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**Comprehensive Guidelines for  
Supervision of Major Banks, etc  
(Provisional Translation)**

**Main Document**

**July 2024**

**Financial Services Agency**

**Comprehensive Guidelines for Supervision of Major Banks, etc**  
(Provisional Translation)

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## I How Major Banks are Supervised and Regulated

### I-1 Key Principles in Financial Supervision

(1) The goal of financial supervision is to preserve the credibility of bank services, to achieve the sound and appropriate management of bank services in order to ensure the protection of depositors and facilitate financial services, and to thereby contribute to the sound development of Japan's economy, as described in Article 1 of the Banking Act of Japan (the "Act").

(2) Since its inception, the Financial Services Agency of Japan ("FSA") has had a mission to ensure transparent and fair financial policy based on explicit rules.

To this end, the FSA is constantly working to improve administrative efficiency and effectiveness, to make rules even more explicit, and to refine administrative procedures in various areas of financial policy, including supervision, inspection, and surveillance.

Another important role that the FSA performs in this context is to promote enhanced disclosure by financial institutions on an ongoing basis, with a view to further enhancing their business transparency, encouraging their self-regulatory and self-corrective behavior under market discipline, and establishing the principle of reasonable sharing of risks between banks and depositors.

(3) Administrative transparency and fairness continue to constitute the backbone of the administrative operations now and in the future. At the same time, however, excessive prescription must be avoided. If enthusiasm to make rules clearer evolved into the preparation of extremely meticulous checklists, the regulator's effort would end up with mechanical repetition and continuation of backward-looking and one-size-fits-all review based on a common comprehensive checklist. In this situation, no attempt would be made to explore root causes of problems and substantive verification of potential secondary problems or consequences. Moreover, such a supervisory approach might bring about further unwanted effects. For example, financial institutions might be discouraged from finding out what is truly important in light of their overall business management and root causes of various problems, and seeking fundamental solutions to prevent recurrences. Or financial institutions might become unwilling to take forward-looking measures at an early stage and to stay innovative in pursuit of best practices.

The FSA is therefore committed to continuous and seamless monitoring through accurate profiling and close communication with individual financial institutions, in light of their business size and characteristics and the likelihood of facing serious problems that could affect their financial stability or compliance. Then, the FSA will implement supervisory measures, where appropriate, to prevent the occurrence of serious problems. In addition, the FSA is continuing various efforts, including dialog with financial institutions and other stakeholders, to encourage financial institutions' initiatives to pursue best practices.



<Reference> “FSA’s Supervisory Approaches (Replacing Checklists with Engagement),” June 29, 2018

- (4) With the key principles described in (1) to (3) in mind, the FSA requires that its staff members engaged in supervision of financial institutions execute their duties in accordance with the following code of conduct and continue efforts to maintain confidence in financial policy.
- (i) **Entrustment from Japanese citizens and observance of professional ethics**  
FSA staff members are assigned to their duties because the corresponding responsibility is delegated from Japanese citizens to the FSA. Therefore, FSA staff members on duty must stay conscious of the goal of financial supervision described in I-1(1) as the highest-priority mission. They must also maintain ethics pertaining to their duties and endeavor to aim at ensuring public confidence in financial policy.
  - (ii) **Official discipline, integrity, and confidentiality**  
In the conduct of financial policy, FSA staff members should never compromise on discipline, integrity, and confidentiality and should maintain an even-minded and immovable attitude.
  - (iii) **Big-picture and medium- to long-term perspectives**  
The standpoints of citizens and companies using financial services should always be remembered. Rather than ending in detecting and clearing away short-term problems from a narrow point of view, FSA staff members’ time and effort must be spent to find out root causes of problems and to seek early solution from big-picture and medium- to long-term perspectives.
  - (iv) **Integrity and fairness**  
Duties must be executed in an integrated and fair manner, through proper administrative procedures conforming to applicable laws, and with due consideration to circumstances of respective financial institutions. Domestic financial institutions and financial business operators and foreign entities operating in Japan (i.e., foreign financial institutions’ branches or foreign corporations’ subsidiaries operating in Japan as financial institutions or financial business operators) should be treated equally, except when different treatment is reasonably accountable based on applicable laws.
  - (v) **Respect for financial institutions’ initiatives**  
To achieve the goal of financial supervision, financial institutions’ initiatives for innovation are indispensable. With this in mind, and recognizing that they are private enterprises, FSA staff members must pay due regard to their self-initiated efforts in their business management.
  - (vi) **Self-improvement**  
FSA staff members are expected to continuously brush up and improve their fundamental understanding of financial laws and regulations and recent conditions of financial institutions, including those of foreign countries, and a broad range of social and economic topics that could affect financial services serving as economic infrastructure. To effectively execute duties, which include dialog with financial institutions, FSA staff members should gain deep insights on individual financial institutions and FSA staff members will need to conduct issue-specific

analyses requiring a high level of expertise in business performance, governance, risk management, asset management, or other themes. To acquire such expertise and skills, FSA staff members need to continue self-development efforts on a regular basis.

(vii) Appropriate and close communication with co-workers and external stakeholders

For effective supervision, FSA staff members need to have a broad perspective through a cross-functional approach. For this reason, they should appropriately and closely communicate and cooperate with a wide variety of parties concerned, both inside and outside the FSA.

## I-2 History of Financial Supervisory Guidelines

### (1) Renewing the handling of ministerial notifications and establishing the Guideline for Administrative Processes

Just before the launch of the Financial Supervisory Agency (a predecessor of the current FSA) in June 1998, Japan's former Ministry of Finance exhaustively redesigned the ways of handling ministerial notifications related to financial affairs, as part of its efforts for a shift to rule-based, transparent, and fair financial policy. Then, the Guideline for Administrative Processes was published as a guidebook for staff members working in supervision teams. This guidebook was intended to ensure integrated financial policy and describes how to interpret and apply laws and regulations, in-house procedures, and supervisory viewpoints to verify the soundness of financial businesses.

### (2) Formulation of comprehensive supervisory guidelines targeted at Major Banks and small- and medium-sized or regional financial institutions

For supervision over small- and medium-sized financial institutions and regional financial institutions (\*1), the Comprehensive Guidelines for Supervision of Regional Financial Institutions were formulated in May 2004, and are based on the Action Program Concerning Enhancement of Relationship Banking Functions published in March 2003.

With regard to major banks, however, it was decided that the formulation of comprehensive supervisory guidelines would be postponed until the complete resolution of the non-performing loans (NPL) problems. In those days, national efforts were underway toward a goal of reducing major banks' NPL ratio to about half by the end of March 2005, based on the Program for Financial Revival (October 2002) and other government policies.

When this goal was achieved, Japan's financial policy outgrew the stage of emergency response to the NPL problems and reached a turning point to move into a forward-looking phase aiming at a desired financial system for the future. In October 2005, the initial version of the Supervisory Guidelines for Major Banks (\*2) was released with the aim of realizing a financial system highly satisfactory to users and deserving of international acclaim.

All the foregoing guidelines serve as a guide for staff members of the FSA's headquarters and the Local Financial Bureaus who are assigned to the duties of supervising small- and medium-size or

regional financial institutions or Major Banks. These guidelines show the key principles in financial supervision, supervisory evaluation points, and the points to note during administrative processes, which have been compiled by reviewing the former administrative guidelines and systematically reorganizing new supervisory approaches.

Note 1: Small- and medium-size or regional financial institutions refer collectively to regional banks, second-tier regional banks, credit associations called “shinkin banks”, and credit cooperatives called “shinkumi banks”. However, the Comprehensive Guidelines for Supervision of Regional Financial Institutions contain some regulations applicable to labour banks and Credit Guarantee Corporations, in addition to the entities mentioned above.

Note 2: The term “Major Banks” refers collectively to Japan's three megabanks, SBI Shinsei Bank, Aozora Bank, and Japan Post Bank.

### (3) Revisions of the supervisory guidelines based on the redefined supervisory approaches

In 2008, the collapse of a US major investment bank in the subprime mortgage crisis triggered the global financial crisis and other ensuing turmoil. Nevertheless, Japan’s financial market remained stable in general. Subsequently, however, the business environment for Japan’s financial institutions has been becoming increasingly challenging due to Japan’s declining birth rate and ageing population followed by shrinking domestic market, persistent global low interest rates, and competition intensified by the rise of new technologies. In addition, a transformation appearing in the form and locus of risks for financial institutions is accelerating. Under these circumstances, Japan’s financial institutions are facing the increasing necessity of undertaking their initiatives to build sustainable business models, to secure their soundness into the future, and to develop adequate compliance risk management mechanisms from a long-term perspective.

Meanwhile, the FSA is required to respond, in a timely and precautionary manner, to changes in environments and new issues that may arise. When a FSA’s forward-looking analysis shows the likelihood that financial institutions may face serious problems that could affect their financial stability or compliance, the FSA will need to take quick actions. For this purpose, the FSA is continuing various reforms to redefine its supervisory approaches.

In June 2018, a report entitled “FSA’s Supervisory Approaches (Replacing Checklists with Engagement)” was issued to present the key principles in financial policy, new supervisory approaches, and the FSA’s internal organization and staff assignment policy. This report states that the Inspection Manuals are to be repealed with a view to urging the FSA to break away from checklist-based and formality-focused inspection of financial institutions and enhancing the FSA’s role to encourage financial institutions’ initiatives for innovation.

In July 2018, the FSA enforced its internal reorganization to allow for effective and efficient monitoring of financial institutions on an ongoing basis. While under the previous organizational structure on-site inspection had been conducted by the Inspection Bureau and interviews and other dialog with firms had been undertaken by the Supervision Bureau, this conventional scheme was

abolished and the new scheme to integrate both on-site and off-site activities for supervision and monitoring is being developed.

In this context, these Supervisory Guidelines were updated accordingly in December 2019, simultaneously with the repeal of the Inspection Manuals. More specifically, the ways of continuous and seamless monitoring through fact-based profiling or engagement in dialog and the roles of the renewed Supervisory Guidelines were redefined. In addition, some clauses with excessive prescription were modified so as not to hinder financial institutions' initiatives for innovation. The FSA will continue review and improvement of these Supervisory Guidelines from such viewpoints.

### I-3 Roles of the Guidelines for Supervision of Major Banks

- (1) These Supervisory Guidelines systematically show the key principles in financial supervision, the points to note during administrative processes, and supervisory evaluation points, serving as a guide for staff members assigned to the duties of supervising Major Banks.
- (2) In addition to these Supervisory Guidelines, the FSA releases various documents showing its supervisory policies, which include theme-specific supervisory approaches and principles, annual policies, and recommendations or requests to industry associations. During supervisory processes, the differences in the purposes and objectives of respective policy documents must be taken into full consideration, and thorough explanations should be provided to the financial institutions.
- (3) For the convenience of administration, these Supervisory Guidelines are applicable not only to Major Banks, but also to other similar entities including long-term credit banks, foreign bank branches, trust banks, and entities newly entering into banking business (in terms of licensing and approval of major shareholders).

Note: Regarding operations using trust accounts conducted by trust banks, see the Comprehensive Guidelines for Supervision of Trust Companies separately established.

- (4) The FSA's relevant bureaus and divisions are required to carry out the processes of supervision over Major Banks in conformity with these Supervisory Guidelines. During those processes, these Supervisory Guidelines must be operated in a way suitable for each firm's circumstances, rather than mechanically and uniformly applying the same rules. This is because these Guidelines have been designed to respect financial institutions' initiatives and to assist them in ensuring sound and proper business operations.
- (5) Follow-up on the banks and bank holding companies which have received capital injections from public funds under the Banking Act on Emergency Measures for Early Strengthening of Financial Functions or the Deposit Insurance Act

- (i) While the FSA needs to follow up on the banks and bank holding companies which have received capital injections from public funds under the Banking Act on Emergency Measures for Early Strengthening of Financial Functions (the “Early Strengthening of Banks Act”), such follow-up activities will be performed based on a set of relevant decisions issued by the Financial Reconstruction Commission and the guidelines established by the FSA specifically for this purpose (\*), to be operated separately from these Supervisory Guidelines. The same applies to follow-up activities for deposit-taking institutions and bank holding companies that have received capital injections from public funds under Article 102(1)(i) of the Deposit Insurance Act.

Note: List of major rules applied to firms subject to capital injections from public funds

(A) Decisions of the Financial Reconstruction Commission

- a. Follow-Up on Financial Institutions Subject to Capital Injections under the Early Strengthening of Banks Act (abstract) (June 29, 1999)
- b. Conversion of Convertible Preferred Shares (June 29, 1999)
- c. Basic Approach for Review of Business Revitalization Plans (September 30, 1999)
- d. Administrative Measures Pertaining to Follow-Up on Banks Subject to Capital Injections (September 30, 1999)

(B) Guidelines established by the FSA

- a. Guidance to Clarify Ways of Implementing Administrative Measures Pertaining to Follow-Up on Banks Subject to Capital Injections (June 11, 2001)
- b. To Improve Corporate Governance of Major Banks Capital Injected with Public Funds (April 4, 2003, followed by partial revision on August 7, 2003)
- c. To Improve Corporate Governance of Regional Banks Capital Injected with Public Funds (June 30, 2003)
- d. Guidance II to Clarify Ways of Implementing Administrative Measures Pertaining to Follow-Up on Banks Subject to Capital Injections (July 30, 2004)

- (ii) The banks which have received capital injections from public funds under the Early Strengthening of Banks Act or the Deposit Insurance Act are required to formulate and publish their business improvement plans and publicly disclose reports on the progress of implementation of such plans. Since such banks are subject to follow-up and administrative actions implemented under the rules listed in the preceding paragraph, the FSA intends to make maximum use of the information from such preceding documents when supervising Major Banks under these Supervisory Guidelines in accordance with the Banking Act and other laws. Such a cross-functional approach will contribute to more efficient and effective supervisory services (cf. II-1(3)).

## II Points to Note in Administrative Services for Supervising Major Banks

### II-1 Key Principles in Supervisory Activities

To achieve the goal of financial supervision described in I-1(1), the FSA needs to make continuous responses commensurate with the size and characteristics of each bank.

The first thing to do in such supervisory processes is to learn respective banks' policies for developing business models, promoting financial intermediation, securing financial stability, building compliance management and risk management systems, and addressing various other issues. What is essential next is to accurately understand how those policies are implemented, what governance systems are operated for such implementation, what potential risks or problems lurk, and how banks recognize and respond to their respective risks and problems.

In order to turn banks' efforts towards addressing their critical issues from a holistic viewpoint into the sound development of Japan's economy, banks should promote self-initiated improvements to pursue best practices and renovate their management systems, even without being instructed by the regulator. What the FSA should do in this context is to encourage individual banks' pursuit of best practices by means of continuous monitoring; i.e., through dialog with banks and checking their conditions.

If, in the course of such monitoring activities, the FSA finds any issue that is considered serious in terms of the soundness and appropriateness of the bank's business or determines that the bank is unable to improve its business by its self-initiated efforts only, the FSA will consider whether to issue a business improvement order or to impose other administrative action pursuant to Article 26 of the Banking Act (as explained in II-5).

Some other points that need to be adequately considered in the course of supervising banks are summarized as follows.

#### (1) Close communication with banks

During the supervisory processes, it is important to adequately gather and analyze information about banks' business operations and to make timely and proper responses. For this purpose, the FSA not just needs to obtain reports from banks from time to time, but also should endeavor to closely communicate with banks and gather information on a day-to-day basis, with a sense of moderate and constructive tension between the regulator and regulated firms. More specifically, day-to-day communication with banks should be secured through periodic and occasional interviews, dialog, and discussions with banks' management, outside directors, internal auditors and various other officers or employees, together with the effort to understand both financial information and business information of those banks.

#### (2) Respect for banks' initiatives

Since each bank, as a private company, makes management decisions at its own risk and responsibility, the role of the FSA as a regulator is to review such decisions based on relevant laws and regulations and to encourage banks to resolve problems by their own efforts and resources. With this role firmly in mind, the FSA must pay due regard to banks' initiatives in their business operations throughout supervisory processes.

(3) Efficient and effective supervisory activities

To make maximum use of limited resources of the FSA and banks, supervisory activities need to be customized based on each bank's size and characteristics, and implemented efficiently and effectively. When the FSA asks a bank to submit reports or other documents, the scope of such documents must be limited to the extent truly necessary for the relevant supervisory processes. More importantly, the FSA must continue efforts to enhance efficiency and effectiveness of supervisory activities; the necessity of the supervisory processes currently adopted and their methodologies should be constantly reviewed and supervisory processes should be redesigned whenever necessary.

The content of the reports previously obtained from banks and the procedures for requesting submission of reports or documents are reviewed every year to streamline such procedures and reduce banks' paperwork burdens. On such occasions, the FSA should seek banks' opinions about submission requirements.

When the FSA asks banks to submit reports or other documents on their small-scale offices, their products and services and other peculiar circumstances must be taken into full consideration and due regard must be given so as not to disturb their efficient operation.

(4) Risk management at financial conglomerates

Japan has unleashed a spectrum of financial sector reforms, including: the financial system reforms in 1993 to deregulate cross-entry among different financial business categories through establishment of subsidiaries, the lifting of the ban on the establishment of financial holding companies in 1998, and modifications of the provisions concerning subsidiary companies in the Banking Act and other laws by virtue of the 1998 Financial System Reform Act. Through these developments, financial groups containing businesses in different categories have been formed in Japan.

While the formation of these financial conglomerates may help strengthen the business structure of financial institutions and improve the quality of their services, such grouping of firms is likely to give rise to new risks. For one thing, a complex organizational structure may lead to inefficient business operations, or the grouping may trigger conflicts of interest among group companies and tend to induce tie-in sales or superior position-abusing transactions. For another thing, risks are apt to spill over and affect the entire group or, conversely, may concentrate in specific firms only.

In light of these characteristics, it is not enough just to ensure the soundness of an individual bank in a banking group, but it is crucial to understand and analyze the entire group's governance, financial stability, and appropriateness of business operations. From the viewpoint of ensuring appropriateness

of business operations, the FSA needs to urge banking groups to engage in integrated management.

This is also the case when a regulated bank is a subsidiary or affiliate of another firm which is a non-banking financial institution, a foreign financial group, or a non-financial company. The FSA needs to check the likelihood that each such bank may have the potential risks mentioned above (e.g., risk contagion or risk concentration), through extending the FSA's regulatory power to major shareholders of such banks, and also, through in-depth interviews.

Since there are various forms of financial groups, the characteristics of risks vary among different types of groups, and the impacts of such risks spread within the group differently. As a consequence, the governance systems adopted by those financial groups vary accordingly. The regulator's review and enforcement activities therefore need to be tailored to each financial group's profile. Moreover, even in cases where business categories or applicable laws and regulations differ, when regulations are based on a similar effect, the FSA needs to implement supervisory activities from a similar standpoint or viewpoint. Especially for financial services provided by financial institutions with different business categories in an integrated manner within any financial group, it is effective for all relevant divisions in the FSA to cooperatively engage in supervisory activities. From these points of view, it is crucial to strengthen the collaboration among all relevant divisions, such as the Securities Business Division of Supervision Bureau and other supervisory divisions, as well as the Securities and Exchange Surveillance Commission.

#### (5) Conformity with international regulatory standards

Given that most Major Banks covered by these Supervisory Guidelines are financial institutions operating internationally, the regulator should, to the extent possible, attempt to make its supervisory approaches and standards compliant with the principles and guidelines for international bank supervision established by the Basel Committee on Banking Supervision or other international organizations (\*).

Regarding Major Banks' activities outside Japan, the FSA needs to closely cooperate with financial regulators in the countries in which the Major Banks are based (host countries).

Note: See the Guidance on Review Processes in Supervisory Services, as shown in Exhibit 1.

### II-1-1 How to Supervise Major Banks

The regulator's supervision over banks is basically intended to encourage their necessary improvements. Such supervisory activities are implemented by combining various approaches and methods, including monitoring through risk profiling or dialog, imposition of supervisory measures, giving feedback, and dissemination of information. Such approaches and methods should be appropriately chosen based on individual banks' circumstances and the characteristics and severity of their problems.

In addition, day-to-day monitoring is essential for adequately understanding changes in the global



economy and in market environments that could affect banks, for the purpose of ensuring stability of Japan's entire financial systems and promoting financial intermediation in Japan. Data from monitoring and findings from occasional interviews may facilitate the regulator's dialog with banks. Through such dialog, the regulator must understand individual banks' circumstances and encourage their efforts to pursue best risk management practices, to develop management and governance systems capable of flexibly responding to changes, and to resolve various challenges.

## II-1-2 Supervisory Approaches and Methods

### (1) Continuous and seamless monitoring focused on priority issues

The FSA's continuous monitoring starts with accurate profiling of individual banks and identification of their issues to be addressed. Then, depending on the nature and priority of those issues, the FSA chooses among and flexibly uses various monitoring methods (including on-site inspection) and follows up on the progress of banks' improvement activities.

Which monitoring method is effective will depend on the target bank's actual circumstances. In addition, which to use should be determined after fully considering the effectiveness of each monitoring method in the given situation, workload burdens of both the regulator and the bank, and the urgency of the issues. In general, what comes first is to conduct monitoring through analyses of the bank's business performance, financial performance, risk data, and other information or through interviews with the bank's personnel and its stakeholders within and outside the bank. On this occasion, whether or not the bank's business is sound and appropriate for the time being is judged based on the analysis findings. After this step, whether or not to conduct on-site inspection under Article 25 of the Banking Act will be determined.

### (2) Methods used for supervisory activities

#### (i) Actions necessary for understanding the bank's circumstances and having dialog

##### (A) Information gathering and profiling

The FSA conducts monitoring with the intention of gaining insights into the bank's characteristics, challenges, self-initiated efforts for improvement, and specific conditions of the time. Such monitoring activities include the step of understanding impacts of changing business environments on the bank's business management and its response measures.

Since changes in economic conditions and financial and capital markets at home and abroad and individual banks' behavior may affect each other, the interplay between these two factors should also be analyzed and assessed.

These information gathering and profiling activities are accumulated through day-to-day monitoring. While no particular forms or methods are designated for these activities, the perspectives illustrated below may be informative.

#### a. Macro-level perspectives

It is necessary to identify and analyze impacts on individual banks and financial systems that may potentially result from changes in economy, financial markets, politics, societies, or other domestic or international environments. One useful way is, for example, to seek cooperation from relevant bureaus and divisions in the FSA, Local Financial Bureaus, or other relevant ministries or governmental agencies to gather various information about changes in domestic and international environments. Such information may cover cases of misconduct committed by domestic and international companies, including enterprises in non-financial sectors, legislative changes and system reforms at home and abroad, judicial precedents in various nations, developments in discussions by foreign regulators or international organizations, and economic or social changes (e.g., increasing attention to sustainable development goals). Analyses of such various information may reveal common challenges which are faced by industry peers or firms in other industries, which can be observed in similar products or services, or which may exist in different countries' legislative systems.

Since the information gathering and analysis activities described above enable horizontal analyses of relevant risk events observed or spreading in the industries, the FSA will continue efforts to identify and highlight problems inherent in Japan's entire financial sector.

b. Micro-level perspectives

For effective dialog and other communication with banks, the regulator absolutely needs to accumulate extensive knowledge about individual banks' conditions. Among other measures, the first thing to do is to check each bank's management philosophy; i.e., what the bank aims to be in its business environment (e.g., customer characteristics, competitive environment) and what the bank wants to do toward this end. It may be advisable to gather the information described below from each bank and its stakeholders (e.g., employees, customers, regional communities, shareholders).

- The scope of information to be analyzed should not be limited to financial data, risk data, or other typical information disclosed, but should be extended to minutes of executive meetings or other organs and documents pertaining to management decisions (including the information about strategies to enhance financial intermediation and related progress reports).
- In addition to periodic interviews in connection with the bank's period-end settlement or risk management, FSA staff should have discussions with the heads of the bank's respective business units and other officers or managers in different positions from time to time in order to learn about the bank's business conditions, efforts to promote financial intermediation, or other activities.
- To understand how the bank perceives its risks and what its business operations ought to be, FSA staff need to exchange views with the bank's internal auditors, audit committee members, company auditors, or outside directors.
- To deepen the regulator's understanding of the characteristics of banks' customers and the

- characteristics of the banking sector, FSA staff are strongly recommended to interact with business operators in non-financial sectors and other stakeholders in regional communities.
- Feedback from users of financial services can be obtained through various channels, and such feedback includes, for example, inquiries or complaints received at FSA's Counseling Office for Financial Services Users, and findings from interviews with corporate borrowers. In addition, media reports, inquiries from third parties, and other external information should be analyzed.

Through these information gathering and analysis activities, as well as through the monitoring activities performed so far, the FSA will figure out banks' business models, management strategies, business operation systems and organizational structures and gain insights into their problems, risk profiles, and potential impacts from changes in business environments.

(B) Identification of priority issues and formulation of monitoring policies and plans

After horizontal challenges common among individual banks and business categories are identified through the information gathering and profiling activities described above, all those issues will be prioritized, taking into full consideration the degree of importance and urgency of the occasion such as social demands. This prioritization is necessary to facilitate subsequent discussions between the regulator and each bank's executives on substantive issues critical to their business and to make maximum use of limited administrative resources. The horizontal challenges identified as priority issues in this process are published in the FSA's annual supervisory policies at the beginning of each program year.

Subsequently, monitoring policies and plans are formulated based on firm-specific conditions, which describe practical policies and plans to address priority issues, and FSA staff need to be reassigned or rearranged appropriately. To enable banks to concentrate their management resources on efforts to address critical and substantive problems, the FSA will choose between on-site inspection and off-site monitoring, and between firm-specific monitoring and horizontal monitoring, depending on the nature of priority issues.

Unlike periodic on-site inspections as was previously done, the on-site inspection practice currently adopted is incorporated in continuous and seamless monitoring processes, for the purpose of understanding individual banks' conditions. However, a long interval between occasional on-site inspections may make it relatively difficult for the regulator to foresee some risk events, which is a negative aspect of the new practice.

In the event that new issues arise or are uncovered, the FSA will flexibly adjust monitoring plans and endeavor to adapt monitoring activities for changing circumstances.

(ii) Accurate profiling of individual banks

To figure out individual banks' conditions, the FSA will chose the most efficient and effective methods among: interviews with various stakeholders, requesting submission of documents on a

non-compulsory basis, questionnaires, demanding submission of statutory reports, on-site inspection, and other methods. Which to choose depends on the nature of issues to be addressed, the progress of countermeasures being implemented, and other firm-specific circumstances.

If the FSA has received reports from banks through any previous monitoring or has already obtained some information about banks from other sources, the FSA must review them in advance and effectively use the information on hand in order to mitigate the banks' paperwork burdens.

If new or previously unpredicted issues come to the attention of the FSA in the course of gathering information, profiling, or dialog after the monitoring based on the previous analyses, the FSA will make appropriate responses in light of the nature of the new issues.

When applying any monitoring method, the points illustrated below should be considered, among others. Regardless of which method is chosen, the FSA must clearly explain the problems recognized by the FSA and the purpose of discussions with the bank.

(A) Interviews

In order for the regulator and each bank to share an understanding of its priority issues, the FSA will conduct multilevel interviews with the bank's personnel, including top executives, the heads of business units, departments, or branches, and working-level managers, depending on the nature of the issues.

The pursuit of best business practices is a matter that each bank should spontaneously promote to find its own way appropriate for its own conditions and circumstances. With this view in mind, the regulator should not impose a particular solution on the bank.

As part of these interviews, the FSA may conduct interviews or discussions on specific themes on banks' premises intensively for a certain period of time.

(B) Requesting submission of documents on a non-compulsory basis

When requesting banks to submit documents, the FSA will pay due regard to their burdens and closely communicate with the banks in advance, in order to convince the banks of what documents are desired and why they are necessary, through clear and accurate explanations. The FSA should try to reduce banks' burdens by carefully asking for submission with adequate intervals, avoiding duplicated submission requests, or allowing sufficient time before submission deadlines. When asking multiple banks for submission of documents at the same time (e.g., questionnaires), due regard should be given to respective banks' characteristics and circumstances.

(C) Demanding submission of reports pursuant to Article 24 of the Banking Act

When it is found necessary, the FSA will ask a bank to make a report pursuant to Article 24 of the Banking Act. In this event, the bank must be fully informed and convinced as to how the regulator perceives the bank's issues and why the regulator asks for such reporting.

(D) On-site inspection pursuant to Article 25 of the Banking Act

The FSA will conduct on-site inspection pursuant to Article 25 of the Banking Act when the FSA determines that detailed examination is required to verify the soundness and

appropriateness of the bank's business for the time being, or when it is found necessary on other grounds. In this event, the FSA needs to stay focused on the bank's critical issues and their root causes, to reaffirm the accuracy of the selection and definition of priority issues together with the bank's executives, and to form hypotheses. To demonstrate the hypotheses, the FSA will gather and analyze more detailed information about the facts and circumstances and continue discussions with the bank's executives based on additional analyses. Such discussions should not end up in seeking a facile solution, but should aim at a fundamental solution of the problems critical in terms of both the bank's management and the regulator's financial policy.

In this regard, see the Basic Procedures for On-Site Inspection, as shown in Exhibit 2. If the FSA issues a notice of inspection results to an inspected bank, within one week after the notice in principle, the FSA will ask the bank to report the bank's fact-checking of the problems pointed out in the notice, its own analyses of the causes of those problems, planned measures for improvement or remediation, and other comments within one month pursuant to Article 24 of the Banking Act. The matters required to be reported will be designated by reference to Form II-1-3-3(2) in the Forms and Reference Information. Since this form is a mere template, adequate and sufficient reportable matters should be specified on an individual basis in a way tailored to the problems detected in the inspection.

(iii) Dialog

The regulator's dialog with a bank is intended to clarify whether any problem that could affect the bank's financial soundness or compliance has occurred or is likely to occur, to review the bank's initiatives for enhancing business management or financial intermediation, or to discuss other issues that are important under the present circumstances or in light of the nature of ongoing problems.

In the course of dialog, FSA staff must avoid imposing their beliefs or hypotheses and endeavor to make the bank's executives or managers feel free to express their views. After hearing their story and understanding the bank's mindset and policies, facts-based discussions will follow.

On the occasion of each such dialog session, the past communications between the FSA and the bank should be fully considered, and consistent and continuous discussions should be pursued.

- (A) If the FSA determines, based on the facts ascertained, that the bank is highly likely to face a serious problem that could affect its financial soundness or compliance, the bank will verify its challenges, their root causes, and the adequacy of remediation measures first of all. Then, in-depth discussions between the FSA and the bank to implement remediation measures will follow. If, however, a serious problem has already arisen or high urgency in any other form is observed, the FSA may go further and pinpoint the issues required to be rectified in the FSA's opinion and then check the bank's policies for rectification.
- (B) If banks are determined to be unlikely to cause serious problems as described in (A), they are expected to exercise diverse initiatives to innovate themselves in ways fitting their

circumstances and to continue efforts to refine business models and risk management practices. The FSA will try to deepen its understanding of those banks' business conditions and challenges and their policies and strategies through day-to-day monitoring and profiling activities. Then, the FSA will conduct in-depth dialog with the banks to discuss their business models, risk management practices, human resources development, and other issues, without a presumption on the right answers, for the purpose of promoting their improved awareness and understanding (and share other banks' model cases for best practices where appropriate).

(iv) Flexible and appropriate use of various methods in combination

As explained before, the FSA may use various methods to make administrative responses to banks. However, each method has some advantages and disadvantages in terms of effectiveness, workload burdens of the regulator and banks, and expenses. The FSA will therefore flexibly choose among such methods, maximize their advantages, and seek their optimized combinations, aiming at even more effective and efficient supervisory activities. Which to choose and combine will depend on individual banks' challenges, the existence of serious problems affecting their financial soundness or compliance, the likelihood of occurrence of serious problems, or other firm-specific ongoing circumstances. For example, the following methods may be available, in addition to the methods already explained.

- Feedback about industry-wide situations and challenges or theme-specific case examples will help encourage the banks' initiatives for innovation. In particular, feedback pertinent to a bank's issues will help the regulator and the bank build a shared value and facilitate their in-depth dialog. Even when giving such feedback, the FSA should respect individual banks' business decisions and avoid unduly interfering with their judgments concerning specific transactions.
- The information voluntarily disclosed by banks may cover their management policies, management reforms, and efforts for better financial intermediation. Such information may not only facilitate dialog between the bank and the regulator, but also promote communication between the bank and its customers or other stakeholders, which will back up the bank's efforts for management reforms.
- If a bank's problems pertain to financial intermediation or convenience for customers, the FSA will contact the bank's business partners, users, or other third parties for questionnaire surveys or interviews, rather than focusing on communication with the bank only. Feedback from communication with such third parties will surely contribute to more effective dialog between the regulator and the bank.
- If the FSA can build a shared value or goal with the stakeholders other than the bank, as necessary, or if the FSA publicly discloses the findings from its analyses or the FSA's philosophy in financial policy, such activities may be helpful for convincing or appealing to stakeholders who are associated with banks' business environments.

(v) Responses based on monitoring findings

The findings from the financial monitoring activities described above may be made known to the

inspected bank in the form of a notice of inspection results, as is conventionally done, or in any other appropriate way. Examiners may choose to confirm where the two sides disagreed and continue discussions. The FSA will explore the best ways suitable for productive discussions focused on priority issues.

Feedback may be given to a bank, for example, in any of the following ways when the FSA intends to continue dialog with the bank, to ask for remedial necessary measures, or to carry out other adequate follow-up activities.

- (A) If the FSA conducts on-site inspection and off-site monitoring for a bank over a full business year, the FSA may compile the monitoring findings, as necessary, in the form of an annual monitoring report called a “Feedback Letter” and issue it to the bank.
- (B) Findings from on-site inspection will be made known to the bank, in principle, in each instance. Forms of providing feedback may vary depending on the types or severity of problems detected or the content of the on-site inspection. For example, when pointing out inconsequential problems or communicating with a bank with low likelihood of causing serious problems as described in II-1-2(2)-(iii)(B), the form of “Feedback,” “FSA Comments” or the like may be used. Meanwhile, the form of “Notice of Inspection Results” or the like will be used when warning about serious issues.
- (C) In addition to the forms of communication described in (A) and (B) above, the FSA will distribute information about industry-wide challenges to banks from time to time.

Issues recognized and information gathered through monitoring activities will be classified into the four categories as follows: firm-specific issues, industry-wide issues, cross-industry issues, and issues affecting administrative activities of FSA’s other bureaus or divisions or other ministries’ or governmental agencies or activities of industry associations or other organizations. After the process of information gathering and profiling in II-1-2(2)-(i)(A), the issues classified above will be incorporated in FSA’s annual policies and monitoring plans for the subsequent program year. When some issues need to be addressed as an industry-wide challenge, when horizontal monitoring may need to be conducted, or when a certain issue is likely to spill over into areas beyond the scope of the FSA’s monitoring activities, the FSA’s monitoring team will seek cooperation from other divisions or from other competent authorities or relevant external organizations.

### II-1-3 Quality Control

In order to ensure that monitoring activities conducted through profiling and dialog are carried out with constant quality and in appropriate depth and that proper judgments are made throughout all supervisory processes, the FSA performs organization-wide quality control. The FSA’s efforts to ensure the quality of its supervisory activities should be promoted from broad perspectives based on the overall national welfare, and such efforts should be intended to assist in making financial functions work most effectively. To be

more specific, the quality of the FSA's supervisory activities will be checked in the following respects: for example, whether FSA staff understand individual bank's business conditions, management philosophy, and other particular features; whether banks' initiatives for innovation are respected; and whether banks are not forced to bear undue burdens.

For this quality check, senior officials of both the Strategy Development and Management Bureau and the Supervision Bureau will verify the FSA's supervisory activities from multi-directional perspectives at multiple levels and try to improve supervisory activities on an ongoing basis. The points described below may be checked based on voices from banks.

- When gathering information from banks or having dialog with banks, effective coordination and information sharing among sector- or area-wise monitoring teams is indispensable in order to eliminate duplication of requests to the banks and to avoid imposing undue burdens on the banks. Is such internal communication and coordination conducted sufficiently? When requesting banks to submit reports or documents, is the purpose of the request clear and is the content of such documents clearly specified? And is due consideration paid to different characteristics of different banks? Is the submission deadline appropriate to secure sufficient time?
- For accurate profiling, are respective banks' business conditions, management philosophy, and other firm-wise features understood well? Are facts and objective evidential documents used to eliminate individual staff's preoccupations?
- When identifying priority issues, are individual banks' circumstances fully considered and are substantive issues critical to their business management selected? If there are issues common to multiple banks or industry-wide issues, are those issues detected unflinchingly?
- When drawing up a monitoring policy or plan, are appropriate monitoring subjects and methods chosen? Is a system for monitoring established?
- When requesting a bank to submit reports, is the bank fully informed and convinced as to how the regulator recognizes the bank's problems?
- Is dialog with each bank appropriate in terms of the points mentioned in II-1-2(2)(iii)? In view that it is called dialog, did the FSA avoid having it end up with unilateral administrative guidance?
- Regarding the issues or problems identified through monitoring, are their root causes analyzed?
- When informing a bank of the findings from monitoring, is the best method chosen? This will affect whether the two sides can have effective discussions focused on the bank's priority issues. Does the feedback letter clearly state the points to be discussed or the matters to be improved? Are they truly critical issues or matters? Is the feedback free of trivial issues? Is there any content that might unduly interfere with the bank's management?

For effective verification of supervisory activities, the FSA will endeavor to expand opportunities to receive candid comments and criticisms from banks. For one thing, the FSA already has a process for inspected firms to file comments on monitoring activities, called the "Inspection Challenge Process." For another thing, FSA's senior officials may visit an inspected bank and conduct interviews to seek comments



on the FSA's monitoring activities directly from the bank's executives and managers.

In addition to the foregoing, the FSA will commission consultants to have them interview banks and FSA staff to seek third-party evaluation of financial policy, and the FSA will also invite insights from external experts by such means as holding a panel of experts.

#### II-1-4 Cooperation with Local Financial Bureaus

- (1) The FSA will try to closely cooperate with the Local Financial Bureaus having jurisdiction over the business territories of Major Banks. In particular, when a Major Bank intends to choose a management strategy likely to significantly affect the regional economy or community, the FSA will offer relevant information to the Local Financial Bureau concerned. Conversely, the FSA will actively gather information from the Local Financial Bureaus, which may include information about Major Banks and the Local Financial Bureaus' views on the FSA's processes of supervising Major Banks.
- (2) If the authority to supervise a subsidiary bank of a bank holding company is delegated to the Director-General of a Local Finance Bureau, the FSA will closely cooperate with the Local Financial Bureau to help ensure the subsidiary bank's proper business operations.
- (3) In addition to the above, when there is know-how or other relevant information obtained from the accumulated cases, the FSA and Local Finance Bureaus will strive to closely cooperate, such as by properly sharing such information with each other, from the viewpoint of strengthening the effectiveness of monitoring.

#### II-1-5 Coordination with Inspection by the Deposit Insurance Corporation of Japan

- (1) If a bank has undergone inspection conducted by the Deposit Insurance Corporation of Japan (the "DICJ") pursuant to the Deposit Insurance Act, the FSA will follow up on the progress of the bank's measures to address the problems pointed out in the DICJ's notice of inspection results in accordance with the following procedures.
  - (i) If the DICJ informs the FSA that the DICJ has issued a notice of inspection results to a bank after inspecting the bank's scheme for ensuring smooth refund of insured deposits or after conducting insurance premiums inspection, the FSA will promptly ask the inspected bank, as necessary, to submit a report within one month (or within two weeks, in the event that the DICJ has determined that the state of noncompliance remains unrectified) pursuant to Article 24 of the Banking Act or Article 136 of the Deposit Insurance Act. Since the DICJ's notice describes the problems identified by the DICJ, a report requested by the FSA needs to cover the bank's explanations about the facts concerning those problems (excluding simple calculation mistakes identified through insurance

premiums inspection), analyses of the causes of those problems, planned measures for improvement or remediation, and other important details (cf. Form II-1-3-4(1) in the Forms and Reference Information).

- (ii) After receiving a report from the bank, the FSA will conduct meticulous interviews with the bank's personnel. On the occasion of such interviews, the FSA will closely cooperate with the DICJ and take into consideration the items on the checklist used in the on-site inspection conducted under Article 137 of the Deposit Insurance Act (i.e., the items related to Article 50(1) of the same Act and those related to Article 55-2(5) and Article 58-3(1) of the same Act). In principle, the FSA will cause DICJ staff to attend the interviews with the bank arranged by the FSA (cf. Reference Document 1 in the Forms and Reference Information).

Note: The FSA must obtain the bank's prior consent to the DICJ's attendance at interview sessions and to information sharing between the FSA and the DICJ.

- (iii) In the case where the DICJ's insurance premiums inspection has ascertained that the bank's noncompliance remains unrectified, if the FSA determines that such situation constitutes a problem that the bank needs to address, as a result of reviewing the DICJ's inspection findings and a subsequent report submitted by the bank under Article 24 of the Banking Act or Article 136 of the Deposit Insurance Act, the FSA will issue a business improvement order to the bank pursuant to Article 26 of the Banking Act.

- (iv) In the case where the DICJ's insurance premiums inspection has ascertained that the bank's compliance management scheme needs to be improved or where the DICJ's inspection of the scheme for ensuring smooth refund of insured deposits has detected some problems in the progress of information systems development, data management and database maintenance, and development of internal manuals and procedures (collectively, the "Progress of Development" ), if the FSA determines that it will take a certain period of time for the bank to resolve the noncompliance in question or overcome problems in the Progress of Development, as a result of reviewing the DICJ's inspection findings and a subsequent report submitted by the bank under Article 24 of the Banking Act or Article 136 of the Deposit Insurance Act, the FSA will ask the bank to submit a follow-on report by a specified deadline pursuant to Article 24 of the Banking Act or Article 136 of the Deposit Insurance Act. If the FSA determines, as a result of reviewing such follow-on report, that the bank is unable to overcome problems in the Progress of Development solely by its self-initiated efforts, the FSA will issue to the bank a business improvement order pursuant to Article 26 of the Banking Act (or a business improvement order pursuant to Article 26 of the Banking Act or a rectification order pursuant to Article 58-3(3) of the Deposit Insurance Act to urge the bank to develop a scheme for ensuring smooth refund of insured deposits).

Note: In addition to the implementation of various measures described above, the FSA's supervisory divisions will seek appropriate cooperation with the DICJ in any other situation. As and when necessary, for example, some information about financial institutions' development of a scheme

for ensuring smooth refund of insured deposits may be provided by the FSA to the DICJ.

- (2) If a bank has undergone inspection conducted by the DICJ pursuant to the Banking Act on Payment of Damage Recovery Benefits from Funds in Deposit Accounts Used for Crimes, the FSA will follow up on the progress of the bank's measures to address the problems pointed out in the DICJ's notice of inspection results in accordance with the following procedures.
  - (i) If the DICJ informs the FSA that the DICJ has issued a notice of inspection results to a bank after inspecting the bank's procedures for processing cancellation of claims on deposits used for crimes or for paying damage recovery benefits to victims of such crimes, the FSA will promptly ask the inspected bank, as necessary, to submit a report within one month (or within two weeks, in the event that the DICJ has determined that the state of noncompliance remains unrectified) pursuant to Article 24 of the Banking Act or Article 35 of the Banking Act on Payment of Damage Recovery Benefits from Funds in Deposit Accounts Used for Crimes. Since the DICJ's notice describes the problems identified by the DICJ, a report requested by the FSA needs to cover the bank's explanations about the facts concerning those problems, analyses of the causes of those problems, planned measures for improvement or remediation, and other important details (cf. Form II-1-3-4(1) in the Forms and Reference Information).
  - (ii) After receiving a report from the bank, the FSA will conduct meticulous interviews with the bank's personnel. In principle, the FSA as well as DICJ staff will attend the interviews with the bank arranged by the FSA.

Note: The FSA must obtain the bank's prior consent to the DICJ's attendance at interview sessions and to information sharing between the FSA and the DICJ. In addition to the implementation of various measures described above, the FSA's supervisory divisions will seek appropriate cooperation with the DICJ in any other situation. As and when necessary, for example, some information about banks' development of a scheme for paying damage recovery benefits may be provided by the FSA to the DICJ.

- (3) If a bank has undergone inspection conducted by the DICJ pursuant to the Banking Act on the Utilization of Funds Related to Dormant Deposits, etc., the FSA will follow up on the progress of the bank's measures to address the problems pointed out in the DICJ's notice of inspection results in accordance with the following procedures.
  - (i) If the DICJ informs the FSA that the DICJ has issued a notice of inspection results to a bank after inspecting the bank's procedures for the transfer and management of funds related to dormant deposits, etc. and the results of the inspection on the entrustment or re-entrustment of payment services, the FSA will promptly ask the inspected bank, as necessary, to submit a report within one month (or within two weeks, in the event that the DICJ has determined that the state of noncompliance remains unrectified) pursuant to Article 24 of the Banking Act and Article 43 of the Banking Act on the Utilization of Dormant Deposits, etc. Since the DICJ's notice describes the

problems identified by the DICJ, a report requested by the FSA needs to cover the bank's explanations about the facts concerning those problems, analyses of the causes of those problems, planned measures for improvement or remediation, and other important details (cf. Form II-1-3-4(1) in the Forms and Reference Information).

- (ii) After receiving a report from the bank, the FSA will conduct meticulous interviews with the bank's personnel. In principle, the FSA as well as DICJ staff will attend the interviews with the bank arranged by the FSA.

Note: The FSA must obtain the bank's prior consent for the DICJ's attendance at interview sessions and for information sharing between the FSA and the DICJ. In addition to the implementation of various measures described above, the FSA's supervisory divisions will seek appropriate cooperation with the DICJ in any other situation. As and when necessary, for example, some information about banks' development of a scheme for the transfer and management of funds related to dormant deposits, etc. and the entrustment or re-entrustment of payment services may be provided by the FSA to the DICJ.

## II-1-6 Administrative Reports on Individual Banks

- (1) Documents concerning period-end settlement, etc.

Since the FSA asks each bank to submit an annual closing report, a daily accounts sheet and other documents, the deadline and other instructions for submission must conform to the rules specified in Exhibit 3.

- (2) Administrative report

If the Director-General of a Local Financial Bureau has implemented any of the administrative measures listed below, its consequences must be reported to the Director-General of the FSA's Supervision Bureau without delay.

If a bank, a bank controlled by its major shareholder(s), or a subsidiary bank of a bank holding company is subject to any administrative measure implemented by a Local Financial Bureau other than the Local Financial Bureau having jurisdiction over the district where such bank's head office is located, the report on the administrative measure prepared by the first-mentioned Local Financial Bureau must be given to the latter-mentioned Local Financial Bureau.

- (i) Ask for submission of reports or materials pursuant to paragraph (1) or (2) of Article 24 or Article 48 of the Banking Act
- (ii) Ask for actions pursuant to Article 26(1), Article 52-14(2), or Article 52-33(3) of the Banking Act (excluding the case of issuing an order for suspension of the whole or part of business, and including the case of asking for submission of an improvement plan)
- (iii) Ask for submission of reports or materials pursuant to Article 52-7 of the Banking Act
- (iv) Ask for submission of reports or materials pursuant to Article 52-11 of the Banking Act

- (v) Ask for submission of reports or materials pursuant to Article 52-31 of the Banking Act

#### II-1-7 Points to Note in Preparation of Application Documents

When entering the names of directors or officers in an application form or any other document to be submitted to the FSA, the current name of a person who has changed his/her surname by marriage may be accompanied by his/her name before marriage in parentheses.

If a bank has already submitted a document using any form in the Forms and Reference Information which contains the current name of a director or officer together with his/her name before marriage in the specified entry column, the bank is allowed to use his/her name before marriage without the current name in all subsequent documents to be submitted to the FSA.

#### II-1-8 Points to note regarding written and face-to-face procedures

According to the provisions of Article 6, Paragraph 1 and Article 7, Paragraph 1 of the Banking Act on the Promotion of Public Administration Utilizing Information and Communications Technology (hereinafter referred to as the "Digital Procedure Act"), applications, notifications, etc. by banks, etc. to the authorities and notices of dispositions, etc. issued by the authorities to banks, etc. may be made by means of an electronic data processing system, notwithstanding the provisions of the relevant laws and regulations, even if such methods are stipulated in such laws and regulations, such as in writing.

In light of the purpose of the Digital Procedure Act, the provisions of these Supervisory Guidelines relating to procedures covered by the Banking Act may be implemented by means of an electronic data processing system, regardless of the written or face-to-face descriptions in the provisions.

In addition, in the midst of dramatic progress in digitalization in all economic and social activities, the government as a whole is reviewing Japan's systems and practices based on documents, seals, and face-to-face procedures, and is making efforts to realize a remote society in which procedures can be carried out without actually visiting.

In order to steadily advance these efforts, the FSA has been promoting the computerization of administrative procedures by renewing the FSA Electronic Application and Notification System, which enables all applications and notifications received from banks to be submitted online, and by revising Cabinet Office Ordinances and Supervisory Guidelines, etc., which abolish the use of seals.

Furthermore, with regard to procedures among private business operators, the FSA has held a "Study Group for the Review of Documents, Seals, and Face-to-Face Procedures in the Financial Industry," and has been working to eliminate the need for electronic documents and seals and review face-to-face regulations by encouraging the industry as a whole to review its practices.

In light of such efforts by the public and private sectors, among the statements concerning documents and face-to-face meetings in these Supervisory Guidelines, matters other than those concerning procedures subject to the Digital Procedure Act may be conducted by means of an electronic data processing system

or by means of other information and communications technology, except for the cases listed in (Note) below where documents and face-to-face meetings are desirable from the viewpoint of customer protection.

In light of the above, supervisors shall be encouraged to take procedures pursuant to the provisions of these Supervisory Guidelines in a manner that does not require written or face-to-face consultation as much as possible, taking into consideration the intention of the other party to the procedures.

Note: It should be noted that the response to people with writing difficulties as described in III-6-4 is not subject to the above treatment.

## II-1-9 Points to note when submitting application forms

Based on II-1-8, applications and notifications by banks, etc. (including attached documents issued by public institutions (such as a copy of the residence certificate, an identification card, and a certified copy of the family register)) to the authorities shall be required to be submitted by the methods listed in (1) and (2) below in principle.

With regard to attached documents issued by public institutions, original copies shall be requested when there is any problem in the course of confirmation due to the blurredness of entries recorded by means of a digital camera or an image scanner or any other reason. As for procedures that require the payment of tax or a fee, original copies shall be separately requested as evidence of the payment of tax or a fee when such payment is received in forms other than electronic payment.

### (1) FSA Electronic Application and Notification System

In principle, banks are required to submit applications and notifications to the authorities by the deadline specified by laws and regulations using the FSA Electronic Application and Notification System, except for procedures requiring submission using the FSA Business Support Integration System (hereinafter referred to as the "Integration System") set forth in (2).

### (2) FSA Business Support Integration System

In principle, business reports (interim business reports in the interim period) shall be required to be submitted using the Integration System.

Exhibit 2: Basic Procedures for On-Site Inspection

Exhibit 2-2: List of Important Matters Explained to Inspected Banks

## II-2 Grievance against Banks and Provision of Information about Banks

### II-2-1 Responding to Inquiries or Complaints

If the FSA receives an inquiry or complaint relating to a bank, the FSA will explain to the consulter that the regulator is in no position to mediate or otherwise become involved in any specific transaction.

Where appropriate, the FSA may introduce a contact desk of the relevant bank, consultation desks of industry associations or other related organizations, or a designated ADR body (meaning a designated dispute resolution organization defined in Article 2(24) of the Banking Act; the same applies hereinafter). If the consuler has given consent to disclosure of the information about the inquiry or complaint to the bank, the FSA will, in principle, provide relevant information to the bank.

#### II-2-2 Cooperation with the Counseling Office for Financial Services Users

- (1) To properly incorporate feedback from inquiries or complaints received at the Counseling Office for Financial Services Users in the FSA's supervisory activities, the FSA's supervisory divisions will carry out the following steps.
  - (i) Analyze details of the inquires and complaints circulated from the Counseling Office
  - (ii) Share information with the Counseling Office
- (2) If the consuler has given consent to disclosure of the information about the inquiry or complaint to the bank, the FSA will, in principle, provide relevant information to the bank.

#### II-2-3 Responding to Curbs on New Loans or Forcible Collection of Outstanding Loans Recognized Based on Information from the Counseling Office for Financial Services Users

##### (1) Interview

If the information received by the FSA from the Counseling Office for Financial Services Users pertains to curbs on new loans or forcible collection of outstanding loans, the FSA will summarize all such information on a quarterly basis and conduct interviews with banks to check their lending policies, systems, and operations. If the informant has given consent to disclosure of the information about the borrower's name and other details to the bank concerned, the FSA will flexibly act according to circumstances, including an attempt to ascertain facts through interviews.

##### (2) Request for reporting

- (i) If the FSA determines, as a result of conducting interviews described in (1), that the bank's internal control systems and their effectiveness need to be checked in greater detail, the FSA will ask the bank to submit a report summarizing current situations and planned measures to improve internal control systems pursuant to Article 24 of the Banking Act.
- (ii) If the FSA determines, as a result of its examination based on the information from the Counseling Office for Financial Services Users, that the bank has problems in connection with curbs on new loans or forcible collection of outstanding loans as alleged by the informant, the FSA will ask the bank to submit a report on improvement measures pursuant to Article 24 of the Banking Act.

(3) Business improvement order

- (i) If the FSA determines, as a result of reviewing a report received from the bank under Article 24 of the Banking Act or on any other grounds, that the bank's situations need to be checked in greater detail, the FSA may conduct on-site inspection of the bank. If such inspection finds out any serious problem, the FSA will issue a business improvement order pursuant to Article 26 of the Banking Act where appropriate.
- (ii) If the FSA determines, as a result of reviewing a report received from the bank under Article 24 of the Banking Act or on any other grounds, that the bank is unable to properly develop compliance management systems solely by its self-initiated efforts, the FSA will issue a business improvement order pursuant to Article 26 of the Banking Act.

II-2-4 Responding to Fictitious Billing with Use of Deposit Accounts or Other Fraudulent Use of Deposit Accounts

If the FSA receives information about suspected fraudulent use of a deposit account (e.g., the case of fictitious billing accompanied by a request for money transfer to a designated bank account), the FSA will promptly provide relevant information to the bank concerned and the police authority, subject to the informant's consent, except where the information is found to be obviously doubtful or unfounded.

Those who intend to report such information to the FSA need to identify themselves, in principle, and are requested to submit the billing statement in question or other supporting documents by personal delivery, facsimile, or e-mail.

II-3 Responding to Inquiries about Interpretation and Application of Laws and Regulations

II-3-1 Scope of the FSA's Inquiry Services

The FSA responds to inquiries about interpretation and application of the laws and regulations falling within the jurisdiction of the FSA, including the Banking Act. If receiving an inquiry about any law outside its jurisdiction, the FSA will strictly refrain from making any comments on the inquiry.

II-3-2 Methods for Responding to Inquiries

- (1) When it is possible to answer to an inquiry based on these Supervisory Guidelines, opinions or reports issued by the FSA's relevant councils or panels, or any other existing documents, the FSA will give an answer appropriately.
- (2) If a business operator directly governed by any law falling within the jurisdiction of the FSA or an



industry association consisting of such business operators (\*) makes an inquiry in connection with the laws and regulations falling within the jurisdiction of the FSA, the director of the FSA's relevant division will provide a written answer to the inquiry and publicly disclose its content, insofar as such inquiry is a common question satisfying all of the criteria listed below and it is determined appropriate to give an answer in writing and publicly disclose it with a view to enhancing predictability in application of the law.

Note: An industry association in this context means an organization formed by a substantial number of business operators of the same type of business directly governed by a certain law falling within the FSA's jurisdiction with the intention of promoting their common interests, or a group of such organizations (limited to the highest-tier organization if the industry has multi-tier associations or federations).

(i) Scope of inquiries covered by the FSA's inquiry services

The FSA's services to respond to inquiries under the procedures explained here are provided when the inquiry satisfies all of the following criteria.

- (A) The inquirer does not ask about a specific business operator's specific transaction and the applicability of any law to such transaction, but wants to know the interpretation of any laws or regulations generally applicable to common cases. (In other words, the inquiry is not a case that can be processed under the so-called no-action letter system).
- (B) The inquirer does not ask the FSA to ascertain or check facts.
- (C) The inquiry pertains to transactions commonly conducted by many business operators directly governed by the law falling within the FSA's jurisdiction (or commonly conducted by the business operators belonging to an industry association, if the inquirer is such industry association), and similar inquiries are expected to be made by many other business operators.
- (D) A clear answer to the inquiry cannot be found in relevant administrative guidelines released in the past.

(ii) Inquiry forms (including electronic forms)

If an inquirer desires to make an inquiry under the procedures explained here, an inquiry must be submitted to the FSA in a prescribed form stating the following matters. After submitting an inquiry in a prescribed form, the inquirer may be asked to rewrite descriptions in the inquiry form or to provide additional information if the FSA finds it necessary to confirm the content of the inquiry or to judge whether or not the inquiry meets the criteria described above.

- (A) The clauses of the laws and regulations relevant to the inquiry, and the points at issue explained in concrete terms
- (B) The inquirer's opinions and their reasoning
- (C) The inquirer's consent to disclosure of the inquiry and the corresponding answer to the public

(iii) Point of contact

Inquiries in a prescribed form will be received by respective divisions of the FSA having the

authority and responsibility for affairs concerning the laws and regulations pertaining to each inquiry.

(iv) Answer

(A) The director of the FSA's relevant division will endeavor to give an answer to the inquirer, in principle, within two months after the arrival of the inquiry at the specified point of contact. If it is difficult to answer within two months, the inquirer will be informed of the reason for such delay and an estimated answer date.

(B) Each answer to any inquiry must contain a disclaimer of the following substance:

“This document offers a general view of the Financial Services Agency, as the competent administrative agency having jurisdiction over the laws and regulations related to the referenced inquiry, as of the date hereof. The views expressed in this document are premised exclusively on the information contained in the inquiry. This document is not intended to make any judgment regarding the application of said laws and regulations to any specific case and is not binding on any judgment of competent investigative or judicial authorities. ”

(C) If the FSA's relevant division decides not to answer the inquiry in accordance with the foregoing procedures, the division director will inform the inquirer and explain the reason for such decision.

(v) Public disclosure

After giving an answer to an inquirer in accordance with the procedures described above, the FSA will promptly disclose the inquiry and the answer on the FSA website to make them available for public access.

(3) Inquiries which are frequently received but deviate from the criteria described in (2) may, where appropriate, be shared among all relevant divisions in the FSA by means of circulation in a prescribed form (Form II-3-2(3) in the Forms and Reference Information). Then, the legal manager of the division primarily responsible will archive such circulated information.

(4) If an inquirer desires to obtain a written answer from the FSA in a situation where the no-action letter system can be used under the rules specified in II-3-3(2), the inquirer will be asked to use the no-action letter system.

### II-3-3 Prior Confirmation Procedures on the Application of Laws and Regulations by Administrative Agencies (No-Action Letter System)

Under the Prior Confirmation Procedures on the Application of Laws and Regulations by Administrative Agencies (the “No-Action Letter System”), private companies can contact the competent administrative agency and seek its confirmation in advance as to whether specific provisions of certain laws and regulations are applicable to a particular action for planned business activities. Administrative agencies

will give answers to the inquiries made under this system and publicly disclose those answers. The FSA has established detailed rules concerning its No-Action Letter System. Below are the administrative procedures to operate the FSA's No-Action Letter System. In this regard, FSA staff are required to read the Details of the Prior Confirmation Procedures on the Application of Laws and Regulations by the Financial Services Agency (Reference Document 2 in the Forms and Reference Information) before using the No-Action Letter System.

(1) Point of contact

Inquiries made through use of the No-Action Letter System are received by the Planning Management Division, the Supervisory Bureau of the FSA.

If the Planning Management Division receives an inquiry in a prescribed form conforming to all of the requirements specified in (2)-(iii) below, the inquiry will be promptly acknowledged and passed on to the division having the authority and responsibility for affairs concerning the laws and regulations pertaining to the inquiry.

(2) Steps following the receipt of an inquiry

The division receiving the inquiry passed on as above will determine whether or not it should be processed under the No-Action Letter System, by checking the points listed in (i) through (iii) below, among others. If the inquiry is not eligible for the No-Action Letter System, the inquirer will be informed to that effect. If it is found necessary to correct any description in the inquiry or to obtain additional information, the division will ask the inquirer for necessary arrangement. However, the scope of documents to be additionally submitted should be minimized, in order to avoid imposing excessive burdens on the part of the inquirer.

(i) Points for which confirmation can be sought

Whether the inquiry is made by a private enterprise having a concrete plan of a new business or transaction in the context of any laws and regulations and related government orders listed on the FSA website as those covered by the FSA's inquiry services (collectively, "Laws and Regulations"), as to the adequacy of such business or transaction from the perspectives listed below.

- (A) Whether or not the business or transaction would constitute unlicensed or unauthorized operation if it were commenced without corresponding formalities
- (B) Whether or not the business or transaction would constitute operation lacking required notification if it were commenced without corresponding formalities
- (C) Whether or not the business or transaction will constitute grounds for imposing suspension of business, revocation of license, or any other adverse disposition
- (D) Whether or not the business or transaction could directly lead to a situation where the firm will face some obligations or restrictions on rights in the context of financial policy

(ii) Eligibility for inquirers

Those who are allowed to make an inquiry under the No-Action Letter System are limited

to persons who intend to perform a particular action referred to in the inquiry in the context of their own business activities and desire to know about the applicability of the Laws and Regulations for such action, or attorneys at law or other agents acting for and on behalf of those persons. To make an inquiry, it must be submitted in a prescribed form conforming to the requirements specified in the next paragraph, and the inquirer is requested to give consent to public disclosure of the inquiry and the corresponding answer.

(iii) Requirements for filling out an inquiry form

Inquiries either in writing or in electronic form must conform to the following requirements.

- (A) The facts specific to the action to be performed by the inquirer must be concretely described.
- (B) The provisions in the Laws and Regulations for which the regulator's confirmation is sought must be identified.
- (C) The inquirer's consent to public disclosure of the content of the inquiry and the corresponding answer must be clearly stated.
- (D) The inquirer's opinions as to the application of the provisions in the Laws and Regulations identified in (B) and their reasoning must be clearly described.

(iv) Answer

The director of the FSA's division receiving an inquiry passed on will give an answer to the inquirer, in principle, within 30 days after the arrival of the inquiry at the specified point of contact. In any of the cases listed below, however, the deadline respectively specified will apply. In all such cases, relevant directors should endeavor to answer within the shortest possible time, including periods for the inquirer's correction or additional documentation, if applicable.

- (A) If the inquiry pertains to any advanced financial technique or technology and requires careful judgment: within 60 days, in principle
- (B) When an effort to answer to a specific inquiry within the standard period is likely to be significantly detrimental to the division's overall operations because of a large number of inquiries exceeding the division's workload capacity: within a reasonable period exceeding 30 days
- (C) If the inquiry pertains to the Laws and Regulations concurrently subject to the FSA and another ministry or agency: within 60 days, in principle

If the inquirer is asked to correct any description in the inquiry, the number of days taken for such correction will not be included for the purpose of recognizing the answer deadline. If an answer is not given within 30 days, the inquirer will be informed of the reason for such delay and an estimated answer date.

(v) Public disclosure of inquiries and answers

The content of an inquiry and its corresponding answer will be disclosed on the FSA website for public access, in principle, within 30 days after the answer date.

However, such public disclosure may be postponed for a reasonable period if the inquiry states why the inquirer requests for public disclosure after a certain period of time following

the answer date and when the inquiry can be disclosed, on condition that such reason is determined justifiable. In this event, the actual postponement period will not necessarily be the same as the period desired by the inquirer. When the reason for the postponement ceases to exist, the FSA may start public disclosure upon notice to the inquirer. If an inquiry or its corresponding answer contains any portion constituting or likely to constitute non-disclosure information defined in the Banking Act on Access to Information Held by Administrative Organs, the FSA may publicly disclose the content of the inquiry and answer after eliminating such portions, where appropriate.

#### II-3-4 System to Remove Gray Zone Areas

Under Article 7(1) of the Industrial Competitiveness Enhancement Act, a person intending to start new business activities may seek confirmation regarding the interpretation of provisions of relevant acts and subordinate orders (including public notices) which may regulate such new business activities and other related business activities (collectively, “Laws” in II-3-4) and the applicability of such provisions to those business activities. This system for requesting confirmation is called the “Gray Zone Elimination System.” Below are the administrative procedures for operating the Gray Zone Elimination System at the FSA. Before applying the Gray Zone Elimination System, FSA staff members are required to read the “Guide to the Use of the ‘Gray Zone Elimination System,’ ‘Regulatory Sandbox,’ and ‘Special Measures on Regulations for New Businesses’” (Ministry of Economy, Trade and Industry (METI), July 15, 2022) (hereinafter referred to as the “Usage Guide,” including those after revisions by the METI in this paragraph).

##### (1) Point of contact

Inquiries made under the Gray Zone Elimination System are received by the Strategy Development Division, the Strategy Development and Management Bureau of the FSA.

When the Strategy Development Division receives an inquiry in a prescribed form conforming to all of the requirements specified in (2)(iii) below, the inquiry will be promptly acknowledged. If the inquiry is to be submitted to two or more ministers, the Strategy Development Division will seek confirmation from the other minister(s).

Inquiries from banks regulated under the jurisdiction of Local Finance Bureaus are received by respective Local Finance Bureaus. When a Local Finance Bureau receives an inquiry, it must be promptly sent to the FSA’s Strategy Development Division.

Note: When a Local Finance Bureau dispatches the original of an inquiry to the Strategy Development Division, a document showing the Local Finance Bureau’s review comments must be attached, in principle. Such comments are required solely for the issues involving the Laws falling within the jurisdiction of the FSA for which confirmation is sought.

(2) Steps following the receipt of an inquiry

After receiving and acknowledging an inquiry, the Strategy Development Division will promptly pass it on to the division having the authority and responsibility for affairs concerning the Laws for which confirmation is sought. Then, both divisions will discuss and determine whether or not it should be processed under the Gray Zone Elimination System, by checking the points listed below, among others. If the inquiry is not eligible for the Gray Zone Elimination System, the person who has submitted the inquiry (a “submitter” in II-3-4) will be informed to that effect. If it is necessary to correct the inquiry or obtain additional information in order to apply the Gray Zone Elimination System to the inquiry, the Strategy Development Division will ask the submitter for necessary arrangement. In this event, the scope of documents to be additionally submitted should be minimized, in order to avoid imposing excessive burdens on the part of the submitter.

(i) Eligibility for requesting confirmation

Those who submit a request for confirmation under the Gray Zone Elimination System must meet both of the following criteria.

(A) The submitter is a person intending to start new business activities.

Note: “New business activities” means the development or production of new products, the development or provision of new services, the introduction of new approaches for producing or selling products, the introduction of new approaches for providing services, or other new business activities which are expected to enhance productivity (as detailed below) or to create new demand and which are unlikely to disrupt public order or morality. The term “productivity” encompasses resource productivity, meaning the degree of contribution to economic activities of a person intending to launch new business activities which is expected to be achieved through use of energy or mineral resources (excluding the case of using mineral resources as energy sources). (Article 2(4) of the Industrial Competitiveness Enhancement Act; as well as Article 2 of the Order Concerning the Development of Special Treatments for Regulations Regarding New Technology Verification and New Business Activities and the Promotion of Regulatory Reforms under the Industrial Competitiveness Enhancement Act (hereinafter referred to as the “Order under the Enhancement Act”).

(B) The new business activities that the submitter intends to start must fall within the scope of businesses subject to the FSA’s jurisdiction. Or the submitter intends to seek confirmation with the FSA regarding the interpretation of provisions of relevant Laws falling within the jurisdiction of the FSA which may regulate the submitter’s new business activities and other related business activities and the applicability of such provisions to those business activities.

(ii) Points for which confirmation can be sought

A submitter intending to start new business activities may seek confirmation regarding the interpretation of provisions of relevant Laws which may regulate the new business activities and other related business activities and the applicability of such provisions to those business activities. Such confirmation may be requested from the perspectives listed below.

- (A) Whether or not the business or transaction would constitute unlicensed or unauthorized operation if it were commenced without corresponding formalities
- (B) Whether or not the business or transaction would constitute operation lacking required notification if it were commenced without corresponding formalities
- (C) Whether or not the business or transaction will constitute grounds for imposing suspension of business, revocation of license, or any other adverse disposition
- (D) Whether or not the business or transaction could directly lead to a situation where the firm will face some obligations or restrictions on rights in the context of financial policy

(iii) Requirements for filling out an inquiry form

Inquiries must be submitted in Form 9 attached to the Order under the Enhancement Act in accordance with the METI Guide. Each inquiry must state the following matters.

- (A) Goals of the new business activities and related business activities
- (B) Descriptions of the new business activities and related business activities
- (C) Time schedule for the new business activities and related business activities
- (D) Clauses of the Laws for which interpretation and applicability need to be confirmed
- (E) Particular issues that need to be confirmed

(3) Answer

- (i) If the Strategy Development Division judges that an inquiry should be answered, the FSA's division receiving the inquiry from the Strategy Development Division will, in principle, issue an answer within one month after the arrival of the original of the submitter's inquiry at the specified point of contact. This answer will be issued in Form 11 attached to the Order under the Enhancement Act.

However, it may be difficult to issue an answer within such time frame, depending on the progress of examinations for the interpretation and applicability of the provisions in the Laws mentioned in the inquiry for which confirmation is sought. If the division receiving the inquiry determines that such situation is unavoidable on reasonable grounds, the submitter will be informed of the situation and its reason and kept updated at intervals of not more than one month until the answer is issued.

II-3-5 Responding to Inquiries about Deposits and Savings

(1) Handling of Deposits and Savings

If the FSA receives an inquiry about the definition of any of the deposits or installment savings listed below, other than specified deposits, etc. defined in Article 13-4 of the Banking Act (collectively, “Deposits and Savings” in II-3-5) or any feature of such Deposits and Savings, the FSA will respond, taking into account general laws or the laws prescribing the handling of other financial products, and keeping in mind the points listed below.

When responding to any such inquiries, FSA staff, as the regulator, must remain aware that banks are, in general, free to design and create any Deposits and Savings plan as a product for their customers, insofar as the principal is guaranteed, and that banks can carry out such product development activities based on their management decisions.

(i) Negotiable certificate of deposit (excluding those issued outside Japan)

A negotiable certificate of deposit, or NCD, is a deposit with a predetermined date for repayment and without a non-assignability clause. In light of these characteristics, the handling of NCDs needs to be checked in the following respects.

(A) Termination before maturity; purchase and amortization

Are NCDs terminated before the date of maturity as designated on the date of deposit or not?

Does the issuing bank purchase and amortize any NCDs or not?

(B) Trading

Does the bank sell or buy back NCDs issued by it or not? Does the bank broker or mediate the issuance of NCDs or not?

(C) Are NCDs issued over the counter on an individual basis? Does the bank issue NCDs in the form of public offering or any other form of issuing a large volume to an unspecified and large number of persons under the same conditions?

(ii) Fixed-term deposits

The handling of fixed-term deposits needs to be checked in the following respects.

(A) Regarding fixed-term deposits, are their periods of depositing consistent with the categories specified in the Banking Act on Reserve Requirement System (Act No. 135 of 1957); i.e., the categories of deposits with a predetermined date for paying out which falls after one month following the date of executing the deposit contract?

(B) Regarding floating-rate term deposits (meaning term deposits for which the interest rate until maturity is not fixed at the time of depositing), are their interest rates set based on specified benchmark indexes by a specified method of setting money rates? Do such benchmark indexes and method of setting money rates remain unchanged until maturity?

(iii) Open-end deposits

The handling of open-end deposits needs to be checked in the following respects.

(A) Deposits with a lock-up period

If a lock-up period is one month or longer, or if the interest rate is to be changed after expiration of a lock-up period, do the conditions similar to those described in II-3-5(1)(ii)(B) apply during the lock-up period?



(B) Savings deposits

Savings deposits are offered to individual customers only and have some other limitations for depositing or paying out. If a bank account is used for automatic transfer services to process continuous payments of wage and salaries, public or private pension (including pension from property accumulation savings), dividends on shares or trusts, cash dividends from investment trusts, or principal and interest payments for Japanese Government Bonds or corporate bonds in custody, used for account transfers based on a packaged transfer request for simultaneously processing transfers to 100 or more accounts, used for automatic transfer and automatic bill payment services under a contract for processing payments of public utility charges, or used for multipurpose account services, such bank account cannot be classified as a savings deposit account. The FSA uses savings deposit balances as a benchmark for securing total deposit balance of both public- and private-sector entities.

(2) Scope of deposit-taking institutions and other issues prescribed in the Long Term Credit Bank Act

If an inquiry received pertains to the issues prescribed in the Long Term Credit Bank Act (e.g., the scope of deposit-taking institutions, the definitions of money equivalent to deposits, the scope of reserve funds), the following points must be considered before responding to the inquiry.

(i) Deposit-taking institutions referred to in Article 6(1)(iii) of the Long Term Credit Bank Act

(A) The term “national or local government” includes administrative organs specified in Article 3 of the National Government Organization Act and various types of local public entities specified in Article 1-3 of the Local Autonomy Act (including prefectures, municipalities, special cities, special wards, associations of local public entities, property controlling districts, and regional development corporations).

(B) The term “borrower” or “customer” equivalent to a borrower means a borrower of loans or a customer of a bank falling under any of the following categories.

- a. A borrower of loaned securities, an account holder concluding an overdraft agreement with a bank, or a borrower of loans provided by a bank acting as an agent for the Development Bank of Japan or other specified financial institution
- b. A prospective borrower to whom a bank has issued a loan commitment letter, etc.
- c. A customer for whom the bank discounted or accepted bills (or a customer for whom the bank negotiated an export bill or foreign currency bill, etc.)
- d. An obligor of any obligations guaranteed by a bank
- e. A joint and several obligor, guarantor, or collateral provider

(C) The term “company entrusting administration of corporate bonds” or “customer equivalent thereto” means a company issuing corporate bonds and entrusting the work for solicitation of subscription for such bonds (including other related claims; the same applies hereinafter) or the work for administration of such bonds, or a customer of a bank falling under any of the following categories.

- a. A company issuing or distributing bonds for which the total amount is fully underwritten
  - b. A company issuing or distributing bonds which are secured
  - c. A collateral provider or surety company to secure bonds to be issued or distributed
  - d. A financial instruments business operator acting as an underwriter for bonds to be issued or distributed
  - e. A financial instruments business operator underwriting bonds and offering those bonds for secondary distribution
  - f. Any other firm which is to undertake certain services equivalent to the foregoing for bonds to be issued or distributed
- (D) “Customers” or other equivalent terms, other than those classified into the preceding items, include the following persons.
- a. Bond subscribers (meaning those who apply for subscription for bonds); in this regard, deposits withdrawn solely for the purpose of payments for financial bonds issued by a long-term credit bank (which may be called a “deposit with a special clause for bond subscription” or the like) are included in the scope of deposits purchased by bond subscribers.
  - b. Financial institutions which subscribe for financial bonds issued by a long-term credit bank on a repeated and ongoing basis, e.g., correspondent banks for international money transfers, users of safe-deposit box services, customers of safe custody services
  - c. Firms which undertake services for receiving amounts paid in for shares (including investment securities; the same applies hereinafter), services for paying dividends on shares, or services for principal and interest payments for corporate bonds, or firms which undertake services for receiving amounts paid in for corporate bonds
  - d. Target companies in which a long-term credit bank invests by means of holding their shares, bonds, or other securities
  - e. Firms which undertake depository services for registered public or corporate bonds
  - f. Firms which undertake services for examination, evaluation, clearance, or other operations of bills
  - g. Persons who are directed to make deposits with a long-term credit bank under special laws or regulations
  - h. Other persons equivalent to any of the foregoing
- (ii) Regarding “deposits or equivalent” referred to in Article 6(2) of the Long Term Credit Bank Act, money equivalent to a deposit includes the following.
- (A) Subscription money for bonds: amounts paid in for subscribing for financial bonds
  - (B) Subscription money for securities: deposits for subscribing for public or corporate bonds or shares, or amounts paid in for such subscription
  - (C) Funds for payments for securities: funds for making principal and interest payments for public or corporate bonds, funds for purchasing public or corporate bonds, or funds for distributing dividends on shares

- (D) Domestic exchange unsettled, credit: amounts received through domestic exchange transactions that remain unsettled
- (E) Loan amounts temporarily retained: amounts received or money paid on account or reserved for loan principal and interest that are temporarily retained because loan disbursements are delayed in the context of formation of a foundation
- (F) Bond principal and interest payable: principal and interests of financial bonds issued by a long-term credit bank that are due and payable on a specified redemption date or such principal amounts that remain unpaid
- (G) Dividends payable: dividends to shareholders (including preferred shareholders) that remain unpaid
- (H) Taxes and charges received: tax amounts withheld at the source upon payment of interest payable, interest receivable, salary, or the like
- (I) Suspense receipts: reserves, allowances, or other amounts reserved which have been received and recorded under a suspense account with a character similar to deposits
- (J) Adjustment accounts payable: gross profits in adjustment accounts
- (K) Borrowings from the Bank of Japan (BOJ), bills or notes re-discounted by the BOJ, borrowings from the BOJ for settlement of import bills, or call money
- (L) Other money equivalent to any of the foregoing

#### II-4 Points to Note in Providing Administrative Guidance or Implementing Equivalent Actions

##### II-4-1 Points to Note in Providing Administrative Guidance or Implementing Equivalent Actions

When providing administrative guidance or equivalent (meaning administrative guidance defined in Article 2(vi) of the Administrative Procedure Act or any other administrative action that cannot be clearly distinguished from administrative guidance, e.g., providing information, consultation, advice or the like) to banks, FSA staff must act properly in accordance with the Administrative Procedure Act and other relevant laws and regulations. In particular, the following points must be noted when intending to provide administrative guidance.

- (1) General principles (Article 32 of the Administrative Procedure Act)
  - (i) Is the administrative guidance fulfilled solely by the bank's voluntary cooperation?  
More specific points to note are as illustrated below.
    - (A) Do FSA staff convince the bank of the content of the administrative guidance, its operation, and the staff's responses?
    - (B) Isn't the administrative guidance forcibly continued even though the bank clearly expresses its unwillingness to cooperate?
  - (ii) Doesn't the bank receive any disadvantageous treatment by reason of its refusal to follow the

administrative guidance?

- (A) If the fact about a certain bank's failure to follow administrative guidance was publicly disclosed without due legal grounds, or if such public disclosure was likely to inflict economic losses on the bank or impose social sanction on the bank in any other way, the regulator's action might eventually be regarded as disadvantageous treatment.
- (B) If there is a possibility that, whether or not exercising the authority to render administrative action remain uncertain at the time when the regulator intends to provide administrative guidance to a bank, it may subsequently turn out that the bank's situation deserves certain administrative action depending on circumstances after provision of the administrative guidance, the FSA will not be precluded from giving administrative guidance by suggesting the possibility of exercising administrative action at a later time.

(2) Administrative guidance for applications filed by banks (Article 33 of the Administrative Procedure Act)

If a bank filing a certain application has clearly expressed its unwillingness to follow the administrative guidance, does the FSA staff's behavior (such as forcibly continuing the administrative guidance) preclude the applicant from exercising its rights?

- (i) Even when the applicant does not express a clear intention of defying the administrative guidance, FSA staff should observe the backgrounds underlying the administrative guidance and changes in objective circumstances surrounding the bank and try to find out whether the bank shows a negative reaction.
- (ii) Even when the applicant appears to go along with the administrative guidance, the applicant may not necessarily accept possible delay in the regulator's judgment or responses for the application in question.
- (iii) More specific points to note are as described below.
  - (A) Does FSA staff avoid behavior that forces the applicant to have no other choice but to follow the administrative guidance and consequently preclude the applicant's exercise of its rights?
  - (B) When the applicant does not express a clear intention of defying the administrative guidance, do FSA staff take care not to intentionally suspend or withhold their process of examinations and responses for the application in question by reason of the ongoing administrative guidance?
  - (C) When the applicant expresses its unwillingness to follow the administrative guidance, do FSA staff stop enforcing the administrative guidance and promptly take appropriate steps for the application in question?

(3) Administrative guidance in relation to the authority to grant permission, license, or other approval (Article 34 of the Administrative Procedure Act)

Even when the regulator is unable to exercise the authority to give permission, license, or other

approval or to render disposition based on such permission, license, or other approval or has no intention of exercising such authority, do FSA staff avoid deliberately threatening the bank with the regulator's power to exercise such authority and eventually coerce the bank to follow the administrative guidance?

More specific points to note are as illustrated below.

- (i) Although the FSA has no authority to refuse to grant certain permission, license, or other approval, do FSA staff avoid pretending to have such authority and coerce the bank into certain action or inaction?
- (ii) Do FSA staff avoid inducing the bank to have no other choice but to follow the administrative guidance in such a way to imply that failure to follow the administrative guidance will immediately lead to the exercise of certain authority or some disadvantageous treatment?

(4) Means of administrative guidance (Article 35 of the Administrative Procedure Act)

- (i) When providing administrative guidance to a bank, is the bank clearly informed of the purpose and content of the administrative guidance and the name of the FSA's official responsible?

More specific points to note are as illustrated below.

- (A) Is the required action or inaction defined clearly?
- (B) Is the name of the official primarily responsible for enforcing the administrative guidance indicated clearly?
- (C) When the administrative guidance is based on any specific act, are relevant provisions in the act identified?
- (D) When the administrative guidance is not based on any specific act, is the purpose of the administrative guidance clarified and explained to convince the bank of the necessity of the administrative guidance?
- (ii) When the bank asks for issuance of a document stating the purpose and content of the administrative guidance and the name of the official responsible, is such document issued except where it is specifically detrimental to financial policy? (The foregoing does not apply in any of the cases set forth in Article 35(3) of the Administrative Procedure Act.)
  - (A) Upon request for issuance of a document in writing, it should be issued as promptly as possible.
  - (B) According to the Administrative Procedure Act, "extraordinary administrative inconvenience" that justifies the regulator's refusal to issue a written document means a situation where the document is expected to be exploited for any purpose or to be interpreted in any way that is irrelevant to the issuer's intention, resulting in failure to achieve the intended administrative purpose, or any other situation where the regulator's administration might be significantly disrupted if the purpose and content of the administrative guidance and the name of the official responsible are put into writing.
  - (C) "Extraordinary administrative inconvenience" will not be recognized merely because the regulator needs to process a large number of applications or to expeditiously process the

application in question.

#### II-4-2 Points to Note in Interviews or Other Direct Communication

When a FSA staff member conducts an interview or other session of personal communication (meaning face-to-face interview, telephonic conversation, or communication by e-mail, facsimile, or any other means; the same applies hereinafter) with an officer or manager of a bank, the following points must be noted.

- (1) While in an interview or communication session, do FSA staff maintain discipline and integrity as well as an even-minded and immovable attitude?
- (2) At the beginning of an interview or communication session, are its purpose, the names and job positions of the bank's participants, and other key information confirmed?
- (3) In light of the purpose and content of the interview or communication session, is a suitable means chosen and are the venue, time of day, and participants of both parties appropriate?
- (4) After the interview or communication session, do both parties confirm the summary of discussions and conclusions to share the same recognition, as necessary? In particular, if such discussions and conclusions need to be kept confidential, do both parties clearly understand this?
- (5) If it is necessary to seek a superior's judgment in relation to a certain issue discussed in the interview or communication session, does the FSA staff member act appropriately, either by asking the superior's judgment beforehand or making a prompt report to the superior afterwards? If it is necessary to interview or communicate with multiple banks on an individual basis to discuss the same issues, are administrative integrity and transparency ensured?

#### II-5 Points to Note in Enforcing Administrative Actions or Other Measures

##### II-5-1 Basic Workflow for Administrative Action (Adverse Action)

###### II-5-1-1 Administrative action

Major adverse actions (as defined in Article 2(iv) of the Administrative Procedure Act; the same applies hereinafter) enforced by FSA's supervisory divisions include: the issuance of a business improvement order under Article 26 of the Banking Act, the issuance of a business suspension order under Article 26 of the same act, the issuance of a business suspension order under Article 27 of the same act, and the revocation of a license under Article 27 of the same act. The basic workflow for rendering such administrative action

is described as follows.

(1) Request for reporting under Article 24 of the Banking Act

- (i) If the FSA's on-site inspection or off-site monitoring (such as interviews or demanding submission of a misconduct notification) finds out any problem in a bank's risk management practices, compliance management systems, governance systems, or other business practices, the FSA will ask the bank to report its fact-checking of the problems, its own analyses of the causes of those problems, planned measures for improvement or remediation, and other comments on important issues pursuant to Article 24(1) of the Banking Act.
- (ii) If the FSA determines, as a result of verifying the report submitted by the bank, that further scrutiny is needed, the FSA will ask the bank to submit an additional report pursuant to Article 24(1) of the Banking Act.

(2) Follow-up on measures for improvement or remediation reported under Article 24(1) of the Banking Act

- (i) If the FSA determines, as a result of verifying the reports submitted by a bank, that no serious issue is found in terms of the soundness and appropriateness of the bank's business and that the bank is capable of promoting its self-initiated improvement efforts, the FSA will follow up on the progress of the bank's measures for improvement reported in (1) above through non-compulsory interviews or other communication.
- (ii) Where necessary, the FSA may ask the bank to make periodic follow-up reports pursuant to Article 24(1) of the Banking Act.

(3) Issuance of a business improvement order under Article 26(1) of the Banking Act

If the verification of the reports received under (1) above (including additional reports) finds out any serious problems, for example, in terms of the soundness and appropriateness of the bank's business, or concludes that the bank is unable to improve its business only by its self-initiated efforts, the FSA will consider whether to issue an order for submission of a business improvement plan and for implementation of the established plan pursuant to Article 26(1) of the Banking Act.

According to circumstances, the FSA may consider issuing an order to refrain from starting a new business for a specified period of time, which business banks are now allowed to operate in the wake of the recent financial reforms in Japan. Such order may be issued either in the form of a single action or in parallel with another administrative action described in (4) or (5) below.

(4) Issuance of a business suspension order under Article 26(1) of the Banking Act

If the FSA determines, on the occasion of intending to issue a business improvement order described in (3) above, that it is expected to take a certain period of time for the bank to improve its business, for which period the bank will need to focus all its efforts on improvement activities, the

FSA will consider whether to issue an order to suspend the relevant business for a specified period pursuant to Article 26(1) of the Banking Act. The period of suspension will be determined based on the length of time that is expected to be required for the improvement.

(5) Issuance of a business suspension order under Article 27 of the Banking Act

If the verification of the reports received under (1) above (including additional reports) finds out any serious violation of laws or regulations or any conduct detrimental to public interests, which is determined serious because of its continuity, repetition, intentionality, or maliciousness, the FSA will consider whether to issue an order to suspend the relevant business pursuant to Article 27 of the Banking Act. At the same time, whether to issue an order to establish internal control systems for ensuring compliance pursuant to Article 26(1) of the Banking Act will be considered.

(6) Revocation of a license under Article 27 of the Banking Act

If the verification of the reports received under (1) above (including additional reports) finds out a large number of cases involving serious violations of laws or regulations or conduct detrimental to public interests and the FSA determines that the bank is incompetent to continue its business, the FSA will consider whether to revoke its license pursuant to Article 27 of the Banking Act.

When the FSA considers invoking any administrative action described in (3) to (6), not just the factors listed in the three categories below must be examined, but also whether there are any other points to consider must be scrutinized.

(i) Severity and maliciousness of the improper conduct

(A) Degree of detriment to public interests

Does the bank avoid acting in a way to undermine confidence in financial markets or to cause any other detriment to public interests? One example of such conduct is to design and offer products that are extremely inadequate in terms of proper disclosure of customers' financial reporting.

(B) Degree of damage to users

Do a large number of users in extensive areas suffer damage? How serious is each user's damage?

(C) Maliciousness of the improper conduct

Is the bank's conduct malicious? One example of malicious conduct is to ignore a lot of complaints from users of certain products and continue selling the same or similar products.

(D) Duration of the improper conduct and its repetitions

Has the conduct in question been continued over a long time or for a short period? Was it committed repeatedly or continuously? Or only once? Had the bank committed any similar act in the past?



- (E) Intentionality  
Did the bank intentionally act with an awareness of illegality or inappropriateness? Or was it mere negligence?
- (F) Institutional involvement  
Was the conduct in question at the sole discretion of a sales manager or based on directions from a high-level officer? Were the bank's top executives involved in the conduct?
- (G) Attempt to cover up the improper conduct  
After the bank or the persons in charge had recognized the problem, did they attempt to conceal its evidence? If so, was it an institutional attempt?
- (H) Involvement of antisocial forces  
Were any antisocial forces involved in the conduct in question? If so, to what extent were they involved?

(ii) Appropriateness of governance systems and business operation systems leading to the causes of the improper conduct

- (A) Are the representative directors and the board of directors fully aware of the significance of compliance and eager to promote compliance-conscious management?
- (B) Is the bank's internal audit department well prepared? Does it exert its functions properly?
- (C) Are the bank's compliance department and risk management department well prepared? Do they exert their functions properly?
- (D) Are the bank's relevant staff fully aware of the significance of compliance? Are they adequately trained or educated in the bank?

(iii) Mitigating factors

In addition to the examination of the bank's conduct in the respects described above, is there any factor that can allow the regulator to mitigate administrative enforcement? For example, is the bank promoting self-initiated efforts for protecting users before receiving any administrative measure?

In particular, if the bank's self-initiated efforts are properly implemented in line with the principles shared with the regulator, this may be considered as a mitigating factor.

(7) Standard period for processing a case subject to administrative action

When the FSA is going to invoke any administrative action described in (3) to (6) above, such action should be rendered roughly within about one month, in principle, after receiving a report or a misconduct notification described in (1) above (or a report submitted based on a request made by the FSA under Article 24 of the Banking Act, if applicable), or roughly within two months if the action is based on any law subject to concurrent jurisdiction of the FSA and another ministry or agency.

Note 1: To recognize the time for receiving a report, the following points need to be noted.

- (i) If asking for submission of a report multiple times pursuant to Article 24 of the Banking Act (limited to the case where each request for submission is made within the time frame

specified above after receiving the immediately preceding report), the time for receiving the last report is regarded as the starting point of the time frame for administrative action.

- (ii) If asking for correction of a report submitted or for submission of additional documents (excluding inconsequential correction or provision of trivial information), the time for receiving corrected or additional documents is regarded as the starting point of the time frame for administrative action.

Note 2: The time spent for formal explanations or hearings are not included in the standard period for processing a case subject to administrative action.

Note 3: The standard period for processing a case subject to administrative action will apply to each set of information to be examined as the basis for invoking administrative action.

## II-5-1-2 Cancellation of the Obligation to Make Progress Reports Based on a Business Improvement Order Issued under Article 26 of the Banking Act

After issuance of a business improvement order to a bank under Article 26 of the Banking Act, the FSA will follow up on the bank's business improvement based on such order and try to encourage their improvement efforts. For this purpose, the FSA is, in principle, supposed to ask the bank to report the progress of its business improvement plan submitted to the FSA, with the following points in mind.

- (1) If the FSA issues a business improvement order to a bank under Article 26 of the Banking Act and asks the bank to report the progress of its business improvement plan for a certain period, the bank will be relieved of the obligation to report after expiration of the specified period.
- (2) If the FSA issues a business improvement order to a bank under Article 26 of the Banking Act and asks the bank to report the progress of its business improvement plan on an ongoing basis, without specifying a definite period, the FSA will cancel the bank's obligation to report when the FSA determines that adequate improvement measures have been completed in line with the business improvement plan to address the problem triggering the business improvement order. In this regard, whether or not to cancel the bank's obligation to report will be determined by evaluating the bank's improvement efforts reported by the bank or confirmed through the FSA's inspections.

## II-5-2 Relations with the Administrative Procedure Act and Other Relevant Acts

### (1) Relations with the Administrative Procedure Act

When the FSA intends to render any adverse administrative action falling under any of the cases set forth in item (i) of Article 13(1) of the Administrative Procedure Act to a bank, the FSA must conduct hearings with the bank. In case of any adverse administrative action falling under the case set forth in item (ii) of the same article, the FSA must offer the opportunity for explanation to the

bank.

In either case, the FSA must show the grounds for the adverse administrative action pursuant to Article 14 of the same act. (When such adverse administrative action is rendered in writing, its grounds must also be indicated in writing.)

If intending to refuse to grant the permission, license, or other approval requested under an application filed by a bank, the FSA must show the grounds for the action of refusal pursuant to Article 8 of the same act. (When such action is rendered in writing, its grounds must also be indicated in writing.)

On this occasion, merely enumerating the provisions of relevant acts is not sufficient; instead, full accountability is required to clarify what facts underlie the decision to render the action and which acts and standards are relied on to justify the action.

(2) Relations with the Administrative Complaint Review Act

If the FSA intends to render any administrative action for which an administrative complaint can be filed, the FSA must explain in writing that the bank is entitled to file a complaint pursuant to Article 82 of the Administrative Complaint Review Act.

(3) Relations with the Administrative Case Litigation Act

If the FSA intends to render any administrative action for which an action for revocation can be instituted, the FSA must explain the information about the procedures for filing such action in writing pursuant to Article 46 of the Administrative Case Litigation Act.

## II-5-3 System for Exchange of Opinions

(1) Purpose of the system

Before rendering any adverse administrative action to a bank, the FSA is supposed to conduct hearings with the bank or give an opportunity for explanations to the bank in accordance with the Administrative Procedure Act. In addition to and separately from such hearings or explanations, there is a system to allow the bank to ask for multi-level exchange of opinions between the regulator and the bank. This system is meaningful to help the parties share the same recognition as to the facts underlying the administrative action and their severity.

(2) How to operate this system

During the course of hearings in relation to the regulator's request for reporting under Article 24 of the Banking Act, the bank in question may feel that an adverse administrative action is likely to be rendered. If the bank asks for an opportunity of exchange of opinions between the regulator's senior officials (\*1) and the bank's executives (\*2) in a situation where the regulator intends to render an adverse administrative action which requires prior hearings or the grant of an opportunity for

explanations, the regulator must arrange an opportunity for exchanging opinions as to the facts underlying the intended adverse administrative action and their severity. Such opinion exchange session must be held before a notice of hearings or an opportunity for explanations preceding the invocation of adverse administrative action is issued by the regulator, except where such administrative action needs to be urgently rendered.

Note 1: Example of the FSA's senior officials: director of its relevant division.

Note 2: If the bank requests that an opportunity for exchange of opinions be arranged, such request must be made during the period after the FSA's receipt of the bank's report explaining the facts underlying the intended adverse administrative action submitted under Article 24 of the Banking Act and before the FSA's issuance of a notice of hearings or an opportunity for explanations preceding the invocation of the disposition.

#### II-5-4 Communication with Relevant Authorities in Japan and Overseas Regulators

When intending to render any adverse administrative action described in II-5-1-1(3) to (6), the FSA will give notice to other relevant authorities in Japan or overseas regulators, as necessary.

#### II-5-5 Basic Stance for Public Disclosure of Adverse Administrative Actions

- (1) If any adverse administrative action described in II-5-1-1(4) to (6) is rendered in the form of a business suspension order or an order for revocation of a license, such administrative action must be published in the official gazette pursuant to item (i) or (ii) of Article 56(1) of the Banking Act.
- (2) If the FSA intends to publicly disclose the cases of adverse administrative actions other than those described in (1) above, such disclosure should be intended to clarify the FSA's supervisory viewpoints. At the same time, efforts to ensure more transparent supervision and administration must be sought through properly operating the No-Action Letter System, the system for exchange of opinions, and other mechanisms available.
- (3) With regard to the adverse administrative actions described in II-5-1-1(3) to (6), the facts underlying the invocation of those administrative actions, the content of administrative actions, and other information are supposed to be publicized, except when adverse administrative actions are related to the financial soundness of the banks concerned or when the disclosure of relevant facts and information is likely to impede the business improvement efforts of the banks concerned. The FSA expects such disclosure and information sharing will increase the predictability for other financial Institutions and prevent recurrence of similar incidents or problems.

#### II-5-6 Preliminary Examination

- (1) If a bank files an application for preliminary examination under Article 39 of the Regulation for Enforcement of the Banking Act (the “Banking Act Enforcement Regulation”), the preliminary examination and other processes will be carried out in the following manner.
  - (i) Addressee of applications: Commissioner of the Financial Services Agency
  - (ii) Examination process: The preliminary examination process is carried out in the same way as applicable to the definitive examination process. However, a standard time frame is not specified, in light of the characteristics of preliminary examination.
  - (iii) Answer: To be issued in the name of the Commissioner of the FSA after completion of the preliminary examination
  
- (2) What to examine and what to answer
  - (i) Applicants may ask for preliminary examination at their option under their individual circumstances. Therefore, the progress of respective applicant’s preparations before filing an application for permission or license may vary greatly among different cases of applications. With this in mind, the FSA will basically try to conduct precise examination in a way tailored to each applicant’s circumstances.
  - (ii) For example, the FSA’s preliminary examination may ascertain that the applicant has completed almost all preparations necessary for applying for permission or license. In this case, the FSA may answer to the applicant as follows: “We have decided to give permission for XXX, subject to our final examination to be separately conducted when a formal application for permission is filed. You can therefore commence the application procedure whenever you are ready.”
  - (iii) For another example, the FSA’s preliminary examination may find that the applicant is not well prepared for applying for permission. In this case, continuing such preliminary examination may not necessarily be beneficial for the applicant. If it is confirmed that there are only a limited number of pending issues and that they are clearly identified, the FSA may choose to finish the preliminary examination after informing the applicant of the points to note in filing an application.

The FSA’s answer in this event may be as follows: “We notify you that we are ready to give permission for XXX, subject to our final examination to be separately conducted when a formal application for permission is filed, and further subject to your completion of the preparations indicated in the attached document before filing a formal application.”

### III Evaluation Points for Supervising Major Banks

#### III-1 Governance

##### III-1-1 Background

Since risks for Major Banks acting in global financial markets are becoming more intricate and sophisticated, effective discipline and good governance are essential in their business management in order to ensure financial stability, to achieve Major Banks' sustainability, and to maintain and even enhance their business soundness.

##### III-1-2 Major Supervisory Viewpoints

To ensure effective governance in a firm, the organs constituting the firm are required to fulfill their respective expected roles, first of all. More specifically, the board of directors and the board of company auditors (or the board of directors, the audit committee, and other organs if the bank is a company with a nominating committee, etc., or the board of directors and the audit and supervisory committee if the bank is a company with an audit and supervisory committee) must check the company's management, mechanisms of checks and balances among divisions and departments in the firm must function properly, and the firm's internal audit department must perform soundly. In addition, representative directors, directors, executive officers, company auditors and all other personnel in any job grade must understand their respective roles and engage responsibly in relevant business processes.

In light of the public nature of banking services, the Banking Act requires that the credibility of bank services be preserved and that the sound and appropriate management of bank services be achieved in order to ensure the protection of depositors and to facilitate financial services. In this context, directors serving in the bank basically on a full-time basis (or directors and executive officers serving in the bank basically on a full-time basis if the bank is a company with a nominating committee, etc.) and the bank's company auditors (or the bank's audit committee members if the bank is a company with a nominating committee, etc., or audit and supervisory committee members if the bank is a company with an audit and supervisory committee) are required to have superior qualities to serve in their position.

Under the Companies Act as amended in 2014 and various rules and regulations established by financial instruments exchanges, listed companies are supposed to have outside directors. In addition, financial instruments exchanges' rules and regulations encourage listed companies to strive for improving their corporate governance with full respect for Japan's Corporate Governance Code. In this way, listed companies are required to maintain a higher level of governance than unlisted companies. With this in mind, the FSA monitors the governance of banks and bank holding companies to verify whether the functions for governance work properly, based on the viewpoints as described below.

- (1) To develop governance systems at a level required under the principles indicated in the Corporate Governance Code, does the bank or bank holding company take appropriate steps, including the following, in line with the Corporate Governance Code?

Note: The Corporate Governance Code adopts principles-based approaches (rather than rules-based approaches) and the “comply or explain” approach. Under the comply or explain approach, regulated firms may either comply with the principles specified by the regulator or explain why they do not if they choose not to comply.

- (i) Independent outside directors of a listed bank or bank holding company are expected to fulfill their roles and responsibilities to contribute to the firm’s sustainable growth and promotion of medium- and long-term corporate value. Does the listed bank or bank holding company have at least two independent outside directors with the competencies sufficient to make such contribution?

Depending on the circumstances of the listed bank or bank holding company such as its industrial category, size, business characteristics, and governance systems designed and developed, it may be recommended that at least one-third of the firm’s directors (rather than at least two) should be independent outside directors. Taking all such factors into comprehensive consideration, does the listed bank or bank holding company adopt such “one-third” policy at its independent judgment and disclose this policy?

- (ii) If the listed bank or bank holding company holds other companies’ listed shares in the form of reciprocal capital holdings, is such capital holding strategy disclosed? Does the firm’s board of directors annually review major shareholdings under such strategy, check their returns and risks and verify their medium- and long-term economic rationality and future prospects? Based on this, does the firm adequately explain the objectives and rationality of such shareholdings? Has the firm formulated and disclosed the criteria to ensure proper exercise of its voting rights related to such shareholdings?

- (2) In Japan, a global systemically important bank, or G-SIB\*, is a bank designated in accordance with Article 2-2(5)(i) of the FSA’s public notice entitled “Standards for Banks to Judge their Capital Adequacy in Light of their Assets and Other Circumstances under Article 14-2 of the Banking Act” (the “Public Notice on Standards for Banks’ Capital Adequacy”) or a bank holding company designated in accordance with Article 2-2(5)(i) of the FSA’s public notice entitled “Standards for Bank Holding Companies to Judge Their Own and Subsidiaries’ Capital Adequacy in Light of Their Assets and Other Circumstances under Article 52-25 of the Banking Act” (the “Public Notice on Standards for Bank Holding Companies’ Capital Adequacy”). Such G-SIBs are hereinafter referred to as “G-SIBs Designated under the Public Notices.” Do those G-SIBs Designated under the Public Notices operate strong governance systems taking into consideration the size, complexity, internationality, and

systemic interconnectedness (for example, by adopting the corporate structure of company with a nominating committee, etc.; or by nominating independent outside directors when reviewing and approving a proposal for appointment of directors if the company is a major subsidiary bank of a bank holding company, regardless of whether it is listed or unlisted)?

Note: The assessment of systemic importance for identifying G-SIBs is conducted by the Financial Stability Board. Such assessment process is required to be carried out for global banks or bank holding companies whose total leverage exposures converted at the exchange rate as of the end of the most recent business year on a consolidated basis exceed EUR 200 billion. G-SIBs are identified based on the following five factors: size, interconnectedness, substitutability/financial institution infrastructure, complexity, and global activity. In Article 2(5) of the FSA's notification entitled "Disclosure Requirements for Capital Adequacy Specified by the Commissioner of the FSA under Article 19-2(1)(v)(d) and Other Provisions of the Regulation for Enforcement of the Banking Act," some quantitative information that banks are required to disclose are enumerated, which includes total leverage exposures calculated in accordance with the Basel III rules; i.e., the amount indicated in item 3 on sheet 32 of Form 2 attached to said public notice. Based on the foregoing, the Public Notice on Standards for Banks' Capital Adequacy or the Public Notice on Standards for Bank Holding Companies' Capital Adequacy are operated to designate G-SIBs in Japan.

### III-1-2-1 If Banks are a Company with a Board of Company Auditors

#### (1) Representative directors

- (i) Do the firm's representative directors list compliance as one of the top-priority issues in the firm's business management? Do they take the initiative in developing compliance management systems?
- (ii) Are the representative directors fully aware that downplaying the risk management department could have grave effects on the firm's earnings? Do they stress the importance of the risk management department?
- (iii) Do the representative directors develop internal control systems to ensure appropriate and timely disclosure of financial information and other corporate information?
- (iv) Are the representative directors aware of the importance of internal auditing? Do they properly set the goals of internal auditing? Do they develop systems to enable the internal audit department to adequately perform its functions (and secure the independence of the internal audit department)? Do they periodically verify the effectiveness of such systems? If company auditors' audits or the regulator's inspections find out any problems in the firm's internal audit systems, do they actively promote efforts to address those problems to develop more effective internal audit systems?



Do they promptly take appropriate steps based on feedback from internal audits?

- (v) Are the representative directors fully aware of the importance and benefit of company auditors' audits? To ensure such benefit, do they recognize that a proper environment needs to be developed?

In particular, do they respond to changes in circumstances surrounding company auditors' audits in order to facilitate company auditors' activities? For example, do the representative directors understand the Code of Audit and Supervisory Board Member Auditing Standards (revised on March 10, 2011, Japan Audit and Supervisory Board Members Association)?

- (vi) Are the representative directors fully aware that emphatically eliminating and rejecting relations with antisocial forces is absolutely essential to maintain public confidence in financial institutions and to ensure the appropriateness and soundness of financial institutions' services? In accordance with the Guidelines for Enterprises to Prevent Damage Caused by Antisocial Forces (Agreement at a Meeting of Cabinet Ministers Responsible for Anti-Crime Measures) issued on June 19, 2007 (hereinafter referred to as the "Government Guidelines" in III-1-2), do the representative directors declare the firm's basic policy against antisocial forces approved by the board of directors, both in and outside the bank?

## (2) Directors and the board of directors

- (i) Do directors warn against and deter dogmatic actions by the representative directors or other top executives? Are directors actively involved in the board of directors' processes to make decisions for business execution and to oversee directors' business execution?
- (ii) If the firm has outside directors, are they fully aware of their own significance and mission to ensure the objectivity of business decisions? And are they actively involved in the board of directors' activities? When the board of directors reviews and approves a proposal for appointment of outside directors, in light of the roles that outside directors are expected to perform, does the board closely check the candidates' personal, capital, and business relationships and other interests with the bank or its personnel and carefully examine the candidates' independence and qualifications?

Does the firm continuously provide information to outside directors or offer other mechanisms to help them make proper judgments at board meetings ?

- (iii) The board of directors may from time to time need to make some important business decisions or management judgments in relation to compliance, credit risk management, or other critical issues. On such occasions, does the board seek advice from outside experts, submit to a panel consisting of outside experts, or take other appropriate steps, where needed, in order to ensure the adequacy and fairness of those decisions or judgments in an objective manner?
- (iv) Does the board of directors clearly define business policies based on the overall picture that financial institutions should aim at? Then, does the board draw up clear-cut business plans in line with the established business policies and familiarize all personnel in the firm with those

plans? Is the progress of each business plan reviewed periodically and revised whenever necessary?

- (v) Do directors and the board of directors sincerely promote compliance ahead of other personnel in the firm and properly exert the functions to develop firm-wide internal control systems?
- (vi) Is the board of directors fully aware that downplaying the risk management department could have grave effects on the firm's earnings? Does the board stress the importance of the risk management department? Among others, do the directors responsible for specified business operations understand the form and locus of risks and possess in-depth recognition and understanding about various approaches for measuring, monitoring, and controlling diversified risks?
- (vii) Does the board of directors clearly define risk management policies based on the firm's strategic goals and familiarize the firm's personnel with the established policies? Are those policies reviewed periodically or whenever necessary? Does the board effectively use risk information in the firm's business operations and development of risk management systems? For example, are they briefed on the status of risk management on a regular basis? And do they make necessary decisions based on the reported risk information?
- (viii) Does the board of directors endeavor to enforce a culture in the firm where the importance of governance is emphasized and demonstrated to all personnel in any job grade? And does the board verify the adequacy and effectiveness of governance and aim at better governance systems?
- (ix) Is the board of directors aware of the importance of internal auditing? Does the board properly set the goals of internal auditing? Does the board develop systems to enable the internal audit department to adequately perform its functions (and secure the independence of the internal audit department)? Do they periodically verify the effectiveness of such systems? If company auditors' audits or the regulator's inspections find out any problems in the firm's internal audit systems, does the board actively promote efforts to address those problems to develop more effective internal audit systems?

When the board approves basic matters described in internal audit plans, including audit policies and priority issues, does the board consider the status of risk management in the divisions or departments to be audited?

In addition, does the board promptly take appropriate steps based on feedback from internal audits?

- (x) Is directors fully aware of the importance and benefit of company auditors' audits? To ensure such benefit, do they recognize that a proper environment needs to be developed? When the board of directors reviews and approves a proposal for appointment of company auditors, does the board carefully examine each candidate's independence and qualifications as a company auditor? In particular, does the board recognize that the appointment of outside auditors is statutorily required with a view to enhancing the impartiality and independence of the firm's audit systems more definitely?

- Does the board continuously provide information to outside company auditors or offer other mechanisms to help them make proper judgments?
- (xi) Developing internal control systems (including compliance management systems, risk management systems, and financial reporting systems) in the firm constitutes a part of directors' duty of due care and duty of loyalty. Do the directors understand this and seek to perform such duties properly?
  - (xii) Does the board of directors identify the prevention of damage from antisocial forces as one of the issues in the firm's compliance and risk management and incorporate clearly defined mechanisms to address this issue in the firm's internal control systems? For example, is the basic policy against antisocial forces established in line with the Government Guidelines? Are the systems to implement such policy developed? And is the effectiveness of those systems verified on a regular basis?
  - (xiii) During the course of reviewing and approving a proposal for appointment of directors who are to serve in the bank's business operations on a full time basis, are the candidates' qualifications properly checked? According to Article 7-2 of the Banking Act, banks' executive members are required to have knowledge and experience to enforce governance appropriately, fairly, and efficiently and to possess sufficient social credibility. Therefore, for example, are the following aspects properly considered in the candidate screening process?
    - (A) Knowledge and experience to enforce governance appropriately, fairly, and efficiently
 

Do the candidates understand the regulator's supervisory viewpoints to check firms' governance as indicated in the Banking Act, other relevant laws and regulations, and these Supervisory Guidelines? Do they have sufficient knowledge and experience to enforce the desired governance? Do they have sufficient knowledge and experience of compliance management and risk management required for the sound and appropriate management of banking services? Do they have knowledge and experience to properly execute services other than banking services that banks are allowed to perform under the law?
    - (B) Sufficient social credibility
      - a. Have they avoided involvement in any antisocial conduct?
      - b. Are they compliant with the requirements not to be an organized crime group member (meaning a member of an organized crime group defined in Article 2(vi) of the Banking Act on Prevention of Unjust Acts by Organized Crime Group Members or a person who used to be an organized crime group member in the past)? Are they complying with the requirements not to be closely associated with an organized crime group?
      - c. Have they violated any provision of the Financial Instruments and Exchange Act or any other finance-related laws or regulations of Japan or any equivalent foreign law or committed a criminal offense referred to in the Penal Code or the Banking Act on Punishment of Physical Violence and Others, resulting in imposition of a fine (or any equivalent punishment under the applicable foreign law)?

- d. Have they been subjected to imprisonment or any heavier punishment in Japan (or any equivalent punishment under the applicable foreign law)?
- e. If any firm to which a candidate previously belonged or currently belongs has been subject to any compliance-related administrative action invoked by the competent financial regulator in the form of a business improvement order, a business suspension order, or revocation of a license, registration, or approval, was the candidate involved in the event or incident underlying such administrative action, either as a main player or as a commander of the main player? If so, was such involvement attributable to the candidate's gross negligence or willful misconduct? (In other words, was he/she aware of expected consequences or too careless to prevent the avoidable event or incident?)
- f. Have they received a dismissal order from the competent financial regulator while in office as an executive member in any firm?
- g. While in office as an executive member in a failing financial institution or firm, did they contribute to such failure?

(3) Company auditors and the board of company auditors

- (i) Is the independence of company auditors and the board of company auditors ensured in accordance with the purport of the corporate auditor system established in Japan?
- (ii) The mission of company auditors and the board of company auditors, as an independent organ, is to audit directors' execution of duties to ensure the bank's soundness and sustainable growth. With this in mind, do company auditors and the board of company auditors properly exercise their extensive authority granted under the law? And do they conduct adequate accounting audits and operational audits and take necessary steps in a timely manner?
- (iii) To enhance the effectiveness of audits and efficiently perform audit activities, do company auditors and the board of company auditors secure mechanisms and tools that assist auditors' execution of duties and use them effectively?
- (iv) Does each company auditor stay conscious of their status as a single-person organ and actively perform audit activities under their own responsibility? In particular, does each outside company auditor recognize that the appointment of outside auditors is statutorily required with a view to enhancing the impartiality and independence of the firm's audit systems more definitely? Moreover, do they recognize that they are particularly expected to express audit opinions from an objective standpoint when conducting an audit? Do full-time company auditors take advantage of their full-time position and oversee and verify the bank's governance systems and their implementation on a routine basis? Do they endeavor to create a better audit environment and actively gather information?
- (v) A proposal for appointment of company auditors is prepared by the incumbent directors to seek approval by the shareholders meeting. When the board of company auditors deliberates such proposal and intends to give consent, does the board closely check the independence,

qualifications, and other aspects of each candidate?

Among others, does the board check the candidates for outside company auditors in terms of their personal, capital, and business relationships and other interests with the bank or its personnel?

- (vi) Company auditors of a bank are responsible for auditing the bank's business operations, including audits to check whether or not directors develop internal control systems. Do the bank's auditors understand that such responsibility constitutes a part of their duty of due care and seek to perform such duty properly?
- (vii) During the course of reviewing and approving a proposal for appointment of company auditors of the bank, are the candidates' qualifications properly checked? According to Article 7-2 of the Banking Act, banks' auditors are required to have knowledge and experience to audit directors' execution of duties appropriately, fairly, and efficiently and to possess sufficient social credibility. Therefore, for example, are the following aspects properly considered in the candidate screening process?

- (A) Knowledge and experience to audit directors' execution of duties appropriately, fairly, and efficiently

Do the candidates have sufficient knowledge and experience to actively perform audit activities as a single-person organ and under each auditor's own responsibility? And do they have knowledge and experience necessary for auditing directors' execution of duties from an independent standpoint in order to ensure sound and appropriate operation of banking services?

- (B) Sufficient social credibility
  - a. Have they avoided involvement in any antisocial conduct?
  - b. Are they compliant with the requirement not to be an organized crime group member, and the requirement not to be closely associated with an organized crime group?
  - c. Have they violated any provision of the Financial Instruments and Exchange Act or any other finance-related laws or regulations of Japan or any equivalent foreign law or committed a criminal offense referred to in the Penal Code or the Banking Act on Punishment of Physical Violence and Others, resulting in imposition of a fine (or any equivalent punishment under the applicable foreign law)?
  - d. Have they been subjected to imprisonment or any heavier punishment in Japan (or any equivalent punishment under the applicable foreign law)?
  - e. If any firm to which a candidate previously belonged or currently belongs has been subject to any compliance-related administrative action invoked by the competent financial regulator in the form of a business improvement order, a business suspension order, or revocation of a license, registration, or approval, was the candidate involved in the event or incident underlying such action, either as a main player or as a commander of the main player? If so, was such involvement attributable to the candidate's gross negligence or willful

misconduct? (In other words, was he/she aware of expected consequences or too careless to prevent the avoidable event or incident?)

- f. Have they received a dismissal order from the competent financial regulator while in office as an executive member in any firm?
- g. While in office as an executive member in a failing financial institution or firm, did they contribute to such failure?

(Reference) “Code of Audit and Supervisory Board Member Auditing Standards,” Japan Audit and Supervisory Board Members Association

(4) General managers (those who head a sales office or branch or serve in an equivalent or higher position)

- (i) Do general managers fully understand the form and locus of risks and various approaches for managing risks? Then, do they choose among measuring, monitoring, and controlling approaches suitable for the types of risks and enforce proper risk management in accordance with the firm’s risk management policies?
- (ii) Do general managers implement measures to make checks and balances work in the office or branch in accordance with the policies established by the board of directors or other equivalent organ?

(5) Internal audit department

- (i) In order to make checks against audited divisions and departments work sufficiently, is the internal audit department independent in the firm? At the same time, does the internal audit department have the systems and abilities to timely gather important information about operations of audited divisions and departments? And does it develop a scheme capable of adequately responding to circumstances surrounding the bank and its business conditions and conducting effective internal audits?
- (ii) Does the internal audit department figure out realities of risk management at audited divisions and departments and make efficient and effective internal audit plans? Are those plans designed to fit with the types and severity of risks at appropriate frequencies and depth? Are those plans reviewed and adjusted flexibly according to circumstances? Then, are internal audits conducted efficiently and effectively in accordance with the plans?
- (iii) Does the internal audit department report important audit findings to the representative directors and the board of directors without delay? Does the internal audit department keep track of improvements promoted by audited divisions and departments based on feedback from internal audits?

(6) Effective use of external audits

- (i) Does the bank fully recognize that effective external audits are essential to ensure sound and appropriate management of the bank’s services? And are external audits used effectively?

- (ii) Is the effectiveness of external audits verified periodically? Is the feedback from external audits utilized to take appropriate measures?
- (iii) Regarding reappointment or retention of an external auditing firm, does the bank properly consider such factors as the total duration of continuous appointment and the number of consecutive years for assignment of particular certified public accountants?

(7) Coordination among multiple auditing functions

Do external auditing functions and the firm's internal audit department, company auditors, or board of company auditors communicate and coordinate effectively?

III-1-2-2 If Banks are a Company with a Nominating Committee, etc.

Note: If a bank is a company with a nominating committee, etc., the regulator needs to verify whether the board of directors, respective committees, executive officers, and other organs in the bank properly fulfill their roles based on the responsibilities and authorities respectively assigned to them. Such verification is conducted with a focus on the details of the authorities delegated to respective organs, taking into consideration the viewpoints shown in these Supervisory Guidelines.

(1) Directors and the board of directors

- (i) Does the board of directors clearly define the authorities to make decisions in business execution? The matters defined in this context include business management policies, the segregation of duties assigned to respective executive officers, direction and order schemes, and issues concerning mutual relations among executive officers.

Does the board develop the systems for ensuring that executive officers execute duties in compliance with laws and regulations and the systems for ensuring disciplined business operations? Is the effectiveness of those systems verified on an ongoing basis? If audit committee' audits or the regulator's inspections find out any problems in the firm's internal audit systems, does the board actively promote efforts to address those problems to develop more effective internal audit systems?

- (ii) Does the board of directors actively develop the systems necessary for facilitating the audit committee to execute duties (e.g., audit assistants, information and reporting controls, internal control systems)?
- (iii) Does the board of directors endeavor to enforce a culture in the firm where the importance of governance is emphasized and demonstrated to all personnel in any job grade? And does the board verify the adequacy and effectiveness of governance and aim at better governance systems?
- (iv) Does the board of directors properly exercise the authority to oversee management and business execution by effectively using and cooperating with committees?

- (v) Does the board of directors develop internal control systems to ensure appropriate and timely disclosure of financial information and other corporate information?
- (vi) Are directors actively involved in the board of directors' processes to make decisions for business execution and to oversee executive officers' execution of duties? Developing internal control systems (including compliance management systems, risk management systems, and financial reporting systems) in the firm constitutes a part of directors' duty of due care and duty of loyalty. Do the directors understand this and seek to perform such duties properly?
- (vii) Does the board of directors identify the prevention of damage from antisocial forces as one of the issues in the firm's compliance and risk management and clearly incorporate the prevention into defined mechanisms in the firm's internal control systems? For example, is the basic policy against antisocial forces established in line with the Government Guidelines? Are the systems to implement such policy developed? And is the effectiveness of those systems verified on a regular basis?
- (viii) During the course of reviewing and approving a proposal for appointment of directors who are to serve in the bank's business operations on a full time basis, are the candidates' qualifications properly checked? According to Article 7-2 of the Banking Act, banks' executive members are required to have knowledge and experience to enforce governance appropriately, fairly, and efficiently and to possess sufficient social credibility. Therefore, for example, are the following aspects properly considered in the candidate screening process?
  - (A) Knowledge and experience to enforce governance appropriately, fairly, and efficiently
 

Do the candidates have sufficient knowledge and experience to actively take part in the board of directors' processes to make decisions in relation to business management policies, internal control systems, and business execution and to oversee directors' and executive officers' execution of duties? And do they have knowledge and experience necessary for enforcing governance as specified in the Banking Act, other relevant regulations, and these Supervisory Guidelines in order to ensure sound and appropriate operation of banking services?
  - (B) Sufficient social credibility
    - a. Have they avoided involvement in any antisocial conduct?
    - b. Are they compliant with the requirement not to be an organized crime group member, and the requirement not to be closely associated with an organized crime group?
    - c. Have they violated any provision of the Financial Instruments and Exchange Act or any other finance-related laws or regulations of Japan or any equivalent foreign law or committed a criminal offense referred to in the Penal Code or the Banking Act on Punishment of Physical Violence and Others, resulting in imposition of a fine (or any equivalent punishment under the applicable foreign law)?
    - d. Have they been subjected to imprisonment or any heavier punishment in Japan (or any equivalent punishment under the applicable foreign law)?



- e. If any firm to which a candidate previously belonged or currently belongs has been subject to any compliance-related administrative action invoked by the competent financial regulator in the form of a business improvement order, a business suspension order, or revocation of a license, registration, or approval, was the candidate involved in the event or incident underlying such action, either as a main player or as a commander of the main player? If so, was such involvement attributable to the candidate's gross negligence or willful misconduct? (In other words, was he/she aware of expected consequences or too careless to prevent the avoidable event or incident?)
- f. Have they received a dismissal order from the competent financial regulator while in office as an executive member in any firm?
- g. While in office as an executive member in a failing financial institution or firm, did they contribute to such failure?

(2) Audit Committee and other committees

- (i) Is the independence of each committee ensured in accordance with the purport of Japan's corporate committees system?
- (ii) Does the audit committee properly exercise its extensive authority granted under the law? And does the committee conduct adequate accounting audits and operational audits and take necessary steps in a timely manner?
- (iii) To audit the legality and adequacy of directors' and executive officers' execution of duties, does the audit committee effectively use employees serving as the committee's assistant, the internal audit department, financial auditors, and other persons?

Unlike a company with board of company auditors where company auditors can readily conduct on-the-spot inspections, the audit committee's activities are usually focused on organizational audits through use of the firm's internal control systems because most committee members are outside directors. In light of such nature of the audit committee, does the firm develop mechanisms to support the audit committee, especially through the internal audit department?

- (iv) During the course of reviewing and approving a proposal for appointment of audit committee members of the bank, are the candidates' qualifications properly checked? According to Article 7-2 of the Banking Act, banks' auditors are required to have knowledge and experience to audit execution of duties by the bank's executive officers and directors appropriately, fairly, and efficiently and to possess sufficient social credibility. Therefore, for example, are the following aspects properly considered in the candidate screening process?

- (A) Knowledge and experience to audit execution of duties by the bank's executive officers and directors appropriately, fairly, and efficiently

Do the candidates have knowledge and experience enough to oversee and verify the development and operation of the firm's internal control systems and to perform proactive

roles in the board of directors' deliberations for the development and operation of the internal control systems? And do they have knowledge and experience necessary for auditing executive officers' and directors' execution of duties from an independent standpoint in order to ensure sound and appropriate operation of banking services?

(B) Sufficient social credibility

- a. Have they avoided involvement in any antisocial conduct?
- b. Are they compliant with the requirement not to be an organized crime group member, and the requirement not to be closely associated with an organized crime group?
- c. Have they violated any provision of the Financial Instruments and Exchange Act or any other finance-related laws or regulations of Japan or any equivalent foreign law or committed a criminal offense referred to in the Penal Code or the Banking Act on Punishment of Physical Violence and Others, resulting in imposition of a fine (or any equivalent punishment under the applicable foreign law)?
- d. Have they been subjected to imprisonment or any heavier punishment in Japan (or any equivalent punishment under the applicable foreign law)?
- e. If any firm to which a candidate previously belonged or currently belongs has been subject to any compliance-related administrative disposition invoked by the competent financial regulator in the form of a business improvement order, a business suspension order, or revocation of a license, registration, or approval, was the candidate involved in the event or incident underlying such disposition, either as a main player or as a commander of the main player? If so, was such involvement attributable to the candidate's gross negligence or willful misconduct? (In other words, was he/she aware of expected consequences or too careless to prevent the avoidable event or incident?)
- f. Have they received a dismissal order from the competent financial regulator while in office as an executive member in any firm?
- g. While in office as an executive member in a failing financial institution or firm, did they contribute to such failure?

(Reference) "Code of Audit and Supervisory Board Member Auditing Standards," Japan Audit and Supervisory Board Members Association

(3) Executive officers (including representative executive officers)

- (i) Are executive officers fully aware of the authorities and responsibilities delegated to them based on the board of directors' resolutions? Are their business decisions made in line with the business management policies approved by the board of directors?
- (ii) Do executive officers clearly define business plans based on the established business management policies and familiarize the firm's personnel with such plans? Is the progress of each business plan reviewed periodically and revised whenever necessary?
- (iii) Do executive officers sincerely promote compliance ahead of other personnel in the bank and

- properly exert the functions to develop and operate firm-wide internal control systems?
- (iv) Are executive officers fully aware that downplaying the Risk Management Department could have grave effects on the bank's earnings? Do they stress the importance of the risk management department? Among others, do the executive officers responsible for specified business operations understand the form and locus of risks and possess in-depth recognition and understanding about various approaches for measuring, monitoring, and controlling diversified risks?
  - (v) Do executive officers clearly define risk management policies based on the established business management policies and familiarize the firm's personnel with such policies? Are those policies reviewed periodically or whenever necessary? Do executive officers effectively use risk information in the firm's business operations and development of risk management systems? For example, are they briefed on the status of risk management on a regular basis? And do they make necessary decisions based on the reported risk information?
  - (vi) Are executive officers aware of the importance of internal auditing? Do they implement measures to make the internal audit functions work adequately? Is the feedback from internal audits utilized to take appropriate measures?
  - (vii) Are executive officers fully aware that emphatically eliminating and rejecting relations with antisocial forces is absolutely essential to maintain public confidence in financial institutions and to ensure the appropriateness and soundness of financial institutions' services? In accordance with the Government Guidelines, do executive officers declare the firm's basic policy against antisocial forces approved by the board of directors, both in and outside the bank?
  - (viii) During the course of reviewing and approving a proposal for appointment of executive officers, are the candidates' qualifications properly checked? According to Article 7-2 of the Banking Act, banks' executive members are required to have knowledge and experience to enforce governance appropriately, fairly, and efficiently and to possess sufficient social credibility. Therefore, for example, are the following aspects properly considered in the candidate screening process?
    - (A) Knowledge and experience to enforce governance appropriately, fairly, and efficiently
 

Do the candidates understand the regulator's supervisory viewpoints to check firms' governance as indicated in the Banking Act, other relevant laws and regulations, and these Supervisory Guidelines? Do they have sufficient knowledge and experience to enforce the desired governance? Do they have sufficient knowledge and experience of compliance management and risk management required for the sound and appropriate management of banking services? Do they have knowledge and experience to properly execute services other than banking services that banks are allowed to perform under the law?
    - (B) Sufficient social credibility
      - a. Have they avoided involvement in any antisocial conduct?
      - b. Are they compliant with the requirement not to be an organized crime group member, and the requirement not to be closely associated with an organized crime group?

- c. Have they violated any provision of the Financial Instruments and Exchange Act or any other finance-related laws or regulations of Japan or any equivalent foreign law or committed a criminal offense referred to in the Penal Code or the Banking Act on Punishment of Physical Violence and Others, resulting in imposition of a fine (or any equivalent punishment under the applicable foreign law)?
  - d. Have they been subjected to imprisonment or any heavier punishment in Japan (or any equivalent punishment under the applicable foreign law)?
  - e. If any firm to which a candidate previously belonged or currently belongs has been subject to any compliance-related administrative disposition invoked by the competent financial regulator in the form of a business improvement order, a business suspension order, or revocation of a license, registration, or approval, was the candidate involved in the event or incident underlying such disposition, either as a main player or as a commander of the main player? If so, was such involvement attributable to the candidate's gross negligence or willful misconduct? (In other words, was he/she aware of expected consequences or too careless to prevent the avoidable event or incident?)
  - f. Have they received a dismissal order from the competent financial regulator while in office as an executive member in any firm?
  - g. While in office as an executive member in a failing financial institution or firm, did they contribute to such failure?
- (4) General managers (those who head a sales office or branch or serve in an equivalent or higher position)
- (i) Do general managers fully understand the form and locus of risks and various approaches for managing risks? Then, do they choose among measuring, monitoring, and controlling approaches based on the types of risks and enforce proper risk management in accordance with the firm's risk management policies?
  - (ii) Do general managers implement measures to make checks and balances work in the office or branch in accordance with the policies established by the board of directors or other equivalent organ?
- (5) Internal audit department
- (i) In order to make checks against audited divisions and departments work sufficiently, is the internal audit department independent in the firm? At the same time, does the internal audit department have the systems and abilities to timely gather important information about operations of audited divisions and departments? And does it develop a scheme capable of adequately responding to circumstances surrounding the bank and its business conditions and conducting effective internal audits?
  - (ii) Does the internal audit department figure out realities of risk management at audited divisions and departments and make efficient and effective internal audit plans? Are those plans designed

to fit with the types and severity of risks at appropriate frequencies and depth? Are those plans reviewed and adjusted flexibly according to circumstances? Then, are internal audits conducted efficiently and effectively in accordance with the plans?

- (iii) Does the internal audit department report important audit findings to representative executive officers and the audit committee without delay? Does the internal audit department keep track of improvements promoted by audited divisions and departments based on feedback from internal audits?

(6) Effective use of external audits

- (i) Does the bank fully recognize that effective external audits are essential to ensure sound and appropriate management of the bank's services? And are external audits used effectively?
- (ii) Is the effectiveness of external audits verified periodically? Is the feedback from external audits utilized to take appropriate measures?
- (iii) Regarding reappointment or retention of an external auditing firm, does the bank properly consider such factors as the total duration of continuous appointment and the number of consecutive years for assignment of particular certified public accountants?

(7) Coordination among multiple auditing functions

Do external auditing functions and the firm's internal audit department or audit committee communicate and coordinate effectively?

III-1-2-3 If Banks are a Company with Audit and Supervisory Committee

(1) Representative directors

- (i) Do the firm's representative directors list compliance as one of the top-priority issues in the firm's business management? Do they take the initiative in developing compliance management systems?
- (ii) Are the representative directors fully aware that downplaying the Risk Management Department could have grave effects on the firm's earnings? Do they stress the importance of the risk management department?
- (iii) Do the representative directors develop internal control systems to ensure appropriate and timely disclosure of financial information and other corporate information?
- (iv) Are the representative directors aware of the importance of internal auditing? Do they properly set the goals of internal auditing? Do they develop systems to enable the internal audit department to adequately perform its functions (and secure the independence of the internal audit department)? Do they periodically verify the effectiveness of such systems? If the audit and supervisory committees' audits or the regulator's inspections find out any problems in the firm's internal audit systems, do the representative directors actively promote efforts to address those

problems and to develop more effective systems?

Do they promptly take appropriate steps based on feedback from internal audits?

- (v) Are the representative directors fully aware of the importance and benefit of the audit and supervisory committee's audits? To ensure such benefit, do they recognize that a proper environment needs to be developed?
- (vi) Are the representative directors fully aware that emphatically eliminating and rejecting relations with antisocial forces is absolutely essential to maintain public confidence in financial institutions and to ensure the appropriateness and soundness of financial institutions' services? In accordance with the Government Guidelines, do the representative directors declare the firm's basic policy against antisocial forces approved by the board of directors, both in and outside the bank?

(2) Directors and the board of directors

- (i) Do directors warn against and deter dogmatic actions by the representative directors or other top executives? Are directors actively involved in the board of directors' processes to make decisions for business execution and to oversee directors' business execution?
- (ii) Are outside directors fully aware of their own significance and mission to ensure the objectivity of business decisions? And are they actively involved in the board of directors' activities? When the board of directors reviews and approves a proposal for appointment of outside directors, in light of the roles that outside directors are expected to perform, does the board closely check the candidates' personal, capital, and business relationships and other interests with the bank or its personnel and carefully examine the candidates' independence and qualifications?

Does the firm continuously provide information to outside directors or offer other mechanisms to help them make proper judgments at board meetings?

- (iii) The board of directors may from time to time need to make some important business decisions or management judgments in relation to compliance, credit risk management, or other critical issues. On such occasions, does the board seek advice from outside experts, submit to a panel consisting of outside experts, or take other appropriate steps, where needed, in order to ensure the adequacy and fairness of those decisions or judgments in an objective manner?
- (iv) Does the board of directors clearly define business policies based on the overall picture that financial institutions should aim at? Then, does the board draw up clear-cut business plans in line with the established business policies and familiarize all personnel in the firm with those plans? Is the progress of each business plan reviewed periodically and revised whenever necessary?
- (v) Do directors and the board of directors sincerely promote compliance ahead of other personnel in the firm and properly exert the functions to develop firm-wide internal control systems?
- (vi) Is the board of directors fully aware that downplaying the risk management department could have grave effects on the firm's earnings? Does the board stress the importance of the risk

management department? Among others, do the directors responsible for specified business operations understand the form and locus of risks and possess in-depth recognition and understanding about various approaches for measuring, monitoring, and controlling diversified risks?

- (vii) Does the board of directors clearly define risk management policies based on the firm's strategic goals and familiarize the firm's personnel with the established policies? Are those policies reviewed periodically or whenever necessary? Does the board effectively use risk information in the firm's business operations and development of risk management systems? For example, are they briefed on the status of risk management on a regular basis? And do they make necessary decisions based on the reported risk information?
- (viii) Does the board of directors endeavor to enforce a culture in the firm where the importance of governance is emphasized and demonstrated to all personnel in any job grade? And does the board verify the adequacy and effectiveness of governance and aim at better governance systems?
- (ix) Is the board of directors aware of the importance of internal auditing? Does the board properly set the goals of internal auditing? Does the board develop systems to enable the internal audit department to adequately perform its functions (and secure the independence of the internal audit department)? Do they periodically verify the effectiveness of such systems? If the audit and supervisory committees' audits or the regulator's inspections find out any problems in the firm's internal audit systems, does the board of directors actively promote efforts to address those problems and to develop more effective systems?

When the board approves basic matters described in internal audit plans, including audit policies and priority issues, does the board consider the status of risk management in the divisions or departments to be audited?

In addition, does the board promptly take appropriate steps based on feedback from internal audits?

- (x) Are directors fully aware of the importance and benefit of the audit and supervisory committee's audits? To ensure such benefit, do they recognize that a proper environment needs to be developed? When the board of directors reviews and approves a proposal for appointment of directors who are to serve as audit and supervisory committee members, does the board carefully examine each candidate's independence and qualifications as an audit and supervisory committee member? In particular, do the candidates for outside directors who are to serve as an audit and supervisory committee member recognize that the appointment of such outside directors is statutorily required with a view to enhancing the impartiality and independence of the firm's audit systems more definitely?

Does the board continuously provide information to outside directors serving as audit and supervisory committee members or offer other mechanisms to help them make proper judgments?

- (xi) Developing internal control systems (including compliance management systems, risk

management systems, and financial reporting systems) in the firm constitutes a part of directors' duty of due care and duty of loyalty. Do the directors understand this and seek to perform such duties properly?

- (xii) Does the board of directors identify the prevention of damage from antisocial forces as one of the issues in the firm's compliance and risk management and incorporate clearly defined mechanisms to address this issue in the firm's internal control systems? For example, is the basic policy against antisocial forces established in line with the Government Guidelines? Are the systems to implement such policy developed? And is the effectiveness of those systems verified on a regular basis?
- (xiii) During the course of reviewing and approving a proposal for appointment of directors who are to serve in the bank's business operations on a full time basis, are the candidates' qualifications properly checked? According to Article 7-2 of the Banking Act, banks' executive members are required to have knowledge and experience to enforce governance appropriately, fairly, and efficiently and to possess sufficient social credibility. Therefore, for example, are the following aspects properly considered in the candidate screening process?
- (A) Knowledge and experience to enforce governance appropriately, fairly, and efficiently
- Do the candidates understand the regulator's supervisory viewpoints to check firms' governance as indicated in the Banking Act, other relevant laws and regulations, and these Supervisory Guidelines? Do they have sufficient knowledge and experience to enforce the desired governance? Do they have sufficient knowledge and experience of compliance management and risk management required for the sound and appropriate management of banking services? Do they have knowledge and experience to properly execute services other than banking services that banks are allowed to perform under the law?
- (B) Sufficient social credibility
- a. Have they avoided involvement in any antisocial conduct?
  - b. Are they compliant with the requirement not to be an organized crime group member, and the requirement not to be closely associated with an organized crime group?
  - c. Have they violated any provision of the Financial Instruments and Exchange Act or any other finance-related laws or regulations of Japan or any equivalent foreign law or committed a criminal offense referred to in the Penal Code or the Banking Act on Punishment of Physical Violence and Others, resulting in imposition of a fine (or any equivalent punishment under the applicable foreign law)?
  - d. Have they been subjected to imprisonment or any heavier punishment in Japan (or any equivalent punishment under the applicable foreign law)?
  - e. If any firm to which a candidate previously belonged or currently belongs has been subject to any compliance-related administrative disposition invoked by the competent financial regulator in the form of a business improvement order, a business suspension order, or revocation of a license, registration, or approval, was the candidate involved in the event or



incident underlying such disposition, either as a main player or as a commander of the main player? If so, was such involvement attributable to the candidate's gross negligence or willful misconduct? (In other words, was he/she aware of expected consequences or too careless to prevent the avoidable event or incident?)

- f. Have they received a dismissal order from the competent financial regulator while in office as an executive member in any firm?
- g. While in office as an executive member in a failing financial institution or firm, did they contribute to such failure?

(3) Audit and supervisory committee

- (i) Is the independence of the audit and supervisory committee ensured in accordance with the purport of Japan's corporate system?
- (ii) Does the audit and supervisory committee properly exercise its extensive authority granted under the law? And does the committee conduct adequate accounting audits and operational audits and take necessary steps in a timely manner?
- (iii) To audit the legality and adequacy of directors' execution of duties, does the audit and supervisory committee effectively use employees serving as the committee's assistant, the internal audit department, financial auditors, and other persons?

Unlike a company with a board of company auditors where company auditors can readily conduct on-the-spot inspections, the audit and supervisory committee's activities are usually focused on organizational audits through use of the firm's internal control systems because most committee members are outside directors. In light of such nature of the audit and supervisory committee, does the firm develop mechanisms to support the audit and supervisory committee, especially through the internal audit department?

- (iv) A proposal for appointment of directors who are to serve as audit and supervisory committee members is prepared by the incumbent directors to seek approval by the shareholders meeting. When the audit and supervisory committee deliberates such proposal and intends to give consent, does the committee closely check the independence, qualifications, and other aspects of each candidate?

Among others, does the committee check the candidates for outside company auditors who are to serve as audit and supervisory committee member in terms of their personal, capital and business relationships and other interests with the bank or its personnel?

- (v) During the course of reviewing and approving a proposal for appointment of directors who are to serve as an audit and supervisory committee member, are the candidates' qualifications properly checked? According to Article 7-2 of the Banking Act, banks' auditors are required to have knowledge and experience to audit directors' execution of duties appropriately, fairly, and efficiently and to possess sufficient social credibility. Therefore, for example, are the following aspects properly considered in the candidate screening process?

- (A) Knowledge and experience to audit directors' execution of duties appropriately, fairly, and efficiently

Do the candidates have sufficient knowledge and experience to oversee and verify the development and operation of the firm's internal control systems and to perform proactive roles in the board of directors' deliberations for the development and operation of the internal control systems? And do they have knowledge and experience necessary for auditing directors' execution of duties from an independent standpoint in order to ensure sound and appropriate operation of banking services?

- (B) Sufficient social credibility
- a. Have they avoided involvement in any antisocial conduct?
  - b. Are they compliant with the requirement not to be an organized crime group member, and the requirement not to be closely associated with an organized crime group?
  - c. Have they violated any provision of the Financial Instruments and Exchange Act or any other finance-related laws or regulations of Japan or any equivalent foreign law or committed a criminal offense referred to in the Penal Code or the Banking Act on Punishment of Physical Violence and Others, resulting in imposition of a fine (or any equivalent punishment under the applicable foreign law)?
  - d. Have they been subjected to imprisonment or any heavier punishment in Japan (or any equivalent punishment under the applicable foreign law)?
  - e. If any firm to which a candidate previously belonged or currently belongs has been subject to any compliance-related administrative disposition invoked by the competent financial regulator in the form of a business improvement order, a business suspension order, or revocation of a license, registration, or approval, was the candidate involved in the event or incident underlying such disposition, either as a main player or as a commander of the main player? If so, was such involvement attributable to the candidate's gross negligence or willful misconduct? (In other words, was he/she aware of expected consequences or too careless to prevent the avoidable event or incident?)
  - f. Have they received a dismissal order from the competent financial regulator while in office as an executive member in any firm?
  - g. While in office as an executive member in a failing financial institution or firm, did they contribute to such failure?

(Reference) "Code of Audit and Supervisory Board Member Auditing Standards," Japan Audit and Supervisory Board Members Association

- (4) General managers (those who head a sales office or branch or serve in an equivalent or higher position)
- (i) Do general managers fully understand the form and locus of risks and various approaches for managing risks? Then, do they choose among measuring, monitoring, and controlling approaches suitable for the types of risks and enforce proper risk management in accordance

with the firm's risk management policies?

- (ii) Do general managers implement measures to make checks and balances work in the office or branch in accordance with the policies established by the board of directors or other equivalent organ?

(5) Internal audit department

- (i) In order to make checks against audited divisions and departments work sufficiently, is the internal audit department independent in the firm? At the same time, does the internal audit department have the systems and abilities to timely gather important information about operations of audited divisions and departments? And does it develop a scheme capable of adequately responding to circumstances surrounding the bank and its business conditions and conducting effective internal audits?
- (ii) Does the internal audit department figure out realities of risk management at audited divisions and departments and make efficient and effective internal audit plans? Are those plans designed to fit with the types and severity of risks at appropriate frequencies and depth? Are those plans reviewed and adjusted flexibly according to circumstances? Then, are internal audits conducted efficiently and effectively in accordance with the plans?
- (iii) Does the internal audit department report important audit findings to the representative directors and the audit and supervisory committee without delay? Does the internal audit department keep track of improvements promoted by audited divisions and departments based on feedback from internal audits?

(6) Effective use of external audits

- (i) Does the bank fully recognize that effective external audits are essential to ensure sound and appropriate management of the bank's services? And are external audits used effectively?
- (ii) Is the effectiveness of external audits verified periodically? Is the feedback from external audits utilized to take appropriate measures?
- (iii) Regarding reappointment or retention of an external auditing firm, does the bank properly consider such factors as the total duration of continuous appointment and the number of consecutive years for assignment of particular certified public accountants?

(7) Coordination among multiple auditing functions

Do external auditing functions and the firm's internal audit department or audit and supervisory committee communicate and coordinate effectively?

(Reference) The resources listed below are helpful to understand the supervisory viewpoints in connection with firms' governance systems.

- (i) "Framework for Internal Control Systems in Banking Organisations," September 1998, Basel Committee on Banking Supervision

- (ii) “Enhancing Corporate Governance for Banking Organisations,” February 2006, Basel Committee on Banking Supervision
- (iii) “Guidelines for Enterprises to Prevent Damage Caused by Antisocial Forces,” June 19, 2007, Agreement at a Meeting of Cabinet Ministers Responsible for Anti-Crime Measures, Prime Minister’s Office of Japan

Note: The subsequent paragraphs in these Supervisory Guidelines are basically intended for banks which are a company with board of company auditors. When supervising banks which are a company with a nominating committee, etc. or a company with audit and supervisory committee, the instructions described in the subsequent paragraphs will apply with appropriate replacement of terms in a way to fit their realities.

### III-1-3 Supervisory Approaches

Interviews and day-to-day supervisory activities described below are intended to verify governance systems of supervised firms.

#### (1) Off-site monitoring

- (i) Interviews with firms on their risk management or internal auditing are intended to verify the functions performed by the board of directors and the board of company auditors and top executives’ awareness and involvement.
- (ii) Interviews with top managers
  - Interviews with banks’ top executives will be held whenever necessary to learn about their business strategies, management policies, and how they recognize and address risk management issues.
- (iii) Where appropriate, the bank’s recognition about governance may be checked through interviews with the bank’s company auditors, outside directors, or financial auditors.

#### (2) Verification of governance systems through day-to-day supervisory activities

- (i) In addition to interviews described in (1) above, the effectiveness of governance systems can be checked to some extent in the course of day-to-day supervisory activities such as: screening license applications, receiving notifications on appointment or registration of directors, executive officers, company auditors, audit committee members, audit and supervisory committee members or financial auditors, follow-up on the inspected banks’ activities in response to the FSA’s notices of inspection results, receiving misconduct notifications, operating the early warning system, and issuing an order for prompt corrective action.
- (ii) In particular, if the FSA has asked a bank to report measures for improvement or remediation pursuant to Article 24 of the Banking Act since problems have been found in the bank’s internal control systems, or if the FSA has asked a bank to submit a business improvement plan pursuant

to Article 26 of the Banking Act since a particularly serious problem has been found, the FSA will analyze the causes of such problems and, as necessary, examine whether the bank's improvement measures or plans are designed in a way to make governance functions work properly.

#### III-1-4 Supervisory Actions

- (1) If the effectiveness of a bank's governance systems is determined to be questionable, as a result of off-site monitoring or day-to-day supervisory activities described above, the FSA will conduct more profound interviews to discuss the cases and improvement measures and urge the bank to surely improve its governance systems, where appropriate, through asking for reporting under Article 24 of the Banking Act.
- (2) If a bank's officer has committed a material violation of any law or any other conduct undermining the bank's social credibility, if a bank's efforts to rectify its weak governance do not go well even after issuance of a business improvement order, or if a bank has received many business improvement orders on the grounds of multiple problems, the bank's governance systems will be determined to be in critical condition. In this event, the FSA will issue a business improvement order pursuant to Article 26 of the Banking Act to ask for the establishment of decent governance systems. Depending on the severity of the problems, the FSA may encourage the bank to consider a drastic improvement, e.g., (i) strengthening the internal audit functions and other mechanisms of checks and balances, (ii) the introduction of a scheme of oversight through outside directors, external experts, or the like, or (iii) transition to a company with board of company auditors, a company with an audit and supervisory committee, or a company with a nominating committee, etc.
- (3) The FSA may conduct in-depth interviews to examine the qualifications of directors, executive officers, company auditors, audit committee members, or audit and supervisory committee members, their execution of duties to enforce governance, how the firm recognizes their performance, the process for reviewing and approving a proposal for appointment of directors, company auditors, or audit and supervisory committee members, the process for appointing executive officers or audit committee members, or other important issues if it is found necessary for ensuring sound and appropriate management of banking services because a certain director or executive officer serving in the bank basically on a full-time basis or a company auditor, audit committee member, or audit and supervisory committee member is determined to be incompetent in terms of any aspect described in III-1-2-1(2)(xiii), III-1-2-2(1)(viii), III-1-2-2(3)(viii), III-1-2-3(2)(xiii), III-1-2-1(3)(vii), III-1-2-2(2)(iv), or III-1-2-3(3)(v), or because it subsequently turns out that their qualifications were not sufficiently checked when approving a proposal for their appointment or nominating them as a candidate. If it is determined necessary as a result of such examination, the FSA may ask the bank to submit a report pursuant to Article 24 of the Banking Act. If the FSA determines, as a result of reviewing a report

received from the bank, that there are serious problems in the bank's governance systems and that adverse impacts on sound and appropriate operation of banking services are unlikely to be avoided by the bank's self-initiated effort only, the FSA will issue a business improvement order pursuant to Article 26 of the Banking Act.

Note: Some viewpoints to check the knowledge, experience, and social credibility of directors, executive officers, company auditors, audit committee members, and audit and supervisory committee members are described in III-1-2-1(2)(xiii), III-1-2-2(1)(viii), III-1-2-2(3)(viii), III-1-2-3(2)(xiii), III-1-2-1(3)(vii) and III-1-2-2(2)(iv), or III-1-2-3(3)(v). These viewpoints are merely illustrated as examples of the points that the regulator may check to determine whether the qualifications set forth in Article 7-2 of the Banking Act are adequately considered in each bank's process of appointing those executives or members, while paying due regard to individual bank's initiatives for operating such process. Therefore, such viewpoints are neither offered as a checklist nor intended to mean that the compliance with or failure to comply with any specific item on the list will immediately affect whether to qualify or disqualify. While those viewpoints may be informative for banks, individual banks are expected to be creative and to make right judgments on their respective responsibility, taking into comprehensive consideration the respective candidates' capabilities in light of the circumstances at the time of deciding a proposal for appointment of directors, company auditors, or audit committee members or appointing executive officers or audit and supervisory committee members. Then, banks are expected to fulfill accountability when filing an application for license, submitting a notification on appointment of directors, executive officers, company auditors, audit committee members, or audit and supervisory committee members or communicating with the FSA in any other opportunities. (cf. Forms 1-1, 1-1[2], 4-10-1-1 to 4-10-3-2, 4-10-5-1 and 4-10-5-2 in the Forms and Reference Information and Reference Information/).

- (4) If the bank has violated any applicable law, the Articles of Incorporation, or an administrative action imposed by the Prime Minister, or committed any act detrimental to public interests and such situation is determined to be primarily attributable to a certain incompetent director, executive officer, company auditor, audit committee member, or audit and supervisory committee member serving in the bank basically on a full-time basis, or if the bank's financial auditor has breached the professional duty or failed to perform any duty for any reason attributable to the financial auditor, the FSA will consider whether to order a bank to dismiss the director, executive officer, company auditor, audit committee member, audit and supervisory committee member or financial auditor, as the case may be, pursuant to Article 27 of the Banking Act.

## III-2 Financial Soundness

### III-2-1 Capital Adequacy

### III-2-1-1 Appropriateness and Sufficiency of Capital

#### III-2-1-1-1 Background

To ensure the confidence of depositors and other stakeholders in banking services, it is extremely important for Major Banks to reinforce their capital base and maintain a solid financial foundation capable of addressing various types of risks. For this purpose, Major Banks need to have a process for evaluating firm-wide capital adequacy based on risk profiles and to take appropriate measures to maintain capital that is sufficient qualitatively and quantitatively.

#### III-2-1-1-2 Major Supervisory Viewpoints

##### III-2-1-1-2-1 Directors and the Board of Directors

- (1) Do the bank's directors understand the characteristics and levels of various risks taken by the bank and the relations between risks and required levels of adequate capital?
- (2) To achieve strategic goals, commensurate capital planning is essential. Do directors and the board of directors understand this and formulate appropriate capital plans in line with the established strategic goals?
- (3) When formulating a business plan, does the board of directors analyze the amounts of capital base needed at the present and in the future in the context of the strategic goals? Does such business plan show the outlines of a desired level of capital base, the amounts of capital that need to be raised, and suitable ways to raise capital in light of the strategic goals?
- (4) Are directors adequately involved in the process for evaluating firm-wide capital adequacy based on risk profiles and the effort to take appropriate measures to maintain capital that is sufficient both qualitatively and quantitatively?
- (5) The Basel Committee on Banking Supervision issued "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" in December 2010 ("Basel III") and "Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement" in July 2011; these two documents and other related accords established by the Basel Committee on Banking Supervision are hereinafter referred to as "Basel Accords." The Basel Accords require the phase-in of capital buffers from 2016. When a bank subject to international standards ("internationally active bank") is to formulate a capital plan, do its directors and board of directors take such capital buffers into full consideration?

- (1) Is the bank's scheme for assessing firm-wide capital adequacy in light of its risk profiles designed properly? To be more specific, does it incorporate all the following factors?
  - (i) Policies and procedures to identify, evaluate, measure, and report all sorts of risks
  - (ii) Processes for assessing capital adequacy in comparison with the risks identified, evaluated, and measured as above
  - (iii) Processes for setting a target capital base in comparison with the risks identified, based on its strategic goals and business plans
  - (iv) Processes for internal controls, including the verification by the internal control department for the purpose of ensuring the adequacy of the bank's overall risk management processes
  
- (2) Since the Public Notice on Standards for Banks has been issued to regulate internationally active banks in accordance with the purport of the Basel Accords, those banks are required to keep their Common Equity Tier 1 capital, Tier 1 capital, and total capital above the levels specified in the Public Notice. In addition, banks subject to domestic standards ("domestically active banks") also are required to hold capital base above the level specified in the Public Notice on Standards for Banks. When such internationally active bank or domestically active bank assesses its capital adequacy, are both the quantity and quality of equity capital analyzed? Do such qualitative analyses cover at least the following points?
  - (i) Does the internationally active bank's Common Equity Tier 1 capital or the domestically active bank's capital base consist of common shares as the primary component of the bank's shareholders' equity? And do the stated capital, capital surplus, and retained earnings pertaining to common shares become a major part of the bank's shareholders' equity?
  - (ii) If the bank is an internationally active bank, isn't there any risk that could significantly affect the bank's Common Equity Tier 1 ratio? Such risk will increase if the bank's Common Equity Tier 1 capital becomes over-dependent on accumulated other comprehensive income, e.g., valuation difference on available-for-sale securities.
  - (iii) Are an internationally active bank's common shares, Additional Tier 1 capital instruments, and Tier 2 capital instruments or a domestically active bank's common shares and mandatorily convertible preferred shares fully compliant with the requirements specified in the Public Notice on Standards for Banks? And do they fully conform to the purport of the Basel Accords?
  - (iv) Do the bank's common shares consist of a single class of voting shares? If the bank issues shares of a certain class with restrictions on the capacity of exercising voting rights at the shareholders meeting and such shares are to be treated as common shares for the purpose of application of the Public Notice on Standards for Banks, are such shares identical to voting common shares of the bank in all respects except the absence of voting rights? And do those shares satisfy all the



requirements specified in the Public Notice?

- (v) Has the bank funded any holder for acquisition of the bank's instruments, either directly or indirectly? Have those instruments been acquired by any of the bank's subsidiaries or affiliates?
- (vi) If a capital instrument is issued in exchange for non-cash assets contributed, are the values of those assets calculated properly? And has the competent authority approved such contribution in kind?

(3) Deferred tax assets

If the bank records a large amount of deferred tax assets or its amount makes up a significant proportion of the bank's capital base, this may pose a problem in the bank's soundness in terms of the quality of its capital base. Such situation means that the bank is financially vulnerable because the total value of its assets depends on future taxable income. In this view, deferred tax assets must be properly processed and recorded in accordance with accounting standards for tax effect accounting and other applicable practices.

- (4) Based on the Basel Accords, internationally active banks are required to build up capital conservation and countercyclical buffers to keep the Common Equity Tier 1 above the levels specified in the Public Notice on Standards for Banks. With regard to the G-SIBs designated under the Public Notice on Standards for Banks or the banks or bank holding companies designated under Article 2-2(5)(ii) of the Public Notice on Standards for Banks or Article 2-2(5)(ii) of the Public Notice on Standards for Bank Holding Companies ("D-SIBs designated under the Public Notice"), each such bank is required to build up buffers (which may be called G-SIB buffers or D-SIB buffers) in order to hold Common Equity Tier 1 capital exceeding the levels specified in the Public Notice on Standards for Banks.

A capital conservation buffer is a capital buffer that can be used to absorb losses in periods of financial or economic stress.

A countercyclical buffer is a buffer that is required to be built up when credit growth is excessive in the financial market in order to cover potential losses from future economic fluctuations. A firm's countercyclical buffer is calculated by adding up the buffer for each of the jurisdictions to which the firm has credit exposures. The buffer for each jurisdiction is obtained by multiplying the ratio specified by the financial regulator in each jurisdiction by the total amount of assets with credit risk that the firm holds (excluding exposures to sovereigns and exposures to financial institutions; hereinafter the same applies in this (4)) in the jurisdiction divided by the total amount of assets with credit risk of the firm. A countercyclical buffer rate is a rate specified by the Commissioner of the FSA under Article 2-2(4)(i) of the Public Notice on Standards for Banks or Article 2-2(4)(i) of the Public Notice on Standards for Bank Holding Companies. Such countercyclical buffer rates are determined after comprehensively considering the indicators determined appropriate by the FSA (e.g., the ratio of total credit to GDP, the lending diffusion index for financial institutions) and the results of discussions with the Bank of Japan. If the FSA raises a countercyclical buffer rate, the new

rate will become effective within one year after its public announcement. If a countercyclical buffer rate is reduced, the new rate will become effective from the date of its public announcement. {This is confined to financial institutions that have applied new regulations (i.e, items (xxii) and (xxiii) of the FSA Public Notice which were published in April 28th of 2022; the same applies hereinafter). In this regard, however, financial institutions that have not yet applied the new regulations follow the previous cases.}

G-SIB buffers and D-SIB buffers are set with the intention of obligating G-SIBs designated under the Public Notice on Standards for Banks and D-SIBs designated under the Public Notice to reinforce their capital base to enhance loss absorbing capacity. This requirement aims at decreasing the possibility of failure of such banks or bank holding companies, since they are systemically important. Therefore, the buffer requirements are supposed to be specified by the Public Notice based on systemic importance.

The assessment of systemic importance for designating domestic systemically important banks (D-SIBs) is conducted by the regulator in each jurisdiction. In the process of assessing systemic importance in Japan, the banks and other financial institutions with consolidated total assets of not less than 15 trillion yen are listed and examined. Each bank is scored using 13 indicators pertaining to the four categories of systemic importance specified in the Basel Accords; i.e., size, interconnectedness, substitutability/financial institution infrastructure, and complexity. In addition to this score, the importance in a specific market or other factors peculiar to each entity are examined if the bank is an entity subject to the international uniform standards (including bank holding companies). After comprehensively considering the scores and other firm-specific factors, entities found to be systemically important are designated as D-SIBs. If such D-SIBs are a bank or bank holding company, their designation will be enforced under the Public Notice on Standards for Banks or the Public Notice on Standards for Bank Holding Companies.

The 13 indicators pertaining to the four categories of systemic importance specified in the Basel Accords and the weight applied against each indicator for calculating the score are as shown in the following table.

Category	Evaluation indicator	Weight
Size	Total exposures (*) as defined for use in the Basel III leverage ratio	25%
Interconnectedness	Total amount (*) of intra-financial system assets as listed below: <ul style="list-style-type: none"> <li>● Deposits and loans receivable from other financial institutions, etc. (including the unused portion of any commitment line)</li> <li>● Amounts of securities (i.e., secured bonds, unsecured corporate bonds, subordinated bonds, short-term bonds, negotiable certificates of deposit, and shares) issued by other financial institutions, etc. which</li> </ul>	5%

	<p>are held by the firm</p> <ul style="list-style-type: none"> <li>● Exposures of repo-style transactions with other financial institutions, etc. calculated by the current exposure method (performing netting under legally valid bilateral netting agreements, if applicable, and limited to exposures which do not fall below zero)</li> <li>● Fair value of off-exchange derivative transactions or contracts with long settlement periods with other financial institutions, etc. and their add-ons for potential future exposures calculated by the current exposure method (performing netting under legally valid bilateral netting agreements, if applicable, and limited to exposures which do not fall below zero)</li> </ul>	
	<p>Total amount (*) of intra-financial system liabilities as listed below:</p> <ul style="list-style-type: none"> <li>● Deposits and loans payable to other financial institutions, etc. (including the unused portion of any commitment line)</li> <li>● Exposures of repo-style transactions with other financial institutions, etc. calculated by the current exposure method (performing netting under legally valid bilateral netting agreements, if applicable, and limited to exposures which do exceed zero)</li> <li>● Fair value of off-exchange derivative transactions or contracts with long settlement periods with other financial institutions, etc. and their add-ons for potential future exposures calculated by the current exposure method (performing netting under legally valid bilateral netting agreements, if applicable, and limited to exposures which do not exceed zero)</li> </ul>	5%
	<p>Total balance (*) of issued and outstanding securities (i.e., secured bonds, unsecured corporate bonds, subordinated bonds, short-term bonds, negotiable certificates of deposit, and shares)</p>	5%
	<p>Values of shares corresponding to available-for-sale securities with market value</p>	5%
	<p>Excess portions of the total balance of general</p>	5%

	deposits or savings and the like over JPY 10 million, if such total balance exceeds JPY 10 million	
Substitutability/financial institution infrastructure	Aggregate amount of payments settled by the firm via the Bank of Japan Financial Network System (BOJ-NET), the Japanese Banks' Payment Clearing Network or other equivalent payment and settlement system during the most recently closed business year (limited to amounts settled in Japanese yen)	8.33%
	Total balance of trust assets and other assets under custody (limited to those retained for customers resident in Japan)	8.33%
	Aggregate value of bonds and shares underwritten by the firm during the most recently closed business year (limited to those underwritten on the bond market or stock market in Japan)	4.165%
	Aggregated trading volume	4.165%
Complexity	Total balance (*) of notional principal for off-exchange derivative transactions and transactions with long settlement periods with other financial institutions, etc.	8.33%
	Cross-jurisdictional claims	8.33%
	Cross-jurisdictional liabilities	8.33%

\*) Including exposures arising from insurance subsidiaries.

- (5) Internationally active banks are required to hold Tier 1 capital at a level equal to or greater than the level specified in the Public Notice titled "Standards for Determining Soundness of Leverage Levels as Supplementary Indicators for Determining Whether Banks' Capital Adequacy is Appropriate in Light of Assets, etc. Held by Banks in Accordance with the Provisions of Article 14-2 of the Banking Act" (hereinafter referred to as the "Public Notice on Leverage Ratio") with regard to the leverage ratio, which is a supplementary indicator for determining whether the level of capital adequacy is appropriate and a simple and non-risk-based indicator for restraining excessive accumulation of leverage. Based on the provisions of the proviso to Article 2 of the Leverage Ratio Public Notice, in an exceptional macroeconomic environment in which the Bank of Japan implements a monetary policy that causes a large fluctuation in the amount of financial institutions' deposits with the Bank of Japan, in order to harmonize with the monetary policy implemented by the Bank of Japan, the minimum required ratio shall be revised by excluding the amount of deposits with the Bank of Japan from the total exposure that constitutes the denominator of the leverage ratio, and such ratio shall be separately designated by the Commissioner of the FSA. The revised minimum required ratio shall be revised as appropriate in light of the macroeconomic environment, etc.

### III-2-1-1-2-3 Measures to Maintain Sufficient Capital

- (1) Based on the capital adequacy assessment described above, does the bank carry out proper risk management as described in III-2-3 and take appropriate measures to maintain capital that is sufficient qualitatively and quantitatively?
- (2) To prepare for potential capital shortage, does the bank examine ways to raise capital and estimate amounts that can be raised? In such examinations, does the bank adequately consider its reputation and evaluation in the capital market, a greater likelihood of being more difficult than usual to raise capital if the bank is in a slump due to unexpected losses, and other conceivable factors?

### III-2-1-1-3 Supervisory Approaches and Actions

- (1) Off-site monitoring
  - (i) The regulator conducts interviews with individual firms on the occasion of semiannual settlement and financial reporting to check their capital position and to verify their reported deferred tax assets by reviewing the reasoning and calculation procedures. If the firm is an internationally active bank, the regulator checks its leverage ratios for the two most recent consecutive quarters through the above interviews.
  - (ii) At interviews with banks' top managers conducted whenever necessary or at any other appropriate opportunities, the regulator may confirm their scheme for capital adequacy assessment, internal analyses on capital position in terms of both quality and quantity, future capital policies, and other related issues based on the viewpoints explained in III-2-1-1-2 above.
- (2) Verification of capital instruments to check their eligibility as capital base in the context of regulatory capital requirements

As part of the activities for monitoring capital adequacy assessment, the regulator will verify whether the capital instruments listed below are eligible as capital base in the context of regulatory capital requirements, upon receipt of a notification on issuance of such capital instruments or other arrangement from a firm or on some other occasions. Such verification should be based on the Public Notice on Standards for Banks and the Basel Accords, with the following points in mind.

- (i) Eligibility for inclusion in Additional Tier 1 capital (in light of the international uniform standards)

When the regulator receives a notification pertaining to any instrument eligible for inclusion in Additional Tier 1 capital filed by a bank; i.e., a notification on increase of the stated capital set forth in Article 53(1)(iv) of the Banking Act, a notification on issuance of share options or bonds with share options set forth in item (ii) of Article 35(1)(ii) of the Banking Act Enforcement

Regulation, a notification on borrowing in the form of a subordinated loan set forth in item (xxxii) of the same article (“Subordinated Loan”) or issuance of subordinated corporate bonds set forth in the same item (“Subordinated Bonds”), or a notification on fund-raising through a “consolidated subsidiary corporation, etc.” established by the bank exclusively for the purpose of raising capital for the bank as set forth in item (xlii) of the same article (“Special Purpose Company”), or when any other similar event occurs, the regulator will verify whether or not the instrument covered by such notification is eligible for inclusion in Additional Tier 1 capital. The points to note in such verification are as follows.

- (A) Dividends of surplus or interest paid for instruments eligible for inclusion in Additional Tier 1 capital cannot exceed the limits of the distributable amounts calculated pursuant to the law. Therefore, if the referenced instrument is not classified into shares defined in the Companies Act, the sum of the amounts of interest to be paid for such instrument and the bank’s other capital instruments of the same priority in receiving interest and the amounts of dividends of surplus to be distributed for the bank’s shares (excluding the amounts of surplus reduced for such payments or distributions) cannot exceed the distributable amount to be calculated in accordance with the Companies Act as of each interest payment date specified for the referenced instrument. Do the terms and conditions for the referenced instrument specify that the payments of dividends of surplus and interest adhere to the limitations explained above?

Note: When the bank is to decide the amount of dividends of surplus to be distributed for its shares (including instruments eligible for inclusion in Additional Tier 1 capital or Tier 2 capital), the bank needs to substantially consider the amounts of interest for the instruments eligible for inclusion in Additional Tier 1 capital which are not recognized as shares under the Companies Act, in the context of calculating the bank’s distributable amount pursuant to the Companies Act. This derives from the characteristics of the scheme peculiar to such capital instruments.

- (B) When the bank is to decide the terms and conditions for redemption in accordance with Article 6(4)(v) of the Public Notice on Standards for Banks, the provisions concerning confirmation prior to a redemption to be performed at the bank’s discretion should be described in a way consistent with the Public Notice on Standards for Banks and the instructions described in III-2-1-1-3(3) below.
- (C) If an instrument eligible for inclusion in Additional Tier 1 capital is a capital instrument with debt-like features (hybrid debt capital instrument) as referred to in Article 6(4)(xi) of the Public Notice on Standards for Banks, the terms and conditions for such instrument need to contain a special clause to prepare for a situation where the Common Equity Tier 1 ratio on a consolidated basis may fall below a specified level (“Going-concern Ratio”). Under such special clause, the issuer of the instrument will be entitled to write down the principal or convert the instrument to common shares, either in full or at an amount necessary for

bringing the Common Equity Tier 1 ratio on a consolidated basis to the Going-concern Ratio (“Principal Write-down or Equity Conversion”). Therefore, do the special clauses or other provisions for the referenced instrument satisfy all of the following requirements?

Meanwhile, the full amount of the referenced instrument may not necessarily be included in the basic elements of Additional Tier 1 capital. On the assumption that a Principal Write-down or Equity Conversion is implemented for the full principal amount for the referenced instrument, only a reasonably estimated amount of Common Equity Tier 1 capital on a consolidated basis to be generated from such Principal Write-down or Equity Conversion can be recognized as the amount to be included in Additional Tier 1 capital.

- a. Is the Going-concern Ratio set at 5.125% of the Common Equity Tier 1 ratio on a consolidated basis or higher? Whether or not the Going-concern Ratio is maintained will be judged based on the Common Equity Tier 1 ratio on a consolidated basis as listed below. In the event that the Common Equity Tier 1 ratio on a consolidated basis falls below the Going-concern Ratio and a Principal Write-down or Equity Conversion follows, will the bank be obligated to immediately announce this situation to the public and notify the holders of the instrument?
  - i) The Common Equity Tier 1 ratio on a consolidated basis provided in an annual financial flash report or interim financial flash report
  - ii) The Common Equity Tier 1 ratio on a consolidated basis provided in an annual business report or interim business report
  - iii) The Common Equity Tier 1 ratio on a consolidated basis reported to the regulator after public disclosure in accordance with the law or relevant regulations of a financial instruments exchange, if applicable
  - iv) The Common Equity Tier 1 capital ratio on a consolidated basis reported to the regulator at any time other than i) to iii), after consultation between the bank and its audit corporation or other external auditor based on the regulator’s inspection findings or other feedback

However, the bank will be allowed to avoid a Principal Write-down or Equity Conversion if the FSA has received and approved a plan to increase the bank’s Common Equity Tier 1 ratio on a consolidated basis to the Going-concern Ratio, without performing such Principal Write-down or Equity Conversion, before the FSA is to receive a report on the Common Equity Tier 1 ratio on a consolidated basis described in i) to iii) above because the FSA determines that such plan is reasonable and feasible.

Note: To meet the Additional Tier 1 criteria in relation to the bank’s capital ratio on a solo (unconsolidated) basis, its Common Equity Tier 1 ratio on a solo basis must be at least 5.125%, which is set as the Going-concern Ratio referred to in Article 18(4)(xi) of the Public Notice on Standards for Banks

- b. If there is a special clause concerning a principal write-down, does the clause satisfy all of the following requirements?

- If principal is to be written down, the value pertaining to the right to demand distribution of residual assets or the principal amount, the amount of redemption, and the amount of dividend of surplus or interest payable must be reduced accordingly.
  - A principal write-down may be followed by a write-up to recover the whole or part of the principal amount previously written down, subject to fulfillment of predetermined conditions. If the bank adopts such write-up mechanism, writing up principal should be allowed only when there is a high degree of probability that the Common Equity Tier 1 ratio on a consolidated basis can remain at a satisfactory level after the intended write-up. Therefore, such requirement should be clearly specified as a precondition for a write-up.
- c. If there is a special clause concerning conversion to common shares, does the clause satisfy all of the following requirements?
- In the event of failure to keep the Going-concern Ratio, the amounts of shares to be converted and other conditions for the conversion must be immediately determined and the amount so determined or the full amount of the referenced instrument eligible for inclusion in Additional Tier 1 capital must be immediately converted to common shares in accordance with applicable laws and regulations.
  - Appropriate minimum conversion prices must be set in order to avoid going over the total number of shares that the bank is authorized to issue under its Articles of Incorporation even after common shares are issued or granted in the wake of failure to keep the Going-concern Ratio. In addition, the total number of authorized shares must be set at a sufficient number in the Articles of Incorporation.
- (D) If the terms and conditions for the referenced instrument contain a special clause for enforcing a Principal Write-down or Equity Conversion upon occurrence of a Trigger Event (as defined in the subsequent sentence), this clause must conform to the Annex to Basel III entitled “Minimum Requirements to Ensure Loss Absorbency at the Point of Non-Viability” issued by the Basel Committee on Banking Supervision in January 2011 and all the requirements listed below. In this regard, a Trigger Event means a situation where the regulator determines that the bank needs to enforce a Principal Write-down or Equity Conversion or to receive public-sector financial assistance pursuant to the main provision of Article 6(4)(xv) or other provisions of the Public Notice on Standards for Banks because it is found that the bank would become non-viable without such Principal Write-down or Equity Conversion or financial assistance.
- a. If the referenced instrument is supposed to be converted to the bank’s common shares upon occurrence of a Trigger Event, the bank must maintain at all times all prior authorization necessary to immediately issue common shares to the holders of the instrument in accordance with applicable laws and regulations. In the event that public-sector financial assistance or other equivalent arrangement is required, such issuance of new shares must occur prior to the public-sector financial assistance or equivalent arrangement.



- b. If the bank intends to include a capital instrument issued by any of its overseas subsidiaries (excluding Special Purpose Companies) in the basic elements of Additional Tier 1 capital for the purpose of calculating the bank's capital adequacy ratio on a consolidated basis, the terms and conditions for the instrument must contain a special clause concerning a Principal Write-down or Equity Conversion. To be more specific, when either or both of the regulator in the jurisdiction where the overseas subsidiary is based and the regulator in Japan determine that the subsidiary needs to enforce a Principal Write-down or Equity Conversion or to receive public-sector financial assistance because the regulator finds that the subsidiary would become non-viable without such Principal Write-down or Equity Conversion or financial assistance, this arrangement will need to be immediately enforced pursuant to applicable laws and regulations. In this event, the bank will not be precluded from issuing its own common shares to the holder of the instrument, instead of the subsidiary's common shares.

If the bank cannot not incorporate a special clause prescribed in Article 6(4)(xv) of the Public Notice on Standards for Banks in a situation where the bank is subject to the proviso of the same article or other provisions of the Public Notice on Standards for Banks or any other applicable laws and regulations, the bank will be required to disclose the principle explained in the subsequent sentence at the time of issuing the instrument in question. According to the principle to be disclosed, a measure corresponding to a Principal Write-down or Equity Conversion will be implemented pursuant to applicable laws and regulations, or the instrument in question will fully absorb losses arising in the bank before public-sector capital is injected or other equivalent financial assistance is provided to the bank.

- (E) If the bank intends to issue an instrument eligible for inclusion in Additional Tier 1 capital through a Special Purpose Company, the procedures for verifying the eligibility for inclusion in Additional Tier 1 capital explained in (A) to (D) above must be carried out for both the instrument to be issued by the Special Purpose Company and the instrument to be issued for utilizing the proceeds from the Special Purpose Company's issue.

Note: One example for the points to check is the definition of Trigger Events for the instrument to be issued by the Special Purpose Company. If the Special Purpose Company's parent corporation faces a Trigger Event, it must be treated as a Trigger Event for the Special Purpose Company as well.

- (ii) Eligibility for inclusion in Tier 2 capital (in light of the international uniform standards)

When the regulator receives a notification filed by a bank in connection with any of its instruments eligible for inclusion in Tier 2 capital; i.e., a notification on increase of the stated capital set forth in Article 53(1)(iv) of the Banking Act, a notification on issuance of share options or bonds with share options set forth in item (ii) of Article 35 (1) of the Banking Act Enforcement Regulation, a notification on borrowing in the form of a Subordinated Loan or issuance of Subordinated Bonds set forth in item (xxxii) of the same article, or a notification on capital-raising through a Special Purpose Company set forth in item (xlii) of the same article, or

when any other similar event occurs, the regulator will verify whether or not the instrument covered by such notification is eligible for inclusion in Tier 2 capital in the context of regulatory capital requirements. The points to note in such verification are as follows.

- (A) Regarding the priority in distributions in the bankruptcy proceedings, the right to claim payment for the holders of the referenced instrument (subordinated creditors) must be subordinated to other subordinate bankruptcy claims prescribed in the Bankruptcy Act. Are the provisions to this effect contained in the terms and conditions for the referenced instrument? In addition, upon occurrence of corporate reorganization, civil rehabilitation, or any other event causing subordination, subordinated creditors' claims for payment will be suspended and subsequently become enforceable on condition that all payments to senior creditors will have been completed. Is the referenced instrument designed as a conditional claim described above to ensure that senior creditors will eventually be given priority in payment or distribution of interest, dividends, or other assets?
- (B) Do the terms and conditions for the referenced instrument contain such provisions to prohibit or invalidate any change, revision, or modification that may be detrimental to senior creditors or in contradiction to the subordination requirements?
- (C) When the bank is to decide the terms and conditions for redemption or cancellation in accordance with Article 7(4)(v) of the Public Notice on Standards for Banks, the provisions concerning confirmation prior to a redemption or cancellation to be performed at the bank's discretion should be described in a way consistent with the Public Notice on Standards for Banks and the instructions described in III-2-1-1-3(3) below.
- (D) If the terms and conditions for the referenced instrument contain the special clauses or other provisions prescribed in Article 7(4)(x) or other provisions of the Public Notice on Standards for Banks, the points explained in III-2-1-1-3(2)(i)(D) above must be noted.
- (E) If the bank intends to issue an instrument eligible for inclusion in Tier 2 capital through a Special Purpose Company, the procedures for verification of the eligibility for inclusion in Additional Tier 1 capital or Tier 2 capital explained in III-2-1-1-3(2)(i)(A) to (D) or III-2-1-1-3(2)(ii)(A) to (D) above must be carried out for both the instrument to be issued by the Special Purpose Company and the instrument to be issued for utilizing the proceeds from the Special Purpose Company's issue.

Note: One example for the points to check to verify the points described in (2)(i)(D) or (2)(ii)(D) above is the definition of Trigger Events for the instrument to be issued by the Special Purpose Company. If the Special Purpose Company's parent corporation faces a Trigger Event, it must be treated as a Trigger Event for the Special Purpose Company as well.

(iii) Adequacy of capital instruments verified under the former notifications

To verify the adequacy of some capital instruments issued before the release of these Supervisory

Guidelines, FSA officials need to refer to III-2-1-1-3(2) of the Supervisory Guidelines of a version prior to the revision by the Partial Amendment of the Comprehensive Guidelines for Supervision of Major Banks announced by the FSA as of August 7, 2012. Such former guidelines apply to the capital instruments issued by internationally active banks on or before March 30, 2013 which are not eligible for inclusion in Additional Tier 1 capital or Tier 2 capital and the capital instruments issued by domestically active banks on or before March 30, 2014 which are not classified into either common shares or mandatory convertible preferred shares. Regarding such capital instruments, the eligibility as qualifying Tier 1 capital instruments or qualifying Tier 2 capital instruments or the eligibility as qualifying perpetual preferred stock or capital instruments respectively should be checked under the former framework of regulatory capital requirements.

- (3) Verification of the capital adequacy in the event of non-mandatory redemption, cancellation, or buy-back
  - (i) When the regulator is to accept a notification filed by a bank pursuant to Article 35(1) of the Banking Act Enforcement Regulation; i.e., a notification on accelerated redemption of bonds with share option set forth in item (ii)-2, a notification on accelerated repayment of a Subordinated Loan or accelerated redemption of Subordinated Bonds set forth in item (xxxiii), a notification on acquisition of treasury shares set forth in item (xxxiv), a notification on acquisition of shares subject to call set forth in item (xxxv), a notification on acquisition of shares subject to class-wide call set forth in item (xxxvi), or a notification on accelerated payment or accelerated redemption of any instrument issued by a Special Purpose Company set forth in item (xlili), the regulator will verify whether the capital adequacy ratio can remain at a satisfactory level even after such accelerated payment or redemption (or the discretionary repayment or redemption, in case of an instrument with no maturity date) or even after such acquisition of shares. Such verification should be based on the Public Notice on Standards for Banks and the Basel Accords.
  - (ii) When an internationally active bank intends to redeem, cancel, or buy back the referenced instrument eligible for inclusion in Additional Tier 1 capital or Tier 2 capital before maturity, or when a domestically active bank intends to redeem, cancel, or buy back mandatory convertible preferred shares, the regulator will need to check whether the terms and conditions for such accelerated redemption, cancellation, or buy-back are appropriate in terms of the issuer's profitability and verify whether capital to replace the redeemed, bought back, or canceled instrument is going to be raised before the intended redemption, cancellation, or buy-back (on condition that the new capital must be the quality same as or better than the quality of the redeemed, canceled, or bought back instrument). The points to note in such verification are as follows.
    - (A) If new capital needs to be raised to redeem, cancel, or buy back the referenced instrument, was such capital-raising completed before the redemption, cancellation, or buy-back? Or is such capital-raising going to be surely completed before the redemption, cancellation, or

buy-back is enforced? If the new capital-raising has been completed, does the bank face any situation that is likely to make it difficult for the bank to maintain its capital adequacy ratio at a satisfactory level? In the case where the bank raises new capital (substituting capital) to redeem, cancel, or buy back the instrument eligible for inclusion in Additional Tier 1 capital (if it is an internationally active bank) or the mandatory convertible preferred shares (if it is a domestically active bank), the paid-in amount cannot be included in the bank's capital during the period from the date of acquisition of substituting capital to the date of redemption, cancellation, or buy-back, except for the portion in excess of the amount scheduled to be redeemed, canceled, or bought back.

- (B) Isn't the redemption, cancellation, or buy-back of the referenced instrument exclusively intended to respond to the holders' expectations for payouts? For example, if the interest rate for the instrument issued for raising new capital (substituting capital) is substantially higher than the rate for the instrument redeemed, canceled, or bought back, is such new capital-raising justifiable regardless of an increased burden of interest payment on the part of the bank?
  - (C) Are the bank's interest payments for the instrument issued for raising new capital (substituting capital) feasible in light of the bank's profit forecast as well as its financial strength to maintain capital adequacy?
- (iii) To verify the adequacy of some capital instruments issued before the release of these Supervisory Guidelines on the occasion of receiving a notification on redemption before maturity, buy-back, or other cancellation, FSA officials need to refer to III-2-1-1-3(3) of the Supervisory Guidelines of a version prior to the revision by the Partial Amendment of the Comprehensive Guidelines for Supervision of Major Banks announced by the FSA as of August 7, 2012. Such former guidelines apply to the capital instruments issued by internationally active banks on or before March 30, 2013 which are not eligible for inclusion in Additional Tier 1 capital or Tier 2 capital and the capital instruments issued by domestically active banks on or before March 30, 2014 which are not classified into either common shares or mandatory convertible preferred shares.

(4) Verification of firms' efforts to maintain quality of equity capital and their capital policies

With a view to adherence to the capital adequacy principles and maintenance of the quality of capital, firms will be asked to submit the documents explaining the matters listed below whenever they implement a capital increase (including issuance of an instrument eligible for inclusion in Additional Tier 1 capital or Tier 2 capital).

- (A) Reasons for choosing such instrument, in comparison with other types of instruments
- (B) Appropriateness of valuation of the assets if non-cash assets are contributed
- (C) Plan for future capital policies (including alternative capital-raising plans)

Note: Regarding compliance management in capital increase (including issuance of instruments eligible for inclusion in Additional Tier 1 capital or Tier 2 capital), see III-3-1-5.

(5) Supervisory actions

If the FSA determines, as a result of conducting interviews or monitoring described in (1) to (4) above, that the bank needs to take improvement measures, the regulator may ask the bank to submit a report pursuant to Article 24 of the Banking Act, as needed. If the problem faced by the bank is considered critical, the FSA will issue a business improvement order or implement any other measures pursuant to Article 26 of the Banking Act (or an order for prompt corrective action (as explained in III-2-1-3) pursuant to Article 26(2) of the Banking Act, as needed in terms of the adequacy of the bank's equity capital).

(6) Points to note in the context of the Banking Act on Special Measures for Strengthening Financial Functions

When applying the Banking Act on Special Measures for Strengthening Financial Functions to Major Banks, relevant instructions specified in the Comprehensive Guidelines for Supervision of Regional Financial Institutions must be followed.

III-2-1-2 Accuracy of Capital Adequacy Ratios and Leverage Ratios

III-2-1-2-1 Background

Accurately calculating capital adequacy ratios and leverage ratios is of utmost importance because they are basic indicators representing the financial soundness of banks.

The accuracy of calculations of capital adequacy ratios and leverage ratios should conform to the Public Notice on Leverage Ratio and the purport shown in the Basel Accords.

III-2-1-2-2 Points to Note

Each firm's capital adequacy ratios and leverage ratios are calculated based on its consolidated financial statements in accordance with the calculation rules, and such consolidated financial statements are prepared in conformity with Japan's various ordinances and regulations concerning consolidated financial statements. In addition to this, the points listed below, among others, should be considered when checking the accuracy of calculations of capital adequacy ratios and leverage ratios.

- (1) Does the firm undergo external audits on the calculation of capital adequacy ratios and leverage ratios? External audits on the calculation of capital adequacy ratios and leverage ratios refer to external audits or other equivalent processes compliant with Practical Guideline No. 30 issued by the Industry Audit Committee established by the Japanese Institute of Certified Public Accountants entitled "Instructions for Examination and Audit Services on Calculation of Capital Adequacy Ratios through Agreed-upon

Procedures” or other appropriate guidelines.

(2) Adequacy of capital instruments intentionally held within the financial system

If members in the financial system reciprocally hold other members’ capital instruments with the intention of increasing their respective capital adequacy ratio, such instruments will eventually constitute unsubstantial capital. Since such reciprocal capital holdings will make the financial system fragile, a mechanism of regulatory adjustments and deductions to exclude such reciprocally held portions from the firm’s capital base is provided in Article 8(6), Article 29(4) or other provisions of the Public Notice on Standards for Banks in line with the Basel Accords. If it is determined that a bank holds a capital instrument issued by another financial institution to increase the capital adequacy ratio and that this firm holds a capital instrument issued by the bank first mentioned or its consolidated corporation, etc. (“Intentional Reciprocal Holdings”), the bank will be required to exclude the full amount of that firm’s capital instrument held by the bank or its corporation, etc. from the bank’s capital base as regulatory adjustments or deductions. While the regulator checks whether or not banks’ capital holdings fall under Intentional Reciprocal Holdings, the sample cases illustrated below are considered to constitute Intentional Reciprocal Holdings.

(A) On or after July 31, 1997, the bank or its subsidiary and a certain deposit-taking institution in Japan promised to mutually hold the other party’s capital instrument. The primary purpose of such cross holdings is to mutually cooperate on capital reinforcement. To this end, the bank or subsidiary holds an instrument of the deposit-taking institution and this firm holds an instrument of the bank or subsidiary.

(B) On or after December 17, 2010 (in case of an internationally active bank) or on or after December 12, 2012 (in case of a domestically active bank), the bank or its subsidiary and another financial institution which is not a deposit-taking institution in Japan promised to mutually hold the other party’s capital instrument. The primary purpose of such cross holdings is to mutually cooperate on capital reinforcement. To this end, the bank or subsidiary holds an instrument of the financial institution and this firm holds an instrument of the bank or subsidiary.

\* If the financial institution in question does not hold any instrument of the bank or its subsidiary, this case does not constitute Intentional Reciprocal Holdings. In addition, each party’s holdings of the other party’s instrument are not regarded as Intentional Reciprocal Holdings in the case where such holdings are not intended to cooperate for the other party’s capital reinforcement (for example, where each firm has separately acquired the other firm’s instrument in the trading market and continues to hold it purely for investment purposes, or where the mutual holdings are solely intended to promote their business alliance, or where a bank’s subsidiary which is a securities firm tentatively holds the other firm’s instrument for market-making purposes).

\*\* If the bank is a domestically active bank, regulatory capital adjustments and deductions will apply to the following amounts, in addition to the amounts of Intentional Reciprocal Holdings as explained above: amounts of common shares or other instruments of financial institutions,

etc. held as a minority interest holder which are recognized as adjustment or deduction items in core capital, amounts above the limit of 10% of common equity which are recognized as specified adjustment or deduction items, or amounts above the limit of 15% of common equity which are recognized as specified adjustment or deduction specified items. If the differences arising from mark-to-market valuation of the amounts of common shares or other capital instruments listed in the preceding sentence are recognized as valuation difference on available-for-sale securities and then recorded under accumulated other comprehensive income or under valuation and translation adjustments, such common shares or capital instruments will be included at their book value, without mark-to-market valuation, for the purpose of regulatory capital calculations.

(2-2) Verification of capital investments in other financial institutions subject to regulatory capital adjustments and deductions

According to Article 8(12)(i), Article 20(9)(i), Article 29(9)(i), or Article 41(8)(i) of the Public Notice on Standards for Banks, if banks are to hold a certain capital instrument for the purpose of providing financial assistance to bail out or liquidate a non-viable firm, the bank may, for a period to be approved, be allowed to exclude such instrument in the calculation of the amounts of adjustment or deduction items in Common Equity Tier 1 capital, Additional Tier 1 capital, Tier 2 capital, or core capital, subject to the Commissioner of the FSA 's approval to be given after examining special circumstances leading to such financial assistance or other relevant factors.

In this event, whether or not it is extremely difficult for the firm in question to survive will be determined, taking into comprehensive consideration the financial standing and business performance of the issuer of the instrument, economic conditions, business environments, and other factors at the time of the bank's acquisition of the issuer's instrument. Conceivable issuers of such instrument may include financial institutions which are likely to suspend repayments of deposits or payments of other obligations in light of their business performance or financial position or which have already suspended such repayments or payments.

Note: One example of capital instruments described here is an instrument issued by an "assuming financial institution" or "assuming bank holding company, etc." defined in Article 59(1) of the Deposit Insurance Act, which may be held by the bank on the occasion of a merger or other arrangement set forth in Article 59(2) of the same Act, subject to the confirmation of eligibility, etc. of such merger or arrangement as prescribed in Article 65 of the same Act.

The period to be approved for exclusion referred to above should be a reasonable time frame necessary to stabilize the financial system, to be determined based on the factors mentioned above and various other factors including: the issuer's size and presence in the financial system, the type of the instrument and the amount held by the bank, the bank's capital position, the developments until the bank has made a decision to hold the instrument and the purpose of such holding, the relationship between the issuer and the bank,

and all other background information. This time frame is basically set at up to 10 years from the date of acquisition of the instrument, which may be subsequently extended or reduced or accompanied by phase-down of the scope of exclusion to alleviate effects of a drastic change, as appropriate.

If the bank desires to adopt the exclusion explained here, an application for approval of such exclusion must be filed with the FSA, in principle, concurrently with or immediately after its acquisition of the relevant instrument.

Moreover, as for domestically active banks, according to Article 29(9)(ii) or Article 41(8)(ii) of the Public Notice on Standards for Banks, in addition to the above, if a bank is to hold a certain capital instrument for the purpose of providing a potentially non-viable firm with financial assistance or other support for the latter's business improvement, the bank may, for a period to be approved, be allowed to exclude such instrument as well in the calculation of the amounts of adjustment or deduction items in core capital, subject to the Commissioner of the FSA's approval to be given after examining special circumstances leading to such holding of the capital instrument or other relevant factors.

In this event, whether or not the firm in question falls under the category of a potentially non-viable firm will be determined, taking into comprehensive consideration not only the financial standing and business performance of the issuer of the instrument at the time of the bank's acquisition of the issuer's instrument, the economic conditions and business environment, but also sustainable profitability and present and future soundness of the firm to continuously play the role of a financial mediator in the region, and other relevant factors. For example, conceivable issuers of such instrument may include a financial institution of which the capital adequacy ratio might not meet the minimum requirement in a future time unless it receives financial assistance or other support for its business improvement in light of the future earnings trend based on its reasonable business plan, although its capital adequacy ratio does meet the minimum requirement at the time of the bank's acquisition of the issuer's instrument.

The period to be approved for exclusion referred to above should be a reasonable time frame necessary to stabilize the financial system, to be determined based on the factors mentioned above and various other factors, including: the issuer's size and presence in the financial system, the type of the instrument and the amount held by the bank, the bank's capital position, the developments until the bank has made a decision to hold the instrument and the purpose of such holding, business improvement prospects for the issuer in the wake of the bank's temporary holding of the instrument and the subsequent contribution status as a continuing financial mediator in the region, the relationship between the issuer and the bank, and all other background information. This time frame is basically set at up to five years from the date of acquisition of the instrument and it may be subsequently extended or reduced or accompanied by a phase-down of the scope of exclusion to alleviate the effects of a drastic change, as appropriate.

If the bank desires to adopt the exclusion explained here, an application for approval of such exclusion must be filed with the FSA, in principle, concurrently with or immediately after its acquisition of the relevant instrument.



(3) Calculation of risk assets

(i) If a bank's asset has been securitized, regardless of whether or not such securitization is treated as a transfer of an asset in terms of legal formalities, has the bank transferred all risks in relation to the securitized asset to the transferee? This means that the effects of such securitization are required to be substantially equivalent to those of a transfer of the asset.

(ii) Assignment of a claim, subject to the bank's right to buy back the claim, is regarded as a transaction to reduce the bank's risk assets, in principle.

If, however, such assignment occurs around the end of a business year and the bank is given an incentive to exercise the buy-back right within one year following the end of the year under the assignment agreement in question, an effect of reducing risk assets cannot be recognized.

If assignment of a claim along with a buy-back right is implemented in an attempt to temporarily raise the capital adequacy ratio, such assignment shall never bring about reduction in the bank's risk assets under any circumstances.

(iii) If the bank has a claim with a guarantee provided by another financial institution or firm around or at the end of a business year, it can be excluded from the bank's risk assets, in principle, only when the remaining period of the claim is fully covered by the guarantee period.

Nevertheless, even when the unexpired guarantee period does not fully cover the remaining period of the claim, reduction in risk assets may be allowed on condition that such short guarantee is justifiable and reduction of credit risk exposures is reasonably expected.(\*)

If a guarantee agreement has been concluded in an attempt to temporarily raise the capital adequacy ratio, such guarantee shall never bring about reduction in the bank's risk assets under any circumstances.

Note: For the time being, a guarantee agreement with an unexpired period of one year or more is qualified. If, however, an incentive to cancel the guarantee agreement within one year is substantially incorporated in the guarantee agreement even when its unexpired period is one year or more, an effect of reducing risk assets cannot be recognized.

(iv) For the time being, the following rule applies to foreign exchange positions to be covered by the calculation of market risk exposure. Does the bank follow this rule?

● Among gold and foreign exchange positions mentioned in II-2-(3) in Exhibit 3 attached to these Guidelines, investments in foreign currency assets made by injecting and converting yen funds can be excluded from the foreign exchange risk position calculated for regulatory capital purposes. This rule will remain effective from now onward. {Except for the financial institutions that have applied the new regulations - financial institutions that have already applied the new regulations which should refer to the Public Notice after the revision.}

(v) With regard to capital surcharge related to non-performing loans (NPL) exposure, doesn't the bank engage in any acts that fall under regulatory arbitrage?

Especially as for Article 267-4(2) or Article 245-4(2) of the Public Notice on Standards for Bank

Holding Companies' Capital Adequacy, even if the bank meets all the requirements set forth in these provisions, the bank is not allowed to apply the risk weight(s) set forth in these provisions when the bank aims to reduce its risk assets in its loan assets other than NPL.

- (4) Verification of use of the proportional consolidation method in calculating the capital adequacy ratio on a consolidated basis
  - (i) If a bank has filed a notification on use of the proportional consolidation method for affiliated corporations, etc. engaged in financial services, for the purpose of calculating the capital adequacy ratio on a consolidated basis, the points listed below must be noted.
    - (A) Each of the agreements for investments or projects set forth in Article 9(1)(ii)(a) or Article 32(1)(ii)(a) of the Public Notice on Standards for Banks ("Joint Venture Agreement") must be checked in the following respects.
      - a. Do the parties to the agreement include all jointly controlling partners? Do they include any firm that is not a jointly venture partner?
      - b. Does the Joint Venture Agreement stipulate all necessary matters for operating a joint venture? The matters to be covered in the agreement may include the establishment of an affiliated corporation, etc. engaged in the financial services to be operated through the joint venture (the "joint venture company"), issuance of shares, the ratio of voting interest (meaning the ratio of voting rights held as referred to in Article 9(1)(i) of the Public Notice on Standards for Banks; the same applies in III-2-1-2) of each joint venture partner, appointment of officers serving in the joint venture company including those who are dispatched by joint venture partners, and respective partners' involvement in the joint venture company's management (e.g., methods or procedures for resolutions at the shareholders meeting, composition of the board of directors, methods or procedures for board resolutions).
    - (B) In accordance with Article 9(1)(ii)(b) or Article 32(1)(ii)(b) of the Public Notice on Standards for Banks, the joint venture company must be controlled and operated jointly by all the members, based on their ratio of voting interest, pursuant to the Joint Venture Agreement. To verify whether the regime and various systems to ensure such operation are implemented, the points listed below must be checked.
      - a. Is each joint venture partner granted voting rights exercisable at the joint venture company's shareholders meeting or other equivalent body ("Decision-Making Body" in III-2-1-2) in the same proportion as their ratio of voting interest?
      - b. Is each joint venture partner entitled to appoint directors of the joint venture company in the number in proportion to their ratio of voting interest? This means the proportion of the number of directors to be appointed or replaced at each joint venture partner's discretion to the total number of directors specified in the Joint Venture Agreement. If this proportion is not consistent with the joint venture partner's ratio of voting interest, is substantial consistency ensured in some way, for example, in terms of the lineup of the Representative Director, the President, the Chairman, or other senior-level officers?

- c. Is there any mechanism that could change the ratio of voting interest specified in the Joint Venture Agreement without amending the Joint Venture Agreement (except for the case described in (D) below)?
  - d. Does the scope of matters subject to resolutions of the Decision-Making Body or the board of directors and the methods or procedures for resolution conform to the law and the joint venture company's Articles of Incorporation?
  - e. During the course of operating the joint venture company, joint venture partners may need to perform various risk-bearing activities such as additional investments, lending (including such cases where a subsidiary or affiliate of a joint venture partner is a lender), and debt guarantee. Are those actions supposed to be implemented in consistency with their ratio of voting interest? Or is any inconsistency found?
  - f. The joint venture company may be established by incorporating a new entity or taking over a business transferred by any existing firm, or in any various other forms. Regardless of whatever form is used, has the joint venture company obtained a license, permission, authorization, or the like required for operating the business specified in the Joint Venture Agreement and completed other required procedures, if any? Is the joint venture company in operation on the date of the bank's calculation of the capital adequacy ratio?
  - g. With regard to the joint control and operation that must be consistent with the ratios of voting interest specified in the Joint Venture Agreement, are there any inconsistencies?
- (C) When judging whether an agreement falls under an agreement in which the bank makes a commitment to take any liability exceeding its ratio of voting interest in connection with the joint venture company's business as referred to in Article 9(1)(i) or 9(1)(ii)(d) or Article 32(1)(i) or 32(1)(ii)(d) of the Public Notice on Standards for Banks, whether it has been made in writing or orally, or whether it is an express or implied one will not be taken into account.
- (D) The Joint Venture Agreement may allow for changing the ratios of voting interest upon fulfillment of some predetermined conditions. Insofar as such conditions are defined clearly and considered reasonable and those conditions are not obviously fulfilled at the time of the bank's commitment to assume excessive liabilities, this Joint Venture Agreement will not be treated as an agreement involving a specific party's commitment to assume excessive liabilities.
- (E) When judging conformity with the requirements prescribed in Article 9(2) or Article 32(2) of the Public Notice on Standards for Banks, a judgment should be made in light of the principle of consistency prescribed in Article 4(1)(iv) of the Ordinance on Terminology, Forms and Preparation Methods of Consolidated Financial Statements.
- (ii) If the bank uses the proportional consolidation method for its affiliated corporations, etc. engaged in financial services, their assets, liabilities, revenues, and expenses will be included in the scope of consolidation solely to the extent attributable to the bank and its consolidated subsidiaries investing in the affiliated corporations, etc. Except for this point, all other rules are the same as those applicable to full consolidation. However, Japan's accounting system does not adopt the proportional

consolidation method. Due to unfamiliarity coupled with heavier workload for accounting operations under the proportional consolidation method, the firms using a simplified method explained below are deemed to adopt the proportional consolidation method for the time being.

- (A) When the bank is an internationally active bank and uses a simplified method for consolidation of its affiliated corporations, etc. engaged in financial services, those entities' capital instruments (excluding instruments issued by other financial institutions, etc. and held by those affiliated entities for Intentional Reciprocal Holdings; the same applies in (B) to (F) below) can be excluded from the calculation of the amounts of: instruments of other financial institutions, etc. eligible for inclusion in Additional Tier 1 capital set forth in Article 6(2)(iv) or other provisions of the Public Notice on Standards for Banks; instruments of other financial institutions, etc. eligible for inclusion in Tier 2 capital set forth in Article 7(2)(iv) of the Public Notice on Standards for Banks; other eligible instruments of other financial institutions, etc. used in the calculation of the amounts set forth in Article 8(9)(i) and Article 8(10)(i) of the Public Notice on Standards for Banks; and assets with credit risk set forth in Article 76-3 or Article 178-3 of the Public Notice on Standards for Banks. When the bank is a domestically active bank and uses a simplified method for consolidation of its affiliated corporations, etc. engaged in financial services, those entities' capital instruments can be excluded from the calculation of the amounts of: eligible common shares, etc. of other financial institutions, etc. used in the calculation of the amounts set forth in Article 29(6)(i) or Article 29(7)(i) of the Public Notice on Standards for Banks; and assets with credit risk set forth in Article 76-2-3, Article 76-4, Article 178-2-3 or Article 178-4 of the Public Notice on Standards for Banks. In such case, the bank is required to adopt the equity method, regardless of the latter part of the main clause of Article 9(1) or the latter part of the main clause of Article 32(1) of the Public Notice on Standards for Banks. To adopt the equity method, the formula for calculating the capital adequacy ratio on a consolidated basis is used with an adjusted denominator. The denominator in this formula, before making the adjustment as aforesaid, represents the sum of: the amounts of assets with credit risk, an amount obtained by dividing the market risk exposure by 8% (limited to the case where the market risk exposure needs to be included in the denominator in this formula), and an amount obtained by dividing the operational risk exposure by 8%; this definition applies in (B) to (F) below.

Note 1: A simplified method for consolidation incorporates the equity method, in order to recognize affiliated entities' net profit or loss, adjust the value of goodwill, eliminate unrealized gains and losses, eliminate dividends, and process other necessary operations for consolidation.

Note 2: No adjustment is made to the value of the numerator in the formula for calculating the capital adequacy ratio on a consolidated basis. The value of the numerator covers the amount of Common Equity Tier 1 capital, the amount of Tier 1 capital, and the total amount of capital, in case of an internationally active bank, and the capital amount, in case of a domestically active bank.

- (B) The value of the denominator in the formula for calculating the capital adequacy ratio on a consolidated basis is obtained by subtracting the amount stated in a. below from the value of the denominator for the same formula excluding the affiliated corporations, etc. engaged in financial services from the scope of consolidation and then adding the amount stated in b. below.
  - a. Amounts of instruments issued by the affiliated corporations, etc. engaged in financial services (limited to the amounts recorded under the shareholders' equity section)
  - b. An amount obtained by multiplying the sum of the amounts listed below to be calculated based on the balance sheet of each affiliated corporation, etc. engaged in financial services as of the last day of each business year (or the first half of each business year) by the ratio of voting interest
    - i) The value of the denominator for the affiliated corporations, etc. engaged in financial services obtained by applying Articles 10 to 12 or Articles 33 to 35 of the Public Notice on Standards for Banks
    - ii) 1,250% of the sum of the values of such instruments subject to adjustments or deductions in Common Equity Tier 1 capital, Additional Tier 1 capital, or Tier 2 capital as specified in Article 5(2), Article 6(2) or Article 7(2) of the Public Notice on Standards for Banks, in case of an internationally active bank, or 1,250% of the sum of the values of such instruments subject to adjustments or deductions in core capital as specified in Article 28(2) of the Public Notice on Standards for Banks, in case of a domestically active bank
- (C) For the calculation specified in (B)b. above, the bank may choose not to offset claims and obligations outstanding between the bank and each affiliated corporation, etc. engaged in financial services. If choosing to offset those claims and obligations, the value of the denominator referred to in (B)b. above is calculated by deducting the values of the claims held by the bank or the affiliated corporation, etc. engaged in financial services from the total assets.
- (D) With regard to the value referred to in (B)b.i) above, the amounts of assets with credit risk held by each affiliated corporation, etc. engaged in financial services may be calculated by using an amount greater than the amount of assets with credit risk specified in Article 10 of the Public Notice on Standards for Banks.
- (E) With regard to the value referred to in (B)b.ii) above, an amount that is reasonably determined to be greater than the amount shown in (B)b.ii) may be used.
- (F) Does the bank use the proportional consolidation method in conformity with generally accepted accounting principles in all other respects?

(5) Consistency in use of the methods for calculating capital adequacy ratios and leverage ratios

Banks may be given a free hand, to a certain extent, in choosing among the methods for calculating capital adequacy ratios or leverage ratios, including the methods that banks are allowed to use as a transitional measure under the Public Notice on Standards for Banks or the Public Notice on Leverage

Ratio. Does the bank use a specific method consistently, except in the case of a shift to a different method on reasonable grounds?

### III-2-1-2-3 Internal Control over Transactions Subject to Market Risk Regulations

Transactions subject to banking regulations concerning market risk refer to “specified transactions, etc.” defined in Article 10(2)(ii) of the Public Notice on Standards for Banks, mainly consisting of the specified transactions defined in Article 13-6-3(2) of the Banking Act Enforcement Regulation. Specified transactions are transactions conducted by banks for the purpose of earning profits by using short-term movements in interest rates, currency exchange rates, market prices on financial instruments markets, or other indexes, by using differences among markets, or by using other means, or for the purpose of reducing losses that may arise from transactions for such profit-earning purposes. Due to these characteristics, specified transactions are subject to market risk regulations. In this context, the scope of transactions subject to market risk regulations needs to be clearly identified. Then, transactions which do not fall under such transactions (\*), if any, must be eliminated and regulated transactions must be properly managed. In this view, the points listed below need to be checked. {Except for financial institutions that have applied the new regulations.}

- (1) Are the transactions that must be recorded under specified transaction accounts and the methods and procedures for managing such transactions defined clearly and put into writing? Such methods and procedures include those for properly measuring values of transactions based on their respective characteristics and with due consideration for estimated holding periods and the probability of extension of holding periods beyond estimations. Are those accounts properly managed in accordance with the documented methods and procedures? Is such management verified through periodic internal audits? Regarding the methods of measuring values and actual valuations, is their adequacy verified through both internal audits and accounting audits? {Except for financial institutions that have applied the new regulations.}
- (2) If a specified transaction or any other equivalent transaction is managed under any account other than such a specified transaction account, is the transaction managed similarly as in a way in the specified transaction account? {Except for financial institutions that have applied the new regulations.}

Transactions subject to market risk regulations mainly consist of products held and classified into trading accounts by banks in accordance with the relevant provisions set forth in the Public Notice. Transactions included in the trading accounts are transactions that banks conduct for the purpose either of gaining profits by taking advantage of short-term fluctuations or arbitrage opportunities among markets such as differences in interest rates, currency prices, market prices in financial product markets or other indices, or of reducing losses that might be incurred by such transactions. Market risk regulations are applied under the consideration of these characteristics. Accordingly, it is crucial to clarify transactions subject to market

risk regulations and eliminate inappropriate transactions (see Note below). In addition, transactions subject to market regulations need to be properly managed. From these viewpoints, the following point needs to be checked. {Applied to financial institutions that have applied the new regulations}

- Are the transactions subject to market risk regulations and the management procedure for such transactions defined clearly and stated in documents? The management procedure include methods to properly measure values of transactions based on their respective characteristics while considering estimated holding periods and the probability where the holding periods may exceed estimations. Are the management procedures properly operated as described in the document? Is such operations verified through periodic internal audits? Regarding the methods of measuring values and actual valuations, is their appropriateness verified through both internal audits and accounting audits? {Applied to financial institutions that have applied the new regulations}

Note: According to paragraph 271 of the Application of Basel II to Trading Activities and the Treatment of Double Default Effects (issued by the Basel Committee on Banking Supervision in 2005), open equity stakes in hedge funds and private equity investments are exemplified as exposures to be excluded.

#### III-2-1-2-4 Supervisory Approaches and Actions

##### (1) Off-site monitoring

If the FSA's examination in response to an inquiry from a bank finds a problem in relation to the accuracy of its calculation of capital adequacy ratios or leverage ratios, the FSA will inform the bank of examination findings and give a warning to the bank.

- (2) If the FSA's inspection finds a problem in relation to the accuracy of the bank's calculation capital adequacy ratios or leverage ratios, the FSA will ask the bank to make a report pursuant to Article 24 of the Banking Act and urge the bank to make steady improvement. If the FSA determines, because of the graveness of the problem found in such inspection or on any other ground, that more resolute response is needed to ensure the bank's implementation of its improvement plan, the FSA will issue a business improvement order pursuant to Article 26(1) of the Banking Act.

#### III-2-1-3 Order for Prompt Corrective Action

##### III-2-1-3-1 Background

To ensure the financial soundness of banks, it is extremely important for the banks to enhance their capital base and maintain a solid financial foundation capable of addressing various risks at their initiative. To back up such banks' self-initiated efforts, the FSA needs to issue necessary orders for corrective actions

promptly and appropriately and to urge banks to push forward management reforms, effectively using objective indicators such as capital adequacy ratios and leverage ratios.

### III-2-1-3-2 Supervisory Approaches and Actions

Details on orders for prompt corrective action are set out in a government order entitled “Order Providing for the Categories, etc. Prescribed in Article 26, Paragraph (2) of the Banking Act” (Ordinance of the General Administrative Agency of the Cabinet and the Ministry of Finance No. 39 of 2000), which is called the “Categorization Order” in III-2-1-3 and III-2-1-4. Concrete corrective measures required under such orders are treated in the following manner.

#### (1) Levels of capital adequacy ratios or leverage ratios that trigger the issuance of an order for prompt corrective action

The capital adequacy ratio or leverage ratio referred to in each of the categories indicated in the tables in paragraphs (1)(i), (1)(iii), (2)(i), and (2)(iii) of Article 1 of the Categorization Order (“Category Requiring Prompt Corrective Action”) is the capital adequacy ratio or leverage ratio described below.

- (i) The capital adequacy ratio or leverage ratio provided in an annual financial flash report or interim financial flash report, as applicable, which will be subsequently replaced with the capital adequacy ratio or leverage ratio provided in the definitive annual business report or interim business report after its submission to the regulator
- (ii) The capital adequacy ratio or leverage ratio reported by the bank to the regulator, at any time other than annual or interim financial reporting, after consultation between the bank and its audit corporation or other external auditor based on the regulator’s inspection findings or other feedback

Note: The capital adequacy ratios of an internationally active bank consist of the three ratios (Common Equity Tier 1 ratio, Tier 1 ratio, and total capital ratio) and a capital buffer. The capital adequacy ratios used as a trigger for issuing an order for prompt corrective action are Common Equity Tier 1 ratios, Tier 1 ratios, and total capital ratios.

#### (2) Issuance of orders based on the Categories Requiring Prompt Corrective Action

- (i) Difference between Category 1 or Leverage Category 1 orders, Category 2 or Leverage Category 2 orders, and Category 2-2 or Leverage Category 2-2 orders

If a bank falls under Category 1 or Leverage Category 1, the bank will be ordered to submit and implement a reasonable improvement plan (which must include measures for capital enhancement, in principle) to secure sound management. The purpose of this order is to ensure that the bank will surely achieve a level exceeding the range of the capital adequacy ratio specified for Category 1 or the range of the leverage ratio specified for Leverage Category 1,



which serves as a threshold for judging the bank's management soundness. Therefore, emphasis is placed on overall planning to ensure management soundness and the plan is, in principle, supposed to be implemented at the bank's initiative.

If a bank falls under Category 2 or Leverage Category 2, the bank will be ordered to take any of the measures listed in such category. Such order is intended to prompt the bank's efforts to improve its capital base because its capital adequacy ratio or leverage ratio is well below the threshold for ensuring management soundness. While the regulator will ask for the bank's opinions to reflect its actual business conditions in the measure to be ordered, the type of corrective measures to be required will be finally determined at the regulator's discretion. If multiple corrective measures are required to be implemented, the bank must complete each and every one of them based on the order.

If a bank falls under Category 2-2 or Leverage Category 2-2, the bank will be ordered to choose among capital enhancement, drastic reduction of business, merger, or abolition, etc. of banking services and to implement the measure as chosen. Such order is intended to urge the bank to promptly improve its business or to withdraw from banking business because the bank is extremely undercapitalized.

(ii) Time frame for improvement

To enable the bank to improve the capital adequacy ratio or leverage ratio, a sufficient time frame must be set to ensure that the bank will formulate and implement a plan for improving management to maintain or restore the confidence in the bank from depositors, investors, and market participants.

If the bank is an internationally active bank, the restoration of market confidence will be the most urgent priority, depending on the degree of the bank's involvement with the market. In this view, such bank's plan should be designed to aim at a return to a level exceeding the range of the capital adequacy ratio specified for Category 1 or the range of the leverage ratio specified for Leverage Category 1 at least within one year (by the end of the following business year, in principle).

If the bank is a domestically active bank falling under Category 1, its improvement plan should aim at achieving the capital adequacy ratio at 4% or higher within one year, in principle. If the bank is a domestically active bank falling under Category 2 (requiring capital enhancement) or Category 2-2 (requiring capital enhancement, drastic reduction of business, merger, or abolition, etc. of banking services) and chooses a measure which is neither a merger resulting in dissolution of the bank nor abolition of banking services, the bank's improvement plan should aim at achieving the capital adequacy ratio at 2% or higher within one year.

If the bank applies for subscription for shares or other securities pursuant to Article 105 of the Deposit Insurance Act, the time frame for improving its capital adequacy ratio or leverage ratio must be identical to the period set for a business revitalization plan referred to in paragraph (3) of the same article.

In a situation where a bank has submitted an improvement plan pursuant to Article 2(1) of the Categorization Order and this plan is determined reasonable for ensuring improvement to surely exceed the range of the capital adequacy ratio or leverage ratio specified for the Category Requiring Prompt Corrective Action applicable to the bank, the FSA may issue an order to the bank to encourage achievement of the capital adequacy ratio or leverage ratio specified for a higher-level category in the corresponding table in the Categorization Order. In this case, the time frame for achieving the capital adequacy ratio or leverage ratio specified in the order issued as aforesaid will not include the period used for achieving the capital adequacy ratio or leverage ratio set out in III-2-1-3-3(1) below.

(iii) Measures applicable to Category 2-2 or Leverage Category 2-2

If the bank chooses a merger or any other measure among capital enhancement, drastic reduction of business, merger, or abolition, etc. of banking services, the measure chosen must be convincingly feasible. In case of a merger, for example, a merger partner's intention must be clarified.

III-2-1-3-3            Criteria for Judging the Reasonableness Prescribed in Article 2(1) of the Categorization Order

When judging whether or not a plan submitted by a bank is reasonable to surely improve the capital adequacy ratio or leverage ratio and to make it exceed the range specified for the relevant category pursuant to Article 2(1) of the Categorization Order, the following criteria must be used.

- (1) The plan must contain concrete capital reinforcement strategies that are conducive to facilitating sound and appropriate management of banking services and reestablishing the confidence in the bank from depositors and other stakeholders. And the plan must be designed with the substance aiming at unflinchingly improving the capital adequacy ratio or leverage ratio, within three months in principle, to make it exceed the range specified for the relevant Category Requiring Prompt Corrective Action.

Note: If a capital increase or other measure is planned, the intention of prospective capital providers or other relevant stakeholders to back up the plan must be clarified.

- (2) If the bank applies for subscription for shares or other securities pursuant to Article 105 of the Deposit Insurance Act, the bank's improvement plan must be consistent with a business revitalization plan referred to in paragraph (3) of the same article.

III-2-1-3-4            Levels of Capital Adequacy Ratios or Leverage Ratios Underlying Order Categories

When issuing an order to a bank pursuant to Article 2(1) of the Categorization Order, the category for such order is required to correspond to a category lower than the capital adequacy ratio or leverage ratio

that the bank is expected to achieve after implementing the relevant plan (excluding the categories called “exception from category” or “exception from category leverage category” in the respective tables in the Categorization Order). For the purpose of application of Article 2(1) as aforesaid, the category applicable to the capital adequacy ratio or leverage ratio that the bank will probably be able to achieve, in principle, within three months (excluding the columns called “exception from category” or “exception from category leverage category”) will be used to issue the order to the bank.

### III-2-1-3-5 Progress Reporting

The progress of an improvement plan must be reported to the regulator after each business year (and each first half) until the plan is completely implemented. Unless the progress reported deviates significantly from the plan, new or additional orders will not be issued, in principle, during the remaining period of the plan. However, a bank subject to an order for Category 2-2 or Leverage Category 2-2 may be given another order applicable to Category 1, Leverage Category 1, Category 2, or Leverage Category 2, as the case may be, when the bank’s capital adequacy ratio or leverage ratio indicated in the former order reaches the range specified for a higher category as aforesaid. In addition, a bank subject to an order for Category 2 or Leverage Category 2 may be given another order applicable to Category 1 or Leverage Category 1, as the case may be, when the bank’s capital adequacy ratio or leverage ratio in the former order reaches the range specified for Category 1 or Leverage Category 1, as the case may be.

In a situation where a bank has submitted an improvement plan pursuant to Article 2(1) of the Categorization Order and this plan is determined reasonable for ensuring improvement to surely exceed the range of the capital adequacy ratio or leverage ratio specified for the Category Requiring Prompt Corrective Action applicable to the bank, the FSA may issue an order to the bank to encourage achievement of the capital adequacy ratio or leverage ratio specified for a higher-level category in the corresponding table in the Categorization Order. If the bank chooses capital enhancement (a capital increase) in this situation, the bank must achieve a level exceeding the capital adequacy ratio or leverage ratio specified for the category relevant to the order, in principle, immediately after expiration of the period required for completing the procedures for the capital increase and other steps. If this is not achieved, the FSA will issue a new order corresponding to the category of the capital adequacy ratio or leverage ratio then applicable to the bank.

### III-2-1-3-6 Criteria for Revaluation of Assets Listed in Article 2(2) of the Categorization Order

The assets set forth in the respective items of Article 2(2) of the Categorization Order include the assets listed below, which will be evaluated by the methods specified respectively as follows.

#### (1) “Securities” in item (i)

The “closing price which is published on the date” referred to in Article 2(2)(i) of the

Categorization Order means a trading price on a financial instruments exchange, an indicative price serving as a benchmark, a reference price, or the like. A “value calculated by a reasonable method equivalent to it” referred to in the same item means an appraised value obtained from a financial instruments business operator or registered financial institution as the market value information as of the calculation date, or a value calculated by an evaluation method prescribed by the bank which is objectively determined to be reasonable.

For this calculation, the points listed below need to be noted.

- (i) If there are serious concerns about failure to redeem shares or bonds as scheduled because the issuing company’s liabilities far exceed assets or any other critical event occurs, those securities are evaluated based on actual conditions.
- (ii) Foreign currency securities are evaluated by conversion to Japanese yen at the telegraphic transfer middle rates on the calculation date.

(2) “Tangible fixed assets” in item (ii)

(i) Land

The amount used in revaluation of land is as follows: appraisal values (appraisal within the past one year) or roadside land prices, posted prices, standard land prices, and objectively estimated amounts based on actual land transactions.

(ii) Buildings and movables

In principle, the book value is used for revaluation for buildings and movables.

(3) “Assets other than the assets listed in the preceding two items” in item (iii)

Regarding securities (including foreign securities) managed as trust property in money trusts (limited to those operated independently and primarily intended for securities investment), revaluation is performed in the same way as specified in Article 2(2)(i) of the Categorization Order and III-2-1-3-6(1) above. If a money trust contains derivative transactions, their unsettled valuation gains and losses must be incorporated in the revaluation of the money trust.

III-2-1-3-7 Miscellaneous Notes for Prompt Corrective Action

- (1) If the FSA issues an order to a bank pursuant to Article 1(1)(i) or 1(1)(iii), Article 1(2)(i) or 1(2)(iii), or Article 2 of the Categorization Order, the provisions of the Administrative Procedure Act or other applicable laws must be observed. In particular, the FSA must grant the bank an opportunity for explanation under Article 13(1)(ii) of the Administrative Procedure Act and carry out other appropriate procedures as required.
- (2) If a bank cannot achieve the lower limit of the range of the capital adequacy ratio for Category 1 or of the range of the leverage ratio for Leverage Category 1, the bank will, in principle, be required to

calculate the values of the assets listed in the respective items of Article 2-2 of the Categorization Order by the respective methods specified and submit a balance sheet adjusted based on such calculations (in any unprescribed form) to the FSA.

- (3) Orders for prompt corrective action are issued on the assumption that the capital adequacy ratios or leverage ratios calculated by banks properly show their financial condition. In this sense, banks should be warned never to deliberately manipulate the data of capital adequacy ratios or leverage ratios in an attempt to evade an administrative order for early corrective action.

#### III-2-1-4 Capital Distribution Constraints

##### III-2-1-4-1 Background

To mitigate procyclical amplification and reduce systemic risk in the financial system, the regulator needs to ensure banks' credit-granting functions by imposing capital distribution constraints on internationally active banks in a prompt and appropriate manner, depending on circumstances, through effective use of capital buffers (including leverage buffers for G-SIBs as designated in the Public Notice) as objective indicators.

##### III-2-1-4-2 Supervisory Approaches and Actions

Capital distribution constraints to be imposed on banks, which are specifically described in the Categorization Order (as defined in III-2-1-3-2), are operated in the following manner.

#### (1) Levels of capital buffer ratio or leverage buffer ratio that trigger capital distribution constraints

The capital buffer ratio (meaning either a capital buffer on a solo basis or a capital buffer on a consolidated basis; the same applies hereinafter) or the leverage buffer ratio (meaning either a leverage buffer on a solo basis or a leverage buffer ratio on a consolidated basis; the same applies hereinafter) referred to in each of the categories indicated in the tables in paragraphs (1)(ii) and (iv) as well as (2)(ii) and (iv) of Article 1 of the Categorization Order (hereinafter referred to as "Category Requiring Distribution Constraints") is either of the following capital buffer ratio or leverage buffer ratio.

- (i) The capital buffer ratio or the leverage buffer ratio provided in an annual financial flash report or interim financial flash report, which will be subsequently replaced with the capital buffer ratio or the leverage buffer ratio provided in the definitive annual business report or interim business report after its submission to the regulator
- (ii) The capital buffer ratio or the leverage buffer ratio reported by the bank to the regulator, at any time other than annual or interim financial reporting, after consultation between the bank and its audit corporation or other external auditor based on the regulator's inspection findings or

other feedback

(2) Issuance of orders based on the Categories Requiring Distribution Constraints

(i) Measures applicable to Capital Buffer Categories 1 to 4 or Leverage Buffer Categories 1 to 4

If a bank is ordered to submit and implement a reasonable improvement plan described in the table in paragraph (1)(ii) or (2)(ii) of Article 1 of the Categorization Order to replenish capital buffer ratio (which must contain planned capital distribution constraints) or if a bank is ordered to submit and implement a reasonable improvement plan described in the table in paragraph (1)(iv) or (2)(iv) of Article 1 of the Categorization Order to replenish leverage buffers (which must contain planned capital distribution constraints), emphasis should be placed on overall planning to ensure that the bank will surely replenish capital buffer ratio or leverage buffer ratio. Furthermore, the capital distribution constraints to be stated in the plan need to surely curb capital distributions below the limits of distributable amounts in accordance with the order applicable to the relevant category. To implement this plan, which events should be included in the scope of restrictions is, in principle, determined at the bank's initiative.

(ii) Amounts available for capital distributions

One example of "special circumstances" referred to in Article 1(10) or other provisions of the Categorization Order is a situation where the bank issues a new capital instrument to increase its Common Equity Tier 1 ratio during the business year covered by a capital distribution constraint plan and intends to disburse amounts running over the ceiling amount available for capital distributions, but not exceeding the amount newly raised.

(iii) Calculation of adjusted profit after tax

To calculate the tax amount that would be payable if the amount equivalent to capital distributions were not recorded as expenses, as referred to in Article 1(11) or other provisions of the Categorization Order, banks are allowed to use a simplified method. Under this method, adjusted profit after tax can be obtained by multiplying the amount equivalent to capital distributions which were actually recorded as expenses for accounting purposes for the previous business year (excluding amounts not included in expenses for taxation purposes) by the effective tax rate as of the end of the previous business year at the relevant taxable unit and adding the actual tax amount for the previous business year.

(iv) Definition of bonus

Bonus referred to in Article 1(10)(v) of the Categorization Order means any salary-like payment made separately from regular salaries; i.e., year-end bonus, semi-annual bonus, year-end allowance, term-end allowance, and other similar payments. Regarding some types of payments, it may be uncertain as to whether they should be treated as salary or bonus. Above all, the following payments should be classified into bonus.

(A) Remuneration to be paid based on the firm's net income

(B) Remuneration to be paid without predetermined rules on amounts or payment criteria

- (C) Remuneration to be paid without predetermined rules on times for payment, except for remuneration for temporary or just-in-time employment
- (D) Salaries set forth in Article 34(1)(ii) of the Corporation Tax Act (excluding payments made under provisions to pay a fixed amount at a designated time of year on an ongoing basis to those who do not receive any other regular pay)
- (E) Profit-linked salaries set forth in Article 34(1)(iii) of the Corporation Tax Act

In addition, “bonuses and other economic benefits” are economic benefits having the nature described above, regardless of what they are called, e.g., an ad hoc or one-off payment added to a regular salary, retirement benefits, or any other predetermined payment.

- (v) Definition of subsidiary companies, etc.

Whether or not an entity affiliated with a bank is a “subsidiary company, etc.” of the bank as referred to in Article 1(19)(v) of the Categorization Order depends on whether or not it is a major subsidiary for the bank, and this judgment is basically left to each bank. If the bank forms a group (as defined in III-3-2-4-4(1) of these Supervisory Guidelines; the same applies in III-2-1-4-2(2)-5(v) and (vi)), the regulator will consider the eligibility of each affiliate as a subsidiary company, etc. in light of its financial standing or influence on the entire group. As an example for using some numeric criteria to make a judgment, the affiliated entity can be excluded from “subsidiary companies, etc.” of the bank if the entity’s total assets make up 2% or less of the bank’s total assets on a consolidated basis. For another example, however, such a small-size entity may need to be included in the scope of subsidiary companies, etc. of the bank if the entity plays an important role in the group’s management.

- (vi) Definition of important officers or employees

Officers or employees who are important for a bank’s management as referred to in Article 1(19)(v) or other provisions of the Categorization Order are selected from among those who receive high compensation from the bank or its subsidiary company, etc. and therefore could have a significant impact on the firm’s business operation or financial condition. To identify such officers or employees, the criteria shown in paragraphs b. and c. of III-3-2-4-5(2)(i)(B) may be informative.

Outside directors and outside company auditors of a bank may be excluded from the scope of important officers at the bank’s discretion. If, however, an outside director or outside company auditor receives high compensation or other large benefits from the bank and therefore could have a significant impact on business operation or financial condition of the bank or its subsidiary companies, etc., such outside director or outside company auditor must be treated as an important officer.

### III-2-1-4-3 Submission of Plans and Progress Reporting

A bank receiving an order for any Category Requiring Distribution Constraints will be required to submit

a plan based on such order every business year and may be asked to report the progress of implementation of the plan, whenever necessary.

#### III-2-1-4-4 Miscellaneous Notes for Prompt Corrective Action

- (1) If the FSA issues an order to a bank pursuant to either Article 1(1)(ii) or (iv), 1(2)(ii) or (iv), or Article 2-2 of the Categorization Order, the provisions of the Administrative Procedure Act or other applicable laws must be observed. In particular, the FSA must grant the bank an opportunity for explanation under Article 13(1)(ii) of the Administrative Procedure Act and carry out other appropriate procedures as required.
- (2) If a bank's capital adequacy ratio or leverage ratio (including the leverage buffer ratio) falls under both a Category Requiring Prompt Corrective Action and a Category Requiring Distribution Constraints, the FSA will issue an order covering the two categories.

#### III-2-2 Improvement in Profitability

##### III-2-2-1 Background

- (1) Since Major Banks' business entails large-scale and complicated risks, Major Banks must adequately prepare for the occurrence of events falling under such risks. More specifically, they are required to reinforce their capital base, to secure a certain level of periodic profits through risk-based profit management, and to maintain a solid financial foundation capable of addressing risks. Promoting these efforts is important for Major Banks to properly exercise financial functions and to ensure sustainability to serve as a banking service provider.
- (2) Major Banks' various efforts to enhance financial functions are underway, which include a shift in lending techniques by such ways as the development of "middle-risk and middle-return" products using scoring models or effective utilization of financial covenants, construction of interest rate systems allowing for flexible adjustment according to adequate credit risk exposures based on credit ratings, redesigning fee structures, and expansion of market-based indirect finance including securitization and syndicated loans. These trends are accompanied by the diversification of revenue sources.
- (3) If banks can make profit constantly and accumulate internal reserves on an ongoing basis, their risk-taking capacity will increase and they will become able to offer more advanced financial services. Successful improvement in banks' profitability in this way is expected to eventually contribute to promoting proactive efforts to reduce non-performing loans and prompting borrowers' business



revitalization.

- (4) On the other hand, unprofitable banks suffering from persistent deficits are obviously reducing their equity capital, even though they have sufficient capital at this moment, and their capital is very likely to fall below the threshold for ensuring financial soundness. Once an unprofitable bank falls into such a worrisome situation, its attempt to gain investor understanding and smoothly carry out a capital increase will result in deadlock in most cases. Therefore, the regulator needs to move early to encourage banks' efforts to improve profitability (meaning capacity to make a profit in terms of profit and loss accounting; the same applies hereinafter).

### III-2-2-2 Major Supervisory Viewpoints in Profitability Improvement

Major Banks should constantly endeavor to offer better services and products responding to diversified customers' expectations, along with the effort to reduce costs and pursue more efficient business operation. Through continuing these efforts, Major Banks are expected to increase profit-making capacity and ensure management soundness. For this purpose, do they develop profit analysis and evaluation systems as well as a regime capable of business restructuring and promoting various other efforts for profitability improvement? More specific points to check may be described as follows.

- (1) Does management analyze and evaluate the firm's profitability in a comprehensive manner? More specifically, can management effectively use the firm's operating profits, ordinary income, net income, and other quantitative indicators, as well as profit margin, ROA, ROE, OHR, and other performance indicators? And does management properly check systems for controlling credit risk, market risk, and other risks?
- (2) Does the firm properly operate managerial accounting systems and precisely analyze and evaluate profitability of each business unit or each customer segment? In particular, do those systems work effectively to help management make reasonable decisions in relation to large loans? To be more specific, are borrowers of large loans monitored with due consideration for their status of credit risk exposures and various transactions with the firm to accurately understand their profitability? In light of large-scale and complicated risks faced by Major Banks, do they conduct proper risk management (integrated risk management) as explained in III-2-3-1 and precisely analyze and evaluate risk-adjusted profitability of respective business units?
- (3) To improve the convenience of business processes in line with diversified sales and marketing channels and to reduce back-office expenses, does the firm consider strategic use of information and communications technology (IT)?

- (4) To promote firm-wide efforts to improve profitability, are the authorities and responsibilities assigned to officers and employees clearly defined and segregated?

### III-2-2-3 Supervisory Approaches and Actions (including Early Warning System)

#### (1) Basic stance

As one of the methods to ensure the soundness of each bank's business management, the regulator is authorized to issue an order for prompt corrective action to maintain the bank's capital adequacy ratio and leverage ratio pursuant to Article 26(2) of the Banking Act. Even when the bank is not included in the scope of banks to which a measure of demanding prompt corrective action is applicable, the bank is strongly recommended to continue business improvement efforts to maintain or even strengthen the management soundness. In light of the significance of improvement in profitability (III-2-2-1), among others, the regulator needs to implement preventive measures (i.e., effectively use the early warning system) while they are profitable.

#### (2) Interview

- (i) The regulator conducts interviews with banks' members on the occasion of semi-annual and annual settlement and financial reporting and conducts comprehensive interviews, to stay updated on and analyze the banks' circumstances including profitability and profit management systems.
- (ii) Through interviews with banks' top executives conducted whenever necessary, the regulator checks their management strategies to improve profitability, business restructuring policies, and other strategic efforts.
- (iii) If a bank has formulated a medium-term business plan or the like, the regulator will conduct interviews with the bank's key persons at any time and verify the bank's management strategies and business restructuring efforts.

#### (3) Early warning system

If a bank's basic profit indicators show the necessity of improvement in profitability, the regulator will act as explained in III-2-3-1-5(4)(i) to (iii). As necessary, the regulator will ask the bank to make reports pursuant to Article 24 of the Banking Act to encourage steady improvement. If the FSA determines that more resolute response is needed to have the bank unfailingly implement improvement measures, the FSA will issue a business improvement order (as a measure for improvement in profitability) pursuant to Article 26 of the Banking Act.

### III-2-2-4 Points to Note for Financial Institutions in the Context of the Industrial Competitiveness Enhancement Act

When reviewing a business reorganization plan or a plan for reorganization of specified businesses prescribed in the Industrial Competitiveness Enhancement Act or other law, the following points need to be noted in line with the instructions for preparing financial statements and related documents of financial institutions.

- (1) Setting goals for improving productivity and financial soundness through business reorganization pursuant to Part I of the Guidelines for the Implementation of Corporate Restructuring established by the Ministry of Economy, Trade and Industry (the “Restructuring Guidelines”)
  - (i) Operating income referred to in I.(A)(1) of the Restructuring Guidelines means net operating profit, for example.
  - (ii) The turnover ratio of tangible fixed assets referred to in I.(A)(2) of the Restructuring Guidelines means operating revenue (e.g., earnings from fund management, earnings from service transactions, other business earnings) divided by the book value of the tangible fixed assets, for example.
  - (iii) Added value per capita in the final business year for a business restructuring plan referred to in I.(A)(3) of the Restructuring Guidelines means added value per employee (i.e., the sum of net operating profits, personnel expenses, and depreciation expenses), for example.
  - (iv) Total interest-bearing liabilities referred to in I.(B)(1) of the Restructuring Guidelines include deposits payable and all other capital instruments with debt-like features, for example. Working capital referred to in the same section means loan claims other than non-performing loans, for example.
  - (v) Ordinary revenue and ordinary expenditure referred to in I.(B)(2) of the Restructuring Guidelines respectively mean ordinary profits and ordinary expenses, for example.
- (2) Definition of business restructuring in II.(A) of the Restructuring Guidelines
  - (i) Sales referred to in II.(A)(3) of the Restructuring Guidelines means operating revenue, for example.
  - (ii) Sales expenses for provision of products or services referred to in II.(A)(5) of the Restructuring Guidelines means sales, and general and administrative expenses, for example.
- (3) Criteria for industries or business sectors causing oversupply due to structural reasons as referred to in II.(B)(3) of the Restructuring Guidelines

In connection with the ratio of operating profit on sales referred to in II.(B)(3)(ii) of the Restructuring Guidelines, operating profit means net operating revenue, and sales means operating revenue, for example.
- (4) Setting goals for improving productivity and financial soundness through specified business reorganization pursuant to Part III of the Restructuring Guidelines

In III.(A)(1) to (3) and III.(B)(1) and (2) of the Restructuring Guidelines, the definitions stated

in III-2-2-4(1)(i) to (v) are used.

- (5) Definition of specified business restructuring referred to in IV.(A) of the Restructuring Guidelines  
Net sales referred to in IV.(A)(4) and (5) of the Restructuring Guidelines means operating revenue, for example.

### III-2-3 Risk Management

#### III-2-3-1 Risk Management (General) and Integrated Risk Management

##### III-2-3-1-1 Background (Risk Management)

To ensure financial safety and soundness and improve profitability, banks are required to adequately manage various risks in a systematic and integrated manner. Such risk management needs to be optimized in light of their own business strategies and the characteristics of related risks ranging from credit risk, market risk to liquidity risk, as well as operational risks (including administrative risks and system risks).

In particular, for the purpose of effective risk management for financial instruments involving complicated risks, each bank's top managers need to be well-qualified, competent, and timely and adequately briefed on various risks faced by different business units in the bank. Then, the top managers must establish a scheme for integrated risk management as explained below so that they can make prompt and shrewd management decisions in a leadership position and from cross-functional standpoints.

##### III-2-3-1-2 Background (Integrated Risk Management)

- (1) Major Banks, which face large-scale and complicated risks, are undoubtedly required to properly control risks inherent in different business units, based on risk categories such as credit risk and market risk. At the same time, it is more important to develop a scheme capable of controlling those risks in an integrated manner. While a standardized framework for integrated risk management is yet to be completely established, Major Banks have already been promoting their own efforts of integrated risk management.

- (2) Risk control based on capital base

First, the risks faced by a bank's respective business units are quantitatively measured to the extent possible on common measurement criteria (e.g., value at risk, or VaR), and the bank's capital is allocated to respective risk categories and respective business units in proportion to their risk quantities (i.e., risk portions to be covered by the equity capital) within the limit of the bank's capital base; this kind of allocated capital is called "risk capital. (\*)" Second, each business unit specifies its position limit and other rules, and controls its business operations to keep its risk position within the

risk capital. With all business units of the bank carrying out this process, the total volume of risks taken by the entire bank is expected to be constantly maintained within the limit of the bank's financial strength (i.e., the bank's capital base).

Note: Risk capital can be described as "allocated capital."

(3) Risk-based profit management

The profitability of each business unit after risk adjustment can be estimated through quantitative indicators (e.g., the business unit's risk-adjusted return) or other financial ratios (e.g., RAROC).

This approach is used to evaluate each business unit's performance and enables profit management in consideration of risks. Such profit management is expected to enhance the bank's business efficiency and profitability.

Note 1: Examples of quantitative indicators

Risk-adjusted return (= Operating profits – Expected losses), known as RAR or RACAR

Economic profit (= RAR – Risk capital x Ratio of capital cost), known as EP

Note 2: Examples of financial ratios

Risk-adjusted return on capital (= RAR / Risk capital), known as RAROC

III-2-3-1-3 Major Supervisory Viewpoints Common in All Types of Risk Management

- (1) Does the board of directors clearly define a risk management policy based on the strategic goal established in conformity with the bank's overall management policy? In addition, does the board of directors implement appropriate measures to familiarize all related personnel in the bank with the established risk management policy?
- (2) Does the board of directors put in place risk management departments, together with a scheme for integrated management of the risks controlled by all those departments? Is this scheme designed in a way to enable the mutual check-and-balance system and other aspects to function sufficiently?
- (3) Do the board of directors and other relevant organs in the bank effectively use risk information for the bank's business operations and development of risk management systems? For example, are the board of directors and other relevant organs briefed on the status of risk management on a regular basis? And do they make necessary decisions based on the reported risk information?
- (4) With regard to the risks involving or inherent in the bank's respective business offices, branches, and consolidated subsidiaries (including overseas business establishments), do they manage those risks by themselves to the extent not contrary to laws and regulations? At the same time, are those risks managed by the head office Risk Management Department in an integrated manner? Does the head office risk management department take control of all risks managed by respective risk management

departments?

- (5) Has the board of directors developed a scheme to enable internal audit departments to function sufficiently? Does the board of directors regularly check whether internal audit departments function effectively?
- (6) Is the effectiveness of internal controls (including risk management activities) in the bank checked through external audits by financial auditors, etc. at least once a year? If the bank is a financial institution subject to international uniform standards, does each of its overseas business establishments undergo external audits in a way that fits in with the respective country's circumstances?
- (7) Do the board of directors and other relevant organs in the bank play a leading role toward fostering the bank's risk management culture? For example, are the bank's officers and employees sufficiently aware of the importance of risk management? For another example, is psychological safety (i.e., situations or atmospheres where each employee can speak out and/or take action without any fear at work) ensured? In addition, has a sound and open corporate culture been well-established in the bank? For example, in such bank, employees should spontaneously be willing to share information promptly and exchange opinions in a candid manner.

(Reference) "Concept and Procedures of Supervisory Activities Concerning Compliance Risk Management (Compliance Risk Management Basic Policy)" (October 2018)

#### III-2-3-1-4 Major Supervisory Viewpoints in Integrated Risk Management

- (1) To understand various risks in a comprehensive manner, after identifying all risks, are the risk categories appropriately identified as the ones that need to be controlled quantitatively within integrated risk management?
- (2) In the context of integrated risk management, are all quantitatively controlled risks measured under common criteria? Are the objectivity and adequacy of such measurement criteria ensured? For example, if VaR is used, is the method of setting confidence intervals and holding periods defined clearly?
- (3) Does the bank conduct ongoing review to further enhance the accuracy of measurements? For example, are correlations among different types of risks (diversification effects) examined in order to ensure the appropriateness of measurements?

- (4) Are the processes of allocating risk capital and reviewing such allocation appropriate?
- (5) With regard to major risks, is the loss absorbency of the capital base considered properly? For example, are major risks covered by Common Equity Tier 1 capital if the bank is an internationally active bank? Or are major risks covered by the bank's capital base recognized in the context of regulatory capital requirements (excluding such instruments eligible for inclusion in Tier 1 capital that are classified into Tier 2 capital under the previous Basel regulatory framework) if the bank is a domestically active bank?
- (6) Is the allocation of risk capital to respective business units consistent with the bank's business plans, earnings plans, and the like?
- (7) Are business operations controlled properly to make sure that the risk quantity of each business unit will not exceed the allocated risk capital?
- (8) If the bank is a domestically active bank, does the bank take actions with due regard to the characteristics of the risks faced by the bank or its capital base? For example, when allocating risk capital, does the bank take into due consideration the impacts of valuation difference on available-for-sale securities?

### III-2-3-1-5 Supervisory Approaches and Actions

#### (1) Basic stance

As one of the methods to ensure the soundness of each bank's business management, the regulator is authorized to issue an order for prompt corrective action to maintain the bank's capital adequacy ratio and leverage ratio pursuant to Article 26(2) of the Banking Act. Even when the bank is not included in the scope of banks to which a measure of demanding prompt corrective action is applicable, the bank is strongly recommended to continue business improvement efforts to maintain or even strengthen the management soundness.

#### (2) Off-site monitoring

- (i) The regulator analyzes the data obtained through interviews on risk management and off-site monitoring of integrated risk management to stay updated on the functions of banks' integrated risk management systems and, where necessary, analyzes or assesses the effectiveness or other features of those systems.
- (ii) The regulator may conduct interviews with banks' top managers at any time, where necessary. The issues covered by such interviews may include integrated risk management, as needed.
- (iii) On the occasion of a bank's review of capital allocation to its respective business units, or in the

event of deterioration in a bank's business performance, fluctuations in interest rates or asset prices, or other unfavorable economic developments, the regulator may conduct ad hoc interviews with the bank, as needed, or verify the effectiveness or other features of the bank's integrated risk management systems.

(3) If any problem is found in a bank's risk management systems or integrated risk management systems as a result of the regulator's financial inspections or off-site monitoring, the regulator may ask the bank to submit detailed reports pursuant to Article 24 of the Banking Act, as needed. If the problem is considered critical, the regulator will issue a business improvement order or implement any other measures pursuant to Article 26 of the Banking Act.

(4) Effective use of the early warning system

Major Banks' risk management activities are expected to be promoted through their self-initiated efforts to set integrated risk management in place in light of the supervisory viewpoints enumerated above. They will also be encouraged to develop their existing systems into more appropriate ones in the wake of the regulator's monitoring or verifications explained in (2) and (3) above.

At the same time, some particular risks need to be controlled on an individual basis in order to prevent them from adversely affecting the bank's soundness. For example, it is necessary to prevent a situation where a deficiency in the risk management scheme will eventually be actualized. The regulator is therefore encouraged to effectively use the early warning system applicable respectively under III-2-2-3(3) (profitability), III-2-3-2-6(1)(iii) (credit risk), III-2-3-3-3(1)(iii) (market risk), or III-2-3-4-3(1)(iii) (liquidity risk). If a bank fails to satisfy the predefined minimum requirement for any specific risk, the regulator will take any measure described in the following three items or other measures.

(i) The regulator's analyses

The regulator's analyses may cover specific risks involving the bank's failure to satisfy the minimum required criteria, as well as related business environments and business models. The regulator may comprehensively analyze the factors existing in present circumstances surrounding the bank's profitability, risk-taking, or capital base, and then formulate hypotheses about the issues faced by the bank and their causes.

(ii) Clarifying the issues and creating shared understanding through mutual communication

Based on the hypotheses formulated, and taking the bank's self-evaluation into full consideration, the regulator and the bank will carry out in-depth discussions, clarify the issues that the bank should address and their causes, and create shared understanding.

(iii) Supervision and communication aiming at improvement

Based on the shared understanding of the issues to be addressed, the regulator will encourage the bank to prepare a plan for necessary improvement actions including the steps to address the identified causes. Where necessary, the regulator will conduct follow-up



monitoring to check the progress of the bank's improvement actions.

Note 1: Under the early warning system, a bank failing to satisfy any minimum required criterion specified for respective risks will be subject to the regulator's supervision in the ways described in the three paragraphs above. However, this kind of situation does not mean that the bank's business management is automatically determined to be unsound, and the regulator does not necessarily ask the bank to take prompt corrective actions.

Even when the regulator finds it necessary to ask a bank for improvement, the regulator should closely observe the impacts on financial markets, trends in small and medium business financing, and other factors, and pay particular attention so as to encourage the bank to implement optimum improvement actions in an optimized schedule.

In the course of follow-up monitoring of the bank's improvement activities, the regulator must check the objectives of the respective improvement steps and the schedule for implementation.

Note 2: While a bank failing to satisfy any minimum required criteria specified for respective risks is, in general, instructed to take action as described in the three paragraphs above, the regulator is expected to act in ways commensurate with the bank's size, characteristics, or other circumstances.

### III-2-3-2 Credit Risk Management

#### III-2-3-2-1 Outline of Credit Risk Management

##### III-2-3-2-1-1 Background

Credit risk is the risk that a bank will incur losses from the decline or disappearance of the value of assets (including off-balance sheet assets ) due to a deterioration in the financial condition of an entity to which credit is provided. The bank needs to strive to ensure its financial stability by properly developing an internal control system related to the risk.

Especially in the process of recent rapid materialization of credit risk, issues such as troubles caused by excessive credit concentration and the necessities of strict asset assessment and credit risk management as a group have come to light. Therefore, the bank needs to develop a system for preventing NPL problems from happening again, by selecting appropriate credit portfolio management and credit risk management methods.

##### III-2-3-2-1-2 Major Supervisory Viewpoints

(1) Has the board of directors formulated a credit risk management policy based on the strategic

objectives established in conformity with the bank's overall corporate management policy? In addition, has the board of directors formulated a credit policy that defines loan borrowers, credit rating standards, portfolio management policies, settlement authorities, etc., based on the credit risk management policy?

- (2) Has the board of directors developed appropriate credit management and screening management systems by separating the marketing and sales division and the screening management division, or establishing a credit audit division and a risk management division, etc.? For example, does the audit division conduct proper internal checks, in terms of whether the relevant scheme puts emphasis on maximization of collection when working on business rehabilitation or handling of problem loans?
- (3) Does the board of directors, etc. periodically receive reports on credit risk conditions and utilize them for risk management, including the verification of compliance with the credit risk management policy and instructions for reducing the credit risk amount? In addition, does the board of directors, etc. take measures to ensure the fairness and appropriateness of the development and review of internal rules and organizations, etc. related to credit risks, including utilization of external experts, etc. as necessary?
- (4) In managing credit risk, has the bank established a system to exert integrated control over the bank, its consolidated subsidiaries, and affiliates to which the equity method is applicable, to the extent not contrary to laws and regulations? Does the bank implement proper loan loss provisions on a consolidated basis especially when its subsidiary companies guarantee loans lent by the bank?
- (5) Does the screening management division accurately comprehend the status of the borrower's financial condition, the purpose of the use of funds, financial sources for loan repayments, etc. and accordingly conduct appropriate screening and management, including verification of the accuracy of credit ratings? For example, has the screening management division developed a management system to control risks by accurately grasping the actual condition of the whole group of debtor companies?
- (6) Has the bank established a system for providing appropriate credit management of conditions of the borrowers, including the trends of their business performance? In addition, for example, have efforts been made to prevent loans from becoming problem loans, to enhance consultation and support functions for business partners, and to prompt business revitalization, in terms of preventing the occurrence of new NPL? Has a risk management system been developed for a business model on the assumption that a certain amount of NPL occur?
- (7) When acquiring or holding shares, does the bank provide appropriate risk (\*1, \*2) management, fully aware of the risks of share price decline or impairment when holding shares, the risk of losses on sale

of shares, and the risk of difficulty in selling shares, especially when holding shares in large volume or non-listed shares?

In particular, based on the fact that regulations on holding of voting rights were reviewed in accordance with the revision of the Banking Act in 2013, in order for banks to supply capital-like funds more flexibly, it is necessary to note the following when acquiring and holding the voting rights whose total number will exceed the maximum threshold for voting rights:

- (i) When acquiring and holding shares of “a company specified by Cabinet Office Order as that engaged in new business activities found to contribute considerably to the improvement of management,” (which is called a business revitalization company) provided in Article 16-2(1)(xiii) or Article 52-23(1)(xii) of the Banking Act, has the bank developed a system for properly examining the company’s business rehabilitation plan as well as accurately evaluating and analyzing the progress status of the plan, etc.?

Furthermore, has the bank developed a system for giving support and advice, as necessary, for the improvement of the management of the company in order to raise its corporate value?

- (ii) In cases where the bank uses its investment subsidiary company to acquire and hold shares of the following companies, although risk isolation measures are thought to have been implemented to some degree in order to protect the bank itself, has the bank developed a system for grasping, analyzing, managing, etc. the status of the risk management of the subsidiary company?
  - (A) “A company specified by Cabinet Office Order as that exploring new business fields” (which is called a venture company) provided in Article 16-2(1)(xii) or Article 52-23(1)(xi) of the Banking Act
  - (B) “A company specified by Cabinet Office Order as that conducting business activities found to contribute to regional revitalization ” (which is called a company revitalizing (reinvigorating) the overall regional economy) provided in Article 16-4(8) or Article 52-24(8) of the Banking Act.

Note 1: Also see “III-2-3-3 Market Risk Management.”

Note 2: About the conflict of interests of the bank between its position as a shareholder and its position as a creditor regarding the acquisition and holding of shares, also see “V-5 Establishment of a System for Protection of Customers' Interests.”

- (8) About creation of an interest rate (proper lending rate) system which builds on adequate credit risk volume based on credit rating, does the management recognize its importance involving the bank’s credit risk? Has the bank developed a system and smoothly managed it while gaining understanding from customers?
- (9) Does the bank appropriately manage sponsorship business, etc., such as ABCP program, etc., keeping in mind the possibility of being required to complement liquidity, etc. due to reputational risk, etc.,

irrespective of the content of contracts?

- (10) Does the bank appropriately manage the credit risk of major counterparties to derivatives transactions, including the following?
- (i) Managing exposures for each counterparty and based on the types of counterparty
  - (ii) Understanding of potential risks arising from the increased exposure due to the changes in market value of the reference assets under the derivative transactions
  - (iii) Confirmation of the effectiveness of collateral and other credit enhancement
  - (iv) Appropriate stress-testing incorporating the scenario assuming tightening market liquidity
- (11) Does the bank appropriately manage risks arising from transacting with a central counterparty (“CCP”) in relation to centrally cleared derivative transactions, etc., including the following?
- (i) Risks specific to the transactions with a CCP
  - (ii) Risks arising from material flaws in the framework to regulate and supervise a qualified CCP
  - (iii) With regard to a CCP other than the qualified CCP, risks that the unpaid portion of the clearing fund to be paid upon request from the CCP will be applied to cover the loss of the CCP
- (12) Do Major Banks (including those whose total average amount of notional value arising from over-the-counter derivatives transactions which fall under Article 123(10)(iv)(b) of the Cabinet Office Order on Financial Instruments Business is less than 300 billion yen ) make efforts to develop a system for managing counterparty risk, for example, in exchange of variation margin in non-clearing over-the-counter derivatives transactions with financial institutions, etc.?

Also, do Major Banks, subject to the provisions of Article 123,(1)(xxi)-6 (Initial Margin) of the Cabinet Office Order on Financial Instruments Business, make an effort to develop a system for managing counterparty risk, for example, in exchange of initial margin in non-clearing over-the-counter derivatives transactions subject to the given item?

For specific supervisory viewpoints, refer to “IV-2-4 (4) Non-Clearing Over-the-Counter Derivatives Transactions, etc.” described in “Comprehensive Guideline for Supervision of Financial Instruments Business Operators, etc.”

### III-2-3-2-2 Credit Risk Management for Large Borrowers

#### III-2-3-2-2-1 Background

In the process of rapid materialization of credit risk in recent times, concentration of credit-granting on a specified group of companies has shown some cases in which the debtor’s unfavorable situation cast concerns over the survival chances of the bank, and early recognition of and response to the financial and operational conditions of large borrowers has become one of the biggest management challenges for the

bank.

III-2-3-2-2-2 Major Supervisory Viewpoints

- (1) Does the board of directors, etc., based on rational criteria, extract large borrowers which are likely to have a significant effect on the management of the bank, and continuously monitors their credit and financial conditions? In particular, with regard to an internationally active bank, in cases where the bank's credit provision to a single borrower is 5% or more of the amount of the bank's Tier 1 capital, does the bank provide credit risk management for the large borrower taking into consideration the amount of credit provision to an entity deemed to have an economically interdependent relationship (\*) with the borrower?

Note: An entity deemed to have an economically interdependent relationship is that found by the bank to have any of the following relationships with its borrower(s): However, when an entity, which has any of the following relationships, can avoid financial problems or a chain reaction of defaults by finding other business partners or new funding sources in a timely manner, the entity does not fall under the category of those deemed to have an economically interdependent relationship.

- When 50% or more of an entity's annual gross income or gross expenditure rises only from the transactions of the counterparty (for example, when 50% or more of the annual income of an entity owning residential and/or commercial real estates depends on the rents paid by other entities)
  - When an entity bears all or some of the credit provided to the counterparty by means of guarantee, and an entity is likely to default if the right to guarantee is exercised
  - When most of the products made by an entity are sold by the counterparty who is an important customer which cannot be easily replaced
  - When the loan provided by an entity to the counterparty is the same as the expected repayment source, and the entity doesn't have other sufficient income sources to finish repaying the loan.
  - When an entity's financial problem is likely to cause a difficult situation to the counterparty, in terms of repaying all the debts in a timely manner
  - When an entity's inability to pay debts (as they become due) or default is likely to have something to do with the counterparty's inability to pay debts (as they become due) or default
  - When multiple entities rely on the same funder for most of their financing needs, and if the funder defaults, none of them can find another funder
- (2) Are internal definitions of sectors important in terms of risk management properly given, including the targets whose risk characteristics are similar such as a specific business type, enterprise group, country, region, or loan product? Also, does the bank accurately understand the breakdown of the

positions and related risks of each business type, country, region, etc.?

- (3) In compliance with the internal sector definitions, has the bank developed a management system in which credit risks can be diversified, for example, by establishing credit limits suited to each portfolio and using credit securitization?
- (4) In order to recognize and respond to credit risks at an early stage, has the bank developed a management system in which the amount of credit provision can be controlled according to credit risks, for example, by utilizing covenants, syndicated loans, credit securitization, etc.?
- (5) In order to deal with large borrowers, does the board of directors, etc. give close examination and precise instruction when implementing strict self assessment and revitalizing businesses? Especially when examining business restructuring plans for large borrowers, has the bank developed a system for making a full and careful examination of the validity and effectiveness of the plans?
- (6) In terms of necessity to recognize the condition of a debtor at an early stage in order to contribute to business rehabilitation, does the bank, in a timely and accurate manner, reflect market signals (including changes in stock prices and ratings) in its credit rating and promptly clarifies its stance (support policies)? Also, has the bank developed a system in which it can properly reflect its willingness to support when approving the disclosure of NPL?
- (7) Has the bank developed a system in which, based on the condition of a debtor, market prices, and ratings, the bank can properly judge credit risks of bonds and the preferred shares acquired through debt equity swaps (DES) as well as loans?
- (8) With regard to an internationally active bank, when managing the credit-granting to funds or securitization products, does the bank identify the parties concerned (including originators, fund managers, and providers of protections such as liquidity support for investment vehicles, CDS, and guarantees) who can be an additional risk factor inherent in the structure itself other than the underlying asset, and, based on that understanding, manages credit for large borrowers? More specifically, does the bank consider (i) managing the total sum of credit-granting, etc. to the structures it is investing in when there are additional risk factors common to these structures, and (ii) managing the credit-granting, etc. to the structures relevant to the parties concerned who can be an additional risk factor, together with the credit-granting, etc. to those concerned?

Note that the bank does not always need to manage the above-mentioned parties as an additional risk factor. For example, when the assets managed by funds are not managed separately from those of management entities and other funds, the bank needs to consider implementing credit risk management combined with credit-granting to management entities and other funds. Moreover,

when the ABCP program in which the bank is investing relies on credit and liquidity enhancements by the same sponsor company, or when the same party provides protections, such as CDS and guarantee, to synthetic-type securitization products, the bank needs to consider the necessity of managing sponsor companies and protection providers as large borrowers.

- (9) Does the bank perform stress tests? Also, does the bank analyze the scenario where the amount of loss will greatly increase in measuring credit risks?

### III-2-3-2-3 Disposal of Non-performing Loans and Business Rehabilitation (Integrated Revitalization of Industry and Finance)

#### III-2-3-2-3-1 Background

Risk taking is an essential element in financial intermediation, and non-performing loans (NPL) are constantly generated in some portion of the credit portfolio, in line with economic fluctuations and competitions between companies.

What is important for the financial stability of the bank is first to manage credit risk properly, and to recognize the occurrence of NPL at an early stage under strict asset assessment and take appropriate measures to turn NPL into sound loans according to each credit risk, and by doing this, to properly manage credit risks arising from occurrence of NPL within its own ability to cover risks. It is particularly essential to strictly manage NPL of large borrowers who might have a significant effect on the bank's finances.

From the perspective of a debtor company, the continued existence of NPL might lead to unnecessary continuation of credit-granting to a problem company and its survival. Therefore, in terms of realizing effective allocation of fund resources in Japan, it is extremely important to judge strictly the possibility of revitalizing problem companies, and implement the measures for rapid revitalization, etc. by establishing and carrying out drastic and highly feasible reconstruction plans.

By dealing properly with NPL in this way in order to prevent non-performing loan problems from occurring again, it is important to keep the non-performing loan ratio of Major Banks as a whole below the level as of the end of March 2005, and it is expected that each bank will make the best efforts.

#### III-2-3-2-3-2 Major Supervisory Viewpoints

- (1) Management system for NPL
- (i) In addition to fully recognizing the effects of occurrence of NPL on the financial soundness of the bank, has the bank established an appropriate corporate governance system for early response, including early recognition of NPL and measures to turn such NPL into sound loans?
  - (ii) Has the policy of NPL management been clearly defined? Also, has the policy ensured consistency with the bank's management policy and business model, etc.?

- (iii) Is proper management of NPL implemented in the responsible departments, along with development of the system based on the policy of NPL management? Also, is the internal audit needed to judge the appropriateness and sufficiency of that management system implemented in a timely manner?

With regard to the NPL required to be specially managed as problem ones, does the bank identify its scope and clarify its stance toward the problem borrower, and take sufficient countermeasures by properly grasping its management condition, etc.?

(2) Strict self-assessment and write-offs and loan loss provisions, etc. relating to NPL

- (i) Does the bank conduct strict self-assessment relating to NPL and implement proper write-offs and loan loss provisions?

Especially, in addition to implementing the bank's internal ratings reflecting corporate results and market signals in a timely manner, does the bank ensure accurate borrower classifications and implement write-offs and loan loss provisions in consideration of recent trends in bad debts, bankruptcies, etc.?

- (ii) With regard to the large borrowers which need special attention, does the bank estimate loan loss provisions of the borrowers based on the DCF (Discounted Cash Flow) method?

- (iii) As for loans categorized as doubtful or below, or loans adopting the DCF method and use the collateral value, it is important to conduct appropriate appraisal in order to implement write-offs and loan loss provisions based on the appraised collateral. To this end, it is necessary to note whether the bank deals with the following regarding the appraisal related to these claims.

(A) Enhancement of utilization of statutory appraisal and clarification of statutory appraisal proceedings

- a. The request shall be made to an appraiser independent from the bank (\*).

Note: The bank shall not be able to exert significant effect on the appraiser's finance and its decision of operations or business policy.

- b. With regard to high-valued collaterals (with an appraised value of 5 billion yen or more) which are special properties (such as a golf course, ball park, marina, or circuit) whose collateral value is difficult for financial institutions to calculate rationally and objectively, the bank shall conduct at least one statutory appraisal when reviewing its appraised collateral values, financial institutions.

- c. In order to ensure that the appraised value is of sufficient precision as an appraised collateral value, a request for an appraisal shall be made based on the actual situation of the type of collateral real property, appraisal conditions, request purposes, etc.

- d. Necessary corrections shall be made as needed by considering appraisal prerequisites, etc. and actual transaction cases.

- e. Internal rules related to collateral appraisal incorporating the above points shall be established.



Note: As for statutory appraisal, “appraised value” refers to an appraisal based on Real Estate Appraisal Standards (notification from the Administrative Vice-Minister of Land, Infrastructure, Transport and Tourism), and does not include appraisals carried out by a simplified method.

- (B) Enhancement of utilization of the bank’s self-assessment (including assessment by its subsidiary companies)
  - a. The assessment method based on statutory appraisal shall be established and if there is a great difference between the actual transaction value and the appraised value, the bank shall take measures such as multiplying the appraised value by the appropriate assessment rate of collateral or correcting the collateral valuation method.
  - b. The audit division shall verify the precision of collateral valuation periodically.
  - c. Internal rules related to collateral appraisal incorporating the above points shall be established.

(3) Efforts to turn NPL into sound loans

- (i) As for non-performing loan disposal, does the bank appropriately assess the debtor’s reconstruction possibilities, and for a debtor which could be reconstructed, make the utmost efforts towards its reconstruction?
- (ii) As for reconstruction of enterprises, does the bank strive to create a reconstruction plan which is respected by the market, making effective use of SME Revitalization Support Councils, laws and regulations related to company split, debt-equity swap (DES), debt-debt swap (DDS), corporate restructuring fund, etc., and executes quick handling, through voluntary liquidation according to the Private Liquidation Guidelines or Guidelines for Business Revitalization, etc. of Small- and Medium-sized Enterprises, and through corporate rehabilitation by legal procedures?
- (iii) In order to strictly examine the debtor’s reconstruction possibilities, etc., does the bank make the following efforts?
  - (A) Continuous and strict inspection of the progress and validity of reconstruction plans
  - (B) Implementation of loan loss provisions using the DCF method for the large borrowers which needs special attention
  - (C) Application of mark-to-market valuation for DES by large borrowers

(4) Liquidation of NPL

- (i) In cases where the bank moves its NPL off balance sheet by selling and securitizing them, are credit risks of loans to be securitized clearly separated? Does the bank continue substantially bearing the credit risks of those loans by using credit enhancement?
- (ii) In cases where the bank buys securitized NPL directly or indirectly, does the bank secure consistency with its corporate management policy, business model, etc.?

As for the NPL to buy, does the bank make appropriate evaluation of newly generated credit

risks, including information asymmetry, industrial and geographical concentration and other viewpoints, conduct full deliberation on the correlation between risk and return, and expect those loans to have a good chance of securing profitability? Also, does the bank implement proper management of those loans after purchasing them?

When securitizing NPL, does the bank holding the loans subject to securitization take due care to protect the original debtors?

Does the bank ensure that the loan claim is not transferred to parties who may oppress the debtor or disrupt the debtor's everyday life and business, etc.?

(5) Approaches to loans categorized as doubtful or below

(i) As for loans categorized as doubtful or below, the credit risk is enormously enhanced; therefore, it is extremely important to recognize such loans at an early stage and dispose of NPL at an early stage. Has the bank developed a policy regarding early recognition and early disposal of loans categorized as doubtful or below, based on the above viewpoints?

(ii) As for borrowers having significant effect on banking management and categorized as "debtors in danger of bankruptcy," does the bank execute quick handling by taking measures including preparation of a thorough reconstruction plan based on the Private Rehabilitation Guidelines, corporate restructuring by legal procedures such as the Civil Rehabilitation Law, or sales of loans?

(iii) When implementing off-balance-sheet treatment, etc. (\*), has due attention regarding the following points been paid?

(A) The judgment should be made based on economic rationality, considering the risks to the management of each bank and the effects on the regional economy, etc.

(B) The bank shall appropriately assess the debtor's reconstruction possibilities, and for a debtor that can be reconstructed, make the utmost efforts towards its reconstruction.

(C) Especially in relation to small and medium-sized enterprises (SMEs), the bank shall fully consider the characteristics of SMEs and the actual condition of each enterprise, and make detailed and accurate judgment of reconstruction possibilities and measures to turn those loans into sound loans.

(D) The bank shall need to avoid a chain-reaction collapse of sound SMEs, clients of the debtor company.

(iv) As for disposal of loans categorized as doubtful or below, does each bank announce its quarterly results regarding off-balance-sheet disposal, etc. in order for depositors to evaluate the financial condition of each bank?

Note: "Off-balance-sheet treatment, etc." described here refers to what is called "off-balance-sheet treatment" (meaning that loans categorized as doubtful or below are dropped from the balance sheet due to sales or collection, relinquishment of loans, restructuring type disposal, etc., or upgrade to the classification of special attention loans or above ) and to "measures to lead to

off-balance-sheet treatment.”

Note that “measures to lead to off-balance-sheet treatment” are those mentioned below:

(A) Legal liquidation

Note: Claims in bankruptcy, liquidation (including special liquidation), corporate reorganization, or corporate rehabilitation, and under civil rehabilitation proceedings, and claims against a debtor whose bank transaction has been suspended

(B) Measures equivalent to legal liquidation

Note: Claims under legal procedures such as a conciliation of civil affairs (including special conciliation) or a judicial settlement, and claims during the period of a repayment plan based on these procedures

(C) Company splits to so-called good and bad companies

Note: With regard to bad companies scheduled to be rationalized after the splits, limited to those to be rationalized promptly.

(D) Implementing partial direct write-offs of small loans on individuals and SMEs (less than one (1) billion yen [on principal amount])

(E) Trust to the Resolution and Collection Corporation in cases where the following requirements are met:

- a. Cases where the purpose of trust is corporate rehabilitation, etc. under the involvement of the Resolution and Collection Corporation
- b. Cases where off-balance-sheet treatment through revitalization or sale is done by the end of the trust period

Note: Loans related to “Trust-Type Schemes to Revitalize SMEs” apply to this matter.

- (v) As for the finance (DIP finance, etc.) to a debtor who is working on a reconstruction plan, does the bank fully consider facilitating it and make an active effort to supply funds? Note that the bank will not refrain from active actions after fully examining potential profitability of DIP finance, etc. irrespective of (A) and (B) of the above (iv).

#### III-2-3-2-4 Country Risk Management

##### III-2-3-2-4-1 Background

Country risk (including transfer risk) refers to a risk related to the economic, social, and political environment of the client’s home country in engaging in international credit-providing and investing activities. It is important for Major Banks, etc. operating globally to properly develop an internal control system related to the risk and to appropriately control country risk.

##### III-2-3-2-4-2 Major Supervisory Viewpoints

- (1) Does the board of directors, etc. recognize the importance of country risk and perform continuous monitoring by developing a system for accurately grasp the risk?
- (2) Has the board of directors, etc., based on appropriate evaluation of country risk, developed a system for controlling and properly coping with country risk by establishing regulations for implementing adequate provisions to international credit-providing activities?
- (3) Has the bank developed a system for responding flexibly to changes in international situations in order to control country risk?

### III-2-3-2-5 Credit Risk Reduction Method

#### III-2-3-2-5-1 Background

The credit risk reduction method provided in section 5 of the Public Notice, in general, is used as an effective risk control tool as it reduces credit risk significantly. In a framework for reducing the credit risk, on the other hand, the method may cause potential regulatory arbitrage, including utilization of the credit risk reduction method against securitization exposure.

Especially in profit and loss calculation, regulatory arbitrage can be found about transactions where the paper profits can be immediately enjoyed in calculating the capital adequacy ratio, by reducing the risk weight of exposure guaranteed by the bank through transfer of nominal risk, along with delaying of recognition of loss and cost arising from guarantee. For example, this regulatory arbitrage is practiced as to the credit guarantee transactions with an unusually high level of premium, fees, and other direct and indirect expenses (hereinafter referred to as “high-cost credit guarantee transactions” ) as compared with the amount of credit risk to be transferred. It can be said that these high-cost credit guarantee transactions have a problem in that, without substantial risk transfer, they enjoy desirable treatment in calculating the requisite equity capital for the short term, while they postpone the realization of losses for the long term.

#### III-2-3-2-5-2 Major Supervisory Viewpoints

- (1) Based on the above problem, when evaluating the credit risk reduction method using guarantee and credit derivatives (hereinafter referred to as “credit guarantee transactions” ) provided in section 5 of the Public Notice, the bank itself should consider the following points, and the FSA will judge the applicability of the credit risk reduction method based on the following points.
  - (i) Comparison between the current values of premium and expenses that are not yet recognized in calculating the capital adequacy ratio, and the expected losses of the exposures under guarantee that can occur under various stress scenarios.
  - (ii) Comparison of transaction prices to market prices (including adequate consideration of premium paid in property other than cash)

- (iii) Timing of payments of premium, etc. by the guarantee buyer (including the potential difference between the timing of loan loss provisions or impairment loss to guarantee exposure by the guarantee buyer and the timing of deposit payment by the guarantee provider)
  - (iv) Analysis on the date of future deposit payment to evaluate the relationship between the timing when potential future losses may occur and the duration when there is a high possibility of credit guarantee
  - (v) Analysis on a specific condition where an increase in the level of dependence of the guarantee buyer on the guarantee provider and a decrease in the level of ability for the guarantee provider to perform its payment obligation can occur at the same time
  - (vi) Analysis on whether the guarantee buyer can pay premium properly based on its income, capital and financial conditions, etc.
  - (vii) Analysis on the internal record which contains the analysis by the guarantee buyer on the rationality of guarantee transactions and future expenses and benefits arising from the guarantee transactions
- (2) The FSA pays more careful attention to credit guarantee transactions that have the following characteristics:
- (i) Transactions where premium paid is higher than the amount of guarantee exposure. For example, transactions where the total amount of expenses arising from the guarantee is as large as or larger than that of the guarantee exposure, or where, according to the price volatility and performance level of guarantee exposure, the guarantee provider pays back to the guarantee buyer part of the premium paid in the form of a rebate, resulting in excessive payment of the premium.
  - (ii) Transactions where the guarantee exposure is not subject to mark-to-market valuation, and loss related to the guarantee exposure is not recognized through profit and loss calculation.
  - (iii) Transactions where the amounts of risk-weighted assets and regulatory capital decrease significantly as a result of a credit guarantee transaction. For example, cases where the ratio of the risk-weighted assets to the exposure subject to credit guarantee exceeds 150%.
  - (iv) Transactions where payment of premium to the guarantee is not proportional to the amount of guarantee exposure. For example, a transaction where payment amount of premium is guaranteed irrespective of the presence or absence of impairment and default of guarantee exposure, and a transaction where advance payment premium and the premium scheduled to be paid when the guarantee expires are not recognized as expenses in profit and loss calculation.
  - (v) Transactions where the total amount of expenses related to credit risk reduction may increase. Examples include a transaction whose costs are high for the guarantee buyer, a transaction where the guarantee buyer takes on obligation to provide additional collateral to the guarantee provider, a transaction where additional payment is required when the transaction expires, a transaction where the guarantee buyer has the right to cancel the transaction prematurely, and a transaction where there is a pre-agreement between the guarantee provider and the guarantee buyer regarding

the discontinuation of the transaction at a pre-determined price at a specific time in the future.

### III-2-3-2-6 Supervisory Approaches and Actions Related to Credit Risk Management

#### (1) Off-site monitoring

##### (i) Continuous monitoring

The FSA always grasps and analyzes the status of credit risk of the bank based on the off-site monitoring data (quarterly) on credit risk information, midterm settlement of accounts, financial flash report, etc.

##### (ii) Off-site monitoring on an as-necessary basis

The FSA grasps and analyzes the status of credit risk of the bank by holding interviews as needed; for example, in cases where financial support measures are announced along with business reconstruction plans for large borrowers, a timely disclosure is made regarding the impossibility of collection of receivables, and revisions to the bank's financial forecasts are announced.

##### (iii) Early warning based on off-site monitoring

In cases where the bank is deemed to be required to improve its credit risk management system, measures indicated in (i) through (iii) of III-2-3-1-5(4) should be implemented against those banks, based on the equity capital ratio in view of the amount of the impact if a risk to a specific large-lot borrower had become apparent (that is, the amount of loss assuming that a certain amount of the unsecured portion of claims (the amount of the claim not secured by security/guarantee and allowances) to large-lot borrowers who are classified as "need special attention" or below was recognized as a loss), in addition to basic indicators such as: NPL ratio; the ratio of large-scale credit provision (the larger of the sums of credit provided to either borrowers that have been given 10% or more of the Tier 1 capital amount when the bank is an internationally active bank, and the amount of equity capital (excluding items corresponding to supplementary items of the eligible old capital-raising instruments) if the bank is a domestically active bank, or a certain number of borrowers whose credit balance is ranked in the upper level (excluding credits provided to the national government, local governments, government-related organizations, etc.)); and the concentration of a specific business type. When necessary, the FSA encourages the bank to improve the risk management system steadily by requiring to make a report based on Article 24 of the Banking Act. Also, in cases where it is found necessary to ensure that a bank will implement its improvement plan, the FSA issues a business improvement order based on Article 26 of the Banking Act (credit risk improvement measures).

#### (2) Gap between self-assessment and inspection results

In cases where a bank is deemed to have difficulty in enhancing its risk management system, etc., with voluntary improvement efforts left to the bank, including those where, after being notified of the

inspection results, the bank is required to submit a report under Article 24 of the Banking Act, and the gap between self-assessment by the bank and the inspection results by the FSA is found to be wide without justifiable reasons, the FSA issues a business improvement order based on Article 26 of the Banking Act.

- (3) If a problem other than that mentioned in the above (1) (iii) and (2) is found in a bank's credit risk management system in light of inspection results or off-site monitoring, the FSA requires the bank to submit a report based on Article 24 of the Banking Act, as needed. If a serious problem is found, the FSA issues a business improvement order or implement any other measures based on Article 26 of the Banking Act.
- (4) It is necessary to note that credit decisions on individual counterparties should be made solely by the management of the bank concerned. In other words, the duties of financial supervisors is to ensure the financial soundness of a bank by inspecting and supervising the bank. Although financial supervisors may inspect the feasibility of the borrower's business improvement plans when inspecting borrower classifications and self assessment results of credits, the inspection results do not reflect on anything other than the amount of the bank's NPL and write-offs/allowances. It is necessary to note that whether to sell NPL and how to revitalize a borrower should be determined by the management of the bank (and the borrower) and that supervisors shouldn't instruct or participate in such decision-making or have any right to do so.
- (5) Large-scale credit provision
  - (i) When an application for the approval pursuant to the proviso of Article 13(1) of the Banking Act (including cases where applied mutatis mutandis pursuant to Article 13(2); the same applies in the following (ii).) has been filed, the FSA examines if there is unavoidable reasons why the total amount of credit extended, etc. by a bank to one person exceeds the limit on extensions on credit, etc., such as a result of a merger or transfer of another person's business by one person who takes credit extended, etc. or other reasons specified by the Order for Enforcement of the Banking Act ("Banking Act Enforcement Order" ) and the Banking Act Enforcement Regulation.

In said approval, as a general rule, the FSA requires the bank to establish a plan to eliminate an excessive amount of the limit on extensions on credit, etc. in the future and also requires the regular submission of reports on the implementation of the plan, except for cases where such elimination is done by the end of the accounting period (including the end of the interim period).
  - (ii) The cases where an approval pursuant to the proviso of Article 13(1) of the Banking Act will be made, and which correspond to "other things found to be appropriate by the Commissioner of the FSA " stipulated in Article 14-3(2)(iii) of the Banking Act Enforcement Regulation (including cases where applied mutatis mutandis pursuant to Article 14-6(1) of the Banking Act Enforcement Regulation) , can be regarded as cases where there is no trouble concerning the

soundness of the bank, taking into consideration the circumstances listed in the following (A) to (C).

- (A) Cases where credits are provided based on obligations under laws and regulations
- (B) Cases where the restructuring of the financial group organization and the reconstruction of business models are implemented and are deemed to be necessary to realize the aim of restructuring the organization, etc.
- (C) Cases where it is deemed necessary to exceed the limit on extensions on credit, etc. regarding call loans and other inter-bank exposures in order to secure the stability of the inter-bank market under stress situations

In cases which correspond to the above (A) or (B) and where an approval pursuant to the proviso of Article 13(1) of the Banking Act is made, the plan to eliminate an excessive amount of the limit on extensions on credit, etc. will not be required, irrespective of the above (i).

### III-2-3-3 Market Risk Management

#### III-2-3-3-1 Background

- (1) Market risk is the risk that a bank will incur losses from changes in the value of assets and liabilities and off-balance-sheet transactions due to fluctuations in market risk factors such as interest rates, foreign exchange rates, and stock prices, and the risk that a bank will incur losses from changes in earnings generated from assets and liabilities. The bank needs to strive to ensure its financial soundness by properly developing an internal control environment related to the market risk, regardless of whether or not the losses are included in the capital defined under regulations concerning capital adequacy requirements.
- (2) In particular with regard to shares, it is necessary to note that the restrictions are placed on banks' shareholdings, provided in "the Banking Act on Limitation on Shareholding by Banks, etc." in order not to "impair the soundness of banks' management, by keeping the price fluctuation risk of shares held by banks within banks' risk management capability, along with measures to promote off-balance-sheet disposal of NPL for the purpose of promoting the structural reform of Japan's financial system and enhancing confidence in its stability" (Emergency Economic Package, April 2001).

Note: Limitation on shareholding by banks is expected to promote structural reform and activation of the stock market in Japan by reducing cross-shareholdings, in addition to issues regarding the financial soundness and risk management of banks, and to contribute to recovery of Japan's economy through improvement in corporate governance.

(Reference) "Report on Shareholding by Banks" by the Financial System Council (June 26, 2001)

#### III-2-3-3-2 Major Supervisory Viewpoints



(1) Risk management system

- (i) Does the board of directors define a market risk management policy based on the strategic objectives established in conformity with the bank's overall corporate management policy? Also, has the board of directors developed an appropriate market risk management system in accordance with the bank's strategic objectives and risk management policy, and commensurate with the bank's profit objectives, etc.?
- (ii) In the rules for market risk management, has the board of directors clarified the respective roles and responsibilities of the manager of each department: the market department (front office), the administrative department (back office), and the risk management department (middle office)?
- (iii) In managing market-related risks, has the board of directors established a system for covering both the segregated trading department and the non-segregated trading (banking) department?
- (iv) Has the management decided a policy for actively and quickly conducting business operations and risk management from a wide range of viewpoints?
- (v) Has the bank established a control environment for reporting important information to the management in a timely manner so that the management can decide a policy for appropriately and quickly conducting business operations and risk management, in addition to collecting and analyzing the information, including economic movements both domestic and abroad that affects the prices of owned assets, etc.?
- (vi) In cases where the operational departments conduct investment management of each owned asset without exchanging information, has a system been established for judging investment properly and quickly in terms of the whole portfolio, recognizing the possibilities of disrupting effective risk management by, for example, resulting in the risk concentration as a whole, or failing to unwind its position in a timely manner as a whole with each department persisting its own position.
- (vii) Does the risk management department not only mechanically distribute risk capital to each operational department and set the limit (for loss cutting points, warning points, etc.), but also collect and analyze various information contributing to risk management, and take the initiative in identifying risks in order to conduct daily risk management?
- (viii) Does the risk management department report identified risks to management as needed, in addition to regularly reporting?
- (ix) Is risk management conducted across the whole group, including overseas operation bases? Has the risk management division responsible for the whole group established a system to capture, analyze, and manage risks on its own, as well as simply receiving reports from the group companies? In order to facilitate this, has the bank established a control environment in which the whole Group, including overseas operation bases, can quickly identify the information necessary for risk management?

(2) Content and method of risk management

- (i) Does the bank accurately understand the position converted to present value, and the breakdown of risks by owned asset and by contract date? In particular, does the bank properly grasp risks of owned assets which have special risk characteristics?
- (ii) Does the bank conduct research, as needed, for elaboration and sophistication of internal models under the market risk management policy?
- (iii) The calculated risk amount of the interest rate risk in the banking book varies significantly, depending on the definition of the so-called core deposits (deposits that have no clearly defined period for interest rate revision and are withdrawn as needed by the depositor which are left with the bank for a long term without withdrawal). Does the bank understand this, give the internal definition of the core deposits properly, and conduct an inspection based on a back test, etc.?
- (iv) In utilizing the VaR (Value at Risk) for risk management, does the bank make efforts to verify the measurement results and secure the validity of the results, in addition to making efforts to properly select the observation period, the holding period, the confidence interval, the measurement method, and the data to populate, based on commodity characteristics?
- (v) There is a certain limit to statistical risk measurement methods, including the possibility that the VaR is too small when the past results are not sufficient or when the credibility of data is low. Based on this recognition, is the bank enhancing the risk management method including stress tests, while using various risk measurement methods (for example, for grasping gross notional amount positions and grasping changes in volatility)? Does the bank flexibly review the preconditions of risk management based on economic movements, etc.?
- (vi) In conducting stress tests, does the bank conduct an analysis based on hypothetical stress scenarios, as well as historical scenarios (adopting major cases of crises and examples of maximum loss)? Does the bank set multiple hypothetical stress scenarios regarding economic movements, both domestic and abroad, while properly simulating situations that might significantly affect owned assets, etc.? Moreover, when conducting such analysis, does the bank take into consideration situations that may break the correlation of prices of the owned assets assumed in the stress tests?
- (vii) In establishing position limits (limits to interest rate sensitivity, notional principal, etc.), risk limits (limits to expected loss amount of the VaR, etc.), loss limits, and stress tests, does the board of directors clearly define the basic concept of the bank's risk management policy in establishing each limit? Also, does the board of directors, etc. regularly (at least once per quarter) reconsider the operations of each department, and review the above established limits and tests?
- (viii) Are the reporting system and authority (such as policies and procedures) clearly specified for prompt reporting to the manager when the risk limits, position limits, and loss limits are exceeded or likely to be exceeded?
- (ix) Has a system been established in which stress test results are fully inspected and analyzed by the

management and are utilized to specific judgement related to risk management?

- (x) Does the bank manage shareholding risks properly, based on the limits on shareholdings stipulated in “the Banking Act on Limits on Shareholdings, etc. of Banks, etc.”?

(3) Risk management of credit investments such as securitization products

In the case of investments in marketable credit products such as securitization products, does the bank conduct risk management with due regard to the following points? It should be noted that similar consideration is required for marketable loans (regardless of whether the bank originates them or acquires them in the secondary market) and transactions of CDS.

(i) Proper price evaluation of products

Does the bank evaluate the price of marketable credit products (including marketable loans and CDS transactions) with due consideration to the following points?

- (A) Does the bank evaluate a price in as objective a manner as possible? For example, through such measures as evaluating the price by referencing the frequently-traded price when such a price is available, and, in cases where such a price does not exist, by referencing the prices of similar products. In addition, in cases where a price evaluation model is used, does the bank understand that such a model is based on certain assumptions and verify the appropriateness of the model by regularly reviewing the assumptions and reasoning behind it?
- (B) In cases where a product price calculated by the front office is used as the market value for risk management purposes, is such a price independently verified by the risk management department, etc.?
- (C) In cases where a price evaluation is obtained from brokers and external vendors, is the bank seeking as much information as possible regarding the methods of price evaluation and making efforts to verify the appropriateness of the relevant price evaluation? Furthermore, in cases where a price evaluation model provided by external vendors is used, does the bank request these vendors to provide as detailed information as possible and make efforts to understand the assumptions, characteristics, and limitations of such a model?
- (D) In cases where a price evaluation model is used and the liquidity risk or uncertainty risk of the price evaluation model is deemed to be significant, does the bank give due consideration to such risks?

(ii) Proper understanding of product details in the investment of securitization products, etc.

- (A) Has the bank established a control environment in order to avoid relying excessively on external credit ratings for investments in securitization products, etc. and for its intra-term management by, for example, precisely understanding the rating methods used by the credit rating agencies and the meaning of such ratings before using them?
- (B) Does the bank, when investing in securitization products, etc., make efforts to understand the nature of those products, such as by understanding the contents of underlying assets;

analyzing their structures by looking into the priority-subordinate structure (extent of leverage) and the status of liquidity support, credit enhancement, and details of credit events; and understanding the situation of price fluctuations, etc.?

- (C) The operation and management of the portfolio of underlying assets rely on relevant parties such as the originators and managers. As such, does the bank investing in securitization products make efforts to understand and monitor the skills and qualifications of the relevant parties and the organizational structure?
  - (D) When the originator, in structuring the underlying assets, intends to transfer the entirety of the underlying assets to vehicles of securitization for securitization products at the initial stage, the risks of the interests in the relevant securitization products may be heightened as a result of inappropriate structuring of the underlying assets due to, for example, inadequate analysis of the investments. As such, it is desirable that the originator continuously retain the part of the risks associated with such securitization products. In view of this, does the bank check if the originator continuously retains the part of the risks associated with the securitization products? In cases where the originator does not retain such risks, does the bank perform deeper analysis of the status of the originator's involvement in the underlying assets, as well as the quality of such assets?
- (iii) Management of market liquidity risk
- (A) Does the bank properly verify the market liquidity for investments in securitization products and for their intra-term management? It should be noted that the following methods can be considered for verifying market liquidity.
    - a. Check whether the operator's invested amount represents an excessive share relative to the overall market size
    - b. Grasp the bid-offer spread in the market, and the price level at which the products can actually be sold, through interviews, etc.
    - c. Monitor changes in market conditions through analysis of various indices (such as those of securitization products)
    - d. Design stress scenarios regarding the market liquidity drying up, and assess the profit/loss, etc. of the securitization portfolio
  - (B) Does the bank have a control environment in order to promptly consider responses when concerns arise regarding market liquidity of securitization products, etc.?
- (iv) Management of risks associated with the structuring of securitization products, etc.
- (A) Has the bank taken into consideration the pipeline risk (i.e. possibility that risks attributable to the underlying assets (or the risk associated with relevant loans) might become difficult to transfer to investors due to changes in market conditions during the process from the structuring of the securitization products to their sale (or the sale of marketable loans))? Also, has the bank previously considered measures to be taken after the buy-back (measures such as securing new investors, the inclusion of the product in the proprietary portfolio, etc.) when

it buys back a securitization product, as well as the risk that it may retake the risks associated with the underlying assets after their sale as a result of, for example, special clauses such as a buy-back clause in the sale contract? Does the bank judge the relevant risks and returns in the provision of securitization (syndication) services, taking the above risks into consideration?

- (B) Even if the risks associated with the underlying assets are transferred to investors by structuring and selling securitization products through unconsolidated special purpose companies, etc., the bank may retake the risks associated with underlying assets due to, for example, reputational risk, depending on the changes in market conditions. As such, has the bank previously considered the above possibility through measures such as reflecting this possibility in its stress tests? Does the bank judge the relevant risks and returns in the provision of securitization (syndication) services, taking the above risks into consideration?

### III-2-3-3-3 Supervisory Method and Actions

#### (1) Off-site monitoring

##### (i) Regular monitoring (monthly)

The FSA always grasps and analyzes the status of market risks, based on off-site monitoring data (monthly) regarding market risk information.

##### (ii) Off-site monitoring on an as-necessary basis

When changes in interest rates and asset prices occur, the FSA grasps and analyzes the status of market risks by holding interviews on an as-necessary basis.

##### (iii) Early warning based on off-site monitoring

Measures indicated in (i) through (iii) of III-2-3-1-5(4) should be implemented against banks that fall under any of the following, and, when necessary, the FSA encourages the bank to improve the risk management system steadily by requiring to make a report based on Article 24 of the Banking Act. In addition, in cases where it is found necessary to ensure that a bank will implement its improvement plan, the FSA issues a business improvement order based on Article 26 of the Banking Act (stability improvement measures).

(A) Banks that are deemed to be required to improve their management system for market risks, etc. based on the effects of changes in prices of securities, etc

(B) Banks that are deemed to be required to hold in-depth dialogs on the improvement actions according to the following a. and b. (applicable to domestically active banks since March 2019, excluding the following b-iv))

##### a. Materiality test

Banks whose maximum value (as for domestically active banks, the maximum value of those which are calculated based on upward parallel shift, downward parallel shift, or steepening in  $\Delta$ EVE) of the  $\Delta$ EVE (calculated as a decrease in economic value against

interest rate shock in measuring the interest rate risk in the banking book, and calculated based on the interest rate shock defined in “Disclosure requirements for capital adequacy specified by the Commissioner of the FSA under Article 19-2(1)(v)(d) and Other Provisions of the Regulation for Enforcement of the Banking Act” (“Public Notice on Disclosure “; the same applies hereinafter )) corresponds to the following elements are subject to the below b.

- i) As for internationally active banks, banks whose maximum value of the  $\Delta$ EVE exceeds 15% of their Tier 1 capital.
  - ii) As for domestically active banks, banks whose maximum value of the  $\Delta$ EVE exceeds 20% of their equity capital
- b. Additional analysis of off-site monitoring data

Analyze substantial effects of the balance of profitability, risk taking, equity capital, and the interest rate shock on equity capital. Specifically, regarding as a basic viewpoint the relationship between “the interest rate risk of all the positions held by the bank in the banking book” and “the excess of equity capital” (the amount exceeding the minimum level of equity capital provided in the Public Notice on Standards for Banks' Capital Adequacy; the same applies in this (B) ), the necessity of holding in-depth dialogs with the bank shall be judged based on the following viewpoints.

- i) Relationship between “the risks regarding changes in prices of securities by the interest rate shock” and “the excess of equity capital” (taking into consideration the unrealized profits/losses of securities in the excess of equity capital of a domestically active bank )
- ii) Relationship between “the interest rate risk by currency” and “the excess of equity capital”
- iii) Relationship between “risk taking related to the interest rate” and “profit-earning power”
- iv) “Effects of the interest rate shock on future earnings” (applicable to domestically active banks since March 2020)

Note 1: In cases where a bank uses its internal models to measure the interest rate risk in the banking book, the bank shall be required to properly document the necessary information (objectives, intended use, underlying theories, limits, assumptions, etc.), the management framework (policies, inspection procedures, organizational system, etc.), and the inspection process of the models, after properly establishing monitoring methods and governance system for the models. In supervision, attention should be paid to the effect of the use of the internal models on the amount of calculated interest rate risk.

Note 2: In measuring the interest rate risk in the banking book, the bank shall be required to properly consider, accordingly with importance levels, so-called behavioral options

(the effects of changes in the customer's behavior, not always based on economic rationality alone, in face of changes in the interest rate, on the cash flow, such as liquidity deposit retention, prepayment of lending fixed interest rate, early cancellation of the time deposit, and implementation of personal interest rate commitment line), by using the internal models or reflecting conservative assumptions.

Note 3: The bank cannot be regarded as taking excessive risks simply because the bank corresponds to a category for materiality tests. In cases where a bank is deemed to be required to hold in-depth dialogs in terms of soundness during the additional analysis of off-site monitoring data, the bank will not automatically be required improvement. In cases where improvement is needed, full consideration shall be given to the effects on the financial market and attention shall be paid to supervising the bank in order to ensure that the method and timing of improvement are properly chosen.

Note 4: With regard to the Japan Post Bank, it is obliged to hold risk-free assets such as Japanese Government Bonds as some of its assets by laws and regulations. Therefore, when taking supervisory actions based on the above (B), proper consideration should be given to said special circumstances.

- (2) If a problem other than that mentioned in (iii) above is found in a bank's market risk management system by the inspection results, etc., the FSA requires the bank to submit a report based on Article 24 of the Banking Act, as needed. If a serious problem is found, the FSA issues a business improvement order or implement any other measures based on Article 26 of the Banking Act.

#### III-2-3-4 Liquidity Risk Management

##### III-2-3-4-1 Background

Liquidity risk consists of the risk that because of deterioration in financial conditions or other factors, a bank will face a credit crunch as it fails to raise necessary funds, or will incur losses as it is forced to obtain funds at markedly higher interest rates than under normal circumstances (funding risk), and the risk that a bank will incur losses because it is unable to conduct market transactions or is forced to conduct transactions at far more unfavorable prices than under normal circumstances, because of market turmoil, etc. (market-liquidity risk). It is important for banks to properly manage liquidity risks by developing an appropriate internal control environment related to the risks.

##### III-2-3-4-2 Major Supervisory Viewpoints

- (1) Does the board of directors consider funding risks in establishing the strategic objectives in conformity with the bank's overall corporate management policy? In addition, has the board of directors, in

managing funding risks, established a system in which check-and-balance functions can be fully exercised in order to conduct proper risk management, by separating the funds management department from the risk management department?

- (2) Do the managers of the funds management department and the risk management department classify the funds status (e.g. “normal”, “needs care”, and “crisis”) according to the urgency level of funds need, and establish the provisions concerning the management method, reporting method, and settlement method for each time period classified as such after obtaining the approval of the board of directors?
- (3) Does the funds management department constantly keep track of the outstanding amount of assets that can be immediately sold or used as collateral in and outside Japan (e.g. Japanese Government Bonds) and the amount of funds that can be raised from yen investments, yen conversions, etc. and the possible timing of such funding, and also secure funding instruments in anticipation of a future liquidity crisis (for example, by obtaining credit lines from central banks and commercial banks)?
- (4) Have Major Banks, in light of the fact that they often secure liquidity from domestic and international markets, established a system for dealing with crises as well as carefully monitoring in particular the market funding environment?
- (5) As for an approximate indicator (“approximate LCR”) created on the basis of liquidity coverage ratio in order to understand early that liquidity coverage ratio meets the minimum requirement (meaning the liquidity coverage ratio on a solo basis provided in Article 8 of “Standards for Determining the Soundness Related to Liquidity Which are Defined as Standards for the Banks to Judge the Soundness of Management based on Article 14-2 of the Banking Act (Public Notice on Liquidity Ratio), the same applies hereinafter.), have internationally active banks established a system for daily calculating the approximate LCR based on the following (applicable from the day following the recording date when liquidity coverage ratio is first calculated and reported to the authorities)?
  - (i) Content of data to be updated

Do the numerator and denominator making up the approximate LCR include as many updated data items as possible in order to properly capture the liquidity coverage ratio? In order to secure the capturing power for liquidity coverage ratio, are numerators, for example, dealt with by updating more than 80% (compared to the most recent liquidity coverage ratio) of the assets corresponding to numerators of liquidity coverage ratio?
  - (ii) Due date for calculating approximate LCR

Is the approximate LCR calculated within two business days following the date when the calculation is made?
  - (iii) Report to the authorities



In cases where the liquidity coverage ratio of the most recent month falls below the level 10 percentage points higher than the lowest level, will the bank promptly start the daily report on the approximate LCR to the authorities? Will the bank continue to submit the daily report until the liquidity coverage ratio after the next month exceeds the level 10 percentage points higher than the lowest level?

(iv) Due date for reporting to the authorities

In cases where the bank has to report to the authorities in the above (iii), does the bank send the report to the authorities within the business day following the date when the approximate LCR is first calculated?

(v) Documentation

Does the bank document the method of calculating the approximate LCR?

- (6) In the case of internationally active banks, if it is expected that the “non-consolidated stable procurement ratio” (hereinafter referred to as the “stable procurement ratio”) prescribed in Article 78 of the Public Notice on Liquidity Ratio is likely to fall below the minimum level, whether it is reported to the authorities promptly?

### III-2-3-4-3 Supervisory Method and Actions

(1) Off-site monitoring

(i) Regular monitoring (monthly or quarterly)

The FSA always grasps and analyzes the status of liquidity risks, based on off-site monitoring data (monthly or quarterly) regarding liquidity risk information.

(ii) Off-site monitoring on an as-necessary basis

When the market funding environment deteriorates, for example when the rise in foreign currency funding costs occurs, the FSA grasps and analyzes the status of liquidity risks by holding interviews on an as-necessary basis.

(iii) Early warning based on off-site monitoring

Banks that are deemed to be necessary to improve their liquidity risk management system based on changes in the deposit status and on the level of liquidity reserve are required to make frequent reports on the status of deposits and liquidity reserve. In addition, measures indicated in (i) through (iii) of III-2-3-1-5(4) should be implemented against those banks, and, when necessary, the FSA encourages the bank to improve the risk management system steadily by requiring to make a report based on Article 24 of the Banking Act. In addition, in cases where it is found necessary to ensure that a bank will implement its improvement plan, the FSA issues a business improvement order based on Article 26 of the Banking Act (cash flow improvement measures).

- (2) If a problem other than that mentioned in (1)(iii) above is found in a bank’s liquidity risk management

system by the inspection results, etc., the FSA requires the bank to submit a report based on Article 24 of the Banking Act, as needed. If a serious problem is found, the FSA issues a business improvement order or implement any other measures based on Article 26 of the Banking Act.

#### III-2-3-4-4 Liquidity Ratio Regulation (for Internationally Active Banks)

##### III-2-3-4-4-1 Background

In order to secure financial soundness, banks need to prepare for liquidity risk as well as to enhance their equity capital. With respect to the short-term preparation for liquidity risk, it is important that the banks, by holding sufficient liquid assets to withstand liquidity risk, increase resilience to business continuity even when they are in a difficult situation for financing. The authorities need to grasp banks' liquidity risk and encourage them to hold sufficient liquid assets as needed.

As a medium - to long-term measure against liquidity risk, it is important to maintain a stable funding structure according to the composition of banks' assets (including off-balance sheet assets). The authorities need to understand the characteristics of banks' assets and funding sources and encourage banks to secure sufficiently stable funding sources as necessary.

From these viewpoints, internationally active banks shall be required to hold sufficient liquid assets and ensure sufficient stable funding sources by using the objective standards of liquidity coverage ratio and net stable funding ratio.

##### III-2-3-4-4-2 Accuracy of Calculation of Liquidity Coverage Ratio and Net Stable Funding Ratio

###### III-2-3-4-4-2-1 Background

The liquidity coverage ratio and net stable funding ratio must be calculated accurately, since these ratios are basic indicators showing the soundness of a bank's liquidity risk management process.

The accuracy of calculation of the liquidity coverage ratio and net stable funding ratio needs to be sufficiently based on the Notice on Liquidity Ratios and the purpose of the Basel Agreement.

###### III-2-3-4-4-2-2 Points of Attention

As for the accuracy of calculation of the liquidity coverage ratio and net stable funding ratio, whether the ratios are accurately calculated in accordance with the provisions of the Notice on Liquidity Ratios. Checks shall be made while paying special attention to the following.

- (1) Points to be considered regarding cases where the bank formulates specific calculation methods and

identification methods of assets and liabilities

In cases where special provisions concerning the qualifying operational deposits in Article 29 of the Notice on Liquidity Ratios, the additional collateral amount required in times of market-value changes based on the scenario method in Article 38 of the same notice, and interrelated assets and liabilities on the net stable funding ratio in Article 101 of the same notice are applied for outflow items in the liquidity coverage ratio, the bank is required to formulate specific calculation methods or identify eligible assets and liabilities that are within the scope of the prescribed requirements. In such cases, the FSA will make sure the specific calculation methods and identification methods of assets and liabilities have been formulated according to the Notice on Standards for Banks' Capital Adequacy by checking the following points beforehand.

- (i) In cases where the bank plans to use the special provisions regarding the qualifying operational deposits, whether the method to calculate the amount of the qualifying operational deposits is formulated in ways that meet the requirements for qualifying business, requirements for operational deposits, qualitative standards, and quantitative standards.
- (ii) In cases where the bank plans to use the additional collateral amount required in times of market-value changes based on the scenario method, whether both the formulation of the stress scenario and the method to estimate the amount meet the selection standards for stress scenarios, quantitative standards, and qualitative standards.
- (iii) In cases where banks intend to use special provisions concerning interrelated assets and liabilities, whether the eligible assets and liabilities subject to the special provisions are set in a manner that satisfies all of the requirements prescribed in Article 101 of the Notice on Liquidity Ratios.

- (2) Judgment of the entities that the calculations of liquidity coverage ratios and net stable funding ratios cover

In calculation of the liquidity coverage ratio and net stable funding ratio, internal controls at the bank should be taken into account in order to judge the entities that its calculations will cover. Is the bank appropriately handling the following specific aspects?

- (i) Judgment of "entities that are considered to be of low importance from the viewpoint of managing risks related to liquidity" in the definition of "financial institutions, etc."

With regard to "financial institutions, etc." prescribed in Article 1(xix) of the Notice on Liquidity Ratios, "entities that are considered to be of low importance from the viewpoint of managing risks related to liquidity" are excluded. In relation to this, whether the bank is engaging in inappropriate practices, such as arbitrarily excluding an entity deemed to be of importance from the definition of "financial institutions, etc." with a purpose of raising the liquidity coverage ratio by reducing cash outflows or raising the net stable funding ratio by increasing the amount of available stable funding, should be checked.

- (ii) Treatment of consolidated subsidiary companies, etc. that are small in scale

For small-scale consolidated subsidiaries, etc. having a significantly small impact on the level

of the consolidated liquidity coverage ratio and the consolidated net stable funding ratio, simplified calculations are allowed, as long as they are conservative (for example, the eligible high quality liquid assets or the amount of available stable funding are assumed to be zero).

In such cases, whether the bank is engaging in inappropriate practices, such as applying the relevant calculation to a financial institution that represents a significantly large percentage of assets (debts) relative to the total consolidated assets (total consolidated debts), or applying the relevant calculation to an entity that is expected to have a large amount of cash outflows from off-balance sheet items by ignoring that and categorizing it as a small-scale consolidated subsidiary, etc.

(3) Judgement of past liquidity stress periods

In judging the "past liquidity stress periods," the bank, while it is basically required to refer to data as old as 2007 (2008 in the case of Japan), is nonetheless urged to look into data as far back as the late 1990s, so far as it is possible. In this regard, does the bank use the data that are available and cover the periods that meet the requirements to be judged as past liquidity stress periods?

(4) Confirmation of rate of decline in prices, etc.

In judging Level 2A and 2B assets under the Notice on Liquidity Ratios, the bank is required to confirm the rate of drop in prices or the extent of haircut of the assessment rate of collateral during past market liquidity stress periods. For example, does the bank properly confirm the granularity of credit ratings and maturity when judging?

(5) Appropriateness of classification of cash inflow/outflow items and the outflow rate

The Notice on Liquidity Ratios has provisions that call for setting a classification of cash inflow/outflow items as well as the outflow rate (amount) and cash inflow amounts with regard to the liquidity coverage ratio, and for setting the amount of stable funding available and the amount of stable funding required with regard to the net stable funding ratio. The bank is required to properly set and verify them. Specifically, attention should be paid to the points listed below.

- (i) Does the bank consider the need to set an additional classification for "less stable deposits" under Article 21 of the Notice on Liquidity Ratios as part of its internal controls, and introduce an appropriate classification if needed? In addition, does the bank set the outflow rate consistent with the outflow rate during the past liquidity stress periods? Further, does the bank check that the possibility that the outflow rate will exceed 10% is sufficiently low even when it does not apply the past outflow rate directly but apply it to the composition of the current, less stable deposit?
- (ii) With regard to the items "other contingency cash outflow" prescribed in Article 53 of the Notice on Liquidity Ratios and contingency liabilities prescribed in Article 100(iii) of the same notice, whether appropriate classification is made with consideration of internal controls. Also, whether

the appropriateness of this classification is examined periodically.

- (iii) Are the "amount of other contracted cash outflow" prescribed in Article 60 of the Notice on Liquidity Ratios and the "amount of other contracted cash inflow" prescribed in Article 73 of the same notice set appropriately with consideration of the importance of managing liquidity risk? Also, is the appropriateness of this classification examined periodically?

(6) Validity of Method for Setting Remaining Maturity

In the calculation of the liquidity coverage ratio and net stable funding ratio, if the remaining maturity is calculated by using a pricing model, whether the operator understands that the model is built on certain assumptions, periodically reviews the assumptions and logic of the model and verifies the appropriateness of the estimation of the remaining maturity.

(7) Appropriateness of allocation method of securities

In the calculation of the liquidity coverage ratio and net stable funding ratio, if the source of securities is unknown (for example, in cases where the source of securities that are offered as collateral for short positions in securities or transactions in the form of repurchase agreements is unknown), and if any allocation method specified by the bank is used, whether the allocation method is clarified in writing and appropriately managed in accordance with the document.

(8) Consistency of calculation methods for liquidity coverage ratio and net stable funding ratio

In some cases, the bank is allowed a certain level of discretion regarding calculation methods for the liquidity coverage ratio and the net stable funding ratio, such as handling of netting (referring to the offsetting of some amounts in the calculation process of cash outflow and inflow amounts) under Article 35(2) of the Notice on Liquidity Ratios, and handling of the special provision regarding the qualifying operational deposits under Article 29 of the same notice and adoption of the scenario method prescribed in Article 38 of the same notice as well as the special provision concerning interrelated assets and liabilities prescribed in Article 101 of the same notice. In such cases, whether the bank adopts consistent and conservative calculation methods except in the case of changes based on reasonable grounds.

III-2-3-4-4-2-3 Supervisory Method and Actions

(1) Off-site monitoring

If a problem is found in the accuracy of calculation of the liquidity coverage ratio and net stable funding ratio, the FSA requests submission of a detailed report and holds an interview with the bank if it is deemed necessary.

For banks that adopt the special treatment of the qualifying operational deposits stipulated in Article 29 of the Notice on Liquidity Ratios and the scenario method prescribed in Article 38 of the same

notice, and in the special provision concerning interrelated assets and liabilities prescribed in Article 101 of the same notice, the FSA requires them to submit reports periodically and review whether the calculation method satisfies the requirements stipulated in the said notice and whether the calculation method has not been changed from the previous reporting period.

- (2) If a problem is found in the accuracy of calculation of the liquidity coverage ratio and net stable funding ratio through the inspection or off-site monitoring as described in (1), the FSA requires the bank to submit a report based on Article 24 of the Banking Act. If a serious problem is found, the FSA issues a business improvement order based on Article 26 of the Banking Act.

#### III-2-3-4-4-3 Supervisory Measures Regarding the Regulation on Liquidity Ratios

In order to complement the bank's efforts in managing liquidity risk, the FSA takes necessary measures in a timely and appropriate manner by using the objective standard of the liquidity coverage ratio and the net stable funding ratio, and requests the bank to make efforts to improve its business management.

##### III-2-3-4-4-3-1 Supervisory Method

- (1) Periodic monitoring (monthly or quarterly)

The FSA periodically requires banks to report their liquidity coverage ratio and net stable funding ratio, and constantly monitors the condition of liquidity risk.

- (i) Liquidity coverage ratio (monthly)

The liquidity coverage ratio as of the reporting date, which can be either the final day or final business day of each month, shall be reported on a monthly basis in a specified format by the 10th business day of the next month. Based on the report, the FSA reviews the level and trends of the liquidity coverage ratio and analyzes the factors and background of such changes by examining the composition of the numerator and denominator of the liquidity coverage ratio.

Additionally, by analyzing other data from off-site monitoring and financial/economic indicators, the FSA will check whether there are signals that may show that the overall financial system may be under stress related to liquidity.

- (ii) Net stable funding ratio (quarterly)

The net stable funding ratio as of the end of each quarter is submitted by the reporting requirement. Based on the report, the FSA reviews the level and trends of the net stable funding ratio and analyzes the factors and background of such changes by examining the composition of the numerator and denominator of the net stable funding ratio.

Although the reporting date of the liquidity coverage ratio is basically the last day of the month, it is permitted to use the final business day of the month only if that is consistent with accounting rules adopted by the bank. The choice of reporting date cannot be changed in the

absence of reasonable grounds.

(2) Monitoring on an as-necessary basis

In addition to (1), the FSA instructs the bank to submit a report on the status of the liquidity coverage ratio and the net stable funding ratio if needed.

III-2-3-4-4-3-2 Supervisory Actions

- (1) The liquidity coverage ratio and the net stable funding ratio that supervisory measures are based on  
The liquidity coverage ratio or the net stable funding ratio that is subject to supervisory measures under (2) is the one reported in the periodical or as-necessary monitoring under III-2-3-4-4-3-1.

(2) Supervisory measures

If the liquidity coverage ratio or the net stable funding ratio falls below the minimum requirement level, the FSA promptly instructs the bank to submit a report on the reason and measures to improve the liquidity coverage ratio or net stable funding ratio in accordance with Article 24 of the Banking Act. If a significant improvement is deemed necessary, the FSA shall issue a business improvement order based on Article 26 of the Banking Act.

If it is expected that the liquidity coverage ratio or the net stable funding ratio may fall below the minimum requirement level at some future date, the FSA holds interviews to ask the bank to explain the reason for such a situation and the likeliness of the situation to be improved. After the interviews with the bank, if there are still issues to be fixed, the FSA requests the bank to submit a report in accordance with Article 24 of the Banking Act and issues a business improvement order in accordance with Article 26 of the same Act, if there is the need for even more certain improvement.

However, supervisory actions should not be taken in a mechanical or uniform fashion; these actions should be taken with due regard to the details and effect of the measures taken by the bank in trying to maintain the liquidity coverage ratio and the net stable funding ratio above the minimum requirement level, and the potential impact on the financial system from the effects of such measures.

- (i) The report based on Article 24 of the Banking Act must include the following. In addition, the FSA requests additional information as necessary.
- (A) Factors that led the liquidity coverage ratio or the net stable funding ratio to fall below the minimum requirement level (such as a decrease in some of the eligible high quality liquid assets that can be included in the calculation or the available amount of stable funding, and/or an increase in the amount of some specific outflow or the available amount of stable funding, etc.), as well as their background
- (B) Prospect of the timeline of when the liquidity coverage ratio or the net stable funding ratio is expected to rise above the minimum requirement level, and the expected trajectory of the individual elements that constitute the numerator and denominator of the ratio

(C) Regarding the liquidity coverage ratio, the amount and types, etc. of liquid assets that are not included in the eligible high quality liquid assets but that can be used to obtain funds in emergency situations.

Note: If a report is submitted based on Article 24 of the Banking Act, the following points can be analyzed, taking into consideration the information in such a report.

- a. Whether the fall in the liquidity coverage ratio or the net stable funding ratio is due to temporary causes or long-term, structural causes
  - b. Possibility that measures to maintain the minimum requirement level of liquidity coverage ratio or net stable funding ratio may cause a negative impact on the financial system as a whole and the channels by which such impact may be transmitted
- (ii) As regards the order based on Article 26 of the Banking Act, the FSA instructs the bank to submit an improvement plan that is deemed reasonable and to ensure that such plan is implemented properly. Such an improvement plan must include the items listed below. In addition, the FSA instructs the bank to submit reports related to (A), (B), and (C) of the above (i) and other reports, along with the improvement plan.
- (A) Measures that have already been implemented and those planned to be implemented and the planned timing of their implementation
  - (B) Time required to implement the improvement plan

Note: III-2-3-4 mainly defines the liquidity coverage ratio and the net stable funding ratio on a solo basis, and in cases where the consolidated liquidity coverage ratio provided in Article 2 of the Public Notice on Liquidity Ratio or the consolidated net stable funding ratio provided in Article 74 of the Notice is applied, the term “on a solo basis” shall be replaced with the term “on a consolidated basis” as needed.

III-2-3-5 Points to Note Regarding Compensation Structure, etc.

III-2-3-5-1 Background

It is possible for Major Banks, which often engage in international financial activities, to design and operate their compensation structure by giving consideration to international employment and compensation practices. On the other hand, depending on that design and operation, incentives for officers and employees to take risks could increase, and if this tendency were to become excessive, it could lead to serious problems, such as for the Group’s overall risk management.

Internationally as well, at the Financial Stability Board and other forums, discussion has been advanced on the design and operation of the compensation structures of financial institutions. The upshot is that Major Banks need to ensure that compensation structures do not lead to officers and employees taking excessive risks, while also giving consideration to these international trends. In light of this, supervisors



shall supervise the compensation structures of these banks with due consideration especially of the following points while also taking into account international guidelines published by the Financial Stability Board(\*). In performing actual supervision, the FSA also takes into account the size of the Group, the complexity of its business operations, and its establishment of overseas bases and be mindful of not applying these guidelines in a mechanical and uniform fashion.

In addition to the risk of officers and employees being provoked into taking excessive risks with regard to the compensation structure, the FSA also takes due care with regard to whether any similar risks are noticeable with regard to employment practices, personnel evaluation systems, and the like. Also, in light of the fact that senior managers are responsible for important duties including governance and other important responsibilities and that they receive compensation for this, it should be kept in mind that they are duly required to conduct appropriate management.

Note:

- Financial Stability Forum “Principles for Sound Compensation Practices” (April 2009)
- Financial Stability Board “Principles for Sound Compensation Practices—Implementation Standards” (September 2009)
- Financial Stability Board “Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices—The Use of Compensation Tools to Address Misconduct Risk” (March 2018)

### III-2-3-5-2 Supervisory Viewpoints

#### (1) Role of the compensation committee

- (i) With regard to the compensation structure for Group officers and employees, has an appropriate control environment been developed, which includes a committee to monitor the condition thereof and a body or other organization by which the necessary checks of the management team can be exercised to ensure the appropriate design and operation of the compensation structure (“compensation committee”)? Also, have the necessary authority, systems, and so forth been secured so that the compensation committee can exercise the monitoring and checking function independently from the operational departments (including officers in charge of operations)?
- (ii) Has the compensation committee confirmed that the overall level of compensation is consistent with the present state and future forecasts of financial soundness of the entire Group, and that it will not have a material impact on the future adequacy of equity capital?
- (iii) Does the compensation committee pay sufficient attention to the perspectives of risk management, such as whether it cooperates closely with the risk management department regarding the evaluation of the appropriateness of the design and operation of the compensation structure?
- (iv) Does the compensation committee, through monitoring how the compensation structure is operated, check whether any problems have arisen, such as compensation being excessively linked to short-term earnings or being overly reflective of performance?

- (2) Consistency between compensation structure and risk management, etc.
- (i) Is the compensation of employees in the risk management department and compliance department determined independently from other business departments? Does such compensation appropriately reflect the importance of their responsibilities? Also, in addition to the degree to which risk management and legal compliance goals are achieved, is compensation-related performance for these employees measured in a way that primarily reflects the degree of their contribution to the establishment of a control environment for risk management and a control environment for legal compliance?
  - (ii) Is the productivity-linked portion of compensation for officers and employees (as for employees, those employees who have a significant influence on the overall risk-taking of the group; the same applies hereinafter ) appropriate given their responsibilities and the actual scope of their work, and in light of the policies concerning the financial soundness of the entire Group and the degree of risk that the Group can face?
  - (iii) In cases where a considerable portion of the compensation for officers and employees is linked to productivity, does the design take into account the response to financial risks (estimates of the required equity capital and liquidity) that could arise before the compensation is finalized?
  - (iv) Has the productivity-linked portion of compensation for officers and employees been designed to decrease to a significant degree in the event of poor business results?
  - (v) Have methods of paying compensation that emphasize the creation of more long-term corporate value (for example, payments in stock or the granting of stock options) or methods of paying compensation that also take into account the period of time up until risks are actualized (for example, setting fixed-period transfer restrictions in cases where payments are made in stock, setting exercise periods if stock options are granted, or redemptions in the event compensation payments are carried over if business results are poor) been adopted according to the responsibilities of officers and employees and the actual scope of their work?
  - (vi) With regard to a compensation structure that could adversely affect risk management (such as guaranteed minimum bonuses paid across two or more years, or large lump sum payment of retirement allowances), have appropriate improvement measures been examined and implemented?
  - (vii) Even in cases where a compensation structure consistent with risk management has been designed, has a control environment been developed for properly monitoring and checking the risk of acts being conducted by officers or employees which could compromise the intent of that design (such as transactions which are likely to reduce risks superficially)?

III-2-3-5-3 Supervisory Method and Actions

- (1) With regard to compensation structures of Major Banks, the FSA holds interviews on a periodic and

ongoing basis on such banks' response to identified issues in light of international trends and other factors. Also, the FSA actively utilizes frameworks of cooperation with overseas authorities and holds in-depth interviews on issues related to overseas bases that are identified through such cooperation.

- (2) If off-site monitoring, inspection results, or the like mentioned in the above (1) reveal a problem, the FSA requires the bank to submit a report based on Article 24 of the Banking Act, as necessary. If a serious problem is found, the FSA issues a business improvement order or implement any other measures based on Article 26 of the Banking Act.

### III-2-3-6 Supervisory Viewpoints for the Capability to Aggregate Data Relating to Risk Management and Reporting to the Board of Directors, etc.

#### III-2-3-6-1 Background

Especially for those banks, among Major Banks, that conduct large and complicated business, it is necessary to develop management information systems and risk management practices relating to data concerning the risk management of the entire Group ("risk data"), in order to accurately and promptly aggregate risk data and report to the board of directors, etc. on risk management ("risk reporting"), from the perspective of reducing potential for loss and securing financial soundness. The improvement of such risk data aggregation capabilities and risk reporting practices of banks is important in ensuring financial soundness. Solid risk data aggregation capabilities and risk reporting practices are also important, in particular, for banks and supervisory authorities to forecast the future and examine countermeasures based thereon in times of stress or crisis, and will lead to the improved feasibility of recovery and resolution of financial institutions as well as profitability.

Internationally, based on the agreement of the Basel Committee on Banking Supervision(\*), compliance with the "Principles for Effective Risk Data Aggregation and Risk Reporting" to enhance risk data aggregation capabilities and risk reporting practices is required of G-SIBs and D-SIBs as follows: banks that were deemed as G-SIBs by the Financial Stability Board by 2012: by January 2016; banks that were deemed as G-SIBs after 2012: within three years after being deemed by the Financial Stability Board; D-SIBs: no later than three years after being deemed as D-SIB. In Japan, it is necessary to continue efforts for the establishment of an IT infrastructure and process as well as the development and improvement of practices related to risk data aggregation and risk reporting in consideration of international moves, with the aim of improving the risk management practices and decision-making processes of banks.

Note: Basel Committee on Banking Supervision "Principles for Effective Risk Data Aggregation and Risk Reporting" (January 2013)

#### III-2-3-6-2 Viewpoints and Supervisory Method and Actions

Based on the agreement of the Basel Commission on Banking Supervision, banks are required to comply with the “Principles for Effective Risk Data Aggregation and Risk Reporting” (for banks designated as G-SIBs by the FSB by 2012; by the beginning of 2016; for banks designated as G-SIBs in subsequent updates or banks designated as D-SIBs through the Public Notice on Standards for Banks' Capital Adequacy: no later than three years from the announcement of their designation). Therefore, banks should implement efforts toward the development and improvement of IT infrastructure and processes as well as practices relating to risk data aggregation and risk reporting to promptly aggregate and report at the entire group level the information that is necessary for reporting to the board of directors, etc. and authorities. The FSA supervises their implementation status taking into consideration the following points in particular.

(1) Comprehensive governance framework and IT infrastructure

- (i) Is a strong governance framework consistent with other viewpoints in the guidelines for supervision or the principles and guidelines stipulated by the Basel Committee on Banking Supervision introduced with regard to risk data aggregation capabilities and risk reporting practices?
- (ii) Are the data structure and IT infrastructure related to risk data aggregation capabilities and risk reporting practices designed, established, and maintained in view of responses in times of stress or crisis as well as in normal times?

(2) Risk data aggregation capabilities

- (i) Are risk data that satisfy the accuracy and integrity that are deemed necessary in reporting in normal times and in times of stress or crisis being prepared? In addition, are the majority of data automatically aggregated in order to minimize the possibility of errors?
- (ii) Are all major risk data captured and aggregated on a Group consolidated basis? In addition, does the framework enable aggregation by business unit, group company, type of asset held, business type and region of exposure, and other important classification so that concentration and generation of exposure and risk can be identified and reported?
- (iii) Are the latest risk data aggregated on a timely basis while satisfying the levels of accuracy, integrity, coverage, and applicability that are deemed necessary? For reference, it is necessary to pay attention that the specific timing of risk data aggregation should be decided based not only on the importance of the risk data in the risk profile of the entire bank, etc., but also the nature and potential volatility of the risk, and the reporting frequency in both normal times and in times of stress or crisis in view of the foregoing.
- (iv) Is a framework in place to enable aggregation of risk data that correspond to the various non-regular and as-necessary requests including responses in times of stress or crisis, changes in internal control necessity, and requests from the supervisory authorities?

(3) Risk reporting

- (i) Does the risk report accurately reflect the aggregated risk data? In addition, does the bank carry out the necessary validations concerning the reported contents?
- (ii) Does the risk report cover all of the important risks of the bank? In addition, are the depth and scope of the report consistent with the size and complexity of operations, risk characteristics, and the requests from the recipient of the risk report such as the board of directors, etc.?
- (iii) Does the risk report comprehensively convey useful information in a clear and concise manner according to the needs of the recipient of the risk report?
- (iv) Does the board of directors, etc. decide the frequency of preparation and distribution of the risk report based on the necessity of the board of directors, etc., the nature and volatility of risks subject to report, and importance from the perspective of effective and efficient decision-making and sound risk management? In addition, is the frequency of preparation and distribution in times of stress or crisis greater than that in normal times?
- (v) Is the risk report appropriately distributed to the recipients of the risk report such as the board of directors, etc., while ensuring confidentiality?

### III-2-3-7 Operational Risk Management

#### III-2-3-7-1 Background

Operational risks refer to the risks that might be incurred either by the inappropriateness or malfunctioning of operational procedures, activities of officers and employees or systems within financial institutions, or by exogenous events. For example, operational risks include the risks that might incur business administrative errors, system failures (including those incurred by cyberattacks), natural disasters, retribution against fraud such as money laundering, and penalty charges. The sub-risk category of operational risks mainly consists of administrative risk (i.e., risk for financial institutions to suffer losses that are incurred by officers and employees who fail to engage in administer accurately or cause accidents or fraud, etc.) and system risk. It is important for financial institutions to properly manage operational risks by developing appropriate operational risk management environments that include personnel management of officers and employees related to these risks.

#### III-2-3-7-2 Major Supervisory Viewpoints

- (1) Operational risk management environments
  - (i) Do the board of directors and other relevant organs proactively get involved in establishing appropriate operational risk management environments and regularly check the progress and outcomes? In particular, do they formulate strategy to identify, evaluate, understand, and manage inherent operational risks in key products, operational processes and systems, as well as any relevant strategy to reduce or shift such risks?

- (ii) Using frameworks such as a three lines of defense (for example, “three lines” refers to the operation execution department, the risk management department, and the internal audit department), have the board of directors, etc. developed any policies on operational risk management, reporting and monitoring systems, incentive scheme for officers and employees, educational and training systems for risk management and ethical norms so that any kind of conflicts of interests can be prevented sufficiently? In addition, have rules relevant to administrative and operational risk management environments been clearly stipulated?
- (iii) Are important legal compliance issues such as checking at every transaction or in the reporting of any suspicious transaction recognized as legal compliance issues across the bank and treated as such, not being recognized and handled as mere clerical issues?

(2) Internal audit environments

Does the internal audit department appropriately conduct internal audits so as to audit operational risk management environments?

(3) Cross-organizational risk management environments

- (i) Have departments in charge of risk management developed cross-organizational risk management environments that include checking operational risk management environments at operational offices and managing the degree of dependence on important third parties, etc., including outsourced contractors and service contacts?

(Note) “Third parties, etc.” refers to the outsourced contractors who are engaged in the outsourced operations (including two- or more-tiered outsourcings) that are stipulated in III-3-3-4 and III-3-7-1-2(8), suppliers, and service contacts, etc. Among them, “important third parties, etc.” refers to those essential to provide important functions at the levels of tolerance as stipulated in III-3-6-1.

- (ii) Have operational risk management environments been developed consistently with frameworks for other risks management, etc., including system risk management, change management (management relevant to the update of IT systems, etc.) and Business Continuity Management (BCM)?

(4) Administrative management relative to operational bases

- (i) Handling of employee dispatch

Dispatch means sending an employee or employees to a certain place within a specified facility and having the employee(s) receive or disburse money on behalf of the operator of the said facility. As long as such facilities are limited to public facilities such as public offices, public housing tracts, and general hospitals, and as long as such employees’ administrative works are limited to receiving or disbursing public money or the equivalents, such places are allowed not to be designated as the bank’s business offices as stipulated in the Banking Act. However, in cases where any acts

equivalent to arrangement for deposits, etc. are conducted for an inevitable reason, does the bank confine such acts to the minimum necessary with the following points in mind?

(A) Are such arrangements made exclusively for employees belonging to the dispatched facility and users of the dispatched facility?

(B) When making such arrangements, have all possible measures, such as issuing certificates of temporarily keeping money or passbooks, in order to prevent accidents been taken?

(ii) Handling of facilities where internal administrative works are conducted

As for the facilities and the like that are established for any bank's employees engaged in business activities at customers' places to conduct internal administrative works, etc., as long as the employees are not permanently engaged in customer services, the facilities are allowed not to be designated as the bank's business offices as stipulated in the Banking Act. However, have any measures been taken so that customers will not misidentify such facilities as business offices?

(iii) Regarding establishment of business offices and handling of the location change

In terms of filing a notification of the location change of a business office as stipulated in Article 8(1) of the Banking Act, it should be noted that the relevant bank will submit the location change due to the change of the location of its business office. In addition, it should be noted that in cases where a bank intends to separate any department from its existing business office (for example, its dealing room that conducts part of the bank's specific operations, or its corporate business department) and establish a new business office for this department (with its location change), the bank needs to file a notification of the establishment of the business office as stipulated in the same Article 8(1).

### III-2-3-7-3 Supervisory Method and Actions

In cases where the regulator recognizes that the bank's operational risk management environments are problematic as a result of the relevant investigation based on the filed notification of misconduct or the like, the regulator should, when necessary, require the bank to make a report based on Article 24 of the Banking Act. If any serious problem is recognized, the regulator should issue a business improvement order or implement any other measures based on Article 26 of the Banking Act.

### III-3 Appropriateness of Business Operations, etc.

#### III-3-1 Legal Compliance (for Especially Important Matters)

It is important to recognize the public nature of the business of the banks, strictly comply with laws and regulations as well as various business rules, and maintain sound and appropriate business operations in order to gain the trust of customers.

Although there are a wide range of laws and regulations to comply with, and there is no difference in

importance between any of the laws and regulations, special attention should be given to the following for the time being, based on various past experiences and recent policy developments.

### III-3-1-1 Supervisory Actions in Response to Misconduct and Other Inappropriate Behavior

Business improvement orders or other supervisory actions should be strictly imposed on misconduct and other inappropriate behavior by officers and employees as follows.

#### (1) Initial report of misconduct and other inappropriate behavior

The FSA checks the following points when receiving an initial report of misconduct and other inappropriate behavior in a bank.

- (i) Whether the bank has promptly reported to the administrative department of the headquarters, etc. and the internal audit department, and has reported to the board of directors, etc. in accordance with its compliance rules.
- (ii) In cases where the conduct could constitute a criminal offense, whether the bank has reported to the police and other relevant organizations.
- (iii) Whether a division independent of the division involved in the incident investigates and resolves the incident.

#### (2) Receipt of misconduct notification and other inappropriate behavior

According to Article 53 of the Banking Act, the bank submits misconduct notification and other inappropriate behavior within 30 days from the date when the bank has become aware of the misconduct. When receiving the notification, the FSA checks whether such reporting has been properly done based on the provisions of the relevant laws and regulations.

It should be noted when a written notification is submitted without an initial report from the bank, points mentioned in (1) above must be checked also.

#### (3) Major supervisory viewpoints

The FSA examines the appropriateness of a bank's business operations in relation to misconduct and other inappropriate behavior, based on the following viewpoints:

- (i) Whether an officer has been involved in the incident and whether there has been firm-wide involvement.
- (ii) What impacts the incident is expected to have on the management of the bank.
- (iii) Whether the internal check-and-balance function is properly working.
- (iv) Whether the bank has formulated improvement measures and is equipped with a sufficient self-rectification function.
- (v) Whether the bank acted appropriately immediately after the incident came to light.



(4) Supervisory measures

In cases in which a misconduct notification and other inappropriate behavior is submitted, the FSA holds interviews regarding facts, the analysis of causes, improvement and corrective measures, and when necessary, requires the submission of reports based on Article 24 of the Banking Act. In cases where a serious problem is found, the FSA issues a business improvement order based on Article of 26 of the Banking Act.

III-3-1-2 Handling of Violation of Laws and Regulations by Officers

III-3-1-2-1 Background

- (1) If an officer makes his organization violate any law or regulation in executing banking business operations, it will be not only a problem related to the responsibility of the officer as an individual but also a serious problem for which the bank should be responsible as a corporate entity. The bank should note that any loss of trust and reputation damage would have a significant impact on the management of the bank.
- (2) Among the banks which have a public nature and play an important economic role, especially Major Banks engaged in large-scale operations, if they fall in such a situation, shall impair the soundness of the financial system and significantly damage confidence from the public, the social effects of which cannot be ignored.

III-3-1-2-2 Supervisory Method and Actions

- (1) In cases where inspection results, and misconduct notification and other inappropriate behavior show that an officer is suspected of making his organization violate any law or regulation, the FSA requires the bank to conduct a strict internal investigation and to submit reports based on Article 24 of the Banking Act.

Especially in cases where an officer is suspected of committing a serious violation of any law or regulation, the FSA requires a perfectly independent third party(\*) such as a lawyer or an external expert to conduct an objective and strict investigation, and to submit reports based on Article 24 of the Banking Act.

Note: It should be noted that, for example, a corporate attorney is not considered a perfect third party.

- (2) In light of the inspection results and the bank's response, etc., the FSA considers taking strict administrative measures in compliance with laws and regulations such as administrative actions based on Article 27 of the Banking Act.

### III-3-1-3 Measures against Organized Crime

#### III-3-1-3-1 Verification at the Time of Transaction

##### III-3-1-3-1-1 Background

###### (1) Outline

Banks that have a public nature and play an important economic role must not be involved or exploited in organized crime activities, such as the provision of profits to “Sokaiya” racketeer groups, so-called underground financing, terrorism financing, or money laundering. In order to prevent banks from being exploited by a crime organization and contributing to expanding profits gained from criminal activities, it is necessary to establish a bank-wide and robust legal compliance system. Banks are particularly required to establish an internal control environment of measures required by the Banking Act for Prevention of Transfer of Criminal Proceeds (“Anti-Criminal Proceeds Act”), including verification at the time of transaction, storage of transaction records, etc. and notification of suspicious transactions (referred to as measures for verification at the time of transaction, etc. provided in Article 11 of the Anti-Criminal Proceeds Act; hereinafter “measure for verification at the time of transaction” ).

###### (2) History, etc. of enactment and amendment of the “Anti-Criminal Proceeds Act”

- (i) Looking back at the history of countermeasures against organized crimes such as interference by anti-social forces in Japan, the revised Commercial Code to prohibit offers of profits to “Sokaiya” racketeer groups was enforced in 1982. Also, the Banking Act on Prevention of Unjust Acts by Organized Crime Groups was enforced in 1991, and many other laws and regulations have been enacted.
- (ii) In addition, looking back at the history of international control on money laundering, the new agreement on narcotic drugs adopted by the United Nations in 1988 regulated drug offense proceeds or the like for the first time, requiring financial institutions to perform identification confirmation and to report suspicious transactions. Afterwards, coping with changes in the international situation since the end of the Cold War, the international community has expanded its attention toward eradication of organized crimes, broadening the scope of the predicate offences for money laundering from drug crimes to major crimes.
- (iii) Under these circumstances, triggered by a series of financial scandals that revealed that Japan’s leading banks and other companies offered profits to corporate extortionists, arrangements regarding the “Key Points of Measures against so-called ‘Sokaiya’ Racketeer Groups” were made at the meeting of relevant cabinet ministers in September 1997.

In the course of these actions, in addition to measures for the time being, “Considerations of

Criminal Law for Measures against Organized Crime” were discussed and examined, and the Law for Punishment of Organized Crimes, Control of Crime Proceeds and Other Matters (the "Organized Crime Punishment Law") was enforced in February 2000.

- (iv) On the other hand, reflecting the international community’s harsh response to terrorism financing since the multiple terrorist attacks against the U.S. in September 2001, transactions suspected of terrorism financing were included in the suspicious transactions subject to notification, stipulated in the Organized Crime Punishment Law, and the “Law concerning the Identity Verification of Customers by Financial Institutions” ("Know-Your-Customers (KYC) Policy Law”) was newly enforced in January 2003.

Note: Afterwards, in light of the situation where bank accounts were illegally used for criminal acts such as so-called “billing fraud”, the KYC Policy Law was amended in December 2004 (and renamed the “Law concerning the Identity Verification of Customers, Etc. by Financial Institutions, Etc. and Prevention of Improper Use of Bank Accounts, Etc.”), with penal provisions provided for regarding the act of accepting the transfer of a deposit passbooks, etc. According to the Banking Act on Payment of Damage Recovery Benefits from Funds in Deposit Accounts Used for Crimes, financial institutions are required to take proper measures to stop transactions related to those bank accounts (i.e. bank accounts used for crime) that are suspected of being used as accounts to be transferred into regarding the overall criminal acts including fraud and other crimes that damage other persons’ property, irrespective of “billing fraud.”

- (v) And in light of domestic situations related to circulation of funds for terrorism and other criminal proceeds in recent years and movements in strengthening international measures based on the FATF Recommendation, the provisions of the Anti-Criminal Proceeds Act that were defined, based on the KYC Policy Law and Chapter 5 of the Organized Crime Punishment Law, to expand the target entities obliged to perform the identification confirmation and to report suspicious transactions into other entities than financial institutions were newly enforced in March 2008.
- (vi) Afterwards, in order to further strengthen measures against the crimes related to recent money laundering, and measures based on the FATF Recommendation, the revised Anti-Criminal Proceeds Act that stipulates the establishment of the system to properly perform added confirmations for transactions as well as verification at the time of transaction and measures for notification of suspicious transactions was enforced in April 2013, and the revised Anti-Criminal Proceeds Act that stipulates the method for judging the notification of suspicious transactions and enhancing the above-mentioned system was enacted in November 2014.

- (3) Key points of organized crime control in Japan and its significance for financial institution compliance
  - (i) Organized crime control in Japan consists of aggravation of penalties imposed on organized crimes, punishment on concealment and receipt of criminal proceeds (also applicable to financial institutions), and provisions on confiscation and collection of criminal proceeds under the

Organized Crime Punishment Law; and verification at the time of transaction to specified business operators including financial institutions and mandatory notification of suspicious transactions under the Anti-Criminal Proceeds Act. (It should be noted that a certain level of identification confirmation is obliged in the revised Foreign Exchange Act, which has been enforced since January 2003.)

- (ii) The Organized Crime Punishment Law and the Anti-Criminal Proceeds Act are meaningful as criminals law against organized crime, and as national legislation suitable for requirements of international control on money laundering. For financial institutions, these Acts are of vital significance for the following reasons:
  - (A) Mandatory preparation and retention of verification at the time of transaction, verification records, and transaction records facilitate the establishment of a system for the management of customers by financial institutions to prevent provision of funds for terrorism through financial institutions, and reposition “prevention of money laundering” from a simple issue in administrative procedures related to verification at the time of transaction to a compliance issue (for establishment of a system for preventing exploitation of financial institutions by a crime organization to expand profits gained from criminal activities);
  - (B) These Acts have made it necessary to establish a bank-wide compliance system for dealing with interference by anti-social forces and organized crime, including dealing with so-called “Sokaiya” racketeer groups.
- (iii) Financial institutions need to seriously take the Anti-Criminal Proceeds Act as a framework for mandating strict measures for dealing broadly with organized crime in general and to establish a thorough and comprehensive system.
- (iv) Furthermore, the Banking Act on Payment of Damage Recovery Benefits from Funds in Deposit Accounts Used for Crimes stipulates procedures for distributing to victims the money left in the bank accounts used for crime in order to help victims promptly recover from financial damage, but in terms of proper account management, this Act is of vital significance to financial institutions in that they are legally required to take measures to stop transactions related to the accounts they used to manage based on the provisions on deposit. Financial institutions need to position measures to stop transactions related to illegally used accounts not as an issue in administrative procedures, but as a compliance issue, and establish a system for taking such measures promptly and properly.

(4) Significance to prevention of abuse of financial services

In order to prevent abuse of financial services through organized crimes, etc. and secure the confidence in the financial systems of Japan, it is of vital significance to establish an internal control environment that enables each financial institution to properly perform verification at the time of transaction, etc. and reporting of suspicious transactions, both of which are required by the Anti-Criminal Proceeds Act, and take proper measures to prevent unauthorized withdrawals of deposits by

using stolen passbooks, counterfeit personal seals, etc. or to stop transactions related to bank accounts, etc. when those accounts are suspected of being used for crime.

Especially, Major Banks doing business both internationally and nationwide need to meet the strict requirements of the international community and note that they have a risk characteristic of being “easily exploited” for organized crimes such as “billing fraud”, because they operate mainly in urban areas where there are many organized crimes.

### III-3-1-3-1-2 Major supervisory viewpoints

With regards to banking operations, the FSA must check whether a bank has established the following system in order to prevent its exploitation for organized crimes such as terrorism financing, money laundering, and illegal use of bank accounts by properly taking measures for verification at the time of transaction, etc. and measures listed in the "Guidelines on Measures for Anti-Money Laundering and Countering the Financing of Terrorism" ("AML/CFT Guidelines" ) including risk-based approaches.

Note 1: In order to appropriately implement measures for verification at the time of transaction, etc., reference must be made to the “Points to Note Concerning the Banking Act on Prevention of Transfer of Criminal Proceeds” (FSA, October 2012).

Note 2: Risk-based approach means that banks are expected to identify and assess money laundering and financing of terrorism risks to which they are exposed and take appropriate AML/CFT measures to mitigate the risks effectively.

(1) Has the bank developed a centralized control environment for appropriately implementing the measures for verification at the time of transaction and the measures listed in the AML/CFT Guidelines? Is the environment properly functioning?

In particular, has the bank implemented the following measures in developing the centralized control environment?

- (i) Whether the bank has selected and appointed an appropriate person as supervisory manager, as stipulated in Article 11(iii) of the Anti-Criminal Proceeds Act, such as a person at a managerial level who is in charge of compliance on measures for terrorism financing and money laundering.
- (ii) Whether the bank has taken the following measures in order to research and analyze risks used for terrorism financing, money laundering, etc. and take action based on the results.
  - (A) Considering the details of the risk report related to transfer of criminal proceeds, which is prepared and published by the National Public Safety Commission based on Article 3(3) of the Anti-Criminal Proceeds Act, the bank properly researches and analyzes the risks in which its own transactions are used for terrorism financing and money laundering, in terms of transaction/commodity characteristics, forms of transactions, countries/regions associated with transactions, customer attributes, etc.; and prepares and regularly reviews documents describing the results ("risk assessment by a specified business operator, etc." ).
  - (B) Whether the bank collects and analyzes necessary information while considering the details

of the risk assessment by a specified business operator, etc., and continuously scrutinizes the preserved verification records, transaction records, etc.

(C) In conducting transactions for which strict customer management stipulated in the first sentence of Article 4(2) of the Anti-Criminal Proceeds Act is deemed to be particularly necessary, or transactions to which special attention must be given in performing the customer management stipulated in Article 5 of the Regulation for Enforcement of the Banking Act on Prevention of Transfer of Criminal Proceeds (“Anti-Criminal Proceeds Enforcement Regulations” ), or other transactions in which the risk level of terrorism financing and money laundering is deemed to be high by giving considerations to the details of the risk report related to transfer of criminal proceeds (“high risk transactions” ), whether the supervisory manager approves those transactions, and prepares documents describing the results of collected and analyzed information, and preserves them together with verification records, transaction records, etc.

(iii) Whether the bank establishes proper policies for recruitment of employees and acceptance of customers.

(iv) Whether the bank conducts necessary audit.

(v) Whether the bank prepares a manual of the customer management method including measures for verification at the time of transaction, disseminates it to employees, and in addition, conducts proper and continuous training to employees so that they can use the manual properly.

(vi) Whether the bank establishes a proper system (policy, method, information management system, etc.) of reporting regarding matters related to the abuses of financial services through organized crimes which an employee has found, for example, during verification at the time of transaction or by detecting suspicious transactions.

(2) Has the bank established a system for properly performing verification at the time of transaction, such as confirmation of a substantial controller in a transaction with a corporate customer, confirmation of eligibility of foreign PEPs(\*), and proper treatment of identification documents including treatment of personal identification numbers and basic pension numbers?

Note: Foreign PEPs refer to heads of foreign countries and persons occupying an important position in a foreign government, etc. listed in each item of Article 12(3) of the Order for Enforcement of the Banking Act on Prevention of Transfer of Criminal Proceeds (the “Anti-Criminal Proceeds Act Enforcement Order”) and in each item of Article 15 of the Anti-Criminal Proceeds Act Enforcement Regulations.

In particular, when conducting transactions for which there is an especially strong necessity for conducting rigid customer management as mentioned in the below (A) through (D), based on the first sentence of Article 4(2) of the Anti-Criminal Proceeds Act and each paragraph of Article 12 of the Anti-Criminal Proceeds Act Enforcement Order, has the bank established an environment in which (re-)verification at the time of transaction is made in a proper manner (for example, a customer’s

identification matters are confirmed not only in a normal way but also in a more rigid way in which customer identification documents or supplementary documents are additionally received)? In addition, when confirmation of the conditions of assets and revenues is obligated, has the bank established an environment in which such confirmation is done in a proper matter?

- (A) A transaction in the case where a counterparty to the transaction is suspected of impersonating a customer, etc., or representative, etc., for whom related verification at the time of the transaction is conducted.
- (B) A transaction with customer, etc., who is suspected of having falsified matters subject to related verification at the time of transaction when such verification has been conducted.
- (C) A specified transaction, etc., with a customer, etc., who resides or is located in a country or region in which the establishment of a system to prevent the transfer of criminal proceeds (as specified in Article 12(2) of the Anti-Criminal Proceeds Act Enforcement Order) is not considered sufficient.
- (D) A specified transaction with a customer, etc. who is a foreign PEP.

Does the bank properly perform verification at the time of transaction by regarding as specified transactions those into which one transaction is apparently divided in order to reduce the amount of money per transaction below the threshold (the transactions are limited to those listed in each item of Article 7(3) of the Anti-Criminal Proceeds Act Enforcement Order.)?

- (3) When reporting suspicious transactions, has the bank established an environment for appropriate examination and judgment based on Article 8(2) of the Anti-Criminal Proceeds Act and Articles 26 & 27 of the Anti-Criminal Proceeds Enforcement Regulations? Such examination and judgment should be made after comprehensively considering the customer attributes, the status at the time of transaction, and other specific information held by the bank and related to the transaction.

Does the bank pay full attention especially to the following points in establishing the environment?

- (i) Whether the bank, according to its operations and business profile, has established an environment for detecting, monitoring, and analyzing suspicious customers and transactions by using the system and manuals, etc.
- (ii) After considering the details of the risk report related to transfer of criminal proceeds, whether the bank fully considers the following aspects: the customer's nationality (whether the customer's home country falls within the FATF's list of non-cooperative countries and territories), eligibility of foreign PEPs, the customer attributes of the business in which the customer is engaging, whether it is a foreign exchange transaction or domestic transaction, the value and number of transactions in light of the customer attributes, and others. Whether the bank conducts proper confirmation and judgment based on transaction categories such as continuous transactions with existing customers and high risk transactions.

- (4) With regard to the correspondent bank agreement, has the bank established the following control environment based on Articles 9 and 11 of the Anti-Criminal Proceeds Act, Articles 28 and 32 of the

## Anti-Criminal Proceeds Enforcement Regulations and the AML/CFT Guidelines?

Note: “Agreement under which the bank conducts continuous and repetitive foreign exchange transactions with a forex transaction service provider located in the foreign country” in Article 9 of the Anti-Criminal Proceeds Act refers to the forex transactions for international settlement through the consignment/trust agreement (Correspondent Bank Agreement) with the forex transaction service provider (Correspondent Bank Agreement Counterparty) as to forex business including electric money transfer, collection of bills, arrangement for letter of credit, and clearing, etc.; and banking business such as fund management.

- (A) Whether the bank appropriately conducts screening and makes decisions on whether to execute/renew the correspondent bank agreement via the decision-making process involving the supervisory manager after appropriately evaluating the counterparty of the agreement through efforts to collect information on the counterparty’s customer base and businesses and the status of development of the system to prevent terrorism financing/money laundering; and the status of supervision by the authority in the relevant jurisdiction.
  - (B) Whether the bank clarifies the allocation of responsibility in relation to the prevention of terrorism financing/money laundering when transacting with the counterparty of the correspondent bank agreement, by means of documenting such responsibility, etc.
  - (C) Whether the bank requires review to ensure that the counterparty of the correspondent bank agreement is not a bank that does not operate any business (a so-called shell bank), and that the counterparty will not permit a shell bank to use a bank account owned by the counterparty. Additionally, if, as a result of review, it is found that the counterparty is a shell bank, or it has been permitting a shell bank to use the counterparty’s bank account, whether the bank systematically stops executing or discontinues the correspondent bank agreement.
- (5) In order to prevent illegal use of bank accounts, has the bank established an internal control environment for performing proper bank account management by conducting verification at the time of transaction and confirming the purpose of use of bank accounts as needed in deposit payment and account opening? Has the bank taken necessary measures by considering how to prevent the damage caused by illegal use of bank accounts?

Especially underground money lenders illegally collect money through bank accounts, and send a false bill to request money transfer to their own bank account. These malicious cases in which bank accounts are illegally used have become a serious social problem. In addition, paying out criminal money makes it difficult for the victims to recover from financial damage. Based on the above, in addition to establishing a system for promptly receiving information on illegal use of bank accounts, such as reports from victimized customers, has the bank, by using the information etc., established a control environment for promptly and properly taking measures to suspend deposit transaction and close bank accounts, etc. stipulated in the provisions on deposit and the Banking Act on Payment of



Damage Recovery Benefits from Funds in Deposit Accounts Used for Crimes? At the same time, is the bank supposed to take necessary measures, for example, to examine the status of transactions regarding bank accounts with the same name as those that are suspected of being used illegally?

- (6) In order to help victims promptly recover from financial damage caused by the criminal act performed by using money transfer, has the bank established a control environment for smoothly and rapidly performing, as clearly defined in the internal rules, the procedures such as those for extinction of liabilities including deposits related to the bank accounts used for crimes, provided in the Banking Act on Payment of Damage Recovery Benefits from Funds in Deposit Accounts Used for Crimes, and those for payment of damage recovery benefit to victims of criminal acts performed by using money transfer? At the same time, whether is the bank supposed to take proper measures to improve convenience of application for payment for applicants reporting damage during the period of the procedure for extinction of liabilities, or to offer necessary information, etc. to inform a person who is suspected of being a victim, of implementation of procedures for payment?
- (7) With regard to the commission of examination issued by a court of illegal use of bank accounts and inquiries based on the Attorney Act, etc., has the bank established a control environment for making proper judgment of each individual specific case, in line with the purpose of these rules, while considering the confidentiality obligation imposed on the bank?
- (8) In order to prevent unauthorized withdrawals of deposits by using stolen passbooks, counterfeit personal seals, etc., has the bank established a control environment for performing verification at the time of transaction as needed when paying back deposits at a counter, etc.? Has the bank taken a measure to prevent counterfeiting of personal seals using the seal imprints in passbooks ?

Has the bank established a control environment for promptly receiving reports from customers victimized by unauthorized withdrawals? Based on the purpose of the Banking Act on Protection of Depositors from Unauthorized ATM Withdrawals Using Counterfeit or Stolen Cards, etc. (the “Depositor Protection Act” ) regarding compensation for losses, has the bank established a control environment for serving customers sincerely, in addition to specifying consistent customer service in general conditions and customer service guidelines, etc. in terms of thorough customer protection?

Is the bank supposed to properly preserve the records of unauthorized withdrawals, and to cooperate sincerely with customers and investigative authorities when asked by them to offer the recorded materials, etc.?

Note: Make sure that measures to prevent the occurrence of unauthorized withdrawals do not greatly impair the convenience for customers.

- (9) In cases where a bank entrusts an electronic payment handling service provider with administrative

works that are necessary to perform some of its duties pursuant to the Anti-Criminal Proceeds Act such as preparing/storing transaction records and monitoring transactions, has the bank developed the following environments?

- (i) The bank must supervise the electronic payment handling service provider in a proper manner so as to make sure that the entrusted administrative works are conducted.

(Note) Examples of such required proper supervision include clarifying the department that is responsible for managing the entrusted electronic payment handling service provider, monitoring the implementation status of the works by the entrusted electronic payment handling service provider regularly or as needed, and confirming the entrusted electronic payment handling service provider properly manages information on customers, etc.

- (ii) The entrustment contract or the like with the electronic payment handling service provider must stipulate that the trustee send necessary records and documents to the bank within a certain period after the request from the bank.

- (iii) In cases where the bank entrusts the electronic payment handling service provider with transaction monitoring and the like, the bank must share the relevant transaction analysis results by the electronic payment handling service provider on a regular basis, confirm and store such results, while also developing environments where the bank will file a notification of any suspicious transaction in a proper manner based on such analysis results.

- (iv) The entrustment contract or the like with the electronic payment handling service provider must stipulate the content and method of analysis to be conducted by the electronic payment handling service provider, as well as the extent of analysis results for the bank to share and such frequency, etc.

(Note) In addition to the above, see “III-3-3-4 Outsourcing”.

### III-3-1-3-1-3 Supervisory Method and Actions

In cases where inspection results, misconduct notification and other inappropriate behavior, reports of crime occurrence related to stolen passbooks, etc. show that, in light of the viewpoints of the above (1) through (8) and the AML/CFT Guidelines, etc., some problem is found in the internal control environment for properly implementing measures such as those to securely perform verification at the time of transaction; those described in the AML/CFT Guidelines; those to prevent unauthorized withdrawals of deposits by using stolen passbooks, counterfeit personal seals, etc.; and those to stop transactions related to bank accounts, etc. when those accounts are suspected of being used for crime, the FSA requires the bank to submit reports (including additional reports ) based on Article 24 of the Banking Act as needed. If a serious problem is found, the FSA issues a business improvement order pursuant to Article 26 of the Banking Act.

When the bank’s internal control environment is deemed to be extremely vulnerable and likely to continue being exploited for organized crimes by anti-social forces and terrorists, etc., the FSA orders a

partial suspension of business, based on Article 26 of the Banking Act, for a limited period of time needed for business improvement.

Moreover, if a bank is deemed to have committed serious illegal acts, or more specifically, if a bank violates obligation for verification at the time of transaction and obligation for reporting of suspicious transactions, or neglects to take measures to suspend transactions when there is probable cause to suspect that the bank account is exploited for crimes, and the bank is deemed to have significantly harmed public interest, the FSA issues a partial suspension of business based on Article 27 of the Banking Act.

(Reference)

- On response to unauthorized withdrawals of deposits, etc. (Japanese Bankers Association, February 19, 2008)

### III-3-1-3-2 Counterfeit Bank Notes and Coins, etc.

In light of the purpose of Article 152 of the Penal Code being to stop the circulation of counterfeit or altered currency, is the bank making the following efforts, for example, to develop a proper internal control system?

- (1) Has the bank a system for promptly submitting the reports to the police or the reports of suspicious transactions when a note or coin presented by a customer proves counterfeit or altered?
- (2) Has the bank developed proper provisions and guidelines for what the bank should do in order not to recirculate counterfeit or altered notes and coins, and has made these provisions and guidelines known to every officer and employee?

(Note) With regard to measures against organized crime, besides the above-mentioned, refer to Measures to Cope with Forged or Stolen Cash Cards (III-3-7-2 Security Measures for the ATM System), and Anti-Phishing for Internet Banking (III-3-8 Internet Banking).

### III-3-1-4 Prevention of Damage that May be Inflicted by Anti-Social Forces

#### III-3-1-4-1 Background

Eliminating anti-social forces from society is a task critical to ensuring the order and safety of society, so it is necessary and important for corporations to promote efforts to ban any relations with anti-social forces from the viewpoint of fulfilling their social responsibility. In particular, as financial institutions have a public nature and play an important economic role, they need to exclude anti-social forces from financial instruments transactions in order to prevent infliction of damage not only on their officers and employees but also on their customers and other stakeholders.

Needless to say, if financial institutions are to retain public confidence and maintain the soundness and appropriateness of their business operations, it is essential that they deal with anti-social forces in accordance with laws and regulations without bowing to pressure from them. Therefore, financial institutions must strive, on a daily basis, to develop a control system for banning any relations with anti-social forces in accordance with the purpose of the “Guideline for How Companies Prevent Damage from Anti-Social Forces” (agreed upon at a meeting on June 19, 2007 of cabinet ministers responsible for anti-crime measures).

In particular, anti-social forces in recent times have become increasingly sophisticated in their efforts to obtain funds, disguising their dealings as legitimate economic transactions through the use of affiliated companies in order to develop business relations with ordinary companies. In some cases, the relations thus developed eventually lead to problems. In order to deal with such cases properly, the management teams of financial institutions need to take a resolute stance and implement specific countermeasures.

It should be noted that if a financial institution delays specific actions to resolve a problem involving anti-social forces on the grounds that unexpected situations, such as threats to the safety of officers and employees, could otherwise arise, the delay could increase the extent of the damage that may be ultimately inflicted on the financial institution and its officers and employees.

(Reference) “Guideline for How Companies Prevent Damage from Anti-Social Forces” (agreed upon at a meeting on June 19, 2007 of cabinet ministers responsible for anti-crime measures)

- (i) Basic principles on prevention of damage that may be inflicted by anti-social forces
  - Firm-wide response
  - Cooperation with external expert organizations
  - Ban on any relations, including transactions, with anti-social forces
  - Legal responses, both civil and criminal, in the event of an emergency
  - Prohibition of engagement in secret transactions with and provision of funds to anti-social forces

- (ii) Identification of anti-social forces

In judging whether specific groups or individuals constitute “anti-social forces,” which are defined as groups or individuals that pursue economic profits through the use of violence, threats, and fraud, it is necessary not only to pay attention to whether they fit the definition in terms of their affiliation, such as whether they constitute or belong to “Boryokudan” crime syndicates, “Boryokudan” affiliated companies, “Sokaiya” racketeer groups, groups engaging in criminal activities under the pretext of conducting social campaigns or political activities, and crime groups specialized in intellectual crimes, but also to whether they fit the definition in terms of the nature of their conduct, such as whether they are committing violent acts of demand, or making unreasonable demands that go beyond the limits of legal liability (refer to the “Key Points of Measures against Organized Crime,” a directive issued in the name of the Deputy Commissioner-General of the National Police Agency on December 22, 2011.).

The bank should not have any relations with anti-social forces and, in cases where it has established a relationship with an anti-social force unwittingly, the FSA while also giving consideration to the characteristics of specific transactions, pays attention to the following points, among others, in order to examine its control environment for banning any relations with anti-social forces as soon as possible after the counterparty has been found to be an anti-social force, as well as its control environment for dealing with unreasonable demands by anti-social forces appropriately.

(1) Firm-wide response

In light of the need and importance of an action to ban any relationship with anti-social forces organically, is the responsibility of responding to the situation is not left solely to the relevant individuals or divisions but the management including directors are appropriately involved? Is there a policy calling for firm-wide response? In addition, is there a policy calling for the corporate group as a whole, not just the involved bank alone, to take on an effort to prevent any relationship with anti-social forces? Moreover, is there a policy to exclude anti-social forces when having transactions such as providing financial services with cooperation of other companies outside the group (credit companies, etc.).?

(2) Development of a centralized control environment through anti-social forces response division

Has the bank established a division in charge of supervising responses to ban any relationship with anti-social forces (“anti-social forces response division”) so as to develop a centralized control environment for preventing infliction of damage by anti-social forces? Is this division properly functioning?

In particular, whether the bank pays sufficient attention to the following points in developing the centralized control environment must be checked.

- (i) Whether the anti-social forces response division is actively collecting and analyzing information on anti-social forces and has developed a database to manage such information in a centralized manner and has a system to appropriately update it (i.e. addition, deletion or change of information in the database). Further, whether the division is making efforts to share information within the group in the process of collecting and analyzing such information, while making active use of information provided by industry associations. In addition, whether the anti-social forces response division has a system to take advantage of information on anti-social forces for screening counterparties of transactions and evaluating the attributes of shareholders of the financial institution.
- (ii) Whether the bank makes sure to maintain the effectiveness of measures to ban any relations with anti-social forces by, for example, having the anti-social forces response division develop a

manual for dealing with anti-social forces, provide on-going training, and foster cooperative relationships with external expert organizations such as the police, the National Center for Removal of Criminal Organizations, and lawyers on an ongoing basis. In particular, whether the bank is prepared to report to the police immediately when it faces the imminent prospect of being threatened or becoming the target of an act of violence, by maintaining close communications with the police on a daily basis so as to develop a systematic reporting system and build a relationship that facilitates cooperation in the event of a problem.

- (iii) Whether the bank has a structure in which relevant information is swiftly and appropriately conveyed to the anti-social forces response division for consultation when transactions with anti-social forces are found or such forces have made unreasonable demands. Further, whether the anti-social forces response division has a structure to swiftly and appropriately report relevant information to management. In addition, whether the anti-social forces response division has a structure to ensure the safety of individuals encountering anti-social forces in person and to support divisions involved in dealing with them.

(3) Execution of appropriate advance screening

Does the bank take measures to ban allowing anti-social forces to become a counterparty to a transaction, by conducting appropriate advance screening using information on such forces in order to prevent transactions with anti-social forces, and making sure provisions regarding the exclusion of organized crime group are introduced in all contracts and terms of transactions?

For affiliated loans (quadrilateral type) (\*), is there a structure for conducting advance screening by the bank itself, as well as the implementation of a clause to exclude organized crime groups (i.e. organized crime group), and for reviewing the development of a database about anti-social forces and the implementation of clauses to exclude anti-social forces at the cooperating credit company?

Note: Affiliated loans (of quadrilateral type) refer to loans where a credit company that received application from the customer through the affiliated store reviews/approves and a financial institution lends money to the customer on the condition of guarantee by the credit company.

(4) Execution of appropriate follow-up review

Whether, for the purpose of making sure any relationships with anti-social forces are eliminated, there is a structure for conducting an appropriate follow-up review on existing claims and contracts.

(5) Efforts to terminate transactions with anti-social forces

- (i) Does the bank have a system under which information confirming the existence of a transaction with anti-social forces is swiftly and appropriately reported to management, including directors, etc., via the anti-social forces response division, and response to the situation is made under appropriate directions and involvement by management?
- (ii) Is the bank making efforts to terminate transactions with anti-social forces by considering the

utilization of DICJ's purchasing system for specified difficult recovery claims and utilizing the Resolution and Collection Corporation's service function for the companies within the group that is not covered by the DICJ's system, while maintaining cooperative relationships with external expert organizations such as the police, the National Center for Removal of Criminal Organizations, and lawyers on an ongoing basis?

- (iii) Does the bank, when it has learned through a follow-up review after initiating a transaction that the counterparty is a member of an anti-social force, take care to prevent the provision of benefits to anti-social forces, such as collecting claims as soon as possible?
- (iv) Does the bank have a structure to prevent providing funds or engaging in inappropriate or unusual transactions for whatever reason if the counterparty has been found to be an anti-social force?

(6) Dealing with unreasonable demands by anti-social forces

- (i) Does the bank have a system under which the information that anti-social forces have made unreasonable demands is swiftly and appropriately reported to management, including directors, etc., via the anti-social forces response division, and response to the situation is made under appropriate directions and involvement by management?
- (ii) Does the bank actively consult external expert organizations such as the police, the National Center for Removal of Criminal Organizations, and lawyers, when anti-social forces make unreasonable demands, and respond to such unreasonable demands based on guidelines set by the National Center for Removal of Criminal Organizations and other organizations? In particular, does the bank have a structure to report to the police immediately when there is an imminent prospect of a threat being made or an act of violence being committed?
- (iii) Does the bank have, in response to unreasonable demands by anti-social forces, a policy to take every possible civil legal action and to avoid hesitating to seek the initiation of a criminal legal action, by proactively reporting damage to the authorities?
- (iv) Does the bank ensure that the division in charge of handling problematic conduct promptly conducts a fact-finding investigation upon request from the anti-social forces response division, in cases where unreasonable demands from anti-social forces are based on problematic conduct related to business activity or involving an officer or employee?

(7) Management of shareholder information

Does the bank manage shareholder information properly, through means such as regularly checking the transaction status of its own shares and examining information regarding the attributes of its shareholders?

In cases where a problem is found in the bank's structure to ban any relations with anti-social forces through inspection results and misconduct notification and other inappropriate behavior, the FSA requires the bank to submit reports based on Article 24 of the Banking Act when necessary, and in cases where inspection of the reports reveals a serious problem in the soundness and appropriateness of the bank's business, the FSA considers issuing a business improvement order based on Article 26 of the Banking Act. At the same time, when the bank's internal control environment is extremely fragile, as shown by, for example, a failure to take appropriate steps toward dissolving relations with anti-social forces despite recognizing the provision of funds thereto and the presence of inappropriate business relations therewith, and it is deemed necessary to make the bank commit to improvement of its internal control environment, the FSA considers issuing a partial suspension of business for a limited period of time needed for business improvement based on Article 26 of the Banking Act.

In addition, in cases where the bank, while recognizing the counterparty as an anti-social force, violates laws and regulations and harms public interest, which are deemed serious and malicious, such as organizationally providing funds thereto and repeating and continuing inappropriate business relations therewith, the FSA considers taking strict actions based on Article 27 of the Banking Act.

### III-3-1-5 Compliance with Third-Party Allotment

#### III-3-1-5-1 Background

- (1) Forms of capital increases of a bank include public offerings and third-party allotment of new shares (common shares and preferred shares). When the capital increase is conducted in the manner in which financial instruments business operators act as their underwriters, as in the case of public offerings, etc., reasonable checking functions appear to operate from the standpoint of legal compliance. (\*1)

Note 1: For rules concerning underwriting by financial instruments business operator, see "Regulations Concerning Underwriting of Securities (Fair Business Practice Regulations No. 14, Japan Securities Dealers Association)", etc.

- (2) However, when capital increases of a bank engaged in deposit-taking and lending, etc. are conducted in the form of third-party allotment of new shares allotted directly to business partners, greater management efforts are needed from the viewpoint of ensuring soundness and faithfulness with respect to the establishment of an internal control environment concerning compliance with laws and regulations in connection with the "principles of capital adequacy" and the prevention of the "abuse of superior position."

In addition, capital increases are not to be made constantly, so a bank-wide control environment for legal compliance concerning such capital increases should be established and thoroughly managed on each occasion of capital increases under the responsibility of the board of directors; provided, however, that this does not apply to the third-party allotment in which the bank holding



company that owns the bank, which is to conduct a capital increase, as a subsidiary company, acts as a party to whom new shares are to be allotted.

- (3) As the Banking Act stipulates that capital increases are to be reported, compliance at the time of third party allotment should be treated as follows.
- (4) It should be noted that the following administrative procedures stipulate supervisory business flows based on schedule (\*2) of general third party allotment, and in cases where a different response is necessary depending on the situation, or the third party allotment is made by a bank holding company, the terms should be replaced accordingly.

Note 2: Schedule of general third party allotment

- (i) Resolution of the board of directors concerning the policy to conduct third party allotment
- (ii) Preparation of a list of parties to whom new shares are to be allotted
- (iii) Resolution of the board of directors concerning (terms and conditions of) issuance of new shares
- (iv) Submission of securities registration statement
- (v) Solicitation of application for acquisition, application, and payment

- (5) Instruments eligible for inclusion in Additional Tier 1 capital or Tier 2 capital issued by internationally active banks or special purpose companies, etc. as stipulated in Article 6(4) or 7(4) of the Public Notice on Standards for Banks' Capital Adequacy, etc. should be replaced accordingly, depending on the specific circumstances (\*3).

Note 3: The FSA implements necessary inspections in order to require at least the following reports in terms of compliance with the principles of capital substantiation, etc.

- (A) Status of establishment of internal control environment
- (B) Actual status of transactions with subscribers of such instruments eligible for inclusion in Additional Tier 1 capital or Tier 2 capital (including follow-up inspections for six months after issuance)

### III-3-1-5-2 Viewpoints and Supervisory Method and Actions

- (1) How to handle the case where a bank has decided to conduct a capital increase through third-party allotment

When the board of directors of the bank has resolved to conduct a capital increase through third-party allotment, the FSA will promptly require the bank to submit the notification (in the Form 4-7-1 described in the Forms and Reference Information) provided in Article 53(1)(iv)(\*1) of the Banking Act, and require the bank to attach the materials concerning the overall internal control environment(\*2) related to legal compliance for properly conducting the capital increase in accordance

with applicable laws and regulations such as the Companies Act, the Law concerning Prohibition of Private Monopoly and Maintenance of Fair Trade (hereinafter referred to as the “Anti-Monopoly Law” ) and the Financial Instruments and Exchange Act.

Note 1: Notification provided in Article 35(1)(xxxii) of the Banking Act Enforcement Regulation with regard to instruments eligible for inclusion in Additional Tier 1 capital or Tier 2 capital in the form of debt liabilities.

Note 2:

- (i) Basic management philosophy
- (ii) Compliance with principles of capital adequacy, etc.
- (iii) Prevention of unfair transactions through the abuse of superior position, etc.
- (iv) Securing appropriate disclosure
- (v) Appropriate explanation of the nature of products
- (vi) Establishment of a follow-up inspection system of compliance status

(2) The FSA inspects the overall internal control environment as stated in the notification. When any doubts on its appropriateness are found, the FSA will require the bank, as necessary, to submit a report based on Article 24 of the Banking Act, or when a serious problem is found, the FSA it will issue a business improvement order based on Article 26 of the Banking Act.

The following categorizes and exemplifies the viewpoints at the time of inspection.

- (i) Basic management philosophy
  - (A) Does the board of directors understand the importance of compliance with laws and regulations concerning capital increases through third-party allotment and develops a bank-wide control environment?
    - For example, are the administrative operations categorized properly and the authority to make decisions and the allocation of responsibilities (including identification of officers in charge and of the controlling division) are clearly defined for each of those categories?
  - (B) Does the board of directors not only establish internal rules and issues notices, but also makes sure that all employees understand the rules and notices? In addition, does the board of directors make internal monitoring/checking functions effective?
  - (C) Does the board of directors take thorough measures for compliance as necessary, for example, by requesting written opinions of lawyers and auditing firms concerning laws and regulations such as the Companies Act, the Anti-Monopoly Law, and the Financial Instruments and Exchange Act?
  - (D) In cases where a bank holding company conducts a capital increase through third-party allotment, does the board of directors deal appropriately with the involvement of its subsidiary banks?
- (ii) Points of special attention
  - Does the bank ensure adequate compliance with all laws and regulations which need to be

observed in connection with capital increases?

In particular, has the bank established an adequate compliance system regarding the following points?

- (A) Complying with the “principles of capital adequacy” Provided in the Companies Act and Securing the “soundness (stability and eligibility) of the bank’s equity capital”
- a. Whether the policies on the preparation of a list of parties to whom new shares are to be allotted and on the solicitation of application for acquisition are adequately specified in accordance with the “principles of capital adequacy” and the policy of ensuring the soundness of equity capital. Whether the bank deals, as necessary, with capital allotment to borrowers based on written opinions of lawyers, etc. concerning the legality of the allotment.
  - b. At least, whether the treatment of questionable cases as follows is clarified.
    - i) Cases where, in light of actual financial conditions, the bank extends direct or indirect loans or other form of credit to parties who are incapable of making repayment or unwilling to make repayment, and has them make payment for subscription of new shares with the funds provided by such loans or other form of credit.
    - ii) Cases where the bank or the bank group is shouldering the share-holding risks of subscribers of new shares in some way or another.
- Note: It should be noted that in terms of credit risk management, the bank must fully investigate the business and financial conditions of borrowers so that the borrowers, for which the bank should provide business improvement support, will not make payment for subscription of new shares. It should be noted that, for example, having borrowers who are classified as “need special attention” or below make payment for subscription of new shares is problematic in terms of appropriate credit risk management.
- (B) Prevention of unfair transactions (under the Anti-Monopoly Law, the Financial Instruments and Exchange Act, etc.)
- a. Anti-Monopoly Law  
How the bank is trying to prevent the occurrence of actions which fall under the unfair trade practice prohibited by the Anti-Monopoly Law, including the occurrence of “abuse of superior position.”
  - b. Financial Instruments and Exchange Act  
How the bank is trying to prevent the occurrence of actions which fall under the unfair transactions (insider trading, prohibition of representing favorable purchases, etc.) prohibited by the Financial Instruments and Exchange Act.
- (C) Securing appropriate disclosure (under the Financial Instruments and Exchange Act, etc.)
- a. In order to conduct capital increases, whether the bank takes measures for observance of the procedures (filing of the securities registration statement and solicitation, preparation and delivery of the prospectus, taking effect of the securities registration statement) provided in the Financial Instruments and Exchange Act.

- For example, whether the bank makes sure that all employees understand basic points of attention, for example, by informing them that the bank must internally prepare a list of parties to whom new shares are to be allotted before the submission of the securities registration statement, and that the bank cannot conduct solicitation of application for acquisition without the submission of the securities registration statement.
- b. Above all, when preparing the securities registration statement and the prospectus, whether the bank takes thorough measures for ensuring the protection of investors, based on regulations specific to banks, such as equity capital ratio regulation, and implementation of financial inspections by the authorities. In addition, whether the bank discloses truly important “risk information” in a readily understandable and succinct manner.
- For example, even in cases of preparing the securities registration statement and the prospectus in accordance with the “incorporation method” or “reference method,” whether the bank understands that the “risk information” as of the date of filing the securities registration statement needs to be described, and the bank takes measures to cope with such requirement.
  - For example, in the event that any significant events in terms of investors protection occur even after the filing of the securities registration statement, whether the bank deals with the events, understanding that the filing of a revised registration is required.
- c. Prevention of representations which may give misleading information concerning financial conditions and other matters
- When the information other than the prospectus (and the securities registration statement) is used for the solicitation of subscriptions to capital increases, whether the content of such information is not different from that of the prospectus.
  - Actually, representations concerning the bank (especially its financial conditions), including revised earnings forecasts(\*1), quarterly disclosure(\*2), IR materials, and press conferences by officers are often used as materials for solicitation.
- Under these circumstances, whether the bank scheduled to make capital increases takes thorough measures for preventing these representations from misleading parties to whom new shares are to be allotted with regard to the bank’s financial conditions.
- Note 1: Whether the bank revises and announces its current earnings forecasts when necessary due to significant changes in economic conditions or findings of financial inspections by the authorities.
- Note 2: For example, though the quarterly disclosures for the first quarter (April to June) and the third quarter (October to December) show the expected values concerning projected equity capital ratios as of the end of September and the end of March respectively, whether the values are speculative ones without clear rationale or without consideration of possibilities.
- (D) Appropriate explanation, etc. of the nature of products (consumer compliance)

- a. Whether the explanation method and content for solicitation of subscriptions to capital increases is appropriate from the standpoints of the Civil Code and the Act on Provision of Financial Services and the Development of the Accessible Environment Thereto (hereinafter referred to as the “Financial Service Provision Act.”)

Note: Whether the bank, based on opinions of lawyers, etc., deals with the possibility that if the bank conducts a capital increase through third-party allotment, it will correspond to the “financial instruments provider, etc.” prescribed in the Financial Instruments Sales Act, and have the obligation of explanation prescribed in the same Act.

- b. Since it is especially important for the bank to prevent misunderstanding that those allotment are equivalent to deposits, whether the bank takes adequate measures for such prevention.
  - Whether explanations for the prevention of misunderstanding that those allotment are equivalent to deposits are given by the delivery of documents or in another appropriate manner, in light of the knowledge, experience, and asset positions of the parties to whom new shares are to be allotted.

Note: At least for individual persons, whether the bank takes measures for giving face-to-face explanations through delivery of written documents, obtaining confirmation about the explanation by both parties, recording and preserving the documents for a certain period of time, etc.

- Whether the explanations for the prevention of misunderstanding are sufficient in that they include the explanations that they are not deposits, are not covered by deposit insurance, and principals are not guaranteed.

- (iii) Establishment of a follow-up inspection system of compliance status

Whether the bank has established a system for conducting a bank-wide follow-up inspection of compliance status in accordance with the progress of capital increase procedures.

- (3) Treatment at the time when the bank resolves issuance (conditions) of new shares

- (i) The FSA will promptly require the bank to submit the notification (in the Form 4-7-2 described in the Forms and Reference Information) provided in Article 53(1)(iv) of the Banking Act and also require the bank to attach the materials concerning inspection results of the overall internal control environment.

- (ii) In case of any doubts on the appropriateness of the bank’s response in the notifications, etc., the FSA will, as necessary, take actions, including:

- (A) requiring the bank to submit a report based on Article 24 of the Banking Act, or
- (B) issuing a business improvement order based on Article 26 of the Banking Act if a serious problem is found
- (C) and reporting to the regulatory divisions responsible for auditing securities if the situation apparently falls under any of the cases where the statements on important matters to be described in the securities registration statement are insufficient, or where the statements

on important matters to be described and on important facts necessary to prevent misunderstandings are missing, etc.

(4) Notification of increase in the amount of stated capital

The FSA will require the bank to submit, on the payment date, the notification (in the Form 4-7-3 described in the Forms and Reference Information) provided in Article 53(1)(iv) of the Banking Act.

(5) Treatment after completion of capital increase through third-party allotment

(i) The FSA will require the bank to conduct a follow-up inspection of its internal control environment concerning compliance with laws and regulations for six months after completion of capital increase through third-party allotment and to submit an additional report on the inspection results as an attached document to the notification provided in Article 53(1)(iv) of the Banking Act.

(ii) In case of any doubts on the appropriateness of the bank's response in the notifications, etc., the FSA will require the bank, as necessary, to submit a report based on Article 24 of the Banking Act, or if a serious problem is found, will issue a business improvement order based on Article 26 of the Banking Act.

III-3-1-6 Inappropriate Transactions, etc.

III-3-1-6-1 Performance Guarantee

In cases where a bank implements so-called performance bonds, or performance guarantees for construction work, etc., whether the contract stipulates that, during the performance of the guarantee specified in the contract, the bank will not be required to do the operations that cannot be done by the bank itself in light of Article 12 of the Banking Act, such as completing the construction work.

III-3-1-6-2 Prevention of the Occurrence of Inappropriate Transactions Contrary to Normal Transaction Practices

How the bank prevents the occurrence of inappropriate transactions contrary to normal transaction practices, including the occurrence of accepting excessive cooperative deposits and excessive "Buzumi-Ryodate" deposits (compulsory deposits), etc.; excessively introducing deposits to other financial institutions; introducing and mediating products not included in the scope of banking business; collecting personal seals from customers; abusing superior positions, which is deemed to be problematic according to the Anti-Monopoly Law, such as forcing transactions with affiliated companies; and asking customers to engage in credit transactions for a short period of time but across multiple accounting periods, not based on the customers' actual demand for funds.

### III-3-2 Appropriateness and Sufficiency of Disclosure

#### III-3-2-1 Background

It is important for banks to enhance disclosure in order to improve transparency of their management, to place market discipline on them, and to provide a base for establishing the principle of self-responsibility among depositors, etc. As the prerequisite for disclosure properly serving these expected functions, banks must prepare financial statements that correctly reflect their business and operations. In this connection, a proper disclosure scheme needs to be designed in consideration of change, etc. in recent economic and social environments.

#### III-3-2-2 Internal Control for Financial Reporting

For disclosure, it is critical to establish an internal control system enabling banks to properly prepare financial statements, to ensure that the senior management of the banks checks and reviews, by itself, how the system functions, on a continuous basis, and to increase their operational governance.

Major banks, etc. are required to have their representative confirm that matters mentioned in the annual securities report are correct and to attach a document stating to that effect (a so-called representative's confirmation letter) to the annual securities report from the fiscal year ending March 2003. In preparing this document, it is necessary for banks to check the validity of their internal control system. In addition, in conjunction with the enforcement of the Financial Instruments and Exchange Act, major banks, etc. that are listed or OTC companies have to submit a confirmation letter stating that the content of a relevant securities report is correct, together with the annual or semiannual securities report. They are also required to submit a report describing the results, etc. of the validity evaluation of the internal control for financial reporting (internal control report) together with the annual securities report, etc. prepared every fiscal year.

(Reference) On the Setting of the Standards and Practice Standards for Management Assessment and Audit concerning Internal Control Over Financial Reporting (Council Opinions) (Business Accounting Council, February 15, 2007)

Internal Control-Integrated Framework (the Committee of Sponsoring Organization of the Treadway Commission, 1992)

Concerning Clarification of Management's Responsibility for Correctness of Financial Statements and Validity of Internal Control (Request) (October 7, 2005)

#### III-3-2-3 Type of Disclosure Required for Banks

##### (1) Disclosure based on the Banking Act

Disclosure requirements under the Banking Act are composed of two schemes; one is "Public Notice

of Balance Sheets” based on Article 20 of the Banking Act and the other is “Making Explanatory Documents about the Business and Financial Condition of a Bank Available for Public Inspection (Disclosure Report)” based on Article 21 of the Banking Act.

The public notice under Article 20 of the Banking Act is considered a special provision of the mandatory publication of financial statements imposed on companies based on the Companies Act, and risk management loans must be mentioned as a footnote.

Information and matters to be disclosed in the explanatory documents for the interim period of the business year and those for the entire business year prepared based on Article 21 of the Banking Act are clearly provided for by the Cabinet Office Order (Articles 19-2 and 19-3 of the Enforcement Regulation)(A person who has made a false statement relating to such information and made it available for public inspection shall be punished based on Article 63 of the Banking Act.) In addition, Article 21(7) of the Banking Act stipulates that “a bank must endeavor to disclose information that should serve as a reference in allowing depositors or other customers to learn of the business and financial condition of the bank and its subsidiary companies, etc.,” although there is no penal provision for it.

- (2) Disclosure based on the Banking Act on Emergency Measures for Revitalizing the Financial Functions (Act No. 132 of 1998, hereinafter referred to as the “Financial Reconstruction Act”)

Results of the asset assessment based on Article 6 of the Financial Reconstruction Act shall be reported to the Prime Minister as well as be made available to the public pursuant to Article 7 of the Financial Reconstruction Act. In addition, Articles 78 and 86 of the Banking Act apply penalties to those who have made a false statement in the report submitted to the Prime Minister.

Pursuant to Article 3(2)(i) of the “Act on Emergency Measures for Early Strengthening of Financial Functions (Act No. 143 of 1998),” financial institutions required to assess their assets based on the criteria provided for in Article 6(2) of the Financial Reconstruction Act are banks, trust banks, long-term credit banks, shinkin banks, credit cooperatives, labor credit unions, Shinkin Central Bank, the Shinkumi Federation Bank, Rokinren Banks, The Norinchukin Bank, Credit Federation of Agricultural Cooperatives, Credit Federation of Fishery Cooperatives, bank holding companies, etc.

- (3) Disclosure based on the Financial Instruments and Exchange Act

Major banks, etc. whose stocks are publicly traded are required to make a proper disclosure in accordance with relevant laws and regulations in order not to mislead investors’ decisions.

Therefore, in addition to the correctness of figures in financial statements, attention should be paid to (i) the appropriateness of disclosure of information relating to “Status of Corporate Governance,” “Risk of Business, etc.” and “Analysis of Financial Position and Operating Results,” which has been introduced from the fiscal year ending in March 2004, as well as to (ii) the appropriateness of disclosure relating to “Status of Corporate Governance,” which has been strengthened from the fiscal year ending in March 2005.



(4) Voluntary Disclosure

For the present, announcement of forecast business performance or revision thereof that may have significant impact on investment decisions, etc. is a voluntary disclosure not required by laws. IR-related activities or advertisements, which are also voluntary disclosures, are important factors for investors and depositors to make judgment.

(5) Accounting Standards

It should be remarked that a corporation, etc. subject to special business accounting standards, etc., is treated differently, in part, with regard to the points to consider mentioned in III-3-2-4.

III-3-2-4 Points to Consider for Disclosure

III-3-2-4-1 Application of Principle of Materiality

(1) It should be noted that the principle of materiality relating to the scope of consolidation and the scope of application of equity method will apply not only to consolidated financial statements prepared based on the Financial Instruments and Exchange Act but also to banks' interim and annual consolidated financial statements (Article 19(2) of the Banking Act and Article 18(3) and (4) of the Enforcement Regulation), banks' interim and annual consolidated balance sheets, etc. (Article 20(2) of the Banking Act), bank holding companies' interim and annual consolidated financial statements (Article 52-27(1) and Article 34-24(1) and (2) of the Enforcement Regulation), and bank holding companies' interim and annual consolidated balance sheets, etc. (Article 52-28(1))

(\*) Explanatory documents for interim and annual consolidated business report shall be clearly provided for in the Enforcement Regulation (Article 19-3 and Article 34-26 of the Enforcement Regulation).

(2) Whether the content thereof complies with Article 5(2) of the Regulation on Terminology, Forms, and Preparation Methods of Consolidated Financial Statements and the "Audit Treatment relating to Application of Principle of Materiality to Scope of Consolidation and Equity Method" (Audit Committee Report No. 52, the Japanese Institute of Certified Public Accountants dated July 21, 1993).

Whether the materiality is judged in parallel in both quantitative and qualitative sides from the viewpoint to ensure that the financial position and operating results of bank groups are properly represented and whether the characteristics of each subsidiary company, etc. doing financial business are well considered.

III-3-2-4-2 Information to be Described in Disclosure Report (concerning Articles 19.2 and 19.3 of the Enforcement Regulation)

(1) General Points to Consider

- (i) Whether all required information is shown in a proper and easy-to-understand manner as provided for in these Guidelines and as referenced in the Cabinet Office Ordinance on Disclosure of Corporate Affairs, etc., and the Regulation on Terminology, Forms, and Preparation Methods of Consolidated Financial Statements, etc.
- (ii) In the case where a bank has no applicable information or where additional explanation is necessary, whether such fact is properly shown.
- (iii) Note that voluntary and active information disclosure other than mandatory items required by the Enforcement Regulation causes no problem, so long as the information is correct and appropriate. In particular, with respect to exposure in fields in which the market is strongly interested, it is preferable that banks actively disclose useful information in line with their own risk characteristics based on the international best practices.

(2) Points to Consider for Individual Items to be Described

- (i) For “Organization of business management,” whether it is explained in a systematic and easy-to-understand manner by using an organization chart, etc.
- (ii) For “Content of principle business of the bank,” whether the content of the bank’s businesses and services, such as deposit, borrowing, transaction of securities-related products, securities-related investment, domestic exchange business, foreign exchange business, corporate bond business, derivatives transaction, or foreign transaction of financial products, is described by each category.
- (iii) For “Summary of its business in the latest interim period of its business year or in the latest business year,” whether the bank’s general business conditions, performance, profit/loss status, and challenges that it should address are described.
- (iv) For “Risk management system,” whether the content of the bank’s risk, its basic policy for risk management, its risk management systems such as assessment, inspection, and ALM management systems, etc. are described.
- (v) For “Compliance system,” whether the bank’s basic policy and operation system on compliance are described.
- (vi) For “Status of its efforts for the improvement of management of small and medium-sized enterprises and for regional revitalization,” whether the content of the following items is described in a concrete and easy-to-understand manner that draws interest and attention of users, etc.
  - (A) Approach to support the management of SMEs (including small enterprises; the same will apply in this (vi).)
  - (B) Development of a scheme to support management at SMEs (including coordination with external experts and institutions, etc.)

- (C) Efforts to support management at SMEs (content of support, coordination with external experts and institutions, case examples, etc.)
  - a. Support in establishing and developing a new business at SMEs
  - b. Support in growing phases of SMEs
  - c. Support in improving management, business revitalization, and change of business type, etc. at SMEs
- (D) Efforts for regional revitalization
  - (\*1) For efforts in c) or d) above, check whether the bank endeavors to describe specific cases and achievements.
  - (\*2) For efforts in c) or d) above, check whether the bank describes its efforts resulting in contribution to growth or revitalization of the local economy.
  - (\*3) “External experts” mean certified public tax accountants, lawyers, certified public accountants, SME management consultants, business advisors, etc.
  - (\*4) “External institutions” mean local governments, the Bureau of Economy, Trade and Industry, chambers of commerce and industry, commercial and industrial associations, the Federation of Small Business Associations, Yoroazu Support Centers, JETRO, JBIC, Regional Economy Vitalization Corporation of Japan, Corporation for Revitalizing Earthquake Affected Businesses, SME Revitalization Support Council, Organization for Small & Medium Enterprises and Regional Innovation, certified agencies supporting SME business innovation, business revitalization funds, regional revitalization funds, etc.
- \* The above mentioned matters do not preclude each financial institution from adding more items to the section of “Status of its efforts for the improvement of management of small and medium-sized enterprises and for regional revitalization” based on its own judgment.
- (vii) Whether the tradename, name, or point of contact of a designated ADR organization which serves as a party of a Basic Contract for Implementation of Dispute Resolution Procedure is described. If there is no designated ADR organization, whether the content of the complaint processing measures and dispute resolution measures is properly described based on the real situation (for example, if the bank uses an external institution, the name and point of contact, etc. thereof.)
- (viii) Whether “Condition of adequacy of equity capital (including details relating to Tier 1 Capital)” relating to the bank or bank group contains description equivalent to that in “Condition of equity capital ratio” in the closing status table.
- (ix) For “Allowance for doubtful accounts,” whether each item in the breakdown by individual allowance for doubtful accounts, general allowance for doubtful accounts, and reserve for specific overseas loans (including reserve for overseas investment loss under Article 55-2 of the Banking Act on Special Measures concerning Taxation) is also described.
- (x) For “Content of principal business and organizational structure of the bank and its subsidiary company, etc.,” whether the content of principal business of the bank group, and the position of

each group-company constituting such business, etc. are described in a systematic and easy-to-understand manner and are shown in a business chart, etc.

### III-3-2-4-3 Disclosure of Risk Management Loans based on the Banking Act and the Financial Reconstruction Act

Risk management loans to be disclosed as in the following categories pursuant to Article 19-2(1)(v)(B) of the Regulation for Enforcement of the Banking Act and Article 4 of the Regulation for Enforcement of the Financial Reconstruction Act should also conform to Article 19-2(1)(v)(B) of the Regulation for Enforcement of the Banking Act and Article 4 of the Regulation for Enforcement of the Financial Reconstruction Act. Temporary payments may be treated as quasi-loans (temporary payments related to the right of reimbursement after subrogation performance based on the payment acceptance and the relevant loans). On such an occasion, rather than mechanically and uniformly applying the criteria listed below, it is appropriate for the bank to consider each debtor's repayment ability based on the debtor's true state of financial standings, cash management, and earning power, etc., check the lending terms and relevant performance status, comprehensively take into consideration various factors, including the business sector's characteristics, prospects for the debtor's business continuity and profitability, the debt redemption ability on the strength of cashflow, appropriateness of the debtor's business improvement plans and the ongoing support from financial institutions, and ultimately categorize the relevant loans and quasi-loans in light of the true state of the borrowing company's business management. In particular, in the case where a debtor is an SME, it is appropriate that judgment should be made based on the company's real management situation by comprehensively considering not only its financial position, but also its technology, sales capacity and growth potential, payment of remuneration to its representative and officers, content of the income and assets of the representative, its guarantee status and ability, etc.

#### (1) Bankrupt and Substantially Bankrupt Loans

Bankrupt and Substantially Bankrupt Loans mean "loans extended to debtors in bankruptcy as the start of bankruptcy procedures, reorganization procedures, or rehabilitation procedures, etc. have been claimed, and such de facto loans." These loans are extended to debtors in bankruptcy due to bankruptcy, liquidation, corporate reorganization, civil rehabilitation, or suspended transactions at any clearing house, as well as debtors practically in bankruptcy, such as being recognized as being in serious financial trouble without any prospect for business reconstruction. In this regard, however, claims for specific mediation pursuant to the Act on Special Conciliation for Expediting Arrangement of Specified Debts shall not constitute the basis for identifying the debtor as being in bankruptcy. The category should be decided in light of the true state of the debtor's business.

Specifically, Bankrupt and Substantially Bankrupt Loans include loans extended to a debtor whose repayment of the principal or interest thereon has been practically deferred for a long period (in principle, being deferred for six or more months, and the deferral cannot be considered as temporary) under the

situation where the debtor formally continues business but has a huge amount of bad debts in the balance sheet or has been borrowing excessive loans beyond the debtor's repayment ability, and thus has substantially larger debts than assets for a considerable period without any prospect for business turnaround, or under the situation where the debtor has been suffering huge losses due to a natural disaster, an accident, or rapid changes in economy, etc. (or being amid any other similar incident) without any prospect for business reconstruction. This category also includes loans to a debtor who is considered as not being in business such as voluntarily going out of business and closing the relevant business office.

In addition, in cases where the progress status has been substantially behind the relevant business improvement plan, rapid business recovery is not expected, and the business improvement plan has not been revised, or in cases where some financial institutions have not agreed on financial support based on the business improvement plan, and when the debtor is considered as being most likely to be in bankruptcy, the loans can fall under the Bankrupt and Substantially Bankrupt Loans category since "the debtor is in serious financial trouble without any prospect for business reconstruction."

## (2) Doubtful Loans

Doubtful Loans mean "loans extended to debtors who have not yet become bankrupt, but collection of the principal and receipt of the interests thereon in accordance with the relevant contracts are most unlikely owing to its worsening financial standing and deteriorating business performance." In other words, loans in this category refer to loans extended to debtors in financial trouble rather than in bankruptcy, who are considered as being highly likely to become bankrupt since the progress in carrying out the business improvement plans have been deteriorating. (Such debtors include those who have been supported by their financial institutions, etc.)

Specifically, Doubtful Loans are loans extended to debtors who are highly likely to become bankrupt because they are practically insolvent despite continuing their business, and there are serious concerns about the final collection of the principal and interests thereon under the situation where their business performance is extremely deteriorating and the loans are deferred and the like, thus they are highly likely to incur losses.

Loans extended to a debtor for whom a reorganization plan, etc. has been approved pursuant to the Corporate Reorganization Act, and the Civil Rehabilitation Act, etc. may be judged to fall under Doubtful Loans. Moreover, with regard to a debtor for whom a reorganization plan, etc. has been approved, as long as either of the following requirements are met, loans to the debtor may be judged to fall under Substandard Loans or Normal Claims, since the reorganization plan, etc. can be judged as reasonable and highly feasible.

- (i) The reorganization plan, etc. assumes that business conditions will improve and there will be no longer any particular financial problems roughly within five years, in principle, after the approval of the reorganization plan, etc. for the debtor, and the reorganization plan, etc. can be considered as being implemented in line with its schedule. (In cases where the debtor will no longer need the reconstruction support from financial institutions and will become capable of ensuring business

continuity by its self-supporting efforts, the debtor even under the following situations is eligible for this categorization: there are some problems in the lending terms, such as a reduction or waiver of interests; there are some problems in the repayment performance such as practically deferred repayment of the principal or interest thereon; and special attention will need to be paid to the debtor as its business performance is deteriorating or unstable, or there are some financial problems.)

- (ii) The reorganization plan, etc. assumes that business conditions will improve and there will be no longer any particular financial problems in more than five years, roughly within ten years after the approval of the reorganization plan, etc. for the debtor, and the reorganization plan, etc. can be considered, in a certain period after the approval of the reconstruction plan, etc., as being implemented at least in line with its schedule and is expected to be carried out in line with its schedule in the future as well. (In cases where the debtor will no longer need the reconstruction support from financial institutions and will become capable to ensure the business continuity by its self-supporting efforts, the debtor even under the following situations is eligible for this categorization: there are some problems in the lending terms, such as reduction or waiver of interests; there are some problems in the repayment performance such as deferred repayment of the principal or interests thereon; and special attention will need to be paid to the debtor as its business performance is deteriorating or unstable, or there are some financial problems.)

### (3) Restructured Loans

Restructured Loans are “loans with agreement of a reduction of money rate, postponement of payment of interest, postponement of payment of principal, waiver of claim, or other agreement which becomes advantageous to a debtor, for the purpose of promoting reorganization or support of the debtor.”

- (i) Whether “it is for the purpose of promoting reorganization or support of the debtor” under Article 19-2(1)(v)(b)(4) of the Enforcement Regulation should be judged based on the debtor’s management situation, the bank’s intention, etc. Note that if such purpose is not recognized, the loan is not considered a Restructured Loan even if an “agreement which becomes advantageous to a debtor” has been made for it.

(Note) It is necessary to judge whether there is the purpose of promoting reorganization or support of the debtor not solely depending on the form of lending but also by comprehensively considering the debtor’s conditions, fund characteristics, etc. For example, even if a loan on bill to be used for an ordinary operating funds has been continuously renewed or extended, note that it is not considered a Restructured Loan, because such extension of lending period is not for the purpose of supporting the debtor.

- (ii) It should be noted that “agreement which becomes advantageous to a debtor” under Article 19-2(1)(v)(b)(5) of the Enforcement Regulation may be based on an agreement between the creditor and the debtor, by laws, or by court judgment. As specific examples, the following loans or combinations thereof are given whose lending terms have changed and from which

substantially the same return is not secured compared to the case where the bank's base rate (meaning the interest rate that the bank usually offers to a borrower who has the same credit risk as the debtor when lending a new loan) would be applied, taking into account comprehensive profitability of the transaction with such debtor including, but not limited to, the rates or charges of the debtor's other loans, earnings such as dividends, etc., change of credit risk, etc. including its collateral, guarantee, or competitiveness, etc. Note, however, that regardless of these examples, any and all loans falling under the definition in the Enforcement Regulation are subject to disclosure.

- A. Loans with reduced interest rate: Loans whose interest rate is reduced
- B. Loans with deferred interest payment: Loans whose interest payment is deferred
- C. Loans to debtor requiring management support: Loans to a debtor whom the bank has provided with financial support such as waiver of claim and DES (debt equity swap) and who has a high probability to need additional support in implementing its reorganization plan in the future
- D. Loans with deferred principal payment: Loans whose principal payment is deferred
- E. Loans with partial waiver of claim: Outstanding debts of the loans of which a part of principal or interest claim is waived as a result of an agreement between stakeholders in voluntary liquidation or an approval or decision under corporate rehabilitation or civil rehabilitation proceedings
- F. Loans with substitute performance: Outstanding debts of the loans for which the debtor has transferred its assets such as real estate or accounts receivable to the creditor as a partial repayment of its debts "including transfer of assets due to exercise of security right"
- G. Loans partially repaid by debtor's shares: Outstanding debts of the loans for which the creditor has received shares issued by the debtor as a partial repayment thereof; except where the loan has been converted to shares issued by the debtor in accordance with the original lending terms.

(Note) In judging the above-mentioned cases, pay attention to the following points, for example;

- i) Even in the case where the applicable interest rate of the loan is lower than the base rate, such loan is not considered a Restructured Loan if the loan is not subject to change of the lending conditions such as the interest rate reduction, deferred principal payment, etc.
- ii) However, even in the case where the loan is not subject to change of the lending conditions such as the interest rate reduction, deferred principal payment, etc., the loan will fall under the scope of Restructured Loans if it is clear that such loan has been executed for the purpose of substantially relaxing the lending terms of the existing loan or repaying such relaxed-terms loan in consideration of the business conditions of the debtor, the purpose of use of the funds, lending terms and conditions, etc. set at the time of entering the loan contract.

iii) The base rate should be set in line with economic rationality.

Specifically,

- In setting the base rate, banks should provide proper and precise categories and adopt the average contracted interest rate on new loans according to such categories as the base rate.
  - However, if the average contracted interest rate on new loans is significantly lower than an interest rate calculated in the manner where it is reasonably and objectively proven that the returns corresponding to the credit risk of a relevant category are secured, such calculated interest should be the base rate.
- iv) In the case of “C. Loans to debtor requiring management support,” judgment on disclosure should be made for each debtor. In addition, in the cases of “E. Loans with partial waiver of claim,” “F. Loans with substitute performance,” and “G. Loans partially repaid by debtor’s shares” of the same debtor, which are recognized to be intentionally divided for the purpose of avoiding disclosure, it is necessary to disclose the outstanding debts of the original loan to such debtor before it is divided. Except for these cases, banks should make a decision on disclosure of each loan, on a one-by-one basis.
- v) In particular, in the case where a debtor is an SME, judgment should be made based on the company’s real management situation by comprehensively considering not only its financial position, but also its technology, sales capacity and growth potential, payment of remuneration to its representative and officers, content of the income and assets of the representative, its guarantee status and ability, etc.
- vi) Even for a loan whose lending terms has changed, its credit risk itself should be mitigated if there is a high probability that the debtor can sell its assets and gain financial resources to repay the loan, etc.
- (iii) Note that, even in the case of a loan to a debtor whose past loan was subject to an interest rate reduction, deferred payment of interest, deferred payment of principal, waiver of claims, substitute performance, or partial repayment with the debtor’s shares for the purpose of facilitating reorganization of the debtor's management or support of the debtor, the current loan is not considered a Restructured Loan if substantially the same return is expected to be secured as compared to the case where the base rate would apply to such loan as a result of decreased lending rate on a new loan due to change of financial and economic situations or due to mitigated credit risk of the debtor by its improved management situation or if the debtor is recognized as achieving good business performance and having no particular problem in its financial situation.

Specifically, if the debtor has commenced management reorganization through implementation of the financial support in line with a highly feasible (Note 1) radical (Note



2) management reorganization plan (Note 3)(Note 4), a loan based on such management reorganization plan may be judged not to fall under Restructured Loans. Even in the case where the debtor has not formulated a highly feasible radical management reorganization plan, if the debtor is an SME who is expected to formulate such management reorganization plan within one year from the date when the lending terms changed (Note 5), the loan to such debtor may be judged not to fall under Restructured Loans for the period up to one year from the date when the lending terms changed.

(Note 1) A “highly feasible” plan means a plan satisfying all the requirements below, provided that when the debtor is an SME and the plan has been smoothly progressing for more than approximately one year, such plan may be judged to be a “highly feasible” plan.

- i) Consent is obtained from all the persons concerned required to implement the plan.
- ii) The amount of financial support through the plan such as waiver of claim is fixed and there is no prospect of needing additional support beyond the plan.
- iii) The assumption of prospective sales, expenses, and profits in the plan is sufficiently severe.

(Note 2) “Radical” means that at the point of three years later (this will not preclude reasonable extension of the period considering the size or business characteristics of the debtor), the debtor becomes recognized as achieving good business performance and has no specific concern in its financial position. In the case where the debtor is an SME, if the debtor has already formulated a “reasonable and highly feasible management reorganization plan” under III-3-2-4-3(iv), such plan may be considered a highly feasible radical management reorganization plan because it often takes more time for an SME than a large company to improve its business condition.

(Note 3) A revitalization plan formulated and supported by an SME Revitalization Support Council or the Resolution and Collection Corporation, a revitalization plan formulated in accordance with revitalization-type private liquidation procedures pursuant to Part 3 of Guidelines for Business Revitalization, etc. of Small- and Medium-sized Enterprises (excluding any plan that does not include a waiver of claim, etc. for a small enterprise and only meets Part 3-4(4)(ii)B and C of the same Guidelines), a business plan supported by Industrial Recovery Consultation Centers in their purchasing fund support business, a corporate rehabilitation plan adopted according to the corporate rehabilitation ADR procedures (meaning Specified Certified Dispute Resolution Procedures under Article 2(16) of the Banking Act on Strengthening Industrial Competitiveness), a business rehabilitation plan (Article 25(1) of the Banking Act on Regional Economy Vitalization Corporation of Japan) of an entrepreneur from whom the Regional Economy Vitalization Corporation has decided to purchase loans, etc. (Article 31(1) of the same Act), and a business rehabilitation plan (Article 19(2)(i) of the Banking Act on Corporation for Revitalizing Earthquake affected Business) of an entrepreneur from whom the Corporation for Revitalizing Earthquake Affected Business has decided to purchase loans,

etc. (Article 25(1) of the same Act) may be judged as a “highly feasible radical management reorganization plan” only if such plan is recognized to satisfy the requirements under (\*1) and (\*2).

(Note 4) The case where a debtor’s business reorganization based on its existing plan satisfies all the requirements under (\*1) and (\*2) should be treated the same as “the case where the debtor has commenced management reorganization through implementation of the financial support in line with a highly feasible radical management reorganization plan.” For example, in the case where a financial institution changes lending terms of a certain debtor and such debtor has formulated a management reorganization plan, etc., (including case where such debtor has formulated a management reorganization plan, etc. in connection with change of lending terms by other financial institutions (including government-run financial institutions, etc.) or in the case where such debtor has prepared a management reorganization plan, etc. in connection with change of the existing guarantee terms by Credit Guarantee Corporations), loans to such debtor for which the financial institution changes lending terms may be judged not to fall under Restructured Loans if such plan is deemed to satisfy the requirements under (\*1) and (\*2).

Note that, even in the case where the plan had initially satisfied all the requirements under (\*1) and (\*2) including the case under (\*3), if it becomes recognized that substantially the same return is not expected to be secured in such loan as compared to the case where the base rate would apply to such loan, the loan based on such plan falls under Restructured Loans.

(Note 5) “(A debtor) is expected to prepare such management reorganization plan” means a situation where although the bank and the debtor have not yet reached an agreement, the bank has confirmed that the debtor has resources, etc. to rehabilitate its management (e.g. liquidable assets, reducible cost, development plan of a new product, prospect to expand its sales channel) and the debtor has an intention to formulate the management reorganization plan.

#### (4) Substandard Loans

Substandard Loans mean “Loans past due three months or more and Restructured Loans” among loans to debtors who require special attention to their management in the future including, but not limited to those who have problems with lending terms (i.e., waivers, reductions, or deferrals of interest); who have problems with fulfillment (i.e., de facto arrears on principal or interest payments); who have poor or unstable business performance; who have problems with their financial position, etc.

Loans for which no deferred payment has occurred formally, but for which repayment has been substantially deferred for more than 3 months fall under Substandard Loans. Whether a loan is substantially deferred should be judged based on whether funds of a loan executed soon before the

due date of the existing loan are used for repayment thereof, etc.

With respect to a debtor who has formulated a reorganization plan, etc. as a precondition to receive support from financial institutions, etc., if the reorganization plan, etc. satisfies any of the following requirements, such reorganization plan, etc. may be considered reasonable and highly feasible and judged to fall under Substandard Loans or Normal Claims (Such plan is referred to as a “reasonable and highly feasible management reorganization plan”.)

When a debtor is an SME, it is often the case that it cannot formulate such a precise management reorganization plan as that by a large company, considering the size of the company and number of employees involved. Even when the debtor has not formulated a management reorganization plan, it is necessary to judge the category of the loans based on, for example, its future property sale plan, scheduled reduction of directors’ remuneration and various expenses, new product development plan or income improvement plan, and other materials prepared and analyzed by relevant financial institutions in line with the actual conditions of the debtor.

With regard to an SME debtor, as it cannot always formulate a precise management reorganization plan, it is often the case where the progress of the plan is below the target (the sales, etc. and current profits generally did not reach 80% of the reorganization plan.) Even in such case, judgment should not be mechanically and uniformly made merely based on the progress of the management reorganization plan, and it is necessary to analyze the factors causing non-achievement as well as to review the future prospects of management improvement, etc. (provided that if the plan goes significantly below the target, such plan should not be treated as a “reasonable and highly feasible management reorganization plan”.) In considering the progress of the management reorganization plan or future prospects, it is proper to put more emphasis on checking cash flow forecast rather than reviewing factors in the balance sheet, although the latter is also important.

Additionally, when a debtor is using government funding to formulate a management reorganization plan, etc. and such management reorganization plan, etc. has been approved by the national or prefectural government, judgment should be made by comprehensively taking into account the involvement of the national or prefectural government and its appropriateness in light of conditions at the debtor.

These criteria are only a guide to verify the rationality and feasibility of the management reorganization plan and should not be applied merely mechanically and uniformly.

- (i) The period for the management reorganization plan, etc. is in principle no more than about five years and the plan is highly feasible.

However, this may include the case where the debtor has formulated management reorganization plans, etc. within the period between approximately five and ten years, and after the plan is formulated, the plan has progressed as planned (the sales, etc. and current profits have reached at least about 80% of the reorganization plan), and it is considered to progress almost as planned thereafter, as well.

(ii) The reorganization plan is designed to enable the debtor to recover to the state where the debtor is recognized as achieving good business performance and having no particular problem in its financial situation (if the debtor becomes able to continue its business on its own without needing reconstruction support from financial institutions, etc., it includes the state where the debtor becomes recognized as one who requires special attention to its management in the future including, but not limited to those who have problems with lending terms (i.e., waivers, reductions, or deferrals of interest); who have problems with fulfillment (i.e., de facto arrears on principal or interest payments); who has poor or unstable business performance; or who has problems with its financial position, etc.) when the plan is completed.

(iii) All the financial institutions with which the debtor does business have agreed to provide the debtor with support based on the management reorganization plan;

However, in the case in which it is possible to reconstruct the debtor with support only from the relevant financial institution, or in the case in which it is possible to reconstruct the debtor with support from only some of the financial institutions, etc. with which the debtor does business, it should be judged that it is sufficient for the relevant financial institution to have reached an agreement on support.

(iv) Support from financial institutions, etc. must be limited to waivers and reductions of interest, maintenance of lending balances, and the like and may not include the waiver of claim, cash gifts, or other provisions of funds to the debtor.

However, this includes cases in which the financial institution has already provided funds to the debtor (waiver of claim, cash gifts) after the initiation of the management reorganization plan but is not expected to do so thereafter, and cases in which the business improvement plan requires the provision of cash to the debtor (waiver of claim, cash gifts) but full reserves have already been allocated for the losses forecast from this support and there are no forecasts for further losses in the future.

Note that when the debtor is making use of government funding, interest subsidies and the like made by prefectural governments with subsidies from the national government as provided for in government funding programs are not included in relinquishment of credits, etc.

## (5) Normal Claims

Normal Claims mean “loans classified as other than Substandard Loans, Doubtful Loans, or Bankrupt and Substantially Bankrupt Loans since the debtor has no particular problem in its financial position and operating results.”

Loans to the national government, local governments, and controlled financial institutions fall under Normal Claims.

III-3-2-4-4 Disclosure of Condition of Capital Adequacy (concerning Article 19-2(1)(v)(d), Article 19-3(1)(iii)(c), Article 19-5, Article 34-26(1)(iv)(c), and Article 34-27-2 of the Banking Act Enforcement Regulation)

The purpose of the disclosure of condition, etc. of capital adequacy based on Pillar 3 (market discipline) of the capital adequacy ratio and leverage ratio requirements is to supplement Pillar 1 (minimum capital adequacy ratio and leverage ratio requirements) and Pillar 2 (self-management by financial institutions and supervisory review process) and to secure sound management of financial institutions by market-driven independent assessment; i.e., market-based discipline. Financial institutions need to properly disclose the condition, etc. of capital adequacy in accordance with the Public Notice on Disclosure by paying attention to the following points. Additionally, financial institutions need to consider what is useful and practical disclosure to users in light of the importance of information subject to disclosure. Note that, in particular, attention is required to avoiding the omission of disclosure of information that might lead users thereof to change their economic decision-making so that it will be properly disclosed.

However, with regard to disclosure of proprietary or confidential information that may cause significant damage to the status of a disclosing bank, the bank may limit their disclosure to more general information relating to such information and disclose the fact that such information is not disclosed and the reason of non-disclosure.

Note: III-3-2-4-4 mainly sets forth disclosure requirements for banks to calculate capital adequacy ratio and leverage ratio on a solo basis. This may apply to cases where banks calculate capital adequacy ratio and consolidated leverage ratio on a consolidated basis or where bank holding companies calculate capital adequacy ratio and leverage ratio on a consolidated basis mutatis mutandis by replacing relevant terms, on a case-by-case basis.

- (1) Qualitative disclosure items (for internationally active banks and bank holding companies)
  - (i) “The following matters relating to the scope of consolidation”
    - (A) “Differences and reasons for such differences between companies belonging to the corporate group that are required to be included in the calculation of the equity capital ratio on a consolidated basis (“Consolidated Group”) and those companies included within the scope of consolidation (“Scope of Accounting Consolidation”) based on Article 5 of the Ordinance on Terminology, Forms, and Preparation Methods of Consolidated Financial Statements (“Regulations for Preparation of Consolidated Financial Statements”).
    - Differences in the scope of consolidation and the calculation method between the case under Article 3 of the Public Notice on Standards for Banks' Capital Adequacy or Article 3 of the Public Notice on Standards for Bank Holding Companies' Capital Adequacy and that based on the Regulations for Preparation of Consolidated Financial Statements (for example, normal consolidation, equity method, proportional consolidation)

- Reasons for differences in the scope of consolidation and the calculation method
- (B) For “Name, total assets, and net assets as shown on the balance sheet, and principal business activities of companies belonging to the Consolidated Group but not included in the Scope of the Accounting Consolidation or of companies not belonging to the Consolidated Group but included in the Scope of the Accounting Consolidation,” the name, total assets, and net assets as shown on the balance sheet, and principal business activities of these companies by each category of companies that are treated in the same manner by listing them, etc.
- (ii) “Overview of the risk characteristics, and the risk management policies, procedures, and structures of the entire bank”
- (A) Description on how the bank’s business model determines and interacts with the overall risk profile (e.g. the key risks related to the business model and how each of these risks is reflected and described in the risk disclosures) and how the risk profile of the bank interacts with the risk tolerance approved by the board of directors.
- (B) Risk governance structure: For example, responsibilities attributed throughout the bank (e.g. oversight and delegation of authority; breakdown of responsibilities by type of risk, business unit, etc.); relationship between the structures involved in risk management processes (e.g. board of directors, senior management, separate risk committee, risk management department, compliance department, internal audit department, etc.)
- (C) Channel to communicate and enforce the risk-sensitive culture within the bank (e.g. code of conduct; manuals containing operating limits or procedures to treat violations or breaches of risk thresholds; procedures to raise and share risk issues between business lines and risk functions)
- (D) Scope and main features of risk measurement systems
- (E) Process of risk information reporting provided to the board of directors and senior management; in particular, the scope and main content of reporting on risk exposure.
- (F) Qualitative information on stress testing (for example, portfolios subject to stress testing, scenarios adopted and methodologies used, and use of stress testing in risk management, etc.)
- (G) Strategies and processes to manage, hedge, and mitigate risks that arise from the bank’s business model and the processes for monitoring the continuing effectiveness of hedges and mitigants
- (iii) “The following matters relating to credit risk”
- (A) “Overview of the risk characteristics, and the risk management policies, procedures, and structures”
- Description on credit risk profile based on business model
  - Criteria and methods to determine the credit risk management policy and credit risk limit
  - Structures and organizations relating to credit risk management and control
  - Relationship between credit risk management department, credit management department,

- compliance department, and internal audit department
- Scope and main content of reporting on credit risk exposure and management function of credit risk
- (B) "Overview of the criteria for loan loss provisions and write-offs under the accounting standards"
- Policies and methods for loan loss provisions and write-offs (including overview of credit rating, debtor classification, loan classification, and asset classification (including description on definition of category, method to classify, and the scope of assets to be classified) and calculation method for loan loss provisions and write-offs.)
  - Number of allowable delayed days in which a "loans in arrears by 3 months or more" is still classified as is and is not downgraded as "doubtful or below" (or not downgraded as a loan to a potentially bankrupt debtor or below) and the reason thereof.
  - Definition of restructured loans (excluding those classified as "loans in arrears by 3 months or more, and doubtful loans or below") (including description on conditions not to classify these loans as "loans in arrears by 3 months or more, doubtful loans or below" and conditions to increase loan loss reserves in connection with relaxed loans)
  - Major differences in credit risk parameters used to calculate loan loss provisions and the equity capital ratio, respectively (including definition of default and differences in parameter calculation methods. If there is no difference, describe so.)
- (C) For "name of qualified rating agency, etc. used to determine the risk weight of the exposure by each category for banks adopting the standardized approach," in the case where the bank classifies a certain debtor's loan without separate credit rating by applying such debtor's other loan credit rating to it pursuant to Article 51(1) of the Public Notice on Standards for Banks' Capital Adequacy or Article 29(1) of the Public Notice on Standards for Bank Holding Companies' Capital Adequacy, description of the scheme of such application process and how the process is operated.
- (D) "For banks adopting the internal ratings-based (IRB) approach, the following matters"; of which "the overview of the IRB approach and the overview of the following matters relating to such system"
- a. For "rating procedures by each asset category," number of major models used in each portfolio and description on major differences between models included in the same portfolio
  - b. "Parameter estimation and validation scheme thereof"
    - PD : Description on definition, methodologies, and data for PD estimation and validation (estimation methodology of Low Default Portfolio, application of the regulatory floor, and key factors for differences between estimated PD and actual default rates for at least past 3 terms)
    - LGD: Description on estimation methodologies for downturn LGD and for LGD in the LDP, and the period between date of default and final liquidation of the exposure

- EAD: Prerequisites and assumptions, etc. to be used in calculating EAD
- c. “Operating structures relating to the IRB approach, development of models used, and management thereof”
  - Role of the departments involved in the development, approval, and subsequent changes of the credit risk models.
  - Relation between risk management department and internal audit department and procedure to ensure the independence of the department in charge of validating the models from the department responsible for developing the models.
  - Scope and main content of reporting on models
- (iv) “Overview of the risk characteristics, and the risk management policies, procedures, and structures relating to the credit risk mitigation techniques”
  - (A) Core features of policies and processes for, and an indication of the extent to which the bank makes use of, on- and off-balance sheet netting.
  - (B) Core features of policies and processes for collateral evaluation and management.
  - (C) Information about market or credit risk concentrations under the credit risk mitigation techniques used (for example, exposure concentration to specific class or category when computing exposure by guarantor type, by type of collateral, or by credit derivative protection providers).
- (v) “Overview of the risk characteristics, and the risk management policies, procedures, and structures relating to the counterparty credit risk of derivative transactions and repo-style transactions”
  - (A) Policies for the allocation method of risk capital and credit ceiling concerning exposures to counterparties and CCPs
  - (B) Assessment on collateral, guarantee, netting, and other credit risk mitigation (CRM) techniques and overview of management policies and disposal procedures for collateral, etc.
  - (C) Policies for identification, monitoring, and management of wrong-way risk exposures
  - (D) Description on impact in terms of the amount of collateral that the bank would be required to provide given a credit rating downgrade
- (vi) “The following matters relating to securitization risk”
  - (A) For “overview of the risk characteristics, and the risk management policies, procedures, and structures,” the bank’s policy on the securitization transactions (including degree of risk transfer by securitization and types of risk.) (Exposures must be segregated between banking book and trading book. Re-securitization exposure, if any, must be segregated from securitization exposure. The same shall apply hereinafter in (vi))
  - (B) For “overview of development of system and operation status thereof,” if the bank has re-securitization exposures, difference from securitization exposure
  - (C) For “name of a special purpose vehicle for securitization and whether the bank has securitization risk relating to such transaction,” at least content of the securitization



transactions executed by the bank during the current business year and whether the bank includes the special purpose vehicle in the scope of consolidation in computing the equity capital ratio

- (D) For “among subsidiaries and affiliate companies, etc. within the corporate group that are required to be included in the calculation of the equity capital ratio on a consolidated basis (“Consolidated Group”), names of companies that have securitization exposures relating to securitization transactions executed by Consolidated Group and in whose management Consolidated Group is involved or to which Consolidated Group provides advice,” securitization transactions executed at least during the current business year
- (E) “Overview of the internal assessment approach if the bank uses the approach”
- Internal assessment process and the structure to control it (including independency and accountability of those who are in charge of control and assessment results, etc. of the internal assessment process.)
  - Relation between internal assessment and external ratings provided by external qualified rating agencies (including information on such qualified rating agencies.)
  - Use of the internal assessment approach for purposes other than calculation of required equity capital
  - Types of securitization exposure to which internal assessment approach is applied and the stress factors to determine the level of credit enhancement by each type of exposure
- (vii) “The following matters relating to market risk” {Except for the financial institutions that have applied the new regulations – financial institutions that have applied the new regulations should refer to the Public Notice after the revision (i.e., item (xxiv) of the FSA Public Notice, 2022; hereinafter the same applies.).}
- (A) “Overview of the risk characteristics, and the risk management policies, procedures, and structures”
- Strategic goal of bank’s trading activities and market risk control process
  - Structure and role of market risk management function
  - Scope and main content of reporting on risk exposures and measurement system thereof
- (B) “Overview and the scope of application of models when the bank is using internal model approach”
- a. Value at risk (VaR) and stressed value at risk (SVaR)
- i) Scope of application of internal model approach (by risk category or by location; or by individual risk or by general market risk)
  - ii) When multiple models are used in different locations in the Group, description on models used by each location
  - iii) Overview of models
  - iv) If there is any difference between internal models and regulatory models, description on such difference

- v) The following matters relating to VaR
    - Update frequency of historical data
    - Observation period of historical data
    - Methodology for weighting historical data
    - Conversion calculation for the holding period regarding VaR calculated based on the holding period of less than 10 business days
    - Aggregation approach of VaR across asset classes (e.g. aggregation across specific and general risks, aggregation across risk factors)
    - Price reevaluation method (e.g. full valuation approach, sensitivity approach, etc.)
    - Capture of risk factor variation (e.g. absolute return, relative return, etc.)
  - vi) The following matters relating to SVaR
    - Approach to choose stress period (for SVaR) and reason why
    - Price reevaluation method (e.g. full valuation approach, sensitivity approach, etc.)
    - Conversion calculation for the holding period regarding SVaR calculated based on the holding period of less than 10 business days
  - vii) Description on Stress Testing
  - viii) Description on Back testing
  - ix) Structure for parameter validation used for internal models
  - x) Additional description relating to model validation technique
- b. Incremental risk
- i) Overview of models
  - ii) How to reflect changes in default risk and credit ratings
  - iii) How to determine various parameters (PD, LGD, transition probability, correlation, etc.)
  - iv) Explanation on how to assign a liquidity horizon
  - v) Model validation technique
- c. Comprehensive risk
- i) Overview of models
  - ii) How to reflect changes in default risk and credit ratings
  - iii) How to determine various parameters (PD, LGD, transition probability, correlation, etc.)
  - iv) Explanation on how to assign a liquidity horizon
  - v) Model validation technique
- (viii) For “overview of the risk management policies and procedures” mentioned in “the following matters relating to operational risk,” structures to ensure risk is identified, assessed, measured, and reported. {Except for the financial institutions that have applied the new regulations – financial institutions that have applied the new regulations should refer to the Public Notice after the revision.}

- (ix) “Overview of the risk characteristics, and the risk management policies, procedures, and structures relating to exposures to the equivalents of shares or exposures to shares, etc.”  
 {Confined to the financial institutions that have applied the new regulations – financial institutions that have not yet applied the new regulations follow the previous cases.}
- (A) Scheme to ensure risk is identified, assessed, measured, and reported.
- (B) Policy on risk management relating to other securities, subsidiary’s shares, and affiliate’s shares by class
- (C) Key accounting policies including assessment of stock exposure, etc. (If the accounting policy is changed, matters corresponding to Article 8-3 of the Regulations for Preparation of Financial Statements should be included. )
- (x) “The following matters relating to interest rate risk”
- (A) “Overview of the risk management policies and procedures”
- Description on concept and scope of interest rate risk subject to risk management and measurement
  - Description on risk management and mitigation policy
  - Frequency in measuring interest rate risk
  - Description on interest rate risk mitigation technique such as hedging, etc. (including accounting treatment of hedging instruments.)
- (B) “Overview of interest rate risk measurement method”
- $\Delta$ EVE and  $\Delta$ NII that are subject to quantitative disclosure based on the Public Notice on Disclosure (of interest rate risk contained in the banking book, those measured as decreased amount of interest income for a period from the base date for calculating interest rate shock to twelve months later, and which is calculated based on the interest rate shock specified in the Public Notice on Disclosure; the same applies in this item) and the following matters regarding interest rate risk to be additionally disclosed by the bank
    - Average maturity in interest-rate change assigned to liquid deposits
    - Longest maturity in interest-rate change assigned to liquid deposits
    - Method to estimate maturity of liquid deposits (core deposit model, etc.) and prerequisites thereof
    - Assumptions for early repayment of fixed-rate loans and early termination of time deposits
    - Aggregation method of multiple currencies and prerequisites thereof
    - Conditions for spreads (whether it is included in discount rate or cashflow in calculating, etc.)
    - Other conditions that may have significant impact on  $\Delta$ EVE and/or  $\Delta$ NII such as use of internal model approach, etc.
    - Explanation relating to change in disclosure from the preceding business year
    - Other explanation relating to interpretation and materiality of measured values
  - In the case where the bank calculates interest rate risk other than mandatory  $\Delta$ EVE and  $\Delta$ NII

that are subject to the quantitative disclosure based on the Public Notice on Disclosure, for the purposes of assessment of the capital adequacy, stress test, risk management, profit and loss management, operational judgment or any others, the following matters relating to such interest rate risk should be considered.

- Description on interest rate shock scenarios
- Prerequisites of the interest rate risk measurement and meanings thereof (in particular, large difference with  $\Delta$ EVE value or  $\Delta$ NII value subject to the quantitative disclosure based on the Public Notice on Disclosure)

(xi) "Explanation of which items on the balance sheet correspond to the items listed in Appendix Form No. 1"

This item shall be described in accordance with Appendix Form No. 13 (for banks calculating capital adequacy ratio on a consolidated basis, Appendix Form No. 14) of the Public Notice on Disclosure .

(xii) "Explanation of the difference between the amount of exposure under the capital adequacy ratio regulation and the amount recorded on the balance sheet and its factors"

- (A) Qualitative explanation of accounts across multiple risk categories or accounts that are difficult to link to risk categories on Appendix Form No. 2, sheet 2 of the Public Notice on Disclosure
- (B) Regarding the difference between the amount of exposure under the capital adequacy ratio regulation and the amount recorded on the balance sheet, an explanation of the main difference items shown in Appendix Form No.2, sheet 3 of the Public Notice on Disclosure

(2) Qualitative disclosure items (for domestically active banks and bank holding companies)

(i) "The following matters relating to the scope of consolidation"

- (A) Whether the following elements are described in "differences and reasons for such differences between companies belonging to the corporate group that are required to be included in the calculation of the consolidated equity capital ratio ('Consolidated Group') and those companies included within the Scope of Accounting Consolidation".
  - Differences in the scope of consolidation and the calculation method between the case under Article 26 of the Public Notice on Standards for Banks' Capital Adequacy or Article 15 of the Public Notice on Standards for Bank Holding Companies' Capital Adequacy and that based on the Regulations for Preparation of Consolidated Financial Statements (for example, normal consolidation, equity method, proportional consolidation, etc.)
  - Reasons for differences in the scope of consolidation and the calculation method
- (B) For "name, total assets and net assets as shown on the balance sheet, and principal business activities of companies belonging to the Consolidated Group but not included in the Scope of the Accounting Consolidation or of companies not belonging to the Consolidated Group but included in the Scope of the Accounting Consolidation," are the name, total assets, and

net assets as shown on the balance sheet, and principal business activities of these companies by each category of companies that are treated in the same manner properly described by listing them, etc.?

(ii) The “summary of capital raising means” includes all or part of the issued capital in “amount of capital” in the formula in Article 25 or Article 37 of the Public Notice on Standards for Banks' Capital Adequacy or Article 14 of the Public Notice on Standards for Bank Holding Companies' Capital Adequacy. Whether the following information on capital raising means (including qualifying old non-cumulative perpetual preferred shares and qualifying old capital raising means included in the amount of capital as a result of transitional measures) is provided.

- Issuer
- Types of capital-raising instruments
- Amount inserted in the basic items relating to Core Capital

(Provide the below if applicable)

- Dividend rate or interest rate (if published)
- If there is a redemption deadline, the fact of the date
- Outline of special agreements that allow redemption, etc. in the event of certain reasons (initial redemption date, redemption amount, applicable reasons, etc.)
- If there is any special conditions relating to conversion to other capital raising instruments, provide an overview thereof.
- Outline of any special contracts for reduction of principal
- If there is a clause for suspension of payment of dividends, etc., whether there is any accumulation of suspended unpaid dividends or interest
- If there are special agreements related to step-up interest rates or other special agreements that increase the probability of redemption, etc., outline them.

(iii) “The following matters relating to credit risk”

(A) Whether the following elements are described in “overview of the risk management policies and procedures”

- Structures to ensure risk is identified, assessed, measured, and reported.
- Accounting standards for allowance for doubtful accounts
- When calculating the credit risk, if the bank has adopted the basic or advanced IRB approach but partially applied the method that the bank has not adopted, each method is applied a description of the nature of the exposures to be exposed and the plans for a full transition of the exposures to the appropriate approach

(B) For “name of qualified rating agency, etc. used to determine the risk weight of the exposure by each category,” if 100% risk weight is assigned to all corporate exposures (excluding SME exposures), does the bank disclose it? {Except for the financial institutions that have applied the new regulations.}

- (C) “Portfolio to which the IRB approach is applied, the following matters”
- a. For “type of IRB approaches used,” if the IRB approach is applied stepwise, is the transition period described?
  - b. Whether or not the following elements are described in “overview of the IRB approach”
    - Mechanism of the IRB approach (including description on the relation of IRB and external ratings when an external rating is used as a major factor in assigning an internal rating)
    - Usage of various estimates for purposes other than the calculation of equity capital ratios
    - Control and validation procedures for IRB approach
- (D) Whether or not the following elements are described in "overview of rating procedures for each portfolio listed below"
- Types of exposure included in each portfolio
  - Definition, methods and data (including assumptions used to derive the parameters) used to estimate and verify PD (also LGD and EAD if the advanced IRB approach is applied )
  - If there is any difference from the definition of default set forth in the Public Notice on Standards for Banks' Capital Adequacy and the Public Notice on Standards for Bank Holding Companies' Capital Adequacy that is deemed important, an explanation on the content of such difference (including an explanation on types of portfolios on which such difference may have impact)
- (iv) For “overview of the risk management policies and procedures relating to the credit risk mitigation techniques,” whether the following elements are described
- Overview of the policies and procedures for set-off between loans and deposits as well as types and the scope, etc. of transactions using this scheme
  - Overview of the policies and procedures for entering a legally valid bilateral netting contract relating to derivative transactions as well as repo-style transactions and credit transactions and these kinds of overseas transactions, and types and the scope, etc. of transactions using this contract {Confined to financial institutions that have applied the new regulations - financial institutions that have not yet applied the new regulations follow the previous cases.}
  - Overview of policy and procedures for collateral assessment and management
  - Main types of collateral
  - Types of guarantors and major counterparties of credit derivative and their credibility
  - Information on concentration of credit risk and market risk in association with the application of the credit risk mitigation techniques
- (v) For “overview of the risk management policies and procedures relating to the counterparties risk in derivative transactions and transactions with long settlement periods,” whether the following elements are described
- Policies for the allocation methods of risk capital and credit ceiling
  - Policies on protection by collateral and calculation of reserves
  - Explanation on impact in terms of the amount of collateral that the bank would be required to

provide given a credit rating downgrade

- (vi) “The following matters relating to securitization exposure”
- (A) Whether or not the following elements are described in “overview of risk management policy and risk characteristics”
- Structures to ensure risk is identified, assessed, measured, and reported.
  - Bank’s policy on the securitization transactions (including degree of risk transfer by securitization and types of risk. Re-securitization exposure, if any, must be separately mentioned.)
  - Bank’s role in the securitization transactions (originator, investor, credit provider, provider of credit enhancement, sponsor of ABCP, liquidity provider, swap provider, etc.) and the extent of the bank’s involvement in each of them
  - Nature of risk other than the credit risk and the market risk, if any, in securitization exposures (for example, liquidity risk)
- (B) For “overview of development of the system and operation status thereof,” if the bank has re-securitization exposures, whether its difference from securitization exposure is described
- (C) For “type of such special purpose vehicle for securitization and whether the bank has securitization exposure relating to such transaction,” whether, at least, content of the securitization transactions executed by the bank during the current business period is described. Additionally, whether the description includes whether the securitization exposure is held as on-balance sheet transactions or off-balance sheet transactions
- (D) For “name of the bank’s subsidiaries (excluding the consolidated subsidiaries ) and affiliates, etc. that hold the securitization exposures relating to the securitization transactions executed by the bank (including securitization transaction executed by the bank by using a special purpose vehicle for securitization ),” whether, at least, content of the securitization transactions executed by the bank during the current business period is described
- (E) For “accounting policies for the securitization transactions,” whether the following elements are described
- How the securitization transactions are recognized in accounting, for example, as sale of assets or raising of funds.
  - At what point is sale of assets recognized.
  - Prerequisites, etc. for evaluation of the retained interest in securitization exposures. Overview and impact of change, if any
  - If there is any difference between the accounting policies for the synthetic securitization and other accounting policies such as for derivatives, an explanation thereof
  - Methods of evaluating assets held for the purpose of securitization and whether such assets are recorded as banking book or trading book
  - Policies for recognizing liquidity enhancement, credit enhancement, or other credit offering without advance payment of funds granted to securitization exposures as liabilities in the

balance sheet

- (F) For “overview of the internal assessment approach if the bank uses the approach,” whether the following elements are described
- Internal assessment process and the structures to control it (including independence and accountability of those who are in charge of control and assessment results, etc. of the internal assessment process)
  - Relation between internal assessment and external ratings provided by qualified rating agencies (including information on such qualified rating agencies.)
  - Use of the internal assessment approach for purposes other than calculation of required equity capital
  - Types of securitization exposure to which the internal assessment approach is applied and the stress factors to determine the level of credit enhancement by each type of exposure
- (G) As examples of “content of important change in the quantitative information, if any” a case where an important change occurred in the amount of assets held for the purpose of securitization or a case where there is a transfer between the banking book and trading book, etc. may be given.
- (vii) “The following matters relating to market risk” {Except for the financial institutions that have applied the new regulations - financial institutions that have applied the new regulations should refer to the Public Notice after the revision.}
- (A) For “overview of the risk management policies and procedures,” whether structures to ensure risk is identified, assessed, measured, and reported are described.
- (B) For “if the incremental risk is measured by using the internal models, overview of such internal models,” whether the definition of the defaults for which the incremental risk is measured, the overview of rating classification, methods of determining a liquidity horizon, and methods of verifying the incremental risk calculation models are described
- (C) For “if the comprehensive risk is measured by using the internal models, overview of such internal models,” whether the types of risk for which the comprehensive risk is measured, the assessment methods thereof, and methods of verifying the comprehensive risk calculation models (including methods of using stress test) are described
- (viii) For “overview of the risk management policies and procedures” mentioned in “the following matters relating to operational risk,” whether structures to ensure risk is identified, assessed, measured, and reported are described. {Except for the financial institutions that have applied the new regulations - financial institutions that have applied the new regulations should refer to the Public Notice after the revision.}
- (ix) For “overview of the risk management policies and procedures for investment or stock exposure,” whether the following elements are described
- Structures to ensure risk is identified, assessed, measured, and reported.
  - Policy on risk management relating to other securities, subsidiary’s shares, and affiliate’s shares



by class

- Key accounting policies including assessment of stock exposure (If the accounting policy is changed, matters corresponding to Article 8-3 of the Regulations for Preparation of Financial Statements should be included. )
- (x) “The following matters relating to interest rate risk”
- (A) “Overview of the risk management policies and procedures”
- Description on concept and scope of interest rate risk subject to risk management and measurement
  - Description on risk management and mitigation policy
  - Frequency in measuring interest rate risk
  - Description on interest rate risk mitigation technique such as hedging, etc. (including accounting treatment of hedging instruments.)
- (B) “Overview of interest rate risk measurement method”
- $\Delta$ EVE and  $\Delta$ NII that are subject to quantitative disclosure based on the Public Notice on Disclosure (of interest rate risk contained in the banking book, those measured as decreased amount of interest income for a period from the base date for calculating interest rate shock to twelve months later, and which is calculated based on the interest rate shock specified in the Public Notice on Disclosure; the same applies in this item) and the following matters regarding interest rate risk to be additionally disclosed by the bank
    - Average maturity in interest-rate change assigned to liquid deposits
    - Longest maturity in interest-rate change assigned to liquid deposits
    - Method to estimate maturity of liquid deposits (core deposit model, etc.) and prerequisites thereof
    - Assumptions for early repayment of fixed-rate loans and early termination of time deposits
    - Aggregation method of multiple currencies and prerequisites thereof
    - Conditions for spreads (whether it is included in discount rate or cashflow in calculating, etc.)
    - Other conditions that may have significant impact on  $\Delta$ EVE and/or  $\Delta$ NII such as use of internal model approach, etc.
    - Explanation relating to change in disclosure from the preceding business year
    - Other explanation relating to interpretation and materiality of measured values
  - In the case where the bank calculates interest rate risk other than mandatory  $\Delta$ EVE and  $\Delta$ NII that are subject to the quantitative disclosure based on the Public Notice on Disclosure, for the purposes of assessment of the capital adequacy, stress test, risk management, profit and loss management, operational judgment or any others, the following matters relating to such interest rate risk should be considered.
    - Interest rate shock scenarios
    - Prerequisites of the interest rate risk measurement and meanings thereof (in particular,

large difference with  $\Delta$ EVE value or  $\Delta$ NII value subject to the quantitative disclosure based on the Public Notice on Disclosure)

(3) Quantitative disclosure Items (for internationally active banks and bank holding companies)

If a significant change occurs in the quantitative disclosure items from the preceding period, an explanation relating to the reasons why

- (i) For “following matters relating to credit risk,” the purpose of complementing the quantitative disclosure items relating to the credit quality of assets held by the bank should be considered.
  - (A) As examples of “breakdown by major types,” the two types such as (a) off-balance sheet exposure other than loans, commitments or other derivatives, and (b) bonds, etc. may be given.
  - (B) For “by area,” at least exposures should be classified into domestic and overseas.
  - (C) The term-end balance of the exposures by deferred periods (excluding doubtful claims and below, deferred periods should be classified into such as “less than 1 month,” “1 month to less than 2 months,” “3 month and over”, etc.)
- (ii) With regard to the quantitative disclosure items relating to G-SIBs indicators in sheet 32 of Appendix Form No.2 of the Public Notice on Disclosure among those as set forth in Article 2(5) of the Public Notice on Disclosure, proper disclosure in accordance with the G-SIBs indicators published by the Basel Committee on Banking Supervision

(4) Quantitative disclosure items (for domestically active banks and bank holding companies)

- (i) “The following matters relating to capital adequacy”
  - (A) For “portfolios to which the IRB approach is applied and, of which, the breakdown by the following portfolios,” whether a bank using both the basic IRB approach and the advanced IRB approach describes the breakdown by each approach
  - (B) For “amount of the required equity capital to the credit risk relating to stock exposures in portfolio to which the IRB approach is applied and, of which, the amount by each category listed below,” whether the amount of the required equity capital by each stock portfolio in line with the category in calculation of the required equity capital is mentioned. {Confined to financial institutions that have applied the new regulations - financial institutions that have not yet applied the new regulations follow the previous cases.}
- (ii) “The following matters relating to credit risk”
  - (A) For “term-end balance of credit risk exposures (if the term-end balance is significantly far from the risk position of such term, the average balance during the period should be disclosed, as well) and the breakdown of exposures by major category,” whether the following elements are described
    - If the bank does not use the daily average in calculating the average balance during the period, the calculation method used

- If the bank uses multiple techniques in calculating the credit risk, the term-end balance of exposures by each technique
- (B) As examples of “breakdown of exposures by major types,” the three types such as (a) loans, commitments and off-balance sheet exposure other than derivatives, (b) bonds, and (c) OTC derivatives, etc. may be given.
- (C) For “by area,” whether exposures are classified, at least, into domestic and overseas
- (D) For “change” in “general allowance for doubtful accounts, individual allowance for doubtful accounts and reserve for specific overseas loans,” whether the breakdown of the change is mentioned
- (E) For “balance after the effects of the credit risk mitigation techniques by risk weight category are considered with respect to exposures to which the standardized approach is applied,” whether the balance of exposures by risk weight category is classified in terms of whether rated or not. {Except for the financial institutions that have applied the new regulations.}
- (F) “Portfolio to which the IRB approach is applied, the following matters”
  - a. In the event that exposures are disclosed with an integrated rating or pool of debtors, whether such integration is designed to enable users to understand debtors’ rating and their distribution in the pool used in the IRB approach
  - b. For “analysis of exposures in pool unit by setting proper number of EL categories,” when the bank uses EL classification in its disclosure, whether such EL categories are proper in terms of decomposition of credit risk, which is meaningful for users of the disclosure
- (G) For “actual loss by exposure applying the IRB approach in the immediately preceding period, comparison with the past actual results and the analysis of factors thereof” whether the analysis on PD, LGD, and EAD levels is mentioned
- (H) For “comparison between estimated loss for long term by exposure applying the IRB approach and actual value thereof” whether the comparison period is long enough to evaluate the accuracy of the IRB approach and the estimated value
- (iii) For “the following matters relating to the credit risk mitigation techniques,” whether credit derivatives that are treated as part of synthetic securitization are excluded from the disclosure for the credit risk mitigation techniques and included in that for the securitization exposure
- (iv) “The following matters relating to securitization exposure”
  - (A) As examples of “breakdown of categories of major underlying assets,” credit cards, housing loans, automobile loans, etc. are given.
  - (B) For “if the bank is an originator, the following matters relating to the securitization exposures for which the assets with credit risk must be calculated” and “if the bank is an originator, the following matters relating to the securitization exposures for which the amount corresponding to the market risk must be calculated”
    - Whether, among the securitization transactions executed by the bank as an originator during the current business period, transactions for which the bank have no securitization exposures

are separately mentioned

- If the bank has two types of securitization exposures (those arising from its service as a sponsor and those other than that), whether the two types of exposures are separately mentioned
- (C) For “loss in the current period,” whether loan loss provisions and write-offs, and write-downs of I/O strips are included
- (D) For “amount of securitization exposures held and the breakdown of the underlying assets by category,” whether the on-balance sheet transactions and the off-balance sheet transactions are separately mentioned
- (E) For “balance of securitization exposures by proper number of risk weight category and required equity capital,” whether the on-balance sheet transactions and the off-balance sheet transactions are separately mentioned
- (F) Whether the I/O strips that have the credit enhancement function are included in “securitization exposures deducted from the equity capital”
- (v) For “amount recorded on the balance sheet and the market value” of “the following matters relating to the investment or stock exposures,” if the prices of listed securities are far from the fair value, whether the comparison is disclosed

- (5) Disclosure items concerning leverage ratio on consolidated basis or leverage ratio on a solo basis (for internationally active banks and bank holding companies)

For “reasons causing a significant difference with the leverage ratio on consolidated basis of the preceding consolidated accounting period” or “reasons causing a significant difference with the leverage ratio on a solo basis of the preceding accounting period,” whether key factors causing such difference are disclosed, for example, in cases where there is an increase or decrease more than 0.5% from the leverage ratio on a solo or consolidated basis as of the end of the preceding accounting period or where the leverage ratio on consolidated basis increased or decreased due to change in the major consolidated subsidiary companies, whether such variation is caused by change in the numerator (amount of capital) of the leverage ratio on consolidated basis or in the dominator (amount of total exposure) thereof

- (6) Quarterly disclosure items (for internationally active banks and bank holding companies)

- (i) These banks must properly disclose the matters set forth in Articles 6 and 9 of the Public Notice on Disclosure on a quarterly basis pursuant to the purpose of the Basel Accords. It is proper to post these disclosure items (including past data) on the website in such a manner that depositors, investors, and other users have easy access to specific information they want to know.

Additionally, when banks disclose quarterly disclosure items set forth in Article 6(1)(ii), (iii) and (v) as well as Article 6(2)(ii) to (iv), and Article 6(2)(vi) to (xi) of the Public Notice on Disclosure, or when bank holding companies disclose quarterly disclosure items set forth in

Article 9(1)(ii), (iii) and (v) to (x) of the Public Notice on Disclosure, it is proper that such disclosure is made promptly after the publication of the annual securities report under Article 24(1) or (3) of the Financial Instruments and Exchange Act, the semiannual securities report under Article 24-5(1) of the Financial Instruments and Exchange Act, or the quarterly financial results under the relevant regulations of a financial instruments exchange, the base date of which is the end day of the relevant quarter.

If matters set forth in Articles 6 and 9 of the Public Notice on Disclosure are disclosed in accordance with sheets 2 and 3 of the Appendix Form No. 8 thereof, it is preferable that such disclosure is made promptly after the publication of the relevant quarterly financial results while the time required to analyze the variation factors should be taken into account.

On the other hand, it is desirable that other disclosure items are made promptly upon publication of the relevant quarterly financial results.

- (ii) For “details of contracts relating to capital-raising instruments” under Article 6(1)(iv) or Article 9(1)(iv) of the Public Notice on Disclosure, it is proper to mention particulars of the contracts relating to capital-raising instruments in addition to the “overview of contracts relating to equity capital-raising instruments” under Article 6(1)(iii) and Article 9(1)(iii) of the Public Notice on Disclosure so that depositors, investors, and other users are able to check them easily.

It is preferable that financial institutions update disclosure information on their capital-raising instruments upon issuance, redemption, or change of the content of the instruments so that users are able to check the latest information.

- (iii) For “reasons causing a significant difference with the leverage ratio on consolidated basis of the preceding quarter” or “reasons causing a significant difference with the leverage ratio on a solo basis of the preceding quarter,” key factors causing such difference should be mentioned; for example, in cases where there is an increase or decrease more than 0.5% from the leverage ratio on a solo or consolidated basis as of the end of the preceding quarter or where the leverage ratio on a consolidated basis increased or decreased due to change in the major consolidated subsidiary companies, whether such variation is caused by change in the numerator (amount of capital) of the leverage ratio on a consolidated basis or in the dominator (amount of total exposure) thereof.

(7) Quarterly Disclosure Items (for domestically active banks and bank holding companies)

Domestically active banks adopting the IRB approach must properly disclose the matters set forth in Articles 14 and 17 of the Public Notice on Disclosure on a quarterly basis. It is preferable that other domestically active banks also disclose information useful for depositors, investors, and other users every quarter.

III-3-2-4-5 Disclosure on compensation system (concerning Article 19-2(1)(vi), Article 19-3(iv) and Article 34-26(1)(v) of the Banking Act Enforcement Regulation)

(1) General points to consider

Disclosure of the compensation system needs to be properly performed with respect to the matters set forth in the “Notice on the matters separately determined by the Commissioner of the FSA as those may have significant impact on the conditions of banks’ business operations or properties among items relating to compensation, etc. in accordance with Article 19-2(1)(vi) of the Banking Act Enforcement Regulation, etc.” (hereinafter referred to as the “Public Notice on Compensation”) fully considering the purpose of ensuring that the compensation system will not cause excessive risk-taking by the bank’s senior management through introduction of the market-based discipline of external assessment by the market and depositors and thereby maintain the sound management of the bank.

However, with regard to information disclosure which may cause significant damage to the competing status of a disclosing bank, information that may identify an individual and unduly harm the rights and interest of such individual or information subject to confidentiality obligation, etc., the bank may only disclose more general information relating to such information and the fact that and reason why such information is not disclosed. If there is no applicable matters to be disclosed under the Public Notice on Compensation, the bank may only mention to that effect.

(Reference)

- “Pillar 3 Disclosure Requirements for Remuneration” the Basel Committee on Banking Supervision (July 2011)
- “Pillar 3 Disclosure Requirements – Consolidated and Enhanced Framework – the 2nd Phase” the Basel Committee on Banking Supervision (March, 2017)

Additionally, in the case where Major Banks form a group (meaning banks or bank holding companies and their major consolidated subsidiaries, etc.; the same applies in (1) and (2) hereof), when the content of the disclosure items set forth in the Public Notice on Compensation are overlapped in the companies within the group, it should be noted whether the group makes efforts to make understandable disclosure such as explaining the content by summarizing key points, etc.

(2) Points to Consider for Individual Matters

(i) For officers and employees, etc. subject to compensation disclosure as defined in the Public Notice on Compensation (hereinafter referred to as “officers and employees, etc. subject to disclosure” in this (2)), for example, whether the following matters are properly described

(A) “Scope of officers subject to disclosure”

- Whether a proper explanation is given in the case where external directors and auditors are excluded from the “scope of officers subject to disclosure”
- Whether officers who retired in the relevant business period are included

(B) For “Scope of employees, etc. subject to disclosure”

a. “Scope of major consolidated subsidiaries, etc.”

- For “scope of major consolidated subsidiaries, etc.,” whether major consolidated subsidiaries are selected while considering importance of impact on the group’s financial

position and operation results without impairing the purpose of disclosure for the compensation structure nor preventing reasonable judgment of depositor, etc. In addition, whether a proper explanation is given with regard to the scope of major consolidated subsidiaries, etc. For example, an explanation using specific criteria may be acceptable such as “consolidated subsidiaries, etc. whose total assets do not exceed 2% of the total consolidated assets of the bank or the bank holding company do not fall in the scope of major consolidated subsidiaries, etc.” However, an operationally key consolidated subsidiary, etc. should be included in the major consolidated subsidiary, etc. even if it is small in size.

- b. For scope of “highly compensated persons”
    - Whether, in selecting “highly compensated persons,” the bank sets proper and reasonable criteria in line with its or the group’s actual status by making the average compensation paid to officers subject to disclosure as base and, when necessary, while considering the past trends of fluctuation of business performance, etc. And whether the grounds for setting such criteria and the rationality thereof are properly described. For example, when the amount of compensation paid to officers subject to disclosure decreased due to poor business results, etc., the bank may adjust the criteria of “highly compensated persons” while considering the past trends of fluctuation of business results, etc. In this case, whether a proper explanation is given with regard to the rationality of such criteria. Also, in case of referring to a group common criteria, whether the rationality thereof is properly described
    - For the scope of “compensation, etc.,” whether it includes any and all proprietary benefits received by an officer as the consideration for execution of his or her duties of whatever name including, but not limited to, compensation, salary, wage, pay, allowance, bonus; for example, in the case where an officer works and receives a salary as an employee also, when such salary includes an important part of his/her compensation, this should be included.
  - c. For the scope of “those who have a material influence on business management or assets of the bank, the bank holding company or major consolidated subsidiary, etc. thereof”
    - Whether those who have a material influence on business management or assets of the group are properly selected among from employees, etc. subject to disclosure by being checked for their risk takings status, etc. In addition, whether a proper explanation is given with regard to the selection method
- (ii) For “name, structure, and responsibilities of a committee or other major organization, etc. that supervises the duties relating to compensation, etc. such as determination and payment of compensation to officers and employees, etc. subject to disclosure” set forth in the Public Notice on Compensation, whether, for example, the following elements are described
- (A) How to develop and maintain the compensation committee, etc. (name, members, authority, and duties of the compensation committee, etc., measures enabling the compensation

- committee, etc. to exercise the monitoring and checking departments independently from the business promotion departments, etc. (including officers in charge thereof) (the scope of region, business area, or the officers and employees, etc. subject to disclosure to be monitored and checked by the compensation committee, etc.))
- (B) In the case where the compensation committee, etc. requests external consultant to give advice on the compensation, etc., the name of such external consultant and purpose and overview of such request
  - (C) With regard to the assessment of the appropriateness of design and operation of the compensation structure, if the compensation committee, etc. and the risk management department cooperate with each other, how their cooperation is going.
  - (D) Total amount of the compensation, etc. paid to members of the compensation committee, etc. (if it is difficult to separate the compensation only for the duty at the compensation committee from total compensation, it is not necessary to mention) and the number of times the compensation committee meetings were held
- (iii) For “matters relating to assessment of the appropriateness of design and operation of the compensation structures for officers and employees, etc. subject to disclosure” set forth in the Public Notice on Compensation, whether, for example, the following elements are described
- (A) Overview of the policies on determination of the compensation, etc. to officers and employees, etc. subject to disclosure (including policies on types and payment methods of the compensation, etc.), if any, and the scope of application thereof (applicable region, business area, and eligible officers and employees, etc. subject to disclosure), and the purpose and background of adopting such policy
  - (B) Explanation on categories of those included in officers and employees, etc. subject to disclosure and numbers of persons belonging to each category (for example, breakdown of officers and employees, etc. subject to disclosure by each category, and explanation on each category)
  - (C) If a significant change occurs in design and operation of the compensation structure, reasons and overview thereof and impact that such change will have on the compensation, etc.
  - (D) In the case where it is confirmed that the overall level of compensation, etc. is consistent with the present state and future forecasts of financial soundness of each bank or the group, and that it will not have a material impact on the future adequacy of equity capital, an explanation to that effect
  - (E) In the case where it is confirmed that, through monitoring how the compensation structure is operated, any problems have not arisen, such as the amount of compensation being excessively linked to short-term earnings or being overly reflective of performance, an explanation to that effect
- (iv) For “matters relating to the consistency between the compensation structure for officers and employees, etc. subject to disclosure and the risk management” set forth in the Public Notice on



Compensation, whether, for example, the following elements are described

- (A) If the design and operation of the compensation structure for employees in the risk management department and the compliance department is independent from other departments that are managed or supervised by these departments, an explanation to that effect (in particular, an explanation whether measurement of performance for the compensation of employees in the risk management department and the compliance department properly reflects the importance of their duties, the degree of achievement in risk management and compliance with laws and regulations, and the contribution to the risk management system and the compliance system)
- (B) If the compensation, etc. to officers and employees, etc. subject to disclosure are evaluated depending on risk, overview of measurement and evaluation methods for such risk and how to consider it (if there is any change from the preceding business period, an overview thereof should be included.)
- (v) For “matters relating to link between the compensation, etc. to officers and employees, etc. subject to disclosure and the bank’s performance,” whether the following elements are described
  - (A) In the case where considerable portion of the amount of the compensation, etc. to officers and employees, etc. subject to disclosure is performance-based compensation
    - If, in determining the ratio of the performance-based portion among the total amount of the compensation to officers and employees, etc. subject to disclosure, the bank takes into account their responsibilities and actual duties, the group’s financial soundness or degree of risk tolerance, an overview of how these factors are taken into account
    - Overview of the method of reflecting performance of the group, bank, business departments or relevant officers and employees, etc. subject to disclosure on the compensation, etc. or the method of measuring the performance
    - In cases where the payment of the performance-based portion of the compensation, etc. is deferred, an explanation that the design takes into account the response to financial risks that could arise before the compensation is finalized (covering the required equity capital and liquidity requirements)
    - Overview of measures, etc. to decrease such performance-based portion of the compensation in the event of poor business results (in particular, an explanation on the criteria to judge the applicability of poor business results)
    - Overview of the control environment to properly monitor and check the risk of acts being conducted by officers or employees, etc. subject to disclosure that could compromise the intent of the design of the compensation structure consistent with the risk management by, for example, applying risk-adjusted profits to the calculation of the compensation, etc. (such as transactions that are likely to reduce risks superficially)
  - (B) If a compensation structure that could adversely affect risk management (such as guaranteed minimum bonuses paid across two or more years, or disproportionately large retirement

allowances with the status of business performance and risk) is provided, an overview of appropriate improvement measures and responses therefor

- (C) If the bank adopts a method of paying compensation that emphasizes the creation of more long-term corporate value (for example, payments in stock or the granting of stock options) and a method of paying compensation that also takes into account the period of time up until risks are actualized (for example, setting fixed-period transfer restrictions in cases where payments are made in stock, setting exercise periods if stock options are granted, or reduction or redemption in the event compensation payments are deferred if business results are poor) according to the responsibilities of officers and employees, etc. subject to disclosure, the policies and overview thereof (if the percentage of deferred payments varies depending on the departments of officers and employees, etc. subject to disclosure, such percentage and factors determining the percentage should be included.)
- (vi) For internationally active banks and bank holding companies, whether the bank discloses “quantitative disclosure items” set forth in the Public Notice on Compensation in a form consistent with the Appendix thereof
- (vii) For domestically active banks and bank holding companies, with regard to “matters relating to types, total amount paid and methods of paying the compensation, etc. for officer and employees, etc. subject to disclosure” set forth in the Public Notice on Compensation, whether, for example, the following elements are described
- (A) Overview of types of compensation, etc. (base compensation, shares, stock options, bonus, retirement allowance, salary, wage, pays, etc.), overview of methods of paying compensation (setting fixed-period transfer restrictions in cases where payments are made in stock, setting exercise periods if stock options are granted, or deferred payment of compensation, or redemption of compensation paid if business results are poor), the purpose and background to apply these types and methods, etc.
- (B) For all the officers subject to disclosure and for all the employees, etc. subject to disclosure, respectively, the total amount of the compensation, number of persons paid, the total amount of the fixed compensation and that of the variable compensation and number of person paid, as well as the total amount of the compensation and number of persons paid by each compensation category and payment method
- (C) If any of the following matters applies, such matter
- Total amount by type of compensation, such as guaranteed bonus, lump sum payment upon taking office, premium retirement allowance, or other similar compensation, respectively, and number of persons paid
  - Balance of the deferred compensation, total amount thereof by type and by payment method, and the amount of the deferred compensation paid in the immediately preceding business period
- (viii) Other than the above, if there are any important matters relating to the compensation

structure, whether such matters are properly mentioned as “matters that should be referred relating to the compensation structure” set forth in the Public Notice on Compensation

III-3-2-4-6 Disclosure of Condition, etc. of Sound Business Operations concerning Liquidity (concerning Article 19-2(1)(v)(e), Article 19-3(1)(iii)(d), Article 19-5, Article 34-26(1)(iv)(d) and Article 34-27-2 of the Banking Act Enforcement Regulation)(Internationally Active Banks)

(1) General points to consider

The purpose of the disclosure of condition of sound business operations concerning liquidity is to complement minimum requirements of the liquidity coverage ratio and the net stable funding ratio, the self-management by banks and the supervisory review, and to secure sound management of banks by market-driven independent assessment; i.e., market-based discipline. Banks are required to properly make such disclosure in accordance with the purpose of the Public Notice concerning “Matters separately determined by the Commissioner of the FSA relating to the conditions of banks’ business operations concerning liquidity in accordance with Article 19-2(1)(v)(e), etc. of the Banking Act Enforcement Regulation” (hereinafter referred to as the “Public Notice on Liquidity Ratio Disclosure”).

In addition, banks need to consider what is useful and practical disclosure to users in light of the importance of information subject to disclosure. In particular, attention is required for information which might lead users to change their economic decision-making if it is omitted, so that it will be properly disclosed.

However, with regard to disclosure of proprietary or confidential information that may cause significant damage to the status of a disclosing bank, the bank may limit their disclosure to more general information relating to such information and disclose the fact that such information is not disclosed and the reason of non-disclosure.

(2) Qualitative disclosure items relating to liquidity coverage ratio on a solo basis

- (i) For “matters relating to time-series change of liquidity coverage ratio on a solo basis,” whether a qualitative explanation is given with regard to major change of the liquidity coverage ratio in the past two years and the reasons why. In such explanation, whether “quantitative disclosure items relating to liquidity coverage ratio on a solo basis (of the latest quarter that are prepared in the form of Appendix Form of the Public Notice on Liquidity Ratio Disclosure)” are used
- (ii) For “matters relating to the evaluation of the level of liquidity coverage ratio on a solo basis,” whether the following elements are described:
  - (A) The bank’s evaluation of the liquidity coverage ratio level
  - (B) If the bank evaluates that there is a challenge in (A) above, a practical countermeasure against the challenge

- (C) If the bank’s forecast on its future liquidity coverage ratio is expected to be far from the disclosed ratio, a qualitative explanation on such forecast
- (D) If the actual result of (C) above is far different from the original forecast, an additional explanation on reasons why
- (iii) For “matters relating to the content of total amount of the high-quality liquidity assets (HQLA),” whether, for example, the following elements are described as necessary:
  - (A) If there is a significant change in the composition of the HQLA, such as currency or type, etc. or the location thereof, an explanation on such change
  - (B) If there is a significant currency mismatch between the total of the HQLA and the net cash outflow in a major currency (meaning, for example, a currency which occupies 5% or more of the bank’s total liabilities), an explanation on the evaluation of such mismatch and practical countermeasures against it
- (iv) For “other matters relating to the liquidity coverage ratio on a solo basis,” whether, for example, the following elements are described as necessary. And whether important matters are described, regardless of the matters below.
  - (A) If the “special provision relating to qualifying operational deposits” set forth in Article 29 of the Public Notice on Liquidity Ratio is applied, an explanation on the following:
    - a. Scope of application of the “special provision relating to qualifying operational deposits”
    - b. Method of estimating the amount of qualifying operational deposits
  - (B) If “additional collateral required upon change of market value based on the scenario approach” set forth in Article 38 of the Public Notice on Liquidity Ratio is applied, an explanation on the method of estimating the amount of additional collateral required upon change of market value based on the scenario approach
  - (C) If there is any important item in “other cash outflow relating to contingencies” in Article 53 of the Public Notice on Liquidity Ratio, “other contractual cash outflow” in Article 60 of the same Public Notice or “other contractual case inflow” in Article 73 of the same Public Notice, a qualitative explanation on such item.

Note: If, among the items constituting the liquidity coverage ratios (daily average values ), there are items for which the daily average value is not used because of less importance and practical aspect (accounting restriction, etc.), the bank should describe why a daily average value is not used with regard to items that are deemed useful for users. Items for which the dairy average value is not used should be regularly reviewed. In the case where these items are reviewed, an explanation to that effect and on reasons why these items were reviewed should be provided.

- (3) Qualitative disclosure items relating to net stable funding ratio on a solo basis
  - (i) For "Matters relating to time-series change of net stable funding ratio on a solo basis,” whether a qualitative explanation is given with regard to major change of the net stable funding ratio in

the past five years and the reasons why. In such explanation, whether "quantitative disclosure items relating to net stable funding ratio on a solo basis (of the latest and previous quarter that are prepared in the form of Appendix Form of the "Public Notice on Liquidity Ratio Disclosure").

- (ii) With regard to "when the requirements listed in each item of Article 101 of the Public Notice on Liquidity Ratio are satisfied," whether the following matter is stated:
    - (A) In cases where the "special provisions on interrelated assets and liabilities" set forth in Article 101 of the Public Notice on Liquidity Ratio is applied, a description of the scope of application and the interrelationship
  - (iii) With regard to "other matters related to net stable funding ratio on a solo basis," whether the following matters are stated:
    - (A) Evaluation of the level of net stable funding ratio by the bank
    - (B) In the case where an issue is assessed in (a) above, practical measures to address the issue
    - (C) In cases where the forecast for the net stable funding ratio in the future by the bank is expected to be significantly different from the disclosed ratio, a qualitative explanation of such forecast
    - (D) In cases where the actual results are significantly different from the initial forecast, an additional explanation of the reason for the difference
- (4) Disclosure items relating to management of liquidity risk on a solo basis
- (i) For "matters relating to the overview of the liquidity risk management policies and procedures," whether structures to ensure that the bank's liquidity risk is identified, assessed, measured, and reported are described.
  - (ii) For "matters relating to indicators for the liquidity risk management," with respect to the idea and use of the major indicators measures evaluated in (i) above, whether, for example, the following indicators, etc. are included:
    - (A) Bank's liquid assets for its internal control
    - (B) Gap between inflows and outflows by maturity in on-balance sheet items and off-balance sheet items
    - (C) Other key indicators, etc. monitored for the internal control
    - (D) Use of limit values to the indicators, etc. of (A) to (C) above
    - (E) Overview of the stress test and how to make use of it
  - (iii) For "other matters relating to the liquidity risk," whether, for example, the following elements are described as necessary. And whether important matters are described, regardless of the matters below.
    - (A) Efforts to mitigate the liquidity risk
    - (B) Measures to handle the liquidity during stress situation (contingency funding plan (CFP))

- (5) Quarterly disclosure items

Banks need to properly make the quarterly disclosure with regard to the “quantitative disclosure items relating to the liquidity coverage ratio on a solo basis” and the “quantitative disclosure items relating to the net stable funding ratio on a solo basis” set forth in Articles 6 of the Public Notice on Liquidity Ratio Disclosure based on the purpose of the Basel Accords.

It is proper to post these disclosure items (including past data) on the website in such a manner that depositors, investors, and other users have easy access to specific information they want to know.

In addition, it is desirable that disclosure is made promptly upon publication of the annual securities report under Article 24(1) or (3) of the Financial Instruments and Exchange Act, the semiannual securities report under Article 24-5(1) of the same Act, the quarterly financial results under the relevant regulations of a financial instruments exchange, the base date of which can be either the final day or final business day of the relevant quarter (See Note in III-2-3-4-4-3-1(1)).

Note: The foregoing sets forth, among disclosure items under the Public Notice on Liquidity Ratio Disclosure, matters relating to the disclosure of condition, etc. of sound business operations concerning liquidity in “matters separately prescribed by the Commissioner of the FSA relating to the conditions of banks’ sound business operations” set forth in Article 19-2(1)(v)(e) of the Banking Act Enforcement Regulation, etc. This may apply to cases under Article 19-3(iii)(d), Article 19-5, Article 34-26(1)(iv)(d), and Article 34-27-2 of the Banking Act Enforcement Regulation *mutatis mutandis* by replacing relevant terms on a case-by-case basis.

III-3-2-4-7 Disclosure of Condition, etc. of Sound Business Operations concerning TLAC (concerning Article 19-3(iii)(d), Article 19-5, Article 34-26(1)(iv)(d) and Article 34-27-2 of the Banking Act Enforcement Regulation)(Banks subject to TLAC)

(1) General points to consider

The purpose of the disclosure of condition of sound business operations concerning Total Loss-Absorbing Capacity (TLAC) is to complement the minimum TLAC ratio requirement, the self-management by banks, and the supervisory review, and to secure sound management of banks in terms of the total loss-absorbing capacity to rebuild capital by market-driven independent assessment; i.e., market-based discipline. Banks are required to properly make such disclosure in accordance with the Public Notice on Disclosure while paying attention to the following.

In addition, financial institutions subject to TLAC need to consider what is useful and practical disclosure to users in light of the importance of information subject to disclosure. Note that, in particular, attention is required to avoiding the omission of disclosure of information that might lead users thereof to change their economic decision-making so that it will be properly disclosed.

However, with regard to disclosure of proprietary or confidential information that may cause significant damage to the status of a disclosing bank, the bank may limit their disclosure to more general information relating to such information and disclose the fact that such information is not

disclosed and the reason of non-disclosure.

(Reference)

- “Pillar 3 Disclosure Requirements – Consolidated and Enhanced Framework – the 2nd Phase” the Basel Committee on Banking Supervision (March, 2017)

(2) Points to Consider for Individual Matters

TLAC disclosure requirements are the matters under Article 4(7) (including cases where applied mutatis mutandis pursuant to Article 5(6)) and under Article 6(3)(xii) to (xiv) of the Public Notice on Disclosure). In particular, attention should be paid to the following points.

- If a significant change occurs in the quantitative disclosure items from the preceding period, an explanation should be made relating to the reasons why.
- Matters subject to quarterly disclosure

(i) In addition to the conditions, etc. of the capital adequacy (see III-3-2-4-4), banks need to properly make the quarterly disclosure with regard to the matters set forth in Article 6 of the Public Notice on Disclosure based on the purpose of the Basel Accords. It is proper to post these disclosure items (including past data) on the website in such a manner that depositors, investors, and other users have easy access to specific information they want to know. In the case of disclosure of TLAC requirements under Article 6 of the Public Notice on Disclosure pursuant to Appendix Form No. 7 or No. 16 thereof, it is preferable that such disclosure is made promptly after the publication of the annual securities report under Article 24(1) or (3) of the Financial Instruments and Exchange Act, the semiannual securities report under Article 24-5(1) of the same Act, or the quarterly financial results under the relevant regulations of a financial instruments exchange, the base date of which is the end day of the relevant quarter.

(ii) For “details of contracts relating to other external TLAC instruments” under Article 6(3)(xiv) of the Public Notice on Disclosure, it is proper to mention particulars of the contracts relating to other external TLAC instruments in addition to the “overview of contracts relating to other external TLAC instruments” under Article 6(3)(xiii) of the Public Notice on Disclosure so that depositors, investors, and other users are able to check them easily.

It is preferable that financial institutions update disclosure information on their other external TLAC instruments upon issuance, redemption, or change of the content of the instruments so that users are able to check the latest information.

Note: The foregoing sets forth, among disclosure items under the Public Notice on Disclosure, matters relating to the disclosure of condition of sound business operations concerning TLAC in “matters separately determined by the Commissioner of the FSA relating to the conditions of banks’ business operations” in accordance with Article 19-3(iii)(d) of the Banking Act Enforcement Regulation. This may apply to cases under Article 19-5, Article 34-26(1)(iv)(d), and Article 34-27-2 of the Banking Act Enforcement Regulation mutatis mutandis by replacing relevant terms

on a case-by-case basis.

### III-3-2-5 Major Supervisory Viewpoints

#### (1) Attitude of management

Whether the management of the bank fully recognizes that its disclosure has more important meaning than that of ordinary companies from the viewpoint of maintaining the bank's sound management and maintaining the credibility, and endeavors to promote environments to ensure active and correct disclosure and enhancement thereof

#### (2) Formulation of disclosure policy (for internationally active banks and bank holding companies)

- (i) Formulation and dissemination in the entire bank of the disclosure policy determining disclosure procedures and structure by the board of directors
- (ii) Publication of key content of said disclosure policies in the Disclosure Report
- (iii) Development of systems to make proper disclosure in accordance with said disclosure policies by the board of directors and senior management
- (iv) Description in the Disclosure Report, etc. that the management, etc., has recognized proper disclosure is made in accordance with said disclosure policies

#### (3) Internal control system for financial reporting

- (i) Whether the management endeavors to develop the internal management structures to ensure the appropriateness and correctness of the disclosure made by the bank
- (ii) As prerequisites of proper disclosure, whether, for example, the financial reporting process is properly documented
- (iii) Whether systems to identify, assess, control, and monitor all the risk relating to the items in the financial statements, etc. are built
- (iv) Whether the internal management system (including internal audit) to verify the rationality and effect of the internal control system functions

#### (4) Easy-to-understand disclosure for users and investors

- (i) Whether the bank uses accurate expressions and plain language in disclosing mandatory disclosure items so that depositors, business partners, and other users are able to properly check the business activities and financial positions of the bank
- (ii) In particular, whether disclosure of risk management loans is properly made
- (iii) Whether the bank endeavors to disclose reference matters based on the purpose of Article 21(4) of the Banking Act. For example, whether the bank makes efforts to disclose the profitability by key business or by customer segment
- (iv) In particular, whether the bank maintains a system to make a management decision with



sufficiently prudent assumptions, especially, in disclosing future information and prospects, etc.

- (v) With respect to exposure in fields in which the market is strongly interested, whether the bank actively discloses useful information in line with their own risk characteristics based on the international best practices.

### III-3-2-6 Supervisory Methods and Measures

- (1) Confirm the appropriateness of disclosure of financial results at interviews on the occasion of settlement and financial reporting, etc. In addition, confirm with the bank how it checked the validity of the internal control system for preparing the representative's confirmation letter.
- (2) With regard to risk management loans and loans required to be disclosed under the Financial Reconstruction Act, the reliability of the calculation data thereof is very critical. In this connection, the FSA will request a report under Article 24 of the Banking Act after receiving the notice of the inspection results (II-1-2(2)(ii)(D)). In cases where the bank is deemed to have difficulty in developing its risk management system, etc., with voluntary improvement efforts left to the bank, including cases where the gap between the bank's self-assessment and the inspection results by supervisors is critical, without justifiable reasons, the FSA will issue a business improvement order based on Article 26 of the Banking Act.
- (3) Other than this, in light of the points of attention above, the FSA will encourage the bank that is judged necessary to improve to make a report in accordance with Article 24 of the Banking Act when necessary. If it is found that the bank has a serious problem, the FSA will issue a business improvement order based on Article 26 of the Banking Act.
- (4) In addition, when, as a result of the supervision and off-site monitoring, etc., it is clear that the bank made a false statement in its annual securities report, the FSA will notify the Securities Surveillance Division to that effect.

### III-3-3 Provision of Information and Consultation Function, etc. for Protection of Users

#### III-3-3-1 Customer Explanation Concerning Credit Transactions, etc. (loan contracts, and related collateral and guarantee contracts and derivative transactions)

##### III-3-3-1-1 Purpose and Significance

- (1) Article 12-2(2) of the Banking Act and Article 13-7 of the Banking Act Enforcement Regulation obligate a bank to, in accordance with the content and method of its business, stipulate internal

regulations, etc. (which means internal regulations and those equivalent) concerning measures in order to provide customers with explanations of material matters in consideration of the customers' knowledge, experience, status of assets, and purposes of transaction, and other measures in order to secure sound and appropriate business management (including explanation of financial instruments, transactions, and their risks by delivery of documents and other appropriate methods, and measures to prevent crime) and develop a sufficient system to manage its business based on training for employees and the abovementioned internal regulations, etc.

In addition, a bank is prohibited from carrying out acts of providing false information to a customer, acts of providing a customer with any conclusive judgment with respect to an uncertain matter, or acts of giving information that is likely to have a customer mistakenly believe an uncertain matter to be certain, etc. with respect to its business (Article 13-3 of the Banking Act and Article 14-11-3 of the Banking Act Enforcement Regulation). These acts are prohibited as acts violating measures to secure sound and appropriate business management of a bank provided for in Article 12-2(2) of the Banking Act.

- (2) The following categorizes and exemplifies the viewpoints when the FSA inspects relevant internal control environments of banks with respect to customer explanation for credit transactions, etc. (loan contracts, and related collateral and guarantee contracts and derivative transactions) and the consultation and complaint handling function to supplement it by focusing on their transactions with SMEs, loans to individuals (including housing loans), and personal guarantees.

(Note 1) The following will apply to a broad range of banks' customer relations covering their efforts in promoting accountability as well as those in expanding information sharing and improving mutual understanding with customers.

(Note 2) The sufficient system for customer explanation mentioned in (1) hereof must be developed for all the businesses operated by banks, while a specific environment in accordance with requirements under the Banking Act on Sales, etc. of Financial Instruments needs to be prepared in connection with sales of asset management products (See III-3-3-2).

### III-3-3-1-2 Major Supervisory Viewpoints

- (1) Establishment of bank-wide internal control environment
- (i) Has the board of directors exercised its functions properly with regard to the establishment of the bank-wide internal control environment relating to customer explanation and the consultation and complaint processing function?
  - (ii) Formulation of internal regulations based on the purposes of applicable laws and regulations
    - (A) Whether internal regulations, etc. clearly stipulate the control environment for customer

explanation according to the content and manner of each business.

There are various types of credit transactions, including discounting of bills and notes, loans (loans on bills, loans on deeds, overdraft), loan guarantee, and foreign exchange, and there are also several types of guarantee contracts, including guarantee instruments and bill guarantees. Whether the bank has developed a control environment suitable to each type thereof.

In addition, whether the control environment is designed to cope with various transaction types including internet transactions, etc.

- (B) Whether the internal regulations, etc. clearly provide for the control environment for customer explanation according to the customers' knowledge, experience, status of assets, and purpose of transaction. In particular, whether it is designed to handle SMEs and individual customers according to their actual status.
- (iii) Establishment of implementation system based on the purposes of laws and regulations
  - (A) Whether training and other measures (including the distribution of manuals and so forth) are in place to ensure the businesses are being operated based on the internal regulations, etc.
  - (B) Whether the internal check-and-balance functions such as inspection, audit, etc. are properly working to ensure the effectiveness of customer explanation, etc.
- (iv) Collaboration between the management consultation function and customer explanation

When a bank offers loans to customers assuming a long-term trade relationship with them, whether the bank has developed customer explanation for information sharing after granting loans as the environment to enhance and strengthen management consultation functions therefor (See III-3-3-1-2(5)).

(2) Explanation when entering a contract

The FSA will inspect whether, with respect to the following, the bank has formulated appropriate internal regulations, etc. and has established a system sufficient to operate its businesses based thereon including holding training for its employees, etc.;

(i) Explanation of the content and risks of products and/or transactions

Whether the bank provides a customer with necessary information to obtain his/her adequate understanding to make a decision for a contract.

For this validation, in particular, the points listed below need to be noted.

- (A) When the loan transaction involves derivative transactions such as options and swaps, etc. (including the case where only derivatives transactions are conducted), whether the bank pays attention to the following, according to the content and risk thereof based on the customer's knowledge, experience, status of assets, and purpose of transaction, so that the transaction will not violate the provisions of the respective items of Article 13-3 of the Banking Act and the respective items of Articles 38 and 40 of the Financial Instruments and Exchange Act.

- a. Whether the bank provides appropriate and sufficient explanations about the descriptions and risks of said derivative transactions by issuing a written document explaining them with diagrams and examples in an easy-to-understand manner.

For example,

- With regard to the maximum anticipated loss assuming the worst-case scenario (based on reasonable assumptions such as data from previous times of stress; the same shall apply hereinafter) regarding the levels of financial indices, etc. that cover said derivatives transaction (including, as necessary, levels of volatility; the same shall apply hereinafter), whether the bank provides explanations to customers in a way that they can sufficiently understand the risk, including the possibility of the loss becoming even greater if circumstances turn out to be different from those assumed.
  - Whether the bank confirmed the amount of losses that are acceptable to a customer as far as said derivative transactions are concerned. Furthermore, when there is the possibility that the customer may suffer loss greater than the acceptable level even in the case where the abovementioned worst-case scenario does not occur, whether the bank has explained such risk to the customer in an easy-to-understand manner?
  - Whether the bank has explained to customers, in an easy-to-understand manner, about how the financial indices or other circumstances would have to be for occurrence of such a situation in which the derivative transaction may have a material impact on the customer's management or financial position.
  - When the bank uses different examples or illustrations that are unavoidably different from the actual derivative transactions for the sake of explanation, whether the bank explains that the mentioned examples or illustrations are different from the actual transactions.
- b. Whether the bank provides appropriate and sufficient explanations about premature cancellation of derivative transactions and the resultant settlement money on cancellation by issuing a document that gives specific and easy-to-understand explanations.

For example,

- In cases where said derivative transactions are, in principle, unable to be canceled prematurely, whether the bank explains this to customers in an easy-to-understand manner.
- In cases where settlement monies arise if said derivative transactions are prematurely canceled, whether the bank provides explanations to customers, in an easy-to-understand manner, about this fact and about the details of the settlement money on cancellation (including the tentatively calculated amount of the settlement money on cancellation assuming the worst-case scenario regarding the levels of financial indices and so forth, and if there is a possibility that the amount could be greater than said tentatively calculated amount, an explanation to this effect)?
- If there is a possibility that occurrence of any event provided for in the acceleration clause

of the bank's transaction contract, etc. would also cause acceleration of the derivatives transactions and customers would be required to pay the settlement monies on cancellation, whether the bank provides explanations to customers, in an easy-to-understand manner, about it.

- Whether the bank has confirmed the amount of settlement money on cancellation that is acceptable to a customer as far as said derivative transactions are concerned. Furthermore, when there is the possibility that the customer may suffer loss greater than acceptable level even in the case where the abovementioned worst-case scenario does not occur, whether the bank has explained such fact to the customer in an easy-to-understand manner.
- c. In cases where the derivative transactions are provided for the purpose of hedging, has the bank confirmed the following? Also, whether the bank provides appropriate and sufficient explanations to a customer in a specific and easy-to-understand manner.
- Whether the bank has confirmed that the derivative transactions serve as an effective hedging tool for the customer to operate its business continuously even taking into account the customer's business situation (environments surrounding its purchase, sales and financial transactions, etc.) and its competitiveness in the market (price-setting practice with suppliers or buyers). (\*1)
  - Whether the bank has confirmed that the abovementioned scenario that the derivative transactions serve effectively as a hedging tool is expected to continue until the end of the contract period. (\*2)
  - Whether the bank has confirmed that the customer would not end up suffering difficulties in terms of its future operation due to said derivative transactions. (\*3)
- (Note 1) It should be kept in mind that, for example, the bank should comprehensively determine, even if exchange rates or interest rates fluctuate, whether the customer has the capability of price bargaining or price setting to reduce the impact of these fluctuations.
- (Note 2) Note that, for example, even in cases where losses have not arisen due to the hedging instrument itself, there may be cases where the customer's hedging needs might be swayed or the effects of the hedge might stop functioning effectively for such needs before the end of the contract period due to changes in the customer's business situation or competitiveness in the market, such as shrinking of the assumed business scale.
- (Note 3) Note that fixing purchase price via hedging instruments could affect the customer's price competitiveness.
- d. Whether the bank has confirmed with customers that they have received an explanation based on the matters listed in a. through c. above. Are the records thereof kept in written form (confirmation letter, etc.)?
- e. With regard to uncertain matters, whether the control environment is designed to prevent

- any representation or explanation that would mislead customers to believe it to be an affirmative decision.
- f. With regard to solicitation of persons deemed to be excluded from the ban on uninvited solicitation for derivative transactions, based on the applicable law(\*), whether the bank has confirmed the customer's hedging needs by using past customer transaction histories, etc. Whether the bank solicits for contracts that are within the scope of those needs.
- (Note) It should be kept in mind that "corporations engaging in foreign trade or any other foreign exchange transactions" (Article 116 (ii) of the Cabinet Office Order concerning the Financial Instruments Business Operators, etc.) that are deemed to be excluded from the ban on uninvited solicitation include cases where, for example, a domestic building contractor, who imports lumber from overseas, in reality, imports and exports through a domestic trading firm rather than transacting directly with overseas exporters, but does not include cases where it simply purchases imported lumber from a domestic trader.
- g. A customer may have concerns that execution of a contract of the derivatives transactions offered by the bank would have effect on loan transactions with the bank (\*1). Based on such assumption, whether the bank provides the customer with explanations to eliminate such concerns. (\*2)
- (Note 1) For example, depending on the situation where the bank solicits for or explains the derivative transactions (cases where the bank does this during the consultation for a loan or where the bank solicits several times, etc.), there is a possibility that the customer would see such sales activities as abuse of the bank's superior position. Whether the bank develops its sales activities taking into consideration such possibilities must be checked.
- (Note 2) For example, whether the bank explains that non-acceptance of solicitation of the derivative transaction, etc. would not have any effect on future loan transactions, and whether measures have been taken in order to confirm that the customer has received an explanation that there is no abuse of superior position must be checked.
- h. Whether the bank has developed a control environment to follow up with a customer, regularly and as needed, after conclusion of the derivative contract. For example, does the bank confirm the effectivity and sustainability of hedge instruments according to the continuance of the needs based on the customer's business situation and financial position and response to inquiries from the customer in an easy-to-understand and appropriate manner, etc.?
- If requested by the customer, does the bank provide in a timely and appropriate manner information that is needed for the customer to settle its accounts or make decisions on canceling transactions? For example, whether the bank provides the customer with market price information on their position or notifies the customer of the amount of settlement

money on cancellation at a particular time on a periodic or as-needed basis.

- (B) With regard to housing loan contracts, whether the bank provides customers with appropriate information and explanations about associated risk thereof. In particular, whether the bank provides customers with sufficient explanations about the risk of interest rate fluctuation, etc. relating to housing loans with variable-interest-rates and housing loans with a fixed-interest-rate for a prescribed limited period of time.

In providing explanations, for example, whether the bank takes measures to explain in accordance with “Explanation about the interest rate fluctuation risk to housing loan users” (by the Japanese Bankers Association dated December 21, 2004). In addition, in presenting an estimated repayment amount in cases where the applicable interest rate rises in the future, whether the bank shows an amount calculated based on assumptions deemed reasonable under the economic situation at that time.

- (C) With regard to a personal guarantee contract, whether the bank provides a guarantor with explanations sufficient to form his/her intention not only to be bound by the guarantee obligation but also to assume the responsibilities under the contract if the guarantee obligation is enforced.

For example, whether the bank gives explanations on the legal effect and risk of the guarantee contract beyond the mere formality thereof, assuming the worst-case scenario where a guarantor is forced to perform the guarantee obligations.

In addition, whether the bank confirms that the guarantor has received the abovementioned explanations and records the results, etc. in writing or in electronic forms.

- (D) When concluding a personal guarantee contract with a business owner, etc., whether the bank provides the principal debtor and the guarantor with detailed and specific explanations about the following points based on the “Guidelines for Personal Guarantee Provided by Business Owners.” In addition, whether the bank confirms that the guarantor has received explanations based on the matters listed below, and records the results, etc. in writing or in electronic forms (See III-9-2).

- a. What part is insufficient and requires the conclusion of the guarantee contract (Note).
- b. What improvements may increase the possibility of modification or cancellation of the guarantee contract (Note).
- c. In principle, when requiring a guarantor to perform the guarantee obligations, the bank will demand performance of the guarantee obligations not unconditionally for the whole guaranteed amount but by setting the scope of performance in consideration of the financial and asset situation of the guarantor at that time (Note).

(Note) The bank should give individual and specific explanations, depending on the debtor’s situation based on 4(2) of the “Guidelines for Personal Guarantee Provided by Business Owners.”

On that occasion, it is desirable that the bank show, to the extent possible, its qualitative standpoint as for the debtor's assets and earning power, and its objective and specific standpoints as for any other relevant factors.

- (E) A joint and several guarantee contract has a different nature from ordinary ones such as having neither "hojusei" nor "bunbetsu-no-rieki". With regard to such joint and several guarantee contract, whether the bank gives explanations to a guarantor about such difference taking into account the guarantor's knowledge, experience, etc.
- (Note 1) "hojusei" means a nature where the principal debtor must first fulfill the obligation and the guarantor will perform the guarantee obligation only when the debtor fails to do so.
- (Note 2) "bunbetsu-no-rieki" means a nature where, when there are two or more guarantors, each guarantor is required to guarantee only the part of the guaranteed amount divided by the number of guarantors.
- (F) When concluding a personal joint and several guarantee contract with a third party other than the business owner (See III-10), does the bank pay attention to the degree of such third party's involvement in the management of the debtor? Also, does the bank give specific explanations about the possibility that the third party would be forced to perform the guarantee obligation in principle even if he/she is not substantially involved in the management of the debtor? At the same time, does the bank confirm that the guarantor has received the abovementioned explanations?
- (Note) In cases where a third party other than the business owner (the contracting party) has proposed to enter a joint and several guarantee contract voluntarily despite he/she not being substantially involved in the management of the debtor, it should be noted that the bank has confirmed that conclusion of such contract was not forced by the bank, by receiving a written document signed and sealed by the contracting party certifying that he/she was going to enter the contract based on his/her own free will after receiving specific explanations from the bank.
- (G) When concluding a revolving guarantee contract with a third party other than the business owner, as a general rule, does the bank provide the guarantor with information on the balance and repayment status of the guaranteed amount regularly or as needed upon request of the guarantor after conclusion of the contract?
- (H) With regard to a loan guaranteed by the Credit Guarantee Corporations, does the bank provide appropriate explanations about the details of the guarantee system to use and the guarantee fee rate, etc. according to the user's knowledge, experience, etc.?
- (ii) Explanation about objective and reasonable grounds to enter a contract
- Whether the bank has developed a control environment to give to a customer, upon request, explanations about objective and reasonable grounds to enter a contract according to the customer's knowledge and experience to gain his/her understanding and satisfaction in order to



prevent any after-the-fact dispute, etc.

For the validation from (A) and (B) below, note whether the bank has developed a control environment to give explanations about matters listed in each of them upon request from customers, and as for validation of (C), whether the bank has developed a control environment to give explanations of the above (D) a. to c. in case of conclusion of a guarantee contract and to record the results, etc. in writing or in electronic form.

(A) Loan contract

Objective and reasonable grounds to enter a loan contract, based on the customer's asset status with regard to the content of the contract such as the loan amount, interest rate, repayment conditions, causes of acceleration and financial covenants, etc.

(B) Pledge contract

Objective and reasonable grounds to enter a pledge contract, based on the actual and prospective transaction status with the debtor and the asset status of the provider of collateral with regard to the content of the contract such as the maximum amount of pledge, etc.

(C) Guarantee contract

Objective and reasonable grounds to enter a guarantee contract with the guarantor based on the guarantor's position, asset status, relationship with a principal debtor and other guarantors, etc.

- a. For a revolving guarantee contract, objective and reasonable grounds to enter the contract, based on the actual and prospective transaction status with the principal debtor and the asset status of the guarantor, with regard to the maximum amount of guarantee established, the principal determination date, etc.
- b. In cases where the bank concludes a personal joint and several guarantee contract with a third party other than the business owner, objective and reasonable reasons to enter the guarantee contract with such third party in light of the perspective of "establishing a loan practice in which, in principle, banks will not demand a personal joint and several guarantee from a third party other than the business owner" while, as needed, considering the concept under "Prohibition of demanding a third-party guarantor by the Credit Guarantee Corporations." (See III-10-2(1).)
- c. In cases where the bank demands a guarantee from the business owner, etc., objective and reasonable grounds to enter a guarantee contract with such business owner based on the "Guidelines for Personal Guarantee Provided by Business Owners." (See III-9-2) (Note)

(Note) When explaining the objective and reasonable reasons, the bank should give individual and specific explanations about which part makes the guarantee contract necessary owing to its insufficiency and what kind of improvement will enhance the possibility to amend or terminate the guarantee contract, depending on the debtor's situation.

On that occasion, it is desirable that the bank show, to the extent possible, its qualitative standpoint as for the debtor's assets and earning power, and its objective and specific

standpoints as for any other relevant factors

(iii) Confirmation of intention to conclude a contract

(A) Whether the bank makes it a rule to first explain the content of the contract to the contracting party, to confirm his/her intention to conclude a contract for a loan, provision of collateral, guarantee, or derivative transaction and then to have the principal of the contracting party(\*) express consent to the content of the contract. In particular, when confirming the intention of guarantee, whether the bank confirms with the contracting party (guarantor) about the degree of his/her involvement in the management of the debtor.

(Note) For conclusion of an important contract with an SME that is a so-called “company run by an owner-operator,” attention should be paid to the fact that, in some cases, it is not sufficient to obtain confirmation from a person who has mere formal authority.

In particular, in cases where the derivatives transaction may have a significant impact on the future operation of the SME, it is important to check whether entering the contract is decided by the board of directors of such SME.

(B) For conclusion of a contract in an exceptional manner such as via written communication only, whether the bank has clearly determined how to handle it in the internal regulations, etc. based on sufficient consideration from the viewpoints of customer protection and compliance. Whether the bank has developed a highly effective internal control environment to secure compliance with the internal regulations.

(C) Whether the bank has established a highly effective internal control environment to prevent improper use of the marginal seal practice or other unjust practices such as a case in which bank staff require a customer to sign and seal a contract document without entering necessary matters and then the bank staff complete the contract document by entering necessary matters later.

(D) Whether the bank has developed a control environment not to provide an improper explanation that may mislead a customer to think that “he/she will surely be awarded with a loan” before the official decision of the bank is made.

(iv) Issuance and delivery of contract documents

When concluding a loan contract, a pledge contract, or a guarantee contract, whether the bank delivers a written contract and/or related documents describing the content thereof to the principal of the contracting party.

For this inspection, in particular, the points listed below need to be noted.

(A) Whether the bank uses the form of signing in counterpart as a banking transaction contract or issuing a copy thereof to the contracting party.

(B) For a loan contract, a pledge contract, or a guarantee contract, whether the bank ensures that the contracting party can check the content of the contract at any time by issuing a copy thereof, etc.

(C) With regard to discounting of bills and notes or loans on bills that are not fit for ordinary

practice where a written contract is prepared and issued upon every trading transaction because of their form of transaction, whether the bank ensures that the contracting party can check the content thereof at any time by developing a proper contractual scheme such as documentation of the terms and conditions of the contract.

(3) Consistency with bank's basic loan management policy (credit policy)

It is also necessary to inspect whether each bank's control environment for customer explanation on credit transactions is consistent with its basic loan management policy (credit policy, etc.).

For this, the FSA will pay attention to the viewpoints, for example, of establishing a sound loan practice and promoting loans without excessive dependence on collateral or guarantee as follows.

Banks should recognize that sound loan practice does not excessively depend on collateral or guarantee and that they must offer loans by comprehensively judging a debtor's management situation, use of funds, and the probability of collection. From the viewpoints of "promoting a loan that does not excessively depend on collateral or guarantee by putting more emphasis on cash flow from the business operation," "further promoting a loan that does not rely on the business owner's guarantee" (see III-9-2) and "establishing a loan practice that makes it a rule not to require a personal joint and several guarantee from a third party other than the business owner" (see III-10), the FSA will inspect how the bank copes with it as its management policy and how the policy is reflected in the bank's actual customer explanation.

(4) Efforts to expand information sharing and to improve mutual understanding with customers

When banks offer a loan to a corporation assuming a long-term transaction relationship with it, it is important to establish a base for mutual understanding between the lender and debtor and to provide the corporation with support for management improvement or quick business rehabilitation when necessary while jointly managing the risk under such base.

From these perspectives, the FSA will inspect as to whether the following control environments are put in place with regard to customer explanation.

(i) Efforts to establish a base for mutual understanding

(A) Communication from banks

Each bank needs to manage loans sufficiently and properly according to the borrowing corporations' real status after granting loans by grasping their business situation, performance of loan, confirmation of use of funds, progress of projects, etc. Whether the bank has developed a control environment of customer explanation aimed at gaining mutual understanding between the bank and the borrower in these processes with regard to the bank's judgment on the borrowing corporation's business situation, financial position, and evaluation of collateral to be provided, etc.

(B) Communication from borrowing corporations

It is important for the borrowing corporations to consult with the bank about their business situation as early as possible so that they can benefit from a long-term reliable relationship with the bank. Whether the bank has developed a control environment to explain such importance to borrowing corporations.

(ii) Efforts to enhance and reinforce management consultation and support functions

In cases where the bank deems it necessary to provide the borrower with management improvement support (including formulation of a management improvement plan or a loan repayment plan) and to back up its prompt business rehabilitation, whether the bank honestly explains its judgment on the borrower's business conditions, financial position, or prospect of the business under mutual understanding and then holds a consultation with and gives advice to the borrower.

(5) Explanation when the bank revises the trading relationship with a customer

Customer explanation in the case where a bank revises the trading relationship with a borrowing corporation should be made under a control environment in which the bank is able to provide appropriate explanations to the borrower in line with its own business decision. In this case, attention should be paid so that the bank will not give improper explanation or use an unfair excuse, for example, that the revision is necessary because of regulatory inspection, etc.

For this, the FSA will inspect as to whether control environments to give proper explanations as follows have been developed in the cases from (i) to (iii) below;

(i) Cases where, after conclusion of a contract, interest rate or repayment conditions are revised, a guarantee contract is revised, collateral is additionally provided or canceled, etc.

Based on the transaction relationship with the customer to date, the customer's knowledge, experience, status of assets, and purpose of transaction, whether the bank has developed a control environment aimed at gaining the customer's understanding and satisfaction in principle in the same manner in III-3-3-1-2(2) (Explanation when entering a contract).

In particular, at the time of the business succession of a borrowing corporation, the bank should, without having the successor unconditionally succeed to the personal guarantee obligation, review the necessity of concluding a new guarantee contract upon obtaining necessary information based on the "Guidelines for Personal Guarantee Provided by Business Owners," and when it has decided to enter a new contract, the bank should give careful and specific explanations to both the principal debtor and the successor. Whether the bank has developed such a control environment.

In addition, when requested by the predecessor (former representative/owner of the borrowing corporation) to cancel the guarantee contract, the bank should make a proper judgment on the cancellation of the contract taking into consideration whether the predecessor still has substantial control of the corporation, how the loan is secured by means other than said guarantee, or the corporation's repayment probability based on its own assets and profitability (see III-9-2). Whether

the bank has developed such a control environment.

(ii) Cases where the bank refuses a request of the customer and no loan contract is concluded

Whether the bank has developed a control environment in which it explains reasons of refusal to the extent possible according to the transaction relationship with the customer to date, and the customer's knowledge, experience, status of assets, and purpose of transaction.

- For example, when the bank refuses a renewal of a loan on a bill requested by a customer with whom the bank has maintained a long-term transaction relationship, whether the bank explains to the customer about such refusal, in principle, by taking sufficient time to gain the customer's understanding and satisfaction based on the principle of good faith.
- For example, with regard to a loan guaranteed by the Credit Guarantee Corporations, whether the bank does not make any improper response such as using the fact that the "Responsibility-sharing System" was introduced in October 2007 as an excuse for refusal without giving true and appropriate reasons according to its own business judgment.

(iii) Cases of collection of delayed loans (including those resulting from disposition of collateral and claim for performing a personal guarantee), assignment of claims, corporation rehabilitation proceedings (legal liquidation and voluntary liquidation), personal rehabilitation proceedings, etc. of the debtor or guarantor

(A) Whether the bank has developed a control environment where it properly performs a series of procedures step by step according to the transaction relationship with the customer to date, and the customer's knowledge, experience, status of assets, and purpose of transaction in compliance with application laws and regulations.

For example, when requesting a third-party guarantor other than the business owner of the debtor to perform the guarantee obligation, whether the bank has a control environment in place to properly cope with it by providing the guarantor with correct information, etc. about the series of proceedings as necessary to prevent future disputes, etc. The bank should keep in mind that the guarantor is not in a position to know the principal debtor's situation naturally (see III-10-2(3)).

(B) Whether the bank explains objective and reasonable grounds to the customer at every step of procedures if requested.

(C) Particularly with regard to the performance of the guarantee obligation of the business owner, the bank should decide the scope of the assets that may be left to the guarantor by comprehensively considering the guarantor's capacity to perform the obligation, the management responsibility and credibility of the guarantor as a business owner, and the consistency with the concept of "property free from any encumbrance" in the bankruptcy proceedings in collaboration with support professionals, as needed, based on the "Guidelines for Personal Guarantee Provided by Business Owners" (see III-9-2). Whether the bank has developed such a control environment.

(6) Enhancement and reinforcement of complaint handling function

- (i) Whether the bank accumulates and analyzes complaints, etc. received from customers and considers measures to improve customer explanation at the time of entering a contract. Whether the bank considers whether it should continue to sell or offer products or transactions for which the bank receives many complaints from customers.

In addition, whether the bank checks complaints from products and transactions sold or made after measures to improve customer explanation were taken and validates the effects of such measures.

For this inspection, in particular, attention should be paid to the effectiveness of the complaint handling system relating to III-3-3-1-2(5) (Explanation when the bank revises the transaction relationship with a customer) and III-3-5-2 (Establishment of Internal Control Environment for Handling Complaints).

- (ii) With regard to the inspection of serious complaints including alleged abuse of superior position, etc., the bank should take proper measures, for example, whereby a person in charge of the inspection at the headquarters or in the relevant inspection division, etc. directly interviews the person who made the complaint as needed without simply believing the content of a report made by the sales person who triggered the complaint, from the viewpoint of securing objectivity and appropriateness of the inspection. Whether the bank has developed such a control environment.
- (iii) Whether the bank has introduced a proper control environment to cope with violence intervening in civil affairs, such as refusal of any connection with anti-social forces.
  - (A) Whether the bank has introduced a control environment to cope with unjust acts such as coercion to cancel a loan or collateral or prevention of collection, etc.
  - (B) Whether the bank has introduced an integrated management environment for legal affairs including loan transactions in order to properly submit a notification of suspicious transactions under the Banking Act on Prevention of Transfer of Criminal Proceeds.

(7) Prevention of explanation falsely recognized as anti-fair trade practice

- (i) Whether the bank has developed a control environment to prevent any explanation that may be falsely recognized as abuse of superior position, which would infringe the Anti-Monopoly Act.

In June 2006, the Fair Trade Commission issued the “Survey report concerning the transaction practices between financial institutions and corporations,” which shows examples of practices that are considered to be abuse of superior position. Whether the bank reflects the content of the report in its customer explanation. Whether the bank has not only distributed the abovementioned report to its sales branches but also introduced a control environment to provide a concrete explanation based on the report in line with its actual business practice.

For this inspection, for example, the points listed below need to be noted.

- (A) As examples of violating practices, the report presents a case where “a bank forces a borrowing corporation to accept an increase of the interest rate under the loan contract or to make a repayment before the due date without any justifiable reasons by implying that the bank will give unfavorable treatment to the borrower relating to future loan arrangements, etc. unless the borrower accepts such request” or a case where “a bank forces a borrowing corporation to provide additional collateral in excess of the necessary extent to secure the loan obligation.” Whether the bank has developed a control environment for customer explanation aimed at gaining the customer’s understanding and satisfaction on the objective and reasonable grounds for revisions of interest rates, etc. while improving its compliance system to prevent it from engaging in such practices.
  - (B) As examples of violating practices, the report shows a case where “a bank forcefully requests a corporate borrower to purchase its financial products and services such as firm banking, derivatives, and corporate bond management, by implying that the bank will give unfavorable treatment to the borrower relating to loan arrangements, etc. unless the borrower accepts such request.” Whether the bank has developed its compliance system to prevent it from making such kinds of requests.
  - (C) Even for a so-called “transaction considering comprehensive profitability,” meaning a transaction in which the bank grasps the profitability of multiple transactions with one customer as a whole (excluding transactions falling under the scope of combined sales), whether the bank has developed the control environment mentioned in (A) and (B) above.
- (ii) Whether the bank has developed a control environment to prevent it from giving explanations that may be falsely recognized as unjust practices such as insider trading under the Financial Instruments and Exchange Act.

### III-3-3-1-3 Supervisory Methods and Measures

- (1) Whether the control environment relating to customer explanation and the consultation and complaint handling function to supplement it have been developed and operated relates to the base of the bank’s sound and appropriate business operation, as well as to the viewpoints of customer protection and user convenience. Therefore, associated internal control environments need to be highly effective.

In cases where any doubt arises on the effectiveness of the bank’s internal control environments and the doubt relates to prohibited acts such as misleading representations to customers, the FSA will inspect the bank by requiring it, as needed, to submit a report (including those under Article 24 of the Banking Act). In cases where a problem is found in appropriateness and soundness of the bank’s business operation, the FSA will require the bank to submit a report pursuant to Article 24 of the Banking Act and if it is a serious problem, the FSA will issue a business improvement order based

on Article 26 of the Banking Act.

- (2) In cases where, as a result of the inspection of the abovementioned reports or the business improvement status, a material violation of laws is detected including cases where it is found that the management of the bank failed to formulate important internal regulations, etc. against the purpose of the laws as described in III-3-3-1-1(1) or where it is recognized that the bank gave a false explanation to customers, the regulator should keep in mind that it is necessary to consider taking administrative dispositions based on Article 27 of the Banking Act (for example, suspension of a part of the business operation until the bank prepares a sufficient system therefor by preparing internal regulations, etc.). It is also necessary to fully cooperate with the Securities Business Division if any improper practices relating to individual financial instruments transaction may violate the Financial Instruments and Exchange Act.

(References)

- (i) Report of Working Group for Legal Affairs for New SMEs Finance (dated July 16, 2003, by the Working Group for Legal Affairs for New SMEs Finance)
- (ii) “Future Vision of Japan’s Financial System with Medium-term Outlook” (dated September 30, 2002, by the Financial System Council)
- (iii) Enhancement of Relationship Banking Functions (dated March 27, 2003, by the Financial System Council)
- (iv) “Evaluation of Efforts in Region-based Relationship Banking and Future Response - to Establish a Sustainable Business Model to Utilize the Accumulated Local Information” (dated April 5, 2007, by the Financial System Council)
- (v) Survey Report concerning the Transaction Practices between Financial Institutions and Corporations (dated July 4, 2001, by the Japan Fair Trade Commission)
- (vi) Survey Report concerning the Transaction Practices between Financial Institutions and Corporations (dated June 21, 2006, by the Japan Fair Trade Commission)
- (vii) Abolishment of Banking Transaction Contract Templates and Preparation of Points to Note (dated April 18, 2000, by the Japanese Bankers Association)
- (viii) Reform of Japan’s Finance System (dated June 13, 1997, by the Financial System Research Committee)

III-3-3-2 Sales and Customer Explanation for Deposit and Risk-Associated Products, etc.

III-3-3-2-1 Purpose and Significance

A bank must provide information on the details of deposit, etc. to depositors when accepting deposits, etc. (Article 12-2(1) of the Banking Act, Articles 13-3 and 13-4 of the Banking Act Enforcement Regulation). In particular, a bank, when handling the financial instruments listed in each item of Article 13-5(1) of the Banking



Act Enforcement Regulation, must provide an explanation to customers in order to prevent customers from misidentifying the financial instruments with deposits, etc. In addition, a bank, in accordance with the content and method of its business, must stipulate internal regulations, etc. concerning measures in order to secure sound and appropriate business management and must develop a sufficient system to manage its business in accordance with said internal regulations, etc. (Articles 12-2(2) and 13-3 of the Banking Act and Articles 13-5, 13-7, and 14-11-3 of the Banking Act Enforcement Regulation)

In selling risk-associated products, a bank must develop the abovementioned control environments in consideration of not only the Banking Act but also other applicable laws and regulations including, but not limited to, the Financial Instruments and Exchange Act.

Particularly, with regard to deposits or installment savings, etc. that carry the risk of loss of the principal due to fluctuations in the interest rate, value of currencies, market price of a financial instruments market, or other indices (hereinafter referred to as “specified deposits, etc.”), it should be noted that the provisions of the Financial Instruments and Exchange Act apply mutatis mutandis to them and that they are subject to the obligation to deliver pre-contract documents, restriction of advertisement, etc. (Article 13-4 of the Banking Act and Articles 14-11-4 to 14-11-30 of the Banking Act Enforcement Regulation)

### III-3-3-2-2 Major Supervisory Viewpoints

From these perspectives, the FSA will inspect as to whether the following control environments are put in place.

- (1) Establishment of bank-wide internal control environment
  - (i) Has the board of directors exercised its functions properly with regard to the establishment of the bank-wide internal control environment relating to customer explanation?
  - (ii) Formulation of internal regulations based on the purposes of applicable laws and regulations
    - (A) Do internal regulations, etc. clearly stipulate the control environment for customer explanation according to the content and manner of each business?

In particular, when handling risk-associated products, such as specified deposits and investment trusts, etc. has the bank prepared a control environment according to each characteristic of these products?

In addition, is the control environment designed to cope with various transaction types including Internet transaction, etc.?
    - (B) Do the internal regulations, etc. clearly provide for the control environment for customer explanation according to the customer's knowledge, experience, status of assets, and purposes of transaction?
  - (iii) Establishment of implementation system based on the purposes of laws and regulations
    - (A) Are training and other measures (including the distribution of manuals and so forth) in place to ensure the businesses are being operated based on the internal regulations, etc.?

(B) Are the internal check-and-balance functions such as inspection, audit, etc. properly working to ensure the effectiveness of customer explanation, etc.?

(C) Does the bank review the contents of financial instruments or sales activity based on the verification of the effectiveness of its customer explanation, etc.?

(iv) Actions based on the Financial Service Provision Act

Are the explanation methods and the content thereof in selling financial instruments to customers appropriate from the standpoints of Article 12-2-2 of the Banking Act, Articles 13-5 and 13-7 of the Banking Act Enforcement Regulation, the Financial Service Provision Act, and other applicable laws? In addition, does the bank make efforts to establish a control environment for customer explanation to secure proper solicitation considering the purpose of the obligations to establish and publicize the solicitation policy under the Financial Service Provision Act?

(v) Prevention of explanation falsely recognized as anti-fair trade practice

When developing a control environment for preventing abuse of superior position, banks must take into consideration a possibility that customers might have concerns that “proposed transaction may have impact on the future loan arrangement.” Based on such assumption, has the bank developed a control environment to prevent any explanation that may be falsely recognized as abuse of superior position?

(2) Acceptance of deposits, etc. (excluding acceptance of specified deposits, etc.)

Base on the purposes of Article 12-2(1) of the Banking Act and Article 13-3 of the Banking Act Enforcement Regulation, with regard to the acceptance of deposits, etc., has the bank developed an environment to provide information with regard to the acceptance of deposits, etc. and to give proper explanation of products information as required by the depositors? For example, the following points should be noted.

(i) For a variable interest rate deposit for which the criteria and method of setting the interest rate are predetermined, is a control environment in place to provide depositors with information on these criteria and the interest rate?

(ii) When giving advice to affiliate financial institutions relating to the sale and customer explanation based on the cooperation agreement for deposit products, does the bank properly provide them with information on risks and merchantability of such deposit products?

(3) Businesses handling risk-associated products

(i) Sale of securities-related instruments

With regard to the businesses subject to the Financial Instruments and Exchange Act including, but not limited to, over-the-counter sale of bonds and investment trusts and other financial instruments intermediary service, does the bank secure the business operation in accordance with the requirements for investor protection set forth in said Act and applicable laws? For example, attention should be paid to whether there is a system in place to prevent occurrence of events that

may disturb customer protection such as handling by a person who has not been registered as a sales representative or handling financial instruments at a place other than a specified window. For other specific supervisory viewpoints, refer to “VIII. Supervisory Evaluation Points and Various Administrative Procedures (Registered Financial Institutions)” described in the “Comprehensive Guideline for Supervision of Financial Instruments Business Operators, etc.”

In particular, when developing a control environment for providing explanations based on the principle of suitability, the bank must take into account that many bank customers are depositors who have less investment experience. Based on such assumption, is a system in place to prevent customers from misidentifying these products as deposits, by ensuring that the bank will give them an explanation that these products may cause loss of the principal amount or are not covered by deposit insurance?

(ii) Acceptance of specified deposits, etc.

Considering that restriction on acts under the Financial Instruments and Exchange Act applies to specified deposits, etc. *mutatis mutandis*, for specific supervisory viewpoints of specified deposits, etc., refer to “III-2-3-1 Principle of Suitability,” “III-2-3-3 Regulation on Advertisements, etc.” “III-2-3-4 Control Environment for Providing Explanations to Customers” and “IV-3-1-2(3) Points of Attention Regarding Solicitation Targeting Elderly Customers” described in the “Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.”

In particular, attention should be paid to whether there is a system in place to give detailed explanations that the value of the financial instruments could fall below the principal amount due to fluctuations in interest rates, values of currencies, market prices of a financial instruments market, or other indices.

For example, has the bank explained the following matters by delivering pre-contract documents?

- (A) If, at the time of premature cancellation, there is a possibility that the amount of the deposits could fall below the principal amount due to the penalty, etc. on cancellation, how to calculate the penalty, etc. on cancellation (including the estimated amount of the penalty, etc. on cancellation on the assumption deemed reasonable in the economic situation at the time of giving an explanation)
  - (B) For specified deposits, etc. denominated in a foreign currency whose value may fall below the principal amount, that fact and the reasons therefor
  - (C) In cases where the bank has an option to choose the currency at the time of repayment and/or the maturity date, the fact that the depositor may suffer disadvantage depending on the exercise of such option by the bank.
- (iii) Solicitation and acceptance of, among specified deposits, etc., those that are complexly structured with derivatives transaction defined in Article 2(20) of the Financial Instruments and Exchange Act or commodity derivatives transaction defined in Article 2(15) of the Commodity Derivatives

Transaction Act (so-called “structured deposits”) that are as complex as the over-the-counter derivative transactions

Considering that restriction on acts under the Financial Instruments and Exchange Act applies to specified deposits, etc. *mutatis mutandis*, attention should be paid to whether the following systems are in place, particularly at the time of accepting complex structured deposits that are as complex as the over-the-counter derivative transactions.

- (A) Points of attention regarding the distribution of notices of warning concerning complex structured deposits

In the event of a problem arising, does the bank alert customers appropriately by distributing clear and concise documents (Notice of Warning) which specify the following in large print and in an easily understandable manner and by giving explanations suited to the customer attributes? (i) an alert to the associated risks and (ii) the contact details of the designated ADR body, etc. Is there a control environment in place in which the implementation status of this can be appropriately inspected?

- (B) Points of attention regarding the solicitation of complex structured deposits (reasonable-basis suitability and solicitation commencement criteria)

When soliciting an individual customer to purchase complex structured deposits, it is important for the bank to ensure appropriate solicitation based on the principle of suitability from the perspective of improving investor protection. Attention should be paid to the following points, for example:

- Whether the bank verifies in advance the suitability of a structured deposit to be sold to a customer (reasonable basis suitability).
- Whether the bank appropriately formulates solicitation commencement criteria according to the risk profile of the structured deposit and the customer attributes and solicits customers based on such criteria.

- (C) Points of attention regarding the explanation of risk on complex structured deposits

For specific supervisory viewpoints of the explanation of risk on complex structured deposits, refer to “IV-3-3-2 Control Environment for Customer Solicitation and Explanations (6)” described in the “Comprehensive Guideline for Supervision of Financial Instruments Business Operators, etc.”

- (iv) Sale of specified insurance contract

For sale and solicitation of a specified insurance contract as provided for in Article 300-2 of the Insurance Business Act, special attention should be paid to the points of attention regarding specified insurance contract described in the “Comprehensive Guideline for Supervision of Insurance Companies.”

- (4) Insurance Sales  
(i) Outline

With regard to the compliance with laws relating to insurance sale, correct explanation on insurance products and contracts, and handling of customer information, is a proper control environment for insurance sales in place via formulation of a manual, provision of training, and internal audit?

For example, banks are required to develop control environments for the efforts of proper insurance sales such as not selling insurance products to parties restricted from life insurance solicitation by banks, etc. by earning commission or other consideration, the efforts to fulfill its accountability while fully considering wishes and suitability of consumers, and the efforts to obtain customers' confirmation and consent relating to the product explanation and the protection of non-disclosure financial information, etc. Has the bank developed such control environments?

(References) "Troubles of bank's over-the-counter sale of personal pension insurance policy to the elderly" (dated July 6, 2005, by the National Consumer Affairs Center of Japan)

(ii) Development of control environment for insurance sales

(A) Based on the purpose of Article 13-5 of the Banking Act Enforcement Regulation, has the bank developed a system to prevent customers from misidentifying insurance contract as deposits, etc., for example, by delivering relevant documents and explaining that an insurance contract is different from a deposit and is not covered by the deposit insurance? Have measures been taken in order to confirm from customers that they have understood the explanation on prevention of misidentification and to check it later; for example, receiving a written confirmation or the like from customers and keeping it?

(B) Based on the purpose of Article 14-11-3 of the Banking Act Enforcement Regulation, is a system in place to prevent any event adversely affecting the customer protection such as sales using superior effect of the bank, failure of provision of an explanation to the effect that it will not affect any transaction with the bank, or handling by a person who has not been registered as a sales agent? In particular, when any unfair trade practice is found in connection with insurance sales such as forced sale, abuse of superior transaction, tie-in sale, etc., this may constitute a violation of the Anti-monopoly Act. Has the bank developed a control environment to prevent such act beforehand?

(References) "Unfair transactions associated with deregulation of business categories and expansion of business scope of financial institutions" (dated December 1, 2004, by the Japan Fair Trade Commission)

For other specific supervisory viewpoints, refer to the "Comprehensive Guideline for Supervision of Insurance Companies."

III-3-3-2-3 Supervisory Methods and Measures

(1) Control environments for sale and customer explanation of risk-associated products should be secured through business operation in compliance with the related laws and regulations such as the Financial

Instruments and Exchange Act and the Insurance Business Act. In cases where the FSA feels, from follow-up of the notice of inspection results, receipt of the misconduct notifications, analysis of consultation and complaints, etc., any doubt in a bank's control to secure its business operation in compliance with the related laws and regulation, etc. or the effectiveness of its sale and customer explanation, etc. of risk-associated products, any possibility that the bank conducts a prohibited act such as misleading representation to customers, or any doubt in the effectivity of the bank's acceptance and customer explanation for complex structured deposits, etc., the FSA will hold an in-depth interview with the bank in light of relevant laws and regulations with regard to the causes and improvement measures, etc. and encourage the bank to make steady improvement, by requiring reports based on related laws as well as reports under Article 24 of the Banking Act as needed.

If it is found that the bank has a serious problem, the FSA will issue a business improvement order pursuant to Article 26 of the Banking Act together with those based on relevant laws and regulations.

- (2) In addition, as a result of the inspection, in cases where a material violation of laws is detected, including cases where it is found that the management of the bank failed to formulate important internal regulations, etc. against the purpose of laws as described in III-3-3-2-1 or where it is recognized that the bank gave a false explanation to customers, attention should be paid to the necessity to consider taking administrative dispositions based on Article 27 of the Banking Act (for example, suspension of a part of the business operation until the bank prepares a sufficient system therefor by preparing internal regulations, etc.)

### III-3-3-3 Control Environments for Management of Information Related to Customers, etc.

#### III-3-3-3-1 Purpose and Significance

Customer information constitutes the basis of financial instruments transactions. Therefore, it is extremely important to ensure the appropriate management of customer information, and banks are required to take measures to ensure proper handling of customer information acquired in relation to their business (Article 12-2(2) of the Banking Act).

In particular, information regarding individual customers needs to be handled in an appropriate manner in accordance with the Banking Act Enforcement Regulation, the Act on the Protection of Personal Information (hereinafter referred to as the "Personal Information Protection Act"), the Guidelines on the Act on the Protection of Personal Information; (General rules), (Provision to foreign third parties), (Obligation to confirm and record at the time of provision to third parties), (Pseudonymized personal information / anonymized personal information) (hereinafter collectively referred to the "Personal Information Protection Guidelines"), the Guidelines on the Protection of Personal Information in the Financial Sector (hereinafter referred to as the "Financial Sector Personal Information Protection Guidelines") and the Guidelines for Practical Affairs regarding Safety Control Measures specified in the

Guidelines on the Protection of Personal Information in the Financial Sector (hereinafter referred to as the “Practical Guidelines”).

In addition, personal information including credit card information (number and expiration date, etc.)(hereinafter referred to as “credit card information, etc.”) needs to be strictly managed, because secondary damage such as spoofed purchase via unauthorized use of such information may occur if it is leaked.

Furthermore, because banks are in position where they can access sensitive corporate-related information (referred to “Corporate Information” as defined in Article 1(4)(xiv) of the Cabinet Office Order concerning the Financial Instruments Business Operators, etc.; the same applies hereinafter), they are required to strictly control that information and to prevent insider trading and any other unfair transactions.

Based on these matters, it is important for banks to establish a control environment wherein they can properly manage customer information and sensitive corporate-related information (hereinafter referred to as “information related to customer, etc.”)

#### III-3-3-3-2 Major Supervisory Viewpoints

- (1) Control environments for management of information related to customers, etc.
  - (i) Whether the management team recognizes the necessity and importance of ensuring the appropriateness in the management of information related to customers, etc. based on the principle that access and use of information related to customers, etc. should be limited to the officers and employees who need to know such information for the execution of business operations (hereinafter referred to as the “Need to Know principle”) , and has developed an internal control environment, such as establishing an organizational structure (including establishing appropriate checks between divisions), formulating internal regulations, and collaborating with other financial institutions (including holding company) within the financial group to ensure the appropriate management of such information, depending on the content and size of the business.
  - (ii) Whether the bank has formulated a specific standard for the handling of information related to customers, etc. and communicated it to all officers and employees through the provision of training and other means. Whether the formulated standard is based on Need-to-Know Principle regarding the sharing of information related to customers, etc. internally and externally, or within the same department of the bank or between different departments. In addition, whether the bank has formulated a standard for the provision of information related to customers, etc. to third parties, based on careful deliberations, so as to ensure that necessary procedures are implemented in accordance with the above laws and regulations, the Personal Information Protection Guidelines, the Financial Sector Personal Information Protection Guidelines, and the Practical Guidelines.
  - (iii) Whether the bank has established an environment for appropriately managing information

related to customers, etc. and has established arrangements and procedures necessary for examining, in a timely and appropriate manner, the status of the management of information related to customers, etc. with the involvement of compliance department, including thorough management of access to information related to customers, etc. (such as preventing the people with access rights from deviating from the scope of the Need-to-Know Principle and preventing access rights assigned to certain people from being used by others), measures to prevent the misappropriation of information related to customers, etc. by insiders, a robust information management system that prevents unauthorized access from the outside, and preventive measures of leakage of information related to customers, etc. at the time of consolidation and abolition of sales branches.

Also, whether the bank has attempted to implement appropriate measures for preventing wrongful acts utilizing information related to customers, etc., such as the dispersal of authority concentrated upon specific personnel and the enhancement of controls and checks over personnel who have broad powers.

- (iv) Whether the bank has established arrangements and procedures for appropriately reporting to responsible divisions when information related to customers, etc. has been leaked, and notifying relevant customers, reporting to the authorities, and disclosing to public in a prompt and appropriate manner to prevent secondary damage.

Also, does the bank analyze the causes of information leaks and implement measures designed to prevent recurrence? Furthermore, in light of incidents of information being leaked at other companies, whether the bank examines measures needed to prevent a similar incident from occurring at its organization.

Regarding operationally important cases such as those posing the possibility of exerting impact on customers, whether the management of the bank appropriately gets involved in the decision-making concerning actions to be taken

- (v) Whether audits covering the broad range of business operations pertaining to information related to customers, etc. are being conducted by an independent internal audit division or the like on a periodic or as-needed basis. When such broad range of business operations are conducted integrally by the entirety of a financial group, whether efforts for cooperation are being made among the internal audit divisions, etc. of other financial institutions within the group (including holding companies).

Also, whether the bank has implemented appropriate measures, such as training programs, in order to increase the specialization of the staff engaged in audits pertaining to the management of information related to customers, etc.

## (2) Management of personal information

- (i) With regard to information concerning individual customers, has the bank implemented the following necessary and appropriate measures for its safe management and supervision of persons



engaged in order to prevent such information from being leaked, lost, or damaged, in accordance with Article 13-6-5 of the Banking Act Enforcement Regulation?

- (A) Measures based on Articles 8 and 9 of the Financial Sector Personal Information Protection Guidelines
  - (B) Measures based on I, II, and Appendix 2 of the Practical Guidelines
- (ii) Has the bank implemented measures to ensure that information regarding the race, religious beliefs, family origin, registered domicile, healthcare, and criminal records of individual customers, as well as other specified non-disclosure information (\*), are not used except for the cases specified in each item under Article 5(1) of the Financial Sector Personal Information Protection Guidelines in accordance with Article 13-6-7 of the Banking Act Enforcement Regulation?
- (Note) Other specified non-disclosure information includes the following;
- (A) Information regarding labor union membership
  - (B) Information regarding ethnicity
  - (C) Information regarding sexual orientation
  - (D) Information regarding matters set forth in Article 2(iv) of the Enforcement Order of the Banking Act on Protection of Personal Information
  - (E) Information regarding matters set forth in Article 2(v) of the Enforcement Order of the Banking Act on Protection of Personal Information
  - (F) Information regarding facts that he/she has suffered damage by crime
  - (G) Information regarding social status
- (iii) For credit card information, etc., has the bank implemented the following measures?
- (A) Whether the bank has set an appropriate period of time for keeping credit card information, etc., which takes into account the purpose of use and other circumstances, and whether it limits the locations where such information is kept, and disposes of the information in a prompt and appropriate manner after the retention period has lapsed.
  - (B) Whether the bank has implemented appropriate measures when displaying credit card information, etc. on computer monitors, such as not displaying whole credit card numbers, unless needed for business operations.
  - (C) Whether the bank's independent internal audit division conducts internal audit on a periodic or as-needed basis on whether the rules and systems for protecting credit card information, etc. are functioning effectively.
- (iv) Has the bank taken measures to comply with Article 12 of the Financial Sector Personal Information Protection Guidelines and other applicable provisions with regard to the provision of personal data to third parties? In particular, does the bank obtain consents from individual customers while paying attention to the following points according to the nature and methods of the business?
- (A) When obtaining a consent from an individual customer for the provision of his/her

information to a third party in a non-face-to-face manner such as via PC or smartphone, etc., whether the bank has designed the relevant webpage so that individual customers can easily understand the content and purpose of use of information provided to such third party by making it more customer-friendly in terms of the text of consent, letter size, screen specifications, manner of giving consent, etc. in accordance with Article 3 of the Financial Sector Personal Information Protection Guidelines.

- (B) Even in the case where the bank has obtained a consent for the provision of personal information to a third party from an individual customer in the past, if the third party to which the information is provided or the content of information to be provided is different from the past case or if the scope of provision of such information exceeds the necessary extent to achieve a utilization purpose specified before, whether the bank obtains a consent from such individual customer again.
- (C) In cases where personal information of individual customers is provided to multiple third party contractors or where the purpose of use of personal information varies at each third party contractor, whether the bank considers the scope of the third parties for which a consent of the customer is necessary to obtain, and how and when to obtain such consent in proper manner so that the individual customers are able to understand the fact that their information will be provided to multiple third parties, as well as the purpose of use at each third party contractor.
- (D) In obtaining consent for the provision of personal information to third parties, whether the bank is mindful not to cause any risk of abuse of superior position or conflict of interest between the bank and the individual customer. For example, whether an individual customer is forced to give consent beyond the reasonable scope of provision in terms of the third parties to which the personal information is provided, the purpose of use, or the content of information to be provided.

- (3) Prevention of insider trading and other unfair transactions using corporate-related information
  - (i) Whether the bank has established procedures needed from the viewpoint of effectively preventing the unauthorized use of corporate-related information for insider trading in a specific manner, such as setting up a Chinese Wall (Organizational, physical, or systemic barriers for information management; the same applies hereinafter.) between private departments (The ones which are considered to permanently obtain corporate-related information among sales departments.) and public departments (The ones other than private departments among sales departments which are to solicitate sale and purchase of securities or other transactions, operate intermediary services, work as an agent for such transactions, or make transactions on its own or through brokerage transaction.) When making Wall Cross (An information sharing across Chinese Walls; the same applies hereinafter.) in an exceptional manner, whether the bank has established necessary procedures in a specific manner from the viewpoint of effectively preventing any

unauthorized use of corporate-related information, including recording names of the relevant officers and employees, the relevant dates, and the relevant stocks, etc. and requiring the approval from the compliance department in advance.

Also, in cases where the bank allows officers, etc. to have access to corporate-related information from the managerial control necessity, whether the bank has taken measures needed from the viewpoint of effectively preventing the leak or unauthorized use of corporate-related information by the officers, etc.

- (Note) Conceivable examples of taking measures for the “organizational barrier” include the separation of departments or reporting lines and the restriction on plural office holding by officers and employees; such examples for the “physical barrier” include the restriction on entry to the department that manages corporate-related information, and the relevant document management; and such examples for the “systemic barrier” include managing the rights of access to corporate-related information.
- (ii) Whether the bank establishes an appropriate internal control environment, such as by developing the internal regulations pertaining to the sale, purchase, and other transactions of securities by its officers and employees and their related persons, and having the compliance department get involved appropriately in the transactions that are stipulated as transactions for which the prior approval and other relevant procedures are required under the internal regulations, and the revision thereof as needed.
  - (iii) Whether the bank makes efforts for strengthening the sense of compliance, such as enhancing professional ethics and ensuring full understanding of relevant laws and regulations and the internal regulations, aimed at preventing insider trading and other unfair trading by its officers or employees.
  - (iv) Whether the bank understands the relevant situations, such as the sale, purchase, and other transactions of securities by its officers and employees who are in a position to access corporate-related information and their related persons, and implements appropriate measures such as the revision of the relevant methods as needed.
  - (v) In cases where the bank has overseas business bases or belongs to an internationally active financial group, with regard to the management of corporate-related information, whether the bank has established appropriate management environments of which levels are suitable for the content and scale, etc. of its business provided globally while also complying with the laws and regulations in each country, for example, whether the bank manages corporate-related information not only at home but also on the global group basis through its organizational and integrated policies, procedures, and systems, etc.

### III-3-3-3-3 Supervisory Methods and Measures

If inspection results, deplorable event notifications, or the like reveal a problem relating to a bank’s

control environment of information related to a customer, etc., the FSA will require the bank to submit detailed reports based on Article 24 of the Banking Act, as needed. If a serious problem is found, the FSA will issue a business improvement order or implement any other measures based on Article 26 of the Banking Act.

In addition to the above-mentioned measures based on the Banking Act, with regard to information of individual customers, note that necessary measures should be taken according to the delegation of authority to the competent minister for the relevant business under the Personal Information Protection Act as needed.

### III-3-3-4 Outsourcing

#### III-3-3-4-1 Purpose and Significance

Outsourcing by banks of a part of their business operation to a third party (hereinafter referred to as “outsourcing”) may lead to not only improvement in management efficiency but also prompt response to various needs of customers based on speedy innovation of technology by entrusting a part of their work to external contractors who have more expertise in the relevant field. However, for this, banks need to ensure that the outsourced business is properly and soundly managed in terms of protection of customers and proper management of various risks associated therewith, and are required by laws to take necessary measures to ensure that the outsourced business is properly performed (Article 12-2(2) of the Banking Act and Article 13-6-8 of the Banking Act Enforcement Regulation).

The following are general points to consider regarding banks’ outsourcing. Note that additional inspection may be necessary according to the content of the outsourced business.

(Note 1) Outsourcing includes cases where a bank outsources part of administrative work critical for its business operation to a third party contractor (cases where a bank is deemed to substantially outsource its business to an external contractor even if a formal contract is not concluded or where the outsourced work is performed overseas.)

(Note 2) In cases where a bank outsources a part of necessary operations relating to its inherent business to a third party (except where such third party serves as a bank agent with the permission under Article 52-36(1) of the Banking Act or as a financial service intermediary with the permission under Article 12 of the Financial Service Provision Act (limited to “deposit, etc. intermediary business operations” stipulated in Article 11(2) of the same Act; the same applies hereinafter), the FSA should inspect, in addition to the following points, whether said outsourcing is not deemed to constitute bank agency services.

(Note 3) For example, outsourcing of a bank’s mere auxiliary business to an external contractor is not considered to be a “bank agency service” which requires permission under the Banking Act or a “financial service intermediary” which requires permission under the Financial Service

Provision Act. However, if the bank outsources such business, the FSA endeavors to grasp the actual situation regularly by holding an interview with the bank based on the following viewpoints.

(Note 4) In case of outsourcing between a bank and its subsidiary company, also refer to V-3-3, etc.

#### III-3-3-4-2 Major Supervisory Viewpoints

- (1) Whether the following control environment is developed (including the bank's requiring its outsourced contractor to do so in the outsourcing contract, etc.) from the viewpoint of customer protection.
  - (i) Whether the bank makes it clear that the outsourcing of business operations does not cause any change in the contractual rights and obligations involving it and its customers and that the customers continue to have the same rights as if the business operations were conducted by the bank itself.
  - (ii) Whether the bank developed a control environment that prevents customers from suffering inconveniences if the bank cannot be provided with the services agreed under the outsourcing contract with its outsourced contractor.
  - (iii) Whether the outsourced contractor has developed a control environment for managing information related to customers, etc. including prohibition of use of the information for unauthorized purposes. Whether the outsourced contractor is bound by the confidentiality obligations.
  - (iv) When outsourcing the handling of individual customer information to an external contractor, whether the bank has taken the following measures to supervise the outsourced contractor in terms of necessary and appropriate measures to prevent such information from being leaked, lost, or damaged based on Article 13-6-5 of the Banking Act Enforcement Regulation.
    - (A) Measures based on Article 10 of the Financial Sector Personal Information Protection Guidelines
    - (B) Measures based on III of the Practice Guidelines
  - (v) With regard to the management of outsourced contractors, whether the bank clarifies the responsible division and confirms that outsourced contractors are properly managing information related to customers, etc., such as by monitoring on a periodic or as-needed basis how business operations are being conducted at outsourced contractors.
  - (vi) Whether the bank has confirmed that outsourced contractors have systems in place to take appropriate actions and to promptly report to the bank in the event that information is leaked, lost, or damaged.
  - (vii) Whether the bank restricts the access right by outsourced contractors to the information related to customers, etc. possessed by the bank to the extent necessary according to the nature of the outsourced business.

On that basis, whether the bank checks whether the officers and employees at outsourced contractors to whom access rights are given have been defined, along with the scope of their access rights.

Furthermore, whether the bank confirms that the access rights are being managed thoroughly at outsourced contractors on a periodic or as-needed basis, such as by checking how the access rights are used (including matching authorized persons against actual users) in order to prevent the access rights assigned to certain people from being used by others.

- (viii) In cases where an outsourced contractor entrusts the outsourced business of the bank to its subcontractors, whether the bank checks whether the outsourced contractor is adequately supervising such subcontractors. Whether the bank directly supervises such subcontractors as needed.
- (ix) Whether the bank has developed a proper system to deal with customers' complaints such as by providing a direct communication line from customers to the bank.

(2) Whether the bank has developed a necessary control environment (including the bank's requiring its outsourced contractor to do so in the outsourcing contract, etc.) by comprehensively reviewing the outsourcing scheme from the viewpoint of securing its management soundness including the points shown below, etc.

(i) Risk management

Whether the bank has comprehensively checked risk that is associated with the outsourcing such as impact on the bank's operation if the outsourced services are not provided as guaranteed in the outsourcing contract. Whether the bank has considered how to cope with the risk upon occurrence.

(ii) Selection of outsourced contractor

Whether the bank selects outsourced contractors from the viewpoint of rationality in its management and reputation.

(iii) Content of contract

Whether the outsourcing contracts fully cover and clearly stipulate the following matters.

- (A) Content and level of services to be provided and cancelling procedures, etc.
- (B) Responsibilities of the outsourced contractor if it fails to provide the bank with the outsourced service in accordance with the outsourcing contract. Matters relating to burden of damages that may arise in connection with the outsourcing (including securing of fulfillment of the obligation to burden damage such as provision of collateral as needed.)
- (C) Content of reports the bank receives from the outsourced contractor relating to the outsourced business and the management status of the outsourced contractor
- (D) Arrangements in response to requirements for inspection and supervision by the competent finance regulators

(iv) Statutory obligations imposed on bank

Whether the outsourcing interferes with the bank's statutory obligations which would be

imposed on it if such operation outsourced is performed by the bank itself.

(v) Control environment by bank

Whether the bank has developed a control environment within the bank in terms of appointment of a manager in charge of the outsourcing, monitoring and inspection scheme, etc. (including insertion of a provision enabling the bank to check and audit the appropriateness of the service provided by the outsourced contractor, etc.)

(vi) Provision of information

Whether the control environment is designed to enable the bank to promptly receive necessary and appropriate information on progress of the outsourced business from the outsourced contractor according to the degree of importance thereof.

(vii) Audit

Whether the outsourcing is included in the scope of audit of the bank.

(viii) Emergency response

Whether the bank has prepared measures to prevent its banking operation from being materially disturbed even when the outsourced service is not provided as guaranteed in the outsourcing contract. In addition, under such circumstance, whether a system is in place to provide relevant services to customers on behalf of such outsourced contractor.

(ix) Outsourcing to group companies

When the outsourcing contract is concluded between the bank and any of its group companies, whether the content of the contract violates the arm's length requirement such as substantially providing favorable support to such group company.

### III-3-3-4-3 Supervisory Methods and Measures

(1) Cases where a problem is found in bank's control environment

If a problem is found in a bank's internal control environment relating to the outsourcing, from the inspection results and the misconduct notifications, etc., the FSA will require the bank to submit a report based on Article 24 of the Banking Act, as needed. If a serious problem is found, the FSA will issue a business improvement order or implement any other measures based on Article 26 of the Banking Act.

(2) Cases where a problem is found in control environment of business operation, etc. of the outsourced contractor

(i) Response to bank

If a problem is found in the business operation of the outsourced contractor from the inspection results or if it is found from the misconduct notifications, etc. that the outsourced contractor performs improper business operation, the FSA will, in principle, first try to find the facts through the bank that entrusted it with the outsourced work (including the management environment of

the bank). In this case, too, the FSA will require the bank, as needed, to submit a report based on Article 24 of the Banking Act, and if a serious problem is found, the FSA will issue a business improvement order based on Article 26 of the Banking Act. This, however, will not preclude the FSA from taking the following action in parallel with the above based on the urgency and importance of relevant cases.

(ii) Action to outsourced contractor

When the FSA considers that it is difficult to grasp the actual situation of the outsourcing sufficiently only by the measures under (i) above, the FSA will make efforts to grasp it by holding a direct interview with the outsourced contractor. When it is deemed particularly necessary (for example, cases where multiple financial institutions entrust similar work to such outsourced contractor or cases where the outsourcing may affect the whole settlement system of the bank), the FSA will request such outsourced contractor to submit a report based on Article 24(2) of the Banking Act with regard to necessary matters such as the fact of occurrence of a problem, analysis on causes of occurrence of the problem, and improvement measures.

(Note) When holding an interview with an outsourced contractor, the FSA asks the bank, which outsourced business to it, to attend the interview as needed.

### III-3-4 Rules, etc. for User Protection

#### III-3-4-1 Measures to Prevent Customers' Misidentification

##### III-3-4-1-1 Purpose and Significance

In some cases, a bank conducts business operations with its business offices located in a building also occupied by another financial institution, from the viewpoint of improving customer convenience and streamlining administrative work. In these cases, it is important that measures should be taken for prevention of misidentification by customers.

##### III-3-4-1-2 Major Supervisory Viewpoints

When a bank has a business office in a building or floor also occupied by another bank's headquarters or branch, whether appropriate measures are taken from the viewpoints of avoiding misidentification by customers, protecting customer information, and preventing crime. In this case, if using computer facilities in common with others, whether the bank develops a control environment to enable it to comply with its own information management regulations.

While banks are actively promoting the revision of their branch development strategy and business operations, there can be some cases where a decision is made to continue the operation of a business office located in a depopulated area based on the needs of the local community or where, as a result of business integration,



multiple business offices are located in the same area, and two or more banks maintain one business office in common in such area. As examples of these cases, in addition to the case where two or more banks operate a common business office, there are given a case where a bank serves as a bank agent or financial services intermediary, or registered financial institution of another bank on a commission basis, and a case where two or more banks entrust the same outsourced contractor with bank agent business or financial services intermediary business.

In this way, when several banks have a common business office in the same building or on the same floor, they do not necessarily have to install a wall between the banks' spaces. However, attention should be paid, especially, to the following points from the viewpoint of preventing customers from misidentifying these banks.

- (i) In cases where the bank conducts business operations with its business offices located in a building or floor also occupied by another financial institution, whether the bank provides customers with sufficient explanations regarding the following matters.
  - (A) The bank and said financial institution, its parent/subsidiary corporations, etc. sharing the same building or floor are different.
  - (B) Products and services provided by the bank are not ones provided by said financial institution or its parent/subsidiary corporations, etc.
- (ii) In cases where an employee of the bank concurrently holds office at the sales division of another bank, etc., whether the following measures have been taken appropriately. In addition, whether his/her reporting line and the chain of command at the bank are clarified.
  - (A) The content of the products or services handled by the employee at the common business office where he/she works, and the name of the corporation that is the provider of such products or services, should be posted at said business office, so that customers visiting the business office can easily understand these matters.
  - (B) The employee should clearly show the customers the scope of the bank, financial institution, etc. where he/she concurrently holds office. In particular, if the employee is engaged in receiving an unspecified number of customers, such as in counter operations, it is recommended that information such as the scope of the major products or services that the employee deals with and the status of his/her holding of multiple offices should always be clearly shown to customers, by posting it at the counter at all times.
  - (C) In particular, when the employee solicits new customers or solicits existing customers for new products or services, he/she should give sufficient explanations on the status of his/her holding of multiple offices and the scope of the products and services that he/she deals with.
  - (D) When concluding contracts with customers, the employee should secure the opportunity for the customers to properly recognize the name of the corporation with which they are to conclude the contracts, such as by making confirmation in writing.
- (iii) Whether the measures based on III-3-3-3 are taken for proper management of customer information so that the bank's customer information will not be used for the business of other financial institutions, etc. which occupy the same business office.

### III-3-4-1-3 Supervisory Methods and Measures

If inspection results, deplorable event notifications, or the like reveal a problem relating to the prevention of misidentification by customers, the FSA will require the bank to submit a report based on Article 24 of the Banking Act, as needed. If a serious problem is found, the FSA will issue a business improvement order or implement any other measures based on Article 26 of the Banking Act.

### III-3-4-2 Points of Attention regarding Private Banking, etc.

#### III-3-4-2-1 Purpose and Significance

In recent years, banks actively launch and promote business for wealthy people in which they identify customers holding wealth beyond the prescribed level (“wealthy customers”) and offer them multiple services and financial instruments for property and asset management (so-called “private banking” or “wealth management”). It is important to supervise and inspect the actual operation of such business and the associated risk from both viewpoints; the principle of self-responsibility of users, and the protection of depositors, investors, and trustors, according to the independent and special nature of such business different from the ordinary service.

#### III-3-4-2-2 Major Supervisory Viewpoints

- (1) Determination of sound and proper profit or sales goal and supervision and management of business operation
  - (i) Banks are required to introduce sufficient internal control and governance to properly balance profitability and compliance and to control the sales activity in order to properly perform the transactions relating to the customer’s property and asset management in a long-term span, to maintain a sound transaction relationship, to set sound and proper profit and sales goals, and to secure the appropriateness and reasonableness of the business operation. Whether the bank introduces such internal control and governance system. Additionally, whether the bank introduces and develops a control environment to properly supervise and manage each sales staff member individually according to the size of the sales activities.
  - (ii) Whether the salary and bonus systems of sales staff, officers, and employees are not excessively linked to short-term earnings or overly reflective of performance. In addition, whether the bank promotes sales activities or product structures improperly concentrating on changeover transaction and revolving trading of foreign exchange, investment trust, or other negotiable instrument overly focusing on earning of commissions as well as solicitation and sale of financial instruments containing derivatives or leverage effect such as structured deposits or bonds.

- (2) Development of control environment to supervise and manage proper sales
- (i) From the viewpoint of fulfilling accountability in consideration of customers' knowledge and experience in financial trading and investment, whether the bank fully validates the suitability of customers and the appropriateness and reasonableness of the financial instruments and transactions offered by the bank. Also, whether the bank properly keeps and maintains the records of approvals and internal decisions for these trading transactions (judgments and reasons thereof, etc.).
  - (ii) Whether the bank develops a control environment to check and validate whether the transactions with customers are continuously monitored and supervised, and whether relevant information such as results of management and performance in the process of transaction, real time market information, occurrence of risk and fluctuation factor, etc. are timely disclosed and explained to customers in a proper and sufficient manner in accordance with applicable laws and regulations and the bank's internal regulations.
  - (iii) Whether there is a situation in which a sound and appropriate relationship that should be maintained between a bank and a customer is not maintained because the bank prioritizes acquisition of customers, such as a case where persons in managerial positions of the bank's sales division excessively respond to customers.
  - (iv) In addition to an individual transaction with customers, whether any conditions that are substantially equivalent to unfair kickback or rebate, etc. are included in any arrangements between the bank's sales staff and those related to the transaction. Whether an internal control environment is in place to restrain and control these conditions, etc.
- (3) Establishment of information control environment, etc.
- (i) When a bank, which has the function to grant credit to them, conducts financial transactions with specific customers, the bank is prohibited from abusing the bank's superior position and conducting so-called "tie-in sales," which means selling financial instruments, etc. in reward for granting credit. Whether the bank develops a control environment to implement the customer assessment and check each transaction in a sufficient manner to prevent the bank from conducting such activities. Whether there are any cases where the customer compels the bank to grant credit and the bank improperly accepts such demand.
  - (ii) Whether the bank has a system to properly use customers' non-disclosure or important information and to keep and reserve it in a proper and sufficient manner. Whether the bank establishes a control environment in which, when customer information has been leaked, the bank is able to correctly grasp the details thereof and take prompt and proper actions to prevent secondary damage. Note that with regard to the actual status of archiving and common use by legal units of customer information, inspection may be needed as to their control environment and to whether the bank has obtained customers' sufficient understanding and prior approvals

and consents.

- (4) Establishment of a control environment to prevent violation of laws and to secure fair and reasonable trade, etc.
  - (i) From the standpoint of eliminating illegal transactions and unfair and improper trade, whether the bank not only checks the compliance of each transaction but also secures a fair trade price and transparency of transaction. Also, whether the bank sufficiently validates the appropriateness and reasonableness of each customer transaction itself by paying attention to the true purpose of the customer, the purpose of the whole structure, transaction effect given to customers and other stakeholders, possibility of risk occurrence, reasonable burden, economic rationality, etc.
  - (ii) Whether procedures and an internal control environment have been established appropriately to validate that the commission earnings and profit margins received by the bank from the transactions, etc. with customers are set at a proper and reasonable level and to check and restrain such level at all times.
  - (iii) Whether the bank has established an internal control environment to properly supervise and manage responses to specific disputes with customers according to the degree and situation thereof.
  
- (5) Establishment of a control environment to detect and eliminate money laundering and other suspicious transactions, etc.
  - (i) Whether the bank has a control environment to enable the bank to grasp the customers' asset background, fund source, the interrelationship between those who are involved in a transaction as well as the true purpose of the financial transactions structured in each case and the background thereof in a proper and sufficient manner. Whether the bank ensures that the checking function works at every transaction, and conducts an adequate assessment as to whether to approve the customer and transaction, etc. in a timely and proper manner.
  - (ii) In particular, whether the bank has appointed experienced staff in charge to detect and check money laundering or other suspicious transactions in which customers' funds or assets are concealed or transferred to overseas or in Japan by way of unlawful means and an unjust mechanism, etc. Whether the bank has established a control environment to restrain and prevent the bank's sales division, etc. from being involved in such kinds of transactions.
  - (iii) Whether the bank has introduced procedures and a system to detect, analyze, monitor, and integrally manage suspicious customers and transactions at all times. And whether the bank has a control environment to properly manage and handle the customers and transactions, etc. with whom/which a problem is found.

If regular supervisory off-site monitoring, inspection results, written reports for notification of misconduct, or the like reveal a problem relating to the operation of such business or the internal control environment, the FSA will require the bank to submit a report based on Article 24 of the Banking Act, as needed. If a serious problem is found, the FSA will issue a business improvement order or implement any other measures based on Article 26 of the Banking Act.

### III-3-5 Dealing with Complaints (including Financial ADR System)

#### III-3-5-1 Purpose and Significance

##### (1) Need for dealing with inquiries, complaints, disputes, etc. (hereinafter, “complaints”)

Many financial products and services have inherent risks, and coupled with being specialized and invisible in nature, it is considered that there is a strong possibility of their leading to problems. Therefore, with regard to the sale and provision of financial products and services, in addition to providing information and adequately implementing other advanced measures from the viewpoint of preventing problems and protecting customers, handling complaints after the fact is also important.

In recent years, increasing the diversity and complexity of financial products and services has led to the greater likelihood of problems, and so from the viewpoint of protecting customers and ensuring customer confidence, handling complaints after the fact has become even more important.

Based on these perspectives, a financial ADR system has been introduced as a framework for simply and expeditiously processing complaints and resolving disputes related to financial products and services (refer to Note for description of ADR), and banks are required to appropriately handle complaints taking into account this financial ADR system.

##### (Note) ADR (Alternative Dispute Resolution)

An alternative method to litigation for resolving disputes which is based on agreement by the parties, such as mediation or arbitration. ADR is expected to result in prompt, simple, and flexible dispute resolution in a manner suited to the nature of the case, the circumstances of the parties, and so on.

##### (2) Scope

There are various forms of expression that can be made regarding the business operations of a bank. Besides inquiries, there are also expressions of dissatisfaction made by customers, such as complaints and disputes. It is important for banks to deal with these various forms of expression appropriately, and so they are required to develop appropriate internal control environments that enable such treatment.

In addition, banks are also required to develop appropriate control environments for complaints and disputes in the financial ADR system.

However, it must be added that the distinction between these complaints and disputes is relative

and they are connected with each other. In particular, in light of the requirement in the financial ADR system for designated ADR bodies to ensure links between complaint processing procedures and dispute resolution procedures, rather than dealing with individual cases by formally dividing applications made by customers into “complaints” and “disputes,” it is important that banks deal with complaints and disputes appropriately while taking into consideration their relativity and connections.

### III-3-5-2 Establishment of Internal Control Environment for Handling Complaints, etc.

#### III-3-5-2-1 Purpose and Significance

Handling complaints, etc. in a prompt, fair, and appropriate manner is an important activity that carries the connotation of complementing the accountability to customers after the fact, and is important for ensuring the confidence of customers in financial products and services. Banks need to develop internal control environments to handle and deal with complaints, etc. made by customers in a prompt, fair, and appropriate manner, including measures and responses required in the financial ADR system.

#### III-3-5-2-2 Major Supervisory Viewpoints

The FSA will examine whether the bank has, in developing an internal control environment for handling complaints, etc., developed an appropriate and effective control environment in light of the size and specific characteristics of its business operations. For this, the FSA will take the following points, among others, into consideration, while being mindful of avoiding their application in a mechanical and uniform fashion.

In particular, for an examination of handling complaints, etc. of credit transactions, deposits, and risk-associated products, the FSA will keep in mind that handling complaints, etc. complements customer explanation, and refer to III-3-3-1-2 and III-3-3-2-2 when necessary.

##### (1) Role of management

Whether the board of directors has exercised its functions properly with regard to the establishment of the bank-wide internal control environment for the function of handling complaints, etc.

##### (2) Internal regulations, etc.

(i) Whether the division in charge of complaints, etc., its responsibility and authority, and the procedures for handling complaints, etc. (including response in case where an administrative error occurs) have been established in the internal regulations so that complaints can be responded to and dealt with in a prompt, fair, and appropriate manner. Also, whether procedures concerning business improvement have been established so that the views of customers are reflected in the conduct of business operations.

(ii) Whether the bank has developed a control environment to disseminate internal regulations, etc.

to its employees by means of training and other measures (including the distribution of manuals and so forth) so that business operations for handling complaints, etc. can be conducted based on those internal regulations.

Particularly in cases where complaints, etc. are being made frequently by customers, whether the bank first confirms how internal regulations, etc. (not only those for handling complaints, etc.) are publicized and enforced at branches. And then whether the bank examines the causes and problem areas in terms of control environments.

- (3) Control environment for handling complaints, etc.
- (i) Whether the bank has appropriately appointed staff in charge of handling complaints, etc.
  - (ii) Whether the bank has developed a control environment wherein relevant departments cooperate and promptly deal with any complaints, etc. made by customers. In particular, whether the bank has developed a control environment wherein the responsible division or person in charge of handling complaints, etc. strives to fully understand the customer complaints, etc. faced by each individual employee, and reports promptly to the relevant departments.
  - (iii) Whether the bank has developed a control environment wherein it promptly settles any outstanding cases and prevents the occurrence of any long-term outstanding cases by conducting progress management aimed at the resolution of complaints, etc. properly.
  - (iv) Whether the bank has developed a control environment wherein it can receive complaints extensively, such as by improving the response provided at contact points according to the occurrence of complaints, etc., and, by setting access hours and means of access (e.g. telephone, mail, facsimile, and email) that are considerate of customer convenience. Also, whether the bank has developed a control environment wherein it extensively publicizes these contact points and ways of making applications, etc. and wherein it makes them well known to customers in an easy-to-understand manner taking into account their diversity.
  - (v) Whether the bank has developed a control environment for, when handling complaints, etc., ensuring the proper handling of personal information in accordance with the Personal Information Protection Act, and other applicable laws and regulations, the Personal Information Protection Guidelines, and the Financial Sector Personal Information Protection Guidelines (See III-3-3-3).
  - (vi) With regard to complaints concerning outsourced business operations conducted by an external contractor, including bank agents or financial service intermediaries, whether the bank has developed a control environment for handling such complaints, etc. promptly and appropriately, such as by establishing a system of direct communication to the bank itself (see III-3-3-4-2(1)(v) and VIII-5-2-2(9)).
  - (vii) Whether the bank has developed a control environment wherein it can communicate quickly with relevant divisions and cooperate with the police and other relevant organizations where necessary, in order to distinguish any pressure by anti-social forces disguised as complaints, etc.

from ordinary complaints, etc. and to take a resolute stance against them.

(4) Dealing with customers

- (i) Whether the bank goes beyond perceiving the handling of complaints as a simple problem of processing procedures, and instead regards it as a question of a control environment for providing after the fact explanations and aim to resolve a complaint with the understanding and agreement of the customer wherever possible while suitably interviewing customers on the circumstances according to the nature of the complaint, etc.
- (ii) Whether the bank has developed a control environment wherein it provides customers who have made a complaint, etc. with appropriate explanations, as according to the progress of the procedures for handling complaints, etc. while also being considerate of the specific characteristics of the customer, from the time the complaint is made to after its settlement (for example, an explanation of the procedures for handling complaints, notification to the effect that the complaint, etc. has been received, an explanation on the progress, an explanation of the results, etc.).
- (iii) With regard to complaints, etc. made by customers, whether the bank has developed a control environment wherein, rather than only handling a complaint, etc. itself, it refers customers to appropriate external organizations according to the nature of the complaint and the wishes of the customer, and provides information such as an overview of the standard procedures.  
In cases where there is more than one means of processing a complaint or resolving a dispute (including the financial ADR system), customers should be able to choose freely, and so in referring customers to external organizations, care should be taken so that a customer's choice is not unduly restricted.
- (iv) Whether the bank has developed a control environment wherein, even during a period when proceedings for handling a complaint, etc. are pending at an external organization, the bank takes appropriate action where necessary with respect to the customer who is the other party to said proceedings (ordinarily handling customers such as providing the customer with general materials or explanations).

(5) Information sharing, business improvements, etc.

- (i) Whether the bank has developed a control environment wherein complaints, etc. and the associated results from handling them are categorized and reported to its internal control division and sales division, and wherein information necessary for the particular case is shared between those concerned, such as reporting important cases to the audit division and management.
- (ii) Whether the bank properly and accurately records and stores information on the contents of complaints, etc. and the results of dealing with them, including both complaints, etc. it deals with itself, and those dealt with through the mediation of an external organization. Also, whether the bank has developed a control environment wherein it analyzes the contents of



complaints, etc., and the results of handling them, taking into consideration information, etc., provided by a designated ADR body, and applies this on an ongoing basis to the improvement of control environments for dealing with customers and conducting administrative processes and to the formulation of measures for preventing any occurrence or recurrence of complaints, etc.

- (iii) Whether the bank has developed a control environment wherein the internal checks and balances functions, such as of inspection and audit, can function properly to ensure the effectiveness of how complaints, etc. are handled.
- (iv) Whether the bank has developed a control environment wherein, when reflecting the treatment of complaints, etc. in the conduct of business operations, the management supervises any decisions to implement measures for business improvement or recurrence prevention, as well as any examination or ongoing review of how the control environment for handling complaints, etc. should be.

(6) Relationship with external organizations, etc.

- (i) Whether the bank has developed a control environment wherein it cooperates appropriately with external organizations, etc. in working toward the prompt resolution of any complaints, etc.
- (ii) Whether the bank has developed a control environment wherein, when filing a petition for dispute resolution procedures with external organizations, etc. by itself, rather than simply filing a petition without fully exhausting its own procedures, it first responds sufficiently to the submission of the complaint from the customer and goes through an appropriate internal deliberation on the need for the petition.

III-3-5-3 Response to the Financial ADR System

III-3-5-3-1 In Cases Where There is a Designated ADR Body

III-3-5-3-1-1 Purpose and Significance

In order to enhance customer protection and improve customer confidence in financial products and services, it is important to ensure substantial equality between banks and customers, and to resolve customers' complaints, etc. in a neutral, fair, and effective manner. Therefore, in the financial ADR system, complaint processing and dispute resolution from a third-person perspective are conducted by designated ADR bodies with the participation of experts and others.

Under the financial ADR system, responses to complaint processing and dispute resolution are primarily regulated according to basic contracts for the implementation of dispute resolution procedures (Article 2(32) of the Banking Act) concluded between banks and designated ADR bodies.

Banks are required to appropriately address their obligations, etc. set forth in their basic contracts for

the implementation of dispute resolution procedures, while bearing in mind the objective of processing complaints or resolving disputes at designated ADR bodies.

### III-3-5-3-1-2 Major Supervisory Viewpoints

The FSA will inspect whether the bank has, in responding to the financial ADR system based on the above-mentioned purpose and significance, developed an appropriate and effective control environment in light of the size and specific characteristics of its business operations. For this, the FSA should take into consideration the following points, among others, while being mindful of avoiding their application in a mechanical and uniform fashion.

See also the points to note in “III-3-5-2 Establishment of Internal Control Environment for Handling Complaints, etc.”

#### (1) Outline

##### (i) Basic contract for the implementation of dispute resolution procedures

- (A) Whether the bank has promptly entered into a basic contract for the implementation of dispute resolution procedures with a designated ADR body with respect to banking services (as defined in Article 2(25) of the Banking Act).

For example, even in cases where there is a reassignment of designation, such as a designated ADR body having its designation rescinded or a new ADR body being designated, whether the bank selects the best measure from the perspective of customer convenience and promptly implements any necessary measures (such as implementing new complaint processing measures or dispute resolution measures, or concluding a basic contract for the implementation of dispute resolution procedures). Also, whether the bank takes appropriate action, such as making the reassignment known to all customers.

- (B) Whether the bank has developed a control environment to faithfully perform the basic contract for the implementation of dispute resolution procedures concluded with a designated ADR body.

##### (ii) Publication, dissemination, and response to customers

- (A) Whether the bank has properly publicized the name or trade name and the contact address of a designated ADR body with which the bank has concluded a basic contract for the implementation of dispute resolution procedures.

With regard to methods of publication, whether the bank takes measures suitable to the size and specific characteristics of its business operations, for example, presenting information on its website, putting up posters at its branches, producing and distributing pamphlets, and conducting publicity activities through the mass media. Even supposing that the bank has posted information on its website, if it is assumed that there are customers who cannot view this information, whether the bank gives consideration to these kinds of

customers.

In publicizing such information, whether the bank presents it in a manner that is easy for customers to understand. (For example, in the case of publicizing information on a website, the page should be so designed that customers can easily access the page that provides information on the use of the financial ADR system.)

- (B) Whether the bank has developed a control environment wherein it disseminates any necessary information to customers, such as the flow of standard procedures by the designated ADR body and the effects of using a designated ADR body (such as the effect of prevention of prescription), in light of the basic contract for the implementation of dispute resolution procedures.
- (C) In cases where the bank sells financial products or insurance products arranged by financial instruments business operators or insurance companies, where multiple operators with varied forms of operation are involved, including the financial instruments business operators or insurance companies that arranged the products and banks that sold the products, whether the bank responds to customers in a careful manner. For example, whether the bank understands what the customers see as the problem and refers them to designated ADR bodies that are appropriate for the causes of the problems.

Note: In the case of an insurance product, even if the problem is related to an explanation made by a bank selling the product (i.e., insurance agent), the entrusting insurance company, etc., shall be liable for any damage caused by an insurance agent to a policyholder in carrying out the insurance solicitation activities under the provisions of Article 283(1) of the Insurance Business Act (except in cases provided in (2) of the same Article). As such, attention should be paid to the fact that customers are in principle eligible to file applications not only with designated ADR bodies with whom the bank executes a basic contract for the implementation of dispute resolution procedures, but also with designated ADR bodies with whom the insurance company concludes a basic contract for the implementation of dispute resolution procedures.

(2) Points of attention regarding complaint processing procedures and dispute resolution procedures

In light of the fact that, under basic contracts for the implementation of dispute resolution procedures, banks assume various obligations, including those to comply with procedures, submit materials, and respect special conciliation proposals, the FSA should take the following points, among others, into consideration when conducting examinations.

(i) Common items

- (A) Whether the bank has developed a control environment wherein, in cases where it receives a request from a designated ADR body for compliance with procedures, submission of materials, or the like, it responds to the request promptly, unless there is a justifiable reason not to do so.

- (B) Whether the bank has developed a control environment wherein, in cases where it refuses a request from a designated ADR body to comply with procedures, submit materials, or the like, rather than the division that caused the complaint or dispute simply deciding by itself to refuse the request, the bank conducts a proper examination as an organization with respect to such decision of refusal. Also, whether the bank has developed a control environment wherein, wherever possible, it explains the reasons (justifiable reasons) for that decision.
- (ii) Response to dispute resolution procedures
  - (A) Whether the bank has developed a control environment wherein, in cases where it is presented with a recommendation to accept a reconciliation plan or with a special conciliation proposal from a dispute resolution committee member, it makes prompt decisions on whether or not to accept it.
  - (B) Whether the bank has developed a control environment wherein, in cases where it has accepted a reconciliation plan or a special conciliation proposal, the division in charge takes prompt action, and the audit division conducts a follow-up examination on matters including the progress of its fulfillment.
  - (C) Whether the bank has developed a control environment wherein, in cases where it rejects acceptance of a reconciliation plan or a special conciliation proposal, it promptly explains its reasoning and takes necessary action, such as instituting legal proceedings, in light of the operational rules of the designated ADR body (Article 52-67(1) of the Banking Act).

### III-3-5-3-2 In Cases Where There is No Designated ADR Body

#### III-3-5-3-2-1 Purpose and Significance

In the financial ADR system, even in cases where there is no designated ADR body, there is a legal requirement for banks to instead implement complaint processing measures and dispute resolution measures. Banks are required to ensure proper customer protection and to strive to improve customer confidence in financial products and services by implementing these measures properly and by resolving any complaints or disputes regarding financial products and services in a simple and expeditious manner.

#### III-3-5-3-2-2 Major Supervisory Viewpoints

The FSA will examine whether the bank has developed a control environment in light of the scale and specific nature of its business operations, wherein, in cases where it implements complaint processing measures and dispute resolution measures, it deals properly with any complaints or disputes made by customers while bearing in mind the objectives of the financial ADR system. For conducting examination, the FSA should take into consideration the following points, among others, while being mindful of avoiding

their application in a mechanical and uniform fashion.

See also the points to note in “III-3-5-2 Establishment of Internal Control Environment for Handling Complaints.”

(1) Outline

(i) Selection of complaint processing measures and dispute resolution measures

- (A) Whether the bank appropriately selects one or multiple measures in each type of registered business prescribed by law as its complaint processing measures or dispute resolution measures, in view of the nature of its business operations, the occurrence of complaints, its business area, and other factors. In this case, it is desirable that the bank has measures in place that would enhance convenience for customers in making complaints or disputes, such as providing an environment that makes it easier for customers to access relevant services in terms of geography.
- (B) Whether the bank has developed a control environment wherein it continuously monitors the processing status of complaints and disputes, and where necessary, reviews and revises its complaint processing measures and dispute resolution measures.
- (C) In cases where the bank utilizes a corporation that can conduct complaint processing services or dispute resolution services in a fair and appropriate manner, whether the bank evaluates whether such corporation has a financial basis and personnel structure that are sufficient to fairly and appropriately carry out operations pertaining to the handling of complaints related to its services (Article 13-8(1)(v) and (2)(v) of the Banking Act Enforcement Regulation), in a reasonable manner based on considerable materials and other factors.
- (D) In cases where the bank utilizes an external organization, although it is not necessarily required to enter an outsourcing contract with such external organization, it is desirable to determine necessary matters with the external organization in advance, such as the flow of standard procedures and the terms and conditions regarding the burden of expenses.
- (E) In cases where expenses are incurred by utilizing the procedures of an external organization, whether the bank has taken measures that would prevent such expenses from becoming an impediment to the filing of a petition for complaint processing or dispute resolution, such as taking measures likely to prevent the customer’s burden of expenses from becoming excessive.

(ii) Operation

The FSA will examine whether the bank operates measures inappropriately, such as unduly restricting the scope of the complaint processing measures and dispute resolution measures. It should also be kept in mind whether the bank has maintained appropriate coordination between complaint processing measures and dispute resolution measures (refer to III-3-5-1(2)).

(2) Points of attention regarding complaint processing measures (cases where banks develop their own

control environments)

- (i) Cases where a control environment is developed wherein consumer counselors, etc. give guidance and advice to employees
  - (A) Whether the bank has developed a control environment wherein it improves the skills of its employees engaged in processing complaints, such as periodically conducting a training run by consumer counselors and the like.
  - (B) Whether the bank has developed a control environment wherein it utilizes the specialized knowledge and experience of consumer counselors and the like, where necessary, for processing individual cases, such as building a network with consumer counselors and the like.
- (ii) Cases where a bank develops its own operational system and internal rules
  - (A) Whether the bank has properly developed an operational system and internal rules on the basis of the status of occurrence of complaints, and whether it has developed a control environment wherein it processes complaints in a fair and appropriate manner based on said system and rules.
  - (B) Whether the bank has made customers aware of the contact point for making complaints in an appropriate manner, and whether it has properly published the operational system and internal rules pertaining to complaint processing.

In terms of the content of the dissemination and publications, although the full text of the internal rules is not necessarily published, in order for customers to confirm for themselves whether complaints are being processed in accordance with appropriate procedures, as it is important that the contact information for inquiry about the processing complaints and the flow of standard operations are clearly indicated, it should be kept in mind whether this information is covered in its publication.

For the methods of publicity and publication, refer to III-3-5-3-1-2(1)(ii).

- (3) Points of attention regarding complaint processing measures (when using external organizations) and dispute resolution measures
  - (i) Dissemination and publication
    - (A) In cases where the bank is using an external organization, from the perspective of customer protection, it is desirable that the bank disseminates and publishes information regarding the external organization, including, for example, the availability of using the external organization when making complaints or disputes, the name and contact information of the external organization, and the instructions on how to use it, in an easy-to-understand manner for customers.
    - (B) Whether the bank has developed a control environment for referring customers to other external organizations, when the petition for complaint processing or dispute resolution is out of the scope handled by the external organization to which the customer was firstly

referred to by the bank due to geographical reasons, the nature of the complaint or dispute, or for any other reason, or when the handling of the complaint or dispute by another external organization is appropriate (not limited to external organizations used by the bank as complaint processing measures or dispute resolution measures).

- (C) For cases in which the bank sells financial products arranged by financial instruments business operators or insurance products arranged by insurance companies, refer to III-3-5-3-1-2(1)(ii)(C).

(ii) Response to procedures

- (A) In cases where the bank receives a request from an external organization for its acceptance of complaint processing or dispute resolution procedures, an investigation of the facts or the submission of relevant materials or the like, whether the bank has developed a control environment wherein it responds to the request promptly in accordance with the rules, etc. of the external organization.
- (B) In cases where the bank refuses a request for its acceptance of complaint processing or dispute resolution procedures, an investigation of the facts, or the submission of relevant materials or the like, whether the bank has developed a control environment wherein it makes a proper decision as an organization with respect to the content of complaints and disputes, the nature of the facts or materials and the rules of external organizations, etc., rather than refusal by the section that caused the complaints or disputes without careful consideration.

Also, whether the bank has developed a control environment wherein it explains the reasons of the refusal wherever possible on the basis of the rules, etc. of the external organization.

- (C) In cases where a proposed solution, such as a reconciliation plan or mediation plan is presented from an external organization that has commenced dispute resolution procedures (hereinafter referred to as a “proposed solution”), whether the bank has developed a control environment wherein it makes prompt decisions on whether or not to accept the proposed solution on the basis of the rules, etc. of the external organization.
- (D) In cases where the bank has accepted a proposed solution, whether the bank has developed a control environment wherein the section in charge takes prompt action, and also the audit section conducts an ex-post review on the status of the progress of its fulfillment, etc.
- (E) In cases where the bank rejects acceptance of a proposed solution, whether the bank has developed a control environment wherein it promptly explains its reasoning and takes necessary action on the basis of the rules, etc. of the external organization.

#### III-3-5-4 Statements in Various Documents

Banks are required to state the details of their response to the financial ADR system in various documents

(such as information for depositors, etc. and pre-contract documents). In cases where there is no designated ADR body, banks are required to state the details of their complaint processing measures and dispute resolution measures in these documents. In addition to this, it should be kept in mind that banks need to include relevant information in the context of their actual situation such as, if, for example, a bank utilizes an external organization, the name and contact information thereof, etc. (in cases where part of the services pertaining to the complaint processing or dispute resolution are entrusted to another organization, then including such other organization).

### III-3-5-5 Administrative Response

Whether or not the control environment with regard to handling complaints, etc., including responses to the financial ADR system, has been established and is functioning is related to the foundation of the bank's sound and appropriate business operation, as well as to the viewpoints of protecting customers and ensuring the bank's reliability. Therefore, associated internal control environments are required to be highly effective.

If the FSA finds a problem in a bank's internal control environment in securing the sound and appropriate operation of the bank's services as a result of comprehensive and continuous reviews on the bank's responses, the FSA, when it deems necessary, will require the bank to submit a report based on Article 24 of the Banking Act. If a serious problem is found, the FSA will consider issuing a business improvement order based on Article 26 of the Banking Act. In addition, if it is identified that the bank commits a serious or malicious violation of any law or regulation, the FSA will take necessary administrative disposition, including issuance of a business suspension order.

In this regard, in cases where there is a designated ADR body, even if the breach or negligence of the obligation to comply with procedures is recognized in the bank, it does not immediately result in administrative disposition as this is primarily the bank's nonfulfillment of the basic contract for the implementation of dispute resolution procedures with the ADR body. Being mindful of that, the FSA will make a relevant judgment by overseeing the bank's responses comprehensively and continuously as mentioned before.

It should also be kept in mind that an individual dispute that arises between a customer and a bank is, in general, a problem pertaining to a private-law contract, and as such, is basically a matter to be resolved between the parties via ADR or other judicial or legal proceedings.

### III-3-6 Development of Environments for Operational Resilience

#### III-3-6-1 Purpose and Significance

“Operational resilience” means the ability of financial institutions to continue to deliver their critical operations (Note 1) at the minimum level that should be maintained even in the event of system failure,



terrorism, cyberattacks, infectious diseases, natural disasters, or other similar events(i.e., tolerance for disruption).(Note 2)

In light of rapid environmental changes in recent years, such as the increasing dependence on IT systems and third parties, etc. (Note 3), pandemics, the increases in cyberattacks and large-scale natural disasters, there is a greater possibility that existing risk management strategies and business continuity plans (BCPs) may not be sufficient to maintain critical operations for the financial system. Thus, it is beneficial to develop a framework for operational resilience while utilizing existing governance scheme (Note4), assuming that business disruption can inevitably occur even after all preventive measures are taken.

In particular, major banks, etc. or entities subject to the international uniform standards (including the highest designated parent companies) need to be aware of ensuring the operational resilience based on the relevant trend of international discussions (Note 5), while also taking account of potential impact on the financial systems and customers both in Japan and abroad.

Each financial institution should decide how to ensure its operational resilience based on its own judgement considering its own size of business, uniqueness of its business, the degree of importance of its operations, and impacts on customers, etc. That is,, it should be noted that there is not any uniform or one-size-fits-all response for financial institutions.

(Note 1) In this section, the term “critical operations” means financial services whose disruption could pose a significant adverse effect on the stability of financial systems or on the everyday lives of end-users.

When a financial institution identifies its critical operations, financial institutions may utilize the existing BCP as well as critical functions which is identified in III-11-4 Measures to Ensure the Continuity of Systemically Important Functions in Orderly Resolution, (which refer to operations to be provided to third parties outside of its group, of which discontinuation could cause a significant disorder in financial systems), while considering the user’s perspective.

Specifically, factors that should be taken into account are: potential impact of disruption of critical operations on the maintenance of the functions of the financial system, the size of the financial institution, its market share, the number of users, the frequency of service use, the institution's revenue and market credibility, and the possibility of service substitution by other institutions.

For instance, under existing BCM frameworks (III-8-2 (2)), certain financial services are considered crucial for maintaining the functions of the financial system. These include the processing of large-lot, large-volume settlements conducted through the interbank market and the interbank settlement system, acceptance of individual users' requests for cash withdrawal and remittance, and bill clearing. Such services could potentially be defined as critical operations in the context of operational resilience.

(Reference) “Discussion Paper on Ensuring Operational Resilience,” April 2023, Financial Services Agency (FSA)

(Reference) “Guidance on Identification of Critical Functions and Critical Shared Services,”

July 2013, Financial Stability Board (FSB)

- (Note 2) The tolerance for disruption of critical operations typically aligns with the Recovery Time Objective (RTO) set in the BCP. However, from the perspective of mitigating the impact on the financial system and users' everyday lives within a certain range, financial institutions can also consider other factors such as scope of business disruption, the number or amount of transactions, and the number of users affected (e.g., the number of complaints from users at the time of business disruption).
- (Note 3) “Third parties, etc.” refer to the outsourced contractors who are engaged in the outsourced operations (including two- or more-tiered outsourcings) that are stipulated in III-3-3-4 and III-3-7-1-2 (8), procurement partners, and service collaboration partners, etc..
- Among them, “critical third parties, etc.” are those who are essential to deliver critical operations at tolerance for disruption e.
- (Note 4) The existing governance scheme here refers to the one stipulated, for instance, in III-1 Governance, III-2-3 Risk Management (especially III-2-3-7 Operational Risk Management), III-3 Appropriateness of Business Operations, etc. (especially III-3-1 Legal Compliance (for Especially Important Matters), III-3-3-4 Outsourcing, III-3-7 Information Technology (IT) System Risk, and III-3-10 System Integration Risk and Project Management), III-8 Business Continuity Management (BCM), and III-11 Ensuring Smooth Implementation of Orderly Resolution, etc. as examples.
- (Note 5) “Principles for operational resilience,” March 2021 and “Revisions to the principles for the sound management of operational risk,” March 2021, The Basel Committee on Banking Supervision

### III-3-6-2 Major Supervisory Viewpoints

- (1) Whether the board of directors, etc. has identified the critical operations from the viewpoint of operational resilience.
- (2) Whether the board of directors, etc. has established the risk appetite, and then, with regard to financial services identified as critical operations, whether the board of directors, etc. has established the minimum level to be maintained as the “tolerance for disruption” on the assumption that the business disruption can inevitably occur even after all measures are taken. For example, whether relevant factors including the recovery time during business disruption, the scope of the business disruption, the number of affected transactions, the amount of such transactions, and the number of users affected.
- (3) Whether the board of directors, etc. has identified the internal and external management resources that are necessary to perform the critical operations at the tolerance for disruption as described in (1)

above. Specifically, whether the board of directors, etc. has employed and assigned relevant employees and officers who have necessary expertise and has ensured that it has the appropriate budget, facilities, and systems. In addition, whether the board of directors, etc. has identified and mapped the interconnection and interdependence among the necessary management resources (both internal and external management resources; including external management resources such as those of third parties, etc.) to perform the critical operations at the level of tolerance for disruption as mentioned above.

- (4) Whether the board of directors, etc. regularly and cross-organizationally verifies the appropriateness of respective setups and allocations of risk appetite, critical operations, tolerance for disruption, and necessary management resources through the analysis and training to be conducted under extreme but plausible scenarios, and revises them or takes additional measures as needed.

### III-3-6-3 Supervisory Methods and Measures

As a result of an on-site inspection or misconduct notifications, etc., a problem relating to a bank's operational resilience is revealed, the FSA will require the bank to submit detailed reports based on Article 24 of the Banking Act, if it deems necessary. If a serious problem is found, the FSA will issue a business improvement order or implement any other measures based on Article 26 of the Banking Act.

### III-3-7 Information Technology (IT) System Risk

#### III-3-7-1 Information Technology (IT) System Risk

##### III-3-7-1-1 Purpose and Significance

Information technology (IT) system risk is the risk of loss incurred in customers and banks because of system adequacies, including a computer system breakdown or malfunction, or because of inappropriate or illegal use of computer systems. As IT systems used by banks are becoming increasingly advanced and complex in line with the integration of computer systems due to mergers and other management restructuring and an expansion of the range of new products and services, the risk of illegal access and leaks of important information has been increasing further with an expansion of computer networks.

In particular, computer systems of major banks, which are originally equipped with advanced functions, tend to be large in scale and complicated in configuration because they are required to process a huge volume of data. In addition, as the system configuration and operational environment become more complicated due to cumulated management restructuring, major banks are particularly required to address various issues related to IT systems appropriately. If a system failure or cyber-security incident occurred in a major bank, it would have an extremely huge impact not only on users' social and economic lives and

corporations' economic activities but also on Japan's economy as a whole. In addition, the impact would not be limited to a single bank but spread over the whole financial system. The secure and stable operation of IT systems is a basic premise for ensuring public confidence in the financial settlement system and banks, and that is why it is extremely important to enhance and strengthen the control environment for managing IT system risk.

Furthermore, taking into account the recent change in environments surrounding the financial industry, the IT strategies of financial institutions are, now, key factors affecting their business models. As such, there are increasing needs in financial institutions to consider business strategies integrally with IT strategies. From these viewpoints, it is very important that "IT governance," which is a framework allowing the management of a bank to show leadership and to create corporate value by linking information technologies to management strategies, works properly and well.

Note: "Cybersecurity incidents" refer to instances of cybersecurity being threatened by so-called "cyberattacks," including unauthorized intrusion, theft, modification and destruction of data, failure or malfunction of information systems, execution of illegal computer programs, and DDoS attacks, committed via the Internet through malicious use of information communication networks and information systems.

(Reference) Discussion Paper on Dialogues and Practices Regarding IT Governance at Financial Institutions (June, 2019)

### III-3-7-1-2 Major Supervisory Viewpoints

#### (1) Recognition of IT system risk

- (i) Whether officers and employees, including the representative director, have fully recognized the importance of IT system risk, reviewed it regularly, and formulated a basic policy for the bank-wide management of IT system risk.
- (ii) Whether the representative director has recognized that prevention and efforts for rapid recovery from an IT system failure and cybersecurity incident (hereinafter referred to as "system failure") is an important issue for the management of the bank, and developed an appropriate control environment.
- (iii) Whether the board of directors has appointed a person who has sufficient knowledge and experience relating to the IT system to properly perform the relevant work as a director who takes overall responsibility for the IT system upon fully recognizing the importance of managing the IT system risk.
- (iv) Whether the representative director and directors (or executive officers in cases where the bank is a company with a nominating committee, etc.) have determined their specific responsibility to assume and the response to take in case of a crisis in which a system failure occurs.  
Also, whether they conduct drills giving directions by themselves and ensure the effectiveness thereof.

(2) Control environment for managing IT system risk

- (i) Whether the board of directors has established the risk management environment while fully understanding that, due to the highly networked computer system, if risk becomes apparent, the impact will cause a chain reaction, spread widely and seriously, and badly affect the management of the bank.
- (ii) Whether the bank has established a basic policy for managing IT system risk, and whether the basic policy for managing IT system risk contains the security policy (a basic policy for proper protection of information assets of an organization) and the outsourcing policy.
- (iii) Whether the bank is basing the details of its control environment for managing IT system risk on criteria that allow it to judge objective levels of its details.

Also, whether the bank revises, on a continual basis, its control environment for managing IT system risk according to the identification and analysis of system failures, results of implementation of risk management, progress of technology, etc.

(3) Assessment of IT system risk

- (i) Whether the section in charge of managing IT system risk recognizes and assesses risks periodically and in a timely manner by recognizing the fact that risks are becoming diverse due to changes in the external environment, such as seen in the examples of system failures induced by large-scale transactions as a result of increased customer channels and efforts to enhance information networks that bring about more diverse and broad-based impacts.

Also, whether it takes sufficient measures to address the risks that have been identified.

- (ii) Whether the section in charge of managing IT system risk checks and manages the upper limit of the transactions through the computer system, such as the number of unrecorded transactions in a bank book per account to be kept in the system, and whether it reviews the countermeasures from the IT system aspect and the administrative work aspect in cases where the transactions exceed the upper limit.
- (iii) Whether the section in charge of product development cooperates with the section in charge of managing IT system risk at the time of introduction of a new product or alternation of the content of an existing product, and also, whether the section in charge of managing IT system risk evaluates the relevant IT system regardless of whether the system is newly developed or not.

(4) Management of information security

- (i) Whether the bank has made a developed policy, instilled organizational readiness, and introduced in-house rules and a developed internal control environment, in order to appropriately manage information assets. Also, whether it is making continuous efforts to improve its information security control environment through the PDCA cycle, taking notice of illegal incidents or lapses at other companies.

- (ii) Whether the bank manages information security by designating individuals responsible for it and clarifying their roles/responsibilities in an effort to maintain the confidentiality, integrity, and availability of information. Also, whether the individuals responsible for information security are tasked with handling the security of IT system, data, and network management.
- (iii) Whether the bank takes measures to prevent unauthorized use of computer systems, unauthorized access, and intrusion by malicious computer programs, such as computer viruses.
- (iv) Whether the bank identifies important customer information that it is responsible for protecting in a comprehensive manner, keeps its records, and manages them.

Whether the scope of important customer information to be identified by the bank covers information and data used in the course of business operations or stored in IT systems and kept by external contractors and includes data, for example, as listed below;

- Data stored in the areas within the IT system that are not used in ordinary operations;
  - Data output from the IT system for analyzing system failures; and
  - Transaction logs stored in ATMs (including those outside of branches), etc.
- (v) Whether the bank assesses important points and risks regarding important customer information that has been identified.

Also, whether it has developed rules to manage information, such as that listed below, in accordance with the importance and risks of each information;

- Rules to encrypt or mask information;
  - Rules for utilizing information; and
  - Rules on handling data storage media, etc.
- (vi) Whether the bank has introduced measures to discourage or prevent unauthorized access, unauthorized retrieval, data leakage, etc. such as those listed below, for important customer information;
  - Provision of access rights only to employees who need access according to their authority;
  - Storage and monitoring of access logs; and
  - Introduction of mutual checking functions, such as by separating the individuals in charge of development and those responsible for operations, system administrators and system users, etc.
  - (vii) Whether the bank has established rules for controlling confidential information, such as encryption and masking. Also, whether it has developed rules regarding the management of encryption programs, encryption keys, and design specifications for encryption programs.

Note that "confidential information" refers to any information that may cause damage or loss to customers if it is disclosed or stolen, including PINs, passwords, credit card information.

- (viii) Whether the bank gives due consideration to the necessity of holding/disposing of, restricting access to, and taking outside, of confidential information, and treats such information in a stricter manner.
- (ix) Whether the bank periodically monitors its information assets to see whether they are managed properly according to management rules, etc. and reviews the control environment on an ongoing

basis.

- (x) Whether the bank conducts security education (including security education at external contractors) to all officers and employees in order to raise awareness of information security.

(5) Management of cybersecurity

- (i) Whether the board of directors, etc. has developed the necessary control environment upon recognizing the importance of cybersecurity amid increasingly sophisticated and cunning cyberattacks.
- (ii) Whether the bank has developed the control environment for managing cybersecurity, such as those listed below, in addition to making the organization more secure and introducing in-house rules.
  - Monitoring systems against cyberattacks;
  - Systems for reporting and public relations when cyberattacks occur;
  - Emergency measures by an in-house Computer Security Incident Response Team (CSIRT) and systems for early warning; and
  - Systems for collecting and sharing information through information-sharing organizations, etc.
- (iii) Whether the bank has developed a multi-layered defense system against cyberattacks that combines security measures respectively for inbound perimeter control, internal network security control, and outbound perimeter control.
  - Security measures for inbound perimeter control (e.g., introduction of a firewall, anti-virus software, intrusion detection system, intrusion protection system etc.);
  - Security measures for internal network security control (e.g., proper management of privileged IDs/passwords, deletion of unnecessary IDs, monitoring of execution of certain commands, etc.); and
  - Security measures for outbound perimeter control (e.g., retrieval and analysis of communication/event logs, detecting/blocking inappropriate communication, etc.)
- (iv) Whether measures such as those listed below are implemented to prevent spreading damage when cyberattacks occur.
  - Identification and blocking of IP addresses from which the cyberattacks originate;
  - Functions to automatically decentralize access against DDoS attacks; and
  - Temporary suspension of the entire or part of the system, etc.
- (v) Whether necessary measures for vulnerabilities in the system, such as updating of the operating system and application of security patches, are introduced in a timely manner.
- (vi) Whether the bank, as part of cybersecurity measures, assesses its security levels by using relevant tests on network intrusion, vulnerability scanning, or penetration tests, etc. and make efforts to improve security.
- (vii) In cases where the bank executes transactions via communication methods such as the internet without any face-to-face contact, whether the bank takes the security measures described in III-

3-8-2(2) or III-3-9-2(2).

For information, the following cases of security measures using authentication methods and anti-fraud measures are described in the agreements or guidelines, etc. of the Japanese Bankers Association.

- Authentication methods that do not rely on fixed IDs/passwords, such as variable passwords and digital certificates;
- Transaction authentication through multiple channels by using, for example, devices other than a PC web browser used in transactions, such as a mobile phone;
- Transaction authentication using transaction signatures by means of a hardware token, etc.;
- Adoption of methods to store digital certificates on media or devices separate from PCs used in transactions, such as IC cards;
- Provision of security software that allows users to detect and remove viruses, etc. when executing transactions;
- Introduction of software that allows the bank to detect virus infection of the user's PC and issue a warning;
- Introduction of a system that allows the bank to detect unauthorized log-ins, irregular transactions, etc. and promptly notify such anomalies to users.

Note: it is desirable to avoid using authentication methods on the internet that use information with a small number of combinations like a cash card PIN as a storage element.

- (viii) In order to prevent unauthorized use of internet banking, etc., whether appropriate procedures are established to not allow unauthorized registration and change of information used for notification of depositors or personal identification, such as a telephone number or an email address.
- (ix) Whether the bank has developed contingency plans against potential cyberattacks, and conducts drills and reviews such plans. Also, whether it participates in industry-wide exercises as necessary.
- (x) Whether the bank has formulated and implemented plans for fostering and developing human resources responsible for cybersecurity.

(6) IT system planning/development/management

- (i) Whether the bank has clearly established a policy for IT system strategy as part of its business strategy, and then established medium- to long-term development plans.  
Also, whether such medium- to long-term development plans have been approved by the board of directors.
- (ii) Whether the bank has been making continuous efforts to identify the risks inherent in the current IT system and to make investment in maintaining and improving it systematically.
- (iii) Whether rules to authorize plans, development, and transitions of IT system development projects are clearly established.



- (iv) Whether the bank appoints and assigns a responsible person to each IT system development project and manages the project according to the development plan.
- (v) In developing IT systems, whether the bank creates test planning and conducts tests in an appropriate and sufficient manner, such as by involving user divisions.
- (vi) With regard to development of human resources, whether the bank creates and implements specific plans for developing human resources with expertise for succession of the current IT system structure and technology.

(7) IT system audit

- (i) Whether an internal audit division that is independent from the IT systems division conducts periodic audits of IT systems.
- (ii) Whether the bank conducts internal audits by computer system experts and utilizes external audits by IT system auditors, etc.
- (iii) Whether the audit covers all business operations related to IT system risk.
- (iv) Whether the results of the IT system audit are reported to the board of directors in a proper manner.

(8) Management of outsourcing relating to IT system

- (i) In selection of outsourcing contractors (including system-related subsidiaries), whether the bank selects after evaluation and consideration based on selection standards.
- (ii) In the outsourcing contract, whether the bank stipulates the division of roles and responsibilities with the outsourcing contractor, audit authority, subcontracting procedures, and level of services provided, etc. Also, whether the bank presents the rules and security requirements to the outsourcing contractor so that its officers and employees comply, and stipulates them in the contract, etc.
- (iii) Whether risk management is carried out properly in outsourced IT system work (including work sub-outsourced).

In particular, where the bank outsources IT system work to multiple contractors, whether the bank has developed a control environment upon fully understanding the situation in which related administrative work becomes more complicated,

In cases where the bank outsources IT system administration, whether the bank properly manage the risk thereof in the same manner as outsourcing of IT system work.

- (iv) Whether the bank, as an entrustor, periodically conducts monitoring to ensure that outsourced work (including further sub-outsourced work) is carried out appropriately.

Also, whether the bank takes necessary measures not to leave everything to contractors by, for example, deploying its staff as an entrustor at a contractor office, etc. In particular, whether the bank receives reports on the status of internal management, and development and operation of the shared system center.

Also, for developing a shared system, etc., whether a control environment is in place that allows the bank, as an entrustor, to monitor and track the status of customer data being processed at outsourcing contractors.

- (v) Whether the bank conducts audits on its important outsourcing contractors such as the shared system center by its internal audit division or IT system auditors, etc.

Note: The abovementioned items would apply to cases where the bank uses an external service such as integrated ATM switching service.

(9) Contingency plan

- (i) Whether the bank has developed a contingency plan and established arrangements and procedures for emergency situations.
- (ii) When developing a contingency plan, whether its content is based on information that could be judged at an objective level (e.g., "Manual for the Development of Contingency Plans in Financial Institutions (Plans for Measures in the Event of Emergencies)" compiled by the Center for Financial Industry Information Systems).
- (iii) When developing a contingency plan, whether the bank assumes not only contingencies due to natural disasters but also system failures due to internal or external factors.

Also, whether the bank assumes sufficient risk scenarios, such as a case of major delay in batch processing.

- (iv) Whether the bank reviews assumed scenarios in its contingency plan by, for example, taking into consideration case studies of system failures at other financial institutions and results of deliberations at the Central Disaster Management Council, etc.
- (v) Whether the bank periodically conducts drills on the basis of the contingency plan at the corporate level, jointly with outsourcing contractors, etc., such as the shared system center.
- (vi) Whether the bank introduced off-site backup systems, etc. in advance for important systems whose failure could seriously affect business operations, and has developed a control environment to promptly continue business operations in the event of disasters and system failures, etc.

(10) Response to IT system failures

- (i) Whether the bank has taken appropriate measures to avoid causing unnecessary confusion among customers when system failures occur.

Also, whether the bank has developed a control environment to take necessary measures accordingly, upon assuming a worst-case scenario in preparation for system failures.

- (ii) Whether the bank has clarified reporting procedures and the framework of command and supervision including at the outsourcing contractors in preparation for system failures.
- (iii) In cases where a system failure that would significantly affect its business operations occurs, whether the bank has developed a control environment to promptly notify the representative

director and other directors and report the maximum risk that could occur under the worst-case scenario (for example, if there is a possibility that the failure could gravely affect their customers, the reporting persons promptly report the maximum possibility without underestimation of the risk).

In addition, whether the bank has developed a control environment to launch a task force where necessary, and the representative director and other directors give appropriate instructions and orders, and promptly resolve the issues.

- (iv) Whether the bank has made mutual support for preparation of system failures clear, such as through prior registration in order to promptly gather human resources with know-how and experience from the IT systems division, other divisions, and outsourcing contractors.
- (v) In cases where system failures occur, whether the bank has published the content and causes of the failure, expected recovery time, etc. and has established a call center to properly respond to inquiries from their customers where necessary.

Also, whether the bank has made the methodology of providing information to the relevant business divisions in preparation for system failures clear.

- (vi) Whether the bank has conducted analysis of causes of system failures, investigation about the impact until recovery, corrective action, and preventive measures for recurrence in a proper manner.

Also, whether the bank has periodically analyzed tendencies of factors that have led to system failures and taken measures according to them.

- (vii) Whether the bank has established a systematic framework to minimize impacts of system failures such as a system to bypass the affected part.

(Reference) As an example of reference materials relating to IT system risk, “FISC Security Guidelines on Computer Systems for Banking and Related Financial Institutions” (The Center for Financial Industry Information Systems) may be taken.

### III-3-7-1-3 Supervisory Methods and Measures

#### (1) When system failure occurred

##### (i) General response

- (A) Upon recognizing the occurrence of an IT system failure or cybersecurity incident, the bank will be required to immediately notify the authority of the fact and then to submit a report to the authority in the form of the “Report on Occurrence of System Failure, etc.” (Form 4-45 in the Forms and Reference Information).

In addition, the bank will also be required to make a report upon recovery of the system or identification of the cause of the IT system failure. Even if the causes are not identified, the bank will be required to make a report on the status within one month from the occurrence of the IT system failure.

Note: IT system failures that should be reported:

Failure or trouble that occurs in the IT systems and devices (both hardware and software) currently used by the bank, regardless of the cause and;

- a. that delays or suspends, or may delay or suspend repayment of deposits or the settlement function of funds transfer transactions;
- b. that affects or may affect its cash flow and grasp of financial situations, etc.; or
- c. that may otherwise be deemed similar to the above in the course of business.

This reporting requirement, however, does not apply, provided that, even when a part of an IT system or device fails or has problems, there is no substantial impact or damage because the affected part is able to be promptly replaced by another system or device (e.g., cases where even when some ATMs are out of service, users can access banking services at other ATMs or the counter of the same branch or nearby branch.)

In the meantime, the bank will be required to make a report, even though failure or trouble does not actually occur, when its customers or business operations are affected or likely to be affected because it receives an advance notice of a cyberattack or it found a cyberattack in its IT system.

(B) The FSA will require the bank to make an additional report pursuant to Article 24 of the Banking Act, when it deems necessary, and if a serious problem is found, the FSA will issue a business improvement order pursuant to Article 26 of the Banking Act.

(ii) Emergency response

In particular, when a large-scale system failure has occurred, or when it takes considerable time for the bank to identify the causes of the failure, the FSA will require the bank to make a prompt identification of the causes and recovery as well as to make a report pursuant to Article 24 of the Banking Act, while immediately monitoring the status of implementing a contingency plan, such as general publication of the facts of the failure and customer relations at the branches.

Additionally, in cases where there is uncertainty about recovery from a large-scale system failure which is seriously affecting market transactions and a settlement system, such as ATM transactions, bank transfers, or remittance of salaries, the FSA will take actions to consider issuing a business improvement order promptly based on Article 26 of the Banking Act.

(2) Updates of IT systems

When the bank intends to update its important IT systems, etc., the FSA, if it deems necessary, will require the bank to make a report based on Article 24 of the Banking Act and confirm the planning and progress as well as appropriateness and feasibility of the project management thereof.

(3) When a problem is found

As a result of on-site inspection results, etc., a problem relating to a bank's control environment for IT system risk is revealed, the FSA will require the bank to submit detailed reports based on

Article 24 of the Banking Act, if it deems necessary. If a serious problem is found, the FSA will issue a business improvement order or implement any other measures based on Article 26 of the Banking Act.

(4) Response to outsourcing contractors

When it deems necessary, for example, in cases where there is a concern that outsourcing contractors fail to properly operate outsourced work relating to IT systems, the FSA will take actions based on III-3-3-4-3.

III-3-7-2 Security for ATM System

III-3-7-2-1 Purpose and Significance

The ATM system provides various banking services in a simple and prompt manner, and it is very convenient for customers and widely used by them. On the other hand, transactions via the ATM system, which are executed without face-to-face contact, have inherent risks, including the difficulty of confirming irregular transactions.

Financial institutions are required to manage customers' assets safely in the course of providing financial services. They are, therefore, encouraged to take sufficient information security measures for the ATM system from the viewpoint of ensuring customer protection, while securing users' convenience. In this regard, the Depositor Protection Act (Act on Protection of Depositors from Unauthorized ATM Withdrawals Using Counterfeit or Stolen Cards, etc.) stipulates that banks are responsible for development of necessary IT systems, provision of relevant information to customers, raising of their awareness, and dissemination of knowledge among them to prevent the occurrence of unauthorized ATM withdrawals, etc. using counterfeit or stolen cards, etc.

Additionally, banks need to take security measures considering the fact that if a certain financial institution leaves its ATMs vulnerable in security, it may adversely affect other financial institutions because ATMs are interconnected among financial institutions via the integrated ATM switching service.

III-3-7-2-2 Major Supervisory Viewpoints

(1) Development of internal control environment

In light of the changing situation with more sophisticated crime techniques, etc., whether the bank positions preventive measures against illegal withdrawals using counterfeit cash cards, etc. as one of the highest priority management issues that the bank must address and implements necessary reviews at the board of directors to improve the security level. Also, to secure sound and proper ATM system operations, whether the bank has each division share information on the current status thereof and has a control environment to address it in the entire bank.

Whether the bank has developed the necessary control environment after conducting reviews according to the characteristics of its customers and operations based on the situation of crime occurrence.

Furthermore, whether the so-called “PDCA cycle” is functioning in terms of risk analysis and security measures, which is composed of plan, do, check, and act.

(Reference) PDCA cycle shown at the Study Group on Cyber Security

- (i) Identifying and understanding risks attributable to financial institutions (development of internal control environment, framework of IT system development, attributes of IT system and outsourcing of IT system configuration, etc.);
- (ii) Identifying and understanding risks regarding use of ATMs (upper limit of transaction amount, operating hours, locations of ATMs, crime occurrence in areas surrounding the ATMs, etc.);
- (iii) Determining the priority as to what kind of crime or risk should be addressed based on the risk characteristics mentioned above;
- (iv) Implementation of measures; and
- (v) Review of the effect of measures and improvement.

## (2) Securing security

Whether the bank has evaluated the security level of its cash cards and ATM system according to relevant criteria. And whether the bank has taken proper measures to keep it safe and proper by reviewing it from the IT system aspect and the technology aspect based on the results of the evaluation. For this, whether the bank has taken measures suitable to the characteristics of its customers and operations while identifying the risk arising at the time of structuring the IT system and each phase of use thereof based on the discussions at the Study Group on Cyber Security. Also, whether the bank aims at improving security as a whole rather than taking individual measures in an impromptu manner.

Whether the bank has taken proper measures to prevent unauthorized withdrawals including introduction of appropriate authentication technology, prevention of information leaks, and early detection of irregular transactions based on the Depositor Protection Act. In this case, whether the bank has taken care not to impose an excessive burden on customers, and makes efforts to avoid causing inconvenience for customers by assuring compatibility, etc.

Whether the bank has taken security measures according to the risk if high-amount transactions with high risk are available at ATMs. In particular, whether the bank has considered methods to enhance the security of magnetic cards which are pointed out to be vulnerable in terms of security. For an internationally active bank, whether it has implemented necessary reviews while considering measures in line with international security trends.

(Reference 1) As an example of the security standards, “FISC Security Guidelines on Computer Systems for Financial Institutions” (The Center for Financial Industry Information Systems) may be taken.

(Reference 2) Materials at the Study Group on Cyber Security can be used as references in identifying and understanding the risks.

(3) Response to customers

Whether the bank has established a control environment to provide sufficient customer explanation about various risks associated with use of cash cards, such as skimming, theft of PIN number and card, use of easily assumable PIN number, possibility of damage expansion (against which the bank could introduce an upper limit of the amount to be transferred or withdrawn at an ATM), and other problems caused from having too many cards.

Whether the bank has established a control environment for promptly receiving and processing notifications from customers. Also, whether the bank has developed a control environment for promptly disseminating necessary information to customers (including public announcement) when needed. In particular, when it is possible to identify customers who are likely to be victimized by a crime, whether the bank takes measures to minimize damage by informing them of such concern as soon as possible.

Whether the rules concerning compensation for loss or damage caused by unauthorized withdrawal are clear and specific as much as possible based on the Depositor Protection Act. Also, whether a control environment is in place to disseminate and make the contents of the rules known to customers sufficiently.

- (i) Whether the bank conducts a necessary review of the policies and standards relating to response to customers and cooperation with investigative authorities after a crime occurs in consideration of the bank's own stance toward anti-crime measures, etc.
- (ii) Whether the bank has determined uniform rules and procedures of compensation for loss or damage caused by unauthorized withdrawals, if any, in the terms and conditions of transaction or the customer policy, etc.
- (iii) Whether the bank has a control environment in place to respond to customers properly and promptly by establishing a dedicated customer contact center, etc. In asking victimized customers for cooperation in providing information, whether the bank is mindful of their age, physical and mental conditions, etc.

Whether the bank properly preserves the records of unauthorized withdrawals and is prepared to cooperate sincerely with customers and investigative authorities when asked by them to offer the recorded materials, etc.

(4) Actions when operation and maintenance of the ATM system are outsourced

When the bank has outsourced its ATM system, whether the bank reviews the outsourcing risk and takes necessary security measures.

(1) When crime occurred

Promptly after recognizing an illegal withdrawal using a counterfeit or stolen cash card, the bank shall be required to make a report to the authorities in the form of a “crime report.”

(2) When a problem is found

If inspection results, crime reports, etc. reveal doubt over the bank’s control environment relating to the security and anti-crime measures for its ATM system, supervisors shall require the bank to submit additional reports under Article 24 of the Banking Act, as needed. If a problem is still found from the viewpoint of customer protection, such as that the bank fails to conduct a necessary review of anti-crime measures and take action after the crime occurs, or that many crimes are reported, supervisors shall take such action as issuing a business improvement order under Article 26 of the Banking Act.

Note: When the bank has outsourced its ATM system, supervisors will take actions under III-3-3-4-3, as needed.

(Reference)

- “Final Report of Study Group on Counterfeit Cash Card Problems” (June 24, 2005 by Study Group on Counterfeit Cash Card Problems)
- “Agreement on Protection of Depositors concerning Counterfeit/Stolen Cash Cards” (October 6, 2005 by the Japanese Bankers Association)
- “Crime Prevention Standards for Financial Institutions” (National Police Agency)
- “The JBA’s IC cash card standard specification” (the Japanese Bankers Association)

### III-3-7-3 Use of Interbank System/Network

#### III-3-7-3-1 Purpose and Significance

Currently, the interbank (including financial institutions) system/network serves as an essential infrastructure for banks to settle financial transactions and to maintain CD/ATM online alliance with other banks and financial institutions. If a failure occurred in the system/network, the impact would spread over the whole settlement system and all services provided to customers. That is why it is critically important to enhance the risk management environment relating to this system/network.

#### III-3-7-3-2 Major Supervisory Viewpoints

- (1) When using services of the interbank system/network including the integrated ATM switching service or the Zengin Data Telecommunication System, etc., whether the bank has implemented proper risk management in the same manner as when it outsources its own IT systems.



- (2) In particular, when the IT system of such external service is renewed or changed, whether the bank fully evaluates and confirms that proper actions are in place on the system both at the administrator of such external service and at the bank in order not to cause any inconvenience or impact on its customers and operations. And, when needed, whether it requires the administrator of the external service to take proper actions.
- (3) In particular, when the bank plays a leading role in operation, renewal, or change of such external service, whether it has developed proper and sufficient control environments for risk management and project management together with the administrator of such external service in order not to adversely affect customer services or the settlement system in Japan.

### III-3-7-3-3 Supervisory Methods and Measures

If inspection results, etc. reveal doubt over a bank's sound and proper business operation relating to the system/network, the bank shall be required to submit detailed reports under Article 24 of the Banking Act, as needed. If a serious problem is found, supervisors shall issue a business improvement order or implement any other measures under Article 26 of the Banking Act. Also when the bank plays a leading role in operation, renewal, or change of such external service, if a doubt arises relating to the risk management environment for such system network, the same actions shall be taken.

Note: Among administrators of the external system/network, with respect to those who fall under the scope of outsourcing contractors, if there is concern about their business operation, supervisors shall take actions under III-3-3-4-3.

### III-3-8 Internet Banking

#### III-3-8-1 Purpose and Significance

The Internet is, for financial institutions, a tool enabling them to provide low-cost services and for users, a useful transaction tool. On the other hand, Internet banking transactions, which are executed without face-to-face contact, have risks peculiar to an online environment, such as that it is difficult to check abnormal transactions.

Financial institutions are required to manage customers' assets safely in the course of providing financial services. Therefore, it is important for them to take sufficient security measures for Internet banking as well as to provide customers with relevant information, enlightenment, and knowledge from the viewpoint of securing user protection, while securing user convenience.

#### III-3-8-2 Major Supervisory Viewpoints

(1) Development of internal control environment

In light of the fact that cybercrime through Internet banking become increasingly sophisticated and cunning, whether the bank positions anti-crime measures via the Internet banking service as one of the highest priority management issues and implements a necessary review at the board of directors to improve the security level. Whether it has developed a control environment to provide customers points of attention in using the Internet banking service. Also, to secure sound and proper operation of Internet banking, whether the bank has a control environment in place to have each division share information on its current status and to address it in the entire bank.

For this, whether the bank provides and collects information on crime occurrence and techniques via information-sharing organizations and shares effective countermeasures with them. And then, whether it endeavors to develop the necessary control environment by conducting a review according to the characteristics of its customers and operations and while considering preventive actions against future crime incidents and techniques.

In addition, in this connection, whether the PDCA cycle works well, which is composed of conducting risk analysis, setting a plan, practicing, and evaluating and reviewing the security measures.

(2) Ensuring security

Whether the bank has taken measures according to the characteristics of its customers and operations while identifying the risk arising at the time of structuring its IT system and each phase of use thereof based on the content of discussions at the Study Group on Cyber Security. Also, whether the bank aims at, rather than taking individual measures in an impromptu manner, improving the security as a whole by combining multiple effective measures as well as determining the necessity and kinds of measures to take prompt actions upon recognizing and evaluating the existence of risks sufficiently.

Whether the bank has a control environment in place to prepare a security program for Internet banking and to verify the effectiveness thereof against various crimes and then to revise it as needed. In addition, whether the bank takes security measures suitable for each transaction risk based on the JBA's agreements while considering the attributes of customers, whether individuals or corporations, according to the program, etc. For this, whether the bank considers the trends in crime, such as crime becoming increasingly sophisticated and cunning ("man in the middle attack" or "man in the browser attack," etc.).

Whether links of the bank's webpage are configured to prevent a user from misrecognizing a counterparty to a transaction. In addition, whether the bank takes proper anti-phishing measures suitable for its business, such as providing for measures to allow users to verify the authenticity of the Web site accessed.

Note: In order for banks to collect information, surveys, etc. of relevant financial organizations or the Center for Financial Industry Information Systems, reviews or discussions at the Study Group on

Cyber Security and at the Financial Institution Anti-Crime Liaison Council, and information given by the FSA and Police can be used.

(Reference)

- JBA's "Agreements" on Improvement and Enhancement of Security (January, 2012; November, 2013; May, 2014; July 2014, etc.)
- Matters to be Considered in Internet Banking (the Japanese Bankers Association)
- FISC Security Guidelines on Computer Systems for Financial Institutions (The Center for Financial Industry Information Systems)
- Materials at the Study Group on Cyber Security

(3) Response to customers

Whether the bank has established a control environment to provide sufficient customer explanation about various risks associated with the use of Internet banking, such as phishing of personal information including PIN number, use of easily assumable PIN number, possibility of damage expansion (against which the bank could introduce an upper limit of amount to be transferred through the Internet banking service), and cautions to customers, including dissemination of anti-fraud security actions they are required to take.

Whether the bank takes measures enabling customers to check the transaction records timely in order for them to detect crime early by themselves.

Whether the bank has established a control environment for promptly receiving and processing notifications from customers. Also, whether the bank has developed a control environment for disseminating necessary information to customers (including public announcement) when needed, in a prompt and easily understandable manner. In particular, when it is possible to identify customers who are likely to be victimized by a crime, whether the bank takes measures to minimize damage by informing them of such concern as soon as possible.

Whether the bank monitors periodically if its anti-fraud measures are widely disseminated among users and takes additional measures for further dissemination.

With regard to the compensation for loss or damage caused by fraud transactions, whether the bank has established a policy to respond to individual and corporate customers, and is prepared to conscientiously respond to them, from the viewpoint of customer protection, based on the purposes of the Depositor Protection Act and JBA's relevant agreements.

Whether the bank properly preserves the records of fraud transactions and is prepared to cooperate sincerely with customers and investigative authorities when asked by them to offer the recorded materials, etc.

(4) Others

Whether the bank has introduced a customer management system such as verification at the time of transaction considering that transactions via Internet banking services are executed without face-to-face contact.

When the bank has outsourced its Internet banking system, whether it reviews the outsourcing risk and takes necessary security measures.

(Reference)

- Matters to be Considered in Internet Banking (the Japanese Bankers Association)
- FISC Security Guidelines on Computer Systems for Financial Institutions (The Center for Financial Industry Information Systems)
- Measures on Illicit Deposit Withdrawals (February 19, 2008 by the Japanese Bankers Association)
- Compensation concerning Unauthorized Withdrawal of Deposits, etc., through Internet Banking Services to Corporations (Jul 17, 2014 by the Japanese Bankers Association)

### III-3-8-3 Supervisory Methods and Measures

#### (1) When crime occurred

Promptly after recognizing a fraud transaction through Internet banking, the bank shall be required to make a report to the authorities in the form of a “crime report.”

#### (2) When a problem is found

If inspection results, crime reports, etc. reveal doubt over a bank’s sound and proper business operation relating to its Internet banking service, supervisors shall require the bank to submit additional reports under Article 24 of the Banking Act, as needed. If a problem is still found from the viewpoint of customer protection, such as that the bank fails to conduct a necessary review on anti-crime measures and action after the crime occurs, and that many crimes are reported, supervisors shall take such action as issuing a business improvement order under Article 26 of the Banking Act.

Note: When the bank has outsourced its Internet banking system, supervisors will take actions under III-3-3-4-3, as needed.

### III-3-9 Cooperation with External Payment Service Providers

#### III-3-9-1 Significance

Along with the development of fintech, a large number of players have appeared who provide settlement services linked with deposit accounts through internet account transfer services, etc. using smartphone applications, etc.

(hereinafter referred to as "linked services").

While these linked services will provide highly convenient financial services to users, which contributes

to realizing a cashless society, there have been crimes targeting linked services, such as fraudulent transactions by impersonating a depositor of a linked deposit account. Therefore, it has become an important issue for both banks and linked service providers to understand the risks of the overall linked services and ensure their security.

In order to protect customers and to secure the trust of deposit accounts, banks need to take security measures related to linked services. In such cases, it is necessary to cooperate with linked service providers and achieve both customer protection and user convenience, based on the following points specific to linked services.

- Although the linked services are provided by the linked service provider to users, banks need to establish the control environment for customer protection together with linked service providers, taking into account that the users of the linked services are depositors.
- There is a risk of damage to depositors who do not use internet banking, depending on the form of fraudulent transactions related to the linked services.
- It is necessary to understand the risks of the entire linked services and take measures at each stage of the linked services, such as linking with deposit accounts, transferring accounts to linked services, monitoring of fraudulent transactions, and responding to customers and compensating for fraudulent withdrawals, etc.

Note: Although banks are conducting fund transfers with business operators other than linked service providers based on account transfer agreements, etc., it should be noted that even in such cases, banks need to appropriately understand risks related to impersonation of depositors and fund transfers under such account transfer agreements, etc., and take measures according to the characteristics of such risks and services, based on the purpose of these Supervisory Guidelines.

### III-3-9-2 Main Supervisory Viewpoints

#### (1) Internal Control Environment

- (i) In light of the increasing sophistication of criminal activities such as fraudulent transactions related to deposit accounts, whether measures related to linked services are positioned as one of the highest priority management issues, and efforts are made to provide services that balance safety and convenience by conducting necessary reviews at the Board of Directors, and by improving the security level.
- (ii) Whether the bank has developed a control environment to confirm that the linked service provider appropriately operates linked services, by such actions as clarifying the responsible department for the linked services or monitoring, on a regular or as-needed basis, and the status of implementation of operations related to the linked services (including the status of implementation of operations at the linked service provider (including cases where the linked service is changed)).
- (iii) Whether the bank has established a control environment for ensuring the sound and appropriate

management of business operations related to linked services, by such actions as collecting and analyzing information about the occurrence of fraudulent transactions, the modus operandi of criminal activities, and consultations from customers related to the linked services, enhancing security or promptly detecting and improving risks related to linked services. Also, whether a system has been established for coordinating necessary information and analysis results with financial-related organizations.

- (iv) Whether the internal audit division periodically or as necessary audits the implementation status related to linked services (including matters related to security levels), and reports to the Board or Directors, etc.
- (v) Whether the so-called PDCA cycle, which consists of risk analysis, formulation and implementation of measures, verification of the effects, and evaluation and review of measures related to linked services, is functioning.

## (2) Ensuring security

- (i) From the viewpoint of preventing fraudulent transactions related to linked services and protecting customers, whether the bank, in cooperation with the linked service provider, continuously identifies and evaluates risks of the overall linked services, and based on the evaluation, takes appropriate measures by considering both systems and technologies to maintain a certain level of security. Also, whether the bank cooperates in risk assessment and verification work conducted by the linked service provider.
- (ii) In order to prevent fraudulent transactions through impersonation of depositors, whether the bank has developed an appropriate security management system based on the continuous monitoring and evaluation of the status of the verification of service users at the time of transaction and confirmation of the identity of the depositors implemented by the linked service provider. Also, whether the bank cooperates in confirming the identity of the depositors conducted by the linked service provider as necessary.
- (iii) Whether the bank has implemented measures to prevent impersonation of depositors by introducing multi-factor authentication that combines effective factors, such as the use of variable passwords using hardware and software tokens and the use of public personal authentication, in addition to identity authentication using fixed IDs and passwords when linking with deposit accounts.

(Note) Refer to III-3-7-1-2 (5) ⑦ for effective authentication methods.

It should be noted that security measures such as effective authentication methods need to be reviewed periodically or as needed, as various methods are being newly developed due to the progress of information and communication technologies.

- (iv) In the monitoring of fraudulent transactions related to linked services, whether the bank has established a monitoring system that enables early detection of fraudulent transactions, by setting appropriate scenarios and thresholds based on environmental changes, including the

sophistication of criminal methods, and the occurrence of fraudulent transactions. Also, whether the bank has developed a system for promptly notifying users when it detects fraudulent transactions.

- (v) In cases where it is difficult for the bank to monitor transactions by users of linked services, such as linked services in which funds are charged in advance, whether the bank has developed a control environment for preventing the spread of customer damage, by confirming the control environment for monitoring fraudulent transactions by the linked service provider and appropriately sharing information on the occurrence of crimes and criminal methods.
- (vi) Whether the bank takes measures to enable customers to check the status of transactions in a timely manner by, for example, notifying customers at the time of the conclusion of an account transfer contract for linked services, in order to enable customers to recognize damage in an early stage.
- (vii) In the process described above, if vulnerabilities are found in the entire linked service, whether the bank takes measures such as suspending the linked service, and is prepared to resume the service after resolving the vulnerabilities.
- (viii) Whether the bank in light of changes in the environment, including the sophistication of criminal methods, and the state of crime occurrences, has continuously identified and evaluated risks and improved measures to prevent fraud as necessary.

(Reference)

"Guidelines for Linking Accounts with Funds Transfer Service Providers, etc. (November 30, 2020: Japanese Bankers Association)"

### (3) Customer Protection

- (i) Although linked services are provided by linked service providers directly to users, since the users of the linked services are depositors and the services are provided in conjunction with their deposit account, whether the bank has established a system to explain to customers the matters to be noted when using the services and to receive consultations from users related to the linked services.
- (ii) Assuming the occurrence of fraudulent transactions in linked services, whether the bank has established an appropriate control environment for preventing the spread of damage, such as the establishment of a communication system with linked service providers and the formulation of a policy to disclose damage.
- (iii) Whether an agreement is made with the linked service providers in advance to share responsibilities arising from business operations. In particular, given that it is necessary to promptly compensate for losses in the event of customer damage due to fraudulent transactions, whether the bank has agreed in advance with linked service providers regarding compensation policies and the sharing of compensation.

Note: Since victims of fraudulent transactions related to linked services are not necessarily limited to

users of the relevant linked services, it should be noted that in cases where consultations or notifications related to fraudulent transactions are received from customers, even if they are not attributable to the bank, it is necessary to take prompt and sincere actions and to cooperate with linked service providers as necessary.

(Reference)

"Measures on Illicit Deposit Withdrawals (February 19, 2008, Japanese Bankers Association)"

"Guidelines for Linking Accounts with Funds Transfer Service Providers, etc." (November 30, 2020: Japanese Bankers Association)

### III-3-9-3 Supervisory Method and Actions

#### (1) When crime occurred

Promptly after recognizing a fraudulent transaction arising from the linked services, the bank shall be required to make a report to the authorities in the form of a "crime report."

#### (2) When a problem is found

If inspection results, crime reports, etc. reveal doubts over the sound and appropriate management of services related to linked services, additional reports shall be requested under Article 24 of the Banking Act, as needed.

In addition, if a problem is still found from the viewpoint of user protection, such as when necessary review has not been conducted on crime prevention measures and action after the crime occurs, or when many crimes are reported, measures such as issuing a business improvement order under Article 26 of the Banking Act shall be taken.

### III-3-10 System Integration Risk and Project Management

#### III-3-10-1 Purpose and Significance

##### III-3-10-1-1 System Integration Risk

IT systems of major banks, which are originally large and complex, have become more and more complicated in configuration and operational structure due to multiple management restructuring of banks. In addition to this, because of the increasing dependency on information and communications technology in banking operation and expansion of online real-time networks, ensuring that IT systems are safe and stable is an important management issue for banks.

Specifically, there was a case where the management of a bank was held responsible for a major system failure occurring in association with the bank's management restructuring, such as a merger. Therefore, the establishment of a control environment for IT system integration risk is one of the most critical issues. (Reference) "Supervisory Viewpoints concerning System Integration Risk Control Environment (Detailed



Version),” Appendix of the Discussion Paper on Dialogues and Practices Regarding Financial Institutions’ IT Governance (June 6, 2019)

- (i) “System integration” means that banks integrate or split their IT systems or establish new IT systems (including joint development or operation of the system) due to management restructuring, including merger, business transfer, transformation to a holding company or a subsidiary company, or business alliance (“management integration”).
- (ii) “System integration risk” means risk caused by IT system integration of multiple financial institutions subject to management integration and suffered by them or their customers, such as risk caused because inadequate preparation for the system integration and related administration work, combined with unaccustomed clerical work, would cause bank’s officers and employees to mishandle clerical jobs, or lead to system failures or malfunctions, and then cause confusion regarding customer service, shake the foundation of financial institutions, or ultimately have a material effect on settlement systems.

### III-3-10-1-2 Risk Characteristics of System Integration Risk and Risk Mitigation Measures

- (1) Risk arising from system integration by major banks affects various areas, and it is particularly important to enhance the management of administrative risk and system risk from the following reasons:
  - (i) it is necessary to operate IT systems in a stable and reliable manner in order to ensure that transactions are properly processed via ATM or telephone banking tools, etc. that are used by a wide range of individual customers;
  - (ii) system failure, etc. may have extremely serious impact under the circumstances that financial transactions and remittance of salaries are widely implemented through IT systems; and
  - (iii) while management integration will significantly change the structure of sales branches and administrative work performed there, the bank is not able to provide customers with sufficient service without developing a control environment for managing the administrative work that would serve as a sales base thereof.

In other words, “system integration risk” is not a mere risk just associated with IT system development but a risk widely covering the scope of “administrative risk,” such as administrative work processed at the administrative divisions and customer responses at branches. Therefore, it is important that banks are required to manage risk while putting the utmost importance on “customer convenience” under the responsibility of its management.

- (2) Key principles for risk mitigation

The scale of the system integration risk should be recognized as a product calculated by multiplying the probability of occurrence of a risk event by the impact thereof. Therefore, it is necessary to recognize that major banks are required to prepare the following in-depth risk mitigation measures

judging from the size and content of their business operations.

- (i) As the basis of the risk mitigation, the bank should focus on an event that has little probability to occur but has an extremely huge impact if it actually occurs, which cannot be controlled by the activation of a contingency plan and may result in a huge and serious impact on customers and the settlement system, and should try to exhaustively find IT systems, operations, and administrative work that would be involved in such risk event and then prevent the event from occurring by conducting thorough tests and rehearsals, etc.
- (ii) In addition, the bank should control the probability of other risk events than those mentioned above to occur at least under a certain level by taking similar measures.
- (iii) The bank should prepare a contingency plan commensurate to the risk mitigation measures mentioned above and develop a control environment to prevent a huge impact on customers even when multiple risk events appear at the same time (when failures occur concurrently).

### III-3-10-1-3 Importance of Project Management

In the IT system integration associated with a merger, due to merger-specific circumstances such as mentioned below, establishment of an effective control environment for project management (so-called implementation of “project management”) is considered essential, not only for an IT systems development contractor but also for the bank.

- (1) Seeing IT system integration associated with a merger, the management teams of banks subject to merger need to promptly make important management decisions on (i) establishment of the management strategy and business model after the merger, (ii) planning of the HR system and cutback and (iii) merger ratio, within a limited schedule and under competitive circumstances with other bank groups.

Amid this situation, the date of merger is often decided not only by taking the period required for preparation of IT system integration into consideration but is affected by various factors surrounding the management of the banks subject to merger. As a result, there are some cases where a major failure occurred because the banks had not taken enough time to test the new system and to have the employees learn the new tools and work at sales branches.

- (2) The basic pattern of merger processes is (i) basic agreement between banks, (ii) conclusion of a merger agreement (including merger ratio), (iii) approval at the general shareholders meeting, (iv) application and acquisition of permission or approval from relevant authorities, and (v) completion of the merger. The management of banks subject to merger needs to obtain approvals from their shareholders and from relevant multiple authorities (\*).

Note: Relevant authorities include the financial supervisory authority, the Fair Trade Commission, and overseas supervisory authorities.

- (3) In case of IT system integration of major banks associated with a merger, the project is assumed to be a long-term and complicated one, and the following are typical patterns thereof;
- (i) IT system integration is often implemented in the following two stages, and there may be a case where it takes a long time (three years or more) from the execution of the basic merger agreement until the full integration of IT systems.
    - (A) First stage: At the time of merger (change of a bank name, branch name, and branch code number), the bank continues to use the existing system and launches a relaying system to connect the systems between banks subject to merger.
    - (B) Second stage: The bank launches a completely integrated IT system and provides uniform products and services of the new bank while closing or consolidating sales branches as needed.
  - (ii) Even in the second stage, in some cases, the bank may prefer “step-by-step system integration by each branch group” to one-time system integration in all branches.
  - (iii) In some cases, IT system integration is performed in parallel with a merger by a holding company of a bank, trust bank, and financial instruments business operators belonging to the same group.

### III-3-10-2 Major Supervisory Viewpoints

While basic supervisory viewpoints are shown in the “Approaches and Viewpoints concerning System Integration Risk Management Structure (Detailed Version), Appendix of the Discussion Paper on Dialogues and Practices Regarding Financial Institutions’ IT Governance (June 2019),” the following are examples of more specific supervisory viewpoints reflecting lessons learned from past cases.

- (1) Allocation of responsibilities among directors and clarification of management philosophy
- Whether the representative directors of banks subject to management integration (hereinafter referred to as the “integrated banks” in III-3-10-2) correctly recognize characteristics of the system integration risk and the importance of project management as mentioned in III-3-10-1 above.
- Whether the representative directors of the integrated banks have clarified the allocation of responsibilities relating to the system integration among directors and officers as well as their management philosophy.
- (2) Rationality of management decisions on the system integration method
- In selecting the system integration method, whether the boards of directors of the integrated banks eliminate friction between them and have held sufficient discussions. Whether they secure enough time to prepare for the system integration and apply a rational decision-making process according to the schedule until the merger and the management strategy after the merger.

(3) System integration plan and adequacy thereof

- (i) Thorough identification of risks from both the administrative aspect and IT system aspect, and mitigation measures thereof

Whether the boards of directors of integrated banks have developed the system integration plan by thoroughly identifying risks from both the administrative aspect and IT system aspect and taking mitigation measures thereof according to III-3-10-1 above from the viewpoints of not causing any damage or trouble to customers in the course of the system integration, taking into account the actual status of IT systems of each bank before the integration and lessons learned from past cases of system failure.

Whether they have prepared sufficient and conservative items and criteria for judgments with regard to system transition from both the administrative aspect and IT system aspect.

- (ii) Adequacy of system integration plan

Whether the system integration plan does not excessively prioritize adherence to the predetermined schedule while downgrading risk management. Whether the bank evaluates the adequacy of the plan objectively and reasonably by using the evaluation of a third party organization.

Also, whether the plan contains clear items and criteria for judgments with regard to system transition as to who should do what and by when, among all directors, officers, and employees.

(4) Establishment of control environment for conducting sufficient test and rehearsal in bank

Based on reflections of past cases of failure in which most failing banks mentioned that “test and rehearsal were not sufficiently conducted,” the following points should be checked.

- (i) Whether the bank has developed a sufficient testing and rehearsal framework for preventing any failure affecting customers and significant miscalculations in the materials that the bank’s management uses in decision-making for risk management purposes due to lack of reviews or tests. Specifically, whether a framework has been developed to formulate review implementation plans in which the implementation status of reviews in each process is examined in order to manage the quality condition, as well as testing plans suitable for the development associated with the system integration.

In particular, whether the testing plans take into account the fact that the final quality of transition of files, etc. cannot be determined until checking the functions at all the branches and with all the data. Also, whether the schedule is managed by reflecting additional administrative burden such as cleansing of inconsistent data unexpectedly detected in the course of the test period.

- (ii) Whether the bank plans testing as much as possible to make sure that even a part deemed not to be affected by the system integration is not affected in actual situations, considering there are some cases that even a part unrelated to the system development would cause a completely

unpredicted risk event, such as a case that potential failure of a vendor's package software used for external connection would become apparent at the time of the system integration and would result in a major failure, etc.

- (iii) Whether training and rehearsals are conducted assuming actual environments to verify the business operation after the system integration in such environments that are as faithfully close as possible to actual situations, for example, by imposing load during the peak period on all possible sales divisions and branches (including ATMs) and external channels (such as the Zengin system, the integrated ATM switching system, exchange of bills and BOJ's RTGS (Real-Time Gross Settlement) etc.) simultaneously.
- (iv) At sales branches where the operation processing will completely change due to the integration, whether education and training are conducted to learn new operation procedures and to cope with system failure in a sufficient manner including response to increase of administrative work burden in association with the decision not to work on so-called "following-up development to incorporate functions of the old system to the surviving system" or "derivational development." Also, whether the bank developed a framework for grasping and evaluating the progress thereof.

(5) Establishment of control environment for customer explanation and implementation of connecting test

- (i) Whether the bank verifies the adequacy of dissemination and explanation to customers and the feasibility of relevant training and manuals including the customer communication plan and detailed plan for training officers and employees, etc. in such communication skills, in a specific and concrete manner.
- (ii) When the financial services handled by the bank change due to the system integration (e.g., a method to collect banking charges or the date when a customer is required to deposit funds to bank accounts, etc.), whether the bank informs customers of such change in a proper manner upon giving consideration to customer convenience.
- (iii) For transactions directly involving customers such as account transfers or electronic banking, etc., whether the bank prepares the connection test schedule considering customer convenience and gives sufficient explanation to them.

In particular, as reflection of past failure cases, "connection test was not conducted sufficiently" is given, whether the bank plans to implement the connection test with customers on the assumption that the test should be actually done covering all areas to the extent possible.

Even for cases where the connection test is not conducted or where the connection test does not need to be conducted, whether the bank confirms as much as possible that no failure or problem will occur from real data, etc.

- (iv) Whether the bank has developed a framework for grasping and evaluating the customer explanation and the progress of the connection testing mentioned above.

(6) Development of basic system for project management

- (i) Whether the boards of directors of the integrated banks, based on sufficient recognition that system integration is not just an issue merely of IT systems but is inseparable from administrative risk such as business operations and customer response and that a risk arising in one area may spread to other areas, resulting in a significant obstacle to the whole management restructuring, cooperate in appointing officers and establishing divisions responsible for the supervision and management of plans and operations of the system integration (hereinafter referred to as the "supervising officers and divisions").
- (ii) Whether a framework has been established for ensuring adequate communications among the integrated banks, among directors and the supervising officers and divisions, among development divisions and user divisions, and within the same divisions or sales branches.
- (iii) Whether the board of directors and the supervising officers and divisions of the integrated banks have collaboratively developed a control environment for properly grasping the progress of integration projects. Whether a reporting system is in place within the bank and between the integrated banks so that the information on the system integration will not be kept only by some directors and officers of the integrated banks.

(7) Project management from design and development phases

In the course of alignment and integration, etc. of financial products of the integrated banks, there may arise some differences in perception between administrative (user) divisions and IT system divisions, omission in identifying requirements or in aligning specifications, from the design and development phases. These events may often result in failure at the time of the integration. Therefore, it is important to conduct quality control for each phase and process of design and development.

Considering the above, whether the quality of each process is properly managed, for example, by clarifying rules for verification and approval of each process, etc. In particular, whether the integration project excessively prioritizes the schedule while sacrificing quality and advances from one process to another without satisfying the completion criteria of each process.

(8) Control environment for outsourcing contractors

When the bank has outsourced to contractors its system development work relating to the integration, whether the bank has established a framework for ensuring adequate communications between such contractors and the supervising divisions.

Whether the bank properly grasps the content and progress of the outsourcing work performed by outsourcing contractors while understanding that failure of early-stage detection and correction of a problem in the outsourcing work may require additional tests and cause delay in the schedule.

In particular, when such outsourcing work involves the integrated banks and two or more outsourcing contractors, whether the banks have designed a framework for enabling the integrated banks to be actively involved based on the understanding that the risks of control environment are

becoming more complicated.

(9) Project management concerning progress, delay, and adequacy validation of schedule

In managing the progress of the system integration project, whether the bank has developed a control environment enabling the board of directors and the supervising officers and divisions of the integrated banks, to collaboratively grasp remaining challenges and problems including to-be-determined items and to determine the plan to solve them in a sufficient manner.

In managing the progress of the project, whether the bank always verifies the adequacy of the plan retroactively.

Whether the bank has established a framework to properly and collaboratively respond to unexpected events, if they occur, such as delay of the system integration project for whatever reason. Specifically, when the system integration project falls behind schedule, whether a framework is in place to make proper response based on the criteria to review the schedule, which obtained approval of the board of directors.

Also, whether a framework is in place to seek and cope with fundamental causes of the delay collaboratively.

(10) Project management concerning resource allocation, plan change, etc.

(i) Whether the integrated banks check the progress of each phase of the integration collaboratively, for example, as to whether the management resources are appropriately allocated. If any problem is found, whether they promptly take proper measures to solve it. Whether the project is properly managed so that related tasks will not be concentrated in a specific division or person.

(ii) When reviewing the project plan, whether the bank has fully evaluated and discussed the adequacy of the revised plan or the impact the revision would have on the whole project.

(11) Implementation of strict judgments with regard to system transition

(i) Whether the supervising officers and divisions of the integrated banks judge the feasibility of transition to the post-integration operational system including IT systems, obtain approval of the board of directors, and carry out the transition in accordance with the judgement criteria on operational transition (including IT system transition) that have been appropriately formulated to secure safety and stability based on III-3-10-1 and were approved by the board of directors.

Whether the schedule and plans are designed to complete necessary tests, rehearsals, education, and training (including training for the contingency plan and review of plans based on the results thereof) and to provide all the factors essential for the management to make decision until the time of the transition judgment.

Whether the time to make judgment on transition is determined sufficiently early from the scheduled integration date so as to allow smooth fallback including external connection and customer response.

- (ii) In case of a so-called “step-by-step system integration/transition by each branch group,” whether the bank conducts a transition judgment, at every transition, considering the implementation status of the responses to failure cases in previous transition (e.g., failure arising from the IT system or operation with regard to the processing involving an already-transited branch and a not-yet transited branch, or secondary failure arising from the response to such failure, etc.) and the characteristics of a branch subject to transition (e.g., major customers to whom it provides specific services such as customer-specific account transfer and employees’ asset formation services, etc.).

(12) Establishment of a framework to cope with fallback

When it is judged that the system integration cannot be completed (it should be restored to its former condition or postponed, etc.) at the time of the transition judgment, whether a framework is in place to make smooth responses in terms of IT systems, internal administrative work, customer response, etc.

Whether the plans to cope with unexpected situations before or after the system integration date (including a suspension of the system integration) have been collaboratively formulated and approved by the board of directors.

(13) Establishment of contingency plan

Whether the existing contingency plans are reviewed based on the system configuration and organizational structures after the system integration and are subsequently approved by the board of directors.

Also, whether the contingency plan for the system integration has been formulated in the same manner. Specifically, based on past cases:

- (i) In preparation for occurrence of an unexpected event such as a system failure, whether the banks have discussed and developed an alternative method until the system is completely recovered.
- (ii) In preparation for a case where delay of account transfer or ATM failure falls on a peak date of transaction, whether the banks have developed a control environment to secure a proper manual response or training at a sales branch to prevent any secondary damage such as double withdrawal or wrong recording in a bankbook, etc.

Also, whether the banks have developed a framework to prevent deterioration in customer services due to confusion, etc. in the over-the-counter operation by sales branch staff who are inexperienced in new administration work after the system integration.

In preparation for a case where administrative work must be processed manually until the system is completely recovered, whether the banks have developed a framework enabling them to properly grasp the work volume and to arrange necessary personnel in consideration of the probability that even small failures may occur simultaneously in a short period of time.

- (iii) When an unexpected event such as system failure, etc. occurs, whether the banks have made



public the details and causes of the failure, expected recovery time, etc. and open a call center to properly respond to inquiries from customers.

- (iv) Whether the banks actually conduct a sufficient amount of training, rather than leaving it as a paper plan, and revise it as needed based on the results thereof to ensure the effectiveness of the plan.

(14) Effective internal audit and third-party evaluation

- (i) Whether a framework has been developed wherein divisions in charge of internal audit of the integrated banks (hereinafter referred to as “internal audit division”) are designed not only to conduct mere monitoring and verification of the progress of the project but also to audit from the perspective of evaluating the impact that each problem would have on the whole integration plan and the effectiveness of the system integration risk management structure, and, for this, conduct operational audits and system audits in cooperation with each other. Also, whether staff members thoroughly knowledgeable about audits on processes, including system development processes, are secured.
- (ii) In making decisions relating to important matters on the system integration, whether the bank makes effective use of evaluation by a third-party organization such as system auditors while assessing the limits of the third-party evaluation.

(15) Overall management function by bank holding company

In the case where banking subsidiaries integrate their systems under a bank holding company, whether their system integration risk management function (including project management function) properly works as a part of the business management function of the bank holding company. (Refer to IV-4)

III-3-10-3 Supervisory Methods and Measures

- (1) In the case where banks are to integrate their systems in the wake of a merger, the FSA, following the announcement of the basic agreement thereon, asks them, pursuant to Article 24 of the Banking Act, to submit regular reports on their system integration plan (including the schedule) and its progress as well as their system integration risk management and project management status, and inspect whether or not a serious problem exists.
- (2) In the case where a notice of inspection results is made with regard to the system integration risk management structure, etc., the FSA asks the banks to make further reporting pursuant to Article 24 of the Banking Act, concerning fact-checking, cause-analysis, improvement measures, and other responses to the FSA’s findings. The FSA also asks for a report on measures to appropriately control risks (such as a measure to accurately implement the relevant plan, and the internal governance

structure including internal audit). Based on these reports, the FSA verifies whether there is a problem with the system integration risk management structure (including the project management structure; the same applies hereinafter).

In addition, the FSA regularly asks for follow-up reporting, and checks the progress in improvement measures, the effectiveness of the project management structure, etc.

- (3) If the transition judgment is made with regard to system integration, the FSA asks the bank for reporting, pursuant to Article 24 of the Banking Act, mainly on such judgmental grounds.

In case of the “step-by-step system integration by each branch group” wherein the transition of existing IT systems to the integrated system is conducted step by step by a group of branches, the FSA asks the bank for similar reporting when they make every transition judgment. Also, the FSA asks for reporting on the evaluation thereof at every time of transition to be submitted before the timing of the next transition judgment.

- (4) If any of the above inspections from (1) through (3) uncovers a problem, the FSA will ask for reporting pursuant to Article 24 of the Banking Act, and if a serious problem is identified, the FSA will issue, pursuant to Article 26 of the Banking Act, a business improvement order concerning the system integration risk management structure.

- (5) In the case where the management integration involving the system integration requires approval of authorities (e.g., merger), the FSA will, with respect to the application for such approval and within the scope of its examination criteria in accordance with laws and regulations, order the submission of materials regarding the policy for implementing the system integration plan precisely, the relevant internal control environment including internal audits and matters under III-3-10-2, and assess whether there is any problem in the system integration risk management structure. The FSA will subsequently give approval through predetermined procedures and arrangement, as needed, or conditionally pursuant to Article 54 of the Banking Act.

Also, the FSA will ask the banks for regular reporting based on Article 24 of the Banking Act for the period from the grant of the approval for the merger, etc. until the completion of the system integration.

- (6) For the supervisory viewpoints and responses when IT system failure occurs, also see sections III-3-7-1-2(10) and III-3-7-1-3(1), etc.
- (7) In the case where there is a specific concern about the operation of outsourcing contractors  
Also refer to III-3-7-1-3(4), etc.

### III-3-11-1 Background

Nowadays, as shown in the past cases of massive loss by domestic and overseas financial institutions, etc., banks' business operations and financial services are developed globally and associated with various risks. In this context, it is all the more important for divisions in charge of business management and operational management of the HQ in Japan to develop and maintain control systems to comprehensively supervise and manage business operations of their overseas bases (branches, local subsidiaries, etc.). Also, in order to make the measures for anti-money laundering and countering the financing of terrorism based on the Financial Action Task Force (FATF) Recommendations, etc. effective, banks are required to develop a scheme to properly respond to these measures not only in their domestic operations but also in overseas bases in accordance with Article 32(2) of the Enforcement Regulation of the Banking Act on Prevention of Transfer of Criminal Proceeds and guidelines for measures for anti-money laundering and countering the financing of terrorism.

### III-3-11-2 Major Supervisory Viewpoints

- (1) Appropriate management of business and operations of overseas business bases by the management of HQ and that of overseas business locations, including personnel affairs management
  - (i) Whether the management of the overseas base and the dispatched staff from HQ at the overseas base are appropriately appointed and placed, with sufficient knowledge about the local management and operations
  - (ii) Whether the staff in charge of internal audit or compliance at each overseas business base have sufficient knowledge and experience about the actual status of the operation and local regulatory matters. Whether the person in charge of internal audit is independent from the line manager and directly reports to the internal audit division of HQ. Whether the bank places a person in charge of compliance with laws and regulations in each country where the bank has its overseas business bases.
  - (iii) Whether the bank regularly provides local staff or employees with training, etc. to ensure compliance with laws and regulations and internal rules necessary for the business operation.
- (2) Inspection, improvement, and enhancement of the risk management and internal control systems at overseas business bases
  - (i) Whether inspection systems are organized and inspections are conducted in line with the actual situation and the risks of the business operations of overseas business bases
  - (ii) Whether the overseas business location undergoes an external audit by an outside expert, etc. according to its operational risk or in times of need
  - (iii) Whether the results of inspection and internal (external) audits are properly reported to the

management

- (iv) Whether control systems are put in place to manage the various risks in the local business base, including market risk and IT system risk. Also, whether enhanced risk management measures are implemented according to the level of risk.
  - (v) In particular, considering past cases of massive losses by domestic and overseas financial institutions, etc. and the causes of those cases, whether the control system is designed to secure effective risk management and internal control by clarifying the role and mandate of each division manager of the front, middle and back office.
  - (vi) In the case where the overseas business base outsources part or all of its clerical work to outsourcing contractors, whether the business base puts into place an appropriate management framework in line with the actual state of its outsourcing and risks, with reference to the above III-3-3-4 titled “Outsourcing.”
- (3) Development and enhancement of reporting and monitoring scheme of overseas business bases
- (i) Whether reporting systems are appropriately developed, in line with the actual situation and risks of the business operations of overseas business bases. In particular, whether timely and appropriate reporting systems are appropriately established between the business base and the HQ of the bank (in Japan) in case any misconduct or other serious issues occur.
  - (ii) Whether measures are implemented to enable appropriate initial response to the overseas business bases when misconduct or other serious issues occur. Also, whether the bank has established or enhanced the business management and operational management functions to enable the overseas business base and the bank HQ (in Japan) to quickly and appropriately respond to the reported issues, etc.
  - (iii) Whether the divisions in charge of business management and operational management analyze and monitor the above reports and/or events occurred and share the information gathered.
  - (iv) Appropriately responding to foreign supervisory authorities
    - (A) Whether the overseas business base has developed and maintained a personnel structure and scheme necessary to quickly and appropriately respond to the regular inspections and supervisions conducted by the foreign supervisory authority
    - (B) From the viewpoint of enabling direct dialogue and smooth communications with the foreign supervisory authority, whether the reporting system in place is necessary to promptly and appropriately explain the situation even when issues occur.
    - (C) Whether assignments of responsibilities are clearly developed through control systems, enabling the management of the bank HQ (in Japan) and the business management and operational management divisions to intervene or make judgments in a timely and proper manner when issues, cases, or misconduct are reported to the foreign supervisory authority.
- (4) Development of systems in response to the measures for anti-money laundering and countering the financing of terrorism at overseas business bases

- (i) Whether the overseas business base implements measures regarding anti-money laundering and countering the financing of terrorism appropriately at the same level as in Japan, to the extent permitted by local applicable laws and regulation

Note: In particular, it should be noted that, even at overseas business bases in countries or regions where the FATF Recommendation is not applied or is insufficiently applied, control systems at a similar level as in Japan are required.

- (ii) In the case where the country where the overseas business base is located applies stricter criteria for the measures regarding anti-money laundering and countering the financing of terrorism than in Japan, whether the overseas base takes measures corresponding to such stricter local criteria
- (iii) In the case where the overseas business base is unable to take measures regarding anti-money laundering and countering the financing of terrorism properly at the same level as in Japan because it is prohibited by local laws and regulations, whether it promptly provides the following information to the FSA or the local Finance Office of the region where the bank HQ is located
  - Name of country or region where it is located;
  - Specific reasons why it cannot take measures regarding anti-money laundering and countering the financing of terrorism; and
  - If it takes alternative measures regarding anti-money laundering and countering the financing of terrorism, the content of such alternative measures.

### III-3-11-3 Supervisory Methods and Measures

- (1) The FSA may request submission of the filing of misconduct submitted to the foreign supervisory authority by the overseas business bases and the results of the inspection conducted by the foreign authority. In cases where problems are found in control systems of the supervision and management of Japanese banks' overseas business bases as a result of the FSA's review, the FSA will consider collaborating with the relevant foreign supervisory authority, taking into account that the necessity of strengthening partnerships with overseas regulatory authorities is increasing as internationalization and financial conglomeratization progresses, and the movement towards the convergence of regulation and standards is accelerating.
- (2) Through the exchange of information, etc. with the relevant foreign supervisory authority, the FSA will share awareness of issues while confirming the status of operation at the overseas business base and, if necessary, will require the bank to submit a report based on Article 24 of the Banking Act and, in case of a serious issue, the FSA will issue a business improvement order based on Article 26 of the Banking Act.

## III-4 Exercise of Finance Facilitation Function

### III-4-1 Basic Roles

Financial institutions, including banks, are expected to understand in detail the situations of individual borrowers, such as small and medium-sized enterprises (including micro businesses; the same applies hereinafter until III-5) and housing loan borrowers, and to strive to facilitate smooth funding (including new credit granting; the same applies hereinafter) and to adjust lending conditions, etc. (Note 1) while sufficiently cooperating with related financial institutions and other financial business operators.

In particular, it should be noted that financial institutions are expected to sufficiently take an appropriate and active part in the vitalization of the regional economy and the facilitation of regional finance, considering the purpose of Article 64 (Note 2) of the Banking Act on Regional Economy Vitalization Corporation of Japan (the “REVIC Act”, Act No.63 of 2009).

From the perspectives discussed above, financial institutions are required to not only act as a fund provider but to also provide maximum support without procrastination to the business improvement efforts of customer enterprises, such as SMEs, by exercising their consulting function, etc. (for their consulting function toward customer enterprises, see III-5-1).

In particular, regarding the support to enterprises that require capital injection due to rapid changes in the business environment, it is strongly expected to not only make changes in loan terms, but also to utilize capital loans (Note 3) and investments to improve the soundness of client enterprises.

Furthermore, in line with the purpose of the Guidelines for Personal Guarantee Provided by Business Owners (the “Personal Guarantee Guidelines”), financial institutions should further promote the provision of financing that does not rely on personal guarantees by the business owners, and also work to provide financing based on a reasonable guarantee agreement as specified in the Personal Guarantee Guidelines. (See III-9-2).

Note 1: “Adjustment of lending conditions, etc.” refers to adjustment or change in loan conditions, refinance of existing loans, DESs (debt-equity swaps), and other measures taken to reduce the borrower’s burden for debt repayment.

Note 2: Article 64 of the REVIC Act stipulates that “REVIC and financial institutions shall, when supporting business owners in revitalizing their businesses or business activities expected to contribute to the vitalization of the regional economy, cooperate with each other to contribute to the vitalization of the economy in the region, and facilitate regional finance by strengthening the overall economy.”

Note 3: “Capital loan” refers to loans whose terms are equivalent to capital and which are recognized as having a sufficient capital nature and can be treated as capital in the evaluation of the borrower. The capital similarity is basically determined from the viewpoints of the redemption conditions, interest rate setting, and subordination, without being limited by the attributes of the borrower (size of the enterprise, etc.), the attributes of the lender (financial institutions, business corporations, individuals, etc.), or the purpose of use of funds. In general, capital loans should have the following aspects:

- (i) The redemption period at the time of the contract shall be more than 5 years, and a lump

sum redemption period or a long grace period equivalent to the redemption period shall be set.

- (ii) Regarding the setting of interest rates, the interest rates shall be set according to the amount of distributable profits in accordance with the amount of capital. (For a period when the borrower is in a difficult situation, a mechanism such as performance-linked interests shall be implemented to reduce the interest burden accordingly.)
- (iii) Subordination at the time of legal failure shall be ensured (or at least a mechanism shall be provided to ensure that the subordinated loan is not collected prior to other loans until the legal failure occurs).

#### III-4-2 Major Supervisory Viewpoints

Taking into account the basic roles of financial institutions discussed above, the FSA needs to monitor financial institution's measures, including the development of its control systems, for the finance institutions to continuously serve as finance facilitators as a whole organization. Therefore, the FSA will examine the financial institutions based on the following major supervisory viewpoints. (For the exercise of the consulting function to customer enterprises, see III-5-2.)

- (1) Whether the bank understands detailed situations of individual borrowers such as SMEs and housing loan borrowers and strives to facilitate smooth funding and adjust lending conditions, etc. Also, if there are other financial institutions or other financial business operators involved, whether the bank sufficiently cooperates with them in facilitating smooth funding or adjustment of lending conditions, etc.
- (2) Based on the purpose of Article 64 of the REVIC Act, whether the bank, when supporting business owners in revitalizing their businesses or business activities expected to contribute to the vitalization of the regional economy, cooperates with the Regional Economy Vitalization Corporation of Japan (REVIC) to contribute to the vitalization of the economy in the region and facilitate regional finance by strengthening the overall economy.
- (3) Whether the bank makes efforts to broaden the choice of loan programs to substitute personal guarantee provided by business owners through options such as guarantee contract with a suspension or cancellation clause, asset-based lending (ABL), additional interest, etc.
- (4) In the case where the bank is asked for a loan by a principal borrower who has separated or tries to separate his/her business assets from his/her personal household, whether the bank makes efforts to consider the possibility not to require a personal guarantee for him/her provided by business owners or the possibility to make use of an alternative means like those listed in (3) above in the course of

comprehensively evaluating the management conditions, use of funds, and collectability of the borrower based on the “Guidelines for Personal Guarantee Provided by Business Owners.”

- (5) In the case where the bank enters a guarantee contract, whether the bank explains what part is insufficient and requires the conclusion of the guarantee contract, and what improvements may increase the possibility of modification or cancellation of the guarantee contract while giving objective and reasonable reasons to get understanding and consent from the customer, depending on the customer’s knowledge and experience, etc.

### III-4-3 Supervisory Methods and Measures

Taking opportunities of various dialogs or interviews, the FSA will encourage financial institutions to sufficiently exercise their finance facilitation function while following up on their efforts based on the supervisory viewpoints mentioned above.

In this context, at a hearing with top management, the FSA will confirm how the management has demonstrated leadership in exercising the finance facilitation function.

Also, when necessary, the FSA will confirm with managers in sales divisions, etc., in depth, how they have exercised the function in individual cases, including in contact with customer enterprises (including challenges at sales scene and coordination with headquarters).

### III-5 Exercise of Consulting Function to Customer Enterprises

#### III-5-1 Key Principles

Basically, in cases of business expansion or management improvement of customer enterprises (including sole proprietors; the same applies hereinafter), it is important for the management of the enterprises to identify the goal and challenges of their business operations and to actively address them to attain the goal and to solve the challenges.

Financial institutions are required, in addition to the role of a fund provider, to provide maximum support for the active efforts of customer enterprises by exercising the consulting function, including support for formulating a turnaround management plan, continuous monitoring after adjustment, etc. of lending conditions, management consultation and instruction, etc., as necessary, through networks with external professionals and organizations, etc.

In particular, main banks providing large amounts of loans to customer enterprises are expected not only to serve as a consultant but also to further exert their consulting function more proactively and to provide maximum support so that customer enterprises can identify their business challenges and make efforts for management improvement, business reorganization, etc.

It is important to establish a scheme where these efforts from both sides; i.e., customer enterprises and



main banks, generate synergetic effects, ensuring that the business expansion and management improvement of the customer enterprise progresses steadily, thereby improving the collectability of loans and expanding future fund demand, which at the same time results in improvement in profitability and financial conditions of financial institutions.

Generally, major banks should exercise their consulting function by understanding and analyzing the management challenges of customer enterprises, providing appropriate advice for customers to gain in-depth awareness of their own challenges, encouraging them to make active efforts, and, at the same time, proposing and implementing optimal solutions. On such occasions, from the viewpoint of preventing business conditions from worsening or making improvements earlier, it is important for major banks to identify a sign of change in situations surrounding customer enterprises timely and appropriately and encourage them to take action ahead of time. The following are examples of the consulting functions of major banks that are expected by customer enterprises.

These examples are just shown in a comprehensive manner so that the FSA, major banks, and customer enterprises can share a common recognition about general cases, as the consulting function, in reality, varies according to the status of customers and the size and characteristics of banks. The specific content of the consulting function should be determined by each financial institution based on its own management decision according to its size, characteristics, and user expectations and needs. It should be noted that the FSA does not require them to follow these examples uniformly and comprehensively.

- (1) Strengthen daily and continuous relations, and understand and analyze management goals and challenges
  - (i) Understand and analyze customer's management goals and challenges, and identify its life stage and practice predictive management

Banks should understand management goals and challenges of the customer enterprise based on its financial information and various qualitative information.

Then, they should analyze the management goals and challenges of the customer enterprise while comprehensively considering the following points, and identify the life stage (development phase) and the degree of business sustainability (hereinafter referred to as the "life stage") of the customer enterprise.

- Management resources of the customer enterprise, its motivation towards business expansion and management improvement, and capacity to realize and solve the management goals and challenges;
- Prospect of its surrounding environments;
- Collaboration of relevant parties of the customer enterprise (business partners, Credit Guarantee Corporations, other financial institutions, external professional and organizations, etc.);
- The bank's position in transactions with the customer enterprise (its share in the customer enterprise's total borrowings) and the content of transaction (funds for capital

investment or working capital, length of transaction periods, etc.); and

- Perspectives of securing the financial stability of the bank

In addition, it is important for major banks, etc. to have dialogues with customer enterprises in a respectful manner from the standpoint of the management of the enterprises and support their management decisions while many solutions are still available for customer enterprises. Accordingly, major banks, etc. should also strive to continuously ascertain whether there is any sign of a customer enterprise shifting to a situation where its business is in trouble or may get in trouble owing to decreasing profitability, worsening financial positions such as excessive debts or worsening cash management (hereinafter referred to as “contingency” in III-5). The shift from usual conditions to contingency may well happen to customer enterprises not only suddenly owing to natural disasters or bankruptcy of their business partners, etc. but also gradually through changes in business or social environments. Accordingly, major banks, etc. should, as needed, encourage customer enterprises, including those who are not aware of being amid such a gradual shift, to deepen their awareness that they are in the process of such a shift toward contingency.

- (ii) Facilitation for the customer enterprise to recognize its management goals and challenges and to make active efforts towards them

Banks should give appropriate advice to a customer enterprise so that it can deepen its awareness of its management goals and challenges even in a case where the customer enterprise has not been able to recognize its management goals and challenges clearly and sufficiently, encouraging it to make active efforts to achieve the goals and solve the challenges. In a case where the customer enterprise has insufficient recognition, banks should encourage the customer enterprise to gain a deeper understanding and take proactive efforts in collaboration with other financial institutions, Credit Guarantee Corporations, external professionals and organizations, etc., if necessary.

- (Reference) When a bank gives advice to a customer SME to support its accurate and sufficient recognition of the management goals and challenges, it is effective to encourage the SME to apply "Guidelines on the Accounting of Small and Medium Enterprises" and "Basic Guidelines for SME Accounting (Chusho Kaikei Yoryo)."

## (2) Proposal of optimal solutions

Banks should properly and carefully identify the respective life stages of the client companies towards realization and solution of their management goals and challenges, and then propose optimal solutions from the viewpoint of the client companies according to their respective life stages, in a timely manner. In doing so, banks should cooperate with other financial institutions, Credit Guarantee Corporations, external professionals and organizations, etc. and use the national or local government's SME support measures.

In addition, assuming that situations surrounding the customer enterprises will change, banks

should identify any sign of change in such situations and encourage them to take action ahead of time. As part of such initiatives, banks should also proactively provide information about available solutions at the time of shifting to contingency.

In particular, in the case where the client companies need support due to business rehabilitation, change, succession, or discontinuance, or where some coordination is necessary among creditors in giving support to the enterprise, banks should make active use of third-party viewpoints, professional knowledge and functions of external professionals and organizations, etc. in order to make the support more effective.

When banks propose a relevant solution to a client company, it is also effective to collaborate with certified agencies supporting SMEs' business innovation (meaning those which are certified pursuant to Article 31(1) of the Small and Medium-sized Enterprises Business Enhancement Act; the same applies hereinafter.)

(Reference) Solutions proposed according to the life stage of the client company (examples)

Types of life stages of client companies	Solutions proposed by financial institutions	Collaboration with external professionals/organizations, etc.
Client companies aiming at start-up and development of new business	<ul style="list-style-type: none"> <li>• To judge the value of the new business based on the quality of the companies' technology, sales force, and management.</li> <li>• To respond to fund needs at the time of business start-up, including introduction of public subsidy programs and making use of public funds.</li> </ul>	<ul style="list-style-type: none"> <li>• Support for the client companies in technology evaluation and commercialization of products in cooperation with public organizations</li> <li>• Introduction of public subsidies and funds programs to the enterprise</li> <li>• Coordination with REVIC</li> <li>• Formation and making use of local revitalization funds and business development funds</li> </ul>
Client companies with potential for further expansion in growing phase	<ul style="list-style-type: none"> <li>• To support the companies in acquiring new sales channels through business matching and support for technology development</li> <li>• To provide information and advice towards new business development, including overseas promotions</li> <li>• To respond to fund needs for business expansion. At the same time, to make use of financing tools based on the business value (financing tools that do not excessively depend on collateralized</li> </ul>	<ul style="list-style-type: none"> <li>• Business matching in coordination with local governments, SME-related organizations, other financial institutions, and industrial organizations, etc.</li> <li>• Support for the companies in technology development by industry/academia/government cooperation</li> <li>• Provision of overseas information and consultation in cooperation with JETRO, JBIC,</li> </ul>

	<p>real property or personal guarantee.)</p>	<p>etc. and introduction of funding tools in overseas countries</p>
<p>Client companies which need management improvement (Client companies that are expected to improve their business management on their own, etc.)</p>	<ul style="list-style-type: none"> <li>• To support the companies in acquiring new sales channels through business matching and support for technology development</li> <li>• To adjust or change lending conditions</li> <li>• To grant a new credit line if it is judged that it may allow the companies to get new profit occasions and reduce costs on a medium-to-long-term basis, thereby improving the debtor's business and financial conditions and collectability. At the same time, to make use of financing tools based on the business value (financing tools that do not excessively depend on collateralized real property or personal guarantee.)</li> <li>• To support the companies in formulating a business reorganization plan including the abovementioned measures (including financial institutions' preparation of materials necessary for formulation of the business reorganization plan based on the actual status of the companies while obtaining the understanding of the companies). When it is difficult to formulate a quantitative business reorganization plan, to propose an alternative direction to solve challenges that are simple and</li> </ul>	<ul style="list-style-type: none"> <li>• Making use of advice and proposals from SME management consultants, certified public tax accountants, management instructors, Yorozu Support Centers, SME Revitalization Support Council, General IP Help Desks, etc. (use of third party knowledge)</li> <li>• Review of the repayment plan in cooperation with other financial institutions and Credit Guarantee Corporations</li> <li>• Business matching in coordination with local governments, SME-related organizations, other financial institutions, and industrial organizations, etc.</li> <li>• Support for the companies in technology development by industry/academia/government cooperation</li> </ul>

	qualitative but effective.	
<p>Client companies which need business rehabilitation and change of business type (Client companies that are expected to recover the business through drastic business rehabilitation and change of business type, etc.)</p>	<ul style="list-style-type: none"> <li>• To change the lending conditions, etc. and to consider use of DES, DDS, or DIP finance or debt waiver according to the financial institution's share in the total lending balance of the enterprise and transaction status</li> <li>• To support the companies in formulating the management reorganization plan including the abovementioned measures</li> </ul>	<ul style="list-style-type: none"> <li>• Formulation of business revitalization measures in cooperation with REVIC, the Corporation for Revitalizing Earthquake affected Businesses, SME Revitalization Support Council, etc.</li> <li>• Implementation of revitalization-type private liquidation procedures pursuant to Part 3 of Guidelines for Business Revitalization, etc. of Small- and Medium-sized Enterprises</li> <li>• Formation and use of business revitalization funds</li> <li>• Use of revitalization-oriented servicers</li> </ul>
<p>Client companies whose business seems unsustainable (Client companies whose purposeless business continuation would presumably hinder the livelihood rehabilitation of the owners of the client companies or to adversely affect their business partners' operation, etc.)</p>	<ul style="list-style-type: none"> <li>• When asked by the companies for change in lending conditions, etc., not to mechanically respond to, but to give careful and sufficient consideration by comprehensively judging the motivation of the business owner towards the continuation of the business, his/her livelihood rehabilitation, impact on trading partners, etc., the bank's share or transaction status, and focus of securing financial stability</li> <li>• And then, to properly implement solutions that are truly favorable to the client companies and their related parties, including proper advice towards the rehabilitation of the client companies subject to debt-workout and cooperation in smooth processing and customer response in the case where the customer chooses voluntary liquidation.</li> <li>• In addition, to endeavor to give sufficient explanation to gain greater understanding from the client companies.</li> </ul>	<ul style="list-style-type: none"> <li>• Implementation of discontinuance-type private liquidation procedures pursuant to Part 3 of Guidelines for Business Revitalization, etc. of Small- and Medium-sized Enterprises</li> <li>• After giving careful and sufficient consideration and full explanation to deepen the client companies' understanding, to study reorganization measures subject to debt-workout in cooperation with tax accountants, lawyers, servicers, etc.</li> </ul>
<p>Client companies which need business</p>	<ul style="list-style-type: none"> <li>• To conduct M&amp;A matching support and countermeasures for inheritance</li> </ul>	<ul style="list-style-type: none"> <li>• Business Transfer &amp; Succession Support Center</li> </ul>

<p>succession</p>	<p>tax taking into account the existence of the successor and business owner's intentions for business continuation</p> <ul style="list-style-type: none"> <li>• To respond to fund demands at the time of business succession such as stock purchase funds in the case of MBO or EBO</li> </ul>	<ul style="list-style-type: none"> <li>• Use of M&amp;A support company, etc.</li> <li>• Evaluation of own stocks and calculation of inheritance tax by public tax accountant</li> <li>• Establishment of the trust by will with the help of a trust business operator, administrative scrivener, and lawyer</li> </ul>
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Note 1: In some cases, other responses than those mentioned in the above table are required. For example, in the case of a client company with whom it is difficult to establish a trust relationship required for a bank to establish a proper credit line (such as a client companies which do not faithfully disclose their financial conditions despite honest efforts from the bank, or client companies which are suspected to have a relationship with an antisocial force, etc.), the bank should make proper and prompt response in cooperation with tax accountants and lawyers, as needed, while considering the necessity of debt protection and being mindful from the viewpoint of securing the financial stability and proper operation of the bank.

Note 2: In the table above, when the bank provides consulting to “Client companies which need business rehabilitation and change of business type,” it should be noted that the range of solutions to be provided becomes wider because the following special tax treatments are introduced to support the rehabilitation of SMEs:

- Special provisions for facilitating corporate reorganization through the corporate reorganization tax system (Application of the corporate reorganization tax system to the debt work-out through the business revitalization funds); and
- Tax-relief treatment of capital gains relating to provision of personal property by a business owner who is a guarantor based on a reasonable rehabilitation plan

(3) Points to note concerning client companies which need support for the management improvement and business reorganization

(i) Support for formulating a management reorganization plan

In the case where, with regard to a solution under (2) above that requires formulation of a management reorganization plan, an agreement is reached between the bank and the client companies and, if needed, with other financial institutions, Credit Guarantee Corporations, external professionals and organizations, etc., (including the case where an agreement is reached with regard to a solution that was first proposed by the bank and then revised through consultation with other financial institutions, Credit Guarantee Corporations, and external professional and organizations, as needed), a management reorganization plan, containing such solution, needs to be promptly formulated.

It is preferable that the client companies formulate the management reorganization plan by themselves to the extent possible so that they will recognize their intrinsic management challenges and address them proactively. For this, the financial institution should endeavor to cooperate with the client companies in checking whether or not the management reorganization plan is adequate and feasible and properly contains the solution under (2) above.

In the case, however, where the client companies are not able to formulate the management reorganization plan by themselves, or in the case where it is judged that the major financial institution's active involvement will be effective, the financial institution will support them in formulating the management reorganization plan while obtaining their understanding (including the financial institution's preparation of necessary materials for formulation of the management reorganization plan based on the actual situation of the client companies). In doing so, the financial institution should fully consider the situation the client companies are facing so that the management reorganization plan can contribute to management improvement. Moreover, even in the case where it is deemed that the client companies have difficulty formulating the management reorganization plan by themselves, it should be noted that the financial institution needs to actively support the client companies in formulating the plan by making positive use of a third party's viewpoints, professional knowledge and functions of external professionals and organizations, etc.

In formulating business revitalization plans of a client company that is an SME, the financial institution should consider the human resources and ability to prepare financial statements of the SME and aim at, rather than adhering to formulation of so large and very detailed a plan as that of a large company, proposing a direction to formulate a simple, qualitative, but effective plan to solve challenges towards management improvement and business reorganization of the client company. In the case where a major bank or the like uses the national or local government's SME support measures and the relevant financial institutions support a client enterprise in formulating a basic management improvement plan such as cash management and grasping the enterprise's own management conditions (hereinafter referred to as the "basic management improvement plan"), it is necessary to check whether the use of these support measures match the client enterprise's needs while also paying attention to preventing the abuse of its superior bargaining position.

Note 1: Even in the case where the financial institution changes the lending conditions of the client company, when the business revitalization plan or the direction to solve the challenges falls under the scope of a highly feasible radical management reorganization plan (for applicable conditions thereof, refer to III-3-2-4-3 Disclosure of risk management loans based on the Banking Act and the Financial Reconstruction Act in these Supervisory Guidelines), the loan based on such plan or the direction is not considered to be a restructure loan.

Note 2: Even in the case where the SME has not formulated a business revitalization plan, etc.,

when “materials are prepared by a financial institution relating to the management improvement of the SME” in line with the debtor’s real management situation by comprehensively considering its technology, sales capacity, and growth potential, the relevant loan does not fall under the scope of the “restructured loan,” as these materials are considered a “highly feasible radical management reorganization plan.” (Refer to III-3-2-4-3 Disclosure of risk management loans based on the Banking Act and the Financial Reconstruction Act.)

(ii) New credit granting

In the case where a bank is asked to grant new credit by a client company for which the bank has changed the lending conditions from the viewpoint of exercising its active and proper financial facilitator function and when it is expected that the client company can enjoy new profit occasions and cost reduction on a medium-to-long term basis and improve its business or financial situation, which is judged to finally contribute to improvement in its recoverability, the bank should endeavor to actively grant a new credit line to the client company in a proper and timely manner.

(iii) Proactive involvement, etc. in management improvement and business revitalization support

In the case where a major bank or the like itself is a main financial institution of a client enterprise, the major bank or the like should have dialogues with the client enterprise in a respectful manner and then proactively get involved in management improvement and business revitalization support based on the actual situation.

In addition to the above, even in the case where the outstanding loan amount is small or the collateral ratio is high, or the guaranteed ratio by a Credit Guarantee Corporation is high, the main bank or the like should, as needed and as early as possible, cooperate with other financial institutions, Credit Guarantee Corporations, and external professionals, other external organizations, etc. and get involved in management improvement and business revitalization support based on the actual situation of the client enterprise while also taking account of its own management resources.

In the case where a major bank or the like is a main financial institution with which a client enterprise does business, when such major bank uses the function of REVIC or the Corporation for Revitalizing Earthquake affected Businesses in supporting the business rehabilitation of such client enterprise, the major bank or the like will be actively and continuously involved in the support.

(4) Implementation of solution and progress management in collaboration with client companies

The bank should verify and check whether or not the solution is adequate and feasible together with the client company and other related entities, and then implement it in collaboration with them.

The bank should, after launching the solution, properly manage the progress thereof in cooperation with the related parties as needed, while continuously monitoring and giving management advice and instructions, etc. to the client company.



In particular, in the case where a financial institution has supported a client enterprise in formulating a basic management improvement plan using the national or local government's SME support measure, the financial institution should take the initiative in appropriately monitoring the progress status of the said plan.

In addition, when knowing that there are two or more financial institutions that provide loans to the client company, the bank will manage the progress of the solution in coordination with these financial institutions and Credit Guarantee Corporations.

If, in the course of managing the progress, it finds a major change, etc., in external circumstances of the client company that could not be expected at the launch of the solution, the bank should consider whether or not to revise the ongoing solution together with the related entities. When it is necessary to revise the solution, the bank should make a proposal of revision (including re-formulation of the business revitalization plan) upon giving proper advice so that the client company can understand the change and the necessity of the revision, and then implement the revised solution with coordination with the related entities.

Note: In implementing the solution, attention should be paid to (3)(iii) above.

### III-5-2 Major Supervisory Focus

Based on the above, the FSA will examine how each major bank has established a control environment for continuously promoting efforts to exercise its consulting function to client companies as the whole organization focusing on the following major supervisory focus.

The specific content and level mentioned in the following supervisory focus should be determined by each major bank based on its own management decision according to its size, characteristics, and user expectations and needs. It should be noted that the FSA does not require the bank to follow these examples uniformly and unconditionally.

- (1) Whether the management of the banks actively promote the evaluation and improvement of the efforts to exercise its consulting function to client companies. Also, whether the management endeavors to establish a necessary control environment to ensure that the bank fulfills requirements under these Supervisory Guidelines as the whole organization while revising the relevant internal rules when needed, including dissemination thereof to its employees.
- (2) Whether the banks endeavor to establish a control environment wherein HQ supports sales branches to supplement their lack of human resources and knowhow and to make effective use of the management resources of the entire bank. For example, whether the banks endeavor to develop relevant environments so as to provide optimal solutions depending on management challenges of customer enterprises under an appropriate division of roles. As part of such efforts, whether sales branches and HQ share client enterprises' management conditions and challenges (including a sign

of shifting to contingency) and any other information that sales branches have obtained through their daily and continuous relations with such enterprises, and whether HQ and sales branches, as needed, work on effective support in an integrated manner.

- (3) In supporting the management improvement and business revitalization of a client company, whether the bank, while keeping a close relationship with it, proposes an optimal solution according to the management challenges from the viewpoints of the client company and supports it in implementing the solution. In addition, whether the bank endeavors to develop relevant environments so as to identify any sign that a client company may shift to contingency and encourage the client company to take action ahead of time. In such case, if there are other financial institutions or other financial business operators involved, whether the bank endeavors to form an alliance and cooperate with them sufficiently such as by holding a joint meeting with them.
- (4) Based on the viewpoints of complementing lack of professionals and expertise and developing human resources and accumulating relevant knowhow within the bank on a medium-to-long term basis, whether the bank endeavors to develop the liaison environment at its HQ and sales branches in order to cooperate with external professionals (tax accountants, lawyers, SME management consultants, certified public accountants, and management instructors, etc.), external organizations (local governments, the Bureau of Economy, Trade and Industry, chambers of commerce and industry, commercial and industrial associations, the Federation of Small Business Associations, Yorozu Support Centers, JETRO, JBIC, Regional Economy Vitalization Corporation of Japan, Corporation for Revitalizing Earthquake affected Businesses, SME Revitalization Support Council, Organization for Small & Medium Enterprises and Regional Innovation, certified agencies supporting SME business innovation, business revitalization funds, regional revitalization funds, etc.), Credit Guarantee Corporations, and other financial institutions, etc.

In particular, in the case where the client company needs support due to business rehabilitation, change, succession, or discontinuance, or where some coordination is necessary among creditors in giving support to the company, whether the bank makes active use of a third-party viewpoint, professional knowledge and functions of external professionals and organizations, etc. without postponing necessary judgment. When the bank, as a main financial institution with which the client company does business, uses external professionals and organizations, or the Guidelines for Business Revitalization, etc. of Small- and Medium-sized Enterprises, etc. in supporting the business rehabilitation of the client company, whether it is actively involved in the support. In addition, in judging that it is presumably difficult for the client company to revitalize its business, whether the main bank fully considers third-party opinions from external professionals and organizations for necessary support. Also, when other financial institutions support the business rehabilitation of the client company by using external professional and organizations, whether the bank endeavors to actively form an alliance and cooperate with them.

In addition, when the bank, as a main financial institution with which the client company does business, uses the function of the Regional Economy Vitalization Corporation of Japan or the Corporation for Revitalizing Earthquake affected Businesses, and supports a client company in revitalizing its business, whether the bank has been actively and continuously involved.

Note: Specific entities with which each financial institution forms an alliance should be determined by it based on its own management decision according to its size, characteristics, and user expectations and needs. It should be noted that the FSA does not intend to require each financial institution to form alliances with all the entities mentioned in the parentheses or to exclude alliance with any other entity.

In addition, it is necessary to note that, when the financial institution shares information of the client company it keeps with other relevant entities, the approval of the client company is required.

- (5) Whether the bank endeavors to develop competent human resources who have professional knowledge and knowhow including specialized financial methodologies to support the framework to exercise its consulting function. In addition, whether the bank collects and accumulates these kinds of knowhow and various information. And whether it endeavors to share the knowhow and information within the whole organization by proper coordination between sales branches and HQ.
- (6) Whether the bank properly reflects each employee's efforts to exercise the consulting function to the client company in their performance evaluation (including the evaluation of sales branches) to contribute to improving employees' motivation.
- (7) Whether the bank confirms that a control environment to exercise the consulting function is properly established by conducting internal audits periodically and as needed. And whether the bank has a control environment in place to make effective use of the audit scheme by improving and enriching the promotion of the consulting function based on the results of the audit, as needed.
- (8) In the case where a main bank or the like supports a client company in formulating a basic management improvement plan using the national or local government's SME support measure, whether the main bank or the like has established an environment to check whether the use of this support measure truly matches the client company's needs while also paying attention to preventing the abuse of its superior bargaining position. Moreover, whether the basic management improvement plan to be formulated takes full account of the situation the client company is facing so that the plan can be effective to improve the client company's management.

The FSA will grasp the bank's efforts in exercising its consulting function based on these Supervisory Guidelines through supervisory activities, including hearings, interviews, etc.

In this context, at an interview with top management of the bank, the FSA will hear their efforts to exercise the consulting function, how they have developed the control environments mentioned in these Supervisory Guidelines, and how the management has shown its leadership relating thereto, and will encourage the bank to implement these efforts steadily.

At each hearing, the FSA will confirm with managers in sales divisions, etc., in depth, how they exercise the consulting function in individual cases including contact with customer enterprises (including problems at sales scene and coordination with HQ).

### III-6 Provision of Various and High-Quality Financial Instruments and Services Suitable to User Needs

#### III-6-1 Outline

- (1) Major banks that are large in size, having great influence on Japan's economy and developing financial businesses globally, are expected to provide users with various and high-quality financial instruments and services suitable to their needs and to contribute to the development of Japan's economy and the improvement of people's lives.
- (2) What kinds of financial instruments or services banks provide to customers should be chosen by each bank among from various products and services based on its own business model and management decision. The following are specific examples of efforts that major banks are expected to make.
  - (i) Efforts towards market-oriented indirect finance  
For example,
    - Project finance
    - Non-recourse loan
    - Syndicated loan
    - Securitization of loans
    - Support for issuance of customer enterprise's bonds, etc.
  - (ii) Efforts towards new SME financing  
For example,
    - Efforts towards the financing that emphasizes cashflow rather than excessively depending on security or guarantee (in particular, a third party guarantee)
    - Development of financing programs for an SME whose financial statements are relatively precise
    - Development, enhancement, and use of a credit risk database, etc. (improvement of the quality in loan assessment, setting of proper loan interest, introduction of proper portfolio, etc.)
  - (iii) Efforts toward personal financing (retail financing)  
For example,

- Provision of financial instruments and services that meet individuals' risk appetite and needs according to the life cycle
  - Credit granting to individuals, etc. by means of housing loans and the scoring system
- (iv) Efforts focusing on growth potential

See III-6-2 for efforts that banks are expected to make.

(Reference)

- (i) "Future Vision of Japan's Financial System with Medium-term Outlook" (September 30, 2002, by the Financial System Council)
- (ii) "Enhancement of Relationship Banking Functions" (March 27, 2003; the Financial System Council)
- (iii) "Evaluation of Efforts in Region-based Relationship Banking and Future Response - to Establish a Sustainable Business Model to Utilize the Accumulated Local Information" (April 5, 2007; by the Financial System Council)

### (3) Supervisory Approaches and Actions

The FSA will check a bank's framework and actual situations to make these efforts through interviews with the bank on the occasion of settlement and financial reporting and the hearing on the risk management or internal audit. Based on that, the FSA will consider supervisory response as needed.

It is also necessary for a bank, in making these efforts, to assume accountability for the characteristics of risk or returns of the financial instruments and services, and the risk associated with change of loan interest and income of a borrower, etc. See "III-3-3 Provision of Information and Consultation Function, etc. for Protection of Users" for banks' accountability.

## III-6-2 Efforts towards Financing, etc. Focusing on Growth Potential

### III-6-2-1 Background

In order for the financial industry to support and back-up the real economy and corporations and to be, itself, a growing industry to lead the economy, it is important that financial institutions engage in efforts to supply funds for growth that are suitable to the characteristics of entities they support. From the viewpoints for promoting these efforts, the FSA summarizes and clarifies major principles as follows;

(Reference) "New Growth Strategy: Blueprint for Revitalizing Japan" (the Cabinet Decision of June 18, 2010)

### III-6-2-2 Key Principles on Efforts towards Financing Focusing on Growth Potential

Banks' efforts towards the financing focusing on growth potential of customer enterprises should be determined by each bank based on its own management decision. As an example, they are expected to make

the following and develop the financing scheme emphasizing on borrowers' strength in technology and sales and their growth potential as well as the profitability and the future potential of the businesses they are engaged in (hereinafter referred to as "borrower's growth potential").

(Reference) Specific examples of developing the above-mentioned schemes

(It should be noted, however, that the following are merely examples and each bank should determine its efforts toward the financing focusing on the growth potential based on its own management decision.)

- (i) The management of the bank should define and position the efforts towards the financing while focusing on the borrower's growth potential, etc. in its financing policy.
- (ii) The bank should develop a framework for promoting the efforts towards financing focusing on the borrower's growth potential, etc. by establishing a division in charge or appointing a person in charge for that purpose.
- (iii) The bank should fully examine, analyze, and discuss the borrower's growth potential, business environment by sector, and information of partner companies (trend of needs) and share the information within the whole organization through proper combination between sales branches and HQ and make effective use of the information in the course of sales activities (including management consultation with partner companies) and loan assessment.

Also, as needed, the bank should evaluate the borrower's growth potential in an objective and reasonable manner in the course of sales activities (including management consultation with partner companies) and loan assessment.

- (iv) The internal rules on loan assessment should stipulate that the bank evaluates the borrower's growth potential properly and sufficiently in the course of loan assessment.
- (v) The bank should disseminate the importance of the efforts towards financing while focusing on the borrower's growth potential to a person in charge of financing and a person in charge of loan assessment, and endeavor to improve their ability to properly evaluate the borrower's growth potential through training, education, etc.

### III-6-2-3 Supervisory Approaches and Actions

The FSA will grasp the bank's efforts towards financing focusing on the borrower's growth potential through ordinary supervisory activities including hearings, interviews, etc.

### III-6-3 Points to Note in Granting Consumer Loans

#### III-6-3-1 Background

From the viewpoint of making Japan's consumer finance market sound and stable on a medium-to-long term basis, banks are expected to actively participate in the market, especially with regard to loaning to

individuals (excluding housing loans; hereinafter referred to as “consumer loans”) and also to assume their social responsibility.

On the other hand, when banks grant consumer loans, it is important for them to establish a relevant control environment based on the intent of the prevention of multiple debts under the amended Money Lending Business Act (enacted in June 2010) and user protection, including proper loan assessment and prevention of forced collection.

Although the provisions of the amended Money Lending Business Act including a so-called “restriction on loan amount” under Article 13-2 thereof do not apply to a bank’s loan guaranteed by a money lender, it is important for banks to develop a relevant control environment mentioned in this section from the viewpoints of customer protection and risk management.

### III-6-3-2 Major Supervisory Viewpoints

#### (1) Establishment of a proper assessment scheme based on the intent of the amended Money Lending Business Act

- (A) Whether the bank has established a proper loan assessment environment considering the actual situations of customers so that a customer loan by the bank will not be excessive for the customer, by inserting the mechanism to make sure that the customer can pay more than he/she borrows based on his/her borrowing status, repayment schedule and results, annual income and property, etc.
- (B) There are processes specific to consumer loans, including assessment using the information of a credit bureau, credit management, and collection. Whether the bank identifies the risk associated with these specific processes and manages it properly. And whether the management of the bank understands the situation and gives necessary instructions.

#### (2) Use of credit information owned by a third party in the assessment

In the case where a bank has too little credit information on the borrower’s repayment capacity to conduct the assessment or credit management for a customer loan (hereinafter referred to as the “assessment” in this section), the bank may obtain the information from a credit bureau or ask a Credit Guarantee Corporation for a guarantee assessment as a supplementary means thereof.

In this case, whether the bank has established the risk management environment paying attention to the following.

- (A) Whether the bank has a control environment in place to properly judge the status of a borrower when conducting the loan assessment by, rather than merely depending on the results of credit assessment of a credit guarantee company or information from a credit bureau, using them together with its own information.
- (B) Whether the bank has developed a control environment wherein it grasps change in the default rates and the subrogated performance rates by a credit guarantee company so that it can verify

the adequacy of the results of credit guarantee assessment as credit information on a continuous basis.

- (C) In particular, when the bank uses a credit guarantee company, whether the bank has developed a control environment for checking the financial situations and the guarantee capacity of such credit guarantee company.
- (D) In addition to developing the control environment under (B) and (C) above, whether the bank discusses with the credit guarantee company and the credit bureau the adequacy of their credit guarantee assessment and credit information processing, as needed.
- (E) Whether the bank confirms with the credit guarantee company and the credit bureau that they have formulated proper rules and procedures for credit guarantee assessment and credit information processing and that they have a control environment in place for properly operating their business in accordance with such rules and procedures.

(3) Compliance, etc.

- (i) Response in line with the intent of the amended Money Lending Business Act

When the bank grants consumer loans, whether the bank has established a proper control environment such as following from the consumer protection viewpoint considering the intent of restriction under the amended Money Lending Business Act.

- (A) Matters relating to collection

Whether the bank has a control environment in place to, in collecting claims of customer loans, prohibit intimidating persons or harming the tranquility of a person's personal life or business operations. In addition, whether the bank has a control environment in place to check the collection procedures of the credit guarantee company in advance so that the credit guarantee company will not engage in excessive demand or forced collection in exercising the right of reimbursement after subrogation performance.

- (B) Control environment for complaint processing

In establishing the internal control for complaint processing, whether the bank has designed it to include not only responses to the debtor but also responses to the ex-debtor in case of subrogation performance by a credit guarantee company.

It is preferable that banks should prepare a scheme such as, according to the content of consultation and complaints from debtors, properly introducing them to a consultation center of external organizations or local governments or the bar association, etc. from the viewpoints of consumer protection and rebuilding their lives.

- (ii) Ban on relationship with antisocial forces

Whether the bank has a control environment in place to ban any relationship with antisocial forces even in case of consumer loans that are not designated for specific purposes of use. Also, whether the bank has a control environment for recommending a customer who is found to have borrowed money from an underground money lender to consult with relevant institutions.



(iii) Others

In the case where the bank grants a loan guaranteed by a credit guarantee company that is any of the bank's subsidiary companies, etc. (meaning subsidiary companies, subsidiary entities, or affiliated companies, etc. of the bank or its holding company), whether the transaction with such credit guarantee company substantially supports the credit guarantee company and, therefore, violates Article 13-2 of the Banking Act (the so-called "Arm's Length Principle".)

### III-6-3-3 Supervisory Approaches and Actions

If a problem is found in a bank's consumer loan business from the various hearings and inspection results, etc., the FSA will require the bank to submit a report based on Article 24 of the Banking Act. If a serious problem is found with respect to the appropriateness of the business operation and customer protection, the FSA will issue a business improvement order based on Article 26 of the Banking Act.

If an inspection has found any serious violation of laws or conduct detrimental to public interests, such as repetition or continuity of an act of intimidating persons or harming the tranquility of a person's personal life or business operations, in collecting claims of loans caused because the management of the banks fails to comply with Article 12-2(2) of the Banking Act and Article 13-7 of the Regulation for Enforcement of the Banking Act, which stipulates that "A Bank (partially omitted) must stipulate internal regulations, etc. (partially omitted) concerning measures (partially omitted) in order to secure sound and appropriate business management (partially omitted), and must develop a sufficient system to manage its business based on training employees and other said internal regulations, etc.," the FSA should consider the necessity of issuing a business suspension order under Article 27 of the Banking Act.

In making an administrative decision, the FSA needs to fully consider the supervisory viewpoints, methods, and responses relating to other supervisory activities including "Grievance and Consultation concerning Banks," "Credit Risk Management," "Prevention of Damage that May be Inflicted by Anti-Social Forces," "Provision of Information and Consultation Function, etc. for Protection of Users," "Control Environments for Management of Information Related to Customers, etc.," "Outsourcing," "Dealing with Complaints (including Financial ADR System)," "Scope of Business of Subsidiary Companies, etc." "Bank Agency Service," etc. under these Supervisory Guidelines.

### III-6-4 Provision of Finance Service with Consideration for Persons with Disabilities

#### III-6-4-1 Background

The Act for Eliminating Discrimination against Persons with Disabilities (Act No.65 of 2013) prohibits a company from engaging in unfair discriminatory treatment for persons with disabilities and requires it to improve reasonable accommodation to implement elimination of social barriers, which banks are required to comply with.

In addition, banks need to give consideration to provide those who are able to express their intention not subject to adult guardianship but have difficulty following procedures, etc. in banking transactions by themselves due to visual, hearing, or physical disabilities (hereinafter referred to as the “persons with disabilities”) with the same services as those for persons without disabilities.

For this, it is deemed important for each bank to comply with laws and regulations related to persons with disabilities and to make efforts to proactively promote measures responding to needs of visually disabled persons, etc., including “introduction of an ATM machine for visually disabled persons” and “making a rule that bank employees (more than one) should assist visually disabled persons in conducting the banking procedure by writing or reading on behalf of them and smooth implementation of the rule” mentioned in the request statement issued by Director-General of the Supervision Bureau of the FSA to financial industry organizations, etc. on August 26, 2010 titled “Active Promotion of Measures with Consideration to Persons with Visual Disabilities.”

### III-6-4-2 Major Supervisory Viewpoints

#### (1) Outline

- (i) Whether the bank makes proper responses in accordance with each provision of the “Guidelines concerning Promotion of Elimination of Discrimination on the Basis of Disability in Business Fields under the FSA’s Jurisdiction” (Public Notice No. 3 of 2016, hereinafter referred to as the “Public Notice on Guidelines for Eliminating Discrimination against Persons with Disabilities.)
- (ii) Whether the bank makes efforts to improve accommodation and convenience for persons with disabilities in the financial transactions at its sales branches, facilities, transaction procedures, etc.

Also, when introducing new facilities in its sales branches or new procedures in its transactions, does the bank consider the introduction of a specification or design friendly to persons with disabilities, as needed.

- (iii) When promoting the measures giving consideration to persons with disabilities, whether the bank checks the national or local government’s related measures and applies them also to banking services, as needed.
- (iv) When receiving opinions or requests (including consultation and complaints) from persons with disabilities, whether the bank makes efforts to take measures responding to them. Also, when the bank is not able to satisfactorily respond to the opinions or requests from persons with disabilities, whether it considers alternative measures.

#### (2) Business operations

- (i) Writing on behalf of those who are not able to write themselves

When the bank receives from a person with a disability who is not able to write himself (hereinafter referred to as a “person having difficulty writing”) an application for opening an

account or for borrowing a loan, whether the bank, upon taking the following measures to fully protect them, formulates internal rules allowing the bank's employees to write on behalf of the person having difficulty writing to sufficiently respond to his/her needs.

Since such application by a person having difficulty writing is deemed as an "oral expression of one's intent," it should be noted that writing on behalf of a person having difficulty writing in transaction documents is limited within the scope of the expression of his/her intent relating to such request.

(A) In case of deposit transaction

a. Whether the bank has established rules allowing any of the persons mentioned below, when asked by a person having difficulty writing, to write his/her intent with regard to the deposit transaction on his/her behalf.

i) A person who accompanies the person having difficulty writing (\*1, \*2, \*3)

ii) Bank employees (more than one employee must attend to check)

Note 1: In the case where a person having difficulty writing does not appear and only a person who is asked by the person having difficulty writing comes to the bank, whether the bank confirms with the person having difficulty writing his/her intent to grant the authority to represent him/her to such person coming to the bank and his/her intent to conduct the relevant transaction.

Note 2: In the case where a person having difficulty writing comes to the bank alone, whether the bank allows any of its employees to write on his/her behalf rather than asking the person having difficulty writing to come again to the bank together with the person under i) above.

Note 3: In the case where a person having difficulty writing does not intend to ask the person accompanying him/her, such as a caregiver, to write on his/her behalf, whether the bank allows any of its employees to write on behalf of the person having difficulty writing rather than asking the person accompanying him/her to write on his/her behalf.

b. Whether the internal rules under a. above set forth at least the following as the relevant procedure.

i) The content of the expression of intent of the person having difficulty writing should be kept as a record;

ii) When a relative or accompanying person has written on behalf of the person having difficulty writing, more than one bank employee should confirm the content of such writing and keep the fact that they confirmed it as a record; and

iii) When a bank employee writes on behalf of the person having difficulty writing, more than one bank employee should confirm the content of such writing and keep the fact that they confirmed it as a record.

(B) In case of a loan transaction

Whether the bank has established rules allowing those who have the possibility to take over the repayment obligations of a person having difficulty writing who intends to apply for a loan transaction, including a presumptive heir or a provider of a third party guarantee (limited to those who are accompanying the person having difficulty writing and hereinafter referred to as the “accompanying presumptive heir”), when asked by the person having difficulty writing, to write his/her intent with regard to the loan transaction on behalf of him/her.

Whether such internal rules set forth at least the following matters.

- i) The content of the expression of intent of the person having difficulty writing should be kept as a record;
- ii) When the accompanying presumptive heir has written on behalf of the person having difficulty writing, more than one bank employee should confirm the content of such writing and record the fact that they confirmed it as a record; and
- iii) When the bank allows a person other than the accompanying presumptive heir to write on behalf of the person having difficulty writing, more than one bank employee should confirm the content of such writing and keep the fact that they confirmed it as a record (\*).

Note: If the bank refuses an application for loan transaction from a person having difficulty writing only on the grounds that there is no accompanying presumptive heir for him/her, this may make it difficult to ensure that the person having difficulty writing can live independent daily and social life.

It is, therefore, important for banks to consider proper solutions including use of the notary public system or attendance by a lawyer, etc. from the perspective to secure independent daily and social lives of persons having difficulty writing. When granting a loan to a person having difficulty writing with such solutions, banks need to be careful not to cause any trouble or dispute as to existence of claim between parties, etc. later, by introducing a control environment wherein a manager having relevant authority in HQ or a local head, etc. checks relevant contracts.

(ii) Reading on behalf of visually disabled persons

Whether the bank has formulated internal rules, when asked by a visually disabled person, allowing banks employees to read his or her transaction documents on behalf of him/her. In this case, whether the bank prevents any disclosure of personal information. And whether more than one bank employee confirm the content of such reading and keep the fact that they confirmed it as a record.

(iii) Confirmation of matters to identify a principal

In the case where a person with disabilities uses the disability certificate as an identification

document, refer to “III-3-3-3 Control Environments for Management of Information Related to Customers, etc.” in these Supervisory Guidelines.

(iv) Disseminating information

Whether the bank makes efforts to disseminate the information on its branches taking measures giving consideration to persons with disabilities or on the location of ATMs with functions enabling completely blind persons to use them by themselves (hereinafter referred to as the “accessible ATMs”) and the content thereof (including whether or not they have a voice guidance system) in such a manner that persons with disabilities can recognize and understand it with their visual or hearing ability, etc.

When the bank and its branches take measures giving consideration to persons with disabilities, it is preferable that such fact should be actively disclosed and disseminated as its CSR approaches. (Refer to “III-7 Information Disclosure Regarding Corporate Social Responsibility (CSR)” in these Supervisory Guidelines.)

(v) Handling complaints

See “III-3-5-2 Establishment of Internal Control Environment for Handling Complaints” in these Supervisory Guidelines.

In particular, when the bank receives requests and complaints from persons with disabilities with regard to the bank’s services and procedures necessary to secure their independent daily and social lives, whether the bank makes efforts to consider or take actions to improve them.

(vi) Training, etc.

Whether the bank disseminates the control environment giving consideration to persons with disabilities to all employees who contact customers, via training or other means (including delivery of manuals, etc.) to make such control environment effective.

(3) Branches and facilities

(i) Whether the bank gives consideration to introduce disabled-friendly specification into its branches and facilities. Even in the case where its branch is located in a building or a land leased from another entity, whether the bank endeavors to ask the landlord of such building or land for cooperation when it receives a request from persons with disabilities.

(ii) Whether the bank makes efforts to improve convenience for persons with disabilities in the financial transactions at each sales branch, as needed.

(iii) Specifically with regard to responses to visually disabled persons, whether the bank makes the following efforts, for example.

(A) Whether the bank gives consideration to visually disabled persons by installing accessible ATMs (ATMs that have the functions to make remittance and to change passwords are more preferable) and to make the screen of the ATMs have greater contrast and flexibility in size of letters. (Screens that are big in size and have no touch panel function are more preferable.)

- (B) Whether the bank gives consideration to visually disabled persons, for example, by placing blocks guiding them (hereinafter referred to as “braille blocks”) from the entrance of the branch to the accessible ATM. (In the case where its branch is located in a building or land leased from another entity, whether the bank endeavors to ask the landlord of such building or land for cooperation when it receives a request from visually disabled persons.)

Assuming the case where installation of the braille blocks may hinder access or mobility of wheelchairs, etc., banks need coordination or arrangements in placing braille blocks, in securing the walking space and in introducing a guiding by their employees, etc.

- (C) In the case where the bank uses an ATM installed and operated by a non-financial institution, such as a convenience store, whether the bank seeks information as to whether or not an accessible ATM is installed, on a periodic basis. In particular, when requested by visually disabled persons for installation of an accessible ATM, whether the bank endeavors to convey such request to an entity who has installed an ATM, in a timely manner.

- (D) Whether the bank gives consideration to visually disabled persons, for example, by placing braille blocks from the pavement in front of the branch to the entrance of the branch. When it is impossible to install braille blocks, whether the bank gives consideration so that a visually disabled person can visit the bank alone, for example, by promoting the installation of a voice guiding system. Also, whether the bank endeavors to encourage the road administrator to install braille blocks guiding a visually disabled person to the bank.

Assuming the case where installation of the braille blocks may hinder access or mobility of wheelchairs, etc., banks need coordination or arrangements in placing braille blocks, in securing the walking space and in introducing a guiding by their employees, etc.

- (E) When providing an Internet banking service or telephone banking service, whether the bank gives consideration to visually impaired persons by establishing a system enabling them to use such services.

- (F) Whether the bank endeavors to make cash cards, bank books, and transaction records available to visually disabled persons in a manner that enables the persons to recognize them.

### III-6-4-3 Supervisory Approaches and Actions

Whether the bank has taken measures based on the Guidelines concerning Promotion of Elimination of Discrimination on the Basis of Disability in Business Fields under the FSA’s Jurisdiction, measures giving consideration to persons with disabilities, and has developed a control environment relating to the consultation and complaint handling function to supplement them relates to the base of the bank’s sound and appropriate business operation, as well as to the viewpoints of customer protection and user convenience. Therefore, associated internal control environments need to be highly effective.

Upon receiving opinions from persons with disabilities to a bank, the FSA will convey these opinions to the bank and check the status of relevant internal controls to establish.

Also, when any doubt arises regarding the development of the bank's internal control environments, the FSA will inspect the bank by requiring it, as needed, to submit a report (including those under Article 24 of the Banking Act). If any problem is found in such development, the FSA will encourage the bank to improve.

### III-7 Information Disclosure Regarding Corporate Social Responsibility (CSR)

#### III-7-1 Background

- (1) CSR is generally interpreted as corporate responsibilities in economic, environmental, and social fields that a company recognizes through its relationship with various stakeholders and its efforts based thereon. CSR is considered to have significance in that the company can enhance its sustainability by fulfilling those responsibilities.
- (2) CSR of each bank including relevant efforts and information disclosure should be conducted by the bank, which is a private company, based on its own management decision in line with the principle of self-responsibility, while evaluation of the bank's CSR should be made by users and other stakeholders under the principle of market discipline.
- (3) However, if a bank discloses CSR information in an easy-to-understand and timely manner, it may enable users who intend to choose a bank with which they conduct transactions to obtain useful information more easily in judging the sustainability of the bank's business operation and financial products and services. From this viewpoint, the FSA encourages banks to make appropriate and useful information disclosure to users by clarifying supervisory viewpoints regarding CSR information disclosure and showing the minimum standards to banks.

#### III-7-2 Major Supervisory Viewpoints

Whether the bank makes proper information disclosure from the following viewpoints so that its various stakeholders, including users, can appropriately evaluate the bank's CSR, thereby contributing to improvement of the convenience of users.

##### (1) Suitability with objective

Whether the bank's CSR report comprehensively covers the fields of the economy, environment, and society. Also, whether it meets the objective of accurately responding to the needs of various stakeholders, including users, by including comprehensive content and reflecting the prevailing social

backgrounds. Whether the disclosure is made in a timely and effective manner.

(2) Reliability

Whether the bank compiles its CSR report using correct, neutral, and verifiable data and information through a transparent process, thereby ensuring that the report is highly reliable and widely acceptable.

(3) Readability

Whether the bank strives to make its CSR report as easy to understand as possible so that various stakeholders, including users, can understand it. Whether the bank pays sufficient attention in compiling the CSR report so that readers can compare it with the bank's past report, for example, maintaining consistency of the content.

### III-7-3 Supervisory Approaches and Actions

A bank's CSR efforts and relevant information disclosure are its voluntary activities conducted based on its management decision in line with the principle of self-responsibility. Therefore, even if the bank fails to make information disclosure in compliance with the above supervisory viewpoints, the FSA will not take supervisory measures.

However, in cases where its disclosure practice is so imprecise and inappropriate that may mislead users, the FSA will examine it from the viewpoint of the appropriateness of its business operations.

### III-8 Business Continuity Management (BCM)

#### III-8-1 Background

Given the increased diversity and complexity of risks faced by banks and changes in the business environment for them in recent years, such as the increasing use of information technology systems, the possibility cannot be denied that a crisis that cannot be dealt with by ordinary methods of risk management will occur, which means that crisis management has become more important than ever. Specifically, for major banks, which are located in the same areas and play fundamental roles in Japan's financial system, it is extremely important for the people's lives and the economy that they act in an appropriate manner in the event of an emergency, by, for example, taking recovery measures quickly and ensuring that the minimum necessary operations and services are maintained. Therefore, banks need to make appropriate preparations in normal times, such as establishing Business Continuity Management (BCM) systems and formulating Crisis Management (CM) manuals and a Business Continuity Plan (BCP).

As the crisis management relating to reputation risk and information technology system risk may significantly affect the bank's cash management and society, the FSA will separately define the supervisory viewpoints for them.



### III-8-2 Actions in Normal Times

#### (1) Actions

Based on the recognition that proactive and preventive measures in preparation for crisis in normal times are vital for crisis management, the FSA will check whether or not there is a serious problem in the bank's crisis management system in the course of offsite monitoring including the early warning system and a hearing or interview on filing of misconduct notifications, or when it receives complaints or information relating to the bank. Also, the FSA will verify the adequacy of the bank's BCP through a hearing and interview. For this, the FSA will pay attention, in particular, to the following points.

#### (2) Major Supervisory Viewpoints

- (i) Whether the bank recognizes what constitutes an emergency and whether it striving as much as possible to prevent or guard against any emergency (prepare countermeasures against an emergency that may be unpreventable) by, for example, conducting inspections and anti-crisis practices periodically in normal times.
- (ii) Whether the bank has formulated a crisis management manual. Whether the bank revises the crisis management manual in light of the actual state of its business operations and its risk environment, etc. on a continuous basis. It is desirable that the bank should use objective benchmarks as a basis for formulation of its crisis management manuals.

#### (Reference) Examples of conceivable emergency

- (A) Natural disasters (earthquakes, wind or flood damages, abnormal weather, epidemics of infectious diseases, etc.)
  - (B) Acts of terrorism and wars (including those that occur outside Japan)
  - (C) Accidents (large-scale power failures, technology failures, etc.)
  - (D) Unfounded/harmful rumors (word-of mouth rumors, Internet messages, e-mail messages, news articles based on speculation, etc.)
  - (E) Crimes committed against banks (cyberattack, intervention by anti-social forces, data theft, and abduction of officers or employees)
  - (F) Problems involved in business processes (responses to complaints and inquiries, errors in data entry, etc.)
  - (G) Problems related to personnel management affairs (accidents and crimes involving officers and employees, internal disputes, sexual harassment cases, etc.)
  - (H) Problems related to labor affairs (cases of whistle-blowing, deaths from excessive workloads, occupational diseases, drain of human resources, etc.)
- (iii) Whether the crisis management manual notes the importance of initial responses, such as accurate identification and objective judgment of the situation and dissemination of information in the period immediately after the occurrence of the emergency.

- (iv) Whether the crisis management manual clarifies the allocation of responsibilities in the event of an emergency and specifies arrangements and procedures for reporting the occurrence of the emergency throughout the organization and to other parties concerned (including the relevant authorities). Whether the crisis management manual specifies arrangements and procedures for reporting the occurrence of an emergency to relevant overseas supervisory authorities, depending on the extent of its possible impact abroad as well as its level and type. It is desirable that anti-crisis arrangements and procedures be established under the supervision of the crisis management headquarters that oversees organization-wide response in light of the levels and types of emergencies assumed for each division and branch.
- (v) Whether the business continuity plan (BCP) provides for measures to enable early recovery from damage caused by terrorism, large-scale disasters, etc. and continuance of the minimum necessary business for the maintenance of the functions of the financial system. For this, whether the bank has developed a scheme to cooperate with the Japanese Bankers Association and other major banks, etc. Whether the BCP enables the bank to deal with international disruptions of business operations in a manner suitable to the actual state of its own business operations.

For example,

- (A) Whether measures are taken to secure the safety of customer data and the like in the event of disasters, etc. (storage of information printed on paper in electronic media, creation of back-ups of electronic data files and programs, etc.)
  - (B) Whether measures are taken to secure the safety of computer system centers, etc. (allocation of back-up centers, securing of staff and communication lines, etc.)
  - (C) Whether the above back up measures have been taken in ways to avoid geographic concentration.
  - (D) From the viewpoints of securing the operations vital for the maintenance of the functions of the financial system, such as acceptance of individual customers' requests for cash withdrawal and remittance and processing of large-lot, large-volume settlements conducted through the interbank market and the interbank settlement system, whether the bank specifically sets a target period for recovery through provisional measures, such as manual operations and processing by back-up centers. Whether operations are especially vital for the maintenance of the functions of the financial system, such as processing of large-lot, large-volume settlements conducted through the interbank market and the interbank settlement system, scheduled to recover within the same day when the business disruption occurs.
  - (E) Whether the bank obtains approval from the board of directors when it adopts the BCP and makes important revisions. Whether the BCM is checked by independent entities, such as internal and external audits.
- (Reference) "Development of BCM at Financial Institutions" (Bank of Japan, July 2003)

“Basic Principles on Business Continuity” (Joint Forum, August 2006)

- (vi) Whether the bank makes daily efforts to disseminate and collect information in a conscientious manner. Whether a scheme and procedures for communicating and collecting information in the event of an emergency are sufficient in light of the level of crisis envisioned and typical cases of emergency assumed.

(3) Points to Note concerning BCP using Overseas HQ or Branches

In the case where a bank assumes in its BCP that it will temporarily conduct its operations from abroad when its business continuity becomes difficult at home owing to a large-scale disaster, etc., in addition to the supervisory viewpoints listed (2) above, the following points should be noted.

- (i) With regard to the operations assumed to be conducted from abroad, whether the BCP specifies the types of critical incident, scope of business operations, scale, places to conduct such operations, and the period, etc.
- (ii) Whether the scope of operations to be conducted from abroad, the scale and the period are confined to the requisite extent depending on the critical incident and are also based on the seriousness of the critical incident as well as its impact on operations.

In addition, in cases where part of internal management operations or back office operations are outsourced to the group’s overseas branches under normal circumstances, whether the impact on such operations conducted from abroad is assessed.

- (iii) In the case where the BCP assumes that domestic customer information will be accessed from abroad, whether the bank has put a proper environment in place to comply with the Personal Information Protection Act and other laws and regulations, etc. For example, whether the right of access is granted only to the officers and employees who need such information, and whether the scope of accessible customer information is limited to the minimum necessity.
- (iv) When implementing the BCP, whether the bank has put in place an environment where the internal control department verifies whether or not there are any violations of laws or regulations or any problems in the protection of users, etc. If such a violation or problem is found in any relevant overseas place, whether the bank clarifies where the responsibility lies.
- (v) With regard to all operations to be conducted from abroad, whether the bank has properly established a reporting system with the FSA and any other relevant organizations.

- (Note) It should be noted that in the case where a bank conducts overseas operations based on the BCP of its group’s overseas branch, it needs to comply with the local laws and regulations as well as the Japanese related laws and regulations.

III-8-3 Actions to Emergencies

III-8-3-1 Outline

When the FSA has recognized the occurrence of an emergency or the possibility of an emergency occurring, it should hold hearings periodically and check the situation first hand so that it can identify and keep track of how the bank is responding to the emergency, including whether the response (status of the development of a control environment for crisis management, recovery status, continuity of business operations, communications with relevant parties and dissemination of information) is sufficient in light of the level and type of the emergency, until the situation is stabilized. In addition, the FSA will require the bank to submit a report based on Article 24 of the Banking Act when necessary.

### III-8-3-2 Measures Regarding Financial Services Support in Event of Disasters (relating to the Disaster Countermeasures Basic Act, etc.)

#### (1) Financial services support measures for disaster-stricken areas

The FSA disaster prevention/mitigation plan based on Article 36(1) of the Disaster Countermeasures Basic Act and the FSA plan for the protection of the people based on Article 33(1) and Article 182(2) of the Banking Act on the Protection of the People in Event of Armed Attacks (hereinafter referred to as the “People Protection Act”) provides for measures regarding financial services support in the event of disasters and other emergencies. In light of this, when a disaster (meaning a disaster as specified under Article 2(i) of the Disaster Countermeasures Basic Act, an armed attack specified under Article 2(4) of the People Protection Act or an emergency as specified under Article 183 of the People Protection Act; the same applies hereinafter) has occurred or may occur, the FSA will, while maintaining close contact with relevant organizations, ensure that banks quickly implement the following measures in an appropriate manner within limits deemed necessary, in light of the extent of damage and other circumstances of the affected areas and the demand for funds in such areas.

##### (i) Financing at the time of disaster

Banks are required to, taking account of the disaster situation and the demands of emergency funds, take timely and proper measures that accommodate disaster victims such as opening of a consultation center for financing, easing loan assessment criteria and procedure, speedy cash lending, additional grace period of loan, etc.

##### (ii) Withdrawal and cancellation of deposit accounts

(A) Banks are required to provide as much convenience as possible to disaster victims whose bankbooks or registered seals, etc. have been destroyed by fire or flood by accepting their request for withdrawal of deposits via presentation of disaster certification or other simple manner of identification in line with the actual situation.

(B) Banks are required to take appropriate measures to allow disaster victims who are deemed to need funds due to inevitable circumstances to cancel their fixed deposits or installment savings before their maturity or provide them a loan against such deposits, etc.

##### (iii) Exchange of bills and operation on holidays, etc.

Banks are required to give appropriate consideration with regard to exchange of bills, handling of dishonored bills, and operation on holidays or outside of ordinary working hours.

Also they are required to, even in the case where it is not able to offer teller services, provide as much convenience as possible to disaster victims such as by operating cash withdrawal services via ATM, etc. while fully considering the safety of customers and employees.

- (iv) Response at the time of suspension of operation, etc.

Banks are required to, when it suspends teller services, ensure that all customers know at which branches services have been suspended and at which branches ATM service is available, and through means such as notices indicated at branches, newspaper advertisements, and notices posted on the Internet.

- (2) Various financial services support measures in Advance Evacuation Areas related to a Nankai Trough Earthquake or other areas

Pursuant to the Basic Plan to Advance Countermeasures against a Nankai Trough Earthquake Disaster, the national government is required to establish its principle of guidance, etc. regarding measures to be taken by financial institutions, such as the withdrawal of deposits and savings, and operation on holidays or outside of ordinary working hours, in the case where a special bulletin on a Nankai Trough Earthquake or other related information (hereinafter referred to as the “mega earthquake alert”) is issued.

However, it is difficult to manage administrative processes related to banking services on an area-by-area basis, given the advanced automation and the expansion of networks of unmanned services operations; therefore, regarding a possible Nankai Trough Earthquake, the FSA will ask banks to take the following measures, etc. in an appropriate manner in light of the fund demand in the affected areas while maintaining close contact with relevant organizations.

- (i) Response to the issuance of a mega earthquake alert by banks with HQ, sales branches, and business offices in Advance Evacuation Areas
  - (A) In cases where a mega earthquake alert is issued during business hours, the FSA will request the bank to suspend all teller services at HQ, sales branches, and business offices except for withdrawal of ordinary deposits (including general accounts; the same applies hereinafter), to accurately capture how crowded branches are with customers, to discontinue teller services for withdrawal of ordinary deposits in a safe manner and to ensure that users know of the suspension of the teller services. However, even in this case, the FSA will request banks to take measures such as operating ATMs for cash withdrawal service upon fully considering the safety of customers and employees in close cooperation with HQ and branches of the BOJ and the police office, etc. in the affected area so that the ordinary life of people who live there is not damaged to the extent possible.
  - (B) With regard to the means to ensure that all customers know at which branches services have been suspended and at which branches ATM service is available, etc., the FSA will

request the bank to make notices indicated at branches, newspaper advertisements, and notices posted on the internet.

(C) In cases where a mega earthquake alert is issued on a holiday or before or after the business hours of sales branches, the FSA will request banks to refrain from resuming teller services so as to enable the smooth implementation of financial business, in case an earthquake actually occurs, provided, however, that even in this case, the FSA will request banks to take measures such as continuing operation of ATMs upon fully considering the safety of customers and employees in close cooperation with HQ and branches of the BOJ and the police office in the affected area so that the ordinary life of people who live there is not damaged to the extent possible.

(D) Others

a. In cases where an evacuation directive due to a mega earthquake alert is removed, the FSA will request banks to resume normal operations and services as soon as possible.

b. The FSA will request banks to take appropriate emergency measures based on “III-8-3-2(1) Financial services support measures for disaster-stricken area” above if an earthquake actually occurs.

(ii) Response to the issuance of a mega earthquake alert by banks with HQ, sales branches, and business offices outside Advance Evacuation Areas

(A) In cases where a mega earthquake alert is issued during business hours, the FSA will request the bank to suspend the clearing bill work such as bill collection involving HQ, sales branches, and business offices located in the Advance Evacuation Areas, and to notify customers of such fact by posting it at HQ, the branches, and business offices to ask for their cooperation.

(B) Even if banks have suspended business operations and services at HQ, sales branches, and business offices located in the Advance Evacuation Areas, the FSA will request them to conduct business and provide services as usual at HQ, sales branches, and business offices in other areas.

#### III-8-4 Post-Crisis Actions

In cases where the FSA has concluded, after the emergency has been brought under control, that it is necessary to examine the bank’s response to the emergency, the FSA will require the bank, under Article 24 of the Banking Act, to submit a report regarding the outline of the crisis, the bank’s response, and analysis of causes and preventive measures for recurrence thereof.

#### III-8-5 Crisis Management System against Reputation Risk

- (1) Whether the bank has developed a control environment for managing reputational risk. Also, whether it has specified rules on how the HQ, divisions, and sales offices should respond to the circulation of unfounded/harmful rumors. It is desirable that the bank consider how to respond when unfounded/harmful rumors regarding other banks or their business clients, etc. are circulated.
- (2) Whether the bank regularly checks whether there are unfounded/harmful rumors circulating in each media category (e.g., internet messages, news articles based on speculation).
- (3) Whether the bank has established rules on the initial responses in the case where an unfounded/harmful rumor leads to withdrawal or cancellation of deposits by customers, including grasping of situations of sales branches and in-branch and external ATMs, customer responses, how to secure cash for withdrawal, public announcement of the situation, etc.
- (4) Whether the bank has a control environment to promptly notify the FSA, the BOJ, other banks, business partners, and security companies when case (3) occurs.  
Under such control environment, whether the bank also communicates with the local government and the police department as needed.
- (5) When receiving a notice under (4) above, the FSA should hold a regular hearing with the bank to check on the situation until it deems that the situation has stabilized.

### III-9 Dissemination and Establishment of the “Guidelines for Personal Guarantee Provided by Business Owners” as Loan Practice

#### III-9-1 Purpose and Significance

A personal guarantee provided by a business owner of a small and medium-sized enterprise, etc. (“SME”) (hereinafter referred to as the “personal guarantee provided by business owners”) may contribute to smooth financing for the SME because it disciplines its management and enhances its credibility. It may, on the other hand, become a factor hindering the business owner of the SME from developing the business drastically, launching a new business, or recovering the management if it worsens after the guarantee is provided, which may result in restraint of vital activities of the SME. These issues cause concerns at the time of entering a contract for personal guarantee provided by business owner and performing the guarantee obligations.

In light of these situations, the “Guidelines for Personal Guarantee Provided by Business Owners” (published by the “Working Group of the Guidelines for Personal Guarantee Provided by Business Owners” on December 5, 2013; hereinafter referred to as the “Guidelines”) were established to serve as self-regulation and self-discipline rules for the SMEs, business owners and financial institutions.

The Guidelines, which were formulated by members from SMEs' organizations and financial institution associations through deliberation with independent and relevant experts, are designed to show what a reasonable contract should be for the personal guarantee provided by business owners, as well as to be used as rules to promote the fair and prompt settlement of guarantee obligations at the time of performance of principal debts, and are expected to be voluntarily respected and complied with by principal obligors, guarantors, and creditors.

Financial institutions are required to disseminate and establish these Guidelines as a prevailing loan practice for the personal guarantee provided by business owners by conducting proper actions fully based on the purpose and content of the Guidelines, and it is desirable for these institutions to announce their policies and initiatives, etc.

### III-9-2 Major Supervisory Viewpoints

- (1) Whether the management of the bank has clearly established the policies and initiatives, etc. on the personal guarantee provided by business owners while recognizing the importance to respect and comply with the Guidelines and taking full initiative. Whether the management has communicated to the employees the rules on the personal guarantee provided by business owners indicated in the Guidelines and the following matters.
  - (i) Further promotion of loans that do not depend on the personal guarantee provided by business owners (including study of possibilities not demanding business owners' personal guarantee when their business assets and personal household are clearly separate, etc.);
  - (ii) Action at the time of entering into a contract for personal guarantee provided by business owner (including setting of a proper guarantee amount, and in the case where the bank enters into a guarantee contract, the bank should explain what part is insufficient and requires the conclusion of the guarantee contract, and what improvements may increase the possibility of modification or cancellation of the guarantee contract while giving objective and reasonable reasons to obtain understanding and consent from the customer, depending on the customer's knowledge and experience, etc.);
  - (iii) Proper review of existing guarantee contracts (including handling at the time of succession of business, and proper review of each personal joint and several guarantee from a third party other than the business owner (see III-10-2 (2)));
  - (iv) Action at the time of settlement of guarantee obligations (including the business owner's management responsibility, the scope of residual assets, and how to treat the guarantee obligations left after the obligations are partially performed); and
  - (v) Others (including how to handle information on guarantors who settle debts according to the Guidelines).
- (2) Whether the bank endeavors to develop a necessary environment to ensure that actions based



on the Guidelines are properly performed by preparing internal regulations and manuals (including the requirement that, after referring to Item (iv)(2) of the “Guidelines for Personal Guarantee Provided by Business Owners,” the bank should show, to the extent possible, its qualitative standpoint as for the debtor’s assets and earning power, and its objective and specific standpoints as for any other relevant factors), contract templates, or introducing a support scheme by HQ towards sales branches, etc.

- (3) Whether the bank has an environment in place to properly respond to a consultation made by a principal obligor and guarantor in connection with the personal guarantee provided by business owners.
- (4) Whether the bank endeavors to enrich the choice of loan programs to substitute the personal guarantee provided by business owners such as a guarantee contract with a suspension or cancellation clause or asset-based lending (ABL), etc. Whether the bank endeavors to explain these programs to customers.
- (5) When being asked by a principal obligor who is an SME for loans, whether the bank, after analyzing the management conditions of the SME, conducts review as to whether the obligor separates or tries to separate his/her business assets from his/her personal household. And when it is recognized that the obligor separates his/her business assets from his/her personal household as a result of the review, whether the bank has an environment in place to study the possibility not to require the personal guarantee provided by business owners for the SME upon hearing the intention of the obligor.
- (6) In the case where the bank enters a guarantee contract, whether the bank has developed an environment where the bank explains what part is insufficient and requires the conclusion of the guarantee contract, and what improvements may increase the possibility of modification or cancellation of the guarantee contract while giving objective and reasonable reasons as well to get understanding and consent from the customer, depending on the customer’s knowledge and experience, etc. In addition, whether the bank has developed an environment where the bank records the results, etc. in writing or in electronic form.
- (7) In settling guarantee obligations, whether the bank respects the purpose of the Guidelines and endeavors to fully coordinate and cooperate with other financial institutions involved, outside experts (CPAs, tax accountants, and lawyers, etc.) and external organizations (SME Revitalization Support Councils, etc.).
- (8) Whether the bank makes sure that actions based on the Guidelines are properly performed, by

conducting internal audits periodically and as needed. And whether the bank has an environment in place to make more use of the audit scheme as needed by improving and enriching it based on the results thereof.

### III-9-3 Supervisory Methods and Measures

Financial institutions need to address the abovementioned issues properly based on the purpose of the relevant policy; “It is important that these Guidelines are disseminated and established as a prevailing loan practice through active use by financial institutions so that faithful cooperation among a principal obligor, guarantor, and creditor in the actions based on the Guidelines will build and reinforce a continuous and good relationship of trust among them, increase the motivations of many SMEs or those who intend to start a business at each stage of their life, and further bring out the vitality of SMEs through the smooth processing of SME-oriented finance, thereby contributing to revitalizing Japan’s economy.”

Taking into consideration these initiatives and the situations of banks, the FSA will encourage financial institutions through various hearing opportunities, etc. to announce their policies and initiatives, etc. to disseminate and establish these Guidelines as a prevailing loan practice.

Moreover, in cases where any doubt arises regarding the effectiveness, etc. of the bank’s internal control environments, the FSA will, as needed, require the bank to submit a report pursuant to Article 24 of the Banking Act, and if a serious problem is deemed to exist, the FSA will issue a business improvement order based on Article 26 of the Banking Act.

### III-10 Establishment of loan practice that does not, in principle, demand a personal joint and several guarantee of a third party other than the business owner

#### III-10-1 Purpose and Significance

Some point out that many SMEs (including sole proprietors) do not separate their business assets and accounting from their household and that their financial statements are not always reliable. Therefore, when granting a loan to an SME, banks often ask the business owner of an SME to provide a personal guarantee from the viewpoint of corporate credit enhancement and discipline for management. On the other hand, others say that, although a personal guarantee by a third party other than a business owner is expected to work in supplementing credit and ensuring the morals of the business owner, there is a concern about whether it is proper to impose the same guarantee obligation as the business owner on a third party who does not have any direct responsibility in business operations.

In addition, other concerns arise in that, depending on the action by the bank at the time of performing the guarantee obligations, the guarantor may lose an opportunity to restart as a business owner and the base of his/her social life. In light of this, financial institutions are required to make detailed responses upon performance of the guarantee obligations considering the property and income of the guarantor.

Under these circumstances, the policy “to establish a loan practice that does not, in principle, demand a personal joint and several guarantee of a third party other than business owner and to promote actions considering the guarantor’s assets and income at the time of performing the guarantee obligations” was introduced by the “Action Plan for the New Growth Strategy” (published on December 24, 2010), and financial institutions need to take actions by following the purpose thereof.

With regard to personal guarantee by a third party not involved in relevant business, procedures to confirm the will of the third party should be required under the revised Civil Code, which came into effect on April 1, 2020. Accordingly, financial institutions need to follow the procedures pursuant to the revised Civil Code when they enter into guarantee contracts, while also following the purpose mentioned in the above paragraph.

### III-10-2 Major Supervisory Viewpoints

- (1) Establishment of loan practice that does not, in principle, demand a personal joint and several guarantee of a third party other than the business owner

Whether the bank has determined a policy not to, in principle, demand third party guarantee other than business owner with respect to the personal joint and several guarantee contract. Also, in addition to entering into relevant contracts only after following the procedures to confirm the will of the third party as stipulated in the Civil Code, whether the bank follows the policy mentioned in “Credit Guarantee Corporations are prohibited, in general, from requiring a third party guarantee” as needed when determining its policies and entering into a personal joint and several guarantee contract with a third party other than a business owner in exceptional cases. In particular, when concluding a personal joint and several guarantee contract with a third party other than business owner in an exceptional case, despite a third party not being substantially involved in the business, whether it is ensured that the third party enters the contract of his/her own will and is not forced to do so by the financial institution.

(Reference 1) “Credit Guarantee Corporations are prohibited, in general, from demanding a third party guarantee.” (March 31, 2006, extracted from the website of the Small and Medium Enterprise Agency  
[https://www.chusho.meti.go.jp/kinyu/2006/060331daisanshahoshou\\_kinshi.html](https://www.chusho.meti.go.jp/kinyu/2006/060331daisanshahoshou_kinshi.html)  
(Japanese).)

(Omitted) The Small and Medium Enterprise Agency prohibits the Credit Guarantee Corporations from demanding a third-party guarantor other than the business owner in general with respect to loan guarantee applications submitted in or after FY 2006; provided, however, that this will not apply in the case of special circumstances as described below: (Partially omitted)

1. when a person who has substantial control in the business, a person who has a business license, or the spouse of the business owner (limited to a spouse who engages in the business together with the owner) becomes a joint and several guarantor;
2. when a successor to the business becomes a joint and several guarantor due to the business owner’s health reasons; or

3. where comprehensively judging the financial and other business situations of the SME, the amount of guarantee requested by the SME exceeds the risk allowance generally acceptable by the bank, but where a collaborator or supporter of the business of the SME actively offers to assume the guarantee obligations (however, limited to cases where it is recognized objectively that the collaborator, etc. has made such offer of his/her own will.)

(Reference 2) Handling of Guarantee Contracts under the Civil Code

Article 465-6

(Preparation of Notarial Instrument and Effect of Guarantee)

A guarantee contract under which the principal obligation is a loan obligation assumed for business or a contract for a revolving guarantee under which the scope of the principal obligation includes a loan obligation assumed for business does not become effective unless the person that will become a guarantor manifests, prior to the conclusion of the contract, the intention to perform the guarantee obligation by means of a notarial instrument prepared within one month prior to the day of conclusion of the contract.

Article 465-9

(Exclusion from Application of Provisions Concerning Preparation of Notarial Instrument and Effect of Guarantee)

The provisions of the preceding three Articles do not apply to a guarantee contract under which the person that will become a guarantor is any of the following persons:

- (i) if the principal obligor is a corporation, its managing administrator, director, executive officer, or any person equivalent thereto; or
- (ii) if the principal obligor is a corporation, any of the following persons:
  - (a) a person that holds the majority of voting rights of all shareholders (excluding voting rights in respect of shares that do not allow voting rights to be exercised for all matters that may be resolved at a shareholders meeting; hereinafter the same applies in this item) of the principal obligor;
  - (b) if the majority of voting rights of all shareholders of the principal obligor is held by another stock company: a person that holds the majority of voting rights of all shareholders of that other stock company; or
  - (c) if the majority of voting rights of all shareholders of the principal obligor is held by another stock company and a person that holds the majority of voting rights of all shareholders of that other stock company: a person that holds the majority of voting rights of all shareholders of that other stock company;
  - (d) if the principal obligor is a corporation that is not a stock company: a person equivalent to the person set forth in (a), (b) or (c); or
- (iii) a person that conducts business jointly with the principal obligor (excluding one that is a corporation; hereinafter the same applies in this item) or the principal obligor's spouse who actually engages in the business conducted by the principal obligor.

- (2) Development of environments to respond when being consulted by a third-party guarantor about termination of the guarantee

In the case where a bank is consulted by a third-party guarantor about termination of the guarantee, whether the bank has put in place environments to respond properly by considering the points mentioned in the Purpose and Significance in III-10-1 and taking into full account the history of why the guarantor has assumed the guarantee, his/her payment capacity, and his/her actual living situations.

- (3) Promotion of actions considering guarantor's capacity to perform guarantee obligations at the time thereof

When requiring a guarantor (including a principal obligor who is a sole proprietor) to perform his/her guarantee obligations (including obligations of such principal obligor), whether the bank has a control environment to make detailed responses to the guarantor by considering the points mentioned in the Purpose and Significance in III-10-1, paying attention to the status of the guarantee obligor in performing the obligations, the history of why the obligor assumes the guarantee and the degree to which the obligor is responsible, and offering the obligor to perform the guarantee rationally according to his/her payment capacity judged properly based on his/her actual living situations.

Whether the bank has a control environment to consider use of the "Guidelines for Personal Guarantee Provided by Business Owners" and take actions based thereon in cases where a third party performs his/her personal joint and several guarantee, as needed, keeping in mind that the Guidelines also apply to that case. (See III-9-2.)

Note: See also III-3-3-1-2 (1), (2), (3), (6), and (7).

### III-10-3 Supervisory Methods and Measures

Financial institutions need to properly address these issues considering the purpose of the policy "to establish a loan practice that does not, in principle, demand a personal joint and several guarantee of a third party other than business owner and to promote actions considering the guarantor's assets and income at the time of performing the guarantee obligations." It is also necessary to uphold proper accountability in addressing these issues. (See III-3-3-1.)

In addition, when a bank enters into a personal guarantee contract with a third party not involved in relevant business, the bank needs to follow the procedures to confirm the will of the third party as stipulated in the Civil Code.

Taking into consideration these initiatives and the situations of the banks, the FSA will study how to supervise them, and when any doubt arises regarding the effectiveness of a bank's internal control environment, the FSA will examine the bank by requiring it, as needed, to submit a report (including those under Article 24 of the Banking Act). In cases where a problem is found in the appropriateness or soundness of the bank's business operations, the FSA will require the bank to submit a report pursuant to Article 24 of the Banking Act and if a

serious problem is deemed to exist, the FSA will issue a business improvement order based on Article 26 of the Banking Act.

### III-11 Ensuring Smooth Implementation of Orderly Resolution, etc.

#### III-11-1 Purpose and Significance

Based on reflections on the global financial crisis that occurred in the recent past, international efforts have been made to develop a new framework to resolve global systemically important financial institutions in a prompt and orderly manner.

This framework is intended to end the so-called “too big to fail” problem, which refers to the issue whereby national authorities are not able to resolve globally active banks and have no option but to rescue them by injecting public funds due to the concern that unorderly failure of such financial institutions would have an extremely serious adverse effect (the “systemic risk”) on financial and economic systems in each country.

At the G20 Cannes Summit in November 2011, the “Key Attributes of Effective Resolution Regimes for Financial Institutions (the “Key Attributes”) submitted by the Financial Stability Board (FSB) was endorsed as a new international standard for resolution regimes. The Key Attributes require that financial institutions that could be systemically significant or critical if they fail to develop a recovery plan be subject to an effective resolution regime that meets certain conditions. Furthermore, at the G20 Antalya Summit in November 2015, the “Principles on Loss-absorbing and Recapitalization Capacity of G-SIBs in Resolution” submitted by the FSB (together with the “Guiding Principles on the Internal Total Loss-Absorbing Capacity of G-SIBs” which was released by the FSB in July 2017, hereinafter collectively referred to as the “TLAC Term Sheet”) was endorsed.

Based on these international agreements, authorities in major jurisdictions have been taking necessary steps to build legal frameworks for orderly resolution of financial institutions. In Japan, with the amendment of the Deposit Insurance Act (hereinafter referred to as the “DIA”) in June 2013 (enforced in March 2014), the “Measures for Orderly Resolution of Assets and Liabilities of Financial Institutions for the Purpose of Ensuring Financial System Stability” were newly introduced. The FSA released its approach to introduce the TLAC framework for Japanese G-SIBs in the “The FSA’s Approach to Introduce the TLAC Framework (published in April 2016 and revised in April 2018)” and subsequently published relevant policies including the “FSA Public Notice on Capital Adequacy Rules for Bank Holding Companies pursuant to Article 52-25 of the Banking Act” (hereinafter referred to as the “Public Notice on TLAC Pillar 1”). Finally in March 2019, the FSA started applying the TLAC requirements in Japan.

However, in order to solve the “too-big-to-fail” problem, not only the regulatory framework but also financial institutions’ own efforts in normal times are essential. The efforts in normal times include formulation of a plan preventing disruption from a bank facing a crisis and development of a control environment to increase the resolvability (\*1) of a bank if it fails (hereinafter referred to as “preparation

for resolution”).

In this regard, the “Key Attributes” above stipulate that a regulatory authority of each country should evaluate the resolvability of financial institutions and have the power to require them to take actions to increase resolvability when necessary. In Japan, the revised DIA introduced a new provision; “The Prime Minister (partially omitted) may, when a need for orderly resolution of assets and liabilities of the financial institution, etc. arises and they find that measures necessary for the smooth implementation thereof have not been taken, order the financial institution, etc. to take the relevant measures to the extent necessary by a specified time.” (Article 137-4 of the DIA)

Considering the intent of the provision above, financial institutions are required to take measures to ensure smooth implementation of orderly resolution, etc. (\*2) The FSA will supervise these efforts and measures of financial institutions taking into account that the priority in preparation for resolution and the timeline for development of the control environment therefor vary depending on the importance of such financial institutions in the finance system. In addition, the FSA will require them to take other measures in addition to those mentioned below based on relevant international discussions, when necessary for smooth implementation of orderly resolution.

Note 1: “A financial institution is resolvable” means the state in which it is feasible and credible for the resolution authorities to resolve it in a way that protects systemically important functions without severe systemic disruption and without exposing taxpayers to loss.

Note 2: In III-11, “orderly resolution, etc.” includes, but is not limited to, the resolution of a financial institution through the specified measures under item (ii) as defined in Article 126-2(1)(ii) of the Deposit Insurance Act.

### III-11-2 Development of Recovery and Resolution Plans

#### III-11-2-1 Purpose and Significance

If major banks, in particular large and complex financial institutions face a crisis, not only the financial institution itself but also the financial system as a whole is likely to face a severe disruption. It is therefore important to prevent such crises to the greatest extent possible, as part of crisis management through the supervisory processes.

In view of the above, Global Systemically Important Financial Institutions (G-SIFIs) and financial institutions deemed by the home authority to have a potential impact on financial stability in the event of their bankruptcy are globally required to develop robust and credible “Recovery and Resolutions Plans (RRPs)” based on an agreement reached at the Financial Stability Board.\*

Taking into account those developments at the international level, it is necessary to continue the ongoing efforts to develop and maintain RRP in Japan.

Note: “Key Attributes of Effective Resolution Regimes for Financial Institutions,” the Financial Stability Board (November 2011)

### III-11-2-2 Viewpoints and Supervisory Method and Actions

- (1) Based on an agreement reached at the Financial Stability Board, etc., the FSA will require, pursuant to Article 24 or Article 52-31 of the Banking Act, the G-SIBs designated by the Public Notice, and where necessary, other systemically important banks to develop and submit a recovery plan once a year or when important changes have been made to its business and group structure. Taking note that the contents of a recovery plan could vary depending on each bank's group structure or business model, the FSA will check whether it covers at least the following items, taking into account relevant agreements reached and discussions held at the Financial Stability Board.
  - (i) Outline of the recovery plan
    - (A) Positioning of the recovery plan in the bank, etc.; and
    - (B) Control environment to develop the recovery plan
  - (ii) Preliminary information for developing the recovery plan
    - (A) Overview of the business and the group structure; and
    - (B) Control environment for managing capital adequacy and liquidity in normal times
  - (iii) Triggers for the implementation of the recovery plan
    - (A) Triggers sufficiently early enough for the bank to respond to the crisis preemptively (including quantitative and qualitative triggers with respect to both capital adequacy and liquidity);
    - (B) Stress tests and reverse stress tests with severer stress than for usual stress testing (including both market-wide and bank specific stress scenarios);
    - (C) Internal decision-making processes concerning both a judgment of the trigger(s) being hit and actions to be taken thereafter; and
    - (D) Relationship between risk management operations based on the degree of crisis in normal times and those at the time of implementing the recovery plan
  - (iv) Overview of subsidiaries, foreign branches, and business divisions in the group
    - (A) A profile of each subsidiary and foreign branch
      - a. Business overview, financial information, and importance of the financial system (analysis for importance of the businesses and subsidiaries, etc. in the group (degree of core business operations) and the financial system (criticality) based on the market shares, etc.); and
      - b. Positioning of the foreign subsidiaries and branches on the business strategy
    - (B) Interconnectedness among main subsidiaries, foreign branches, and business units  
Intra-group capital relations, intra-group fund transactions, intra-group guarantees, and interdependency of IT systems, identification of subsidiaries which provide services to business units providing critical functions, and personnel relations
  - (v) Analysis of recovery options



- (A) Effectiveness, appropriateness, and adequacy (including quantitative assessment) of recovery options (measures to improve liquidity and financial soundness) for each stress scenario; and
- (B) Assessment for considerations and feasibility of the recovery options to be implemented
- (vi) Others
  - (A) Management information systems
    - List of information necessary for formulation of the recovery plan and implementation of the recovery options, as well as the time needed to gain the information

(2) Based on the agreements reached at the Financial Stability Board, the FSA will develop resolution plans for the G-SIBs designated by the Public Notice and where necessary, other systemically important banks. The FSA will review the resolution plans and assess the resolvability once a year or when important changes have been made to the bank's business operations and group structure, etc.

### III-11-3 Measures to Ensure the Effect of a Stay Decision in Contracts Governed by Foreign Laws

#### III-11-3-1 Purpose and Significance

By the amendment of the Deposit Insurance Act (DIA) in June 2013, the Prime Minister has been authorized to make a decision to the effect that a clause providing for specified cancellation, etc. of a contract ("specified cancellation, etc." is defined in Article 137-3(2) of the DIA) based on the reason that a related measure, etc. defined in Article 137-3(1) of the DIA has been taken does not become effective during the period for implementing a measure as set forth in Article 137-3 (1) of the DIA (such a decision is hereinafter referred to as a "stay decision"). In the above conjunction, the 2013 amendment revised the provisions in Article 131 of the DIA with respect to special provisions for procedures of creditor protection in the transfer of business. In order to avoid a severe disruption to Japan's financial system, the financial institutions to which the confirmation set forth in Article 102 (1) of the DIA is applicable or the financial institutions to which the specified confirmation set out in Article 126-2 (1) of the DIA is applicable are required to develop a control environment to ensure that the effect of a stay decision and special provisions for procedures of creditor protection set out in Article 131 of the DIA (hereinafter collectively referred to as the "effect of a stay decision") extends to contracts governed by foreign laws.

#### III-11-3-2 Major Supervisory Viewpoints

Based on the development of the global discussion for ensuring the effect of a temporary stay on early termination rights in contracts governed by foreign laws, the following items should be noted in examining the banks' control environment on contracts governed by foreign laws,\* taking into account the circumstances of individual transactions.

Note: Banks are required to take necessary measures at their group level.

(1) Points to consider concerning the execution of contract, etc.

Whether the bank has taken necessary actions\* to ensure, regardless of the counterparties' jurisdictions, that the effect of a stay decision applies to the contract, in cases where the bank concludes a new contract (including cases where the bank materially amends the content of an existing contract) or enters into a new transaction based on an existing contract with respect to, among the "transactions of instruments that have a market price at an exchange or other markets and their equivalent transactions" under Article 35-18 of the Enforcement Regulation of the DIA, over-the-counter derivative transactions, financial and other derivative transactions, the sale or purchase of securities on condition of repurchase or resale, the lending and borrowing of securities, the trading of bonds with options, forward foreign exchange transactions, over-the-counter commodity derivative transactions, and similar transactions (including transactions entered into for the purpose of collateralizing these transactions; and hereinafter referred to as the "subject transactions"), when such new or existing contract is governed by foreign laws, contains a clause on specified cancellation and is agreed with any counterparty other than central counterparties (CCPs).

Note: Necessary actions may include the following;

- (i) Adhering to an internationally common protocol aimed at ensuring the effect of a stay decision on contracts governed by foreign laws and confirming that the counterparty has adhered to such a protocol; and
- (ii) Indicating clearly in the contract that the effect of a stay decision applies to the subject transactions.

(2) Points to consider concerning existing contracts

It is desirable that banks should take actions under (1) above, as necessary, with respect to an existing contract of the subject transactions which include a clause on specified cancellation and are governed by foreign laws (excluding the cases where the bank enters into a new transaction based on such existing contract), taking into account the significance of the potential systemic impact that may be caused by the non-enforceability of the effect of a stay decision on the contract.

### III-11-3-3 Supervisory Methods and Measures

Based on the supervisory viewpoints above, the FSA will conduct in-depth reviews on the relevant management and control of the bank group. Where necessary, the FSA will also require the bank to submit a report pursuant to Article 24 or Article 52-31 of the Banking Act and Article 136 of the DIA.

If any material impediment to ensuring smooth execution of orderly resolution is identified as a result of the submission of a report, the FSA will consider issuing a business improvement order pursuant to Article 26 or Article 52-33 of the Banking Act and an order pursuant to Article 137-4 of the DIA.

### III-11-4 Measures to Ensure the Continuity of Systemically Important Functions in Orderly Resolutions

#### III-11-4-1 Purpose and Significance

In the resolution of a financial institution, it is essential to maintain the continuity of systemically important functions performed by it in order to implement an orderly resolution and to avoid systemic risk. Discussions with an emphasis on this issue have been made internationally. In Japan, with the amendment of the DIA in June 2013, the specified measures under item (ii) were introduced, which is a mechanism enabling a failed bank to transfer its systematically important functions to a successor organization, etc., from the viewpoint of avoiding a severe disruption in Japan's financial market, thereby securing the continuity thereof.

Under the current situation where functions provided by financial institutions are interconnected with various services supplied by inside and outside group entities, it is also necessary to maintain access to the IT infrastructure services, etc. and the financial market infrastructures by clearing organizations, etc. which are vital for its operations throughout an orderly resolution, in order to ensure the continuity of such functions in resolution.

Based on the above purpose and the guidance\* issued by the Financial Stability Board, financial institutions are required to take measures to secure the continuity of their systemically important functions in an orderly resolution.

Note: "Guidance on Arrangements to Support Operational Continuity in Resolution" (August 2016); "Guidance on Continuity of Access to Financial Market Infrastructures (FMIs) for a Firm in Resolution" (July 2017), etc. by the Financial Stability Board

#### III-11-4-2 Major Viewpoints and Supervisory Method and Actions

The FSA will require the G-SIBs designated by the Public Notice and, where necessary, other systemically important banks to take the following measures for maintaining the continuity of systemically important functions in the process of an orderly resolution while considering their systemic importance. For this, the same supervisory methods and measures as specified in III-11-3-3 will apply.

##### (1) Identification of critical functions

Banks are required to identify critical functions (meaning activities performed for third parties outside of the group; the failure of which would lead to a severe disruption of the financial system) provided by group entities based on the Guidance of the Financial Stability Board\* and the analysis of the subsidiaries, etc. conducted as part of the formulation of the recovery plan under III-11-2-2(1)(iv)(A).

Note: "Guidance on Identification of Critical Functions and Critical Shared Services," the Financial Stability Board (July 2013)

(2) Ensuring continuity of critical shared services (CSS)

Banks are required to take the following measures in order to continue the critical shared services that support the continuity of the critical functions in orderly resolution.

- (i) To identify critical shared services (meaning services provided to a financial institution that provides critical functions or its group entities, the failure of which would lead to the inability or material hindrance to perform critical functions; hereinafter referred to as “CSS”) based on the in-depth analysis of each critical function identified in (1) above or the identification of legal entities that provide services to departments having critical functions that is conducted as part of the formulation of the recovery plan under III-11-2-2(1)(iv)(B).
- (ii) In the case where, with respect to each CSS identified in (i) above, the supply contract concluded between the financial institution that receives such CSS and the provider thereof may discontinue the provision of the CSS if the financial institution or any of its group entities is subject to orderly resolution or relevant measures including change of parent company, the financial institution must take contractual measures to ensure provision of the CSS continues even when such measure is taken.

Such contractual measures may include inserting a provision in the contract or executing a separate memorandum containing a provision to that effect that the contract may not terminate for causes of cancellation or termination even when the abovementioned measures are taken except for breach of payment obligation under the contract.

- (iii) To take financial measures to maintain the continuity of the provision of CSS. Such measures may include development of a control environment to financially secure the following;
  - (A) CCS provided by group entities: to ensure that CSS providers continue to provide the CSS in orderly resolution.
  - (B) CSS provided by non-group entities: to ensure that payment obligations to CSS provider are performed in orderly resolution.

(3) Maintaining access to critical FMI services

Banks are required to take the following measures to maintain access to critical FMI in order to secure the continuity of critical functions in orderly resolution.

- (i) To identify critical FMI services (meaning clearing, payment, securities settlement and custody activities, functions or services provided by finance market infrastructures including, but not limited to, clearing organizations, fund settlement organization, securities settlement organizations, transfer organizations or custodians, the discontinuance of which could lead to the inability or material hindrance to provide critical functions; including services in which the bank participates indirectly via direct participation inside or outside of the group) based on the in-depth analysis of each critical function identified in (1) above.
- (ii) With regard to each critical FMI service identified in (i) above, to grasp existence of financial or other requirements necessary for maintaining access to such critical FMI service (including requirements arising relating to the relationship with direct participants in case of indirect

participation) and credit line provided relating to such critical FMI service (including credit line provided by direct participants in case of indirect participation) and the content thereof.

- (iii) In cases where a participant of the critical FMI service within the group or other legal entity within the group is subject to measures for an orderly resolution or relevant measures, including a change of parent company through consultation with the critical FMI service providers, to grasp the measures assumed to be taken by the critical FMI service provider against such participant (if there are measures relating to the continuance or discontinuance of access and additional requirements, including additional contributions of deposits, etc., the contents thereof should be also grasped).
- (iv) To develop a plan to maintain access to the critical FMI services in orderly resolution (contingency plan). It should be confirmed that the contingency plan contains at least the following items;
  - (A) Information grasped in (i), (ii), and (iii) above;
  - (B) If there are additional requirements assumed to be required by the provider of the critical FMI service under (iii) above, the countermeasures against it;
  - (C) Measures to meet financial requirements for maintaining access to the critical FMI services;
  - (D) Decision-making process when the measures under the contingency plan are implemented; and
  - (E) Analysis of the impact on the continuity of the critical functions arising when access to the critical FMI services discontinue despite the measures taken under (B) or (C) above, and if alternative measures are assumed to be taken to mitigate such impact, the content thereof.

### III-11-5 Liquidity Monitoring and Reporting System for Ensuring Smooth Implementation of Orderly Resolutions

#### III-11-5-1 Purpose and Significance

For smooth implementation of an orderly resolution, etc., it is important to conduct liquidity monitoring with sufficient granularity, including grasping of the required liquidity amount throughout resolution processes and available liquid assets to cover the required liquidity amount. For example, for ensuring the continuity of the critical functions in an orderly resolution, it is important to grasp available liquid assets that can be allocated to the payment obligation to CSS providers and margins to critical FMI service providers. It is also important that a financial institution can report the degree of shortage of liquid assets, if any, to the authorities in a prompt and timely manner when the regulatory authorities judge and confirm that such financial institution is insolvent.

Based on the above intent and the guidance\* issued by the Financial Stability Board, financial institutions are required to develop the liquidity monitoring and reporting framework for ensuring the smooth implementation of orderly resolutions.

Note: “Guiding principles on the temporary funding needed to support orderly resolution of a global systemically important bank (“G-SIB”)” (August 2016) and “Funding Strategy Elements of an

## Implementable Resolution Plan (June 2018)” by the Financial Stability Board

### III-11-5-2 Major Viewpoints and Supervisory Method and Actions

The FSA will require the G-SIBs designated by the Public Notice and, where necessary, other systemically important banks to develop a control environment for liquidity monitoring and reporting to grasp liquid assets available in an orderly resolution in a timely manner while considering their systemic importance.

As an example of relevant measures, it may be considered to develop a control environment to grasp eligible liquid assets that are freely transferable among legal entities and jurisdictions (referred to the “eligible liquid assets” as defined in Article 1(xiv) of the Public Notice on Liquidity Coverage Ratio, etc.) by each major legal entity, business location, and major currency in a timely manner, taking into account the regulations in each jurisdiction and internal control limitations, and to report the information gained there to the regulatory authorities.

For this, the same supervisory methods and measures as specified in III-11-3-3 will apply.

### III-11-6 Enhancement of Loss Absorbing Capacity

#### III-11-6-1 Adequacy, Sufficiency, and Correctness of Loss Absorbing Capacity

##### III-11-6-1-1 Purpose and Significance

The FSB TLAC Term Sheet requires G-SIBs to have sufficient total loss-absorbing capacity (TLAC). The purpose of the TLAC Term Sheet is to facilitate an orderly resolution of a G-SIB when it fails, in a manner that minimizes the impacts on financial stability without exposing taxpayers to loss and ensures the continuity of its critical functions by imposing the losses on shareholders and creditors, in addition to meeting the recapitalization needs of the G-SIB.

More specifically, under the resolution regime envisaged by the TLAC Term Sheet, an entity to which resolution powers and tools are assumed to be applied by the relevant authority (hereinafter referred to as the "resolution entity") is supposed to raise loss-absorbing and recapitalization capacity from external sources (hereinafter referred to as "the loss absorbing capacity") and distribute it to its material subsidiaries in the group during normal times. At the time of stress, following the relevant authority's determination that one or more of the material subsidiaries have reached the point of non-viability (PONV), losses incurred to them would be passed on to the resolution entity. While this could lead to a resolution of the resolution entity, the material subsidiaries are expected to continue their business as usual. Under this resolution regime, in cases where cross-border resolution plans are executed, close co-operation between the local (where the subsidiary incurring losses locates) and the home (where the resolution entity locates) authorities would be essential.

The following is the FSA's approach to the TLAC requirements as a home authority.

### III-11-6-1-2 Major Viewpoints and Supervisory Method and Actions

#### (i) Financial institutions subject to TLAC requirements

Based on the FSB TLAC Term Sheet, the G-SIBs designated by the Notice will be subject to the TLAC requirements in Japan. In addition, for internationally active financial groups, entry into the resolution of one or more of their foreign subsidiaries could result in their losses being passed on to the parent entity in Japan, potentially leading to a resolution of the group as a whole. Assuming that such financial groups have particular systemic significance to the Japanese financial system if they fail, a sufficient level of loss absorbing capacity available at the time of resolution should be ensured, as the need for addressing the so-called "too big to fail" problem is markedly high for such financial groups, regardless of whether they are designated as G-SIBs or not.

Accordingly, the FSA intends to apply the TLAC requirements to the D-SIBs designated in the Notice that are deemed of particular need for a cross-border resolution arrangement and of particular systemic significance to the Japanese financial system if they fail, in addition to G-SIBs designated in the Notice (hereinafter collectively referred to as "Covered SIBs"). The FSA will, for the financial groups designated as Covered SIBs, in line with the preferred strategy for resolution mentioned below, designate their resolution group in Japan (hereinafter referred to as a "Domestic Resolution Group") and the resolution entity in Japan to which losses are concentrated in resolution (hereinafter referred to as a "Domestic Resolution Entity") based on the Notice on TLAC Pillar 1, and then require them to issue and maintain the External TLAC and distribute the Internal TLAC.

In newly choosing and designating a Covered SIB, the FSA will give sufficient consideration in advance, reviewing the adequacy of equity capital and finding structures of a candidate financial institution. In addition, considering the period needed for the candidate financial institution to issue the required External TLAC in the market, the FSA will make a public announcement to the effect that the candidate financial institution will be newly designated as the Covered SIB, together with the preferred strategy for it, in advance.

Note: In the case where it is agreed through discussion with overseas competent authorities that, with regard to an overseas G-SIB group whose preferred strategy for resolution is the MPE approach, its holding company or subsidiary bank, etc. located in Japan is deemed as a single resolution entity, it is expected that the FSA considers designating a Domestic Resolution Entity and Domestic Resolution Group based on the Notice on Pillar 1 by applying (i) above *mutatis mutandis*.

#### (ii) Choice of preferred strategy for orderly resolution

The resolution strategies for systemically important financial institutions that are being developed internationally are broadly based on two stylized approaches: (i) SPE (Single Point of

Entry) resolution, in which resolution tools are applied to the ultimate holding company by a single national resolution authority, and (ii) MPE (Multiple Point of Entry) resolution, in which resolution tools are applied to different parts of the group by two or more resolution authorities acting in a coordinated way. (Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Developing Effective Resolution Strategies by the Financial Stability Board, July 2013)

In determining the preferred strategy for a Covered SIB, the FSA will choose whether the SPE approach or the MPE approach will apply to it, taking into account resolvability based on its organizational structure as a financial group (including interconnectedness and interdependency within the group). When the SPE resolution strategy is chosen for the Covered SIB, its ultimate holding company is considered the Domestic Resolution Entity, while such bank group is considered the Domestic Resolution Group.

Regardless of which strategy is chosen for a Covered SIB as the preferred strategy for resolution, the FSA should determine how the Covered SIB is actually resolved, taking its real situation into consideration on a case by case basis.

(iii) Enhancement of External TLAC

To execute the preferred strategy effectively in resolution, a resolution entity and its group entities need to build a structure to raise and distribute funds during normal times that ensures that the resolution entity absorbs the losses of its subsidiaries and then enables such losses to ultimately be absorbed by the resolution entity's shareholders and creditors.

For this, the Notice on TLAC Pillar 1 requires the Domestic Resolution Entity of the Covered SIBs to meet a minimum requirement for instruments (including capital instruments, debt instruments, liabilities, or other items) which are recognized to have a loss-absorbing/recapitalization capacity.

(A) Minimum requirement

a. Timing of implementation

For a financial institution group that becomes a “G-SIB designated in the Notice” on or after April 1, 2019, TLAC requirements will apply to its Domestic Resolution Entity approximately three years after such designation as a G-SIB. In this case, at the launch of the application, the Domestic Resolution Entity must maintain an External TLAC of 18% of the group’s consolidated RWAs and 6.75% of the Basel III leverage exposure (full application).

In the case where a financial institution group that becomes a “D-SIB designated in the Notice” on or after April 1, 2019, is newly designated as a Covered SIB, the Domestic Resolution Entity of such financial institution must maintain, at the beginning of implementation of TLAC requirements, an External TLAC of 16% of the group’s consolidated RWAs and 6% of the Basel III leverage exposure (partial application), and must meet the minimum External TLAC requirements of 18% of the



consolidated RWAs and 6.75% of the Basel III leverage exposure approximately 3 years later (full application).

If the Commissioner of the FSA designates a different ratio for the minimum required total exposure based External TLAC ratio pursuant to the provisions of Article 1, Item 11 of the Notice on TLAC Pillar 1, such ratio shall apply.

However, the FSA should not implement these requirements in a mechanical or uniform fashion, but rather should take account of the period required for the financial institution to respond to the TLAC requirements, the details and effect of the measures taken by the Domestic Resolution Entity in trying to maintain the minimum External TLAC ratio, and the potential impact on the financial system from the effects of such measures.

b. Assessment of sufficiency of External TLAC

i) When evaluating the sufficiency of the External TLAC, the Covered SIBs need to analyze not only its quantity but also its quality, including at least the following:

- Other TLAC-eligible instruments should meet all the requirements under the Notice on TLAC Pillar 1 and respond in a satisfactory manner to the purpose of the TLAC Term Sheet.
- The Domestic Resolution Entity has not provided holders of other TLAC-eligible instruments with any funds, either directly or indirectly. Those instruments have not been obtained by any of subsidiaries or affiliates of the Domestic Resolution Entity.
- For the period until March 30, 2022, with regard to Additional Tier 1 instruments and Tier 2 instruments that were issued by overseas subsidiaries or that were issued by major subsidiaries and contain a special provision of being transferred to common shares under predetermined conditions or any similar provision, the inclusion of such instruments to External TLAC must be approved by the relevant authority.

ii) External TLAC is just a tool for absorbing losses and recapitalizing in resolution, and it is more important for financial institutions to maintain sufficient equity capital in normal times for their stability. It would be, therefore, putting the cart before the horse if too much focus on enhancement of External TLAC would lead to deterioration of the equity capital in terms of both quality and in quantity, which must be avoided.

In cases where a Covered SIB were likely to fail, it is assumed that Tier 1 capital, such as common shares, and Additional Tier 1 instruments (hereinafter referred to as “going-concern capital”) would not be expected to function as loss-absorbing and recapitalization capacity any longer. It is, therefore, favorable that the Covered SIB should maintain sufficient Tier 2 capital instruments and other

TLAC-eligible instruments (hereinafter referred to as the “gone-concern capital”) rather than relying on the going-concern capital only.

Losses incurred by a shareholder of a financial institution in case of failure are limited to the amount invested based on the principle of limited liability of shareholders. In particular in the time of crisis, as this may cause a moral hazard, it is necessary to check the decision-making of the financial institution through oversight and supervision by creditors. In addition, as the more likely to fail an issuer becomes, the more its bond costs increase, a financial institution is expected to enhance an incentive not to fail by issuing bonds in normal times.

Sufficiency of External TLAC should be, therefore, evaluated considering the sufficiency of such gone-concern capital.

More concretely, a financial institution whose gone-concern capital exceeds approx. 33% of the External TLAC requirements is evaluated as maintaining incentives to mitigate the risk of failure in normal times and having sufficient loss-absorbing and recapitalization capacity against failure. On the other hand, for a financial institution whose gone-concern capital is below that level, the FSA will continuously monitor it as to whether it takes sufficient measures to increase the TLAC, including planning and implementation of external issuance of the gone-concern capital and building a governance framework to prevent a moral hazard.

c. Measures to maintain sufficient External TLAC

- A Domestic Resolution Entity needs to take proper measures to maintain sufficient External TLAC in terms of both quality and quantity based on the evaluation of sufficiency in External TLAC above.
- A Domestic Resolution Entity needs to manage the structure of External TLAC instruments so that it can maintain sufficient External TLAC even when access to the capital market is temporarily hindered, in such a way that the maturity dates of their bonds are arranged to fall on different days or periods.
- A Domestic Resolution Entity needs, in advance, to examine methods to raise capital and estimate amounts that can be raised through other TLAC-eligible instruments in case of the shortage thereof considering its reputation and evaluation in the capital market, a greater likelihood of it being more difficult than usual to raise capital if the bank is in a slump due to unexpected losses, and other conceivable factors.

d. Supervisory measures

When the External TLAC of the bank is below the minimum requirement of the Basel III leverage exposure, the FSA will require the bank to promptly submit a report on the reasons thereof and measures to raise the External TLAC ratio based on Article 52-31 of the Banking Act. If a significant improvement is deemed necessary, the FSA will issue a business improvement order based on Article 52-33(1) of the Banking Act.

In the calculation of the External TLAC of the RWAs, the capital buffer will first be allocated to the External TLAC in case of a shortage in the External TLAC. Therefore, if the External TLAC is below the External TLAC of the consolidated RWAs, the capital buffer is deemed zero. In this case, the capital distribution constraints will be imposed on the bank (if its required capital equity is below the required level, a prompt corrective action order is imposed at the same time), according to which, the bank is expected to recover its stability.

However, the FSA should not apply these supervisory measures in a mechanical or uniform fashion, and should take account of the period required for the bank to respond to the TLAC requirements, the details and effect of the measures taken by the bank in trying to maintain the minimum External TLAC ratio and the gone-concern capital, and the potential impact on the financial system from the effects of such measures.

(B) Confirmation of eligibility of External TLAC instruments

In connection with the evaluation of the degree of adequacy of External TLAC, when the bank makes a report on borrowings or issuance of corporate bonds according to the order for submission of a report under Article 52-31 of the Banking Act, the FSA will check whether or not they are eligible for other TLAC-eligible instruments, based on the Notice on TLAC Pillar 1 and full consideration of the purport of the TLAC Term Sheet as well as the following points:

- a. With regard to other TLAC-eligible instruments as unsecured senior bonds under the proviso of Article 4(3)(ii) of the Notice on TLAC Pillar 1, attention should be paid to the following points:
  - In order that creditors of the unsecured senior bonds issued by the Domestic Resolution Entity (issuer) are recognized to be structurally subordinate to the creditors of other entities of such Domestic Resolution Group (hereinafter referred to as “structurally subordinate”), the ratio of the excluded liabilities that are contractually or legally equivalent or subordinate to the unsecured senior bonds to the total of the issuer’s non-consolidated existing External TLAC (the sum of the amount recorded on the net assets on the issuer’s balance sheet, the issuer’s liabilities for TLAC eligible Additional Tier 1 instruments, those for TLAC eligible Tier 2 instruments and other TLAC-eligible instruments) (hereinafter referred to as the “excluded liabilities ratio”) must not exceed 5% in principle.
  - The following excluded liabilities ratio may be used for such purpose.
    - i) Excluded liability ratio on a consolidated basis provided in an annual financial flash report or interim financial flash report;
    - ii) Excluded liability ratio reported in the annual business report or interim business report;
    - iii) Excluded liability ratio reported to the regulator after public disclosure in

accordance with the law or relevant regulations of a financial instruments exchange, if applicable; or

- iv) Excluded liability ratio extraordinarily reported by the Domestic Resolution Entity based on the FSA's inspection in times other than (i) to (iii) above.
  - In the case where once the Domestic Resolution Entity is deemed to be structurally subordinate and thereafter its excluded liability ratio is likely to exceed 5%, the FSA will require the bank to promptly submit a report on the reasons therefor and measures to reduce the excluded liability ratio based on Article 52-31 of the Banking Act. Furthermore, when its excluded liability ratio actually exceeds 5%, upon confirming whether or not such Domestic Resolution Entity continues to seek to be structurally subordinate, the FSA will issue a business improvement order based on Article 52-33(1) of the Banking Act.
  - To implement the orderly resolution smoothly, the Domestic Resolution Entity should avoid as much as possible the issuance of unsecured senior bonds that neither fall under the scope of the excluded liabilities nor are eligible for the External TLAC, even when its excluded liability ratio is under 5%. And then, the FSA will ask the Domestic Resolution Entity to report its total liabilities owed to non-group third parties that are not eligible for External TLAC recorded in an annual financial flash report or interim financial flash report.
  - As mentioned in III-11-6-2-2 (i)(C), other TLAC-eligible instruments that are senior unsecured bonds entail the risk that the bond holders will not able to receive part or the whole thereof in the orderly resolution. An issuer of senior unsecured bonds is required to appropriately describe such risk in a bond contract and attached documents (prospectus, etc.) and provide possible bondholders with a sufficient explanation of the risk according to their degree of understanding so that they will subscribe to the bonds with a full recognition of such risk.
- b. When the bond contract has a redemption clause in accordance with Article 4(3)(viii) of the Notice on TLAC Pillar 1, the FSA will, in checking the optional redemption of the Domestic Resolution Entity, pay attention to the provisions in the Notice on TLAC Pillar 1, and in addition, the descriptions about equity capital in III-2-1-1-3(3) of these Supervisory Guidelines with appropriate replacement of terms in a way to fit other TLAC-eligible instruments.
  - c. When the bond contract is governed by laws other than Japanese laws in accordance with Article 4(3)(ix) of the Notice on TLAC Pillar 1, the FSA will require the bank to submit a written legal opinion by a lawyer or legal professional and relevant documents to the effect that such bond can be effectively used for absorbing losses and recapitalization of the Domestic Resolution Entity (the issuer of the bond), as needed.
- (C) Cases to be judged as other TLAC-eligible instruments intentionally held within the financial

system

If members in the financial system reciprocally hold other members' External TLAC instruments (including such equivalents; the same applies in this (C)) with the intention of increasing their respective External TLAC ratio, such instruments will eventually constitute unsubstantial total loss-absorbing capacity with regard to both the bank and the relevant financial institution. Since such reciprocal holdings will make the financial system fragile, in accordance with Article 8(6) and other capital adequacy ratio-related provisions of the Notice on Standards for Banks' Capital Adequacy in line with the Basel Accords, a bank or its consolidated corporations will be required to exclude the full amount of such other TLAC-eligible instruments from the bank's equity capital (Tier 2 capital) as regulatory adjustments or deduction if the relevant Japanese bank is recognized as reciprocally holding such other TLAC-eligible instruments of such other financial institutions with the intention of increasing their respective External TLAC ratios between the relevant Covered SIBs and the relevant financial institutions, and if it is also determined that the relevant financial institutions intentionally hold other TLAC-eligible instruments of the relevant Covered SIBs ("Intentional Reciprocal Holdings"). The sample cases illustrated below are considered to constitute Intentional Reciprocal Holdings in this regard, given the above III-2-1-2-2 (2), which describes the Intentional Reciprocal Holdings of capital instruments.

- Covered SIBs and other financial institutions (that are not confined to deposit-taking institutions in Japan) promised to mutually hold the other party's other TLAC-eligible instruments. The primary purpose of such cross holdings is to mutually cooperate on their total loss-absorbing capacity reinforcement. To this end, the Covered SIBs hold such other TLAC-eligible instruments of the other financial institutions, and these other financial institutions hold such other TLAC-eligible instruments of the Covered SIBs.

(iv) Enhancement of Internal TLAC

As for a Domestic Resolution Entity, such firm is required to distribute its loss-absorbing capacity secured by means of External TLAC to its major subsidiary company (including any group of such subsidiary companies) based on size and other factors.

(A) Selection of a major subsidiary to which Internal TLAC is to be distributed

The purport of Internal TLAC is to secure the continuity of significant operations undertaken by a major subsidiary company (including any group of such subsidiary companies; the same applies in this (iv) hereafter) of the relevant financial Domestic Resolution Group even when the subsidiary company is in the process of resolution, by consolidating the subsidiary's loss into the holding company. In light of this, if the size of a subsidiary company reaches a certain level that could incur loss which in turn might plunge the entire group of the Domestic Resolution Entity into crisis, and if the domestic subsidiary company provides significant operations in the financial system, then the subsidiary company should be recognized as a major subsidiary company and the ensuring of loss-consolidating

capacity through Internal TLAC needs to be required.

Specifically, when selecting such a major subsidiary company, the following criterion (i) is basically used, with criterion (ii) being used complementarily, based on the relevant TLAC agreement document.

Criterion (i): Its risk assets, total exposure, or ordinary income exceeds 5% of the entire group's.

Note: If the accounting title of "ordinary income" does not exist in the adopted accounting standards, the title that shows the total amount of income is used.

Criterion (ii): The significance of the subsidiary company's operations in the Japanese financial system and the likelihood of loss incurred to such a degree that disturbs the continuity of significant operations in the Japanese financial system

Any selected major domestic subsidiary company is designated as the entity to which Internal TLAC is to be distributed by the relevant Domestic Resolution Entity, in accordance with the Notice on TLAC Pillar 1.

In accordance with Article 52-31 of the Banking Act, such selected subsidiary company is annually reviewed and, in principle, is required to submit the relevant data as of the end of March each year for reporting purposes. If there is a change in the group structure, the submission of post-change estimates is required as far in advance as possible.

As for any major overseas subsidiary company, such subsidiary will be selected by the local authority. Accordingly, consultation will be made with the relevant foreign authority when necessary.

(B) Required level

a. Timing of application to financial institutions designated as Covered SIBs on or after April 1, 2019

With regard to domestic Material Sub-groups in the respective financial institutions groups of either "G-SIBs designated by the Notice" on or after April 1, 2019, or "D-SIBs designated by the Notice" that have newly become Covered SIBs on or after April 1, 2019, the application starts on the same day as the minimum level of External TLAC started to apply to the respective Domestic Resolution Entity in these financial institutions groups.

As for domestic Material Sub-groups that were newly designated on or after April 1, 2019, the required amount of Internal TLAC will start to apply to them about three years after the designation.

b. Internal TLAC level adjustment factor

As for a domestic Material Sub-group, based on the capital adequacy ratio regulation applied to the Material Sub-group, the required External TLAC level is calculated on

the assumption that the Material Sub-group would be a Domestic Resolution Entity. In addition, the required amount of Internal TLAC is determined by multiplying the above-calculated level by an Internal TLAC level adjustment factor set by the FSA in a range from 75% to 90%.

In determining an Internal TLAC level adjustment factor for a domestic Material Sub-group, the adjustment factor is in principle initially set at 75%, firstly because the processing is in principle domestically completed, and secondly because the Japanese authority can generally supervise the domestic Material Sub-group as a group company in an integrated manner, and ultimately because, for the above reasons, the requirement is not high for the loss-absorbing capacity to be allocated in advance. Then, adjustments are made according to the respective necessity of advance allocation, based on (i) the financial institutions group's desirable processing strategy and (ii) the Material Sub-group's matters such as its significance in the financial system, its capital structure, and its business model.

The decided Internal TLAC level adjustment factor is prescribed in the Notice on TLAC Pillar 1, and will be reviewed when necessary.

As for any overseas Material Sub-group, the local authority plays a leading role in determining an Internal TLAC level adjustment factor. Accordingly, the Japanese authority may consult with the relevant foreign authority when necessary. In the case where any local authority sets up and applies a certain required amount of Internal TLAC without any involvement from the Japanese authority in advance, the requirement will not be deemed as a "quasi-requirement concerning the minimum required amount of Internal TLAC" stipulated in Article 2 (3) of the Notice on TLAC Pillar 1 until a consensus is built through consultations with the foreign authority relevant for the financial institution's crisis management group (CGM).

- c. Evaluation on the degree of enhancement of Internal TLAC and measures to maintain sufficient Internal TLAC
- With regard to the evaluation on the degree of enhancement of Internal TLAC and measures to maintain sufficient Internal TLAC, the descriptions about External TLAC in the above (1) (iii) (A) b (i) and c will apply with appropriate replacement of terms in a way to fit Internal TLAC.
  - If there are Basel III-qualified Additional Tier 1 instruments and Tier 2 capital instruments held by a third party outside of the group, such instruments' conversion into shares, if any, would change the control structures in a Material Sub-group whereby the management control might be affected. Therefore, it is advisable to structure such capital instruments so as to reduce the principal, instead of the conversion into shares, at the time of trigger.
  - In the case where a Domestic Resolution Entity does not directly allocate Internal

TLAC to a Material Sub-group but does so indirectly through another subsidiary company, it is necessary, when the Material Sub-group reaches the point of non-viability (PONV) and the principal reduction of Internal TLAC (“triggering of Internal TLAC” hereafter) is made, to ensure that the loss is ultimately transferred to the Domestic Resolution Entity. Except for the case where any change in the control relationship due to the triggering of Internal TLAC is not conceivable, such allocation through any party other than the parent company is, in principle, is not allowed.

- When a Material Sub-group issues regulated capital with debt-like features for subscription by a Domestic Resolution Entity, and if the Material Sub-group intends to make such capital eligible for Internal TLAC, a special provision is required to the effect that the Material Sub-group’s principal will be reduced in the case where the Material Sub-group reaches the PONV. In addition, from the viewpoint of maintaining the hierarchy of claims, when a Domestic Resolution Entity has held a Material Sub-group’s regulated capital with debt-like features that was issued before application of the TLAC regulations, the relevant contract contents may be altered if necessary so as to make the regulated capital subordinated to debts that constitute other Internal TLAC instruments in terms of the distribution of the Material Sub-group’s residual assets, or the repayment of or changes in its debts during bankruptcy proceedings.

d. Unallocated TLAC

Since the full amount of External TLAC procured by a Domestic Resolution Entity does not need to be distributed, such Domestic Resolution Entity may have an unallocated portion. Handling of such unallocated portion (so-called “Unallocated TLAC”) has been and will continue to be discussed in light of the progress in the relevant international debate and each country’s implementation status.

e. Supervisory measures

The FSA takes necessary measures if such Material Sub-group becomes unable to sustain itself. Specifically, if the loss-absorbing capacity is recognized as insufficient after the consideration of the relevant issues such as whether or not the amount of Internal TLAC meets the requirement, the FSA will promptly ask for report submission. Subsequently, if further improvement is deemed necessary, the FSA will issue a business improvement order to the Domestic Resolution Entity and demand the firm to additionally allocate Internal TLAC.

(C) Confirmation of eligibility of Internal TLAC instruments

In reference to evaluation on the degree of enhancement of Internal TLAC, eligibility of other Internal TLAC instruments will be verified from the regulatory viewpoint, based on the Notice on TLAC Pillar 1 and full consideration of the purport of the TLAC agreement



document as well as the following point:

- When contract contents regarding reimbursements are stipulated in accordance with Article 7(3)(ix) of the Notice on TLAC Pillar 1, in verifying an optional reimbursement by the relevant Material Sub-group in advance, the FSA will pay attention to the stipulation in the Notice on TLAC Pillar 1, and, in addition, the descriptions about equity capital in III-2-1-1-3(3) of these Supervisory Guidelines will apply with appropriate replacement of terms in a way to fit other Internal TLAC.

### III-11-6-2 Orderly Resolution Using TLAC

#### III-11-6-2-1 Purpose and Significance

If a Material Sub-group of a financial group to which TLAC regulations apply faces difficulty in continuing significant operations in the financial system due to its worsening business conditions, and when the supervisory authority determines that countermeasures such as asset sales, capital reinforcement by the parent company, or other alternative measures are not feasible, the triggering of Internal TLAC related to the Material Sub-group could, as a last resort, recover its soundness.

When losses are consolidated into a Domestic Resolution Entity, and as a result, if the authority determines that the resolution of the financial group is necessary, then shareholders and creditors of the Domestic Resolution Entity will bear the losses while operations of the Material Sub-group itself will continue.

The following are specific examples of orderly resolution using TLAC in Japan where the FSA functions as the supervisory authority.

#### III-11-6-2-2 Specific Examples of Procedures

- (i) In the case where a domestic Material Sub-group faces a crisis

Conceivable procedures using TLAC on the premise of taking the SPE approach include the following flow from (A) to (D). As for (A) to (C), the implementation will be done promptly over a weekend; i.e., on non-business days, in order to avoid market disruption, and the Material Sub-group is assumed to continue operations as usual.

Note: It is useful for the supervisory authority to announce its desirable resolution procedure strategy in advance in order to enhance the transparency for market participants, elevate the credibility of the resolution system, and make the resolution procedure timely. On the other hand, how to actually carry out the procedure is a matter to be decided on a case-by-case basis after the concerned authorities consider the actual status of the Covered SIB. Therefore, apart from the following Specified Measures Under Item (ii) applied to a Domestic Resolution Entity based on the SPE approach, there are other

measures, such as: Based on the Deposit Insurance Act, the Prime Minister may take “Specified Measures Under Item (i)” for a Domestic Resolution Entity (Article 126-2(1)(i) of the Deposit Insurance Act), and/or may take Specified Measures Under Item (i) or may take Measures Under Item (i) for a domestic Material Sub-group (Article 102(1)(i) of the same Act).

(A) Loss absorption through Internal TLAC of a domestic Material Sub-group

Inherently, the triggering of Internal TLAC may substantially affect the entire financial group. In light of this possibility, situations where the triggering of Internal TLAC for a domestic Material Sub-group is implemented are confined to the case where, even if the supervisory authority issues a business improvement order to the Material Sub-group based on Article 26 of the Banking Act, any improvement in its financial conditions is not expected and there also seem to be no alternative measures, such as support from the group, that might be effective for the recovery of the Material Sub-group’s soundness, and the case where there is no time left to implement a business improvement order or any other alternative measure due to its rapidly worsening financial conditions that require the emergency response.

When the triggering of Internal TLAC is forced to be selected, in terms of Internal TLAC distributed to a domestic Material Sub-group that incurred loss, the loss of the Material Sub-group will be transferred to the Domestic Resolution Entity.

Specifically, when the FSA determines that a domestic Material Sub-group has (or is likely to have) excess debt or insufficient liquidity resources (including the case where a Domestic Resolution Entity and a Material Sub-group report to the FSA that the Material Sub-group has (or is likely to have) excess debt or insufficient liquidity resources), the FSA will consider the emergency as well as whether or not alternative measures exist as mentioned above. And then, if the FSA issues to the Domestic Resolution Entity an order concerning the Material Sub-group’s soundness recovery by means of Internal TLAC, including capital reinforcement and liquidity recovery, among the orders based on Article 52-33(1) of the Banking Act (“when a Material Sub-group reaches the PONV” hereinafter), principal reduction or conversion into shares will be implemented in accordance with the relevant Internal TLAC conditions (such as a loan contract) (Note 1).

In issuing the order, the FSA will consider whether or not the soundness recovery of the Material Sub-group is difficult or unexpected even if it receives support from any of its group companies. When the order is issued, the effect will be disclosed.

Even if the triggering of Internal TLAC is implemented, the resolution procedure of the entire group as stipulated in and after (B) below may not be implemented, depending on the financial conditions of both the holding company and the entire group (Note 2). In such a case, the FSA will pay careful attention to its communication with markets in order to avoid the misconception that the resolution procedure of the entire group would start.

Note 1: When a Material Sub-group is recognized as reaching the PONV, the FSA issues

an order, based on Article 52-33(1) of the Banking Act, to the effect that it has recognized the cause of a specific domestic Material Sub-group's financial crisis. Such order includes the wording of "order concerning the Material Sub-group's soundness recovery by means of Internal TLAC." (Therefore, even when an order is based on Article 52-33(1) of the Banking Act, unless the order has the effect that the FSA has recognized the cause of a specific domestic Material Sub-group's financial crisis or unless it includes the wording of "order concerning the Material Sub-group's soundness recovery by means of Internal TLAC," the order is not identified as having been issued "when a Material Sub-group is recognized as reaching the PONV.")

Note 2: Conceivable cases may include the case where no more measures are taken for both the Domestic Resolution Entity and the Material Sub-group within the legal framework of the Deposit Insurance Act, and the case where the Specified Measures Under Item (i) (Article 126-2(1)(i) of the Deposit Insurance Act) are taken for a Domestic Resolution Entity, and the case where either the Specified Measures Under Item (i) or the Measures Under Item (i) (Article 102(1)(i) of the same Act) are taken for a domestic Material Sub-group.

(B) Specified Confirmation by the Prime Minister

When the triggering of Internal TLAC is implemented and the Domestic Resolution Entity which absorbed the losses from the Material Sub-group fulfills the requirements for the application of Specified Measures Under Item (ii) as set forth in the Deposit Insurance Act, the Prime Minister shall confirm the necessity to take Specified Measures Under Item (ii) (Article 126-2(1)(ii) of the same Act) and issue an Injunction Ordering Specified Management (Article 126-5 of the same Act) following deliberation by the Financial Crisis Response Council with regard to the Domestic Resolution Entity (When a Domestic Resolution Entity receives such order for Specified Confirmation, the firm hereafter is referred to as the "Non-viable Holding Company.").

When the Specified Confirmation is taken, Basel III-eligible Additional Tier 1 instruments and Tier 2 instruments issued by the Non-viable Holding Company will be written off or converted into equity under the terms and conditions of such instruments prior to other liabilities including the External TLAC eligible debt liabilities.

In addition, a movable or claim pertaining to the business of the Non-Viable Holding Company that shall be succeeded to by the Specified Bridge Financial Institution, etc. under (C) below (limited to those designated by the Prime Minister) may not be seized (Article 126-16 of the same Act).

Note: In the case where any Covered SIBs have issued other Tier 1 capital instruments with debt-like features through its Domestic Resolution Entity on or after March 31, 2013, all or part of the principal reduction or the like will also be implemented

if the consolidated Common Equity Tier 1 ratio (calculated in accordance with the Notice) of the Domestic Resolution Entity falls below 5.125%.

(C) Transference of business, etc.

The Non-viable Holding Company transfers its business to the Specified Bridge Financial Institution, etc. incorporated by the Deposit Insurance Corporation of Japan (DICJ) (Article 126-34(3) of the Deposit Insurance Act) with the permission of the court in lieu of the extraordinary resolution of the shareholders' meeting (Article 126-13(1)(iii) of the same Act), under a decision by the Prime Minister that the Specified Bridge Financial Institution, etc. should carry out the Specified Assumption of Business, etc. in order to succeed to the business of the Non-viable Holding Company (Article 126-34(1)(ii) of the same Act).

At this point, it is expected that the obligation of the External TLAC eligible debt liabilities (including those with the remaining period of the claim being less than one year) will not be transferred to the Specified Bridge Financial Institution, etc., and the Non-Viable Holding Company continues to be the obligor of such liabilities.

Note: The Specified Bridge Financial Institution, etc. will transfer its business to financial institution(s) within two years in principle after the Specified Confirmation with regard to the Domestic Resolution Entity by the Prime Minister (Article 126-37, Article 96-1, and Article 126-3 of the Deposit Insurance Act).

(D) Court Insolvency Proceedings of the Non-Viable Holding Company

After transferring its business, the DICJ files a petition for the commencement of bankruptcy proceedings against the Non-Viable Holding Company. It is expected that the Non-Viable Holding Company will enter into "liquidation proceedings" (in particular, bankruptcy proceedings) through which the company will be dissolved, not into "reconstruction procedures" through which business continuity will be attempted.

In this case, creditors of the Non-Viable Holding Company, including the holders of the External TLAC eligible debt liabilities, will receive liquidating distributions within the scope of the Bankruptcy Estate under the Bankruptcy Act or relevant laws, and thus will absorb the losses in the bankruptcy proceedings.

(ii) In the case where an overseas Material Sub-group of any Covered SIBs faces a crisis

As for each overseas Material Sub-group of any Covered SIBs, the relevant local authority will determine whether or not to implement the triggering of Internal TLAC. In making such decision, the local authority might contact the Japanese authority to ask whether or not the latter agrees with the former, within a certain period in accordance with the relevant TLAC agreement document. In such a case, the FSA will consider whether or not the soundness recovery of the Material Sub-group is possible through support from any of its group companies, and then will determine whether or not to consent.

Even if the triggering of Internal TLAC is implemented for an overseas Material Sub-group, the

resolution procedure of the entire group as stipulated in and after (i) (B) may not be implemented, depending on the financial conditions of both the holding company and the entire group. In such a case, the FSA will pay careful attention to its communication with markets in order to avoid the misconception that the resolution procedure of the entire group would start.

### III-11-7 Valuation for Ensuring Smooth Implementation for Orderly Resolution, etc.

#### III-11-7-1 Purpose and Significance

In order to ensure smooth implementation of Orderly Resolution, etc., it is necessary for authorities to take timely and appropriate measures. To this end, financial institutions are required to evaluate their own financial conditions, and assets and liabilities (hereinafter referred to as "valuation") in a timely and appropriate manner and to report to the authorities.

At the international level, the Financial Stability Board published the "Principles on Bail-in Execution" in June 2018, which establishes the principles for valuations necessary to execute an orderly resolution.

Reflecting the international trend, authorities need to ensure that financial institutions develop valuation capabilities necessary for smooth implementation of Orderly Resolution, etc.

The following sections describe the purpose, significance, etc. of valuations required in the process of an orderly resolution, based on the specific example of orderly resolution procedures of SIBs subject to TLAC in Japan (III-11-6-2-2-2).

#### (1) Valuation 1 (Valuation for determination of non-viability of Material Subgroup)

When the FSA issues an order under Article 52-33, Paragraph 1 of the Banking Act to a domestic resolution entity for recapitalization and soundness recovery, including liquidity recovery, of the Material Subgroup with the usage of Internal TLAC (determination of non-viability of Material Subgroup), the FSA will need to (a) determine that the Material Subgroup has reached (or is likely to reach) excess debt or insufficient liquidity resources, and (b) consider whether the soundness recovery of the Material Subgroup is difficult or unexpected even if, for example, it receives support from its group companies.

Specifically, corresponding to (a) aforementioned, it is necessary to ensure a timely and appropriate assessment of the financial condition including assets and liabilities of the Material Subgroup. Corresponding to (b) aforementioned, for determining the possibility of restructuring the entire group, it is necessary to identify capital and assets (including unallocated TLAC) that are held by the group as a whole and are transferable to the Material Subgroup, and their location, taking into account intra-group support agreements, local regulations, etc.

#### (2) Valuation 2 (Valuation for Specified Confirmation of Domestic Resolution Entity)

In order for the Prime Minister to determine the Specified Confirmation for Specified Measure Item II

against a domestic resolution entity that absorbed losses from its Material Subgroup by triggering internal TLAC, the Domestic Resolution Entity needs to satisfy the applicable requirements for Specified Measure Item II prescribed in the Deposit Insurance Act.

Namely, it is necessary for the Prime Minister to confirm that the Domestic Resolution Entity has reached (or is likely to reach) excess debt or insufficient liquidity resources. As a precondition for such confirmation, the Domestic Resolution Entity shall report its financial condition to the FSA, including reports in response to the FSA's order.

Therefore, it is considered necessary for the Domestic Resolution Entity to assess its own financial condition in a timely and appropriate manner in the case of triggering Internal TLAC of the Material Subgroup, and to report to the FSA. The measures for such valuation include adjustments of assets and liabilities based on the most recent financial statements of the Domestic Resolution Entity, taking into account the impact of the triggering of Internal TLAC.

(3) Valuation 3 (Valuation for calculation of consideration for transfer of businesses, etc.)

When businesses, etc. related to systemically important transactions are transferred from the Domestic Resolution Entity (i.e., Non-viable Holding Company) to the Specified Bridge Financial Institution, etc. established by the DICJ, it is considered necessary for the Specified Bridge Financial Institution, etc. to provide consideration for the transfer to the Non-viable Holding Company.

In calculating the consideration for the transfer of the businesses, etc., the appropriate calculation method should be selected from widely used equity valuation methods such as the income approach, the market approach, and the cost approach, or a combination of these methods, taking into account elements such as the business to be transferred and the availability of information.

In doing so, it is necessary to take into account, for example, (a) changes in the business and market environment of the company to be transferred from the time of most recent financial statements to the time of transfer, (b) information on the net asset value of the company based on such changes, (c) the details of the group-wide restructuring plan under the Specified Bridge Financial Institution, etc., and (d) future business forecasts including the timing of re-transfer. Therefore, it is desirable to use an objective and reasonable valuation method (e.g., obtaining opinions and assessments of financial advisors and other external experts).

(Note) It is, however, expected to be difficult to precisely calculate the fair share value of the company to be transferred at the time of transfer of businesses, etc. in a short period of time.

Therefore, with respect to the consideration for the transfer of the business, etc., for example, in petitioning the court for permission in lieu of a special resolution of the shareholders meeting (i.e., substituted permission), it may be considered to set a provisional consideration with a price adjustment clause (e.g., calculated based on book value/market value net assets). In this case, after the transfer of the business, etc., a third party will be requested to calculate the value of the shares, taking into account elements

such as the future business forecasts of the subsidiaries, etc. of the Non-viable Holding Company, over a certain period of time. The petition for such substituted permission may be filed on the premise that the ex post obtained value is used as the basis for calculating the transfer consideration as a firm value.

The specific method of ex post adjustment should be handled flexibly in accordance with each case.

### III-11-7-2 Major Viewpoints and Supervisory Method and Actions

The FSA will, taking into account the systemic importance, etc. of the financial institutions, verify the capabilities to conduct valuations for smooth implementation of Orderly Resolution, etc. (including conducting testing exercises described in III-11-8) from the following viewpoints, regarding the G-SIBs designated by the Public Notice and, where necessary, other systemically important banks, etc. To this end, the same supervisory methods and measures as specified in III-11-3-3 will apply.

#### (1) Valuation 1

- (i) Whether financial institutions develop capabilities to identify transferable capital and assets, including unallocated TLAC, taking into account local regulations, etc. in overseas jurisdictions, in order to determine the possibility of restructuring the group as a whole;
- (ii) Whether financial institutions develop capabilities to identify and report on the financial conditions of subsidiaries, including those overseas, in a timely manner, on the basis of appropriate understanding of the regulations and approaches in overseas jurisdictions of valuation in times of crisis, and whether financial institutions develop capabilities to identify in a timely manner the amount of intra-group support from parent companies and other entities, including allocation of unallocated TLAC, in case such support is necessary; and
- (iii) Regarding Material Subsidiaries, whether financial institutions develop capabilities to enable timely calculation of assets and liabilities that require adjustments of market value from the viewpoint of their impact on the amount of net assets after the most recent financial statements, and whether financial institutions verify and confirm valuation assumptions, models, reporting periods, etc.

#### (2) Valuation 2

- (i) Whether financial institutions have capabilities to calculate the financial statements of the domestic resolution entity on both standalone and group consolidated basis after principal write-down or equity conversion of Additional Tier 1, Tier 2 (as long as they are Basel III eligible instruments), and internal TLAC; and
- (ii) Regarding the Domestic Resolution Entity (standalone basis), whether financial institutions develop capabilities to enable timely calculation of assets and liabilities that require adjustments of market value from the viewpoint of their impact on the amount of net assets after the most recent financial

statements, and whether financial institutions verify and confirm valuation assumptions, models, reporting periods, etc.

(3) Valuation 3

- (i) As aforementioned, in calculating the transfer consideration, it is desirable to use an objective and reasonable valuation method (e.g., obtaining opinions and evaluations from financial advisors and other external experts); and
- (ii) Whether financial institutions develop capabilities to provide external experts, etc. with information necessary for calculating the consideration for the business transfer in a timely and appropriate manner from the viewpoint of enabling a smooth business transfer, etc.

(4) Common Points for Valuation 1-3

- (i) Whether financial institutions develop an appropriate governance system to enable implementation of (1) - (3) above; and
- (ii) Whether financial institutions develop a reporting system of the result of valuation described in (1) - (3) above to the FSA in a timely manner.

III-11-8 Testing of System for Ensuring Smooth Implementation of Orderly Resolutions, etc.

III-11-8-1 Purpose and Significance

To ensure smooth implementation of Orderly Resolution, etc., it is important for financial institutions to enhance the effectiveness of an orderly resolution by testing their resolution preparedness, etc. in normal times. For example, financial institutions are expected to codify the procedures for implementing a recovery plan and Orderly Resolution, etc., as playbooks, followed by testing the feasibility of their resolution preparedness, etc. based on these documents, and thereby continuously enhancing their preparedness by addressing the identified issues through testing, if any.

III-11-8-2 Major Viewpoints and Supervisory Method and Actions

The FSA will, taking into account the systemic importance, etc. of the financial institutions, verify the testing activities to ensure smooth implementation of Orderly Resolution, etc., from the following viewpoints, regarding the G-SIBs designated by the Public Notice and, where necessary, other systemically important banks, etc. To this end, the same supervisory methods and measures as specified in III-11-3-3 will apply.

- (i) Whether financial institutions codify, as playbooks, the procedures for dealing with crisis situations (for example, decision-making processes within financial institutions and communication processes with the relevant authorities, stakeholders, etc. with regard to the implementation of a recovery plan and Orderly



- Resolution, etc.) based on the resolution preparedness, etc. stipulated by these Supervisory Guidelines;
- (ii) Based on the aforementioned playbooks, whether financial institutions make continuous efforts to improve their resolution preparedness through the so-called “PDCA cycle”: (a) conducting simulation exercises, etc., with the involvement of management and overseas offices, depending on the subject of the testing, (b) conducting effective verification of the feasibility of their resolution preparedness, etc. with the internal audit departments, third parties, etc., (c) identifying issues for improvements based on the verification, and thereby (d) making efforts for sophistication;
  - (iii) Whether financial institutions develop their medium-term plan for testing, while clarifying policies and thematic topics; and
  - (iv) Whether financial institutions develop necessary control environments for implementing the measures described above.

## IV Bank Holding Company

### IV-1 Purpose and Significance

A bank holding company conducts business management of bank(s) which are its subsidiaries (hereinafter referred to as "subsidiary bank(s)") and its companies listed in Article 52-23(1) (i) through (xiii) of the Banking Act. Its scope of business is confined to business management of the bank holding company group ("business management" as stipulated in Article 52-21(2) of the Banking Act), the auxiliary business, and the business activities stipulated in Article 52-21-2(1) of the Banking Act. In business management of its subsidiaries, any bank holding company should endeavor to ensure sound and appropriate management of its subsidiary banks' business in light of the purport of the Banking Act, such as ensuring the soundness of bank management and the protection of depositors.

### IV-2 Main Points to Note

Supervisory guidelines for bank holding companies basically conform to the provisions concerning banks in these Supervisory Guidelines. At the same time, however, the following points are also to be noted, given business characteristics of their banking subsidiaries:

- (1) Whether the bank holding company plays a responsible role in constructing the entire group's business management (governance) structure.
- (2) Whether the bank holding company accurately calculates its consolidated capital adequacy ratio, consolidated liquidity coverage ratio and consolidated net stable funding ratio (refer to III-2-1 and III-2-3-4-4).
- (3) Whether the group as a whole has a compliance structure for third-party allotment (refer to III-3-1-5).
- (4) Whether the bank holding company appropriately manages the entire group's financial affairs, including its financial structure on a solo basis (such as the status of interest-bearing liabilities).
- (5) Whether the bank holding company understands its exposure to potential systemic risk, and puts in place a liquidity risk management structure.
- (6) Regarding the appropriateness and sufficiency of disclosure (refer to III-3-2), the ultimate accountability lies with a bank holding company as a publicly traded company. Whether this recognition is put into practice.

- (7) In the case where its subsidiary banks integrate their systems in the wake of the merger, whether the bank holding company puts into place a system integration risk management structure based on the content in III-3-10.
- (8) Whether the bank holding company plays a responsible role in matters to be managed/controlled in a group-based integrated manner, such as control environments for management of information related to customers, etc. (refer to III-3-3-3), relations between banks and their securities subsidiary companies, etc. (refer to V-3-3-6), and constructing a system to protect benefits for the entire group's customers (refer to V-5).

#### IV-3 General Supervisory Methods and Measures

- (1) When necessary, the FSA conducts interviews with the bank holding company about the business management over its subsidiary banks. If necessary, the regulator also interviews the relevant subsidiary banks.
- (2) When the regulator asks a subsidiary bank to make a report pursuant to Article 24 of the Banking Act, and if the matter involves the bank holding company's business management, then the regulator also asks the bank holding company to make a report pursuant to Article 52-31 of the Banking Act.
- (3) If the regulator finds a problem with business management of a bank holding company from the viewpoint of ensuring sound and appropriate management of its subsidiary banks' business, the regulator asks the bank holding company to make a report pursuant to Article 52-31 of the Banking Act. If a serious problem is identified, the FSA will issue a business improvement order pursuant to Article 52-33 of the Banking Act.

#### IV-4 System Integration

- (1) In the case where subsidiary banks integrate their systems in the wake of a merger, the FSA regularly asks the bank holding company, pursuant to Article 52-31 of the Banking Act, to submit a report on their system integration risk management structure and their project management structure, grasps their actual status, and inspect whether or not a serious problem exists.

Note: In the case where any full-scale system integration does not follow the merger of subsidiary banks, or in the case where the system integration has nothing to do with any merger, the regulator will, if necessary, request such reporting pursuant to Article 52-31 of the Banking Act.

- (2) In the case where a notice of inspection results is issued in regard to the system integration risk management structure and the project management structure, the FSA asks the bank holding company

to make further reporting pursuant to Article 52-31 of the Banking Act. Such reporting is to describe the fact-checking, the cause-analysis, improvement measures, and other responses to the FSA's findings. The regulator also asks for a report on measures to appropriately control risks (such as a measure to accurately implement the relevant plan, and internal governance structure including internal audit). Based on these reports, the FSA verifies whether there is a problem with the system integration risk management structure and the project management structure.

In addition, the FSA regularly asks for follow-up reporting, and checks the progress in improvement measures and the effectiveness of the project management structure, etc.

- (3) If the transition judgment is made in regard to system integration, the FSA asks for reporting, pursuant to Article 52-31 of the Banking Act, mainly on such judgmental grounds.
- (4) If any of the above inspections from (1) through (3) finds a problem, the FSA will ask for reporting pursuant to Article 52-31 of the Banking Act, and if a serious problem is identified, the regulator will issue, pursuant to Article 52-33 of the Banking Act, a business improvement order concerning the system integration risk management structure and the project management structure.

#### IV-5 Certified Bank Holding Company

##### (1) Certification criteria

With regard to the requirement under Article 34-19-7(2)(ii) of the Banking Act Enforcement Regulation, namely "appropriate systems should be developed in order to ensure proper business operations at the bank holding company and the group of its subsidiary companies," it should be noted that the regulator should consider whether effective internal control systems for business operations within the bank holding company's group are put into place, after taking into account issues, etc. that the bank holding company has identified through monitoring, etc. in a broad manner.

##### (2) Measures when the bank holding company does not conform to the certification criteria any longer

When the bank holding company does not conform to the certification criteria any longer, the regulator may revoke the certification based on Article 52-34-2(1) of the Banking Act. However, the same item of the same Act also stipulates that the regulator may order the bank holding company to take necessary measures to conform to the criteria within the designated period.

In this regard, when considering whether the certification should be revoked or whether the bank holding company should be ordered to take necessary measures to conform to the criteria, the FSA needs to consider individually and specifically the reasons why the bank holding company does not conform to the criteria any longer. For example, it should be noted that, in the case where the bank holding company does not conform to the criteria because it acquired its group's bank to rescue the latter, the certification does not need to be revoked immediately.

#### IV-6 Administrative Processes to Note

In the case where both a bank holding company and its banking subsidiary need to file for an identical matter pursuant to the following, the bank holding company and the banking subsidiary may submit one notification in their joint names.

- (i) Article 53(1)(ii) and Article 53(3)(iii) of the Banking Act
- (ii) Article 53(1)(iii) and Article 53(3)(iv) of the Banking Act
- (iii) Article 35(1)(viii) and Article 35(3)(v) of the Banking Act Enforcement Regulation
- (iv) Article 35(1)(xii) and Article 35(3)(ix) of the Banking Act Enforcement Regulation
- (v) Article 35(1)(xv) and Article 35(3)(xii) of the Banking Act Enforcement Regulation
- (vi) Article 35(1)(xvi) and Article 35(3)(xiii) of the Banking Act Enforcement Regulation
- (vii) Article 35(1)(xvii) and Article 35(3)(xiv) of the Banking Act Enforcement Regulation
- (viii) Article 35(1)(xviii) and Article 35(3)(xv) of the Banking Act Enforcement Regulation
- (ix) Article 35(1)(xix) and Article 35(3)(xvi) of the Banking Act Enforcement Regulation
- (x) Article 35(1)(xx) and Article 35(3)(xvii) of the Banking Act Enforcement Regulation
- (xi) Article 35(1)(xxi) and Article 35(3)(xviii) of the Banking Act Enforcement Regulation

## V Consolidated-base Supervision over Bank Groups

### V-1 Key Principles

#### (1) Risk management of bank groups

The risk exposure of a bank group can be divided into the risk exposure of the entire bank group and that of individual banks in the bank group. When considering the role of risk management, it should be clarified which risk exposure should be more seriously regarded on the assumption that the ultimate objective is to protect depositors and settlement systems. In this regard, there are two conceivable approaches for risk management. One approach is to manage risks as a whole bank group, while setting clear boundaries within the bank group. The other approach is to keep each bank away from the risks of other group companies, while maintaining open boundaries within the bank group. Individual systems to monitor and surveil risk management need to incorporate the concepts of both approaches, depending on the feasibility of addressing regulations. However, taking into account various factors, such as the actual status of risk management, stakeholders' monitoring over a bank group, users' convenience through group development, and further enhancement of international competitiveness, it is appropriate to set up risk management with the former approach (i.e. manage risks as a whole bank group, while setting clear boundaries within the bank group) in mind.

#### (2) Scope of a bank group

Regardless of whether it is a bank holding company, a sister company, a subsidiary company, or an affiliate company, risks related to the company's business transactions spread to any bank in the group. With this contagion effect in mind, it is appropriate to determine the scope of a group by taking a conservative stance on the contagion of risks in light of the inherent nature of any bank group's risk management as the preemptive protection, and by focusing on substantial relations. Based on these principles, the scope of a bank group should be consistent with the criteria for consolidation in corporate accounting of a bank holding company or a bank (Note).

Note: If consolidated financial statements are prepared in accordance with designated International Financial Reporting Standards (referring to the corporate accounting standards adopted by a "corporation, etc. subject to special business accounting standards, etc." stipulated in Article 14-7(3) of the Banking Act Enforcement Regulation; the same applies hereinafter), the scope of a bank group should also be consistent with designated International Financial Reporting Standards.

#### (3) Outline of consolidated-base supervision

Consolidated financial statements in corporate accounting and risk-monitored loans under the Banking Act are disclosed on a consolidated basis. Furthermore, the capital adequacy ratio regulation, the liquidity ratio regulation, the large-scale credit provision regulation, and the arm's length

principle are applied on a consolidated basis.

(Reference) “Council Report on Risk Management of Bank Groups, etc.” by the Financial System Research Committee (January 1998)

## V-2 Arm’s Length Principle

The arm’s length principle is a rule to prevent conflict-of-interest transactions between a bank and any of its group member companies that would otherwise undermine the soundness of bank management. The following points should be noted.

- (1) When a bank outsources or conducts other transactions within its bank group, whether the bank adequately verifies that the transaction does not violate the arm’s length principle.

For example, the following transactions or conduct may constitute the transactions or conduct stipulated in Article 14-10 or Article 14-11 of the Banking Act Enforcement Regulation. Accordingly, when becoming engaged in such transactions or conduct, whether the bank checks the necessity of approval from the Prime Minister based on the proviso of Article 13-2 of the Banking Act and Article 14-8 of the Banking Act Enforcement Regulation.

- (i) Reduction or waiver of rent/commission
- (ii) Reduction or waiver of interest, deferred interest payment
- (iii) Waiver of claim, DES (debt equity swap)
- (iv) Underwriting of capital increase in the case where a specified related person is insolvent

- (2) When a bank files an application for approval in accordance with the proviso of Article 13-2 of the Banking Act, the FSA evaluates whether the bank has any of the compelling reasons listed in each item of Article 14-8 (1) of the Banking Act Enforcement Regulation or whether the bank meets requirements stipulated in Article 14-8 (2) of the Banking Act Enforcement Regulation for the bank to become engaged in such transactions or conduct listed in each item of Article 13-2 of the Banking Act. For this evaluation, the points listed below should be noted.

- (i) Case where Article 14-8 (1)(iii) of the Banking Act Enforcement Regulation is applied
  - (A) Whether its specified related party runs into financial difficulty and needs support for reconstruction.
  - (B) On the assumption of receiving support for reconstruction, whether the specified related party has been striving to make sufficient self-help efforts and clarifies management accountability.
  - (C) Whether the transaction or conduct has more economic rationality, compared to the conceivable liquidation of the specified related party.
  - (D) In the case where the bank waives its claim or offers a monetary grant, whether the bank intends to write off or set aside adequate reserves to cover the full amount of estimated loss due to its support during the period of the relevant business improvement plan, and whether

it declares the intention before said plan commences.

When the application is approved, the following conditions will be added, if necessary, from the viewpoint of ensuring that the specified related party implements the business improvement plan.

- a. The bank should have the specified related party implement its business improvement plan.
  - b. The bank should annually report the implementation status of the specified related party's business improvement plan, the bank's recognition of the implementation status, and the bank's business management policy for the specified related party every fiscal year during the period of the business improvement plan.
  - c. If the specified related party's implementation of the business improvement plan is not sufficient, the bank should consider fundamental reviews on the business improvement plan, including a review on the specified related party's operations.
- (ii) Case where Article 14-8 (1)(iv) of the Banking Act Enforcement Regulation is applied
- Whether it is clear under normal social conventions that the bank will suffer a larger loss if the bank does not become engaged in the transaction or conduct with the specified related party.

### V-3 Scope of Business of Banks and Their Group Companies

#### V-3-1 Key Principles

##### (1) Purport of Prohibiting Banks from Engaging in Non-banking Business

Under the Banking Act, banks are restricted from engaging in non-banking business. The main purport is to prevent the commingling of different kinds of risk that would otherwise arise from the engagement in non-banking business (Note).

Note: Other purports may include the efficiency achieved through the devotion to banking business, and the prevention of conflict-of-interest transactions.

##### (2) With regard to regulations on the scope of business of any bank group, the main purport of restricting any bank from the engagement in non-banking business is also applied to the entire group whose handling is pursuant to regulations on the bank.

Note 1: If a bank group applies the designated International Financial Reporting Standards, the acts (such as venture capital investment related to the Small and Medium-sized Enterprises Business Enhancement Act, etc., DES (debt equity swap), and the enforcement of security rights) permitted as exceptions to the restriction on the acquisition of voting rights (so-called the 5% Rule) in Article 16-4 of the Banking Act are not subject to any particular limitation, even if such acts may consequently expand the scope of the group

Note 2: In the case where a company or a business entity equivalent to a company, which does not



belong to any bank group, becomes a subsidiary company of a bank solely because of the bank's changing some of its accounting standards, it is desirable to take a certain measure within a proper period (in principle, within a year), from the viewpoint of preventing a loophole in the purport of prohibiting banks from engaging in non-banking business.

#### V-3-2 Handling of Article 10(2)(xxi) of the Banking Act

##### V-3-2-1 Points to Note regarding Services for Regional Development, etc.

- (1) Each item of Article 13-2-5 of the Banking Act Enforcement Regulation specifically lists types of the services performed by banks under Article 10(2)(xxi) of the Banking Act (hereinafter referred to as the "services for regional development, etc."). However, provisions in parenthesis in chapeau of the same article of the Banking Act Enforcement Regulation add the requirement that "When the bank acquires new management resources for the services in addition to the bank's management resources for its banking business, the extent of such acquisition should be confirmed to levels where the acquisition will not cause any trouble in the bank's sound and proper business operation even if most of its new management resources are not used, depending on the demand."

The regulator needs to keep in mind that the said requirement should not be handled too strictly in light of the fact that the bank has added the services for regional development, etc. to the scope of its banking operation so as to contribute to building a sustainable society through digitalization and regional revitalization, etc.

Accordingly, it should be noted that this requirement does not mean that the bank should limit the acquisition of its new or additional management resources to the minimum necessity, but should be recognized as meaning that as long as there is clearly no significant trouble in the performance or the soundness of the bank's proper operation, the bank meets the requirement even if there is no demand for its services for regional development, etc., and that the services are feasible.

- (2) Among the services for regional development, etc. performed by banks, each bank should not unfairly take advantage of its superior bargaining position in business with regard to the services stipulated in Article 13-2-5(ii) of the Banking Act Enforcement Regulation.

##### V-3-2-2 Handling of "Other Auxiliary Business"

When a bank engages in operations stipulated in Article 10(2) of the Banking Act (excluding those listed in each item of the same Article 10(2); "other auxiliary business" hereafter), whether the bank validates the sufficiency of its measures to put in place the relevant structure from the following points of view.

- (1) The following operations also fall under the category of "other auxiliary business:"

- HR search & recruitment, business matching service for operating lease (excluding real property lease), M&A-related service, and administrative agency business, all of which are provided to client companies (including the case where these operations are provided separately from its inherent business from the viewpoint of strengthening the functions of management consulting and support for the client companies)

(Note) It should be noted that HR search & recruitment services require a license pursuant to the Employment Security Act. When providing these services, the bank should not unfairly take advantage of its superior bargaining position in business.

- Service of providing individual customers (excluding those engaged in business) with consultation for their property accumulation
- Education and training services, management consulting service, finance-related research and study services, all of which are provided by the bank's subsidiary companies or the bank holding company's subsidiary companies to officers and employees of other business operators, and agency and intermediary services for the service of providing individual customers (excluding those engaged in business) with consultation for their property accumulation

For these business engagements, the bank needs to put into place the relevant structures from the viewpoints of customer protection and the compliance with laws and regulations as described below:

- (i) Whether the bank puts into place the relevant structures for strict compliance with laws and regulations, including those for preventing acts that may be problematic as the abuse of its superior bargaining position under the Act on Prohibition of Private Monopolization and Maintenance of Fair Trade.

Note: For providing individual customers (excluding those engaged in business) with consultations for their property accumulation, whether the bank puts into place the relevant structures for strict compliance. For example, whether the bank ensures that its consultation does not fall under the investment advisory business as stipulated in provisions of the Financial Instruments and Exchange Act.

- (ii) Whether the bank clearly specifies the contents of its contract, including instruments/services to be provided and their values, in writing or in some other appropriate form.
- (iii) With regard to auxiliary business-related customer information management, whether the bank sets up specific handling standards including those for unintended use. Whether the verification system is put into place to check how thoroughly its employees are informed about such standards (refer to III-3-3-3-2).

- (2) With regard to operations related to the issuance of e-money (including offline debit E-cards), which banks have already been allowed to engage in, banks should put into place the relevant structure so that they can offer by themselves sufficient evidence to prove that they have paid full attention to user security in various aspects, including the issuance-corresponding fund administration.

- (3) Transactions with economic effects similar to those of lending funds
- (i) In the case where a bank engages in transactions (including those where Article 10(1)(ii) or Article 10(2)(xviii) of the Banking Act applies) with effects similar to those of lending funds that involve the purchase and sales (including off-exchange transactions; the same applies in this (3)) of commodities (referring to goods that can be traded on an exchange; the same applies in this (3)), leasing of property, or the acquisition of rights related to a customer's business, while taking account of the religion of either a customer or the relevant person, the following points should be noted.
    - (A) In the case where such transactions include the purchase and sales of any commodity, the bank should not bear any risks related to the commodity (including the risk of being unable to purchase and sell the commodity that is necessary for such transactions; the same applies in this (3)), other than the credit risk related to the trading value of the commodity.
    - (B) In the case where such transactions include leasing of property (including the case where the bank pays the acquisition value before the acquisition of the property), the bank should not bear any risks related to the property, other than the credit risk related to the property rent. In addition, the requirements stipulated in Article 10(2)(xviii) of the Banking Act must be satisfied, and the bank will not engage in any business (such as construction of property) that no bank is allowed to conduct.
    - (C) In the case where such transactions include the acquisition of rights related to a customer's business, cash flow to be generated from the rights should be considered equivalent to lending funds, and the bank should not bear any risks that cannot be recognized as the credit risk of the customer among the risks related to the business
  - (ii) In the case where a bank engages in transactions (including those where Article 10(1)(i) of the Banking Act applies) with effects similar to those of taking a deposit that includes the purchase and sales of any commodity, while taking account of the religion of either a customer or the relevant person, it should be noted that the bank should not bear any risks related to the commodity.
  - (iii) In the case where a bank engages in transactions with effects similar to those of interest and/or currency swap transactions that include the purchase and sales of any commodity, while taking account of the religion of either a customer or the relevant person, it should be noted that the bank should not bear any risks related to the commodity.
- (4) In determining whether operations other than those defined in the above (1) through (3) (including operations for the purpose of effectively utilizing the excess capacity) fall under "other auxiliary business," the regulator will check whether the following viewpoints are comprehensively taken into account, while also paying careful attention to the fact that non-banking business is prohibited under Article 12 of the Banking Act.

- (i) Whether the operation is equivalent to any of the operations listed in each item of Article 10(1) and each item of Article 10(2) of the Banking Act.
- (ii) Whether the scale of the operation is not excessive, compared to the scale of the inherent business with which the operation is associated.
- (iii) Whether the operation has functional closeness and homogeneous risks with banking operations.
- (iv) Whether the operation contributes to utilizing the excess capacity that has been duly generated while the bank has been engaging in its inherent business.

Note 1: The case where a bank leases its commercial real property to a group company for the purpose of efficient and rational business management of the bank group (limited to the case where the group company itself uses the property) is considered to fall under “other auxiliary business.”

In light of the abovementioned purpose, the scope of the bank group is limited to the scope stipulated in V-1 (2), and needs to be consistent with accounting standards for consolidation criteria of either the bank holding company or the bank.

Note 2: When considering the above provisions in a comprehensive manner, if, for example, a bank has no other choice but to lease its commercial real property to a third party other than the group companies, the bank should put into place the relevant structure so that it can offer by itself sufficient evidence to prove that the following requirements are satisfied. In the case where a bank leases such property to the national or local government, or an entity that is considered to have a public role in light of local needs and current conditions, in response to the request from such lessee, the matter described in the following (D) may be judged in light of the contents of such request from the viewpoints of regional revitalization and central city invigoration.

(A) The bank does not aggressively promote the operation internally.

(B) The work is neither bank-wide nor organizational between the bank and a specified management company.

(C) Expenditures for the property should be kept at a bare minimum level, such as minimum amounts of conversions and repairs. In this regard, however, if reconstruction or new construction is required from a public redevelopment project or a local government or the like, the relevant expenditures should be kept at a bare minimum level.

(D) The scale of leasing should not be excessive compared to the scale of the inherent business that is conducted by utilizing the real property in question.

\* The scale of leasing should be evaluated in a comprehensive manner by taking account of several factors such as rent income, expenditures, and the lending area. (Such evaluation does not need to be mechanical, judging from only one single item.)

Note 3: The above (Note 2) applies mutatis mutandis to the case where a bank has no other choice but to temporarily lease a certain property on the assumption of the sale in the future due to the difficulty in selling it in the near term. (In this regard, however, the provisos of (C) and

(D) are excluded.) As background information, the property used to be commercial real property but no longer serves such function due to restructuring.

In the case where a bank leases such property to the national government or a local government, or an entity that is considered to have a public role in light of local needs and current conditions, in response to the request from such lessee, from the viewpoints of regional revitalization and central city invigoration, the leasing period may be determined in light of the contents of such request.

Note 4: In determining whether operations fall under “other auxiliary business,” refer to the FSA’s replies about the written referral procedures concerning general interpretation of laws and regulations and the no-action letter system (the FSA’s website “Referral Procedures concerning Interpretation of Laws and Regulations (No-action Letter System, etc.)”).

### V-3-3 Scope of Business of Subsidiary Companies, etc.

In light of the fact that non-banking business is prohibited under Article 12 of the Banking Act, the scope of business of a bank’s subsidiary companies (those stipulated in Article 2(8) of the Banking Act (including companies that are recognized as subsidiary companies in accordance with the said Article 2(8); the same applies hereinafter), subsidiary corporations, etc. (those stipulated in Article 4-2(2) of the Banking Act Enforcement Order (excluding subsidiary companies); the same applies hereinafter), and affiliated corporations, etc. ( those stipulated in Article 4(3) of the Banking Act Enforcement Order; the same applies hereinafter) (hereinafter collectively referred to as “subsidiary companies, etc.” ) should be as follows:

In this regard, virtually the same will be applied to subsidiary companies, etc. of a bank holding company.

Note 1: In the case where a bank or any of its subsidiary companies hold shares of a domestic company (excluding any subsidiary company of the bank) with its holding shares in total exceeding the voting right holding threshold (as stipulated in Article 16-4(1) of the Banking Act; the same applies hereinafter), the scope of business of the domestic company (“specified investee company” hereinafter) is the same as that of companies set forth in Article 16-2(1)(i) through (vi), (xi), (xiii), (xv) and (xvi) of the Banking Act (as for companies set forth in Article 16-2(1)(xiii), companies under special business revitalization process are excluded), special holding companies which banks have as their subsidiaries (meaning special holding companies stipulated in Article 16-2(6)(i) of the Banking Act), and companies subject to special provisions (meaning companies subject to special provisions stipulated in Article 16-4(8) of the Banking Act). It must also satisfy the criteria concerning subsidiary companies as stipulated in the Banking Act Enforcement Regulation, the Notice and these Supervisory Guidelines.

With regard to authorization as stipulated in Article 16-2(4), the examination authority requires the applicant bank and the company for which authorization the applicant bank is filing (hereinafter referred to as the “company subject to the authorization” in this item) to be expected to have a good balance of payments and to maintain such good balance after the authorization, but the projection

period for the balance of payments is not stipulated in the examination. In this context, the applicant bank may set the projection period for the balance of payments as three years or longer.

In receiving a notification on the subsidiary companies, etc. (as for the subsidiary companies, a notification pursuant to Article 53(1)(ii) of the Banking Act; as for the subsidiary corporations, etc. or the affiliated corporations, etc., a notification pursuant to Article 35(1)(xv) of the Banking Act Enforcement Regulation; as for specified investee companies, a notification pursuant to Article 35(1)(xvii)), the FSA verifies whether the subsidiary companies, etc. comply with the scope of business, based on the Articles of Incorporation of the subsidiary companies, etc. or the business agreement between the bank and the subsidiary companies, etc.

Note 2: When evaluating the subsidiary corporations, etc. or the affiliated corporations, etc., the FSA also pays careful attention to whether they comply with terms of financial statements, regulations concerning forms and preparation methods, Implementation Guidance for Accounting Standard No. 22 “Implementation Guidance for Determining the Scope of Subsidiaries and Affiliates in Consolidated Financial Statements” (dated May 13, 2008), and other generally accepted accounting standards, irrespective of whether or not the bank prepares annual securities reports based on the Financial Instruments and Exchange Act.

(Reference) If the consolidated financial statements are prepared in accordance with the designated International Financial Reporting Standards, such evaluation should be based on said Standards.

Note 3: “Companies” stipulated in Article 16-2 and Article 16-4 of the Banking Act do not include special purpose companies (conceivable purposes include asset securitization, and procurement of equity capital), general partnerships, securities investment corporations, partnerships, and other business entities equivalent to companies (“business entities equivalent to companies” hereinafter). In this regard, however, the regulator pays careful attention to whether or not any business entities equivalent to companies serve as a loophole to avoid the regulation on the scope of business of subsidiary companies, etc. as well as the purport of prohibiting non-banking business.

Note 4: With regard to a regional development business company (Article 16-2(1)(xiv) and Article 16-4(8) of the Banking Act), when the regulator is consulted by a bank about whether the content of business is acceptable or not in pre-consultation, the regulator may make a judgement solely based on whether the company subject to the authorization meets the requirement to be “a company that was established for the purpose of undertaking a business activities that contribute to the revitalization of the regional economy” stipulated in Article 17-7-3(1)(ii) of the Banking Act Enforcement Regulation.

Note 5: In the revised Banking Act (enacted in November 2021), Article 16-2(1)(xiv) has been added, and yet it should be noted that handling of the real property business of any regional development business company (the same (xiv), and Article 16-4(viii) of the same Act) remains the same as before the revision.

V-3-3-1 Scope of Business of Subsidiary Companies, etc.

(1) With regard to any business dependently engaged in by a subsidiary company of a bank (referring to “dependent business” stipulated in Article 16-2(2)(i) of the Banking Act; the same applies hereinafter), whether a dependent business is appropriately handled in accordance with III-3-3-4 of the Supervisory Guidelines.

(2) The scope of finance-related business engaged in by a subsidiary company of a bank (referring to “finance-related business” stipulated in Article 16-2(2)(ii) of the Banking Act; the same applies hereinafter) needs to be within the scope as described below:

(i) Credit guarantee business

Whether a subsidiary company engaging in this business (“the guarantee company” hereinafter) deals in credit guarantees related to commercial loans by the bank, by any subsidiary companies, etc. of either the bank or the bank holding company, and those by any of their subsidiary corporations, etc. and affiliate corporations, etc. In addition, whether the handling takes into consideration the following respects.

(A) Regarding its business management, whether the guarantee company pays full attention to the establishment of a pure-play guarantee business system, the enhancement of internal reserves, and the ensuring of other decent payment reserves. As specific measures to these ends, whether it has set up decent guarantee charge rates in light of guarantee characteristics, and it has been making appropriate provision of reserves so as not to disrupt the smooth flow of performing its guarantee obligations.

As for intragroup guarantees in particular, taking into account that any risk related to such guarantees does not transfer outside of the group, whether the guarantee company is careful enough not to have its business conditions affect the soundness of the bank.

(B) When offering credit guarantee services, whether the guarantee company avoids demanding unnecessary personal collateral, other than physical collateral.

(C) Whether the bank avoids forcing a debtor who needs a credit guarantee scheme to receive a guarantee from the guarantee company established by the bank itself.

(D) Whether the bank sets up lower interest rates than usual on its loans guaranteed by the guarantee company, by reducing the portion corresponding to any of the following.

- a. Normally estimated loss from bad debts
- b. Costs required for the setting-up, management, and disposition of collateral
- c. Estimated cost reduction due to the simplification of credit investigations, loan application screening, etc.

(ii) Leasing business

When making a real property lease contract, any bank’s subsidiary company engaging in this business (“the leasing company” hereinafter) needs to confine the form of contract to the same

lending format (so-called finance leasing), except for cases that involve the improvement/management of public facilities such as educational/cultural facilities and social welfare facilities. Accordingly, it needs to be checked whether or not the leasing company has been engaging in operations other than those in which any bank's general real property subsidiary companies are allowed to engage.

(Note) The leasing company needs to put into place the relevant management framework to prevent the abuse of its superior bargaining position and conflict-of-interest transactions. In addition, taking into account that any bank cannot engage in real property business, and from the viewpoint of complying with laws and regulations, the FSA checks whether full consideration and inspection are conducted in advance for the leasing company not to substantially engage in the agency and brokerage of real property transactions and rent.

(iii) Investment advisory business

From the viewpoint of protecting investors as well as in light of the operational particularity, the handling of investment advisory business needs to be checked in the following respects:

(A) Whether the handling of safe custody is conducted by the bank itself or a relevant trust bank, instead of by the subsidiary company engaging in this business ("the investment advisory company" hereinafter).

(B) Whether the investment advisory company excludes real property and antiques from the scope of its advisory business and concentrates on negotiable securities and financial instruments.

(iv) Telecommunications business (so-called VAN business)

Whether most (roughly 50% or more) of the subsidiary company's telecommunications work consists of that related to banking business, corporate finance, and accounting (such as those related to placing/receiving orders, accounts receivable/payable management, credit management, and other fund settlement as well as data processing related to accounting, tax affairs, and fund management).

(Note) If the subsidiary company makes an inquiry about the notification to the Ministry of Internal Affairs and Communications under Article 16(1) of the Telecommunications Business Act, the FSA will give a reply as follows: If the subsidiary companies, etc. engage in communications transmission services (hereinafter "transmission services") for non-commercial purposes, it does not need to submit such notification. (For example, in the case where the jointly-funded subsidiary companies, etc. provide only the investing financial institutions with the transmission services, it is obvious that the subsidiary companies, etc. do not aim to make profits from the transmission services through its price-setting and the terms of offering. A wholly-owned subsidiary company falls under this case.)

(v) Business involving sales of trust beneficial interests

When any bank's subsidiary company functions as an agency and brokerage for the purchase and sales of trust beneficial interests with real property as the trust property, the FSA checks whether



full consideration and inspection are conducted in advance for the subsidiary company not to substantially engage in the agency and brokerage for real property transactions and rent, taking into account that any bank cannot engage in real property business, and from the viewpoint of complying with laws and regulations.

- (vi) Consulting business, etc. at any bank's subsidiary specialized in investment

When any bank's subsidiary specialized in investment conducts the business stipulated in Article 17-2(14)(ii) of the Banking Act Enforcement Regulation, whether the subsidiary puts into place the relevant management framework to prevent the abuse of its superior bargaining position and conflict-of-interest transactions, and whether it considers and verifies the conduct sufficiently from the viewpoint of complying with laws and regulations, etc. in advance.

- (3) Whether the scope of business of any bank's specified subsidiary corporations, etc. (referring to subsidiary corporations, etc. that are not specified investee companies; the same applies hereinafter) and specified affiliated corporations, etc. (referring to affiliated corporations that are not specified investee companies; the same applies hereinafter) is prescribed as follows. However, this does not apply to business entities that are equivalent to companies.

- (i) The scope of business of any bank's specified subsidiary corporations, etc. and specified affiliated corporations, etc. needs to be within the scope of business of companies eligible for subsidiary companies (referring to "companies eligible for subsidiary companies" stipulated in Article 16-2(1) of the Banking Act; the same applies hereinafter), and it also has to satisfy the criteria regarding subsidiary companies set forth in the Enforcement Regulation, the Notices, and the Supervisory Guidelines.

Consider, as an example, a company engaging in specialized insurance-related business (referring to "specialized insurance-related business" stipulated in Article 16-2(2) (iv) of the Banking Act). Only if a bank has an insurance company as its subsidiary company, the bank may hold the abovementioned company as its specified subsidiary corporations, etc. or specified affiliated corporations, etc.

Note that, under the enforcement of the Banking Act on Revision, etc. of Related Acts for the Financial System Reform (hereinafter referred to as the "Act on Financial System Reform"), in the case where the specified subsidiary corporations, etc. or the specified affiliated corporations, etc. engaging in trust business (limited to those engaging in real property business as the main unit) of a bank actually engage in general real property business (the subject corporation is referred to as a "specified corporation" in (ii) below), the general real property business is within the scope of business allowed to the bank's specified subsidiary corporations, etc. and specified affiliated corporations, etc.

- (ii) Among those that were reported as "affiliated companies" (including companies established by said affiliated companies to have them conduct said companies' business, and other companies engaging in similar business; excluding companies where the above (3) applies and specified corporations), suppose that the specified subsidiary corporations, etc. or the specified affiliated corporations, etc.

of a bank actually engaged in business that was not within the scope of business of companies eligible for subsidiary companies when the Banking Act on Financial System Reform was put in force. In the case where the subject corporation continues to engage in such business after the enforcement of the Financial System Reform, such case is not deemed, until otherwise provided for by law, to violate the abovementioned (i), only if the name, business, and other necessary information of the specified subsidiary corporations, etc. or the specified affiliated corporations, etc. have been reported as ordered separately.

However, this does not apply to the case where the specified subsidiary corporations, etc. or the specified affiliated corporations, etc. are the subsidiary companies or the specified investee companies of the bank, and the case where the specified subsidiary corporations, etc. or the specified affiliated corporations, etc. newly engage in business other than the business engaged in by the subject corporation before the enforcement of the Banking Act on Financial System Reform.

(Note 1) Among companies in which a bank invests, affiliated companies refer to those that have a close relationship with the bank, given the backgrounds of their establishment, and their financial and personal relations with the bank.

(Note 2) For example, the following cases are deemed to be the same cases as applicable to the abovementioned specified subsidiary corporations, etc. or specified affiliated corporations, etc., unless they violate the purport of the Banking Act.

(A) The case where an affiliated company already reported by the bank had engaged in the abovementioned business under the enforcement of the Banking Act on Financial System Reform and it became a specified investee company (confined to a subsidiary corporation or an affiliated corporation) of the bank for a compelling reason as the bank acquired a certain number of the affiliated company's shares that other companies held. (The case is applicable only if the notification stipulated in Article 104 of the Supplementary Provisions of the Banking Act on the Financial System Reform has been made.)

(B) The case where the specified subsidiary corporations, etc. or the specified affiliated corporations, etc. had satisfied the abovementioned requirements at the time of the enforcement of the Banking Act on Financial System Reform and later they became the specified investee companies (confined to a subsidiary corporation, etc. or an affiliated corporation, etc.) of the bank pursuant to the provisions of Article 16-4(4)(i) of the Banking Act. (The case is applicable only if it has received permission stipulated in said Article 16-4(4)(i).)

(C) The case where the respective specified subsidiary corporations, etc. or the respective specified affiliated corporations, etc. of two banks had satisfied the abovementioned requirements at the time of the enforcement of the Banking Act on Financial System Reform and they merged and became the specified subsidiary corporations, etc. or the specified affiliated corporations, etc. of one or the other

bank (hereinafter referred to as “merging company”). (If the merging company started to engage in business other than the business it had engaged in before the merger, such new business needs to have received necessary review by the end of the fiscal year ended in March 2002 for the case to be applicable.)

- (iii) Whether the specified subsidiary corporations, etc. or the specified affiliated corporations, etc. avoid engaging in any business that is not within the scope of business of companies eligible for subsidiary companies, such as general real property business, merchandising business, and travel agency. In this regard, however, if the specified subsidiary corporations, etc. or the specified affiliated corporations, etc. had engaged in such business under the enforcement of the Banking Act on Financial System Reform, whether the necessary review was completed by the end of the fiscal year ended in March 2002.

Suppose two cases when the Act on Financial System Reform was put in force: one is the case where the specified subsidiary corporations, etc. or the specified affiliated corporations, etc. had actually engaged in either dependent business or finance-related business (including business that was reported as virtually equivalent to the abovementioned business in accordance with the relevant order separately issued); the other is the case where the specified subsidiary corporations, etc. or the specified affiliated corporations, etc. had actually engaged in both businesses. These cases are not deemed, until otherwise provided for by law, to violate the abovementioned (i), only if the necessary review on business other than the dependent business or the finance-related business was completed by the end of the fiscal year ended in March 2002.

(Note) If the specified subsidiary corporations, etc. or the specified affiliated corporations, etc. have not completed the necessary review beyond the deadline of March 31, 2002, the FSA asks for reporting on due reasons why the review has not yet been completed, in accordance with the relevant order separately issued.

#### V-3-3-2 Handling of Agency/Brokerage Firms for the Purchase and Sale of Collateral Assets (excluding Real Property) Related to Other Firms’ Loans

Whether the operation of agency/brokerage firms for the purchase and sale of collateral assets (excluding real property) related to other firms’ loans is confined to the agency/brokerage (hereinafter the “agency, etc.”) for the purchase and sale of collateral assets (excluding real property) for the enforcement of security rights necessary for the other firms to collect loans.

- (Note 1) Agency, etc. for the purchase and sale for any purpose other than the enforcement of security rights is not allowed in light of the purport of prohibiting non-banking business.
- (Note 2) Agency, etc. for the purchase and sale of real property is not allowed in light of the fact that banks are not allowed to engage in real property business.
- (Note 3) No one other than companies stipulated in Article 17-3(1)(xxiv) of the Banking Act Enforcement Regulation is allowed to engage in the acquisition, holding, management, and sale of collateral assets.

V-3-3-3 Handling of Collateral Asset Holding/Management Companies with the Collateral Related to Financial Institutions' Loans

The handling of companies holding and managing collateral assets related to financial institutions' loans needs to be checked in the following respects:

- (1) Whether the business of companies holding and managing collateral assets related to financial institutions' loans is limited to the following activities.
  - (i) Acquisition of the relevant collateral assets (as for assets other than real property, methods for the acquisition include not only foreclosure purchase but also private enforcement) when the parent bank and/or other financial institutions need to enforce their security rights to collect their loans (and also when a third party enforces security rights on the collateral assets related to the parent bank and/or other financial institutions)
  - (ii) Holding, management, and sale of the acquired assets (hereinafter referred to as "holding")
- (2) Whether the company's business performance complies with the following points.
  - (i) Holding of real property
    - (A) Whether the company strives to effectively utilize the acquired real property to enhance its value. To this end, whether the company levels land, constructs a suitable building on the land, and purchases adjoining land, while also collaborating with Organization for Promoting Urban Development, real property specified business partners, real estate brokers, etc. when necessary.
    - (B) Whether the company strives to sell the acquired real property smoothly. To this end, whether the company is considering securitization by utilizing a specified purpose company stipulated in the Banking Act on Securitization of Assets.
    - (C) In terms of the holding of real property, whether the company avoids engaging in business that is improper for affiliated companies to engage in, such as hotel business.
  - (ii) Holding of movables
    - (A) In light of the recognition that holding of various movables inherently involves a wide range of assumed risks, whether the company accurately grasps, analyzes, and manages risks that may arise from holding of the movables, such as management liability risk, and seller's liability for non-conformity with a real property contract, by type and attribute of the movables. Then, in order to properly deal with these risks, whether the company puts into place the relevant framework.
    - (B) During the process of acquiring movables, whether the company evaluates the movables by an objective and rational evaluation method.
    - (C) Whether the company properly manages the acquired movables by type and attribute of the

movables, and strives to enhance and maintain their value

- (D) Whether the company considers proper sales/foreclosure sales methods by type and attribute of the acquired movables, and strives for the realization
- (E) In terms of the holding of movables, whether the company avoids engaging in business that is improper for affiliated companies to engage in.

(iii) Holding of claims

- (A) During the process of acquiring claims, whether the company evaluates the claims by an objective and rational evaluation method.
- (B) Whether the company strives to maintain the value of the acquired claims. To this end, whether the company acquires necessary information to evaluate the creditworthiness of the third-party debtor (the debtor of target claims) as needed, and continuously monitors said debtor's financial conditions.
- (C) Whether the company strives to collect the acquired claims smoothly by taking proper collection measures (including assignment to a third party) in a timely manner.

(iv) Holding of other assets

Whether the handling of other assets also conforms to the abovementioned holding of real property, movables, and claims.

- (3) Whether eligible assets are defined as collateral assets related to loans, etc. by the parent bank, etc. Whether the purchase of these assets enables the parent bank, etc. to reasonably expect collection.

(Note) Loans, etc. include the right to indemnification and other claims that the parent bank, etc. acquired by making good on the relevant guarantee and accordingly have become secured claims on the assets.

(4) Others

- (i) Whether the company engaging in the holding of real property obtains the license pursuant to Article 3 of the Building Lots and Buildings Transaction Business Act.
- (ii) Whether the company engaging in the holding of assets other than real property obtains the necessary license, permission, registration or approval, etc. for the holding of the assets.
- (iii) Whether the company separately manages revenue and expenditure/profit and loss by acquired asset.
- (iv) Whether the parent bank, etc. and the company have taken necessary measures to ensure the company's financial soundness.

V-3-3-4 Non-banking Advanced Banking Service Companies

(1) Key principles

When a bank invests in each company set forth in Article 16-2(1)(xv) (excluding each company stipulated in Article 17-4-3 of the Banking Act Enforcement Regulation (hereinafter referred to as a

“certain advanced banking service company”); hereinafter referred to as a “non-banking advanced banking service company”), it may hold such shares in excess of the voting right holding threshold. Anticipating bank groups’ various developments in the future, this is designed to enable them to develop their business flexibly on the condition that they obtain authorization. It also enables a bank to invest in a company that engages in business which cannot be said to be contributing to the advancement of banking business, the enhancement of users’ convenience, or regional development, etc. when making the investment, although such contribution is expected in its bank group’s strategy for the future potential.

On the other hand, when the application for authorization of a non-banking advanced banking service company is filed, the FSA needs to examine the filing in light of the purport of prohibiting banks from engaging in non-banking business, i.e., request for the efficiency through the avoidance of non-banking business risks, the ban on conflict-of-interest transactions, and the prevention of abuse of their superior bargaining position.

(Note 1) It should be noted that each advanced banking service company that was authorized before the revision of the Banking Act (enacted in November 2021) is treated as a non-banking advanced banking service company after the revision, regardless of its operation at the time of authorization. In the case where such a non-banking advanced banking service company engages in a new business, etc., following the conditions at the time of authorization, the company should report the fact to the FSA.

(Note 2) In the revised Banking Act (enacted in November 2021), business contributing to regional development has been added as business that any non-banking advanced banking service company may engage in, and yet it should be noted that handling of the real property business of any non-banking advanced banking service company remains the same as before the revision.

(Note 3) In the case where the bank itself and other group companies conduct a demonstration test as part of preparation for the establishment of a non-banking advanced banking service company, they should limit the content, scale, and scheduled period of the demonstration test as well as the persons being tested to the minimum necessity, in light of the purport of prohibiting non-banking business and the positioning of such demonstration tests in these Guidelines. The bank and the bank group should also pay close attention so as not to affect their soundness and proper business operation by considering individual and specific risks, etc., due to the demonstration test.

\*1 “Demonstration test” here means that, for the purpose of verifying the profitability and business continuity of its non-banking advanced banking service company to be established, the bank and its group companies, on a trial basis, engage in similar business as to be conducted by its non-banking advanced banking service company as part of preparation for the establishment so that the management of the bank and/or the bank group will make a judgement as to whether or not the establishment of the non-banking advanced banking service company is appropriate. The bank should pay close attention to the fact that the bank itself needs to prove the intended demonstration test will not

affect the soundness and proper business operation of the bank and the bank group.

- \*2 Each “demonstration test” being conducted by a bank itself and the bank group as part of preparation for the establishment of a certain advanced banking service company will be treated in the same manner as in the above.

(2) Points to note in examining authorization

The examination criteria for authorizing a non-banking advanced banking service company are stipulated in Article 17-5-2 (2) of the Banking Act Enforcement Regulation. In examining each criterion, the FSA pays close attention to the following points:

(i) Investment amount

The regulator makes a judgment on the appropriateness of the investment amount, in light of the amount of stated capital of the bank that has filed the application for authorization of a non-banking advanced banking service company (referred to as the “applicant bank” in the (2) through (3)) as well as its financial and profit & loss situations, etc. On the assumption that the full amount of the bank’s investment in the non-banking advanced banking service company is damaged, the impact is examined in terms of such impact on the bank group’s capital adequacy ratio, among others.

(ii) Investment ratio, etc.

If a bank makes a non-banking advanced banking service company one of its subsidiary companies, etc., the non-banking advanced banking service company also needs to put into place an appropriate framework for business management, internal management, internal audit, etc. as a member of the bank group.

Assuming a case where the bank has little controlling power over the non-banking advanced banking service company, the regulator examines whether the bank is capable of managing the non-banking advanced banking service company’s governance and the appropriateness of its business contents. In addition, assuming a case where the business of the non-banking advanced banking service company no longer contributes to the advancement of its bank group, the enhancement of users’ convenience, or the regional development, etc., and another case where the advanced banking service company no longer satisfies the criteria for authorization, the FSA examines whether the bank is capable of appropriately dissolving the investment in excess of the voting right holding threshold.

(iii) Contents of business

When filing the application for authorization, the applicant bank needs to clearly explain the contents of the business engaged in by the non-banking advanced banking service company.

With regard to contents of business engaged in by a non-banking advanced banking service company, even if some part of the non-banking advanced banking service company additionally engages in certain business that is neither the business contributing to the advancement of banking business, the enhancement of users’ convenience, or the regional development, etc. (hereinafter referred to as the “contributing business”) nor the business where such contribution is anticipated

(hereinafter referred to as the “anticipated business”), the fact itself does not make the subject company ineligible for the authorization. However, there are cases where the authorization will not be given, due to their conceivable infringement of the purport of prohibiting non-banking business. Such cases include an obvious case where contents of the additional business have adverse effects on banking business, and less obvious cases where the additional business is much larger in scale than the “contributing business” or the “anticipated business.”

If a non-banking advanced banking service company engage in certain business of a bank, etc. eligible to be a subsidiary company other than its own main business, it may also engage in said business under the authorization for the non-banking advanced banking service company. On the other hand, the following two types of cases could become a loophole in the authorization system for a bank, etc. eligible to be a subsidiary company, against the purport of regulations on the scope of business. One type is a case where a non-banking advanced banking service company engages in business of a bank, etc. eligible to be a subsidiary company without obtaining the authorization for a bank, etc. eligible to be a subsidiary company, stipulated in Article 17-5 of the Banking Act Enforcement Regulation; and the other type is a case where a bank, etc. eligible to be a subsidiary company obtains the authorization for a non-banking advanced banking service company in order to engage in non-banking business. For this reason, any such case where a non-banking advanced banking service company engages in certain business of a bank, etc. eligible to be a subsidiary company other than its own main business is to be examined from the viewpoint of whether it could become such a loophole as mentioned above.

It should be noted that even in the case where the business is not assumed to be operated at the time of capital injection, if it is specifically assumed to be operated later, the business needs to be examined in the same way as in the above.

On the other hand, as for the business of each non-banking advanced banking service company, such business is, in many cases, operated by an ordinary business company that is outside of the FSA’s jurisdiction. Besides, in examining such a company, total loss is required to be examined in accordance with the provision (Article 17-5-2(2)(ii) of the Banking Act Enforcement Regulation). In light of the above, it should be noted that detailed confirmation regarding the feasibility of the business or risks related to the intended business, etc. is not compulsory.

(iv) Effects, etc. on the applicant bank’s business

Whether the investment amount is large or small, any case that is recognized as highly likely to have adverse effects on the applicant bank’s business cannot obtain the authorization for the non-banking advanced banking service company, even if contents of the non-banking advanced banking service company can be said to be “contributing business” or “anticipated business” in terms of contribution to the advancement of banking business, the enhancement of users’ convenience, or the regional development, etc. (Such cases include a case where the non-banking advanced banking service company’s compliance risk and/or reputational risk could have a contagion effect on the applicant bank, causing an obstacle to the bank’s inherent business operations or even on the bank



group, causing serious damage.)

- (v) Applicant bank's business management of its non-banking advanced banking service company as a member of its group

In accordance with Article 16-3 of the Banking Act, each bank is required to perform business management of the bank group, and each applicant bank must continue to be recognized as having no significant risk of getting in trouble of maintaining its sound and proper business operation after acquiring or holding voting rights in its non-banking advanced banking service company in excess of the maximum threshold for voting rights pursuant to the examination criteria for the authorization. In light of these requirements, the regulator should pay close attention to checking whether each applicant bank needs to change its control environments after acquiring, etc. voting rights in its non-banking advanced banking service company in excess of the maximum threshold for voting rights, such as intending to add a new framework to the applicant bank group's overall management frameworks or risk management frameworks as a response measure to have the non-banking advanced banking service company in the applicant bank group.

### (3) Management after the investment

In the case where a bank invests in a non-banking advanced banking service company after obtaining the authorization for the non-banking advanced banking service company, and if the number of its holding shares exceeds the voting right holding threshold, then the bank has to properly monitor business conditions and other relevant situations of the non-banking advanced banking service company. Especially, if the non-banking advanced banking service company's business or its operations are expected to expand, the bank also needs to properly manage the related risks and the conceivable effects on the bank group.

In some cases, for example, in a case where an advanced banking service company had engaged in "contributing business" at the time of the authorization but contents of the business substantially changed after the investment, and in another case where certain business regarded as "anticipated business" at the time of the authorization can no longer be deemed as "anticipated" after the investment, then the bank needs to take proper measures, such as dissolving the investment in excess of the voting right holding threshold.

#### V-3-3-5 Scope of Business of Any Japanese Bank's Overseas Subsidiary Companies, etc.

- (1) With regard to the scope of business of any bank's overseas subsidiary companies, etc., the FSA also applies similar key principles as those applied to the scope of business of such domestic subsidiary companies, etc., and pays close attention to ensure that such overseas subsidiary companies, etc. should not engage in any business other than the business in which companies eligible for subsidiary companies may engage.

(Note) This does not apply to the case where a bank needs to enforce its security rights to collect its overseas credited loans but the sale of the relevant collateral assets is extremely difficult due to

the local market conditions and there is no other proper disposition method under the local legal system. In this case, the bank may establish a management subsidiary company to have it hold and manage the unsellable collateral assets.

With regard to business engaged in by any foreign company which engages in banking business (hereinafter referred to as a “bank incorporated abroad”), in light of the purport of the Basel Concordat (the formal name “Principles for the supervision of banks' foreign establishments” (Basel Committee original publication in 1975), revised publication in 1983), the FSA will in principle permit what the local supervisory authority permits, unless it violates the purport of the Banking Act.

- (2) When certain business engaged in by any bank’s overseas subsidiary company (except for any bank incorporated abroad) satisfies all of the following conditions, the business may, unless otherwise provided for by law, be accepted as being within the scope of business of companies eligible for subsidiary companies, unless it violates the purport of the Banking Act: the overseas subsidiary company had actually engaged in certain business other than the business that could be engaged in by companies eligible for subsidiary companies when the Banking Act on Financial System Reform was put in force; there is no problem with such engagement under the local legal system; and the notification stipulated in Article 104 of the Supplementary Provisions of the Banking Act on the Financial System Reform was made about the business whose abolishment within a year might cause a serious trouble. However, the FSA pays close attention to whether necessary measures have been taken so that the review on the business can be conducted as promptly as possible.
- (3) Among subsidiary corporations and affiliated corporations that have been reported as “foreign investee corporations” (including companies that were established by the foreign investee corporations to have them engage in business of said corporations and other companies that engage in similar business as these, but excluding subsidiary companies as mentioned in the above (2)), the handling of the subsidiary corporations and affiliated corporations that had actually engaged in certain business other than the business that could be engaged in by companies eligible for subsidiary companies when the Banking Act on Financial System Reform was put in force should conform to the handling as described in the above V-3-3-1.

(Note) A foreign investee corporation is defined as a foreign corporation in which a Japanese bank invests in the accompanied form of management control or management participation.

Management control refers to the case where a bank effectively owns a majority of the voting rights at a foreign corporation (including shares with voting rights or subscribed capital nominally owned by officials of the financial institution but counted as the bank’s own holding by the bank). (The case includes a case where the bank and the foreign corporation substantially own a majority of the voting rights at another foreign corporation or another case where the foreign corporation substantially owns a majority of the voting rights at another foreign corporation.)

Management participation refers to the case where a bank substantially owns up to 50% of the voting rights at a foreign corporation and can have a substantial influence on the foreign corporation's financial and marketing policies through their relations in several areas, such as personnel affairs, funding, and transactions.

For reference, a case where another investor substantially owns a majority of the voting rights at the foreign corporation does not in principle fall under "the case where the bank can have a substantial influence."

- (4) When a bank files the application for authorization pursuant to Article 16(4) of the Banking Act (including Article 16(7) of the same Act being applied mutatis mutandis; the same applies in this (4)) in order to make a foreign company eligible to be a subsidiary company stipulated in Article 16-2(6)(i) of the Banking Act or a foreign specified finance-related services company stipulated in the same Article 16-2(6)(i) (hereinafter referred to as the "foreign company eligible to be a subsidiary company or the like") one of its subsidiary companies, the bank needs to clearly describe the following matters in application forms for the authorization including the statement of reasons.
- (i) Whether or not the foreign company eligible to be a subsidiary company or the like has any subsidiary company other than companies eligible to be subsidiary companies
  - (ii) If any company described in (i) has been made a subsidiary company, the company's content of business as well as its recent assets and profit-and-loss situations
  - (iii) Details of the relevant planned measures within ten years after the date when a company described in (i) was made the subsidiary company

Specifically, one of the plausible ways to implement the relevant measures will be to receive the authorization, etc. necessary to make the company eligible to be a subsidiary company one of the applicant bank's subsidiary companies after taking measures to make the subsidiary company a company eligible to be a subsidiary company such as (a) receiving the approval stipulated in Article 16-2(8) of the Banking Act; (b) making the subsidiary not eligible to be a subsidiary company by selling the relevant voting rights or the company's liquidation, etc.; or (c) discontinuing or transferring certain business operations, among the company's business, that are not allowed for any company eligible to be a subsidiary company to operate.

Note that there are cases where the abovementioned authorization pursuant to Article 16-2(4) will not be given. Such cases include a case that might negatively affect the bank's financial soundness, a case where content of business of the company other than companies eligible to be subsidiary companies impairs the public order or good manners, which might ruin the social credibility of the foreign company eligible to be a subsidiary company or the like, a case where it could become a loophole in the regulation on the scope of business, such as a company other than the company eligible to be a subsidiary company engaging in certain business that is not allowed for any company eligible to be a subsidiary company to operate in Japan, and a case where the regulator cannot confirm

that the foreign company eligible to be a subsidiary company or the like is capable of accurately and fairly managing their subsidiary companies so that it can ensure the appropriateness of the business engaged in by the company other than companies eligible for subsidiary companies.

The provision of Article 16-2(6)(i) of the Banking Act, which describes the requirement for foreign specified finance-related services companies to meet, include the term “mainly.” In this context, the regulator will make a judgement as to whether or not the requirement is fulfilled based on whether or not 50% or more of the company’s total income comes from the business stipulated in Article 17-4-4 of the Banking Act Enforcement Regulation (leasing business, lending business, etc.). Note that in the case where necessary environments to maintain the said requirement cannot be confirmed, the authorization pursuant to Article 16-2(4) will not be given.

\* The above handling applies mutatis mutandis to the case where a bank holding company files the application for authorization pursuant to Article 52-23(3) of the Banking Act (including Article 52-23(6) being applied mutatis mutandis) in order to make any of foreign companies eligible to be a subsidiary company set forth in Article 52-23(5)(i) or any of foreign specified finance-related services companies stipulated in the same Article 52-23(5)(i) one of its subsidiary companies.

- (5) The purport of Article 16-2(6) of the Banking Act is to allow a bank to make a foreign company eligible to be a subsidiary company or the like one of its subsidiary companies for ten years, regardless of regulations on the scope of business of subsidiary companies, when the bank makes a company other than any company eligible to be a subsidiary company one of its subsidiary companies by making the foreign company eligible to be a subsidiary company or the like one of its subsidiary companies, from the viewpoint of enabling a bank or a bank group that aims to enhance its international competitiveness to make a flexible acquisition so that the bank or the bank group will not be unreasonably forced to separate or liquidate the relevant foreign company or such foreign company group that has locally created the added value together with the bank or the bank group.

In addition, the provision of Article 16-2(8) of the Banking Act allows a bank to have a foreign company other than companies eligible to be subsidiary companies as one of its subsidiary companies permanently after obtaining approval from the Commissioner of the FSA. The purport of this is similar to that mentioned above (the approval based on the same Article 16-2(8) is hereinafter referred to as the “permanent approval.”)

In the course of permanent approval pursuant to Article 16-2 (9) of the Banking Act, the FSA will examine whether it is necessary for an applicant bank to continue to hold a foreign company eligible to be a subsidiary company or the like, which is actually a subsidiary company of the bank, in light of the subsidiary company’s competitiveness and other circumstances. For example, conceivable points to be examined include the following:

- (i) Content of business performed by any foreign company other than companies to be eligible to be subsidiary companies and the relevant risks

- (ii) Reasons why the business mentioned in the above (i) is necessary for the local group, such as business of any foreign company eligible to be a subsidiary company in the local group or synergy with the finance-related services operated by any foreign specified finance-related services company and the consistency with the local authority's request and administrative guidance
- (iii) Local practices and how local competitors handle the business mentioned in the above (i)  
Note that circumstances to be taken into account are not necessarily limited to the above (i) through (iii).

(6) In the case where a bank does not receive the permanent approval, the bank needs to take required action within 10-year grace period for any foreign company other than companies to be eligible to be subsidiary companies. Meanwhile, when there are some circumstances listed in each item of Article 16-2(10) of the Banking Act, the Commissioner of the FSA may extend the grace period by one year or may extend the period again. In this case, conceivable examples of "a compelling reason" in each item of Article 16-2(10) include the following reasons:

- (i) Related to Article 16-2(6)(i)
  - (A) The bank started negotiations and other activities to sell its holding shares of the company other than companies eligible to be subsidiary companies, but the schedule has been delayed mainly due to the local economic conditions and more time-consuming negotiations with a potential buyer or buyers than initially expected.
  - (B) The liquidation procedure for the company other than companies eligible for subsidiary companies has made little progress for local legal reasons.
- (ii) Related to Article 16-2(6)(ii)

In light of characteristics of the local financial market, it is essential to continuously own the company other than companies eligible to be subsidiary companies as a subsidiary company, and any business entrustment to a third party with no capital ties will not enable the bank to achieve the target.

When filing the approval pursuant to Article 16(10), each time of such filing, an applicant bank needs to specifically describe, in the application form, the existence of compelling reasons at the time of filing the application, and its policies to hold the voting rights at the company other than companies eligible to be subsidiary companies (such as measures under consideration to remove the compelling reasons within one year).

\* The above handling applies mutatis mutandis to Article 52-23(7) through (9) of the Banking Act.

(7) Notwithstanding the above V-3-3-5(1), owning a foreign company eligible to be a subsidiary company or the like as a subsidiary company enables any bank to make a foreign company other than companies eligible to be subsidiary companies one of its subsidiary corporations (excluding subsidiary

companies; the same applies here in this (7)) or one of its affiliated corporations. In this case, in light of the purport of regulations on the scope of business of subsidiary companies, the bank should take measures that conform to the outline mentioned in the above (4).

The same applies to the case where a bank makes a foreign company other than companies eligible for subsidiary companies one of its subsidiary corporations or one of its affiliated corporations by owning a foreign company eligible to be a subsidiary company or the like (excluding a special holding company) as a subsidiary corporation or an affiliate corporation.

\* The handling of any bank holding company's subsidiary companies, etc. (excluding subsidiary companies) conforms to the abovementioned handling.

#### V-3-3-6 Relations between Banks and Their Securities Subsidiary Companies, etc.

(1) With regard to banks' conduct with financial instrument business operators having capital ties, the following points should be noted, in light of the purport of the existing measures to prevent adverse effects between banks and their securities subsidiary companies under the Financial Instruments and Exchange Act, and also in light of the purport of "to take measures in order to secure sound and appropriate performance of business of the bank, etc. eligible to be a subsidiary company" stated in Article 17-5(2)(v) of the Banking Act Enforcement Regulation (examination criteria for the authorization to make the bank, etc. eligible to be a subsidiary company actually one of its subsidiary companies).

- In relations between a bank and the financial instrument business operator mentioned above (referring to a financial instrument business operator in a case where the bank is the parent bank, etc. (stipulated in Article 31-4(3) of the Financial Instruments and Exchange Act) of the financial instrument business operator or another case where the bank is the subsidiary bank, etc. (stipulated in Article 31-4(4) of the Financial Instruments and Exchange Act); hereinafter, "related financial instrument business operator"), whether the bank has avoided getting involved in any conduct prohibited by the provisions of Article 44-3 of the Financial Instruments and Exchange Act.

(2) When a bank, etc. conducts acts in relation to affiliated financial instruments business operators stipulated under Article 153(1)(vii) of the Cabinet Office Order on Financial Instruments Business, etc. concerning the management of legal compliance, management of risks of loss, internal audits and inspections, financial affairs, accounting affairs, tax affairs, business administration of subsidiary juridical person, etc., or affairs related to sales and purchase of securities, settlement of derivatives and other transactions (referred to as "internal control operations" in this section), the bank, which is a registered financial institution, and the affiliated financial instruments business operator should specify the information management system in the business operation manual, such as the appropriate implementation of measures to prevent leak of non-disclosure information from divisions engaging in internal control operations. The integration of internal control operation not only enables enhancement and efficiency

improvement of the execution of the operation, but may also generate risks that may impede sound and appropriate management. The risks, for example, are that the range and the location of responsibilities for the integrated internal control operation between the bank and the affiliated financial instruments business operator, would be unclear, and that the substantial internal control function of the bank, etc. would not work, when the person in charge of internal control at the bank, etc. neglects the execution of the management and supervision of internal control and does not execute them by itself. Due to these reasons, and from the viewpoint of supervision of banks, the FSA will pay special attention to the following points:

- (i) Regarding the integrated internal control operations, whether the office regulations and organization regulations specify the distribution of authority and responsibility between the bank, etc. and the affiliated financial instruments business operator, and whether they specify the range of authority and responsibility of the director, etc. in charge of the internal control operations and the range of the officers engaged in the business operation at the bank, etc. including officers concurrently engaged in the business operation of the affiliated financial instruments business operator, to prevent the bank, etc. from neglecting the execution of the substantial management and supervision of internal control and does not execute them by itself. In the case of a foreign bank branch, the director in charge of the internal control operations means the branch manager, deputy branch manager, the head of the management division or other officers, suited to take responsibility, hereinafter referred to as “director, etc. in charge.”
- (ii) Regarding the organization and personnel structure to enable a bank, etc. to fulfill the responsibility for managing internal control operations, whether management systems as described below have been developed:
  - (A) Whether the director, etc. in charge accurately recognizes the status of business operations and has the responsibility and authority to ensure appropriate execution of the business operations. And whether the director, etc. in charge has the responsibility and authority to make appropriate reports and explanations to the board of directors, etc. including a superior in the line of duty at the head office and the officer in charge of the internal control operations in the case of a foreign bank branch; hereinafter referred to as the “board of directors, etc.” and to supervisory authorities.
  - (B) When there is a possibility that the check-and-balance function by the director, etc. in charge of the sales division will fail to work, whether measures to ensure the effectiveness of the check-and-balance function have been taken. For example, when the manager of a foreign bank branch is concurrently engaged in an executive post at a particular sales division or is virtually engaged in the operations of the division, whether an officer in charge of supervising the administrative operations other than the branch manager has been appointed independently from the sales division, and whether there is a system for the officer to directly report to the board of directors, etc. in addition to reporting to the branch manager.
  - (C) When the bank, etc., has opted to establish a consultation body between an affiliated financial

instruments business operator for the purpose of ensuring the effectiveness of the check-and-balance function, the FSA shall pay special attention to the following points: Whether the duties of the director, etc. in charge regarding the decision-making process of the consultation body and the involvement of the bank, etc. therein have not lost substance and whether the effectiveness of the check-and-balance function has not been undermined, through the use of the consultation body for the purpose of promoting sales activity. For example, to prevent this, whether the purpose of the consultation body and the procedures regarding the body, including the method for decision-making and the compilation of minutes of meetings and the authorities and responsibilities of each member have been clarified.

(iii) When necessary for the purpose of supervision, the FSA shall require the bank, etc. to submit reports and materials regarding the following points under Article 24(1) or Article 52-31(1) of the Banking Act. When necessary, the FSA shall also require the financial instruments business operator which is a subsidiary of the bank, etc. to submit reports (excluding the affiliated financial institution related to a foreign bank branch; however, it should be noted that regarding the financial instruments business operator that has special relationship with a foreign bank pertaining to the foreign bank branch, specified in Article 14 of the Enforcement Ordinance, the FSA can require the foreign bank branch to submit reports under Article 48 of the Banking Act).

(A) Policy and procedures regarding the implementation of internal control operations

(B) The division of the authorities and administrative work of the officer engaged in internal control operations, such as the director, etc. in charge

(C) The status of development of various other rules

(D) The state of the personnel and organizations engaged in the implementation of internal control operations

(Note) “Bank, etc.” refers to ordinary banks, foreign bank branches and bank holding companies.

(3) Prevention of the abuse of superior bargaining position related to easing of the firewall regulation between banking and securities businesses

(i) Background

The regulation of information transfer between banking and securities businesses stipulated in Article 153(1)(vii) of the Cabinet Office Order on Financial Instruments Business, etc. (so-called the firewall regulation between banking and securities businesses) is mainly designed to prohibit the sharing of non-public customer information from the viewpoint of ensuring prevention of the abuse of a superior bargaining position, prevention of conflicts-of-interest transactions, and proper protection of customer information, etc. The firewall regulation between banking and securities businesses was introduced in 1993 when the mutual market entry by banks and securities companies was allowed for the first time in Japan. Since then, it has been repeatedly reviewed. In 2022, from the viewpoints of further activating the Japanese capital market, the necessity to provide customers with more advanced financial services, strengthening the international competitiveness, and



enhancing the convenience for customers, etc., the regulation was eased in some ways, such that, in sharing non-public information, etc. regarding certain corporations such as listed companies, consent of these corporations has become no longer necessary. (In this regard, however, if any of such corporations requests the suspension of sharing, the request needs to be responded.)

On the other hand, some people point out that such easing of the regulation might increase improper acts that could lead to the abuse of a superior bargaining position (Note). Accordingly, it is important to ensure effective prevention frameworks suitable for the business details, characteristics, and scale, etc. of each bank and its group companies while paying close attention to such improper acts.

(Reference) “Second Report by the Working Group on Capital Market Regulations – To Create an Attractive Capital Market toward the Post-COVID Era” of the Financial System Council (June 18, 2021)

(Note) In the context of the alignment between banking and securities businesses, conceivable examples of the abuse of a superior bargaining position or improper acts that could lead to such abuse include the following, but are not limited to them. It should be noted such abuse or such acts may vary, depending on the actual state of each bank’s business model, business categories of other financial institutions within a group to which the bank belongs, and so on.

- A case where regardless of verbally or in writing or irrespective of whether expressed or implied, some officers or employees of the bank request customers to make transactions with the bank group’s securities company by implicating otherwise disadvantageous treatment, such as referring to a possible effect on their loan transactions unless they use the group’s securities company or increase the share of the group’s securities company in financial transactions such as underwriting securities.

(ii) Viewpoints

As for the abuse of a superior bargaining position over customers, whether the bank and its group companies have put in place effective prevention frameworks suitable for the business content, characteristic, and scale, etc. of the bank and its group companies, for example, in terms of the following, in addition to III-3-3-1-2(7):

(A) Whether the management of the bank recognizes the importance of preventing the abuse of a superior bargaining position and taking the initiative of putting it into practice in good faith by cooperating with other financial institutions within the group (including the bank holding company), etc. Among issues where a superior bargaining position is suspected of being improperly used, whether managerially important issues, such as cases that may have a significant impact on customers, are systematically reported to the management of the bank timely and properly, and the management properly gets involved in creating frameworks to prevent the abuse of the superior bargaining position.

- (B) Whether or not the bank's performance evaluation of officers and employees gives any incentive that induces the abuse of a superior bargaining position. In addition, whether the bank's earning structure tends to induce the abuse of a superior bargaining position, and whether the profitability management of its banking business significantly lacks the rationality, such as frequent transactions of loans by setting lending interest rates so low for some customers, with such rates being unfeasible without the assumption that these customers make or will make transactions with the bank group's securities company.
- (C) Whether the bank evaluates the risk of abusing its superior bargaining position over each transaction counterpart and each transaction form based on the scale, credit status, and degree of transaction reliance on the bank of each transaction counterpart, as well as in light of the business content and market positioning of the bank and its group companies. Moreover, in response to this risk, whether the bank has clarified its procedures and compliance matters to effectively prevent the abuse of a superior bargaining position. Such procedures and compliance matters may vary, depending on the business content and the actual transactions with customers, but, for example, the following action can be taken:
- When the bank provides customers with information about financial products or services to be provided by its group's securities company, the bank clearly explains in advance that, even if customers do not make any transaction with the group's securities company, their transactions with the bank will not be affected.
  - The bank properly prepares and keeps records of reception and dialogue with each customer, which will enable ex-post verification concerning the abuse of a superior bargaining position.
- (D) Whether the bank has thoroughly disseminated the matters mentioned in (C) above to all its officers and employees by providing the relevant training and education programs.
- (E) Whether the bank has established a system in which check-and-balance functions can be fully exercised by means such as separating the relevant department that is responsible for taking measures to prevent the abuse of a superior bargaining position from the sales department. In terms of the verification as to whether the procedures and compliance matters mentioned in (C) above are properly complied with, whether the relevant department properly gets involved in and manages them, depending on the degree of importance of these issues.
- (F) As for the procedures and matters mentioned above, whether the bank's internal audit department is well prepared. In addition, whether the group-based integrated control, such as cooperation among audits of the bank group's companies, is exercised.
- (iii) Supervisory Methods and Measures

The FSA will analyze not only financial services users' voices collected through various channels, such as information received at the information gathering contact for preventing the abuse of a superior bargaining position, and results of hearing from borrowing companies, but also external

information including media reporting, and inquiries from the outside, and will carry out focused monitoring. Based on these monitoring and examination results as well as filing of misconduct notifications, etc., when any problem related to the abuse of a superior bargaining position is recognized, the FSA will, as needed, ask the bank to make a report pursuant to Article 24 of the Banking Act, and when any serious problem is recognized, the FSA will issue a business improvement order based on Article 26 of the Banking Act. Other similar measures will also be taken, when necessary.

Meanwhile, based on Article 153(1)(x) of the Cabinet Office Order on Financial Instruments Business, etc., each securities company is also prohibited from improperly using the superior bargaining position of its parent bank or subsidiary bank in order to conclude or solicitate any financial instruments transaction contract. Since this purport is the same as in Article 14-11-3(3) of the Banking Act Enforcement Regulation, it should be noted that the regulator needs to fully cooperate with the Securities Business Division and the Securities and Exchange Surveillance Commission in order to conduct the examination and supervisory activities with the same focus and viewpoints . The FSA will also exchange opinions regularly with the Fair Trade Commission in light of prohibition of the abuse of a superior bargaining position stipulated in the Anti-Monopoly Law.

#### V-3-3-7 Relationship between Financial Institutions, etc. and Their Affiliated Insurance Companies

With regard to financial institutions' conduct with insurance companies having capital relationships, etc., the following points should be noted, in light of the purport of establishing preventive measures against adverse effects between financial institutions, etc. and insurance companies under the Enforcement Regulation of the Insurance Business Act, etc., in cases where financial institutions (including each financial institution set forth in the items of Article 53-4(3) of the Enforcement Regulation of the Insurance Business Act and a bank holding company; the same applies hereinafter) are identified as "Specified Related Party" stipulated in Article 100-3 of the Insurance Business Act or Article 53-4(2) of the Enforcement Regulation of the same Act or "Specially Related Party" stipulated in Article 194 of the same Act.

- (1) In relationships between a financial institution and its related insurance company (referring to the insurance company when the financial institution is identified as the Specified Related Party stipulated in Article 53-4(2) of the Enforcement Regulation of the Insurance Business Act), whether the financial institution has not been involved in any conduct that runs counter to any of the measures to be taken as stipulated in Article 53-4 and Article 53-6 of the Enforcement Regulation of the Insurance Business Act on the basis of Article 100-2 of the Insurance Business Act.
- (2) In relationships between a financial institution and its related insurance company (referring to the insurance company when the financial institution is identified as the Specified Related Party stipulated in

Article 100-3 of the Insurance Business Act and the Specially Related Party stipulated in Article 194 of the same Act; the same applies hereinafter) as well as insurance agents, etc. belonging to the related insurance company, whether the financial institution has not been getting involved in any conduct prohibited by the provisions of Article 300 of the same Act.

(Note) Insurance agents, etc. belonging to the related insurance company refer to officers of the related insurance company, life insurance agents belonging to the related insurance company, non-life insurance agents belonging to the related insurance company, or insurance brokers or their officers or employees.

#### V-3-3-8 Other Matters to Note Regarding Subsidiary Companies, etc.

- (1) Whether the bank has a clear management strategy to produce a synergy effect as the entire group. Also, whether the organizational structure of its subsidiary companies, etc. does not have redundant or unnecessary elements due to the backgrounds of their mergers, etc.
- (2) Whether financial soundness is ensured in the financial-related subsidiary companies, such as a credit card company and a housing loan guarantee subsidiary company.
- (3) Whether subsidiary companies engaging in dependent business such as a clerical work contractor and a temporary staffing company aim to enhance the cost competitiveness of the entire group.
- (4) Whether financial soundness is ensured in the bank's affiliated or so-called "close relationship" real property management company.

#### V-3-4 Restrictions on the Acquisition of Voting Rights

- (1) The following points should be noted in giving approval pursuant to the proviso of Article 16-4(2) or the proviso of Article 52-24(2) of the Banking Act.

For risk management concerning holding shares, refer to III-2-3-2-1-2 (7).

- (i) When a bank files the application pursuant to Article 17-7(1) or Article 34-21(1) of the Banking Act Enforcement Regulation, the FSA will examine whether the bank has any compelling reasons for the inability to dispose its holding shares in excess of the voting right holding threshold within the period. Conceivable "compelling reasons" are, for example, as follows:
  - (A) In order to support the reconstruction of a certain company which is going through a business revitalization as well as the company's stable business operations, it is necessary to hold the voting rights during the period of the revitalization plan.
  - (B) In the case where the bank acquired the voting rights in accordance with the business revitalization plan, it is difficult to dispose by selling the shares in question partly because the

company will not pay dividends until the completion of all procedures under the plan.

(C) Since the bank found undisclosed material facts about the company, the selling of its voting rights may infringe the provisions concerning insider trading in Article 166 of the Financial Instruments and Exchange Act, which makes it difficult to dispose by selling the shares in question.

(ii) In the following cases, it should be noted that “promptly dispose” of voting rights in excess of the voting rights holding threshold as the condition of approval stipulated in Article 16-4(3) or Article 52-24(3) of the Banking Act aims to mean “promptly dispose of voting rights at least after termination of the plan (\*) for the company’s business improvement.”

(A) DES (debt equity swap), in cases where the voting rights were acquired in accordance with Article 17-6(1)(iii) or Article 34-20(1)(iii) of the Banking Act Enforcement Regulation.

(B) In cases where the voting rights at a company stipulated in Article 16-2(1)(xiii) or Article 52-23(1)(xii) of the Banking Act (a company going through a so-called business revitalization) will be held beyond the period stipulated in each item of Article 17-2(13) of the Banking Act Enforcement Regulation (three years (in principle) or ten years (for small and medium-sized enterprises)) due to a compelling reason where it is extremely difficult to transfer such voting rights and they cannot be disposed of.

(Note) “Termination of the plan” refers to the case where the plan period expired; the case where the plan was achieved earlier than initially planned; the case where the company went bankrupt or de-facto bankrupt; and the case where the plan was reviewed.

## (2) Other matters of attention

(i) It should be noted that the voting rights that the financial instruments business operator which is a bank’s subsidiary exercises or instructs another relevant party to exercise on behalf of its customers based on the respective discretionary investment contracts are not included in the voting rights that any bank’s subsidiary company acquires or holds as stipulated in Article 16-4 of the Banking Act.

(ii) New business activities conducted by “companies specified by a Cabinet Office Ordinance as those exploring new business fields” (so-called venture business companies) stipulated in Article 16-2(1)(xii) or Article 52-23(1)(xi) of the Banking Act refer to development or production of new goods, development or provision of new services, introduction of a new method of producing or selling goods, introduction of a new method of providing services, R&D on technology and the use of relevant achievements, other new business activities, all of which enable the exploration of new business fields. Therefore, the eligible business types are not confined to start-up businesses on the premise of R&D but also include service and other types of business. In assessing the adequacy, while the region-specific and business type-specific factors will be taken into account, it should be noted that introduction of technology or methods that have already been prevailing to quite a degree are not included.

- (iii) It should be noted that it is permitted to hold voting rights of companies stipulated in each item of Article 17-2(6) of the Banking Act Enforcement Regulation in excess of the voting right holding threshold as a company exempted from the restrictions on acquisition of voting rights pursuant to Article 16-4(7) or Article 52-24(7) of the Banking Act only if such acquisition is based on the capital procurement plan incorporated in the company's business revitalization plan.
- (iv) In making a judgement as to whether the company falls under the "company" in Article 17-2(6)(ix) of the Banking Act Enforcement Regulation, it should be noted that a company that is not yet in the stage where deterioration of its financial conditions has come to the surface may be eligible.

#### V-4 Major Shareholders of Banks

##### V-4-1 Purpose, Significance, and Supervisory Viewpoints

In order to ensure sound management of the bank, notification and authorization systems, etc. for major shareholders have been established based on the concept that it is necessary for developing an appropriate check mechanism by the public administration for corporate and individual shareholders that intend to become involved in bank management by acquiring a considerable portion of voting rights of a bank both at the time of and after such acquisition.

Additionally, in order to block the risks for the bank to be affected by its major shareholder's business conditions, while large exposure regulation and the arm's length rule, etc. have been basically applied to the bank's transactions such as lending to its major shareholders, additional measures have been implemented, including the establishment of adequate quantitative regulation on credit provision to its major shareholders, with the objective of preventing potential negative effects of "institutionalization of a bank" that might result from an undue influence exerted by its major shareholder.

In the case where a major shareholder holds more than 50% of a bank's outstanding shares, as the shareholder alone has controlling power over the bank, it is assumed that such major shareholder, broadly similar to a bank holding company, will be expected to support the bank when the bank's business becomes worse.

Note that these major shareholder systems have a common concept with consolidated-base supervision for preventing contagion effects where risk within a bank group spreads to the bank, and that the system design is similar to that for bank holding companies.

(Reference) "Development of rules concerning major shareholders in banking business, etc. as well as new business models and relaxation of regulations, etc." (The First Subcommittee reporting, the Financial System Council, December 21, 2000)

##### V-4-2 Supervisory Methods and Measures

For measures at the time of and after the acquisition of a considerable portion of voting rights at a bank,

refer to VII.

## V-5 Development of Systems to Protect Customers' Interests

### V-5-1 Purpose and Significance

As financial institutions are providing more diversified services and forming more internationalized groups across business categories, there is an increased risk that conflicts of interest may occur in a financial institution or financial group owing to the existence of competing and opposing interests. In light of such a situation, each bank is required to manage transactions that might cause conflicts of interest, depending on its business content, characteristics, and size, etc. of the bank and the group companies so as not to improperly harm customers' interests.

In this context, based on Article 13-3-2(1) of the Banking Act, it is important for each bank to develop appropriate frameworks to manage the conflict of interests in the bank and its subsidiary financial institutions.

Adverse effects from conflicts of interest may occur not only between a bank and a securities company, but also between divisions within a bank (or bank group) or among a parent company, subsidiary companies, sister companies, and affiliated companies within a single financial group. Therefore, it is desirable for each bank to manage all business operations within its financial group while paying close attention to the potential risk of conflict. In light of the fact that sharing non-public information is allowed between a company and its parent corporation or subsidiary corporation under certain conditions such as establishment of an information management system, the importance of managing conflicts of interest should be recognized now more than ever, and a proper business management framework needs to be constructed.

Accordingly, for a financial group that engages in a broader range of business operations, it is necessary to conduct internal control with discipline based on self-responsibility in order to prevent adverse effects from conflicts of interest not only between its bank and its securities company but also within the group. It should be noted that rules for managing conflicts of interest will effectively work if financial institutions construct proper business management and compliance frameworks through their voluntary efforts.

In developing a control environment for managing conflict-of-interest transactions, it is necessary not only to take into account business contents engaged in by its group companies, and their size and characteristics, but also to consider the reputational risk for the bank or the identical financial group.

Meanwhile, some of any bank's group companies may be engaged in business that is irrelevant to the bank's customers. In light of this likelihood, the level and depth of banks' conflict-of-interest management does not need to be identical. In this way, when a bank creates any difference in the level and depth of the conflict-of-interest management within its group, it should be noted that the bank is required to externally provide sufficient explanation.

(1) Identification of potential conflict-of-interest transactions

- (i) Whether the bank has identified and categorized potential conflict-of-interest transactions (see Note below) under its department in charge of managing and controlling conflict of interests (hereinafter referred to as the “conflict-of-interest management and control division”), and also whether the bank has established a control environment that enables continuous reviews.

(Note) Since the firewall regulation between banking and securities businesses was eased in 2022, the conflict of interests needs to be properly and strictly managed, and it should be noted that specific examples of “potential conflict-of-interest transactions” are to be appropriately identified, depending on the actual state of each bank’s business model as well as the business categories, etc. of other financial institutions (including its bank holding company) in the group to which each bank belongs. In addition, with reference to “IV-1-3 Development of Conflict-of-Interest Management Systems (2)(i)” described in the “Comprehensive Guideline for Supervision of Financial Instruments Business Operators,” the regulator should pay close attention to consistently handling the relevant issues with potential conflict-of-interest transactions that are identified and categorized in the securities company in each financial group.

- (ii) Whether the process of identifying any conflicts of interest reflects the business contents, size, and characteristics of the bank and its group companies.

Additionally, whether such identified potential conflict-of-interest transactions can appropriately cope with new business activities as well as changes in laws and regulations/business practices.

(2) Methods of conflict-of-interest management

- (i) As for potential conflict-of-interest transactions, whether the bank has established a framework so that it can appropriately identify such transactions before they are carried out. In addition, whether the bank has established the framework so that it can select or combine the following management methods as examples, depending on characteristics of the transactions. In selecting these management methods, whether the bank has put into place the framework so that it can select appropriate management methods, such as making it mandatory to receive the confirmation of the conflict-of-interest management and control division.

(A) Separation of divisions (restrictions on internal information-sharing)

To implement the restrictions on internal information-sharing, whether the bank has taken proper information-blocking measures based on the business content and actual situation among divisions where conflicts of interest might occur, including the creation of the Chinese Wall (see III-3-3-2(3)(i)).

(B) Changes in transaction conditions or methods, or cancellation of a transaction by one



party

In the process of changing transaction conditions or methods, or canceling a transaction by one party, whether the authority and responsibility to make a decision on the issue are clearly defined, including in the case where an officer or officers of the parent financial institution or the subsidiary financial institution get(s) involved in making such a decision.

(C) Disclosing the fact of a conflict of interest to customers

When disclosing the fact of a conflict of interest to customers, whether the bank has established a control environment to ensure fair treatment for customers, such as disclosing details of the conflict of interest and reasons to have selected a certain disclosure method (including reasons not to have selected other management methods), for example, in writing and receive the consent of customers clearly and fairly before the conclusion of contracts relating to the transactions. In addition, whether the level of disclosure content is sufficiently suitable for the customer attributes.

(D) Monitoring people who share information

When implementing the management method of monitoring people who share information, whether an independent division or the like appropriately monitors these people's respective transactions.

- (ii) When the bank or any of its subsidiary financial institutions, etc. enters into a new transaction, whether the bank has established a framework so that it can make necessary confirmation as to whether or not there is any transaction that will cause a conflict of interest with the new transaction, while having the conflict-of-interest management and control division get involved.
- (iii) Whether the bank has established a framework to regularly examine its conflict-of-interest management methods from the viewpoint of ensuring their effectiveness. In addition, whether the bank properly prepares and keeps relevant records, which will enable ex post verification as to whether potential conflict-of-interest transactions are accurately identified, and whether conflict-of-interest management methods are appropriately selected and implemented.

(3) Control environment, etc. for managing conflicts of interest

- (i) Whether the management of the bank and that of its subsidiary financial institutions, etc. recognize the importance of conflict-of-interest management and take the initiative of putting it into practice in good faith by cooperating with other financial institutions (including the bank holding company), etc. within its financial group. Regarding managerially important issues, such as cases that may have a significant impact on customers, whether the management appropriately gets involved in making decisions about response measures, such as selecting appropriate conflict-of-interest management methods.
- (ii) Whether business management procedures based on the conflict-of-interest management policy (which refers to the policy stipulated in Article 14-11-3-3(1)(iii) of the Banking Act Enforcement Regulation; the same applies hereinafter) have been clarified in writing, etc.

(including internal rules). Also, whether the bank has thoroughly familiarized officers and employees of the bank and those of subsidiary financial institutions with conflict-of-interest management mainly through training and education about its conflict-of-interest management policy and the said procedures..

- (iii) Whether the bank has established an appropriate environment for identifying and managing potential conflict-of-interest transactions in an integrated manner, such as setting a conflict-of-interest management and control division.
- (iv) Whether the conflict-of-interest management and control division identifies potential conflict-of-interest transactions, accurately implements the conflict-of-interest management, and properly examines its effectiveness in accordance with the conflict-of-interest management policy.
- (v) Whether the conflict-of-interest management and control division has ensured its independence from the sales division, fully
- (vi) Whether the conflict-of-interest management and control division has established an appropriate control environment for gathering necessary information regarding conflicts of interest, including information about transactions by the parent financial institution or by the subsidiary financial institution.
- (vii) Whether the bank has established the relevant framework for an independent internal audit division to regularly examine the bank's personnel structure and business operation system relating to the conflict-of-interest management. In the case where a financial group has been implementing its integrated conflict-of-interest management as a whole, whether the bank's internal audit division has been cooperating with the respective internal audit divisions of other financial institutions (including its bank holding company) within the group.
- (viii) In cases where the bank has overseas business bases or belongs to an internationally active financial group, with regard to the conflict-of-interest management including identifying potential conflict-of-interest transactions and proper control thereof, whether the bank has established appropriate management environments of which levels are suitable for the content and size, etc. of its business provided globally while also complying with the laws and regulations in each country. For example, whether the bank manages its conflict of interests not only at home but also abroad through its global group-based organizational and integrated policy, procedures, and systems, etc.

(4) Formulation of a conflict-of-interest management policy and publication of its outline

- (i) Whether the conflict-of-interest management policy clearly states the types of potential conflict-of-interest transactions, main examples of such transactions and a certain process to identify such transactions, the conflict-of-interest management methods (including the content of and reason for the difference, if any, in the level and depth of the conflict-of-interest management), the conflict-of-interest management systems and structures (including the responsibilities and

roles of the conflict-of-interest management and control division and its independence as well as the verification system concerning the identification of potential conflict-of-interest transactions and the conflict-of-interest management methods), and the scope of companies subject to the conflict-of-interest management. In this case, whether the types of potential conflict-of-interest transactions, such transaction examples and the conflict-of-interest management methods are described in such a way as to correspond to each other. In addition, whether such management policy sufficiently reflects the business content engaged in by the financial group companies and their size.

- (ii) When publishing the outline of the conflict-of-interest management policy, whether the outline describes the types of conflict-of-interest transactions, the conflict-of-interest management methods, the conflict-of-interest management systems and structures, and the scope of companies subject to the conflict-of-interest management in an easy-to-understand way. And whether the methods of publication (such as putting up a poster at the front of any bank office or over-the-counter site, or posting on the website) is appropriate to sufficiently convey the outline to customers and others.

### V-5-3 Supervisory Methods and Measures

In the case where an inspection result or a misconduct notification, etc. reveals that there is a problem with the bank's framework for the protection of customers' interest, the FSA asks for reporting from the bank, when necessary, based on Article 24 of the Banking Act. If the result provides evidence that there is a serious problem in terms of operational soundness and appropriateness, the FSA considers issuing a business improvement order based on Article 26 of the Banking Act.

In that case, if it is recognized that the bank's internal control environment is extremely fragile, as shown by, for example, a failure to take specific measures to eliminate the adverse effects caused by conflicts of interest despite recognizing the occurrence of such conflicts, and it is deemed necessary to make the bank commit to improving its internal control environment, the FSA considers issuing an order for partial suspension of business (for a limited period of time needed for business improvement) based on Article 26 of the Banking Act.

### V-6 Points of attention on crypto-assets

#### V-6-1 Purpose and Significance

While the design and specifications of crypto-assets vary, some crypto-assets have a high risk of being used for terrorist financing or money laundering, in light of the fact that there are crypto-assets whose transfer records are not disclosed and whose transactions are difficult to trace. In addition, since crypto-assets generally have no assets to back up their value, it is difficult to conceive of their intrinsic value and

their prices fluctuate significantly. Therefore, it is necessary for banking groups to consider the risk of price fluctuations when holding crypto-assets. Furthermore, the management of crypto-assets is subject to system risks such as system malfunction and cyber attacks.

In addition to the above, taking into account the reputational risk in the event that these risks materialize, the acquisition of crypto-assets by the banking group should be limited to the minimum necessary extent, and when the acquisition, holding, or disposal of crypto-assets (including indirect methods such as investment in funds that substantially invest in crypto-assets; hereinafter referred to as “acquisition, etc. of crypto-assets”) in the course of the business of the banking group, a sufficient framework should be in place to ensure that there is no risk of interference with the operation of the banking entity's own business or serious damage to the banking group.

## V-6-2 Major Supervisory Viewpoints

As mentioned above, the banking group needs to have a framework in place for the acquisition, etc. of crypto-assets in accordance with Article 13-6-9 and Article 13-6-10 of the Banking Act Enforcement Regulation. Specifically, the following points need to be taken into consideration.

(i) Identification, evaluation, and reduction of risks based on the characteristics of the crypto-asset

Based on the structure (including the issuer, administrator, and other related parties, as well as the details of projects closely related to the crypto-asset), expected use, distribution status, technology used for the crypto-asset, and other characteristics of the crypto-asset (hereinafter referred to as the "characteristics of the crypto-asset"), whether sufficient consideration has been given to the identification and evaluation of the risks of the crypto-assets, and whether an internal control environment has been established to appropriately reduce such risks, including the measures described in (ii) through (iv) below. In addition, whether these measures are periodically verified and reviewed.

(ii) Measures against money laundering and financing of terrorism

In cases where there is a high risk of being used for money laundering or financing of terrorism, whether the appropriateness of the acquisition, etc. of crypto-assets is carefully determined. For example, crypto-assets whose transfer records are extremely difficult to trace have a particularly high risk of being used for money laundering and financing of terrorism, and therefore, care should be taken not to conduct acquisition, etc. of such crypto-assets.

In addition, whether measures have been appropriately taken in line with the measures described in the Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism, such as paying attention to the status of the countermeasures against money laundering and financing of terrorism of the counterparty to the acquisition, etc. of crypto-assets. In particular, in cases where the acquisition, etc. of crypto-assets may involve the transfer of crypto-assets from or to a person

residing or located overseas, whether the measures described in III-3-1-3-1-2(4) have been taken.

(iii) Measures to ensure financial soundness

Even if the business of the banking group requires the acquisition of crypto-assets, whether appropriate policies have been established from the perspective of ensuring soundness, such as limiting the amount of crypto-assets to be acquired to the minimum extent necessary for the relevant business. In addition, with respect to the holding of crypto-assets, whether a framework is in place that enables the appropriate disposal of such assets by promptly selling them, etc., in consideration of the market risk, liquidity risk, etc. of such crypto-assets.

Whether the banking group has a policy which does not allow the group to conduct acquisition, etc. of crypto-assets for the purpose of investment.

(iv) Security management measures for acquisition, etc. of crypto-assets

- Whether the department in charge of the management of crypto-assets and the responsible person are clarified. (When multiple departments are in charge of managing crypto-assets, whether responsibilities and assignments between departments are clearly defined.) Whether a person with sufficient knowledge and experience of the characteristics of the crypto-assets to be handled is assigned.
- Whether the internal rules about management, response to outflows and other rules related to crypto-assets have been properly established, and are being thoroughly communicated to officers and employees. Whether the internal rules are periodically verified and reviewed.
- Whether the system management framework for the management of crypto-assets to be handled, including measures to prevent the outflow of crypto-assets due to unauthorized access, etc. has been sufficiently established. Whether the system risk management framework is periodically verified and reviewed by experts.

## VI Supervision of Foreign Bank Branches

### VI-1 Purpose and Significance

A foreign bank that has a branch office, a sub-branch or other business office (hereinafter collectively referred to as the “branch office”) in Japan is directly subordinate to the head office located in a foreign country where the Banking Act and other relevant Japanese laws and regulations are not applicable. Depending on the business management methods of the head office, and on the types or contents of operation, as well as on the business division to which the branch office belongs, the management and control relationships might not sufficiently work among business divisions within a branch office or among branch offices if there are more than one.

Therefore, when supervising the soundness and appropriateness of the operations of a branch office of a foreign bank, it is important to make efforts to identify the actual state of the management of business operations at the branch office and the risks involved therein, in light of the management characteristics of the foreign bank as well as the individuality and diversity of the branch office’s business operations, and when necessary, to engage in communication and consultation with the foreign bank’s head office or the supervisory authority of the bank’s home country, or to take supervisory measures, such as requiring the submission of reports based on the Banking Act or other relevant laws and regulations.

(Note) The following Major Supervisory Viewpoints describe key points to be especially noted in light of the characteristics of foreign bank branch offices. During the supervisory process, not only the supervisory viewpoints described below but also other parts of this guideline should be properly referred to, depending on the branch office’s business and other factors, when necessary.

### VI-2 Major Supervisory Viewpoints

- (1) Appropriate control over business management and operations of the branch office by the head office and the management team of the branch office
  - (i) When the head office or the regional head office (hereinafter collectively referred to as the “head office”) formulates the entire group’s management policies or plans, whether the purpose and significance of having a branch office in Japan and its position within the group are clarified. Whether the business strategies or plans of the branch office are consistent with the group’s policies or plans, and are also sustainable.
  - (ii) Whether the management team of the branch office and employees dispatched from the head office, who are adept in the management and business operations of the branch office, are appointed and appropriately allocated. (Whether a management team and person in charge of business operation and management with sufficient qualifications and experience in managing the business operations of the branch office in Japan are appointed.)

- (iii) In order to ensure the appropriate operation of the branch offices, whether the head office has delegated adequate and appropriate authorities to the management team of the branch office and the person in charge of business operation and management, and clarified division of the responsibilities between the branch office and the head office. In addition, whether the authority and the responsibility is adequately and appropriately distributed within the branch office so that the management team can appropriately manage the business. (Whether legitimate and effective rules concerning the organizations and administrative authorities have been formulated, and whether the rules are ensured to be well known.)
- (iv) Whether the head office has developed and maintained systems or structures to supervise, manage and monitor the branch office in a manner suited to the actual state of the branch office's business operations and risks. (Whether it is ensured that the head office's business management division, international business control division, and any other relevant division has an appropriate and adequate system or structure to supervise, manage and monitor the foreign branch office.) In the case where a foreign bank has more than one branch office in Japan, whether the representative recognizes the strategic policies and plans such as profit target of all branches in Japan, and comprehensively manages the branch offices by, for example, requiring necessary reports from each branch office, in order to establish an internal control environment which is consistent with such policies and plans.
- (v) Whether a system or structure has been put in place that will enable the branch office to promptly and appropriately contact with and report to the head office and the relevant supervisory authorities in case of any operational or managerial problems or any cases of misconduct.
- (vi) Whether the internal control environment of the branch office is sufficient, based on the positioning of the branch office within the entire bank, its business strategies and plans, and its actual business operations and risk characteristics.
- (vii) Whether the head office properly recognizes the status of risks of the branch office, and takes necessary measures, having identified not only the business operation and financial condition, but also the risk characteristics of the branch office.
- (viii) Whether the management team of the branch office checks for any inadequacies in light of (i) through (vii) above, and, when necessary, takes appropriate measures after consulting with the head office.

(2) Development of legal compliance framework

- (i) Whether a legal compliance framework (including the development of effective rules about organization and management, personnel structure and operational structures) has been established and maintained so as to thoroughly comply with the Banking Act of Japan as well as other domestic and foreign laws and regulations related to its operations.
- (ii) Whether a framework is in place so as to continuously check the understanding of its officers

and employees in the branch office about the Banking Act and other related laws and regulations, and when necessary to provide training and education.

- (iii) Whether a framework has been established and maintained to enable the branch office to promptly and appropriately report and respond in case of the occurrence of any legal violation or the revelation of any improper business operation in practice. (Whether independent internal functions are in place to check and monitor the activities of the branch office's manager in charge of business operations, as well as the activities of the sales division.)
- (iv) In the case where some officials and employees at a branch office do not understand Japanese laws and regulations well for any reason, whether the head office and the branch office strive to establish the relevant systems and make continuous efforts to deal with the situation appropriately and to thoroughly ensure necessary guidance and monitoring.

(3) Development of risk management framework

- (i) Whether a framework to manage various risks such as credit risk, market risk, liquidity risk, and operational risk (including administrative risk and IT system risk) are developed, which are suited to the actual status of the business operations of the branch office. Whether the head office appropriately and sufficiently supervises and monitors the risk management.
- (ii) Whether an in-branch control framework (including the development of effective rules about organization and management, personnel and operational structures) has been appropriately and sufficiently developed, to detect operational risk at an early stage and to appropriately deal with and rectify them.
- (iii) Whether a framework has been established and maintained to enable the branch office to promptly and appropriately report and respond in the case where any problem with its risk management comes to light. (Whether independent internal functions are in place to check and monitor the activities of the branch office's manager in charge of business operations, as well as the activities of the sales division.)
- (iv) When a foreign bank group has transactions that involves two or more operational bases (for example in the case of credit transactions or market transactions, the location where credit examination or making contracts is conducted is different from the location where it is managed as an account branch), whether the respective functions and roles of the head office and the branch offices are clarified in the context of the entire bank. Whether these functions and roles are reasonable and appropriate in the entire group's risk management framework.

(4) Implementation of inspections and audits of business operations of branch offices and follow-up

- (i) Whether the effectiveness of inspections (including self-inspections) and internal audits of the business operations of the branch office is ensured. Especially, whether the internal audit division at the head office or the branch office is able to conduct internal audits, taking into account the business contents and risk profile of the branch office. Whether the management



of the head office and the branch office take appropriate measures based on the outcome of the internal audit.

- (ii) Whether employees and managers well versed in the Banking Act and other laws and regulations related to the bank's business operations are allocated to the divisions in charge of inspections (including self-inspections) and the internal audit.
- (iii) Whether audits of business operations are implemented in a suitable manner that matches the actual state and risks of the branch office's business operations. Whether external experts are utilized according to the risk level when necessary.
- (iv) Whether the implementation of improvement measures and follow-up actions in response to the matters pointed out in the inspections and audits of the branch office is ensured. (Whether the internal responsibility-sharing has been clarified to ensure the implementation and completion of the improvement measures and follow-up actions.)

(5) Establishment of appropriate information management framework

- (i) Whether the branch office and the head office appropriately and sufficiently developed the branch office's information management framework (including the development of effective rules of information management, the full awareness of the rules by executives and employees, and the development of personnel and operational structures).
- (ii) Whether a framework has been put in place to ensure that the branch office and the head office promptly and appropriately take measures and provide explanations to their customers, relevant parties, and relevant supervisory authorities in the case of a problem related to information management concerning the business operations of the branch office or any customer information leakage.
- (iii) Whether the branch office and the head office investigate and analyze the causes of such information management problem or customer information leakage accident, formulate a proper and appropriate improvement plan, and steadily implement them.
- (iv) Especially, with regard to customer information management, whether a management framework has been put in place suited to the business operations of the branch office, in reference to III-3-3-3 "Management of customer Information."

(6) Enhancement and reinforcement of complaint handling function

- (i) Whether the branch office accumulates and analyzes complaints arising from its business operations, and makes effort to improve the control environment for customer explanations at the time of contract signing or on other occasions.
- (ii) Whether the branch office has any proper framework to deal with violence intervening in civil affairs, such as refusal of any connection with anti-social forces. Especially, whether an integrated management framework for legal affairs has been developed and is functioning, in order to properly report suspicious transactions including remittance, fund settlements and

credit-related transactions under the Banking Act on Prevention of Transfer of Criminal Proceeds.

(7) Entrustment of business operation of branch office

- (i) In the case where a branch office entrusts part or all of its operations necessary to engage in its business, whether a management framework has been appropriately established, in accordance with the actual state of its entrustment and risks, with reference to III-3-3-4 “Entrustment.”
- (ii) It should be noted that entrustment refers to the entrustment of part or all of administrative operations in order for the branch office to engage in its business, and does not mean to have the branch office’s business management or such management functions (including an important personnel management policy) handled by an external entity.

(8) Entrustment of operation to business operation service provider

In the case where a branch office of a foreign bank entrusts its operations to an entity stipulated in Article 32(ii) of the Cabinet Office Ordinance on Financial Instruments Business, etc. (hereinafter referred to as a “business operation service provider” in this section), the following points shall be noted from the perspective of ensuring the sound and appropriate management of the banking business.

- (i) Whether the scope and content of the entrusted operation are limited to administrative operation that does not involve the fundamentals of the banking business. And even in the case where the entrusted business operation does not involve the fundamentals of the banking business, in light of the fact that the entrusted operation is closely related to the execution of the banking business, whether the appropriateness of the entrusted operation and the appropriateness of the trustee, including information management risks and operating risks associated with the entrusted operation, as well as the business execution capabilities and management systems of the business operation service provider, are adequately reviewed and verified.
- (ii) It should be noted that the ultimate operational and regulatory responsibility for the entrusted operation lies with the branch office of the foreign bank as the entrustor, even if the responsibility stems from the business execution by business operation service provider. Therefore, in order to accurately respond to the supervisory authority by the branch office related to the entrusted operation, whether a responsible person for the entrusted operation has been appointed, and whether a system to manage the business operation service provider has been developed and the division of responsibilities has been clarified.

(9) Development of internal control environment in cases where the concurrent position system has been introduced

Among foreign financial institutions groups in which respective foreign banks have their securities subsidiary companies or branch offices engaging in securities-related business in Japan, when such foreign bank branch office has introduced the concurrent position system, the appropriateness and

sufficiency of its internal control environment need to be examined, improved, or enhanced. For details, refer to the above V-3-3-6 “Relations between Banks and Their Securities Subsidiary Companies.”

(10) Remuneration system

The planning and application of the branch office’s remuneration system is, in principal, to be appropriately supervised by the authority in its home country on a group basis, so as to ensure that the incentive of the executives and employees to take risks is not excessive.

On the other hand, the FSA also monitors each such branch office’s planning and application of the remuneration system with an objective of appropriately cooperating with the authority in its home country. Especially, in the case where excessive risk-taking is likely to be induced, the FSA will examine such risk management issues to a deeper degree, and will take necessary measures, such as proactively raising an issue with the authority in the home country.

(11) Protection of depositors and maintenance of other orderly financial systems (examination criteria at the time of licensing and supervisory viewpoints when foreign bank branch office engages in deposit-taking operations)

(i) Regarding asset management at a foreign bank branch office, if the asset management excessively relies on overseas operation bases, there are several problems, such as the difficulty for the bank branch office to grasp its own asset management portfolio, and the difficulty for the Japanese supervisory authority to verify the appropriateness of asset management by the foreign bank branch office.

(ii) Therefore, foreign bank branch offices should develop a control system that enables them to conduct their banking business properly and fairly, taking into account the need for secure transactions for depositors, such as ensuring that the branch office fully understand how the funds, especially funds raised through collecting deposits, are invested, and does not excessively rely on transferring the funds to any other operation base of the group.

(iii) Based on the foregoing, when examining a license for a foreign bank branch office, it is necessary to determine whether or not such branch office’s fund management excessively relies on transferring its funds to any other operation base of the group. For example, the business plan after the establishment of the branch office would be assessed based of the viewpoint of whether or not most of the deposits collected domestically will be managed in overseas operation bases.

(Note) When a foreign bank branch office takes retail deposits, it should be noted that, under the current circumstance where the deposit insurance system is not applicable to foreign bank branch offices, a safer fund management framework is generally required for such funds, taking into account the characteristics of retail deposits, such as the fact that these funds are directly linked to the lives of individuals.

(iv) Even after the establishment of a branch office, the status of intra-group fund transfers,

including those between the head office and branch accounts, the status of assets held in Japan, as well as the content and method of its deposit-taking operations, etc. should be verified to determine, for example, whether or not most of the deposits collected domestically are constantly transferred abroad through the head office and branch accounts, and whether or not the branch office's fund management excessively relies on transferring its funds to any other overseas operation base of the group.

- (v) Furthermore, when a foreign bank branch office engages in deposit-taking operations, in addition to the matters stipulated in Article 30-2(i) and (ii) of the Banking Act Enforcement Regulation, the internal control system to provide its customers with appropriate explanations on the following matters that will serve as useful references for depositors, in accordance with the customers' level of knowledge and experience, is examined.
  - (A) Whether or not the deposit product is covered by the deposit insurance system in the foreign bank's home country, and if so, the details of the system.
  - (B) The facts that the solvency of a foreign bank branch office is ultimately sourced from the foreign bank as a whole, and that the financial stability of the foreign bank as a whole is under supervision of its foreign authority.

### VI-3 Supervisory Methods and Measures

- (1) With regard to each item described in the above VI-2, while taking account of characteristics of the branch office's operations, when necessary, interviews shall be conducted periodically and continuously. The FSA will also take the opportunity to have a direct dialogue with the foreign bank's head office to share the recognition of the issues for the entire group and those for the branch office. In addition, if necessary, interviews shall be conducted on the results of the internal audit on the branch office conducted by the internal audit division of the head office or the branch office.

In light of a circumstance where the necessity of strengthening cooperation with overseas supervisory authorities is increasing in the wake of progress in both the internationalization of business operation and the diversification of business contents across the group, and taking account of another circumstance where regulations and standards are converging at an accelerated pace, the FSA shall cooperate and exchange information with the supervisory authorities of the foreign bank's home country and other relevant foreign supervisory authorities, while proactively utilizing the frameworks to cooperate with supervisory authorities of the foreign bank's home country.

Based on the issues for the group as a whole identified through these actions, the FSA will conduct in-depth interviews on the effect of these issues on the branch office's business management and on the measures that have been taken to cope with the effect.

- (2) If, based on the off-site monitoring as mentioned in the above (1), inspection results, or reports on a misconduct notification, etc. it is found that there is a problem in the business operations or internal

control system of a branch office of a foreign bank, the FSA shall, when necessary, require the foreign bank branch office to submit a report based on Article 24(1) of the Banking Act, and will also ask the foreign bank's head office to submit a report based on Article 48 of the Banking Act. If a serious problem is found, the FSA will issue a business improvement order or take any other measures based on the Article 26 of the Banking Act.

- (3) In addition, the FSA shall seek to engage in direct communication and share the recognition of the issues with the foreign bank's head office in the home country through the "System for Exchange of Opinions" described in II-5-3, and as necessary, consult with the supervisory authority in the branch office's home country.

## VII Handling of New Entry into Banking Business

### VII-1 License Examination for New Entry into Banking Business and Supervisory Actions after Granting the License

#### VII-1-1 Purpose and Significance

New forms of banks or those with distinctive features have been established, including settlement services-focused banks with their ATMs installed at convenience and other chain stores, online banks, and middle-risk and middle-return loan providing banks mainly targeting small and medium-sized enterprises. In terms of the shareholding structure, some outsiders such as non-financial companies are entering into the banking business.

When a would-be bank applies for a banking license or when a would-be major shareholder of a bank applies for the approval, the FSA needs to strictly examine whether or not the applicant's financial basis, personnel structure, and other attributes meet the examination criteria stipulated in the Banking Act.

In general, when a would-be bank applies for a banking license, the supervisory viewpoints stipulated in the Supervisory Guidelines should also serve as a reference to determine whether or not the applicant is capable of accurately, fairly, and efficiently carrying out the banking business in accordance with the business model that the applicant intends to implement. The following subsections especially illustrate the FSA's supervisory viewpoints during the process of the license examination and in the course of subsequent supervisory actions, with regard to new entry into the banking business.

As for the specific examination approach, the FSA conducts thorough interviews with the applicant about the application content, and when inspecting the management executive's qualification, as well as inspecting whether the application content is consistent with the actual status of the relevant framework in place to carry out the banking business accurately, fairly, and efficiently, the FSA will ask, if necessary, the applicant to submit additional data and materials that should serve as evidence to support the applicant's explanation.

The FSA also examines whether measures stipulated in Article 55-2(5) and Article 58-3(1) of the Deposit Insurance Act will be specifically taken.

(Reference) "Check Items related to Article 55-2(5) and Article 58-3(1) of the Deposit Insurance Act"  
(Material 1 described in the Forms and Reference Information)

#### VII-1-2 License Application Filed by a Bank whose Finance and Management Are Influenced by a Shareholder

When inspecting the prospective income and expenditures and adequacy of capital base after the commencement of business (Article 1-8(3)(ii) and (iii) of the ), the FSA also pays close attention to the premises on which these prospects are based. At the same time, the prospects for how the bank's major

shareholders, and persons who are as influential on the bank's finance and management as the former (hereinafter representatively referred to as the "bank's major shareholders" in this VII-1-2 below) will take actions when the bank's business conditions get worse also provides an important indication for the FSA to determine the bank's financial soundness.

Specifically, the FSA will also grasp whether and how the bank's major shareholders have discussed their action plan in case of the bank's business deterioration, and whether the bank and the major shareholders have shared and confirmed the contents of the major shareholders' action plan to maintain the bank's financial soundness in case of the bank's worsening financial standings.

### VII-1-3 Handling of License Application for Limited Banking Operations

#### (1) Supervisory approaches for license examination

In the case where a banking license application is filed by a would-be-bank whose business model does not necessarily envisage all banking operations, for example, with no intention of engaging in loan business or funds transfer transactions, the FSA examines, based on the criteria stipulated by laws and regulations, whether or not the applicant has systems in place to appropriately carry out such limited banking operations.

In this regard, however, after obtaining the license, the new bank might aim to develop its business in a direction that was not assumed at the time of license application. In such a case, the FSA needs to re-examine whether the bank has systems in place to appropriately carry out such business.

Therefore, when granting a banking license to any applicant whose business model does not envisage all banking operations, the FSA attaches a condition to the effect that, if the new bank intends to engage in any new banking operation that was not assumed at the time of license application, the FSA's approval is required in advance.

#### (2) Points of attention in the post-license supervision

After obtaining the license, if the new bank develops its business in a direction that was not assumed at the time of license application, based on the licensing condition, the FSA re-examines whether the bank has systems in place to appropriately carry out such business, and determines whether or not to approve it.

In case the bank violates the licensing condition, the FSA considers invoking an administrative disposition based on Article 27 of the Banking Act.

### VII-1-4 Risk Management and Profitability in Cases Where the Asset Structure is Biased towards Securities including Government Bonds

#### (1) Key principles

When the asset structure of any bank is biased toward government bonds and other securities,

instead of loans, the required amount of capital base is quite small, since there is little credit risk under the current capital adequacy ratio regulation that focuses on credit risk. However, taking into account a business form different from the traditional banking business, a capital base is required to be set up which is commensurate with risk characteristics such as interest rate risk and operational risk. In addition, if any bank does not take the credit risk that is assumed in the traditional banking business, the bank cannot expect such return (profitability) that corresponds to the credit risk. This point also needs to be taken into account when the authority examines the prospective income and expenditures.

- (2) Major supervisory viewpoints during the license examination process and after granting the license
  - (i) Matters to be checked in the license examination
    - (A) In the case where the bank's asset structure is biased toward government bonds and other securities, instead of loans, whether the bank's level of capital base is commensurate with risk characteristics such as interest rate risk and operational risk, in light of a business form different from the traditional banking business; whether the bank has systems in place for proper risk management, such as ALM (Asset Liability Management).
    - (B) When examining the prospective income and expenditures, the FSA needs to check the following: What the would-be-bank expects to be the source of earnings. Whether the source of earnings is expected to be steady and stable in the future. Whether the applicant has contingency plans in case the prerequisites for earnings fall behind the estimates. Whether the level of earnings is expected to be enough to cover ordinary expenses, even under such a scenario.
    - (C) In the case where the would-be-bank plans to engage in the settlement business across the country, whether steady settlement will be ensured.
  - (ii) Points of attention in the post-license supervision

Mainly through inspection or collection of reports, the FSA checks whether the capital base at the time of license examination has been maintained, and whether the bank's risk management such as ALM has been properly conducted. With regard to the source of earnings checked at the time of license examination, the FSA checks whether the actual earnings are in line with the plan and whether there are any changes in the prerequisites for earnings. In cases where the actual earnings fall behind the respective plans, the FSA checks the corresponding measures mainly through the collection of reports.

#### VII-1-5 Customer Protection and Other Viewpoints in Cases Where New Types of Banks are Exclusively Focused on Non-face-to-face Transactions Using Online Banking or ATMs without any Manned Offices

- (1) Key principles



As existing banks have already started to handle online financial transactions, there is a need to effectively protect customers by revising the roles of regulations and supervisory approaches in such a way as to match the characteristics of electronic transactions. New types of banks that are exclusively focused on non-face-to-face transactions using online banking or ATMs without any manned offices, in particular, need to have alternative tools to take over the functions of conventional manned offices, specifically by formulating fair internal rules and having appropriate internal frameworks in place. If any bank intends to provide IT (information and communications technology)-based new services, the bank needs to have a certain mechanism in place for ordinary users to safely and conveniently use without any special training. Based on the above viewpoints, in granting the license to and supervising over banks that are exclusively focused on non-face-to-face transactions using online banking or ATMs, the FSA pays close attention to the following points. As for the general regulations and supervision pertaining to online financial transactions, the FSA will revise the existing ones in light of findings and suggestions from various reports by experts in related fields.

- (2) Major supervisory viewpoints during the license examination process and after granting the license
  - (i) Matters to be checked in the license examination
    - (A) Whether the bank has systems in place to appropriately handle each of the matters listed below even without manned offices.
      - a. Handling of complaints and consultations from customers
      - b. Response to customers in the wake of a system shutdown
      - c. Fulfillment of accountability to customers based on laws and regulations
      - d. Making disclosure
      - e. Fulfillment of the duty of checking at the time of transaction and reporting suspicious transactions in order to counter organized crimes including money laundering
    - (B) Regarding the prospective income and expenditures, whether the bank has clear contingency plans in case of a worsening business environment, such as the new entry of competitors or system obsolescence, and whether the plan anticipates a certain level of earnings, even under such a scenario.
    - (C) Whether the bank has a solid measure to ensure liquidity in the case of a temporary and massive customer churn, taking into account the characteristics of an interest rate- or any other condition-sensitive customer segment, as well as the characteristics of transactions for which cancellations and changes are easily made.
    - (D) Whether the security level of the bank's system is satisfactory. Whether the bank has appropriately set up any security management system for system operations (including the management of any outsourced contractor) and crisis management systems in case of the occurrence of failure. (Submission of evaluation documents from an external institution is required.)

(ii) Points of attention in the post-license supervision

The FSA checks the implementation status of each measure checked at the time of license examination mainly through inspection or collection of reports.

VII-1-6 License Application Filed by a Bank of Which Parent Company is a Non-Financial Company

VII-1-6-1 Perspective of Ensuring the Independence of Any Subsidiary Bank from Its Parent Non-Financial Company

(1) Key principles

A prerequisite for ensuring any bank's sound management is to ensure the independence of management. In cases where a non-financial company is one of the major shareholders who are assumed to have influence on management policies of a bank, the FSA pays especially close attention to whether the independence of bank management is ensured so that the soundness of the subsidiary bank is not impaired by the requests from the non-financial company (referred to as the "parent non-financial company" in this VII-1-6 below ) from the viewpoint of its business strategy.

(2) Major supervisory viewpoints during the license examination process and after granting the license

(i) Matters to be checked in the license examination

(A) Whether the subsidiary bank has a solid management system in place for the management team to always place top priority on the soundness of bank management and make managerial decisions independently. Whether the bank avoids undermining the independence of the subsidiary bank's management, for example, by having an officer of the subsidiary bank concurrently serve as an officer or an employee of the parent non-financial company.

(B) In the case where the subsidiary bank shares its office with the parent non-financial company, whether the bank avoids undermining of the sound and appropriate management of the banking business in terms of security or risk management by entrusting part of the banking business to the parent non-financial company, or by having some employees of the parent non-financial company concurrently serve as those of the bank. (This matter should apply to a general form of "in-store branches" such as installing ATMs at convenience stores.)

(ii) Points of attention in the post-license supervision

Based on the Banking Act, mainly through the inspection on the subsidiary bank or the collection of reports, the FSA checks the independence of the subsidiary bank's management after granting a license, and how the soundness and appropriate management of banking business has been ensured.

## VII-1-6-2 Perspective of Blocking the Parent Non-Financial Company's Business Risk

### (1) Key principles

Even if the independence of bank management is ensured, unexpected risks of the parent non-financial company, such as its business deterioration, may affect the subsidiary bank. Especially if the subsidiary bank and the parent non-financial company share their operating base, the subsidiary bank is likely to lose the operating base at once in the wake of bankruptcy of the parent non-financial company (risk of going to bankrupt together). In order to deal with these risks, the current large-scale credit provision regulation, and the arm's length principle should be rigorously complied with. In addition, the following points should be noted.

### (2) Major supervisory viewpoints during the license examination process and after granting the license

#### (i) Matters to be checked in the license examination

Whether the subsidiary bank sufficiently takes measures to block the parent non-financial company's risks (\*). These measures need to include the following items at minimum:

- (A) If the parent non-financial company's business conditions get worse, the subsidiary bank should not provide the parent with support and loans.
- (B) The subsidiary bank should assume in advance the parent non-financial company's business deterioration, sales of some or all shares in the subsidiary bank held by the parent non-financial company, withdrawal of deposit, and various risks arising from the parent non-financial company (such as the loss of synergy effects, falling share prices or a run on deposit due to the reputational risk, and the defection of business partners). Based on these assumptions, measures (such as the ensuring of both sources of earnings and sources of fund procurement, and the enhancement of equity capital) should be taken to prevent undermining of the sound management of the subsidiary bank.
- (C) Especially if the subsidiary bank and the parent non-financial company share their operating base, the subsidiary bank must take measures so as not to allow the parent non-financial company's failure to cause difficulty for the subsidiary bank to continue its business.

(Note) In addition, if another subsidiary company of the parent non-financial company shares the operating base with the subsidiary bank, the subsidiary company's risks may be highly likely to affect the subsidiary bank. Therefore, the FSA requires the subsidiary bank to take necessary measures to block the subsidiary company's risks as well.

- (D) Even after taking the above risk-blocking measures, in some cases, it might be difficult to completely block the parent non-financial company's risks. With the objective of grasping the subsidiary bank's business deterioration due to the parent non-financial company's management risks at an early stage, during the examination process related to the approval

for the bank's major shareholders, the FSA checks the business conditions of the parent company, which may have influence on the subsidiary bank's management. Specifically, in examining the prospective income and expenditures as well as the social credibility of the license applicant, the FSA also takes into full account the parent non-financial company's financial conditions and its social credibility.

(ii) Points of attention in the post-license supervision

After granting a license, the FSA checks the implementation status of the risk-blocking measures (whose steady implementation is a prerequisite for the license) mainly through inspection of the subsidiary bank or collection of reports. If the implementation status of the risk-blocking measures is found to be problematic or if the initially planned risk-blocking measures are found to be insufficient, the FSA may issue a business improvement order to the subsidiary bank, based on Article 26 of the Banking Act.

VII-2 Approval Examination for Major Shareholders of Banks and Supervisory Actions after the Approval

VII-2-1 Purpose and Significance

(1) Some non-financial companies have been entering into banking business, with the aim of obtaining synergy effects by sharing their customer base and store network. Others hold shares of banks for the purpose of investment. Among them, excluding the national and local governments, etc., those who may have influence on bank management need to be approved as major shareholders of banks, based on the Banking Act.

(2) Therefore, when a banking license application is filed by a would-be-bank, and if a non-financial company or an investment fund intends to become a major shareholder of the applicant, it is necessary to simultaneously file the approval application for the major shareholder of the bank. Accordingly, the FSA needs to conduct examination related to approval for the bank's major shareholder in parallel with the license examination.

VII-2-2 Matters to be Checked in the Bank's Major Shareholder Approval Examination

VII-2-2-1 Bank's Major Shareholder Approval Application Filed by a Non-Financial Company

(1) When the FSA examines whether or not the sound and appropriate management of the bank's operations is likely to be undermined, in light of matters concerning funds for the non-financial company to acquire voting rights at the bank, the purpose of its holding, and other matters related to the holding of the voting rights, the following points, for example, are fully inspected.

- (i) Whether the non-financial company's policies and purposes to hold shares of the bank are likely to undermine the soundness and appropriateness of the bank's operations. For example, whether the purpose of holding the voting rights is other than short-term purchase and sales.
  - (ii) In light of the source of funds for the non-financial company to acquire the voting rights, whether there is any possibility that the soundness and appropriateness of the bank's operations will be damaged. For example, whether the funds to acquire the voting rights are supposed to come from excessive borrowings.
  - (iii) Whether fair transactions are ensured among group members including the non-financial company.
- (2) When the FSA examines whether or not the sound and appropriate management of the bank's operations is likely to be undermined, in light of the non-financial company's assets as well as income and expenditures, the following points, for example, are fully inspected.
- (i) In light of the non-financial company's financial conditions and fund procurement, whether there is any possibility that the soundness and appropriateness of the bank's operations will be damaged.
  - (ii) In particular, suppose that a non-financial company has more than 50% of the voting rights at its subsidiary bank. In this case, whether the relevant contingent plan earmarks a sufficient cash flow to ensure the sound management, even if the subsidiary bank's earnings fall below the plan.
  - (iii) For the process of approval examination, the FSA requests the submission of materials such as the latest annual financial statements and the audit report (or similar materials that show the non-financial company's financial conditions, if said company is a foreign corporation), and checks whether or not the audit report has additionally pointed out a material uncertainty regarding the going concern assumption.
- (3) When the FSA examines whether or not the non-financial company fully understands the public nature of banking operations and also has social credibility in full measure, in light of its personnel structure and other factors, the following points, for example, are fully inspected.
- (i) Whether the non-financial company fully understands the public nature of banking operations and also has social credibility in full measure, in light of the non-financial company's management system, and its management control system relevant to the bank where the non-financial company holds the voting rights of more than the Major Shareholder Threshold (referred to as the "subsidiary bank" in the following VII-2-2 and VII-2-3).
  - (ii) A prerequisite for ensuring any subsidiary bank's sound management is to ensure the independence of the subsidiary bank's management. In cases where a non-financial company is a major shareholder of a bank, the FSA fully examines, for example, the following points, in order to prevent any request by the non-financial company from the viewpoint of its business strategy from undermining the independence of the subsidiary bank's management.

- (A) Whether the independence of the subsidiary bank's management is not undermined by having an officer or an employee of the non-financial company concurrently serve as an officer or an employee of the subsidiary bank.
  - (B) In the case where the subsidiary bank shares its office with the non-financial company, whether the sound and appropriate management of banking business is not undermined in terms of security or risk management by part of the banking business being entrusted to the non-financial company, or by having some employees of the non-financial company concurrently serve as those of the bank. (This matter should apply to a general form of "in-store branches" such as installing ATMs at convenience stores.)
- (4) Even if the independence of the subsidiary bank's management is ensured, unexpected risks of the business company, such as its business deterioration, may affect the subsidiary bank. Especially if the subsidiary bank and the business company share their operating base, the subsidiary bank is likely to lose the operating base at once in the wake of bankruptcy of the business company (risk of going to bankrupt together). In order to deal with these risks, the FSA fully examines, for example, the following points:
- (i) Whether the relevant measures are sufficiently taken in order to prevent the business company's risks from spreading to the subsidiary bank. These measures need to include the following items at minimum:
    - (A) If the business company's business conditions get worse, it should not receive any support and loans from the subsidiary bank.
    - (B) The business company should assume in advance its business deterioration, sales of some or all of its holding shares in the subsidiary bank, withdrawal of deposit, and various risk arising from the subsidiary bank due to the business company (such as loss of synergy effects, falling share prices of and withdrawal of deposits from the subsidiary bank due to the reputational risk, and the defection of business partners). Based on these assumptions, measures (such as the ensuring of both sources of earnings and sources of fund procurement, and the enhancement of equity capital) should be taken to prevent undermining of the sound management of the subsidiary bank.
    - (C) Especially if the subsidiary bank and the business company share their operating base, the subsidiary bank must take measures not to let the business company's failure cause difficulty for the subsidiary bank to continue its business.
  - (ii) Even after taking the above risk-blocking measures, in some cases, it might be difficult to completely block the business company's risks affecting the subsidiary bank. With the objective of grasping the subsidiary bank's business deterioration due to the business company's management risks at an early stage, during the examination process related to the approval for the bank's major shareholders, the FSA fully examines financial conditions and social credibility of the business company, which may have influence on the subsidiary bank's management.

VII-2-2-2 Bank's Major Shareholder Approval Application Filed by an Investment Fund

- (1) When the FSA examines whether or not the sound and appropriate management of the bank's operations is likely to be undermined, in light of matters concerning funds for the investment fund to acquire voting rights at the bank, the purpose of its holding, and other matters related to the holding of the voting rights, the following points, for example, are fully examined.
  - (i) Whether the investment fund's policies and purposes to hold shares of the bank aren't likely to undermine the soundness and appropriateness of the bank's operations. For example, whether the purpose of holding the voting rights is not short-term purchase and sales.
  - (ii) In light of the source of funds for the business company to acquire the voting rights, whether there is any possibility that the soundness and appropriateness of the bank's operations will be damaged. For example, whether the funds to acquire the voting rights are not supposed to come from excessive borrowings.
  - (iii) Whether a fund manager or a major stakeholder concurrently serves as an officer or an employee of the subsidiary bank.
  - (iv) Whether it is stipulated that the investment fund should not receive any support and loans from the subsidiary bank if its performance becomes worse.
  - (v) Whether fair transactions are ensured among group members including the investment fund and its stakeholders.
  
- (2) When the FSA examines whether or not the sound and appropriate management of the bank's operations is likely to be undermined, in light of the investment fund's assets as well as income and expenditures, the following points, for example, are fully examined.
  - (i) In light of the investment fund's performance and fund procurement, whether there isn't any possibility that the soundness and appropriateness of the bank's operations will be damaged.
  - (ii) In particular, suppose that an investment fund has more than 50% of the voting rights at its subsidiary bank. In this case, even if the subsidiary bank's earnings fall below the plan, whether the relevant contingent plan earmarks a sufficient cash flow to ensure sound management.
  - (iii) For the process of approval examination, the FSA requests the submission of materials such as the latest annual financial statements and the audit report (or similar materials that show the investment fund's performance, if it is a foreign investment fund).
  
- (3) When the FSA examines whether or not the investment fund fully understands the public nature of banking operations and also has social credibility in full measure, in light of its fund management system and other factors, the following points, for example, are fully examined.
  - (i) Whether the investment fund fully understands the public nature of banking operations and also has social credibility in full measure, in light of its fund management system.

- (ii) Whether the investment fund's major stakeholders fully understand the public nature of banking operations and also have social credibility in full measure.
- (4) Especially taking into account common cases where it takes a certain period for a new bank to put the business on track after obtaining a new license, the FSA checks whether the investment fund intends to hold its bank shares for a certain long-term period; whether it has a policy to stabilize and nurture the management of the new bank with its governance as a shareholder; and if so, in what way that can be guaranteed.

At the same time, the FSA also checks the investment fund's view on the stock offering.

### VII-2-3 Points of attention in the Post-Approval Supervision

- (1) Based on Article 52-11 of the Banking Act, the FSA requests major shareholders of banks to annually submit their annual securities reports and other disclosure materials (including those showing the status of fund procurement; or materials showing business and financial conditions if there are no disclosure materials), and documents describing the business relations (such as deposits, and borrowings) between the respective major shareholders of banks and the respective subsidiary banks.
- (2) If off-site monitoring and/or inspection results raise a question about the effectiveness of measures for ensuring the independence of the subsidiary bank and blocking business risks affecting the subsidiary bank, the FSA will, when necessary, require the major shareholder of the bank to submit a report based on Article 52-11 of the Banking Act. If a serious problem is found, the FSA will issue an order for action or take any other measures based on Article 52-13 of the Banking Act.

### VII-3 Application to Capital Participation in Existing Banks

#### VII-3-1 Matters to be Noted in Capital Participation in Existing Banks

- (1) The points of view described in the above VII-1 basically also apply to supervisory viewpoints toward any bank that has changed the conventional business model in the wake of capital participation in the bank by a business company and/or an investment fund. The conceivable new business models include one that envisages the full-scale development of online banking business. When necessary, the FSA asks for reporting pursuant to Article 24 of the Banking Act; grasps the status of preparation for the change of business model as well as the status of protection of existing customers; and examines the appropriateness of such business.
- (2) When the examination results indicate the necessity of ensuring the smooth and appropriate preparation of systems for both the protection of depositors and the change of business model, the



FSA orders a partial suspension of business, based on Article 26 of the Banking Act, for a limited period of time needed for the preparation, or takes other actions.

#### VII-3-2 Approval for Major Shareholders of Banks

- (1) The points of view described in the above VII-2 basically also apply to the examination related to the approval for major shareholders of existing banks in which business companies and investment funds take their respective stakes. During the approval process for such major shareholders of banks, the FSA conduct in-depth interviews and full examinations.
- (2) The supervisory viewpoints mentioned in the above VII-2 basically also apply to cases where a business company intends to hold shares of a bank holding company.

#### VII-4 Application Mutatis Mutandis of the Supervisory Guidelines to New Forms of Banks

Domestic banks comprise not only major banks, to which the Supervisory Guidelines apply, and regional banks, to which the Comprehensive Guidelines for Supervision of Regional Financial Institutions apply, but also new forms of banks and so-called subsidiary trust banks. For supervision over the latter banks, the Supervisory Guidelines apply mutatis mutandis when necessary, while the respective banks' forms and the actual state of their business are also taken into account.

- (Note) Regarding operations using trust accounts conducted by trust banks, see the Comprehensive Guidelines for Supervision of Trust Companies separately established.

## VIII Bank Agency Service

### VIII-1 Purpose and Significance

- (1) “Bank agency service” refers to a type of business performing any of the following acts on behalf of a bank: (i) acting as an agent or intermediary for conclusion of a contract on acceptance of deposits or installation savings, etc.; (ii) acting as an agent or intermediary for conclusion of a contract on loans of funds or discounting of bills; or (iii) acting as an agent or intermediary for conclusion of a contract on exchange transactions. “Bank agent” (including “secondary bank agent” (meaning a bank agent that carries out bank agency services on re-entrustment from a principal bank agent); the same applies hereinafter) refers to a person who provides the bank agency service under the license of the Prime Minister prescribed in Article 52-36(1) of the Banking Act.

“Principal bank” refers to a bank which, through agency or brokerage services provided by the bank agent, concludes (i) a contract on acceptance of deposits or installation savings, etc.; (ii) a contract on loans of funds or discounting of bills; or (iii) a contract on exchange transactions.

- (2) Bank agents, as those who themselves engage in the bank agency service, must take necessary measures to ensure sound and appropriate management for their bank agency service. Principal banks and principal bank agents (meaning a bank agent that further entrusts another bank agent with bank agency services; the same applies hereinafter) are also held responsible for taking measures to ensure sound and appropriate management for the bank agency service engaged in by their respective bank agents.

The purport of the Banking Act, which makes not only bank agents but also principal banks and principal bank agents take such responsibility, is to declare that principal banks (in cooperation with the respective principal bank agents if the bank agency service is sub-entrusted) must primarily fulfill their responsibility of ensuring the sound and appropriate conduct of business operations related to the bank agency service engaged in by the respective bank agents. Even when supervising a bank agent, full attention should be paid to the primary responsibility of its principal bank.

### VIII-2 Key principles

#### VIII-2-1 History and Purport of Introduction of the Bank Agency Service System

In the past, under the restrictions on capital contribution and the regulations of concurrent business, a bank agency had been authorized, in principle, only when a bank’s subsidiary company had committed to exclusively engaging in the agency. Then, in accordance with the law to partially revise the Banking Act, etc., which was enforced on April 1, 2006, the bank agency service system was created.

The new system has enabled general enterprises to enter into the bank agency service. Partly because of

this, users' access to financial services is expected to be ensured and enhanced, and various distribution channels of financial institutions are also expected to be effectively utilized. On the other hand, in order to prevent any general enterprise from taking advantage of its business relations to conduct unfair transactions, the sound and appropriate management of the bank agency service must be ensured.

Accordingly, when supervising bank agents, it is necessary to supervise bank agents and principal banks in a timely and appropriate manner in order to ensure the adequate and steady conduct of the bank agency service, in light of the purport of making the entrance into the bank agency service subject to the license system and the purport of making concurrent business subject to the case-by-case approval system. Especially in cases where bank agents concurrently engage in other business, including the case where an existing general enterprise has entered into the bank agency service, it should be noted that such bank agents are urged to put into place the relevant business operation framework to prevent inappropriate handling, such as cross-selling (lending), preferential lending, and diversion of customer information.

#### VIII-2-2 Supervision through Principal Banks

With regard to the bank agency service engaged in by bank agents, principal banks are held responsible for taking measures to ensure the sound and appropriate management as mentioned in the above VII-1 (2). Therefore, when supervising a bank agent, it is of course important to supervise the bank agent itself, but it is more necessary to place emphasis on supervision of its principal bank, and the relevant supervisory method should be to ensure the sound and appropriate conduct of business operations related to the bank agency service engaged in by the bank agent principally through supervision over its principal bank.

In this regard, however, in cases where the FSA needs to directly guide and supervise a bank agent or bank agents, including the case where a bank agent has its particular problem and another case where there is a common problem among certain bank agents, close attention should be paid to reduce the administrative workload, based on the full consideration of the size and characteristics of the bank agent(s).

(Note) When the FSA asks a principal bank or a bank agent to submit a report or other documents about the bank agent's small-scale office (e.g., a small-scale post office), the sales office's characteristics related to the services and products available there must be taken into full consideration and due regard must be given so as not to disturb its smooth operation.

#### VIII-3 Administrative Processes Related to Supervision over Bank Agents

##### VIII-3-1 General Administrative Processes

###### VIII-3-1-1 Flow of General Administrative Processes Related to Supervision over Bank Agents

In terms of supervision, the flow of administrative processes is shown in Exhibit 4.

### VIII-3-1-2 Supervisory Actions through Principal Banks

#### (1) Supervisory approaches

When supervising a bank agent, the FSA checks whether the sound and appropriate business operations of the bank agent is ensured, and also checks its principal bank's business management framework. Specifically, during the offsite monitoring of the principal bank, the FSA, when necessary, includes matters related to the bank agent to which the principal bank entrusts the bank agency service. In addition, when conducting interviews with the bank agent, the FSA also conducts interviews with the principal bank.

On such an occasion, based on the above VIII-1 and VIII-2, the monitoring will focus on whether the bank agent and the principal bank have appropriately taken the following measures: those to prevent inappropriate handling approaches, such as cross-selling (lending) and preferential lending; those to appropriately manage customer information; and those to sever relations with antisocial forces.

In addition, by referring to the entries in notifications submitted by the principal bank, the FSA checks whether the principal bank effectively guides and supervises the bank agent.

#### (2) Supervisory actions

- (i) When the off-site monitoring as mentioned in the above (1) and examination results through usual supervisory administrative processes raise a question about the sound and appropriate business operations of the bank agent or the principal bank's guidance to the bank agent, the FSA asks for reporting based on Article 52-53 of the Banking Act. In addition, when necessary, the FSA conducts an improvisational interview with the principal bank, or asks for reporting based on Article 24 of the Banking Act, or takes any other actions to set the record straight, striving to grasp points at issue. If any problem is identified, the FSA urges efforts for the improvement.
- (ii) When interviews with the principal bank indicate that there is a problem with the bank agent, if necessary, the FSA also conducts interviews with the bank agent, or asks for reporting based on Article 52-53 of the Banking Act, or takes any other actions to set the record straight, striving to grasp points at issue. If any problem is identified, the FSA urges efforts for improvement.
- (iii) If examination results of the reporting reveal a serious problem with the bank agent's business execution framework, the FSA will issue a business improvement order based on Article 52-55 or a business suspension order based on Article 52-56 of the Banking Act.
- (iv) If such results provide evidence that there is such a serious problem as the principal bank's lacking relevant frameworks to guide and supervise the bank agent, the FSA will consider issuing a business improvement order to the principal bank, based on Article 26 of the Banking Act.

### VIII-3-1-3 Cooperation between Supervisory Departments

(1) When a license application for the bank agency service is filed (or the intention to file such application is identified), or when a problem is found in the internal control environment of any of the applicants, principal banks, bank agents or principal bank agents, or when any problem is found in relevant frameworks to guide and supervise a bank agent or an applicant, the principal bank's supervisory department or the bank agent's supervisory department promptly provides the relevant supervisory department with information about details of the application and the problematic situation. If necessary, the receiving supervisory department will check the internal control environment of the applicant or principal bank or bank agent or principal bank agent, or the frameworks to guide and supervise the bank agent or the applicant. In addition, when invoking an administrative disposition or giving approval or license, the principal bank's supervisory department or the bank agent's supervisory department provides the relevant supervisory department with information or asks for its opinion, striving for close cooperation.

(Note 1) Principal banks refers to any principal bank stipulated in Article 34-43(2) of the Banking Act Enforcement Regulation. The same applies hereinafter.

(Note 2) Principal banks and principal bank agents include would-be principal banks and would-be principal bank agents applying for the bank agency service license for the first time. Before receiving a license, these persons do not have obligations such as an obligation to guide their respective bank agents, but such obligations will be imposed when a license is granted; and banks have obligations to supervise their overall outsourced operations including the bank agency service (Article 12-2(2) of the Banking Act). Thus, if necessary, the supervisory departments in charge of these persons will examine whether the relevant measures are taken to ensure the appropriate business operation of the bank agent in question even before the license, in accordance with VIII-4-2-6 and VIII-5 of the Supervisory Guidelines.

(2) When the bank agency service is sub-entrusted, especially when the sub-entrusted service is rolled out as numerous or extensive operations under the so-called franchise system or in any other form, closer cooperation between supervisory departments is required, with the objective of giving more appropriate guidance and supervisory attention to the principal bank and the principal bank agent.

If any party concerned grasps the intention to roll out the sub-entrusted bank agency service as numerous or extensive operations, the party must promptly contact the FSA.

(3) Regardless of the method used, information should be promptly provided.

VIII-3-1-4 Internal Delegation of Part of the Authority of the Director-General of Local Finance Bureau to the Director, etc. of the Competent Finance Office

When the principal office or other office of the bank agent is located within the jurisdictional district of

the local finance office, Otaru sub-office, or Kitami sub-office, the authority delegated to the Director-General of Local Finance Bureau can be delegated internally to the director of the local finance office or sub-office, according to the judgment of the director-general.

Written applications and notifications regarding these matters should be submitted to the Director-General of Local Finance Bureau.

#### VIII-3-1-5 Administrative Report

- (1) The Director-General of Local Finance Bureau should report to the Director-General of the FSA's Supervision Bureau the situation of the bank agent as of the end of each quarter by the 20th day of the following month.

(Reference) Form VIII-3-1-5 described in the Forms and Reference Information

- (2) With regard to supervision over bank agents, the Director-General of Local Finance Bureau should report the details of cases (i) through (vii) listed below to the Director-General of the FSA's Supervision Bureau without delay, and should also provide the supervisory departments in charge of principal banks, principal bank agents, and secondary bank agents, respectively, with the relevant information.

Cases (i) and (iii) should be reported in Form VIII-3-1-5.

- (i) Case where the Director-General of Local Finance Bureau has given license under Article 52-36(1) of the Banking Act
- (ii) Case where the Director-General of Local Finance Bureau has given approval for concurrent business under Article 52-42(1) of the Banking Act
- (iii) Case where the Director-General of Local Finance Bureau has received a notification of discontinuance of business, etc. pursuant to Article 52-52 of the Banking Act
- (iv) Case where the Director-General of Local Finance Bureau has asked for submission of reports and materials under Article 52-53 of the Banking Act
- (v) Case where the Director-General of Local Finance Bureau has received the result of an on-site inspection pursuant to Article 52-54 of the Banking Act
- (vi) Case where the Director-General of Local Finance Bureau has issued a business improvement order under Article 52-55 of the Banking Act
- (vii) Case where the Director-General of Local Finance Bureau has rendered a supervisory disposition under Article 52-56 of the Banking Act

#### VIII-3-1-6 Application Mutatis Mutandis of the Supervisory Guidelines

For supervision over bank agents, in addition to the matters set forth below, the above sections II and III as well as the Forms and Reference Information are timely applied mutatis mutandis, if necessary.

- (1) The above II-2 applies mutatis mutandis to providing information as well as handling complaints about bank agents, while the above II-3 applies mutatis mutandis to responses to cases where inquiries concerning the interpretation of laws and regulations, etc. are received, and the above II-4 to points of attention in giving administrative guidance.
- (2) When invoking an administrative disposition to a bank agent, II-5 applies mutatis mutandis. In addition, in light of its principal bank's responsibilities of giving guidance on business operations related to the bank agent engaged in by the bank agent as well as taking other measures to ensure the sound and appropriate conduct of the business operations, the matters described in VIII-3-1-2 and VIII-3-1-3 should be noted.

#### VIII-3-2 Administrative Processes Related to License Application

##### VIII-3-2-1 Points to Note in Applying for License

###### VIII-3-2-1-1 Necessary or Unnecessary of License

- (1) Criteria to determine whether license is necessary or unnecessary

Whether a license is necessary or unnecessary needs to be determined in a comprehensive manner, after taking into consideration the positioning of such conduct in a series of conduct toward concluding a contract either on the acceptance of deposits or installation savings, etc., or on the loans of funds or discounting of bills, or on the exchange transactions (hereinafter representatively referred to as a "contract on acceptance of deposits"). Note that it is not appropriate to focus on only part of the series of conducts and immediately determine that a license is unnecessary.

- (2) Cases where license is necessary

For example, a person who engages in any of the following conduct (i) through (v) as its business operation, in principle, needs to receive the license for a bank agent stipulated in Article 52-36(1) of the Banking Act.

- (i) Solicitation for conclusion of a contract on acceptance of deposits
- (ii) Financial instrument explanation for the purpose of solicitation for conclusion of a contract on acceptance of deposits
- (iii) Negotiation on terms and conditions with the aim of concluding a contract on acceptance of deposits
- (iv) Receipt of application for a contract on acceptance of deposits (excluding a case where a

written application for the contract is simply received or collected, and another case where any wrong description or omission in a written application for the contract or failure to attach at least one of the necessary documents is pointed out)

(v) Acceptance of a contract on acceptance of deposits

(3) Cases where license is unnecessary

(i) A license for the bank agent is unnecessary for a person who acts as an agent or intermediary for a contract on acceptance of deposits on behalf of a customer.

In this context, however, full attention should be paid to some cases where such license may be required. For example, even when a contract or a scheme agreed on between a bank and the person in questions stipulates that the conduct should be engaged in on behalf of a customer, if the person practically engages in agency or intermediation services substantially on behalf of the bank beyond or against the scope of business stipulated in the contract or the scheme, a license may be necessary.

(Note) "On behalf of a customer" means receiving a request from a customer, taking the customer's side, and aiding for the benefit of the customer.

(ii) When a person receives entrustment from a bank and engages in the entrusted conduct that falls short of intermediation, the person does not need to obtain a license for a bank agent.

For example, a license for a bank agent may be unnecessary for a person who receives entrustment from a bank and engages in entrusted conduct that is only part of business processing of the conduct (A) though (d) cited below:

(A) Simple distribution and delivery of advertising leaflets, brochures, contract application forms

(Note) In this case, although the name of the handling financial institution and its contact information are allowed to be conveyed, explaining how to fill in the distributed or delivered documents may be deemed as intermediation.

(B) Receipt and collection of contract application forms and attached documents

(Note) In this case, checking the content of a filled-in contract application form, beyond the simple receipt and collection of the contract application form or beyond pointing out any wrong description or omission in the contract application form or failure to attach at least one of the necessary documents, may be deemed as intermediation.

(C) In an explanatory meeting about financial instruments, explanation about the structures and how to utilize general financial instruments handled by banks

(D) Business of simply introducing customers to financial institutions without conducting solicitation activities

(Note) The above "introduction" includes the following acts.

a. Leaving or posting advertising media in which the financial institution introduces



itself in the store of the operator.

- b. Providing an explanation of the relationship between the business operator and the financial institution or the business contents of the financial institution.
  - c. Only a link to the financial institution's site shall be established, and negotiations and procedures leading to the conclusion of the contract shall be conducted between the financial institution and the customer, and the business operator shall not be involved in the conclusion of the contract.
- (iii) As for the conduct of installing an ATM in a sales office or other office in response to the entrustment from a bank, if the ATM falls under the “unmanned equipment” in Article 35(1)(iv) of the Banking Act Enforcement Regulation, a license for a bank agent is unnecessary.

#### VIII-3-2-1-2 Points of Attention in Acceptance of License Application Forms

##### VIII-3-2-1-2-1 Acceptance Procedures for License Applications Forms

###### (1) Submission destination of the license application forms

When a license application form for a bank agent is submitted by a license applicant, check whether the submission destination is the Director-General of Local Finance Bureau administering the applicant’s principal office or other office.

###### (2) Proxy application related to license application

- (i) When a proxy application related to a license application is made, check whether or not a power of attorney exists, and if it exists, the scope of the power of attorney, based on the letter of attorney or any other document with similar effect.
- (ii) Even when a proxy application is made, whether the principal applicant has business execution capability as a bank agent needs to be fully inspected in some way, such as conducting interviews with the applicant if necessary.

##### VIII-3-2-1-2-2 Entries in the License Application Form

When checking the entries in the license application form, the following points should be noted.

(Reference) Forms 7-1 and 7-2 described in the Forms and Reference Information

###### (1) Trade name or name of the applicant (Article 52-37 (i) of the Banking Act)

In the case where an applicant is an individual, check whether the applicant enters, in the “trade name or name” column, either his/her trade name when the trade name has been registered or his/her fictitious business (dba, doing business as) name when a fictitious business name has been used.

- (2) Name and location of the applicant's business office(s) or other office(s) at which the bank agent would perform (Article 52-37(iii) of the Banking Act)

“Business office(s) or other office(s)” in the license application form refers to certain facilities to be established for the operation of all or part of the bank agent, and exclude facilities that serve for purposes other than bank agent-related operations.

- (3) If that individual is involved in the ordinary business of another corporation, the other corporation's trade name or name (Article 34-32 (i) and (ii) of the Banking Act Enforcement Regulation)

As for the other corporation's trade name or name, check whether the official name (such as “XX Incorporated”), instead of the informal name (such as “XX Inc.”), has been entered.

- (4) In the case where the person also engages in businesses other than bank agent, the type of each of these businesses (Article 52-37(v) of the Banking Act)

As for the types of these other businesses, check whether the entry is in accordance with the Middle Classification as set forth in the Japan Standard Industrial Classification stipulated in the Ministry of Internal Affairs and Communications Public Notice No. 139 titled “Establishment of the nomenclature and classification table concerning industries pursuant to the provision of the Cabinet Order Providing for Industrial Classification and Classification of Diseases, Injuries and Death to be used for Statistical Surveys” (hereinafter referred to as “the Japan Standard Industrial Classification”) (in cases where these other businesses fall under the Large Classification J- FINANCE AND INSURANCE, the entry should be in accordance with the Fine Classification).

#### VIII-3-2-1-2-3 Attached Documents

When checking the attached documents, the following points should be noted.

- (1) Articles of incorporation (Article 52-37(2)(i) and (ii) of the Banking Act)

Whether business operations are related to the bank agent stipulated in the purposes of the articles of incorporation.

- (2) Documents that contain statements on matters specified by a Cabinet Office Order as those relating to details and methods of the bank agent (Article 52-37(2)(ii) of the Banking Act)

(i) Among the entries in the “documents that contain statements on matters specified by a Cabinet Office Order as those relating to details and methods of the bank agent,” check whether “the type of contract as prescribed in each item of Article 2(14) of the Banking Act that a bank agent handles” (Article 34-33(1)(i) of the Banking Act Enforcement Regulation) has been entered in accordance with the following formulae:

- (A) In the “type of deposits” column, whether deposits are classified. For example, whether yen deposits and foreign currency deposits respectively are classified into current deposits, ordinary deposits, saving deposits, notice deposits, fixed-term deposits, fixed term savings, and negotiable certificate of deposits.
  - (B) In the “type of borrowers” column, whether borrowers are classified, for example, in consumers and enterprises.
  - (C) In the “use of funds borrowed” column, whether the uses (such as living expenses, funds to purchase a house, funds to purchase an automobile, and education expenses) have been entered in cases where borrowers have specific uses. As for cases where the use is not specified, whether said effect has been entered.
- (ii) Among the entries in the “documents that contain statements on matters specified by a Cabinet Office Order as those relating to details and methods of the bank agent,” “the system of carrying out the bank agent” (Article 34-33(1)(iii) of the Banking Act Enforcement Regulation) is to include systems set forth in each item of Article 34-33(2) of the Enforcement Regulation. In order to grasp those systems, a pictorial drawing of the surrounding area and the layout prescribed in Article 34-34(xiii) of the Enforcement Regulation should be used as a reference when necessary, and the supervisory department in charge should also timely ask for the submission of the structure chart and the organizational chart relevant to said system.
- (3) Resume (Article 34-34(i) of the Banking Act Enforcement Regulation), or Resume of every officer (Article 34-34(ii) of the same Regulation)
- (i) In cases where the present address in the “resume” (when the applicant is an individual) or in the “resume of every officer” (when the applicant is a corporation) is not identical to the address in the corresponding extract of the resident record, check the reason. Also check whether the two addresses have been entered in the “resume” or the “resume of every officer.”
  - (ii) Check whether the Chinese characters used in the name in the “resume” or the “resume of every officer” are identical to those used in the name in the corresponding extract of the resident record. (For example, when an old-style Chinese character has been used in the name in the extract of the resident record, the same old-style Chinese character should be used in the name in the “resume” or the “resume of every officer.”)
- (4) Extract of a resident record (Article 34-34 (i) and (ii) of the Banking Act Enforcement Regulation)
- The “extract of a resident record” to be submitted should contain the following items:
- (i) Address
  - (ii) Name
  - (iii) Date of birth
  - (iv) Registered domicile

- (5) Any document alternative thereto (Article 34-34 (i) and (ii) of the Banking Act Enforcement Regulation)

When a foreigner who does not have residence in Japan submits a copy of a document issued in his/her home country, which is equivalent to a residence record in Japan, or any other similar document, the submitted document falls under the “any document alternative thereto” stipulated in Article 34-34 (i) and (ii) of the Banking Act Enforcement Regulation.

- (6) Document in which the person pledges not to fall under the provisions of the Article 34-37(iv) (Article 34-34(i) of the Banking Act Enforcement Regulation)

The “document in which the person pledges not to fall under the provisions of Article 34-37(iv)” to be submitted should contain not only the pledge that the person shall not fall under any of sub-items (a) to (h) of item (iv), but also declare to the effect that “the person recognizes that, if the pledge turns out to be false, it would fall under the cause set forth in Article 52-56(1)(ii) of the Banking Act.”

- (7) Document in which the person pledges not to fall under the provisions of the Article 34-37(v) (Article 34-34(ii) of the Banking Act Enforcement Regulation)

The “document in which the person pledges not to fall under the provisions of the Article 34-37(v)” to be submitted should contain not only the pledge that the person shall not fall under any of sub-items (a) to (c) of the item (v), but also declare to the effect that “the person recognizes that, if the pledge turns out to be false, it would fall under the cause set forth in Article 52-56(1)(ii) of the Banking Act.”

- (8) Document in which an officer pledges not to fall under any of the provisions of sub-items (a) to (h) of Article 34-37 (iv) (Article 34-34(ii) of the Banking Act Enforcement Regulation)

The “document in which an officer pledges not to fall under any of the provisions of sub-items (a) to (h) of Article 34-37 (iv)” to be submitted should contain not only the pledge that the officer shall not fall under any of sub-items (a) to (h) of item (iv), but also declare to the effect that “the officer recognizes that, if the pledge turns out to be false, it would fall under the cause set forth in Article 52-56(1)(ii) of the Banking Act.”

- (9) Draft of the entrustment contract (Article 34-34 (iii) and (iv) of the Banking Act Enforcement Regulation)

- (i) Whether the matters prescribed in each item of Article 34-35(1) of the Banking Act Enforcement Regulation have been stipulated in the “draft of the entrustment contract.”
- (ii) Provisions regarding the measures prescribed in each item of Article 34-63(1) of the Banking Act Enforcement Regulation fall under the “other particulars found to be necessary” (Article 34-35(1)(x) of the Enforcement Regulation) for the entries of the “draft of the entrustment contract.”

(10) Documents stating the condition of securing persons with abilities concerning the bank agent and the condition of placement of those persons (Article 34-34(v) of the Banking Act Enforcement Regulation)

(i) Check whether the “documents stating the condition of securing persons with abilities concerning the bank agent and the condition of placement of those persons” contain the following matters:

(A) Person(s) with sufficient knowledge about the bank agent’s operations that the applicant carries out (Article 34-37 (iii) (a) and (b) of the Banking Act Enforcement Regulation) as well as the method for the person(s) to have acquired the knowledge (including a document that proves the acquisition of the knowledge, if any), and the planned placement of the person(s)

(Note 1) The “sufficient knowledge about the bank agent’s operations that the applicant carries out” means necessary knowledge to carry out the operations in a sound and appropriate manner. Conceivable examples include the knowledge about the bank agent’s practical operations that the applicant carries out, and the knowledge about laws and regulations such as the Banking Act, the Banking Act on the Protection of Personal Information, the Banking Act on Prevention of Transfer of Criminal Proceeds, and the Foreign Exchange and Foreign Trade Act.

(Note 2) Persons with sufficient knowledge about the bank agent’s operations that the applicant carries out are to be assigned as a “responsible person for operations in order to secure compliance with laws and regulations, etc. pertaining to the bank agent’s operations that the applicant carries out” (Article 34-37(iii)b of the Banking Act Enforcement Regulation) and as a “supervising manager for supervising of securing compliance with laws and regulations” (ditto). Accordingly, in addition to professional knowledge about the abovementioned laws and regulations, the knowledge described below is also required.

a. In the case of a “responsible person for operations in order to secure compliance with laws and regulations, etc. pertaining to the bank agent’s operations that the employer engages in”

In terms of basic laws such as the Civil Code, the Commercial Code, the Companies Act, and the Penal Code, professional knowledge about certain parts of such basic laws that are relevant to the bank agent’s operations

b. In the case of a “supervising manager for supervising of securing compliance with laws and regulations”

In terms of basic laws such as the Civil Code, the Commercial Code, the Companies Act, and the Penal Code, professional knowledge not only about certain parts of such basic laws that are relevant to the bank agent’s operations

but also about a wide range of matters related to compliance

(B) Background of each person with experience involved in the bank agent's operations that the employer engages in (including a document that proves the experience, if any) and the planned placement of the person(s)

(ii) With regard to the background of each person with experience involved in the bank agent's operations that the employer engages in, check whether the background contains necessary information (such as the name of each company where the person has previously worked, the assigned departments, the assigned roles, the date of each assignment, each tenure, and each operation in his//her charge) to accurately grasp the person's experience.

(11) "Record concerning assets" (Article 34-34(vi) of the Banking Act Enforcement Regulation)

With regard to the "record concerning assets," the FSA will check accordingly whether a certificate of deposit balance, a certificate of property tax assessment, and/or any other document that proves the amount of assets is attached, where necessary.

(12) "Documents certifying the guarantee" (Article 34-34(x) of the Banking Act Enforcement Regulation)

Conceivable examples of the "documents certifying the guarantee" include a guarantee contract and a letter of awareness.

(13) "Documents stating the content and means of concurrent business" (Article 34-34(xi) of the Banking Act Enforcement Regulation)

With regard to the "documents stating the content and means of concurrent business," the FSA will check whether they contain the classification information in accordance with the Middle Classification as set forth in the Japan Standard Industrial Classification (in cases where the concurrent business falls under the Large Classification J- FINANCE AND INSURANCE, the information should be in accordance with the Fine Classification).

(14) "Documents stating matters which to be referenced for an examination as prescribed in Article 52-38 (1) of the Banking Act, beyond the provisions set forth in each of the preceding items" (Article 34-34(xiv) of the Banking Act Enforcement Regulation)

The documents stating matters which are to be referenced for a permission examination of the bank agency service (Article 52-38 (1) of the Banking Act), for example, include a certificate of deposit balance and a certificate of property tax assessment (as in the above (12)). If there is any other reference document necessary for the examination, the FSA will ask the applicant for the submission accordingly so as to conduct the examination in an accurate and prompt manner.

- (1) When examining permission for bank agency services, a careful examination will be made of whether a person who intends to obtain the permission is able to execute the business as a bank agent as described in the Banking Act, the Enforcement Order, the Enforcement Regulation, and this Supervisory Guideline as well as the points to note to be listed below.
- (2) If problems are recognized during the examination, it should be noted that it is necessary to cooperate with relevant supervisory departments in accordance with VIII-3-1-3(1), as there might be problems in the instructions by a principal bank or a principal bank agent.

Moreover, if a person who conducts numerous or extensive operations by giving sub-entrustment of bank agency services to another party, for example, in the form of a franchise system, applies for the permission, it should be noted that it is more important to cooperate with relevant supervisory departments, as similar problems might happen to other applicants. In a case like this, the FSA must be contacted promptly.

#### VIII-3-2-2-1 Examination Related to Financial Basis

It is necessary to make an examination of a financial basis provided in Article 52-38(1)(i) of the Banking Act, in consideration of matters listed in Article 34-37(ii) of the Banking Act Enforcement Regulation. The main points to note are described, for example, in the following (1) and (2).

The examination will be made based on the written application for permission, Article 52-37(2) of the Banking Act, Article 34-34(vi) to (x) and (xiv) of the Banking Act Enforcement Regulation, and other documents or materials on a case-by-case basis, together with the cooperation from the applicant through interviews and submission of additional documents when necessary.

- (1) Whether the amount of net assets is calculated accurately, as found by scrutinizing the balance sheet and other documents or materials.
- (2) In examining the amount of net assets during the applicable period for the estimation of income and expenditures and property status, the conditions on which to estimate the income and expenditures and property status will be closely scrutinized. Moreover, when the conditions, which are prerequisite for the estimation of income and expenditures and property status, are found to be below the estimation, whether to expect enough profit to cover the ordinary expenses, etc. will be examined.

#### VIII-3-2-2-2 Examination Related to Business Execution Ability

It is necessary to make an examination of “the ability necessary to perform bank agency services appropriately, fairly, and efficiently” in Article 52-38(1)(ii) of the Banking Act, in consideration of matters listed in Article 34-37(iii) of the Banking Act Enforcement Regulation.

The examination will be made based on the written application for permission, Article 52-37(2) of the Banking Act, Article 34-34(i) to (v), (ix), and (xii) to (xiv) of the Banking Act Enforcement Regulation, and other documents or materials on a case-by-case basis, together with the cooperation from the applicant through interviews and submission of additional documents when necessary.

- (1) When the applicant is an individual (excluding a person who engages in bank agency services in two or more offices; the same applies hereinafter), assign the personnel necessary for conducting the business (Article 34-37(iii)(a) of the Banking Act Enforcement Regulation)

When the applicant is an individual, it should be noted that the applicant needs to have the knowledge described in (\*1) and (\*2) of VIII-3-2-1-2-3(11)(i)(A) as “sufficient knowledge about bank agency service’s operations that the applicant carries out.”

- (2) “Regular loan agreement” (Article 34-37(iii)(a) of the Banking Act Enforcement Regulation)

“Regular loan agreement” refers to a loan agreement in which there is little room for the discretion of a loan officer because procedures such as judging whether or not to conclude the agreement and setting the conditions of the agreement are stylized.

(Note) This “regular loan agreement” includes a loan agreement pertaining to “standardized loan products” provided in (3).

- (3) “Standardized loan products” (Article 34-37(vi)(c) and 34-37(vii)(b) of the Banking Act Enforcement Regulation)

“Standardized loan products” mean loan products for which the loan possibility and conditions have been determined only by mechanical processing of financial data concerning the fund consumers; “financial data” described here are data related to finance of the fund consumers, including each account item listed in financial statements, and against which there is little or no room for the discretion of a loan officer.

- (4) A person who has engaged in the services of loaning of funds, or is found to possess abilities equal or better thereto (Article 34-37(iii)(a) and (b) of the Banking Act Enforcement Regulation)

- (i) A person who has engaged in the services of loaning of funds refers, for example, to a person who has engaged in loan business in a financial institution or a money lender. It should be noted that “the services of loaning of funds” do not refer to mere services for transmitting documents, but need to satisfy the requirements of the services of loaning of funds that the applicant engages in as a bank agent.

- (ii) It should be noted that a person who has engaged in analyzing corporate finance, for example, as a certified public accountant, a certified public tax accountant, a financial consultant, an investment banking business manager, a management consultant at a chamber of commerce and industry can be defined, in some cases, as a person who is found to possess abilities equal



to or better than a person who has engaged in the services of loaning of funds, and that the knowledge and experience required for the services of loaning of funds that the applicant engages in as a bank agent need to be judged in light of his or her qualifications and job history.

(iii) It should be noted that even a person who has engaged in the services of loaning funds, or is found to possess abilities equal or better thereto, needs to have sufficient knowledge about bank agency services.

(5) When the applicant is a corporation (including an individual who engages in bank agency services at two or more offices; the same applies hereinafter), assignment of the personnel necessary for conducting the business (Article 34-37(iii)(b) of the Banking Act Enforcement Regulation)

As for “a responsible person for operations in order to secure compliance with laws and regulations, etc. pertaining to bank agency services that the corporation engages in” and “a supervising manager for supervising of securing compliance with laws and regulations, etc.” who need to be assigned when the applicant is a corporation, it should be noted that the former and the latter need to have the knowledge described in (\*1) and (\*2)a of VIII-3-2-1-2-3(11)(i)(A) and (\*1) and (\*2) of VIII-3-2-1-2-3(11)(i)(A), respectively.

(6) Main points to note pertaining to internal rules (Article 34-37(iii)(d) of the Banking Act Enforcement Regulation)

While a bank agent must establish internal rules concerning bank agency services, the following (i) to (viii), for example, should be noted when confirming the internal rules for examination of permission:

(i) Method of segregated management of property

Whether the internal rules specifically define the methods of segregated management of property delivered by customers with regard to the operations pertaining to bank agency services and stipulate that the delivered property be able to be managed in a condition that is immediately distinguishable as to whether said property is its own asset or belongs to any principal bank. Also, whether they prescribe specific procedures for properly examining the status of compliance.

(Note) It is preferable to manage money in a physically segregated manner. At least, it is necessary to manage it in a segregated account.

(ii) Methods of solicitation for the conclusion of contracts and clarification of the contents of the contract

Whether the internal rules specifically define the methods of customer solicitation, clarification of the contents of contracts, and provision of documents at the signing of contracts, and stipulate that the bank agent conducts appropriate business operations in compliance with laws and regulations. Also whether they prescribe specific procedures for properly examining the status of compliance with laws and regulations.

- (iii) Methods for preparation and storage of books and documents
  - Whether the internal rules specifically define the methods for preparation and storage of the books and documents listed in Article 34-58 of the Banking Act Enforcement Regulation.
- (iv) Method of implementing training
  - Whether the internal rules stipulate specific provisions concerning the development of a control environment for properly implementing training for sales representatives in order to ensure compliance with laws and regulations, and provision of appropriate solicitation and explanation of financial instruments, as well as provision of documents, to customers.
- (v) Method for verification at the time of transaction
  - Whether the internal rules specifically stipulate the development of a system for appropriate identification confirmation based on the Foreign Exchange Act and appropriate verification at the time of transaction based on the Anti-Criminal Proceeds Act, and appropriate submission of doubtful transactions.
- (vi) Development of internal control environment
  - Whether the internal rules specifically stipulate the methods of managing operations pertaining to internal controls and the internal system of responsibility.
- (vii) Management of customer information
  - (A) Whether the internal rules specifically specify the methods and systems for properly managing customer information (including separation of organizations and persons in charge, installation of information barriers in terms of equipment and systems, blockade of information) and other handling pursuant to III-3-3-3.
  - (B) Whether the internal rules specifically specify the measures in order to obtain the customer's prior consent concerning treatment of non-public financial information and other non-public information (information as prescribed in Article 34-48 of the Banking Act Enforcement Regulation; the same applies hereinafter).
- (viii) Method for dissemination of internal rules
  - Whether the contents of the internal rules will be well disseminated to all officers and employees engaging in bank agency services.

(7) “It is not found that the personnel structure, capital structure, or organization, etc. of the applicant is likely to hinder carrying out of bank agency services precisely, fairly, and efficiently.” (Article 34-37(iii)(e) of the Banking Act Enforcement Regulation)

When examining the applicant's business execution ability, decisions should be made on whether or not to give the applicant the permission to operate as a bank agent by considering whether there is a corporation or an individual that has great influence on the applicant, and the degree of its influence, etc. based on the personnel structure, capital structure, or organization, etc. of the applicant.

(Note) For example, cases where the applicant has a parent company, or the applicant has a company

to which it sends a majority of its directors are typical ones where it is found that there is a corporation that has a great influence on the applicant, but are not limited to these cases.

#### VIII-3-2-2-3 Examination on Social Credibility

It is necessary to make an examination of “a person who has sufficient social credibility” provided in Article 52-38(1)(ii) of the Banking Act, in consideration of matters listed in Article 34-37(iv) and (v) of the Banking Act Enforcement Regulation.

The examination will be made based on the written application for permission, Article 34-34(i), (ii) and (xiv) of the Banking Act Enforcement Regulation and other documents or materials on a case-by-case basis, together with cooperation from the applicant through interviews and submission of additional documents where necessary.

#### VIII-3-2-2-4 Examination on Concurrent Engagement in Other Businesses

It is necessary to make an examination of concurrent engagement in other businesses provided in Article 52-38(1)(iii) of the Banking Act, in consideration of matters listed in Article 34-37(vi) of the Banking Act Enforcement Regulation. The main points to note are described, for example, in the following (1) to (6).

The examination will be made based on the written application for permission, Article 52-37(2) of the Banking Act, Article 34-34(iii), (iv) and (xi) to (xiv) of the Banking Act Enforcement Regulation, and other documents or materials on a case-by-case basis, together with cooperation from the applicant through interviews and submission of additional documents where necessary.

It should be noted that the relationships between the contents of the main concurrent business and the business related to bank agency services are prescribed in Article 34-37(vi)(c) and (vii), etc.; Exhibit 5 shows classified information on the relationships. (However, when examining concurrent engagement in other businesses, Exhibit 5 should not always be applied mechanically; individual cases should be fully examined in order to ensure that the applicant is not likely to inhibit the proper and reliable management of the bank agency services by concurrently engaging in other businesses.)

(1) It should be noted that the businesses (for example, acting as an agent or intermediary for repayment of deposits, and receiving payment of loans) usually carried out incidentally to the operations in which to engage by performing the activities listed in each item of Article 2(14) of the Banking Act do not correspond, in principle, to other businesses provided in Article 52-38(1)(iii) of the Banking Act, excluding those cases where they correspond to businesses required to be licensed, permitted, and registered in other laws and regulations, including claim management and collection businesses as set forth in the Banking Act on Special Measures Concerning Claim Management and Collection Business.

(Note) Accordingly, these cases do not correspond to concurrent businesses subject to examination

for permission, and approval does not need to be obtained for concurrent business

- (2) “Standardized loan products” (Article 34-37(vi)(c) and (vii)(b) of the Banking Act Enforcement Regulation)

“Standardized loan products” mean loan products for which the loan possibility and conditions have been determined only by mechanical processing of financial data concerning the fund consumers; “financial data” described here are data related to finance of the fund consumers, including each account item listed in financial statements, and against which there is little or no room for the discretion of a loan officer.

- (3) “The act is pertaining to a loan agreement that is concluded with security of goods or articles purchased with the loan funds” (Article 34-37(vii)(a) of the Banking Act Enforcement Regulation)

“A loan agreement that is concluded with security of goods or articles purchased with the loan funds” includes a housing loan (that places mortgage on a house to be purchased with the loan funds) or an auto loan (that places mortgage on an automobile to be purchased with the loan funds, or sets ownership retention, etc.).

- (4) “The content of its concurrent business is likely to damage the social credibility as a bank agent” (Article 34-37(vi)(b) of the Banking Act Enforcement Regulation)

While the cases where the content of its concurrent business is likely to damage the social credibility as a bank agent are, for example, thought to be those where the bank agent concurrently engages in a business that is likely to damage good morals and customs or peace in public life, or that is contrary to public order and decency, and in an antisocial business, the judgment should be made by taking into comprehensive consideration the characteristics and mode of the concurrent business, and the impact on the transaction counterparty and society.

- (5) “The content of main concurrent business” (Article 34-37(vi) and (vii) of the Banking Act Enforcement Regulation)

Whether or not the concurrent business that the bank agent engages in corresponds to the main concurrent business should be judged by taking into comprehensive consideration the scale of the concurrent business including the expenses, sales, and earnings pertaining to the business, and the job titles and number of those engaged in the business, and the time required for the business.

- (6) The act of “making use of its advantageous position in a transaction for concurrent business” (Article 34-37(vi)(d) of the Banking Act Enforcement Regulation)

With regard to the act of “making use of its advantageous position in a transaction for concurrent business,” while a document, “Regarding Unfair Trading Practices Following Loosening of Financial Institutions’ Business Categories and Expansion of Business Scope,” issued on December 1, 2004, by

the Fair Trade Commission, will be referenced, the following practices, for example, may constitute the act of making use of its advantageous position in a transaction for concurrent business.

- (i) The bank agent actually forces customers to sign contracts which stipulate that it accepts deposits for which it acts as an agent or intermediary (the same applies to other acts listed in each item of Article 2(14) of the Banking Act; the same will apply in the following (ii) to (iv)), by implying that it will suspend transactions related to concurrent businesses, or give unfavorable treatment to such businesses unless they sign the contracts.
- (ii) The bank agent actually forces customers to sign contracts on acceptance of deposits for which it acts as an agent or intermediary, by requesting them to do so when it conducts transactions with them regarding concurrent businesses.
- (iii) In cases where customers intend to sign contracts with a competitor who conducts business related to bank agency services, the bank agent prevents customers from signing the contracts on acceptance of deposits with its competitor (including a bank or a bank agent; the same will apply in (iv)) by implying it will suspend transactions with them regarding concurrent businesses or give unfavorable treatment to such businesses.
- (iv) The bank agent actually forces customers not to sign contracts on acceptance of deposits with its competitor, by requesting them to do so when it makes transactions with them regarding concurrent businesses.

### VIII-3-2-3 Others

#### VIII-3-2-3-1 Handling of Approval of Permission Application

##### VIII-3-2-3-1-1 Permission Number

- (1) The permission number of a bank agent will be as follows (Serial numbers will be given also to secondary bank agents.):

〇〇財務（支）局長（銀代）第〇〇号

Director-General of the XX Local Finance (Branch) Bureau (Bank Agent) No. XX

- (2) Handling of permission numbers

- (i) Each permission number will be identified by a serial number, which is assigned by the local finance bureau.
- (ii) When a permission is no longer valid, the applicable permission number will be a missing number and will not be replaced.
- (iii) Permission numbers will be managed using Form VIII-3-1-5 described in the Forms and Reference Information.

#### VIII-3-2-3-1-2 Notification to Permission Applicants

When the FSA gives permission to an applicant to engage in bank agency services, the FSA will issue a written permission to the permission applicant.

#### VIII-3-2-3-2 Handling of Denial of Permission Application

- (1) In case the FSA denies the application for the permission, the FSA will issue a written notice which describes the reason for the denial and the right of the applicant to request the Commissioner of the FSA to examine the permission applicant (See II-5-2).

#### VIII-3-3 Points to Note Regarding Receipt of Notification

- (1) In general, when receiving a notification based on Article 52-39, 52-52, or Article 53 of the Banking Act, or Article 34-56, Article 34-61, or Article 35 of the Banking Act Enforcement Regulation or other laws and regulations, it is necessary to closely examine the content of the notification to find out whether the notification violates any laws and regulations, and whether there are problems with the appropriateness and soundness of the applicant's business operations. As a result of confirmation, when some problem is found, measures for a report request under Article 52-53 of the Banking Act and for a business improvement order under Article 52-55 of the Banking Act will be properly taken (See II-5-2).

(References) Form 7-4 described in the Forms and Reference Information

#### VIII-3-4 Administrative Processes Related to Application for Approval of Concurrent Business

##### VIII-3-4-1 Points to Note in Approval of Concurrent Business

##### VIII-3-4-1-1 Necessity of Approval of Concurrent Business

When a bank agent who has already received an approval of concurrent business begins an operation classified separately from that before the change made in the middle classification (small classification when the bank agent belongs to the large classification [J] for finance and insurance) set forth in the Japanese Standard Industrial Classification, it is necessary, with regard to the new operation, to newly obtain an approval of concurrent business described in Article 52-42(1) of the Banking Act.

##### VIII-3-4-1-2 Points to Note in Acceptance of Written Application for Approval of Concurrent Business

Form 7-3 described in the Forms and Reference Information as well as VIII-3-2-1-2 should be applied to matters to be stated in a written application for approval of concurrent business.

#### VIII-3-4-2 Points of Attention in Examination of Approval of Concurrent Business

VIII-3-2-2 should be applied.

#### VIII-3-4-3 Others

##### VIII-3-4-3-1 Handling of Approval

When the FSA approves a concurrent business, a written approval of concurrent business should be issued to the applicant.

##### VIII-3-4-3-2 Handling of Disapproval

When the FSA refuses to approve a concurrent business based on Article 52-42(2), a written disapproval notice which describes the reason for the disapproval and the right of the applicant to request the Commissioner of the FSA for examination will be issued to the applicant.

#### VIII-4 Bank Agent

##### VIII-4-1 Purpose and Significance

Bank agency services means a business performing any of the following acts on behalf of a bank: (i) acting as an agent or intermediary for conclusion of a contract on acceptance of deposits or installation savings, etc.; (ii) acting as an agent or intermediary for conclusion of a contract on loans of funds or discounting of bills; or (iii) acting as an agent or intermediary for conclusion of a contract on exchange transactions. The bank agent means a person who provides bank agency services under the license of the Prime Minister prescribed in Article 52-36(1) of the Banking Act. The bank agent, as a person who provides bank agency services themselves, should take measures to ensure sound and appropriate management in relation to the bank agency services it provides.

##### VIII-4-2 Major Supervisory Viewpoints

- (1) In view of the nature and business content of a bank agent, appropriateness of business operations, etc. of the bank agent should be supervised based on III-3 when necessary, as well as on the matters

set forth in the following VIII-4-2-1 to VIII-4-2-7.

- (2) If problems are recognized with regard to a bank agent, it should be noted that it is necessary to cooperate with relevant supervisory departments of a principal bank or a principal bank agent in accordance with VIII-3-1-3(1), because there might be some problems with instructions by the principal bank or the principal bank agent.

Moreover, if problems are recognized with regard to a person who conducts numerous or extensive operations by giving sub-entrustment of bank agency services to another party, for example, in the form of a franchise system, it should be noted that it is more important to cooperate with relevant supervisory departments, because similar problems might happen to other agents. In a case like this, the FSA must be contacted promptly.

#### VIII-4-2-1 Prohibited Acts, and Inappropriate Transactions Pertaining to a Bank Agent

- (1) Wrongful use of an advantageous position in a transaction as a bank agent (Article 34-53(iii) of the Banking Act Enforcement Regulation)

Supervision of wrongful use of an advantageous position in a transaction as a bank agent must be conducted with due consideration of “Regarding Unfair Trading Practices Following Loosening of Financial Institutions’ Business Categories and Expansion of Business Scope,” a document issued on December 1, 2004, by the Fair Trade Commission. For example, the following practices may constitute a wrongful use of an advantageous position in a transaction as a bank agent ((i) and (ii) of the following practices may also constitute “wrongfully acting as an agent or intermediary in the conclusion of a contract as prescribed in one of the items of Article 2(14) of the Banking Act on the condition that the customer effect a transaction with the bank agent or a business operator it designates” provided in Article 34-53(ii) of the Banking Act Enforcement Regulation).

- (i) The bank agent effectively forces customers to purchase products in which it deals in its concurrent business by implying that it will stop acting as an agent or intermediary in the contract on the lending of funds (including other acts set forth in each item of Article 2(14) of the Banking Act; the same will apply in the following (ii) to (iv)) or give unfavorable treatment to agent or intermediary services it provides in the contract on the lending of funds unless they make transactions with the bank agent regarding the bank agent’s concurrent business.
- (ii) The bank agent requests, and effectively forces, customers to purchase products in which it deals in its concurrent business when it acts as an agent or intermediary in the contract on the lending of funds to customers.
- (iii) In cases where customers intend to sign contracts with a competitor who conducts the same business in which the bank agent engages as its concurrent business, the bank agent prevents customers from purchasing the products by the competitors in its concurrent business by implying that it will stop acting as an agent or intermediary in the contract on the lending of



funds or give unfavorable treatment to agent or intermediary services it provides in the contract on the lending of funds.

- (iv) The bank agent requests, and effectively forces, customers not to purchase products by the competitors in its concurrent business when it acts as an agent or intermediary in the contract on the lending of funds to customers.

- (2) Wrongful use of an advantageous position in a transaction based on concurrent business (Article 34-53(v) of the Banking Act Enforcement Regulation)

Supervision of wrongful use of an advantageous position in a transaction in concurrent business must be conducted with due consideration of “Regarding Unfair Trading Practices Following Loosening of Financial Institutions’ Business Categories and Expansion of Business Scope,” a document issued on December 1, 2004, by the Fair Trade Commission. For example, the practices set forth in VIII-3-2-2-4(6) may constitute a wrongful use of an advantageous position in a transaction in concurrent business ((i) and (ii) of these practices may also constitute “wrongfully having the customer effect a transaction with itself or a person doing business it designates on the condition that it act as an agent or intermediary in the conclusion of a contract as prescribed in each item of Article 2(xiv) of the Banking Act” provided in Article 34-53(iv) of the Banking Act Enforcement Regulation).

- (3) With regard to a control environment that prevents prohibited acts as prescribed in Article 52-45 of the Banking Act and Article 34-53 of the Banking Act Enforcement Regulation, attention should be paid to the points listed below.

- (i) Whether the bank agent establishes a division or appoints a person responsible for implementing measures for preventing prohibited acts. Also, whether the bank agent develops a control environment for examining whether such division or person has properly implemented measures for preventing prohibited acts.
- (ii) Whether the bank agent establishes internal rules on a system for implementing training required to prevent prohibited acts and a system for dealing with complaints from customers and disseminates these rules within the organization.
- (iii) In order to prevent prohibited acts, whether the bank agent conducts training, on a regular and as-needed basis, by a person who has knowledge and practical experience of laws and regulations pertaining to bank agency services.
- (iv) Whether the bank agent establishes a control environment for responding to complaints, such as specifying the contact point for customer complaints regarding prohibited acts, establishing a division in charge of processing complaints and prescribing procedures for processing complaints.

- (4) In addition to the above (1) to (3), prevention of inappropriate transactions, etc. should be based on

### III-3-1-6.

#### VIII-4-2-2 Legal Compliance (for Especially Important Matters)

Supervisory methods and measures related to verification at the time of transaction, obligation for reporting of suspicious transactions and elimination of relations with antisocial forces should be based on III-3-1 as well as on the following (1) and (2).

- (1) If inspection result notices, misconduct notifications, or the like reveal a problem relating to a bank agent's internal control environment for ensuring the fulfillment of obligation of verification at the time of transaction and obligation for reporting of suspicious transactions, or to its structure to ban any relations with antisocial forces, the FSA requires the bank agent to submit reports based on Article 52-53 of the Banking Act when necessary. If a serious problem is found, the FSA issues a business improvement order based on Article 52-55 of the Banking Act.
- (2) Moreover, if a bank agent violates laws and regulations, including the obligation of verification at the time of transaction and obligation for reporting of suspicious transactions, or a bank agent is deemed to have significantly harmed public interest, the FSA issues a business suspension under Article 52-56 of the Banking Act. The same will apply to cases where a bank agent, who recognizes the relationship with antisocial forces, hasn't taken proper actions, and is found to have violated laws and regulations or to have significantly harmed public interest.

#### VIII-4-2-3 Provision of Information and Consultation Function for Protection of Users

Based on Article 52-44(2) and (3) of the Banking Act and Article 34-43 to 34-53 of the Banking Act Enforcement Regulation, supervisory measures regarding the bank agent's provision of information and consultation function, etc. for protection of users should be taken in accordance with III-3-3 and the following (1) to (3).

- (1) Control environment for preventing explanation that might be falsely recognized as abuse of superior position  
If a bank agent concurrently engages in other businesses, confirmation should be made as to whether the bank agent has developed a control environment that prevents the provision of explanations that could be mistaken as an abuse of a superior bargaining position banned under the Antimonopoly Act; it is necessary to note that, for example, activities listed in VIII-3-2-2-4(6) and VIII-4-2-1(1) can be those which correspond to an abuse of a superior bargaining position.
- (2) System for prevention of misrecognition of financial products as deposits (Article 34-45 of the

Banking Act Enforcement Regulation)

If a bank agent sells financial instruments or acts as an agent or intermediary, it should be noted that the bank agent needs to develop a control environment for preventing misrecognition of financial products as deposits.

(3) Management of customer information

- (i) Customer information should be basically managed in accordance with III-3-3-3. If a bank agent concurrently engages in other businesses, the bank agent should pay attention to whether it has developed methods and systems for properly managing customer information (including establishing internal rules regarding separation of organizations and persons in charge, installation of information barriers in terms of equipment and systems, blockade of information, conducting employee education and training, etc.) in order to prevent the customer information obtained through its bank agency services from being used for its concurrent business without the customer's prior consent.
- (ii) As for the customer's prior consent, particularly, with regard to treatment of non-public financial information and non-public information (note that information on customer attributes (name, residential address, telephone number, sex, birthdate and occupation) is personal information, but is not included in non-public financial information and non-public information), it is necessary to confirm whether the bank agent has taken measures in order to obtain the customer's prior consent (described in Article 34-48 of the Banking Act Enforcement Regulation), for example, in the following appropriate methods.
  - (A) Face-to-face contact

Method of giving a prior explanation in writing to and obtaining prior consent in writing from the customer before the customer makes an application for a contract
  - (B) Mail

Method of sending a prior written explanation and obtaining a written reply showing the customer's consent before informing the principal bank of the conclusion of the contract
  - (C) Telephone

Method of giving a prior oral explanation, then promptly sending the written document describing the given explanation (the document can be delivered directly to the customer in the case of having face-to-face contact with the customer after obtaining the customer's consent by telephone) and obtaining the customer's consent in writing before the customer makes an application for a contract
  - (D) The internet, etc.

Method of giving a prior explanation by electronic or magnetic means, and obtaining the customer's consent by electronic or magnetic means

#### VIII-4-2-4 Rules, etc. for User Protection

Rules are based on III-3-4 and are as follows.

As for posting by a bank agent of signs prescribed in Article 52-40 of the Banking Act, and Article 34-40 and 34-45(3) of the Banking Act Enforcement Regulation, attention should be paid to whether the shapes and sizes of the signs and the intelligibility of letters written, and the conditions under which the signs are posted might cause customers' misidentification and confusion.

Posting of holidays and business hours of a specified bank agent prescribed in Article 52-46 of the Banking Act, Article 16-7 of the Banking Act Enforcement Order, and Article 34-55 of the Banking Act Enforcement Regulation, and posting by a bank agent of discontinuance of a principal bank prescribed in Article 52-48 of the Banking Act and Article 34-57 of the Banking Act Enforcement Regulation will be similarly carried out.

#### VIII-4-2-5 Measures to be Taken by a Bank Agent When Undertaking Bank Agency Services for Two or More Principal Banks

##### VIII-4-2-5-1 Explanation to Customers (Articles 34-43 and 34-46 of the Banking Act Enforcement Regulation)

If a bank agent undertakes services on behalf of two or more principal banks, it must explain the following items from (i) to (iv) to customers in advance. It should pay attention to whether it has developed a control environment for doing its utmost to enable customers to understand the items, by using written explanations, for example.

- (i) If the amount of fees to be paid by the customer is different from the amount of fees to be paid under a similar contract with another principal bank, the fact that there is a difference must be explained to the customer.
- (ii) If the bank agent acts as an agent or intermediary for another principal bank regarding the signing of a contract similar to the one which the customer intends to sign, this fact must be explained to the customer.
- (iii) The contents of the similar contract described in the above (ii) and other information that could be useful for the customer must be provided upon his/her request.
- (iv) The trade name of the principal bank which is the ultimate counterparty to the customer's transaction must be made clear to the customer.

##### VIII-4-2-5-2 Management of Customer Information

If a bank agent undertakes bank agency services on behalf of two or more principal banks, the bank agent

should fully examine whether it has developed methods and systems for properly managing customer information (including establishing internal rules regarding separation of organizations and persons in charge, installation of information barriers in terms of equipment and systems, blockade of information, and conducting employee education and training, etc.) in order to prevent the customer information obtained through the bank agency services for one principal bank from being used for the bank agency services for another principal bank without the customer's prior consent.

#### VIII-4-2-6 Measures Taken by a Principal Bank Agent to Ensure the Sound and Appropriate Conduct of Business Operations of a Secondary Bank Agent

- (1) A principal bank agent is responsible for taking measures to provide guidance regarding business operations related to bank agency services that a secondary bank agent engages in, and to ensure the sound and appropriate conduct of other business operations of the secondary bank agent. In order to supervise the secondary bank agent, full attention should be paid to the responsibility of the principal bank agent as well as of its principal bank.

Therefore, in order to ensure the sound and appropriate conduct of business operations related to bank agency services that the secondary bank agent engages in, it is necessary to supervise the principal bank agent properly.

- (2) If problems are recognized with a secondary bank agent (or a person who would be a secondary bank agent), or if off-site monitoring is given to a principal bank agent, information will be collected from a principal bank agent. This information collection should be based on VIII-5-2 when necessary, and attention should be paid to whether an internal environment has been developed in order to prevent a secondary bank agent from entrusting to the third party the bank agency services that the secondary bank agent conducts by receiving sub-entrustment from the principal bank agent.

- (3) If problems are recognized with regard to a principal bank agent's control environment for instructing and supervising a secondary bank agent, it should be noted that it is necessary to cooperate with relevant supervisory departments of the secondary bank agent in accordance with VIII-3-1-3(1), because there might be some problems with the internal control environment of the secondary bank agent.

Moreover, if problems are recognized with regard to a person who conducts numerous or extensive operations by giving sub-entrustment of bank agency services to another party, for example, in the form of a franchise system, the FSA must be contacted promptly.

#### VIII-4-2-7 Others

##### VIII-4-2-7-1 Prohibition of Name-Lending

When judging whether a use of a name corresponds to “the name of that bank agent” prescribed in Article 52-41 of the Banking Act, it should be noted the use of a name corresponds to “the name of that bank agent” even if, for example, the bank agent permits to use the abbreviated name of the bank agent.

#### VIII-4-2-7-2 Points to Note Regarding Public Inspection of Written Reports of Bank Agency Services

Public inspection of written reports of bank agency services prescribed in Article 52-50(2) of the Banking Act and Article 34-59(5) of the Banking Act Enforcement Regulation should be treated as follows:

- (1) The date of public inspection of written reports should be a day other than a holiday as specified in Article 1 of the Banking Act on Holidays of Administrative Organs, and the public inspection period should be within the duration designated by the director-general of the local finance bureau. However, when it is necessary to organize written reports for any other reason, the public inspection date or time may be changed.
- (2) Written reports must not be taken out of the place of the public inspection designated by the director-general of the local finance bureau.
- (3) When any inspector falls under the following category, the public inspection may be suspended or refused:
  - (i) Any person who does not follow the above (1) and (2) or the instructions of the bureau.
  - (ii) Any person who has defaced or damaged written reports, or who may do so.
  - (iii) Those who have caused trouble to other inspectors, or who may do so.
- (4) Of the written reports, “particulars which are likely to cause unfair disadvantages to the carrying out of the business of the bank agent”, which are excluded from public inspection, are thought to include records on property and balance sheets to be submitted as documents attached to the written reports.
- (5) When a request is made for the inspection of written reports related to a bank agent to which the license has been granted by another director-general of the local finance bureau, the applicant for inspection will be informed that such inspection can be supplied by the finance bureau that granted the license.

#### VIII-4-2-7-3 Public Inspection of Written Explanation of Principal Bank

“Compelling reasons why the bank agent that filed the application has to postpone the commencement

of the public inspection as under the provisions of paragraph (1)” prescribed in Article 34-60(4) of the Banking Act Enforcement Regulation, include cases where the legitimate interests of third parties are likely to be adversely affected by natural disasters or public inspection. It should be noted that the bank agent’s own reasons are not included.

## VIII-5 Principal Bank

### VIII-5-1 Background

- (1) The term “principal bank” means a bank which, through agency or brokerage services provided by the bank agent, concludes (i) a contract on acceptance of deposits or installation savings, etc.; (ii) a contract on loans of funds or discounting of bills; or (iii) a contract on exchange transactions.

A principal bank is responsible for taking measures to provide guidance regarding business operations related to bank agency services a bank agent engages in, and to ensure the sound and appropriate conduct of business operations of the bank agent.

- (2) The purpose for which the Banking Act makes a principal bank as well as a bank agent take such responsibility is to declare that primarily a principal bank must fulfill its responsibility of ensuring the sound and appropriate conduct of business operations related to bank agency services that a bank agent engages in. Even when supervising a bank agent, full attention should be paid to the primary responsibility of a principal bank.

Thus, when supervising a bank agent, it is of course important to supervise the bank agent itself, as specified in Exhibit 4. However, it is more necessary to place emphasis on supervision of a principal bank, and mainly supervision of a principal bank should be carried out to ensure the sound and appropriate conduct of business operations related to bank agency services that a bank agent engages in.

### VIII-5-2 Major Supervisory Viewpoints

- (1) When collecting information from a principal bank, for example, in cases where a principal bank submits a notification prescribed in Article 35(1)(vi)- 2 of the Banking Act Enforcement Regulation, off-site monitoring is given to a principal bank, and a problem is found in an internal control environment of a bank agent (or a person who intends to be a bank agent), attention should be paid to whether examine is carried out in a principal bank, based on the following perspectives:
- (2) If problems are recognized with regard to a principal bank’s control environment for guidance and supervising a bank agent, it should be noted that it is necessary to cooperate with relevant supervisory departments of the bank agent in accordance with VIII-3-1-3(1), because there might be some

problems with internal control environment of the bank agent.

Moreover, if problems are recognized with regard to a person who conducts numerous or extensive operations by giving sub-entrustment of bank agency service to another party, for example, in the form of a franchise system, the FSA must be contacted promptly.

#### VIII-5-2-1 Points of Attention Regarding Selection of Bank Agent

(1) When signing contracts for entrusting bank agency services (including if further entrustment of entrusted bank agency services is authorized), whether the principal bank specifies the significance of the entrustment in relation to governance, identifies the various risks involved therein and conducts full deliberations on the method of risk management.

(2) Whether full deliberations are conducted on whether a person with whom the principal bank intends to entrust bank agency services meets the criteria for legal approval.

In particular, when a person with whom the principal bank intends to entrust bank agency services engages in concurrent business, whether the contents of his or her concurrent business are not only examined based on the provisions (on whether the contents of concurrent business are not likely to damage social credibility as a bank agent) under Article 34-37(vi)(B) of the Banking Act Enforcement Regulation, but also fully examined from the viewpoint of reputational risk for the bank.

(3) With regard to whether a person with whom the principal bank intends to entrust bank agency services is an antisocial force, or takes measures to ban any relations with antisocial forces, whether full deliberations are conducted in light of the purpose of the “Guideline for How Companies Prevent Damage from Antisocial Forces” (agreed upon at a meeting on June 19, 2007, of cabinet ministers responsible for anti-crime measures).

#### VIII-5-2-2 Measures to Ensure Appropriateness of the Business of a Bank Agent by a Principal Bank (Article 52-58 of the Banking Act, Article 34-63 of the Banking Act Enforcement Regulation)

(1) Development of internal control environment for supervision of a bank agent

(i) Whether a system for supervising a bank agent (including a business audit management system for a bank agent) is properly developed, for example, by establishing a division responsible for the implementation of measures to ensure the sound and appropriate conduct of business operations related to bank agency services or by appointing a person responsible thereof.

(ii) Whether an internal control environment is developed to examine whether measures are properly taken by those divisions and persons to ensure the appropriateness of business operations related to bank agency services that each bank agent provides.



(iii) When giving sub-entrustment of bank agency service to another party, particularly by having the party conduct numerous or extensive operations, for example, in the form of a franchise system, more attention should be paid to whether a principal bank conducts the instruction and supervision properly due to an increasing number of those concerned. Moreover, it should be noted that it is necessary to examine whether a principal bank develops an appropriate control environment in which a principal bank agent properly instructs and supervises a secondary bank agent.

(2) Contents of entrustment contracts

(i) Whether the matters listed in each item of Article 34-35(1) and Article 34-63(1) of the Banking Act Enforcement Regulation, and the provisions on monitoring of compliance with these matters constitutes the content of an entrustment contract.

Moreover, in terms of guidance and supervising bank agents, whether a control environment is developed in order to examine whether the contract has similar contents, even when the principal bank is not a contracting party.

(ii) Whether there is a control environment that enables full examination on internal regulations, etc. of a bank agent. Moreover, when revising the internal regulations, etc., whether there is a control environment that enables full scrutiny of the contents of the revision with the relevant bank agent.

(3) Implementation of training for compliance with laws and regulations, etc. (Article 34-63(1)(i) of the Banking Act Enforcement Regulation)

(i) In order to secure compliance with provisions of laws and regulations, etc. pertaining to bank agency services, whether comprehensive training programs are conducted not only on the Banking Act, but also on the Anti-Criminal Proceeds Act, the Personal Information Protection Act and other relevant laws and regulations, and the internal regulations of the bank agent, etc.

(ii) Whether a person who has knowledge and practical experience of laws and regulations pertaining to bank agency services gives instruction as a lecturer in the training programs.

(Note) It does not matter whether the lecturer in the training program is an officer or employee of the principal bank or the bank agent, as long as he or she has knowledge and practical experience.

(iii) Whether there is a control environment that enables the bank agent or the person who engages in the bank agency services to maintain and improve his or her business execution ability through implementation of regular training programs.

(iv) As for the contents of the implemented training programs, whether examination is conducted to determine whether the bank agent and the person who engages in the bank agency services understand the contents within a range necessary to conduct the services properly.

- (4) Measures for necessary and appropriate supervision, etc. of the bank agent (Article 34-63(1)(ii) of the Banking Act Enforcement Regulation)
- (i) Whether the supervision based on Article 34-63(1)(ii) of the Banking Act Enforcement Regulation is implemented properly, and whether monitoring of the implementation status is conducted.
  - (ii) Whether there is a control environment developed in which the results of the above monitoring, etc. are examined in the responsible division of the bank, are reported to the management when necessary, and are reflected in appropriate business instruction by the bank and appropriate business operations by the bank agent.
- (Note) In the case where the principal bank and the bank agent (only when the agent is a bank) belong to the same bank holding company group, it should be noted that the proper business management of such bank agent needs to be ensured as such group's business management conducted by such bank holding company based on Article 52-21(1) of the Banking Act.
- (5) Measures to terminate the entrustment contract with the bank agent when necessary (Article 34-63(1)(iii) of the Banking Act Enforcement Regulation)
- When a problem is found as a result of the monitoring conducted against the bank agent, whether there is a control environment developed for implementing appropriate measures such as providing guidance to the bank agent, and terminating the entrustment contract. In addition, whether there is a control environment established for properly protecting customers when terminating the entrustment contracts.
- (6) Measures the principal bank itself needs to take to conduct an examination (Article 34-63(1)(iv) of the Banking Act Enforcement Regulation)
- With regard to examining the loan of funds or the discounting of bills conducted by the bank agent, whether there is a standard or a control environment developed for dealing with cases where preliminary reports or approvals made to the principal bank are needed so that the principal bank can conduct an examination when necessary.
- (7) Measures to ensure appropriate management of customer information and to prevent crime (Article 34-63(1)(v) and (vii) of the Banking Act Enforcement Regulation)
- (i) With regard to development of a control environment to secure appropriate management of customer information in the bank agent, and measures to prevent crime concerning business pertaining to bank agency services at the business office or other office of the bank agent, whether appropriate guidance and know-how are provided so that the bank agent can develop a control environment to the same extent as the principal bank takes measures to manage its

own customer information and prevent crime at the business office or another office, for example, through physical facilities, assignment of personnel, and security countermeasures of the IT system.

- (ii) Whether there is a control environment developed for encouraging the bank agent to understand the provisions of the Anti-Criminal Proceeds Act and the Foreign Exchange Act as well as preventing the deposit account, etc. from being used for organized crime or other illegal activities.

- (8) Measures for the closure of business offices of the bank agent (Article 34-63(1)(viii) of the Banking Act Enforcement Regulation)

When the bank agent closes its business office or office where it engages in bank agency services, whether the bank agent has developed a control environment for smoothly implementing measures for preventing significant effects on the customers, by establishing the schedule and business transfer method for succession of transactions pertaining to the customers to a business office of the principal bank or another financial institution or another bank agent, etc., without any problems, and the customer notification method.

- (9) Measures to process complaints (Article 34-63(1)(ix) of the Banking Act Enforcement Regulation)

Whether the bank agent has developed a control environment for responding to complaints, such as specifying the contact point for customer complaints pertaining to bank agency services that the bank agent engages in, establishing a division in charge of processing complaints and prescribing procedures for processing complaints.

#### VIII-5-2-3 Points of Attention Regarding Inspection of the Registry of Bank Agent

When a depositor or another interested person requests inspection of the registry regarding a bank agent based on Article 52-60 of the Banking Act, it should be noted that a principal bank needs to comply with the request for inspection in principle. For such occasions, the regulator shall encourage the principal bank to show the registry online using the Internet where possible.

#### VIII-5-2-4 Points of Attention Considered Regarding a Case Where the Bank Agent is the Parent Company or a Major Shareholder of the Principal Bank

VII-1-6 and VII-2-3 apply mutatis mutandis to cases where the bank agent is the parent company or a major shareholder of the principal bank, when necessary, and in particular, whether the principal bank secures the appropriateness of the business operations of the bank agent should be fully examined.

## IX Electronic Payment Handling Services

### IX-1 Background

Electronic payment handling services refer to the business that (1) based on an entrustment from a bank, to come to an agreement with a depositor that has opened an account for deposits with the bank to carry out any of the following actions by a means that uses an electronic data processing system: (i) to transfer funds in that account, and decrease the amount of deposit claims by an amount equivalent to the amount of the transferred funds, or (ii) to increase the amount of deposit claims by an amount equivalent to the amount of funds received through a fund transfer transaction,; and to increase or decrease the amount of claims under a deposit contract based on the agreement, on behalf of the bank, and as (2) to provide intermediary services for concluding contracts for the acceptance of deposits on behalf of the bank referred to in the preceding item (hereinafter referred to as the "entrusting bank") in relation to the action listed in (1). Electronic payment handling service provider is those engaged in electronic payment handling services upon registration by the Prime Minister based on Article 52-60-4 of the Banking Act.

Amid the advancement of the fintech field, and along with the trend of separating the issuance function and the transferring function of digital money, required roles of regulation are to assure intermediaries of a certain degree of their independent activities and to enable them to cooperate and collaborate smoothly with multiple financial institutions. In light of the facts that electronic payment handling service providers, as intermediaries, increase or decrease the amount of each relevant deposit claim on behalf of relevant banks and that services relating to electronic payment handling services are important ones involving the rights and obligations of their customers, the regulator needs to request electronic payment handling service providers to develop systems for delivering their services properly, as well as to provide customers with information, etc. from the perspective of customer protection.

### IX-2 Key Principles

#### IX-2-1 Key Principles concerning Supervision of Electronic Payment Handling Service Providers

The registration system for electronic payment handling services is to impose necessary regulations to assure intermediaries of a certain degree of their independent activities and to enable them to cooperate and collaborate smoothly with multiple financial institutions along with the trend of separating the issuance function and the transferring function of digital money. Accordingly, the framework of supervising electronic payment handling services should not adopt the principal system under the license system, but should adopt a system to ensure the appropriateness and legality of the services by requiring these service providers to have a certain financial basis and comply with restriction on acts under the registration system.

In electronic payment handling services, prompt alignment of books between a bank and an electronic payment handling service provider is necessary so that the bank can identify relevant depositors and the

respective amounts of their deposits. In this way, electronic payment handling service providers are positioned between users and banks, and increase or decrease the respective amounts of deposit claims on behalf of relevant banks. Accordingly, they are required to secure the stability of their systems in order to protect users.

For this reason, in supervising electronic payment handling service providers, the FSA focuses on the main risks and conducts monitoring from the perspective of customer protection. In particular, such monitoring will focus on their IT system risk management frameworks and their efforts to protect users, and thereby the regulator will encourage electronic payment handling service providers to provide services that contribute to improving the convenience of payment services while also ensuring the stability of their systems and the protection of customers.

## IX-2-2 Key Principles concerning Administrative Processes related to Supervision

### (1) Supervisory approaches

The supervisory authority's continuous monitoring starts with accurate profiling of electronic payment handling service providers and identification of their issues to be addressed. Then, depending on the nature and priority of those issues, the authority chooses among and flexibly uses various monitoring methods (including on-site inspection) and follows up on the progress of the improvement.

Which monitoring method is effective will depend on the target electronic payment handling service provider's actual circumstances. In addition, which to use should be determined after fully considering the effectiveness of each monitoring method in the given situation, workload burdens of both the supervisory authority and the electronic payment handling service provider, and the urgency of the issues. In general, what comes first is to conduct monitoring through analyses of the electronic payment handling service provider's business performance, financial performance, annual fact-finding surveys concerning money laundering risk and measures for terrorism financing, etc. or through interviews with the electronic payment handling service provider's personnel and its stakeholders within and outside the electronic payment handling service provider. On this occasion, whether or not the electronic payment handling service provider's business is sound and appropriate for the time being is judged based on the analysis findings. After this step, whether or not to conduct on-site inspection under Article 52-60-21 of the Banking Act will be determined.

For specific implementation, the monitoring will be based on the description in IX-2-1 above while also taking into account supervisory viewpoints in these Supervisory Guidelines as supplements or amplification. The supervisory authority will also take account of the discussion content in the industry so as to have dialogues smoothly with these providers.

### (2) Cooperation between supervisory departments

#### (i) Cooperation between the FSA and respective Local Finance Bureaus

The FSA and respective Local Finance Bureaus need to properly share information that is recognized as necessary to supervise electronic payment handling service providers so as to share what they see as problems. Therefore, these supervisory authorities should endeavor to strengthen their cooperation, such as by mutually providing information timely and appropriately and exchanging opinions actively about information, etc. except for coordination, etc. related to internal delegation as listed in (3) below. In addition, among respective Local Finance Bureaus, when a Local Finance Bureau identifies a non-public problem or the like about an electronic payment handling service provider who is under the administration of another Local Finance Bureau, it should timely provide the administering Local Finance Bureau and the FSA with relevant information and endeavor to strengthen their cooperation.

(ii) Contact and coordination with the Director-General of Local Finance Bureau

When a Local Finance Bureau invokes an administrative disposition to an electronic payment handling service provider who is under its administration, it should promptly contact and report the details of such disposition to the Director-General of another relevant Local Finance Bureau, who administers the area where the business office of the electronic payment handling service provider is located.

(3) Internal delegation of part of the authority of the Director-General of Local Finance Bureau to the director, etc. of the competent finance office

When the main business office (referring to the “main business office” stipulated in Article 34-63-5 of the Banking Act Enforcement Regulation; the same applies hereinafter) of the registration applicant or the electronic payment handling service provider is located within the jurisdictional district of either the local finance office or Otaru sub-office, or Kitami sub-office, among the authorities delegated to the Director-General of Local Finance Bureau, the authority to receive the written notifications, applications and reports submitted by the registration applicant or the electronic payment handling service provider can be delegated internally to the director of the local finance office or sub-office, according to the judgment of the Director-General. Written notifications, etc. regarding these matters should be submitted to the Director-General of Local Finance Bureau administering the area where the main business office of the registration applicant or the electronic payment handling service provider is located.

(4) Coordination with the FSA

The Director-General of Local Finance Bureau should coordinate in advance with the FSA with regard to the following matters (which does not preclude the coordination with the FSA with other matters on an as-needed basis), regarding the authority over which is delegated to them as a matter of supervisory process concerning electronic payment handling service providers. It should be noted that the Director-General should report the results of the deliberations made by their bureau and express opinions thereof in the coordination.

- (i) Business improvement orders under Article 52-60-22 of the Banking Act
  - (ii) Revocation of registration or business suspension orders based on Article 52-60-23(1) of the Banking Act
- (5) Administrative report
- (i) The Director-General of Local Finance Bureau should report to the FSA, without delay, the content of supervision of electronic payment handling service providers if the content falls under any of the following cases (A) to (E). In addition, if the content falls under the following case (F), the Director-General of Local Finance Bureau should report the content to the FSA without delay and send the relevant materials to other finance bureaus. In doing so, the Director-General should also report and send the materials related to the names of persons working as officers within 30 days before the revocation.
    - (A) Case where the Director-General of Local Finance Bureau has registered under Article 52-60-5(1) of the Banking Act
    - (B) Case where the Director-General of Local Finance Bureau has received a notification of discontinuance of business, etc. pursuant to Article 52-60-36(1) of the Banking Act
    - (C) Case where the Director-General of Local Finance Bureau has asked for submission of reports or materials under Article 52-60-20(2) of the Banking Act
    - (D) Case where the Director-General of Local Finance Bureau has issued a business improvement order under Article 52-60-22 of the Banking Act
    - (E) Case where the Director-General of Local Finance Bureau has ordered the suspension of the services under the provisions of Article 52-60-23(1) of the Banking Act
    - (F) Case where the Director-General of Local Finance Bureau has revoked the registration under the provisions of Article 52-60-23(1) of the Banking Act
  - (ii) Written business reports based on Article 52-60-19(1) of the Banking Act
 

In preparing written business reports, the following points should be noted:

    - (A) After examining the reported content with reference to matters confirmed at the time of registration filing, such as the management plan and the finance plan, in a case where the regulator finds any substantial discrepancy between them, he/she should check the actual management conditions through the hearing from the electronic payment handling service provider.
    - (B) As a result of the checking, in the case where there is any possibility that the target provider “does not have a financial basis that satisfies the criteria specified by Cabinet Office Order as those found to be necessary for performing electronic payment handling services in a proper and reliable manner,” the regulator should consider necessary measures such as collecting relevant written reports based on Article 52-60-33 of the Banking Act.
  - (iii) Sending to the FSA

- (A) Reports concerning electronic payment handling service providers to be sent as needed
- The following should be sent to the FSA's relevant division within one month after the submission deadline: a duplicate copy of the written report concerning management of users' property and a copy of each reference document, and if there is any electronic payment handling and other similar service provider who attaches its opinion, the relevant document that describes the electronic payment handling service provider's opinion regarding (ii) above.
- (B) Regular reporting concerning electronic payment handling service providers
- a. The Director-General of Local Finance Bureau should collect the annual business report as of the end of March from each electronic payment handling service provider by the end of May every year pursuant to Article 62-20(1) of the Banking Act.
  - b. A copy of such business report from each electronic payment handling service provider should be sent to the FSA's relevant division by the end of June every year.
- (C) Submission of the registration status list concerning electronic payment handling service providers
- a. The registration status list of all registered electronic payment handling service providers should be updated whenever new registration is made, and the updated list should be sent to the Director-General of the FSA's Supervision Bureau within 20 days after the 6th month.
  - b. The list must include the following entries:
    - Name of each registered electronic payment handling service provider
    - Registration number
    - Date of registration
    - Date of discontinuation
    - Telephone number and email address of each registered electronic payment handling service provider
    - Type of concurrent business

- (6) Points to note in preparation of written applications and written notifications submitted by electronic payment handling service providers

It should be noted that, when entering the names of directors or officers in written applications or written notifications submitted by an electronic payment handling service provider, the current name of a person who has changed his/her surname may be accompanied by his/her old name in parentheses.

### IX-3 Information Technology (IT) System Risk

In supervising electronic payment handling service providers, III-3-7-1 is applied mutatis mutandis. Also,



depending on attributes of services and systems, the following supervisory viewpoints should be especially noted.

In this regard, however, even in a case where an electronic payment handling service provider has not taken measures literally as described in III-3-7-1 and the following supervisory viewpoints, if the electronic payment handling service provider is recognized as having no particular problem in light of its size and attributes, the provider does not need to be judged as being unsuitable from the perspective of customer protection.

#### IX-3-1 Main Supervisory Viewpoints

##### (1) Response measures to attributes of services and systems

- (i) In the case where an electronic payment handling service provider has advanced and complex IT systems linked to various services and systems, in addition to what is described in III-3-7-1-2 (3)(i), whether the electronic payment handling service provider includes the following risk in its IT system risk:
  - Risk incurred by using external services;
  - Risk incurred by connecting with API, etc.;
  - Risk incurred by linking with various services and systems, such as a response measure to cope with its rapidly increased transactions, and so on

(Note) It is desirable to use objective benchmarks as a basis for identifying IT system risk in a comprehensive manner. For example, in terms of the connection with banking systems, the standards shown by The Center for Financial Industry Information Systems (API Connection Checklist Manual) may be used as reference.

- (ii) Whether the IT system risk management division identifies and manages the upper limit of the transactions through the computer system, such as the number of feasible transactions per day, and whether it reviews the countermeasures from the IT system aspect and the administrative work aspect in cases where the transactions exceed the upper limit.

It should be noted that the said division also needs to identify the upper limit with the relevant contacts such as banks, and to review the countermeasures collaborating with those contacts in cases where the transactions exceed the upper limit.

- (iii) Whether the user division cooperates with the IT system risk management division at the time of introduction of a new service or alternation of the content of an existing service, and whether the IT system risk management division evaluates the relevant IT system regardless of whether the system is newly developed or not.
- (iv) In addition to the matters described in III-3-7-1-2(6), in a case where an electronic payment handling service provider links its system with a system of a bank or any other company, or in a case where many users are expected to use the electronic payment handling service system, whether the electronic payment handling service provider has formulated and properly

implemented rules and policies, etc. including the following points in order to ensure the quality of the entire systems.

- Establish a policy to conduct tests in order to ensure quality.
- In managing its system performance capacity, formulate a plan that assumes a rapid increase in its transactions based on relevant cases of other companies and set up the threshold (including cases where the number of transactions is anticipated to temporarily increase, such as launching a large-scale sales promotion campaign).
- Establish monitoring points, monitor and, as needed, control the loading condition by taking into account the limit of performances and capacities of various resources.
- Identify the respective upper limits of relevant systems, including linked systems with banks, etc., at the time of development of such systems, and so on.

In addition, whether the electronic payment handling service provider sets and verifies the test scenarios based on the operation environment of the user side with regard to new services provided, changes in the relevant bank's API specification, and changes in the authentication system.

- (v) In addition to the matters described in III-3-7-1-2(9)(i) and (v), for emergency situations, whether the electronic payment handling service provider has developed an appropriate communication system with the relevant bank and important outsourcing contractors, etc. (including any external service provider and any linked system counterparty), and whether it considers holding any joint training session with the relevant bank or any other linked system counterparty based on its contingency plan, taking the importance and relevant risks into consideration.

Moreover, based on such training results, whether it reviews its contingency plan as needed.

- (vi) Whether the electronic payment handling service provider performs a risk evaluation in terms of influence spread, for example, by understanding how effects of partial system failures spread and identifying a single point of failure that cannot be circumvented, in order to mitigate the effects of system failures, in addition to coping with the matters described in III-3-7-1-2(10)(vii). And whether the electronic payment handling service provider considers establishing a service system mechanism for minimizing the damage to users by using a cloud service mechanism properly to mitigate risks.

(2) Response measures to external services such as a cloud service

- (i) In addition to the matters described in III-3-7-1-2(4)(iv), in identifying important user information, whether the electronic payment handling service provider includes data transferred or forwarded to subcontractors and linked system counterparties in its target coverage.
- (ii) In addition to the matters described in III-3-7-1-2(8)(ii), when selecting and using external services such as a cloud service, whether the electronic payment handling service provider

properly assesses the safety of information security on the basis of its attributes. Also, whether it considers risk suitable for the service(s) to be used and takes the relevant measure(s).

For example, whether the electronic payment handling service provider implements the following:

- Identify the base that processes and stores important information.
- Include the audit and monitoring authorities, etc. in the relevant contract.
- Check and evaluate guarantee reports and third-party certificates.
- Identify cloud service-specific risk.
- Assess security risk (including the risk inherent in the authentication function), and so on.

(iii) Whether the electronic payment handling service provider makes efforts to establish its communication system between the electronic payment handling service provider and its cloud service provider so as to prepare for potential failure in the cloud service, in addition to coping with the matters described in III-3-7-1-2(10)(ii). The electronic payment handling service provider is required to recognize the importance of considering the measures to be taken and timely and appropriate calling of attention to users in such cases.

(3) Response measures for transactions via communication methods such as the internet without any face-to-face contact

(i) Whether the electronic payment handling service provider has introduced an appropriate authentication system that matches risk of the following transactions as examples, in addition to the cases in III-3-7-1-2(5)(vii).

(A) Authentication methods that do not rely on fixed IDs/passwords alone, such as variable passwords, biometric authentication, digital certificates and other multi-factor authentication that combines effective factors

(B) Adoption of passwords for transactions, which are different from log-in passwords (It is important not to allow users to set the same passwords.)

In addition, whether the electronic payment handling service provider recognizes and assesses risks regularly and timely in light of changes in internal and external environments as well as the state of accident/incident occurrence and reviews its authentication method as needed.

(ii) Whether the electronic payment handling service provider has taken anti-fraud measures suitable for its services, such as the following as examples, in addition to the matters described in III-3-7-1-2(5)(viii):

- Blocking-off of communication from any unauthorized IP address;
- Measures to encourage users to introduce or update security software that allows them to detect and remove viruses, etc.;
- Development of systems/structures to detect unauthorized log-ins/irregular transactions, etc. and promptly inform the relevant users;

- Suspension of use of IDs that are confirmed as being unauthorized;
  - Display of the previous log-in (log-off) time and date on the screen;
  - Notification to each user at the time of transaction, and so on.
- (iii) Whether the electronic payment handling service provider has taken measures related to security at the system design/development stages, including the following, in addition to the matters described in III-3-7-1-2(6):
- Clarification of specific security requirements;
  - Measures to prevent the occurrence of vulnerable points, such as implementing secure coding, security design based on the entire services including linked parts in the case where the electronic payment handling service provider links its system with any other company's system, and so on.

#### IX-4 Legal Compliance (for Especially Important Matters)

Supervisory methods and measures related to verification at the time of transaction, obligation for reporting of suspicious transactions and elimination of relations with antisocial forces should be based on III-3-1 as well as on the following (1) and (2). In addition, related to prohibited acts, the following (3) and (4) should be noted.

- (1) If the inspection result finds that a misconduct notification or the like has revealed a problem relating to an electronic payment handling service provider's internal control environment for ensuring the fulfillment of obligation of verification at the time of transaction and obligation for reporting of suspicious transactions, or to its structure to ban any relations with antisocial forces, the FSA requires the electronic payment handling service provider to submit reports based on Article 52-60-20 of the Banking Act when necessary. If a serious problem is found, the FSA issues a business improvement order based on Article 52-60-22 of the Banking Act.
- (2) Moreover, if an electronic payment handling service provider violates laws and regulations, including the obligation of verification at the time of transaction and obligation for reporting of suspicious transactions, or an electronic payment handling service provider is deemed to have significantly harmed public interest, the FSA issues a business suspension under Article 52-60-23 of the Banking Act. The same will apply to cases where an electronic payment handling service provider, who recognizes the relationship with antisocial forces, has not taken proper actions and is found to have violated laws and regulations or to have significantly harmed public interest.
- (3) Prohibition of deposit of money, etc. / Segregation management of property (Article 52-60-13 of the Banking Act / Article 34-63-26 of the Banking Act Enforcement Regulation)

Whatever the pretext is, each electronic payment handling service provider must not receive a

deposit of money or any other property from any customer, or must not have the person closely related to the electronic payment handling service provider (Article 16-8-2 of the Banking Act Enforcement Regulation) deposit any customer's money or any other property related to the electronic payment handling services that the electronic payment handling service provider engages in, except for cases prescribed in Article 34-63-26 of the Banking Act Enforcement Regulation.

In a case where an electronic payment handling service provider receives a deposit of money related to its electronic payment handling services, the electronic payment handling service provider must segregate the money from its own property to execute segregation management immediately after the receipt of the deposit. It also must deliver the money to its entrusting bank (Article 34-63-26(4) of the Banking Act Enforcement Regulation).

- (4) With regard to a control environment that prevents prohibited acts as prescribed in Article 52-60-16 of the Banking Act, attention should be paid to the points listed below.
  - (i) Whether the electronic payment handling service provider establishes a division or appoints a person responsible for implementing measures for preventing prohibited acts. Also, whether the electronic payment handling service provider develops a control environment for examining whether such division or person has properly implemented measures for preventing prohibited acts.
  - (ii) Whether the electronic payment handling service provider establishes internal rules on a system for implementing training required to prevent prohibited acts and a system for dealing with complaints from customers and disseminates these rules within the organization.
  - (iii) In order to prevent prohibited acts, whether the electronic payment handling service provider conducts training, on a regular and as-needed basis, by a person who has knowledge and practical experience of laws and regulations pertaining to electronic payment handling services.
  - (iv) Whether the electronic payment handling service provider has established a control environment for responding to complaints, such as specifying the contact point for customer complaints regarding prohibited acts, establishing a division in charge of processing complaints and prescribing procedures for processing complaints.

#### IX-5 Provision of Information and Consultation Function for Protection of Users

Based on Article 52-60-11(2) of the Banking Act as well as Article 34-63-13 to 34-63-22, and Article 34-63-28 of the Banking Act Enforcement Regulation, supervisory measures regarding the electronic payment handling service provider's provision of information and consultation function, etc. for protection of users should be taken in accordance with III-3-3 and the following:

- (1) Customer information should be basically managed in accordance with III-3-3-3. If an electronic payment handling service provider concurrently engages in other businesses, the electronic payment

handling service provider should pay attention to whether it has developed methods and systems for properly managing customer information (including establishing internal rules regarding separation of organizations and persons in charge, installation of information barriers in terms of equipment and systems, blockade of information, conducting employee education and training, etc.) in order to prevent the customer information obtained through its electronic payment handling services from being used for its concurrent business without the customer's prior consent.

- (2) As for the customer's prior consent (described in Article 34-63-19 of the Banking Act Enforcement Regulation), particularly, with regard to treatment of non-public financial information and non-public information (note that information on customer attributes (name, residential address, telephone number, sex, birthdate and occupation) is personal information, but is not included in non-public financial information and non-public information), it is necessary to confirm whether the electronic payment handling service provider has taken measures in order to obtain the customer's prior consent by appropriate methods, such as a method of displaying the relevant information on the screen of the customer's electronic device using the Internet.

#### IX-6 Rules, etc. for User Protection

- (1) Coordination with an entrusting bank

One of the services that an electronic payment handling service provider offers may be a service that is coordinated with account transfer service by a bank (hereinafter referred to the "electronic payment handling coordinated service"). While this electronic payment handling coordinated service has the potential to become a highly convenient service for users of electronic payment handling services, it may have inherent risks, differing from services that are completed by an electronic payment handling service provider alone. For example, a malicious third-party may pretend to be a depositor of such a coordinated deposit account and execute a fraud transaction through the electronic payment handling coordinated service. Moreover, along with the progress in technological innovation, such coordination among service providers is likely to increase, and risks associated with such coordination may rise in the future.

Based on the above, it is important for electronic payment handling service providers to establish a control environment to cope with the above-mentioned risks in cooperation with their coordination partners, from the perspective of the proper and reliable performance of electronic payment handling services, including the protection of interest of users of electronic payment handling service providers and those of their coordination partners. In supervising electronic payment handling service providers who offer the electronic payment handling coordinated service, the FSA will pay close attention to IX-3 and will also refer to II-2-5 in "14 Guideline for Supervision of Funds Transfer Service Providers" for Administrative Processes Part III: Concerning Financial Companies.

- (2) Obligation to conclude a contract with an entrusting bank (Article 34-63-27 of the Banking Act Enforcement Regulation)
- (i) Each electronic payment handling service provider should conclude a contract which stipulates matters regarding the sharing of compensation liability between the electronic payment handling service provider and its entrusting bank to prepare for cases where a customer suffers damage in their electronic payment handling coordinated service. Based on the contract, the electronic payment handling service provider must engage in its electronic payment handling services relevant to its entrusting bank. For example, the contract may set forth the following matters:
    - (A) Contact point for any relevant customer to file his/her damage
    - (B) Criteria and procedure for compensation in cases where compensation is made (information to be received from the user in question, judgement as to whether or not the alleged negligence exists)
    - (C) Compensation method in cases where compensation is made (including the person or persons to make compensation, how to calculate the damage)
    - (D) Compensation coverage in cases where compensation is made
    - (E) Claim for compensation in cases where one of the parties has made compensation (sharing of the damage)
  - (ii) In addition, each electronic payment handling service provider should conclude a contract with its entrusting bank, which sets forth necessary matters for the electronic payment handling service provider to promptly provide the entrusting bank, upon the bank's request, with information necessary for the entrusting bank to identify relevant depositors. (Such matters include the frequency and timing to provide the information.) Based on the contract, the electronic payment handling service provider must engage in its electronic payment handling services relevant to its entrusting bank. As for necessary information for the entrusting bank to identify any depositor relevant to the liability for the bank to bear, conceivable examples include the transaction records as prescribed in Article 34-63-61(1)(ii) and information related to the documents as prescribed in Article 34-63-61(1)(iii). It should be noted that the information needs to be handled based on III-3-3-3.

## IX-7 Others

### IX-7-1 Measures to Ensure Precise Execution of Entrusted Business (Article 34-63-20)

Each electronic payment handling service provider should basically conform to III-3-3-4 in the case where it entrusts a third party with part or whole of its services. It should be noted that the electronic payment handling service provider must take measures to ensure precise execution of entrusted business, matching the content of its entrusted business.

#### IX-7-2 Prohibition of Name-Lending

When judging whether the use of a name corresponds to “the name of that electronic payment handling service provider” prescribed in Article 52-60-10 of the Banking Act, it should be noted the use of a name corresponds to “the name of that electronic payment handling service provider” even if, for example, the electronic payment handling service provider permits the use of the abbreviated name of the electronic payment handling service provider.

#### IX-7-3 Special Provisions concerning Electronic Payment Services Involving Entrusting Banks, etc.

An electronic payment handling service provider may engage in electronic payment services involving its entrusting bank only when a customer of its electronic payment handling services entrusts it with such agency services who has opened a deposit account with the entrusting bank. In this case, provisions from X-1 to X-5 are applied *mutatis mutandis*.

#### IX-8 Application *Mutatis Mutandis* of the Supervisory Guidelines

For supervision over electronic payment handling service providers, in addition to the matters set forth below, the above sections II and III as well as the Forms and Reference Information are timely applied *mutatis mutandis*, if necessary.

- (1) Concerning electronic payment handling service providers, II-1-1 is applied *mutatis mutandis* to the inspection and supervisory processes, III-1-2 is applied *mutatis mutandis* to specific methods for the inspection and supervisory processes, III-1-3 is applied *mutatis mutandis* to quality control, II-2 is applied *mutatis mutandis* to grievance and provision of information, II-3 is applied *mutatis mutandis* to responding to inquiries about interpretation and application of laws and regulations, and II-4 is applied *mutatis mutandis* to points to note in providing administrative guidance or implementing equivalent actions, respectively.
- (2) Regarding the coordination with inspection by the Deposit Insurance Corporation of Japan concerning electronic payment handling service, II-1-5 is applied *mutatis mutandis*.
- (3) When invoking an administrative disposition to electronic payment handling service providers, II-5 is applied *mutatis mutandis*.



## X Electronic Payment Services

### X-1 Purpose and Significance

Amid the accelerating development of fintech on a global scale, the registration system for electronic payment service providers was introduced as an institutional framework for promoting open innovation through cooperation and collaboration between financial institutions and fintech companies while securing the protection of users, and enforced as of June 1, 2018, under the Banking Act for the Partial Amendment of the Banking Law (Act No. 49 of 2017, referred to as the “Amendment Act” in the following X-2-2(1)).

Electronic payment service providers are expected to serve as a center that expands services based on the needs of users and to achieve innovation in financial services agilely while securing the protection of users and the stability of the system.

### X-2 Key Principles

#### X-2-1 Key Principles in Supervising Electronic Payment Service Providers

The registration system for electronic payment service providers is different from other finance-related systems and requires only that the amount of net assets not be negative on a financial basis, and does not ask for staffing requirements. The conditions for new entry are set very low and the system design is implemented assuming that individuals, and micro, small, and medium-sized enterprises will apply for registration. The main purport is to encourage various participants, including IT companies, to promote innovation in financial services. From the perspective of protecting users, the regulation is reduced to the required minimum.

On the other hand, electronic payment services are located between users and banks, give instructions for settlement, acquire account information and provide it to customers. Therefore, the stability of the system is needed to secure the protection of users.

Thus, from the perspective of protecting users, when supervising electronic payment service providers, major risks should be focused on, and the efforts to improve the system along with business expansion, should be monitored.

Electronic payment services are basically engaged in business operations using information technology (IT), and their major risk is IT system risk. In addition, since there are risks associated with cooperation between electronic payment and other agency services and banks (in addition, there are cases where an electronic payment and other agency service subcontractor intervenes), efforts to protect users among providers are also important. In supervising electronic payment service providers, monitoring should be given mainly to the control environment for managing IT system risk and for measures to secure the protection of users, and the electronic payment service providers should take the lead in advancement of technology and be encouraged to provide services contributing to improvement of user convenience while

securing the stability of the system and the protection of users.

## X-2-2 Key Principles in the Administration of Supervision

### (1) Supervisory approaches

The supplementary resolution of the Amendment Act requires that report requests and inspections not inhibit the activities and innovation of relevant enterprises, etc. from the perspective of helping to encourage various participants, including IT companies, to promote innovation in financial services, amid the rapid development of fintech. From the perspective of easing the burden on businesses in light of the above and based on the large number of small businesses and the business characteristics of not keeping money from users, while taking care to avoid mechanical and uniform operation, off-site monitoring, in principle, should be given to IT system risk, which is one of the major risks and status of efforts to secure the protection of users.

### (2) Cooperation between supervisory departments

In cases where a registered electronic payment service provider submits a notification based on the Shinkin Bank Act and engages in electronic payment services for a Shinkin bank, and its supervisory department finds a problem in the business operations of the electronic payment service provider, including the control environment for managing IT system risk, the supervisory department of the registered electronic payment service provider should reduce the paperwork burden on the electronic payment service provider by cooperating closely with the supervisory departments of the electronic payment service providers for Shinkin banks, including informing the relevant department of the situation of the problem without delay.

Information should be provided without delay, regardless of the method.

### (3) Internal delegation of part of the authority of the Director-General of Local Finance Bureau to the director-general of the competent finance office

When the principal office or other office of the electronic payment service provider is located within the jurisdictional district of the local finance office or branch office, the authority delegated to the Director-General of Local Finance Bureau can be delegated internally to the director-general of the finance office or the head of the branch office, according to the judgment of the director-general.

Written applications and notifications under laws and regulations should be submitted to the Director-General of Local Finance Bureau.

### (4) Coordination with the FSA

The Director-General of Local Finance Bureau should coordinate in advance with the FSA with regard to the following matters (which does not preclude the coordination with the FSA with other matters on an as-needed basis), the authority over which is delegated to them as a matter of supervisory process concerning electronic payment service providers. It should be noted that the

directors-general should report the results of the deliberations made by their bureau and express opinions thereof in the coordination.

- (i) Business improvement orders under Article 52-61-16 of the Banking Act
- (ii) Revocation of registration or business suspension orders based on Article 52-61-17(1) of the Banking Act

(5) Administrative report

The Director-General of Local Finance Bureau should report to the FSA the situation of the electronic payment service providers as of the end of each quarter by the 20th day of the following month.

Moreover, the Director-General of Local Finance Bureau should report to the FSA, without delay, the content of supervision of electronic payment service providers if the content falls under any of the following cases (i) to (v). In addition, if the content falls under the following case (vi), the director-general of the local finance bureau should report the content to the FSA, without delay, and send the relevant materials to other finance bureaus. In doing so, the director-general should also report and send the materials related to the names of persons working as officers within 30 days before the revocation.

- (i) Case where a registration under Article 52-61-4(1) of the Banking Act has been applied for
- (ii) Case where a notification of discontinuance of business, etc. under Article 52-61-7(1) of the Banking Act has been received
- (iii) Case where a submission of reports or materials has been requested under Article 52-61-14 of the Banking Act
- (iv) Case where a business improvement order under Article 52-61-16 of the Banking Act has been issued
- (v) Case where a business suspension order under the provisions of Article 52-61-17(1) of the Banking Act has been issued
- (vi) Case where a registration under the provisions of Article 52-61-17(1) of the Banking Act has been canceled

(6) Points to note in preparation of written applications and written notifications submitted by electronic payment service providers

When entering the names of directors or officers in written applications or written notifications submitted by an electronic payment service provider, the current name of a person who has changed his/her surname may be accompanied by his/her old name in parentheses.

X-3 Information Technology (IT) System Risk

X-3-1 Background

- (1) Information technology (IT) system risk is the risk that users and electronic payment service providers and banks will incur losses because of a computer system breakdown due to a programming error, vulnerability or other inadequacies, or because of malfunction, or the risk that users and electronic payment service providers and banks will incur losses because of inappropriate or illegal use of computer systems. Electronic payment service providers are required to address various challenges related to IT systems in a clear-cut way, mainly due to expanded provision of new products and services. If electronic payment service providers were to have system failures and cybersecurity incidents (hereinafter referred to as “system failures”), there might be problems that would not only impair availability in users’ socioeconomic life and the economic activities of companies but also that would have serious effects on the protection of users. Therefore, it is important for the electronic payment service provider who performs auxiliary functions for settlement systems to enhance and reinforce the control environment for managing IT system risk.
- (2) However, even if an electronic payment service provider does not literally comply with what is written in the following viewpoints, with due consideration for the scale and business nature of the electronic payment service provider, or in case where only the system of the electronic payment service provider stops, users can issue remittance instructions or acquire account information if they use the bank’s system directly, without passing through the system of the electronic payment service provider. In light of this, it is not necessary to require the electronic payment service provider to improve its system immediately, if no significant problems, such as erroneous money transfer, have been found from the standpoint of user protection.

Or even if the electronic payment service provider alone cannot, in light of its capability, meet some part of the necessary standards for electronic payment services in which it engages, the electronic payment service provider is judged to meet the necessary standards if the bank that cooperates and collaborates in performing the services shares the part (however, if the electronic payment service provider newly cooperates and collaborates with another bank, it should be noted whether the bank can share the part).

(Note) "Cybersecurity incidents" refer to instances of cybersecurity being threatened by so-called “cyberattacks” including unauthorized intrusion, theft, modification and destruction of data, failure or malfunction of information systems, execution of illegal computer programs and DDoS attacks, committed via the internet through malicious use of information communication networks and information systems.

#### X-3-2 Major Supervisory Viewpoints

- (1) IT system risk management
  - (i) Whether the division in charge of managing IT system risk recognizes and assesses risks

periodically and in a timely manner by recognizing the fact that impacts are more complicated and extended as seen in the examples of system failures induced by large-scale transactions as a result of increased services and efforts to enhance information networks.

In addition to undertaking regular review, when providing new services (including making changes seriously affecting users, conducting large-scale sales promoting activities not accompanied by system changes), whether the division conducts review of each new service.

- (ii) Whether the electronic payment service provider recognizes measures to prevent damage from spreading during system failures and rapid recovery from such failures as an important managerial issue and provides a system to handle failures.

In particular, whether the electronic payment service provider recognizes the prevention of cybersecurity incidents as an important managerial issue and provides a system to prevent them.

- (iii) When system failures that may significantly affect business operations occur, whether the electronic payment service provider reports the failures swiftly to the persons responsible for the business operations.

In addition, whether it is prepared to launch a task force and consider developing a system to seek resolution of the issue in a swift manner.

- (iv) Whether the management works out and carries out plans on technological improvements required to continue business operations including the inheritance of the current system structure and development technology.
- (v) Whether the electronic payment service provider sets and verifies the test scenarios based on the operation environment of the user side with regard to new services provided, changes in the bank's API specification, and changes in the certification system.
- (vi) Whether the electronic payment service provider uses objective benchmarks as a basis for the development and revision of its control environment for managing IT system risk, including evaluations by a third party and the standards shown by the Center for Financial Industry Information Systems concerning the contents of such development and revision. Also, whether the electronic payment service provider revises, on a continual basis, its control environment for managing IT system risk according to identification and analysis of system failures, results of implementation of risk management, progress of technology, etc.

## (2) Management of information security

- (i) Whether the electronic payment service provider has developed a policy, prepared organizational readiness, introduced in-house rules, and developed an internal control environment in order to appropriately manage information assets, and whether it regularly revises these policies, rules, and control environment. Also, whether it makes continuous efforts to improve its information security control environment through the PDCA cycle, taking notice of illegal cases at other companies.
- (ii) Whether the electronic payment service provider manages information security by designating

individuals responsible for business execution related to safety management of information assets and clarifying their roles/responsibilities in efforts to maintain the confidentiality, integrity and availability of information. Also, whether the individuals are responsible for the business execution tasked to handle the security of IT systems, data, and network management.

- (iii) Whether the electronic payment service provider takes measures to prevent unauthorized use of computer systems, unauthorized access, and intrusion by malicious computer programs such as computer viruses.
- (iv) Whether the electronic payment service provider identifies, in a comprehensive manner, the important user information that the electronic payment service provider should be responsible for, keeps its records, and manages them. In identifying important user information, whether the electronic payment service provider considers setting business operations, IT systems, outsourcing contactors, and subcontractors for the electronic payment service provider as the scope of protection when necessary.
- (v) Whether the electronic payment service provider assesses the importance and risks regarding important user information that has been identified.

Also, whether it has developed rules to manage information, such as those listed below, in accordance with the importance and risks of each type of information.

- Rules to encrypt or mask information;
- Rules for utilizing information; and
- Rules on handling data storage media, etc.

- (vi) Whether the electronic payment service provider has introduced measures to discourage or prevent unauthorized access, unauthorized retrieval, data leakage, etc. such as those listed below, for the important user information that has been identified.
  - Provision of access rights only to employees who need to access according to their authority;
  - Storage and monitoring of access logs; and
  - Introduction of mutual checking functions such as by separating the individuals in charge of development and those responsible for operations, or system administrators and system users, etc.
- (vii) Whether the electronic payment service provider has introduced rules for controlling confidential information, such as encryption and masking. Also, whether it has introduced rules regarding the management of encryption programs, encryption keys, and design specifications for encryption programs. Moreover, whether it has set rules to manage information in accordance with the importance of information.

Note that "confidential information" refers to any information, which may cause damage or loss to users if it is disclosed or stolen, such as passwords, tokens, etc.

- (viii) Whether the electronic payment service provider gives due consideration to the necessity of holding/disposing of, restricting access to, and taking outside, confidential information, and treats such information in a strict manner.

- (ix) Whether the electronic payment service provider periodically monitors its information assets to see whether they are managed properly according to management rules, etc. and reviews the control environment on an ongoing basis.
- (x) Whether the electronic payment service provider conducts security education (including confirmation of whether security education has been conducted at outsourcing contractors) to all officers and employees in order to raise awareness of information security.
- (xi) When selecting and using one from among cloud services provided by third-party organizations, whether the electronic payment service provider properly assesses the safety of information security on the basis of its characteristics.
- (xii) Whether the bank has taken measures to comply with Article 12 of the Financial Sector Personal Information Protection Guidelines and other applicable provisions with regard to the provision to third parties of the personal data which is acquired concerning the electronic payment services. In particular, whether the electronic payment service provider obtains consents from individual users while paying attention to the following points according to the nature and methods of the business.
  - (a) When obtaining consent from an individual user for the provision of his/her information to a third party in a non-face-to-face manner such as via smartphone, etc., whether the electronic payment service provider has prepared it so that individual users can easily understand and consent to the content and purpose of use of information provided to such third party by making it more user-friendly in terms of the text of consent, font size, screen specifications, manner of giving consent, etc. in accordance with Article 3 of the Financial Sector Personal Information Protection Guidelines.
  - (b) Even in the case where the electronic payment service provider has obtained consent for the provision of personal information to a third party from an individual user in the past, if the third party to which the information is provided or the content of information to be provided is different from the past case or if the scope of provision of such information exceeds the necessary extent to achieve the purpose of utilization specified before, whether the electronic payment service provider obtains consent from such individual user again.
  - (c) In cases where personal information is provided to multiple third-party contractors or where the purpose of use of personal information varies at each third-party contractor, whether the electronic payment service provider properly considers how and when to obtain the users' consent so that individual users can understand the fact that their information will be provided to multiple third parties, as well as the purpose of use at each third-party contractor. Also, whether an individual user is forced to give consent to the third parties beyond the reasonable scope of provision in terms of the third parties to which the personal information is provided, the purpose of use, or the content of information to be provided.

(3) Cyber security management

- (i) Whether the person responsible for the business operations has recognized the importance of cybersecurity amid increasingly sophisticated and cunning cyberattacks and introduced the necessary control environment.
- (ii) Whether the electronic payment service provider has introduced systems to maintain cybersecurity, such as those listed below, in addition to making the organization more secure and introducing in-house rules.
  - Monitoring systems against cyberattacks;
  - Systems to report cyberattacks and a public-relations system when attacks occur;
  - Emergency measures by an in-house Computer Security Incident Response Team (CSIRT) and systems for early warning; and
  - Systems of information collection and sharing through information-sharing organizations, etc.
- (iii) Whether the electronic payment service provider has introduced a multi-layered defense system against cyberattacks that combines security measures respectively for inbound perimeter control, internal network security control, and outbound perimeter control.
  - Security measures for inbound perimeter control (e.g., introduction of a firewall, anti-virus software, unauthorized intrusion detection system, unauthorized intrusion prevention system, etc.);
  - Security measures for internal network security control (e.g., proper management of privileged IDs/passwords, deletion of unnecessary IDs, monitoring of execution of certain commands, etc.); and
  - Security measures for outbound perimeter control (e.g., retrieval and analysis of communication/event logs, detecting/blocking inappropriate communication, etc.)
- (iv) Whether measures such as those listed below are implemented to prevent damage from expanding when cyberattacks occur.
  - Identification of IP addresses from which the cyberattacks originate, and blocking-off of attacks;
  - Functions to automatically decentralize access against DDoS attacks; and
  - Suspension of the system in whole or in part, etc.
- (v) Whether necessary measures for vulnerabilities in the system, such as updating of the operating system and application of security patches, are introduced in a timely manner.
- (vi) Whether the electronic payment service provider, as part of cybersecurity measures, assesses its security levels periodically by using relevant vulnerability scanning or penetration tests, etc. and makes efforts to improve security.
- (vii) Whether the electronic payment service provider has developed contingency plans against potential cyberattacks. And whether it conducts exercises and reviews such plans in order to



enhance security management.

(4) Management of outsourcing relating to IT system

- (i) Whether the electronic payment service provider, in selecting the outsourcing contractors, assesses them based on selection standards and gives careful consideration.
- (ii) Whether the electronic payment service provider, in entering an outsourcing contract with an outsourcing contractor, sets out division of roles and responsibilities with the contractor, supervising authority to audit outsourced work, subcontracting procedures, level of services provided, etc. in the contract. Also, whether the electronic payment service provider presents to the outsourcing contractor the rules and security requirements which all of its officers and employees are required to adhere to, and defines them in the contract, etc.
- (iii) Whether risk management is carried out properly in outsourced IT system work (including work further subcontracted)

In particular, in cases where the electronic payment service provider outsources its IT system work to two or more contractors, related administrative work becomes complicated and higher risk management is required. In this context, whether the electronic payment service provider has developed a control environment upon fully understanding such fact.

In cases where the electronic payment service provider outsources IT system-related administrative work to contractors, too, whether the electronic payment service provider properly manages the risk thereof in the same manner as outsourcing of IT system work.

- (iv) Whether the electronic payment service provider, as an outsourcer, periodically monitors whether outsourced work (including work further subcontracted) is carried out appropriately.

(5) Measures to prevent damage from spreading

- (i) Whether the electronic payment service provider considers taking appropriate measures to avoid causing unnecessary confusion among users (including measures to prevent the spread of damage) when system failures occur. In cases where only the system of the electronic payment service provider stops, users can issue remittance instructions or acquire account information if they use the bank's system directly, without passing through the system of the electronic payment service provider. In light of this, whether the electronic payment service provider is able to properly guide users and respond to consultation and inquiry from users.

Also, whether the electronic payment service provider makes efforts to establish its communication system between the electronic payment service provider and the cloud provider when some failure occurs in the cloud service. The electronic payment service provider is required to recognize the importance of considering the measures to be taken and timely and appropriate arousing of the attention to users in such cases.

- (ii) Also, whether it considers a control environment, upon assuming a worst-case scenario in preparation for system failures, to take necessary measures accordingly.

Whether the electronic payment service provider has introduced backup systems, etc. in advance, particularly for important systems whose failure could seriously affect business operations. And whether it has developed a control environment to address disasters and system failures so that normal business operations can be speedily brought back.

- (iii) Whether the electronic payment service provider considers analysis of causes of system failures that occurred, investigation about impact until recovery, corrective actions, and preventive measures for recurrence in a proper manner.
- (iv) Whether the electronic payment service provider performs a risk evaluation in terms of influence spread, for example, by understanding the spread of effects of partial system failures and a single point of failure that cannot be circumvented, in order to mitigate the effects of system failures. And whether the electronic payment service provider considers establishing a service system mechanism for minimizing the damage to users by using a cloud service mechanism properly to mitigate risks.

### X-3-3 Supervisory Methods and Measures after Registration

- (1) When a system failure related to electronic payment services has occurred
  - (i) Immediately after recognizing the occurrence of a system failure, etc., the electronic payment service provider is required to report the fact to the FSA.

In addition, the electronic payment service provider is required to report on causes of the system failure when they are identified and resolved upon recovery of the system. However, even in cases where the causes are not identified, the electronic payment service provider is required to report the current situation within one month from the occurrence of the system failure.

In particular, when a system failure that has a great impact on society has occurred, or when it takes time for the electronic payment service provider to solve the causes of the failure, the FSA, while monitoring the electronic payment service provider activate its contingency plan including a general announcement of the details of the failure to the public and responses to users on its website, etc., requires the electronic payment service provider the prompt clarification of the cause and restoration of operations.

(Note) System failures that must be reported

Problems that must be reported are those which, no matter what the causes are, affect systems and equipment (including both hardware and software) which are currently used by electronic payment service providers (including outsourcing providers and cloud service providers used by the electronic payment service providers) and whose functions are or could be delayed or stopped.

However, even though some of the systems and equipment have such troubles, the reporting requirement is not applicable in cases where a backup system has quickly started

up and effectively prevented adverse effects.

Even though a failure or trouble does not actually occur, the electronic payment service provider is required to report when the users or business operations are affected or highly likely to be affected because it receives an advance notice of cyberattack or it has found a cyberattack in its IT system. (Response is done based on the business characteristics of the electronic payment service provider.)

- (ii) The FSA requires the electronic payment service provider to make an additional report pursuant to Article 52-61-14(1) of the Banking Act, as needed, and if it is found that the electronic payment service provider has a serious problem, the FSA issues a business improvement order pursuant to Article 52-61-16 of the Banking Act. (When implementing administrative dispositions, they shall be subject to II-5.)

- (2) Illegal remittance, wrong remittance, information leakage, etc.

If the electronic payment service provider finds a problem which affects users and the management, such as illegal remittance through the abuse of a privileged ID and wrong remittance due to a program error of the system, the FSA requires the electronic payment service provider to report the fact to the FSA within 30 days after finding the problem. If a serious problem is found, the FSA issues a business improvement order pursuant to Article 52-61-16 of the Banking Act. (It should be noted that with regard to an information leak related to individual users, responses will be made based on the Banking Act, and other necessary measures will be taken according to the situation of authority delegation to the minister in charge based on the Personal Information Protection Act.)

- (3) Response to outsourcing providers

In cases where there is concern that outsourcing providers will fail to properly operate the IT system work outsourced to them and the FSA deems it necessary to take actions, it takes the actions described in the following:

- (i) Cases where a problem is found in the control environment of the electronic payment service provider

If a problem is found in the internal control environment of the electronic payment service provider relating to the outsourcing provider from the report to the FSA mentioned in (2) above, the FSA requires the electronic payment service provider to submit a report based on Article 52-61-14(1) of the Banking Act, as needed. If a serious problem is found, the FSA will issue a business improvement order or implement any other measures based on Article 52-61-16 of Banking Act.

- (ii) Cases where a problem is found in the control environment of business operation, etc. of the outsourcing provider.

The FSA makes efforts to understand the situation through the electronic payment service provider which has entrusted operations to the outsourcing provider. In this case, too, the FSA

will require the electronic payment service provider, as needed, to submit a report based on Article 52-61-14(1) of the Banking Act, and if a serious problem is found, the FSA will issue a business improvement order based on Article 52-61-16 of the Banking Act. However, when the case involves an urgent and substantially important matter or when the FSA considers that it is difficult to grasp the actual situation of the outsourcing sufficiently only by asking for confirmation from the electronic payment service provider, the FSA will make efforts to grasp the situation by holding a direct interview with the outsourcing provider. When it is deemed particularly necessary (for example, in cases where multiple electronic payment service providers entrust similar work to such outsourcing provider), the FSA will request such outsourcing provider to submit a report based on Article 52-61-14(2) of the Banking Act with regard to necessary matters, such as the fact of occurrence of a problem, analysis on causes of occurrence of the problem, and improvement measures. (When implementing administrative dispositions, they shall be subject to II-5.)

(Note) When conducting an interview with an outsourcing provider, the FSA asks the electronic payment service provider that has entrusted operations to the outsourcing provider to attend the interview as needed.

#### X-4 Rules for Protection of Users

##### X-4-1 Significance

Settlement services provided by an electronic settlement agency as an act set forth in Article 2, paragraph (21), item (I) of the Banking Act (including services provided by an electronic settlement agency, hereinafter referred to as "electronic settlement services") may increase the convenience of users' socio-economic lives and economic activities of businesses and other entities.

On the other hand, as described in (III-3-9) above, there are crimes committed by banks and payment service providers other than banks that aim to provide collaborative services. Therefore, it is important for both banks and payment service providers to understand the risks of electronic payment services as a whole and ensure their safety.

Based on the above, electronic payment and settlement service providers that provide electronic payment and settlement services should provide services to users of electronic payment and settlement services and users of cooperating banks (hereinafter referred to as "users, etc." in X-4 and X-5), from the viewpoint of ensuring the sound and appropriate management of electronic payment and other agency services, including the protection of the interests of the users, etc., it is important to establish a control environment suited to such risks. In supervising electronic payment and other agency services, for example, the following points shall be noted.

##### X-4-2 Main Focus

(1) Development of internal control

- (i) Whether the management, at the time of introduction of electronic settlement services and at the time of changes to the contents and methods thereof, has the department in charge of internal control identify any inherent risks, including problems related to the protection of the interests of users, etc., with regard to the electronic settlement services as a whole, and develop a control environment for reducing risks in a timely manner, based on the following:
- (ii) Whether the division in charge of internal control collects and analyzes information on the occurrence status and modus operandi of related crimes based on the types of crime expected to occur in electronic settlement services, and improve the control environment for the implementation of services related to electronic settlement services (including measures to prevent fraud) by taking into consideration the possible future crime modus operandi.

Also, whether the Financial Instruments Business Operator reports the details thereof to the management in a regular and timely manner.

- (iii) Whether the division in charge of internal audit regularly and in a timely manner audits the control environment for services related to electronic settlement services (including measures to prevent fraud) and reports the audit results to management.
- (iv) Whether the management creates an environment in which the so-called PDCA cycle comprising risk analysis, formulation and implementation of risk mitigation measures, and evaluation and review of such mitigation measures functions as described above.

(2) Ensuring security

- (i) From the viewpoint of preventing illegal transactions, when introducing electronic settlement services and when changing their contents and methods, whether risk assessments are conducted for the entire electronic settlement services in cooperation with cooperating banks.

Also, whether it cooperates in risk assessment work at cooperating and collaborating banks.

- (ii) Whether the Financial Instruments Business Operator has clarified the division of roles and responsibilities with the cooperating and collaborating banks.
- (iii) Based on risk assessment, whether the credit rating agency, in cooperation with cooperating and collaborating banks, collates information pertaining to users and takes appropriate and effective measures to prevent fraud in line with risks.

For example, when cooperating with banks in electronic settlement services, information necessary for authentication by electronic settlement agencies may be sent to the telephone numbers and addresses of depositors registered with the cooperating banks, and the upper limit of usage may be used to prevent illegal transactions.

Whether the TR has taken appropriate and effective measures to prevent fraud, such as setting the level at which the TR can prevent fraud.

(Note) When collating information with cooperating banks, it is desirable to include the

address and telephone number in addition to the user's name and date of birth, except when using public personal identification.

Also, whether the TR has confirmed that multi-factor authentication and other authentication methods that combine effective elements have been introduced at cooperating and cooperating banks, such as the use of variable passwords using hardware tokens and software tokens in addition to personal authentication using fixed IDs and passwords, and the use of electronic certificates such as public personal authentication.

(Note) It should be noted that anti-fraud measures taken by electronic payment service providers must not overlap with anti-fraud measures taken by cooperating banks. In addition, it should be noted that a robust authentication method must be introduced for the registration and change of information used for authentication, such as telephone numbers, in cooperating banks.

(iv) Whether the credit rating agency recognizes and reassesses risks on a regular and timely basis and improves measures to prevent fraud, including the introduction of public individual certification, based on environmental changes, including the sophistication and sophistication of criminal methods, and the occurrence of incidents at its own company or at other business operators.

(v) As a result of the risk assessment, if it is found that there is a problem from the viewpoint of ensuring sound and appropriate management of electronic payment and other agency services, including the protection of the interests of users, etc., temporary suspension of all or part of services, including electronic payment and other services, or other measures, whether appropriate measures are taken.

(3) Notification to users, etc.

In order to enable users, etc. to recognize damage at an early stage, when coordinating and collaborating with banks related to electronic settlement services, whether measures are taken for users, etc. to confirm the fact of collaboration and the content of collaboration in a timely manner, such as by cooperating with the banks and notifying the contact information of users, etc. registered with the banks in advance.

(Note) When taking the above measures by notifying the contact information registered in the cooperating bank, it should be noted that the bank must have a robust authentication method for registering and changing the contact information, such as the phone number (including the mobile phone number) and email address.

(4) Detection of illegal transactions

With regard to electronic settlement services, from the viewpoint of preventing illegal transactions, whether a control environment for appropriately conducting the following measures in cooperation with cooperating banks is established.

- To quickly detect suspicious transactions by setting appropriate scenarios and thresholds based on environmental changes, including the elaboration and sophistication of criminal methods, and on the occurrence of incidents at the agent and other business operators.
- To share information on transactions detected based on the above in a timely manner with cooperating and cooperating banks, implement temporary suspension of use of services and other measures as necessary, and conduct investigations.
- To promptly contact those who are likely to be affected.
- To suspend IDs that have been found to be fraudulent.

(5) Responding to inquiries from users, etc.

- (i) Whether a control environment is developed for accumulating and analyzing consultations regarding electronic settlement services from users, etc. (hereinafter referred to as "consultations"), early detection of risks, implementation of measures to prevent fraud, and improvements in response to consultations from users.
- (ii) Whether a control environment is developed for sincere responses to consultations, including consultations about cooperating and collaborating banks. Also, whether specific methods of cooperation and responsibilities with the cooperating and collaborating banks are clarified.
- (iii) Whether the agent examines whether the cooperating and collaborating banks do not encourage users to consult with other parties, and when such inappropriate responses are found, together with the cooperating and cooperating banks, whether the agent takes appropriate measures, such as clarification of the cause of occurrence, improvement measures and recurrence prevention.

#### X-4-3 Supervisory Measures

With regard to issues related to electronic settlement services that have been identified through daily supervisory processes, such as the reporting of misconduct, the FSA will, based on the above-mentioned points, conduct in-depth dialogues on the causes and improvement measures, and, if necessary, require reports based on Article 52-61-14 of the Banking Act, in order to identify the status of voluntary business improvement by electronic settlement service providers.

In addition, when it is deemed that there is a serious problem from the viewpoint of ensuring sound and appropriate management of electronic settlement services, including protection of the interests of users, etc., the FSA will issue a business improvement order based on Article 52-61-16 of the Banking Act. Also, when serious or malicious violations of laws or regulations are found, the FSA will consider whether to issue a business suspension order based on Article 52-61-17 of the Banking Act. (When implementing administrative dispositions, they shall be subject to II-5.).

#### X-5 Compensation for Fraudulent Transactions

There is a risk of harm to users, etc. due to fraudulent transactions related to electronic settlement agents.

In the event of such damage, an electronic settlement agent should take appropriate and prompt actions (including measures in cooperation with the cooperating and collaborating banks) for victims from the viewpoint of ensuring sound and appropriate management of electronic settlement services, including protection of interest of users, etc.

The following points shall be taken into consideration, for example, when supervising an electronic settlement agent in response to fraudulent transactions.

#### X-5-1 Major Supervisory Viewpoints

- (i) Whether the electronic settlement agent establishes a policy regarding compensation for losses caused by fraudulent transactions in relation to electronic settlement services (hereinafter referred to as the "Compensation Policy") and provides information about the policy to users, and whether it is possible for other users to know about the policy.

(Note) The "losses caused by fraudulent transactions in relation to electronic settlement services" are not limited to losses incurred by users of electronic settlement services due to instructions given by unauthorized persons against users' will, but include losses incurred by users of cooperating and collaborating banks due to the provision of electronic settlement services, such as losses incurred by a depositor caused by transmission of a settlement instruction against the depositor's will by disguising a user of an electronic settlement service as a depositor of a linked account, etc.

- (ii) With regard to the matters concerning compensation for damages prescribed in Article 52-61-8, paragraph (1), item (iii) of the Banking Act, whether at least the following matters are prescribed (including cases where such matters are prescribed in contracts pertaining to electronic settlement services concluded with cooperating and collaborating banks pursuant to the provisions of Article 52-61-10 of the Banking Act):

- A. Whether or not compensation for losses will be provided to victims in each specific case where losses are likely to occur, the details thereof, and if there are any requirements for compensation, the details thereof, in accordance with the contents of the services of electronic settlement services
- B. Details of compensation procedures
- C. In the case of providing electronic settlement services, matters concerning the sharing of compensation between the cooperating and collaborating banks and the electronic settlement agent (including persons who implement compensation for victims)
- D. Contact information regarding compensation
- E. Disclosure standards for illegal transactions

(Note) With regard to the matters specified in sub-item (c), it is not necessary to provide information, etc. to users regarding all of the contents of the contract with the



cooperating and collaborating bank related to said matters. However, it should be noted that it is necessary to provide information, etc. to users at least for those who provide compensation to victims.

- (iii) Whether a control environment for implementing compensation appropriately and promptly in accordance with the established compensation policy is established (including systems for cooperation with the cooperating and collaborating bank).

## X-5-2 Supervisory Methods and Responses

### (1) Problem recognition

With regard to issues related to responses to fraudulent transactions identified through daily supervisory processes, such as the filing of reports on misconduct, the FSA will conduct in-depth dialogues on the causes and measures for improvement, based on the above points of view, and if necessary, require reports based on Article 52-61-14 of the Banking Act in order to identify the status of voluntary business improvement made by an electronic settlement agent.

In addition, when it is found that there are serious problems from the viewpoint of ensuring sound and appropriate management of electronic settlement, including protection of the interests of users, etc., the FSA will issue a business improvement order based on Article 52-61-16 of the Banking Act to an electronic settlement agent. Also, when a serious or malicious violation of laws or regulations is found, the FSA will consider whether to issue a business suspension order based on Article 52-61-17 of the Banking Act (in the case of implementing an administrative disposition against an electronic settlement agency, etc., it will be subject to II-5.).

### (2) When a fraudulent transactions occurs

As soon as a fraudulent transaction is detected related to an electronic settlement agent etc., the FSA shall promptly request the agent to submit a report on the occurrence of the transaction by the "Report on the Occurrence of Illegal Transactions."