
- Management should take initiatives to develop **prevention measures based on root-cause analysis**.
- Secure **adequate human resources** and **coordinate with external directors, auditors, etc.**

- Develop and implement compliance risk management system on a corporate group basis.
- Firm control on overseas branches taking into account the difference in regulations.
- Effective and efficient risk management with the employment of information and telecommunication technology.

Risk-based Approach

- ✓ Effective and efficient risk management system should be developed, with the aim to prevent significant risks.

Current Practices

Effectiveness & Efficiency

- **Incomplete risk-based approach** without due consideration on the effectiveness and efficiency, leading to excessive burden.
- **Difficult to secure sufficient resources to address the critical issues.**

Prevention Measures

- Concentrate on backward-looking responses to the problems which have already materialised.
- **Need to consider major potential risks and prevent them beforehand.**

Addressing New Types of Risks

- Inadequate consideration about new types of risks, coming from newly developed business areas.
- These risks tend to be **out of scope of the traditional risk management system.**

Risk-based Approach

Focus on preventing the serious risks which may damage FIs' confidence, with significantly negative impacts on customer protection, market fairness and transparency.

Risk Identification & Assessment

- **Identify significant risks and their sources**, with a broad range of information and comprehensive and concrete risk assessment.
- Identify potential incidents which may have significantly negative impacts on customer protection, market fairness and transparency and FIs' confidence.

Risk Mitigation & Control

- **Develop and implement concrete action plans** with the aim to mitigate and control risks in the individual business area.

* **Management should take firm initiatives to implement this process so that the risk-based approach could be put in place.**

JFSA's Supervisory Approach

- ✓ JFSA also needs to ensure risk-based monitoring.

Wide-ranging Intelligence Gathering

- **Understand FIs' business and the issues in risk management** through various sources, including:
 - ✓ Discussion with the management, officers and employees; and
 - ✓ FIs' disclosure, materials submitted to JFSA (e.g. materials for the board of directors)
- **Gather a broad range of information** which may affect FIs' compliance risks (e.g. news stories, complaints and scandals) in a timely manner.

Setting Monitoring Issues

- Set the subjects for monitoring, based on the profiling of the risks related to customer protection, market fairness and transparency, financial system and FIs.
- Have in-depth discussion on the subjects with FIs, so that JFSA and FIs could **share and deepen the awareness of risks** each other.

Strategy Development & Monitoring

- **Profiling**
 - ✓ In-depth understanding on FIs' business and practices.
- **Strategy Development**
 - ✓ Set the scope of issues, FIs to be monitored, methodology, etc.
- **Review**
 - ✓ Consistently improve the strategy through the PDCA process, eliminating subjectivity.
- **Monitoring**
 - ✓ Conduct **interactive, fact-driven discussions** and obtain **FIs' understanding** on the monitoring results.
 - ✓ Evaluate the management's actions related to risk management, respecting FIs' own business models/strategies.

Feedback

- **Provide individual FIs with JFSA's findings and implication** through the monitoring process.
- **Disclose major findings and implication** through JFSA's reports and meetings with industries.

JFSA's Next Step

- ✓ JFSA will share our views on compliance risk management and further understand FIs' practices.

JFSA's Next Step

Sharing JFSA's Awareness of Issues

- Discuss JFSA's views on compliance risk management with FIs' management through meeting with industries.
- Hold dialogues with the related parties including overseas authorities.

In-depth Understanding

- Gather information on each FI's practices in compliance risk management, making use of the monitoring opportunities on each FI.

Feedback

- Share major findings and common challenges for compliance risk management with FIs and industries.
- Provide individual FIs with the challenges which JFSA considers is important for each FI.

Consideration for Future Monitoring

- Develop necessary measures to enhance industry-wide compliance risk management practices (e.g. develop principles with regard to the specific areas where some norms are needed).
- Consider necessary methodology to evaluate FIs' practices.

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