12-21-2016

Japan Peer Review

Financial Stability Board (FSB)

Peer Review of Japan

Review Report

21 December 2016

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Foreword

Financial Stability Board (FSB) member jurisdictions have committed, under the FSB Charter and in the *FSB Framework for Strengthening Adherence to International Standards,*[1] to undergo periodic peer reviews. To fulfil this responsibility, the FSB has established a regular programme of country and thematic peer reviews of its member jurisdictions.

Country reviews focus on the implementation and effectiveness of regulatory, supervisory or other financial sector standards and policies agreed within the FSB, as well as their effectiveness in achieving desired outcomes. They examine the steps taken or planned by national authorities to address International Monetary Fund (IMF)–World Bank Financial Sector Assessment Program (FSAP) and Report on the Observance of Standards and Codes (ROSC) recommendations on financial regulation and supervision as well as on institutional and market infrastructure that are deemed most important and relevant to the FSB's core mandate of promoting financial stability. Country reviews can also focus on regulatory, supervisory or other financial sector policy issues not covered in the FSAP that are timely and topical for the jurisdiction itself and for the broader FSB membership. Unlike the FSAP, a peer review does not comprehensively analyse a jurisdiction's financial system structure or policies, or its compliance with international financial standards.

FSB jurisdictions have committed to undergo an FSAP assessment every 5 years; peer reviews taking place 2-3 years following an FSAP will complement that cycle. As part of this commitment, Japan volunteered to undergo a peer review in 2016.

This report describes the findings and conclusions of the Japan peer review, including the key elements of the discussion in the FSB's Standing Committee on Standards Implementation (SCSI) on 25 October 2016. It is the eighteenth country peer review conducted by the FSB, and it is based on the objectives and guidelines for the conduct of peer reviews set forth in the *Handbook for FSB Peer Reviews.*[2]

The analysis and conclusions of this peer review are based on the responses to a questionnaire by financial authorities in Japan and reflect information on the progress of relevant reforms as of August 2016. The review has also benefited from dialogue with the Japanese authorities as well as discussion in the FSB SCSI.

The draft report for discussion was prepared by a team chaired by Andreas Dombret (Member of the Executive Board, Deutsche Bundesbank) and comprising Elizaveta Danilova (Central Bank of the Russian Federation), Silvia Scatizzi (European Commission), Matthew Poggi (United States Department of the Treasury) and Aslihan Yildirim (Banking Regulation and Supervision Agency, Turkey). Dimple Bhandia, Sam Smith and Costas Stephanou (FSB Secretariat) provided support to the team and contributed to the preparation of the peer review report.

[1] See http://www.fsb.org/2010/01/r_100109a/.

[2] See http://www.fsb.org/2015/03/handbook-for-fsb-peer-reviews/.

Abbreviations

BCBS	Basel Committee for Banking Supervision
BHC	Bank holding company
BOJ	Bank of Japan
CCFS	Council for Cooperation on Financial Stability
CET1	Common equity tier 1 capital adequacy ratio
CMG	Crisis management group
CoVAR	Conditional value-at-risk
DIA	Deposit Insurance Act
DICJ	Deposit Insurance Corporation of Japan
D-SIB	Domestic systemically important bank
EU	European Union
FAIX	Financial Activity Indexes
FCRC	Financial Crisis Response Council
FMR	Financial Monitoring Report
FSB	Financial Stability Board
FSAP	Financial Sector Assessment Program
FSI	Financial Soundness Indicators
FSR	Financial System Report
FX	Foreign exchange
G-SIB	Global systemically important bank
JFSA	Japan Financial Services Agency
J-REIT	Japanese real estate investment trust
MOF	Ministry of Finance
MoU	Memorandum of understanding
MPC	Monetary Policy Committee
OFIs	Other financial intermediaries
OTC	Over-the-counter
RRP	Recovery and resolution plan
SIFI	Systemically important financial institution
SPE	Single point of entry
TLAC	Total loss-absorbing capacity
UNCITRAL	United Nations Commission on International Trade Law

Executive summary

Background and objectives

The main purpose of this peer review is to examine two topics relevant for financial stability in Japan: the macroprudential policy framework, and the framework for resolution of financial institutions. The review focuses on the steps taken by the Japanese authorities to implement reforms in these areas, including by following up on relevant FSAP and FSB recommendations.

Main findings

Progress has been made in developing the macroprudential policy framework and in expanding the scope and range of tools of Japan's resolution framework in recent years. However, there is additional work to be done in both areas. On the macroprudential framework, this involves strengthening the institutional arrangements for financial stability; improving inter-agency cooperation to develop coordinated systemic risk assessments; and broadening financial stability analysis. On resolution, this involves developing guidance on the choice of resolution measures; clarifying preferred resolution options and provisions for funding; developing sector-specific adaptations to, and strategies based on, the resolution regime; and ensuring that court involvement does not compromise implementation of resolution measures.

Macroprudential policy framework

The authorities have taken important steps in recent years to address FSAP recommendations and strengthen their macroprudential policy framework. The creation of the Council for Cooperation on Financial Stability (CCFS) in June 2014 facilitates the periodic exchange of views among senior Bank of Japan (BOJ) and Japan Financial Services Agency (JFSA) officials. The establishment in July 2015 of the Macroprudential Policy Office has enhanced the JFSA's macroprudential monitoring, which focuses to date mainly on financial markets and on the three Japanese global systemically important banks (G-SIBs). There is improved data collection (e.g. on cross-border exposures and foreign exchange (FX) mismatches) and use of market intelligence for risk analysis, and enhanced dissemination of information. The analytical frameworks of the BOJ and JFSA have become more sophisticated, including via the use of macroprudential dashboards and heat maps, early warning indicators and stress tests. Finally, the public communication of risk assessments has improved through the BOJ's Financial System Report (FSR) and the JFSA's Financial Monitoring Report (FMR).

Building on these accomplishments, as is the case in other countries, additional work is needed to flesh out and operationalize a comprehensive macroprudential policy framework. Much of this work relates to making policy-setting more explicit, with clearer roles and responsibilities between authorities and with stronger cooperation and analytical tools for decision-making.

- ***Strengthening institutional arrangements for financial stability***: Both the BOJ and the JFSA carry out assessments of systemic risks, although the use of regulatory prudential tools (including for macroprudential purposes) and the decision on when to activate them reside with the JFSA as the integrated financial regulator. The JFSA's macroprudential policy is conducted as an integral part of its micro-prudential regulation and supervision, and the same internal processes are used for decision-making. Assessments of systemic risks are discussed at various levels in the BOJ (e.g. by the Policy Board in the context of deliberations on the FSR publication and ahead of monetary policy decisions) and in the

JFSA (in the context of weekly meetings of senior officials). Further developing distinct processes within both authorities to assess systemic risks and discuss their policy implications at senior level would ensure a stronger focus on macroprudential issues.

The CCFS, as an important inter-agency coordination mechanism on financial stability issues, should be put on a sound institutional footing. This includes providing it with a formal mandate, expanding its membership to other relevant authorities, and defining members' responsibilities and accountabilities. This can help provide clarity about the contribution of different members to its functioning and promote stronger cooperation in system-wide risk assessment and mitigation, without overriding the respective mandates or impeding the operational autonomy of its members. The CCFS can be made more operationally effective by creating structures as necessary to support its functioning. The authorities could also consider assigning the CCFS with explicit powers to issue warnings and make comply-or-explain policy recommendations, and to communicate its activities and decisions to the public, as is the case with similar bodies in some other countries.

- ***Enhancing inter-agency cooperation***: In recent years, the BOJ and JFSA have more actively shared information with each other on the findings from their respective risk analyses; however, there is potential for further improvements. For example, the BOJ and JFSA do not generally share the information each of them collects, which results in banks having to submit separately some of the same data to both authorities. This practice also restricts the BOJ's access to reporting data from financial institutions other than banks and securities firms (since only these have accounts with it) and limits its ability to assess, other than in a largely qualitative manner, the systemic risks posed by such entities.

  Coordination between the BOJ and JFSA on their analyses of systemic risks is also limited and tends to be largely ex-post. For example, the two authorities inform each other about their respective assessment of risks after the publication of the FSR and FMR respectively. There is relatively little ex-ante coordination on the focus of those assessments or the respective methodologies that are used. As a result, both authorities cover similar types of risks with different analytical tools but without leveraging on the data and approaches of each other. Similarly, there is little coordination between bottom-up stress tests overseen by the JFSA and top-down stress tests conducted by the BOJ in terms of defining common stress scenarios on an ex-ante basis, comparing the results on an ex-post basis (only the BOJ shares its results with the JFSA) or agreeing on any follow-up from these exercises.

  A more coordinated risk assessment framework – e.g. by fostering joint analytical work on interconnectedness and comparing stress testing approaches – would bring together the data and expertise of the two authorities to enhance assessments of systemic risks. This is particularly important given the current interest rate environment, which underscores the close relationship between monetary, micro- and macroprudential policies. More joint work would also highlight any differences of view on systemic risks and their drivers, which would improve mutual understanding and communication to market participants.

- ***Broadening financial stability analysis***: The BOJ and JFSA have enhanced their analysis of risks to financial stability in recent years through more in-depth stress testing, enhanced monitoring of Japan's G-SIBs (also known as mega-banks), and better analytical tools. The increased focus on the cross-border activities and associated credit and FX funding risks of the three mega-banks seems appropriate in light of those banks' expansion in foreign markets. Notwithstanding this progress, there remain some areas for improvement.

At present, the FSR is primarily focused on the banking sector; its coverage of potential risks from non-bank financial institutions is limited and largely qualitative. The non-bank financial sector is large and its growth has outpaced that of the banking sector in recent years. The current interest rate environment, if sustained for an extended period, could pose a threat to the business model of some non-bank financial institutions. The authorities should continue to expand their assessment of systemic risks from, and complement their thematic work with more quantitative analysis on, the non-bank financial sector. There is also a need to improve the analysis of interconnectedness in the financial system. The availability of data and analysis between banks and other financial institutions is currently limited in terms of coverage and may be insufficient to assess fully related risks.

Similarly, it would be useful to enhance the analysis of sovereign-financial stability interlinkages, as was recommended in the FSAP. This is a key issue in many countries and is particularly important in Japan given the high level of government debt and its holdings by the domestic financial system. The assessment of the risks of sovereign exposures in stress tests could be expanded to include, for example, scenarios involving an increase in domestic sovereign bond yields, as is the case in some other countries.

The JFSA has made important progress since the FSAP in introducing bottom-up stress testing and incorporating it into its supervisory process. It already requires such tests for G-SIBs and intends to introduce them for domestic systemically important banks (D-SIBs) as well. Going forward, it may be worth expanding this exercise to a wider range of financial institutions (e.g. large regional banks, major insurance companies and pension funds) to enrich its assessment of systemic risks for a wider set of institutions.

Framework for resolution of financial institutions

The authorities have made progress in developing the resolution framework to address the FSAP recommendations and include the elements described in the FSB *Key Attributes of Effective Resolution Regimes for Financial Institutions* (*Key Attributes*). In particular, the June 2013 revisions to the Deposit Insurance Act (DIA) introduced a regime for 'orderly resolution' and expanded the scope of the regime to cover all financial institutions (but not financial market infrastructures, such as central counterparties) as well as the holding companies and operating subsidiaries of such institutions and domestic branches of foreign banks. Few other FSB jurisdictions have implemented a cross-sectoral resolution regime, so this represents a substantial enhancement to Japan's resolution framework.

The resolution framework provides a wide range of powers, including to: transfer assets and liabilities; establish a temporary bridge institution; and impose a temporary stay on the exercise of early termination rights. The authorities have also expanded the scope of recovery and resolution planning to include D-SIBs where necessary, and developed a preferred resolution strategy for Japanese G-SIBs in their proposed framework for orderly resolution of such firms.

Notwithstanding this progress, further work is needed to ensure that the resolution framework fully aligns with the *Key Attributes* and is perceived as credible by market participants.

- ***Choice of resolution measures:*** The orderly resolution regime, which applies to all types of financial institutions, includes two measures. Under Special Resolution Regime I, liquidity and capital support may be provided to a financial institution that is expected to remain a going concern and under the special oversight of the Deposit Insurance Corporation of Japan (DICJ). Under this option, shareholders' equity may be diluted and only liabilities with contractual triggers tied to a Common Equity Tier 1 ratio of 5.125% (or higher) of risk-weighted assets may be written down and/or converted to equity. Special Resolution Regime II, the resolution measure intended to align with the *Key Attributes*, envisages a wider imposition of losses on shareholders and certain creditors for a financial institution that is insolvent or likely to become insolvent. Systemically important assets and liabilities are transferred to a bridge institution, while shareholders and remaining creditors of the failed institution are subject to loss through ordinary insolvency proceedings.

The *Key Attributes* require timely and early entry into resolution before a firm is balance sheet insolvent. Accordingly, Special Resolution Regime II may be applied to a firm that is likely to become insolvent. However, for such a firm the authorities could also choose to apply Special Resolution Regime I or, in the case of a deposit-taking institution, a DICJ capital injection as part of the measures against financial crisis, both of which may protect all liability holders. The determination of which measure/regime to take is made on a case-by-case basis, and there are no clear standards or detailed indicators to guide the authorities' decision prior to insolvency. Moreover, the concept of likely insolvency under Special Resolution Regime II is not clearly elaborated.

The flexibility allowed by the current framework has fed market perceptions that a pre-emptive recapitalisation (rather than orderly resolution) is the authorities' preferred option for a failing systemically important financial institution (SIFI). For example, the credit ratings for debt issued by the Japanese G-SIBs still incorporate government support, reflecting the view of the major credit rating agencies that pre-emptive capital and liquidity injections, as applied in previous banking crises, remain the preferred method of the authorities to deal with failing but still solvent financial institutions.

The authorities express support for the objectives of resolution in the *Key Attributes*, and point out that the JFSA's publication of the approach to introduce the FSB's Total Loss-absorbing Capacity (TLAC) standard and description of the preferred resolution strategy for Japanese G-SIBs demonstrates their commitment to Special Resolution Regime II. They note, however, that limiting their flexibility under the current framework may increase the time or cost of resolution actions and that experience with public support during the crisis in the late 1990s has been positive in that public financial assistance was generally recouped (albeit over time) while financial stability and credit to the economy were maintained.

There seems to be therefore an apparent discrepancy between market expectations and the authorities' intentions concerning the actions to be taken in the event of a failing SIFI. Affecting market expectations is an objective of resolution reforms, so as to reduce moral hazard and to ensure that SIFIs internalise the systemic risks to which they give rise. The authorities should address this discrepancy and seek to dispel market perceptions by being more explicit, in terms of their implementation guidance and in public communication, about the factors that will determine the choice of resolution measures. This includes clarifying those instances in which measures for orderly resolution (as opposed to measures against financial crisis) will likely be undertaken; and elaborating on the concept of likely insolvency so as to better align it with the intent of the *Key Attributes* and to clarify more clearly the differences between the application of Special Resolution Regimes I and II.

- ***Resolution funding***: Japan's resolution framework provides the authorities with a well-developed system of resolution funding that, following the revisions to the DIA, also applies to non-bank financial institutions. Financial assistance from the DICJ is funded through the issuance of bonds and borrowings, the large majority of which are government guaranteed. This is complemented by temporary backstop funding by the BOJ, and by a provision in the revised DIA that any costs incurred by the authorities in the provision of resolution funding are recovered from the financial industry, consistent with the *Key Attributes*. Article 125 of the DIA provides that the government may instead cover part of those costs, though the condition for such coverage is strictly limited under the Act.

The *Key Attributes* require that the provision of temporary funding by the authorities should include a determination that private sources of funding have been previously exhausted or cannot achieve the objectives of orderly resolution. However, the relevant conditions under the current framework do not seem sufficiently strict to ensure that this is met. Special Resolution Regime I imposes losses only on holders of instruments with certain contractual triggers, while Special Resolution Regime II imposes losses on unsecured and uninsured creditors only to the extent that the liabilities are not deemed "systemically important". There is at present no guidance or clarity on which assets and liabilities should be considered systemically important, and this decision is made on a case-by-case basis. Moreover, the possibility of government support under Article 125 of the DIA, while strictly limited, raises the question of whether costs incurred in the provision of resolution funding would be fully recovered from the financial industry.

- ***Sector-specific adaptations to the resolution regime***: The 2013 amendments to the DIA expanded the scope of the resolution regime to cover all financial institutions (such as insurance and securities companies). At present, there is no sector-specific adaptation to the framework and powers under the regime. This reflects the fact that insurance companies in Japan have to date been resolved under the existing framework of bankruptcy. With regard to securities firms, recovery and resolution planning is being carried out for those firms that conduct large and complicated business operations, based on the use of resolution tools and strategies similar to those envisaged for banks.

  Nevertheless, the orderly resolution of non-bank SIFIs may require adaptations to the resolution regime to take into account sector-specific considerations. Drawing on international policy work in this area, the authorities should consider adaptations such as, for example, resolution objectives and conditions for entry into resolution that are specific to non-bank SIFIs, and amendments to existing resolution powers (e.g. those conferred under the Insurance Business Act for insurance companies) to ensure that the exercise of those powers is not contingent on the cooperation of policyholders.

- ***Requirement for court approval to implement certain resolution actions***: In the context of a resolution action under Special Resolution Regime II, court approval is required to execute a transfer of systemically important assets and liabilities to a bridge financial institution, and to commence bankruptcy proceedings against the failed institution. In the context of a foreign financial institution operating in Japan, the framework to recognise or give effect under Japanese law to a foreign resolution action is a judiciary procedure, which may not recognise administrative foreign resolution proceedings.

  Given this, the authorities may wish to take steps to ensure that the time required for court proceedings will not compromise the effective implementation of resolution measures. This could include, for example, interaction with the court as part of resolution planning to gain a better understanding of the timing of the process and the information that the court may require in advance of any possible actions. As regards foreign resolution proceedings, the authorities could consider developing an administrative regime for the recognition of foreign resolution actions, as is currently the case in some other jurisdictions.

Recommendations

In response to the aforementioned findings and issues, the peer review has identified the following recommendations for consideration by the Japanese authorities:

Macroprudential policy framework

1. The institutional arrangements for financial stability in Japan should be strengthened by: (a) further developing distinct processes within BOJ and JFSA to assess systemic risks and discuss policy implications at a senior level; and (b) putting the CCFS on a strong institutional footing by providing it with a formal mandate, expanding its membership to other authorities relevant for financial stability, and developing structures as necessary to support its functioning.
2. The BOJ and JFSA should develop a more coordinated risk assessment framework. This includes expanding data sharing arrangements between the two authorities for systemic risk analysis, and fostering coordinated analytical work (e.g. stress-testing and analysis of interconnectedness) to complement and leverage on the information and expertise of each authority.
3. The BOJ and JFSA should consider broadening their systemic risk analysis by: (a) expanding the scope of bottom-up stress tests beyond SIBs; (b) enhancing the assessment of risks in the non-bank financial sector, including through interconnectedness and other quantitative analysis; and (c) expanding the analysis of sovereign-financial stability interlinkages.

Framework for resolution of financial institutions

4. To provide greater clarity to market participants, strengthen the credibility of the resolution framework and ensure timely entry into resolution, the authorities should develop transparent and formal guidance on the choice of resolution measures that: (a) clarifies the differences between the measures against financial crisis and the measures for orderly resolution; and (b) elaborates on the concept of likely insolvency under Special Resolution Regime II (e.g. by setting out clear standards or detailed indicators).
5. To minimise the gaps between market expectations and the authorities' intentions regarding the provision of temporary funding in resolution, the authorities should clarify in public communication that: (a) they intend to rely in the first instance on private sources of funds to cover the losses from the failure of a financial institution; and (b) any such funding by the authorities is expected to eventually be recovered from the industry in line with the *Key Attributes*.
6. The authorities should consider developing sector-specific adaptations to, and strategies based on, the resolution regime for non-bank financial institutions that could be systemic in failure, building on the ongoing international policy work.
7. As part of resolution planning, the authorities should take into account the court involvement in the resolution process – particularly for the transfer of systemically important assets and liabilities to a bridge financial institution – so as to ensure that it will not compromise the timely and effective implementation of resolution measures.

1. Introduction

Japan underwent an assessment update under the Financial Sector Assessment Program (FSAP) in 2011-12. The FSAP Update included assessments of the BCBS *Basel Core Principles for Effective Banking Supervision,* IAIS *Insurance Core Principles* and IOSCO *Principles and Objective of Securities Regulation.*[3]

The FSAP concluded that Japan had made important progress towards strengthening and stabilizing the financial system. Significant restructuring had been encouraged among large banks and insurance companies, nonperforming loans had been reduced, capital positions had improved, as had supervision and oversight. This progress, and an effective policy response, helped the Japanese financial system withstand one of the most severe output contractions experienced among the G7 during the global financial crisis. The FSAP, however, highlighted that high public sector indebtedness and slow growth remained two of the central risks to financial stability. It stressed that close monitoring and contingency planning were needed, especially with regard to risks related to the government bond market, sovereign funding pressures, regional bank vulnerabilities, and credit quality. The FSAP observed that further advances in the regulatory and supervisory regime would help to better anticipate and manage systemic risks and recommended that the mechanisms for systemic and macroprudential oversight be enhanced and that more forward-looking cross-sectoral approaches be adopted by all agencies. It also recommended that cross-border risk monitoring arrangements be deepened given the growing activities of Japanese financial institutions overseas. The FSAP stated that a broad-based financial reform plan could contribute to an enabling environment for private sector growth as the economy recovers and undergoes more ambitious fiscal consolidation and identified some key steps to this end.

The IMF's 2016 Article IV report[4] noted that the outlook for growth and inflation remains subdued. The authorities responded to the weaker domestic and external economic environment through additional monetary and fiscal support, including the adoption of a negative interest rate policy. The financial system has remained sound and resilient, with good capitalization and a declining non-performing loan ratio. However, there are downside risks over the medium term relating to weak external and domestic demand, uncertainty about the sustainability of low interest rates in a high public debt environment, and financial stability risks in the context of unprecedented monetary easing. The report called for a credible fiscal consolidation plan and bold structural reforms and stronger policy frameworks to address these issues. It also emphasized the importance of safeguarding financial stability to ensure a smooth transition to fiscal sustainability and higher inflation and to deal with external uncertainty.

This peer review report has two main sections, corresponding to the two topics being reviewed. Section 2 focuses on the macroprudential policy framework, while Section 3 covers the framework for the resolution of financial institutions. In addition, Annex 1 provides background information on the structure of the Japanese financial system and on recent

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3 See "Japan: Financial System Stability Assessment" (August 2012, IMF Country Report No. 12/210, https://www.imf.org/external/pubs/ft/scr/2012/cr12210.pdf). The ROSC assessments have been published and are available on the IMF website (http://www.imf.org/external/np/fsap/fsap.aspx).

4 See Japan's "2016 Article IV Consultation" (July 2016, IMF Country Report No. 16/267, http://www.imf.org/external/pubs/ft/scr/2016/cr16267.pdf).

regulatory developments; Annex 2 discusses the experience of the “mini-bubble” in the Japanese real estate market of 2006-07; Annex 3 compares the various resolution options under the current regime; and Annex 4 sets out the measures for orderly resolution. Annex 5 presents the follow-up actions reported by the authorities to other key FSAP recommendations; these actions have not been analysed as part of the peer review and are presented solely for purposes of transparency and completeness.

2. Macroprudential policy framework

Background

The current institutional framework for financial stability in Japan was established in the 1990s and early 2000s in response to instability experienced in the post-bubble period, which included the failures of large financial institutions. The steps taken included the establishment of the Financial Services Agency (JFSA), the amendment of the Bank of Japan (BOJ) Act, and the formulation of a crisis management framework. The FSAP in 2012 noted, however, that there was no formal financial stability council or committee to coordinate decisions on macroprudential policy outside of crisis periods, and that the coordination between agencies was largely informal. The FSAP stated that this informal mechanism had, thus far, not posed any impediment to the quality of cooperation and risk monitoring. Nonetheless, it noted that there may be merit in further enhancing and formalizing coordination and information sharing arrangements among oversight bodies on systemic issues. Such arrangements could support consistent oversight approaches, minimize the industry’s reporting burden, and avoid the risk of supervisory gaps. It also noted that the JFSA and BOJ should intensify their cooperation and joint work on systemic risk monitoring via enhanced information sharing, including of findings from supervisory activities.

The FSAP noted that the BOJ’s semi-annual Financial System Report (FSR), issued since 2005, represents a key component of the authorities’ macro-financial surveillance and that it is complemented by an extensive research program within the BOJ, including efforts to establish an early warning system. To enhance macroprudential surveillance and bolster oversight of systemic risks, the FSAP recommended: adoption of more forward-looking cross-sectoral approaches; deepening of cross-border risk monitoring arrangements; closer monitoring of sovereign-financial stability interlinkages; intensified monitoring and oversight of systemically relevant financial institutions, markets, and infrastructures; and developing a framework for regular thematic risk assessments (across types of financial institutions) and bottom-up stress tests for macroprudential purposes.

The section reviews the progress made to date and planned next steps vis-à-vis the FSAP recommendations on the macroprudential policy framework. Drawing on the experience of other FSB jurisdictions and on international guidance in this area,[5] it analyses the main elements of the framework in order to evaluate progress and identify remaining tasks.

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[5] See “Macroprudential Policy Tools and Frameworks – Progress Report to the G20” (October 2011, http://www.financialstabilityboard.org/wp-content/uploads/r_111027b.pdf) and “Elements of Effective Macroprudential Policies” by the IMF, FSB and BIS (http://www.fsb.org/2016/08/elements-of-effective-macroprudential-policies/); “Macroprudential Policy: An Organizing Framework” (March 2011,

Steps taken and actions planned

Institutional arrangements: The BOJ and the JFSA are the main authorities involved in macroprudential policy in Japan.

Article 1 of the BOJ Act defines the BOJ's purpose as being to issue banknotes and carry out currency and monetary control as the central bank of Japan as well as to ensure smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of stability in the financial system. In order to fulfil this mandate, the BOJ conducts regular on-site examinations and off-site monitoring of financial institutions that, together with financial markets data and information on the functioning of payment and settlement systems, serve as a basis for its analysis of systemic risks and of policy measures to address them. The BOJ also seeks to provide a macroprudential perspective when conducting monetary policy with the aim of maintaining sustainable growth and price stability.[6]

The JFSA is the integrated regulatory and supervisory authority for all financial institutions in Japan. Its mandate is to ensure the stability of financial functions, promoting the protection of depositors, policyholders, investors in securities and other persons similar thereto, and facilitating the smooth functioning of financial services. Given its ministry-level status, it has the authority to draft laws for approval by the Diet. The JFSA is responsible for the designation of systemically important financial institutions (SIFIs) and for the use of regulatory prudential tools, including for macroprudential purposes; it is also the resolution authority (see section 3).

Other authorities are less involved in systemic risk monitoring and macroprudential policymaking. The Deposit Insurance Corporation of Japan (DICJ) is entrusted with functions in the field of resolution and works in close cooperation with the JFSA and the BOJ. The Ministry of Finance (MOF) is mandated with ensuring healthy fiscal conditions, maintaining trust in the currency, and ensuring a stable foreign exchange (FX) market.

In July 2015, the JFSA established the Macroprudential Policy Office within the Planning and Coordination Bureau. This division carries out macroprudential monitoring focusing to date mainly on financial markets and on the three Japanese global systemically important banks (G-SIBs, also known as mega-banks).[7] This task includes collaborating with the teams that monitor financial institutions' activities in the Inspection Bureau and Supervisory Bureau.[8] There are

http://www.imf.org/external/np/pp/eng/2011/031411.pdf), "Institutional Models for Macroprudential Policy" (November 2011, http://www.imf.org/external/pubs/ft/sdn/2011/sdn1118.pdf), "Key aspects of macroprudential policy" (June 2013, http://www.imf.org/external/np/pp/eng/2013/061013b.pdf) and "Staff Guidance on Macroprudential Policy" (December 2014, http://www.imf.org/external/np/pp/eng/2014/110614.pdf) by IMF staff; and "Macroprudential instruments and frameworks: A stocktaking of issues and experiences" (May 2010, http://www.bis.org/publ/cgfs38.pdf), "Operationalising the selection and application of macroprudential instruments" (December 2012, http://www.bis.org/publ/cgfs48.pdf) and "Experiences with the ex ante appraisal of macroprudential instruments" (July 2016, http://www.bis.org/publ/cgfs56.pdf) by the Committee on the Global Financial System.

6 For example, in a March 2006 announcement the BOJ clarified that, in assessing the outlook for economic activity and prices when making monetary policy decisions, it analyses the risks considered most relevant to the conduct of monetary policy, including potential risks to financial stability in the longer term.

7 These are Mitsubishi UFG Financial Group, Mizuho Financial Group, and Sumitomo Mitsui Financial Group. See http://www.fsb.org/2015/11/2015-update-of-list-of-global-systemically-important-banks-g-sibs/.

8 A separate department within the Supervisory Bureau monitors the activities and risks of regional banks.

about 31 employees in the Macroprudential Policy Office; some of the staff in the Inspection and Supervisory Bureaus have additional responsibilities related to macroprudential analysis and also support the work of the Macroprudential Policy Office. The results of macroprudential analysis are shared with other bureaus and any policy proposals are submitted to the Commissioner who decides on potential actions. Systemic risks are sometimes discussed at the weekly management meetings headed by the Commissioner and at other levels in the JFSA.

At the BOJ, the Financial System and Bank Examination Department is mainly in charge of carrying out financial stability-related activities. Divisions in charge of on-site examination and off-site monitoring gather information related to business conditions and risk management systems at individual financial institutions. The Financial System Research Division, together with the Planning and Coordination Division, analyses and assesses financial system risks. The department uses information on financial market trends from other BOJ departments, such as the Financial Markets and the Payment and Settlement Systems Departments; the FSR write-up is also a collective effort involving these departments. The draft FSR is submitted to the BOJ's Policy Board for review and discussion before its publication. In addition, financial institutions' business conditions and financial risks, along with an analysis of credit and market conditions, are presented to Board members ahead of every Monetary Policy meeting.

Arrangements for inter-agency cooperation on macroprudential policies in Japan remain largely informal. The FSAP recommended that the authorities "consider more regular arrangements for more intensive and continuing interagency cooperation in systemic risk monitoring and contingency planning". In June 2014, the BOJ and the JFSA established the Council for Cooperation on Financial Stability (CCFS). The establishment of the Council was announced in a press release[9] and is not formalised in regulation or law. The CCFS consists of senior officials of the JFSA and BOJ, including the JFSA Commissioner and BOJ Deputy Governor. The Council, which meets on average every six months, provides a mechanism for periodic exchange of views between the BOJ and the JFSA on their respective analysis and assessment of risks in the financial system. The JFSA's Planning and Coordination Bureau and the BOJ's Financial System and Bank Examination Department jointly provide secretariat support to the CCFS. The agenda of Council meetings is decided by both authorities, reflecting current domestic or international financial developments. While both authorities utilise the information shared in the meetings, the Council is not a decision making body, and it cannot make requests to assess specific vulnerabilities or issue recommendations or directions to any authorities. At present, only the fact that a Council meeting has taken place is publicly disclosed.

In March 2016, following heightened volatility in global markets, the authorities also set up a monthly meeting mechanism to exchange information on international financial market developments. These meetings are attended by the JFSA Commissioner and the Vice Minister for International Affairs, the Vice Minister of Finance for International Affairs, the Deputy Vice Minister for Policy Planning and Coordination, and the BOJ Assistant Governor and Executive Director. The meetings generally do not have a pre-defined agenda, and their objective is not to make joint decisions on specific policies, elaborate directions or make recommendations for policy action.

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[9] See http://www.fsa.go.jp/news/25/sonota/20140625-5.html and https://www.boj.or.jp/announcements/release_2014/rel140625a.pdf (only available in Japanese).

Information collection and sharing: Data used for risk assessments by the JFSA and BOJ is collected from regulated financial institutions and public sources.

Data collected through supervisory returns by the JFSA are supplemented by information from on-site monitoring and through face-to-face meetings with officers of financial institutions and market analysts. The JFSA has the authority under existing legislation to request additional data on an ad-hoc basis for supervision purposes, although this power is restricted to regulated financial institutions. The JFSA began a review of data collection scope and methods to improve its financial supervision and monitoring from a systemic risk perspective, although no defined timelines have been set to complete the review.

The BOJ collects information on the financial status of banks and securities firms through on-site examination and off-site monitoring. This information is collected on the basis of contracts agreed with those institutions that maintain accounts with it. The BOJ also collects information through market operations and the management of payment and settlement systems, while it relies on public data sources (e.g. trade associations and commercial vendors) and ad-hoc surveys for information on other financial entities (insurance companies, pension funds etc.).

The JFSA and BOJ increasingly collect market intelligence for risk assessment purposes. For example, in view of concerns arising from the growing cross-border lending activities and associated FX funding mismatches of Japanese banks, the authorities improved collection of data on the largest cross-border exposures of the three mega-banks and on market liquidity conditions. Data relating to over-the-counter (OTC) derivatives transactions is now available with the establishment of a trade repository in Japan, which is authorised and regulated by the JFSA, although the use of such data for systemic risk assessments is limited thus far.

The FSAP recommended that the authorities strengthen the formal basis for data and information sharing among supervisory authorities given confidentiality provisions in different financial sector-related laws. The CCFS and the monthly inter-agency meetings on international financial market developments that began in 2016, while helpful, are informal and focused on sharing the results of authorities' analyses of conjunctural conditions and risks. The sharing of information on the inputs used for systemic risk assessments (e.g. calibration of stress tests – see below) remains limited, and there is no memorandum of understanding (MoU) between the two authorities governing this process. Onsite examination/inspection schedules are coordinated between the BOJ and the JFSA, but their scope and findings are not shared on a formal or regular basis.

The BOJ and JFSA share the same formats for requesting data from banks in order to reduce the reporting burden, and they review jointly the approach to requesting new data sets. This cooperation, however, does not extend to the sharing of information collected by each of them, which results in banks having to submit some of the same data to both authorities separately. This practice restricts the BOJ's access to reporting data from financial institutions other than banks and securities firms, since these institutions do not have accounts with it. The BOJ also has not accessed information from the OTC derivatives trade repository for its risk analysis.

The FSAP recommended that the authorities make active use of MoUs with foreign supervisory counterparts in monitoring cross-border risks. The authorities note that, subsequent to the FSAP, they have entered into several such arrangements and that they also share information through their participation in international initiatives such as the FSB Global Shadow Banking

Monitoring Report; supervisory colleges and crisis management groups of G-SIBs; and the IOSCO Hedge Funds survey.

The FSAP also recommended that Japan consider expanding the dissemination of the encouraged set of IMF Financial Soundness Indicators (FSIs) for banks and other financial institutions.[10] Since 2013, the authorities have submitted seven additional components of the encouraged set, including ratios for capital-to-assets and gross asset and liability positions in financial derivatives to capital. However, the authorities do not yet submit the full set of encouraged indicators, including a large number of series for the non-bank financial sector.

Analytical framework and risk assessments: The FSAP made a number of recommendations to improve the authorities' analytical framework for assessing risks to financial stability. In particular, it recommended that: the framework for regular thematic risk assessments (across types of financial institutions) and bottom-up stress tests for macroprudential purposes be developed; the monitoring and oversight of systemically relevant financial institutions, markets and infrastructures be intensified; the sovereign-financial stability interlinkages be monitored more closely to ensure that risks management frameworks are sufficiently robust to deal with stress situations; cross-border risk monitoring arrangements be deepened; and more regular arrangements for more intensive and continuing interagency cooperation in systemic risk monitoring and contingency planning be considered.

Since the FSAP, both the BOJ and the JFSA have taken steps to enhance risk assessments, including via the use of macroprudential dashboards and heat maps, early warning indicators and the development of bottom-up stress tests (see Box 1). To date, the two authorities have not articulated intermediate objectives specific to macroprudential policy, although the JFSA publishes objectives on financial stability and results (in terms of measures such as capital adequacy and non-performing loans) in its annual Policy Evaluation Implementation Plan.

As regards SIFIs, the JFSA is actively monitoring the activities of the three Japanese G-SIBs based on both regular supervisory reporting and ad hoc data requests. For example, the JFSA collected information on most foreign exposures of these mega-banks to assess credit (including concentration) risks and the adequacy of their FX funding; the BOJ also actively monitors the liquidity risks of those banks. In December 2015, the JFSA designated two other banks (Sumitomo Mitsui Trust Holdings, Norinchukin Bank) and two securities companies (Daiwa Securities Group, Nomura Holdings) as domestic systemically important banks (D-SIBs). These entities will be subject to additional capital requirements and more intensive monitoring, including regular submissions of internal management reports.[11]

[10] The FSIs were developed by the IMF, together with the international community, to support the analysis and assess the strengths and vulnerabilities of financial systems. See http://data.imf.org/?sk=9F855EAE-C765-405E-9C9A-A9DC2C1FEE47 for more details.

[11] In June 2016, the BCBS published its assessment of the Basel III G-SIB framework and review of the D-SIB framework in Japan. The Japanese G-SIB framework was assessed as compliant with the Basel framework, while the Japanese D-SIB framework was found to be broadly aligned with the BCBS D-SIB principles. See http://www.bis.org/bcbs/publ/d371.pdf.

Box 1: Systemic risk analysis by the BOJ and the JFSA

The JFSA conducts daily monitoring of market conditions; monthly monitoring of risks and vulnerabilities at financial institutions (particularly G-SIBs) using public information, supervisory reporting and other data; and quarterly analysis of financial system risks and macroeconomic prospects in Japan and other major countries with potential spillovers for Japan. An internal macroprudential dashboard, which includes a financial stability heat map, is prepared on a quarterly basis but is not published. The dashboard contains risk indicators across different sectors (banking, capital markets, shadow banking and public sectors) for the financial systems of leading economies and detailed quantitative analysis of trends in the Japanese financial system.

The JFSA publishes since 2014 an annual Financial Monitoring Report (FMR)[12] that describes trends of different groups of financial institutions, analyses the risks and adequacy of their business models, assesses different aspects of their business strategies, governance and risk management, and provides recommendations for the supervised entities. The FMR is primarily focused on micro-prudential and regulatory issues, although it also includes a high-level assessment of system-wide macroprudential issues relating to (for example) interest rate risk and foreign currency exposures.

The BOJ publishes a semi-annual Financial System Report (FSR),[13] with the objective of assessing the stability of Japan's financial system and facilitating communication on tasks and challenges in order to ensure such stability. The report covers macro-financial risks as well as vulnerabilities of financial markets and financial institutions, although the analysis primarily focuses on the banking sector. The FSR also specifies the actions that BOJ intends to take to ensure financial stability.

The BOJ has developed an early warning system to regularly assess the stability of the financial system using Financial Activity Indexes (FAIXs), Financial Cycle Indexes and systemic risk indicators. These macro risk indicators first appeared in the 2011 FSR and are now published in every issue. The FAIXs are indicators used to gauge financial imbalances across various financial activities. By examining 14 selected indicators in terms of the deviation from their trends, signs of overheating can be identified. By contrast, the Financial Cycle Indexes are used to detect cyclical changes in financial system conditions. Systemic risk indicators, including conditional value-at-risk (CoVaR), are used to measure each financial institution's contribution to systemic risk, based on the volatility of individual stock prices of major global banks and the degree of their co-movement.

One of the main tools used by both authorities for risk assessment purposes has been stress tests. In 2013-14 the JFSA provided the three G-SIBs with a number of scenarios to stress test their capital positions for credit and market risks. Bank-specific stress scenarios were designed jointly by the JFSA and the relevant G-SIB to reflect that institution's particular business and risk profile (e.g. banks providing loans to the energy sector assessed their sensitivity to a decline in oil prices). Stress testing was also conducted on a set of common scenarios that reflected the common risks faced by these institutions (e.g. risks from a decline in economic output or a sharp increase in Japanese government bond yields). The results of these tests are not published but they are reviewed by the JFSA (including for those banks' risk management and business strategies) and form an integral part of the "capital policy dialogue". The JFSA intends to repeat the exercise annually and to extend it to other D-SIBs.

The BOJ has undertaken top-down macro stress tests since 2007, which are described in detail in the FSR. Macro stress testing involves examining banks' capital adequacy by estimating the extent of capital loss under specific stress events. Data on individual financial institutions (115 banks and 258 *shinkin* banks accounting for approximately 80-90% of total credit) is used as an input. A macroeconomic model is used to assess the links between the financial system and the real economy. The two stress scenarios are a "tail event scenario" and a "tailored event scenario". Liquidity risk is not covered by the BOJ top-down stress test but it is analysed in the FSR, focusing particularly on FX liquidity risks. Against the background of growing cross-border activity of Japanese banks, the BOJ monitors their FX "stability gap" and cost of FX funding.

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12 See http://www.fsa.go.jp/en/news/2015/20150909-1/01.pdf.

13 See https://www.boj.or.jp/en/research/brp/fsr/index.htm/.

Since the FSAP, the authorities have also expanded their analysis of sovereign-financial stability interlinkages by examining related interest rate risks via both top-down and bottom-up stress tests and by monitoring liquidity conditions in the Japanese government bond market.[14] However, the credit risk implications of banks' sovereign exposures, such as the impact to their capital positions from an increase in domestic sovereign bond yields, have not been regularly examined.

Interagency cooperation on systemic risk monitoring continues to be mostly informal, although the creation of the CCFS and the launch of monthly inter-agency meetings have helped this process. The BOJ and the JFSA explain to each other the contents of the FSR and FMR respectively, including the results of their risks assessments; however, there is no joint risk assessment. The BOJ and JFSA officials also discuss stress testing practices of the BOJ (but not of the JFSA), but there is at present no coordination between the two authorities on the calibration (e.g. in terms of common scenarios), scope or follow-up of these tests.

Communication and transparency: The authorities have improved in recent years the public communication of their assessment of financial stability risks through their respective flagship reports: the BOJ's FSR and the JFSA's FMR (see Box 1). Both documents contain analysis of financial system trends and risks using increasingly more refined analytical tools and thematic assessments (e.g. on the implications of the negative interest rate environment on banks' profitability). The JFSA's annual Strategic Directions and Priorities document also sets out any proposed actions on macroprudential analysis.[15] In addition, a number of senior BOJ officials have made speeches in recent years on the BOJ's macroprudential initiatives and approach.[16] Both authorities also report that their risk assessments are discussed in bilateral meetings with market participants, including supervised entities.[17]

Notwithstanding this progress, the authorities do not offer an integrated assessment of macro-financial conditions and risks or of a macroprudential policy stance to the public. The communication strategy focuses on the authorities' actions (which are typically supervisory in nature – see below) in response to their respective risk assessments, but it does not explain the considerations underpinning these actions or how their success can be evaluated.

Macroprudential tools: Regulatory tools for macroprudential purposes, as well as the decision on when to activate them, reside with the JFSA as the integrated financial supervisor. The JFSA is responsible for implementing internationally agreed policy tools to address systemic risks, such as those relating to Basel III (capital conservation buffer, countercyclical capital buffer,

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[14] Starting in August 2015, the BOJ has been publishing quarterly liquidity indicators in the market. See 'Liquidity Indicators in the JGB Markets' (May 2016, https://www.boj.or.jp/en/paym/bond/ryudo.pdf).

[15] For example, the "2015-16 Strategic Directions and Priorities" document stated that the JFSA will enhance its capability in macroprudential analysis and that it will review how SIFIs are prepared for stresses in the markets and the economy. See http://www.fsa.go.jp/en/news/2015/20151019-2/01.pdf. The JFSA plans to publish a follow-up report in the second half of 2016 to review the progress made.

[16] See, for example, the November 2014 speech on 'Macroprudential Policy and Initiatives by the Bank of Japan' by Sato (https://www.boj.or.jp/en/announcements/press/koen_2014/data/ko141112b1.pdf).

[17] For example, the BOJ organises follow-up meetings with market participants after the publication of its FSR to more effectively communicate its assessment of risks to financial stability.

designation and policy measures for SIFIs), margin requirements for securities financing transactions etc. Other tools, such as loan-to-value and debt-to-income limits, are currently not available and changes in legislation would be needed to be able to introduce them in Japan. The JFSA reports that it does not see the need for additional tools at this point.

There are no recent examples of the use of regulatory prudential tools to address systemic risks in Japan. The authorities express a clear preference for relying on supervisory processes under Pillar 2 of Basel III to curb potential risks.[18] Their view is that past experience in Japan[19] supports a reliance on bilateral interactions with supervised financial institutions, which allows more flexible and dynamic responses. Such interactions take place through on-site and off-site initiatives (implementing inspections, making suggestions, conducting follow-up and checking the extent of improvements), and involve a strong element of moral suasion. This approach was used during the episode of overheating in the real estate market in 2006-07 (see Annex 2), and more recently when the three mega-banks started to expand their overseas activities and the authorities became concerned about their FX liquidity gap. Both the BOJ and the JFSA discussed with these banks the need to reduce dependence on short-term market sources of FX liquidity (such as FX swaps) and increase the share of stable client FX deposits.

Given the authorities' preference for a supervisory approach on macroprudential issues, there is no explicit framework for macroprudential policy decision-making as distinct from micro-prudential regulation and supervision. Each authority uses its own micro-prudential activities, such as on-site examinations and off-site monitoring, to implement those actions that it deems necessary based on its assessments of systemic risks. It is unclear to what extent those actions are coordinated between the two authorities, or whether (and how) the systemic risk analysis of the BOJ feeds into the decision-making process of the JFSA.[20] Relatedly, there is no explicit framework for ex-ante analysis of the potential impact of changes in macroprudential policies, or for ex-post assessment of their overall effects (whether direct or indirect).

Lessons learned and issues to be addressed

The authorities have taken important steps in recent years to address FSAP recommendations and strengthen their macroprudential policy framework. The creation of the CCFS in June 2014 facilitates the periodic exchange of views among senior BOJ and JFSA officials. The establishment in July 2015 of the Macroprudential Policy Office has provided the impetus for enhancing the JFSA's macroprudential monitoring, focusing mainly to date on financial markets and on the three Japanese G-SIBs. There is improved data collection (e.g. on cross-border exposures and FX mismatches) and use of market intelligence for risk analysis, and

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18 Under Pillar II (supervisory review process), supervisors are expected to evaluate how well banks are assessing their capital needs relative to their risks and to intervene where appropriate. This process is intended not only to ensure that banks have adequate capital to cover all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks.

19 Japan was one of the first jurisdictions to implement quantitative measures to curb excessive growth in the real estate market during the boom of the late 1980s. Limits on loans to the real estate industry were introduced in March 1990, and the downward trend in land prices started soon thereafter. These limits were removed at the end of 1991, but they coincided with the start of the collapse of the bubble economy and they have been often criticized as implemented too late and contributing to that collapse. Learning from this lesson, the JFSA did not introduce a one-size-fits-all regulation during the "mini-bubble" episode of 2006-07 when signs of overheating resurfaced in the real estate sector (see Annex 2).

20 The authorities report that the countercyclical buffer was set by the JFSA in consultation with the BOJ.

enhanced dissemination of information (e.g. FSIs and government bond market liquidity). The analytical frameworks of the BOJ and JFSA have become more sophisticated, including via the use of macroprudential dashboards and heat maps, early warning indicators and the development of bottom-up stress tests. Finally, the public communication of risk assessments has improved through the FSR and FMR as well as through the authorities' interactions with market participants.

Building on these accomplishments, as is the case in other countries, additional work is needed to flesh out and operationalize a comprehensive macroprudential policy framework. This includes, in particular, a strengthening of the institutional arrangements for financial stability; improving inter-agency cooperation to develop coordinated systemic risk assessments; and broadening financial stability analysis. Much of this work relates to making macroprudential policy-setting more explicit, with clearer roles and responsibilities between authorities and with stronger cooperation and analytical tools to support decision-making.

Strengthening institutional arrangements for financial stability: Both the BOJ and the JFSA carry out assessments of systemic risks, although the use of regulatory prudential tools (including for macroprudential purposes) as well as the decision on when to activate them reside with the JFSA as the integrated financial regulator. The JFSA's macroprudential policy is conducted as an integral part of its micro-prudential regulation and supervision, and the same internal processes are used for decision-making purposes. Micro- and macroprudential policies, however, have different objectives: the former is concerned with the risk to individual financial institutions and takes the macro economy as given, whereas the latter is concerned with the risks to and from the financial system as a whole and its interaction with the macro economy. Assessments of systemic risks are discussed at various levels in the BOJ (e.g. by the Policy Board in the context of deliberations on the FSR publication and ahead of monetary policy decisions) and in the JFSA (in the context of weekly meetings of senior officials). Further developing distinct processes within both authorities to assess systemic risks and discuss their policy implications at senior level would ensure a stronger focus on macroprudential issues.

In addition, the CCFS, as an important inter-agency coordination mechanism on financial stability issues, should be put on a sound institutional footing. This includes providing it with a formal mandate (its establishment was announced in a press release, but it is not formalized in regulation or law), expanding its membership to other relevant authorities, and defining members' responsibilities and accountabilities. This can help provide clarity about the contribution of different members to its functioning and promote stronger cooperation in system-wide risk assessment and mitigation (e.g. in assessing the financial stability implications of different policies), without overriding the respective mandates or impeding the operational autonomy of its members. The CCFS can be made more operationally effective by creating structures as necessary (e.g. inter-agency working groups on specific financial stability issues) to support its functioning. The authorities could also consider assigning the CCFS with explicit powers to issue warnings and make comply-or-explain policy recommendations, and to communicate its activities and decisions to the public (e.g. via press releases or periodic reports), as is the case with similar bodies in some other countries.[21]

[21] See the Annexes in the August 2015 FSB peer review report of China (http://www.fsb.org/2015/08/peer-review-of-china/) and the November 2015 FSB peer review report of Turkey

- ***<u>Recommendation 1</u>: The institutional arrangements for financial stability in Japan should be strengthened by: (a) further developing distinct processes within BOJ and JFSA to assess systemic risks and discuss policy implications at a senior level; and (b) putting the CCFS on a strong institutional footing by providing it with a formal mandate, expanding its membership to other authorities relevant for financial stability, and developing structures as necessary to support its functioning.***

Enhancing inter-agency cooperation: In recent years, the BOJ and JFSA have more actively shared information with each other on the findings from their respective risk analyses; however, there is potential for further improvements. For example, the BOJ and JFSA share the same formats for requesting data from banks in order to reduce the reporting burden, and they review jointly the approach to requesting new data sets. But they do not generally share the information each of them collects, which results in banks having to submit separately some of the same data to both authorities. This practice also restricts the BOJ's access to reporting data from financial institutions other than banks and securities firms (since only these have accounts with it) and limits its ability to assess, other than in a largely qualitative manner, the systemic risks posed by such entities.

Coordination between the BOJ and JFSA on their analyses of systemic risks is also limited and tends to be largely ex-post. For example, the two authorities inform each other about their respective assessment of risks after the publication of the FSR and FMR respectively. There is relatively little ex-ante coordination on the focus of those assessments or the respective methodologies that are used. As a result, both authorities conduct their respective analysis of similar types of risks with different analytical tools (e.g. BOJ heat map and JFSA dashboard) but do not leverage on the data and approaches of each other. Similarly, there is little coordination between bottom-up stress tests overseen by the JFSA and top-down stress tests conducted by the BOJ in terms of defining common stress scenarios on an ex-ante basis, comparing the results on an ex-post basis (only the BOJ shares its results with the JFSA) or agreeing on any follow-up from these exercises. More coordination could help further refine and improve stress test assumptions and scenarios.

A more coordinated risk assessment framework – for example, by fostering joint analytical work on interconnectedness and comparing stress testing approaches – would bring together the data and expertise of the two authorities to facilitate better assessments of systemic risks. This is particularly important given the current interest rate environment, which highlights the close relationship between monetary, micro-prudential and macroprudential policies. More joint work would also highlight any differences of view on systemic risks and their drivers, which would improve mutual understanding and communication to market participants.

- ***<u>Recommendation 2:</u> The BOJ and JFSA should develop a more coordinated risk assessment framework. This includes expanding data sharing arrangements between the two authorities for systemic risk analysis, and fostering coordinated analytical work (e.g. stress-testing and analysis of interconnectedness) to complement and leverage on the information and expertise of each authority.***

Broadening financial stability analysis: As previously mentioned, the BOJ and JFSA have enhanced their analysis of risks to financial stability in recent years through more in-depth

(http://www.fsb.org/2015/11/peer-review-of-turkey/) on the institutional arrangements and communication strategies respectively of inter-agency financial stability committees in Germany, Netherlands, UK and US.

stress testing, enhanced monitoring of mega-banks, and better analytical tools. In particular, the increased focus on the cross-border activities and associated credit and FX funding risks of the three mega-banks seems appropriate in light of those banks' expansion in foreign markets. Notwithstanding this progress, however, there remain some areas for improvement.

At present, the BOJ's FSR is primarily focused on quantitative analysis of the banking sector; its coverage of potential risks from non-bank financial institutions is limited and largely qualitative. The non-bank financial sector is large in Japan[22] and has been outpacing growth in the banking sector in recent years. The current interest rate environment, if sustained for an extended period, could pose a threat to the business model of some non-bank financial institutions, so the authorities should continue to expand their assessment of systemic risks outside the banking sector.

There is also a need to improve the analysis of interconnectedness in the financial system. A number of non-bank financial institutions are connected with Japanese banks through financial transactions and cross-holdings of equity and debt. The availability of data and analysis of interconnectedness between banks and other financial institutions is currently limited in terms of coverage and may be insufficient to assess fully the related risks.[23]

The FSR includes regular thematic assessments on current or emerging themes. While useful, such assessments (especially related to the non-bank financial sector) tend to be largely qualitative in nature, and it may be useful to complement them with more quantitative analysis. The impact of negative interest rates is one example. The April 2016 FSR points out the need to examine their impact on financial stability from the perspective of both the risk of overheating (e.g. through excessive accumulation of macro risks and exuberant asset prices) and of a gradual pullback in financial intermediation due to a persistent decline in bank profits. The FSR includes a preliminary discussion on these issues but does not, however, make a quantitative assessment of potential long-term risks for different types of financial institutions.[24]

Similarly, it would be useful to enhance the analysis of sovereign-financial stability interlinkages, as was also recommended in the FSAP. This is a key issue in many countries and is particularly important in Japan given the high level of government debt and its holdings by the domestic financial system. The assessment of the risks of sovereign exposures in both top-down and bottom-up stress tests could be expanded by, for example, including a scenario of increasing domestic sovereign bond yields,[25] as is the case in some other countries.[26]

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22 According to the FSB Global Shadow Banking Monitoring Report 2015 (http://www.fsb.org/2015/11/global-shadow-banking-monitoring-report-2015/), insurance companies, pension funds and other financial intermediaries (OFIs, excluding central banks and public financial institutions) accounted for 36% of the financial system assets in Japan at the end of 2014.

23 For example, Japan is among the few FSB jurisdictions that do not provide information on banks' assets and liabilities to OFIs as part of the FSB's annual shadow banking monitoring exercise.

24 The BOJ made a quantitative assessment of the effects of quantitative easing and negative interest rates in the October 2016 FSR (https://www.boj.or.jp/en/research/brp/fsr/fsr161024.htm/).

25 The April 2016 FSR presented an assessment of the impact of an increase in overseas (and not domestic) long term interest rates; see page 98 (https://www.boj.or.jp/en/research/brp/fsr/fsr160422.htm/).

26 See, for example, the shocks to the sovereign yield curve undertaken by the European Banking Authority (https://www.eba.europa.eu/documents/10180/1259315/2016+EU-wide+stress+test-

The JFSA has made important progress since the FSAP in introducing bottom-up stress testing and incorporating it into its supervisory process. It already requires such tests for G-SIBs and intends to introduce them for D-SIBs as well. Going forward, it may be worth expanding this exercise to other banks and non-bank financial institutions. In some other advanced economies the list of banks required to conduct regular stress tests using the supervisor's methodology is wider,[27] while the focus of such tests has recently expanded to non-bank financial institutions given the current interest rate environment. Expanding the scope of coverage of bottom-up stress tests in Japan would enrich the JFSA's assessment of systemic risks by helping to detect potential problems in a wider set of institutions.

- ***Recommendation 3:*** ***The BOJ and JFSA should consider broadening their systemic risk analysis by: (a) expanding the scope of bottom-up stress tests beyond SIBs; (b) enhancing the assessment of risks in the non-bank financial sector, including through interconnectedness and other quantitative analysis; and (c) expanding the analysis of sovereign-financial stability interlinkages.***

3. Framework for the resolution of financial institutions

Background

The FSAP noted that Japan's resolution authorities had a range of crisis prevention and resolution powers, which included special measures under "systemic risk exception" for public injections of capital into the financial system, the establishment of a blanket guarantee and the nationalisation of financial institutions. In times of financial crisis, high-level coordination is provided by the Financial Crisis Response Council (FCRC), which was established in 2001.[28] The FSAP further noted that the authorities are working closely with other countries to improve arrangements for collectively resolving cross-border problems; and that they are preparing recovery and resolution plans (RRPs) for Japan's G-SIBs and examining their extension to a wider range of domestic financial institutions.

The FSAP set out a number of recommendations in relation to the resolution framework:

- extension of the regime beyond banks to include systemically important nonbank financial institutions;
- extension of the scope of RRPs to all systemically relevant bank and non-bank financial institutions;

Methodological+note.pdf, page 56 clause 3.6.2) and the US Federal Reserve Board (https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160623a1.pdf, page 60).

[27] For example, banks with assets exceeding Euro 30 billion in the European Union and US$ 50 billion in the United States are subject to stress tests. According to information from the Japanese Bankers Association, about 20 Japanese banks (in addition to D-SIBs) had assets higher than US$50 billion as of 1 October 2015.

[28] The FCRC is chaired by the Prime Minister. Other members are the Chief Cabinet Secretary, Minister of Finance, Minister of Financial Affairs, Governor of BOJ and Commissioner of the JFSA. The Supervisory Coordination Division of the JFSA's Supervisory Bureau, in cooperation with the Financial System Stabilization Division of the Ministry of Finance, is responsible for the general affairs of the Council.

- refinements to the bank resolution framework in order to minimise its costs (e.g. through earlier triggers and speedier administrative procedures);
- rebalancing of the roles of the JFSA, DICJ and the judiciary to ensure the resolution decisions implemented by the JFSA/DICJ are subject to ex post judicial review; and
- amendments to the governance structure of the DICJ to make it more independent.

This section reviews progress by the authorities in strengthening the resolution framework for deposit-taking and other financial institutions since the FSAP. Drawing on the FSB *Key Attributes of Effective Resolution Regimes for Financial Institutions* (*Key Attributes*)[29] and other policy guidance[30] as well as experience in other countries, it examines the objectives, scope and functioning of the framework in order to identify any gaps and lessons of experience for FSB members.

Steps taken and actions planned

Legal framework and institutional arrangements: The Deposit Insurance Act (DIA) was introduced in 1971 and was amended most recently in June 2013 to introduce the 'orderly resolution' regime (see Box 2 for a history of the crisis management and resolution framework in Japan). The 2013 amendments go some way towards addressing the recommendations of the FSAP and putting in place a resolution framework that contains the elements described in the *Key Attributes*. In particular, the amendments expand the scope of the resolution regime to all insurance and securities companies, along with deposit-taking institutions, regardless of their size or systemic importance. The regime also extends to the holding companies and operating subsidiaries of these financial institutions, as well as to domestic branches of foreign banks, though it does not extend to financial market infrastructures such as central counterparties.

Historically, the Japanese authorities have managed failing banks using purchase and assumption methods, temporary nationalisation or capital injections.[31] The revised DIA introduced a framework for 'orderly resolution', under which systemic risk arising from the failure (or likely failure) of a financial institution is deliberated by the FCRC. The FCRC considers actions that the authorities may need to take in response to such an event, based on measures in the DIA including the provision of liquidity and financial assistance and, more recently, additional resolution powers.

The JFSA, as resolution authority, determines the resolution strategy and actions. In the case of the orderly resolution regime, it is expected that the DICJ will become a receiver and implement the resolution action under the supervision of the JFSA, with some of its actions (e.g. providing financial assistance) requiring JFSA and MoF approval. The BOJ may, in certain circumstances, provide resolution funding to the DICJ (see sub-section on '*Resolution funding*' below).

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29 See http://www.fsb.org/2014/10/r_141015/.

30 See, for example, http://www.fsb.org/wp-content/uploads/Principles-for-Cross-border-Effectiveness-of-Resolution-Actions.pdf and http://www.fsb.org/wp-content/uploads/Guiding-principles-on-the-temporary-funding-needed-to-support-the-orderly-resolution-of-a-global-systemically-important-bank-%E2%80%9CG-SIB%E2%80%9D.pdf.

31 For example, Resona Bank and Ashikaga Bank were resolved in 2003 using capital injection and temporary nationalisation powers respectively.

Box 2: Reforms to the crisis management and resolution framework in Japan	
1971	DIA introduced and DICJ established
1986	Amendments to the DIA - *Introduction of financial assistance and provisional payment method*
1996	Amendments to the DIA - *Introduction of temporary blanket guarantees and asset purchase powers*
1998	Temporary legislation (Financial Functions Stabilization Act, Financial Revitalization Act, Early Strengthening Act) - *Capital injection operations and temporary nationalisation powers*
2000	Amendments to the DIA - *Permanent introduction of bank resolution measures (financial administrator, bridge bank, crisis management measures)*
2004	Financial Function Strengthening Act - *Temporary capital injection scheme*
2005	Abolition of blanket guarantees (partially lifted in 2002)
2013	Amendments to the DIA - *Introduction of measures for orderly resolution (enacted March 2014)*

The FSAP noted that the inclusion on the DICJ's Policy Board of representatives of banking associations gives the appearance of conflicts of interest, and recommended that the DICJ's governance structure should be amended to make it more independent. However, the revised DIA did not introduce any changes to the institutional arrangements for resolution and the composition of the DICJ policy board is unchanged, with five out of thirteen members representing banking associations.[32]

Resolution options: The resolution framework as set out in the DIA – distinct from the ordinary corporate insolvency regime – has three separate regimes (see Figure 1 for entry into resolution under these regimes and Annex 3 for a comparison of the various measures):

(i) Failure resolution under limited coverage

Failure resolution under limited coverage applies to deposit-taking institutions and involves the use of the deposit insurance fund to facilitate a pay-out of insured deposits and the liquidation of the failed bank (insurance approach), or a transfer of insured deposits to an acquiring bank with some financial assistance (P&A approach). This regime applies only where the authorities determine that the failure of a deposit-taking institution would not cause systemic risk.

(ii) Measures against financial crisis

If, on the other hand, the authorities determine that the failure of a deposit-taking institution poses a systemic risk, then the second resolution regime – measures against financial crisis – may apply. Entry into resolution under the measures against financial crisis requires

[32] See https://www.dic.go.jp/english/e_kikotoha/e_unei/index.html for the full list of members.

confirmation by the Prime Minister, following deliberations by the FCRC.[33] This regime includes three separate measures: *measures under item I* (recapitalisation of a deposit-taking institution that is not insolvent); *measures under item II* (financial assistance in an amount exceeding the insured deposit pay-out cost); and *measures under item III* (temporary nationalisation of an insolvent deposit-taking institution in cases that threaten financial stability). The measures under items I and III seek to protect all liabilities, while those under item II seek to protect at least all deposit liabilities.

(iii) Measures for orderly resolution

The measures for orderly resolution were introduced following the revisions to the DIA and are distinct from the regimes above in that they apply to all types of financial institution (see Annex 4). The activation of the orderly resolution regime requires confirmation by the Prime Minister, following deliberations by the FCRC. The orderly resolution regime includes two measures: *Special Resolution Regime I*, where a financial institution that is not insolvent maintains its operations and takes steps to improve its financial condition (through special oversight and loan of funds/capital injection by the DICJ); and *Special Resolution Regime II*, where an insolvent (or likely to become insolvent) financial institution is liquidated in an orderly manner. The measures for orderly resolution seek to protect only the systemically important assets and liabilities, while Special Resolution Regime II envisages the imposition of losses on non-systemically important liability holders.

Special Resolution Regime II under the measures for orderly resolution is the resolution regime that is intended to align with the *Key Attributes*. However, the determination between the different measures is made on a case-by-case basis by the FCRC, taking into account the financial institution's solvency and the impact of its failure on Japan's financial system (in the case of the measures for orderly resolution) or on Japan's credit system (in the case of a deposit-taking institution under the measures against financial crisis). There are no specific criteria set out for the different measures, and the authorities do not preclude the possibility of using any of the measures conferred under the DIA, though they have stated that a single point of entry resolution strategy based on Special Resolution Regime II is the preferred strategy for an orderly resolution of Japanese G-SIBs (see Box 3). As such, the Japanese resolution framework leaves room for flexibility regarding the circumstances under which the Prime Minister would select Special Resolution Regime II under the measures for orderly resolution, as opposed to other types of measures available under the DIA.

Resolution powers: Under the revised DIA, different sets of powers under different resolution options are available to deal with a failed financial institution, depending on whether the failure of that institution is determined to have a systemic impact.

In cases where the Prime Minister (following deliberations by the FCRC) confirms the need for orderly resolution, the authorities have a wide range of resolution powers including those to: control and operate a firm in resolution; replace management; transfer assets and liabilities; establish a temporary bridge institution; and impose a temporary stay on the exercise of early termination rights.

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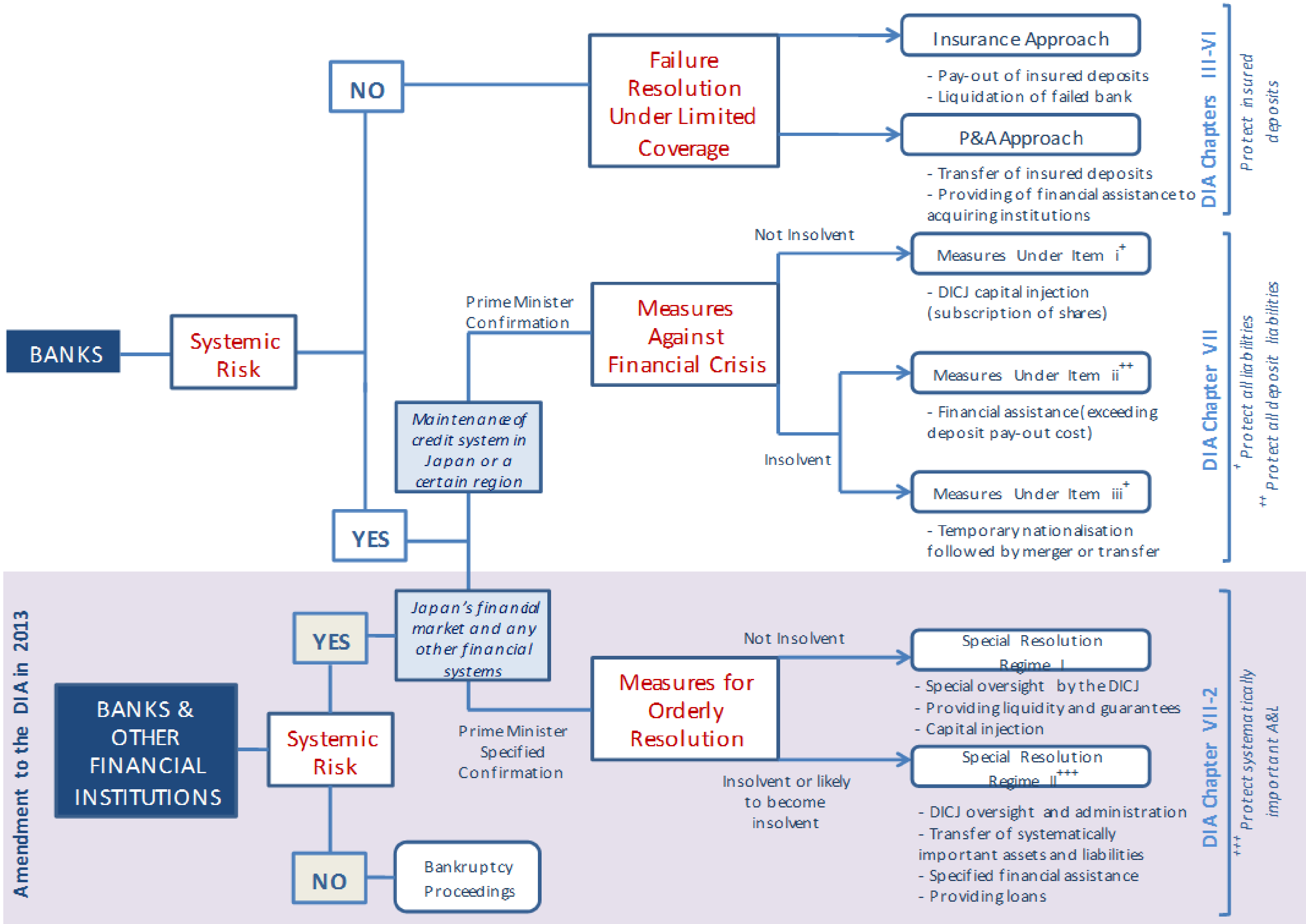
[33] The FCRC will be convened when the relevant authorities recognise that a financial institution is at a risk of failure. The FCRC may be convened by any of its members, but in practice the JFSA – as competent authority – is likely to be best placed to assess the financial condition of a financial institution and determine that the FCRC should be convened.

Figure 1: Entry into resolution for failing financial institutions under the DIA



In a few cases, however, there remain discrepancies with the characteristics of the resolution powers set out in the *Key Attributes*.

For example, the temporary stay on the exercise of early termination rights is not strictly limited in time. The duration of the stay is the "period necessary to avoid the risk of severe disruption to financial system" and the exact time period will be specified by the Prime Minister.[34] Nevertheless, the authorities have stated that they will apply the temporary stay taking into account the expectation in the *Key Attributes* that the duration of the stay be strictly limited in time (e.g. for a period not exceeding two business days).[35]

Moreover, none of the three resolution regimes provides for a statutory power to write down and convert liabilities. Pursuant to Key Attribute 3.5, authorities should have the powers within resolution to: (i) write down uninsured and unsecured creditors' claims; (ii) convert into equity or other instruments of ownership of the firm under resolution (or of any successor in resolution or the parent company), all or part of unsecured and uninsured creditors' claims; and (iii) convert or write-down any contingent convertible or contractual bail-in instruments whose terms had not been triggered prior to entry into resolution. Under the DIA the Japanese authorities have the power to write down or convert into equity contractual bail-in instruments upon entry into orderly resolution (according to their contractual terms), but they cannot statutorily write-down other claims of uninsured and unsecured creditors or convert them into equity of the failed firm or of any successor in resolution.[36]

In the absence of a statutory bail-in power, the authorities envisage the use of Special Resolution Regime II to impose losses on unsecured and uninsured creditors and achieve the economic effect of bail-in, as part of the work to develop resolution strategies for G-SIBs. The JFSA's April 2016 *Approach to Introduce the TLAC Framework*[37] outlines its approach to introduce the FSB's standard on Total Loss-Absorbing Capacity (TLAC)[38] for Japanese G-SIBs. Under this approach, a failed G-SIB's systemically important assets and liabilities are transferred to a bridge financial institution, while the shareholders and remaining creditors of the failed bank (i.e. constituting the non-systemically important liabilities) are placed into ordinary insolvency proceedings (see Box 3). The resolution framework does not provide guidance or clarity on which assets and liabilities should be considered "systemically important". This decision is made on a case-by-case basis, based on a consideration of whether the close-down, rather than transfer, of the business relevant to the assets and liabilities would cause severe disruption in Japan's financial system.

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34 For more details, see Annex H of the FSB's March 2016 Second Thematic Review on Resolution Regimes (http://www.fsb.org/wp-content/uploads/Second-peer-review-report-on-resolution-regimes.pdf).

35 See http://www.fsa.go.jp/news/25/20140305-1/01.pdf (available only in Japanese).

36 As noted in the August 2016 FSB report to the G20 on progress in resolution, "The Japanese authorities report that they are able to achieve the economic objectives of bail-in by capitalising a bridge institution to which functions have been transferred and by liquidating the residual firm via powers to separate assets and liabilities of a failed institution. However, it is not clear that the resolution regime provides for powers to convert claims of creditors of the failed institution into equity of that institution or of any successor in resolution as required by KA 3.5 (ii)". See http://www.fsb.org/wp-content/uploads/Resilience-through-resolvability-%E2%80%93-moving-from-policy-design-to-implementation.pdf.

37 See http://www.fsa.go.jp/en/news/2016/20160415-1/01.pdf.

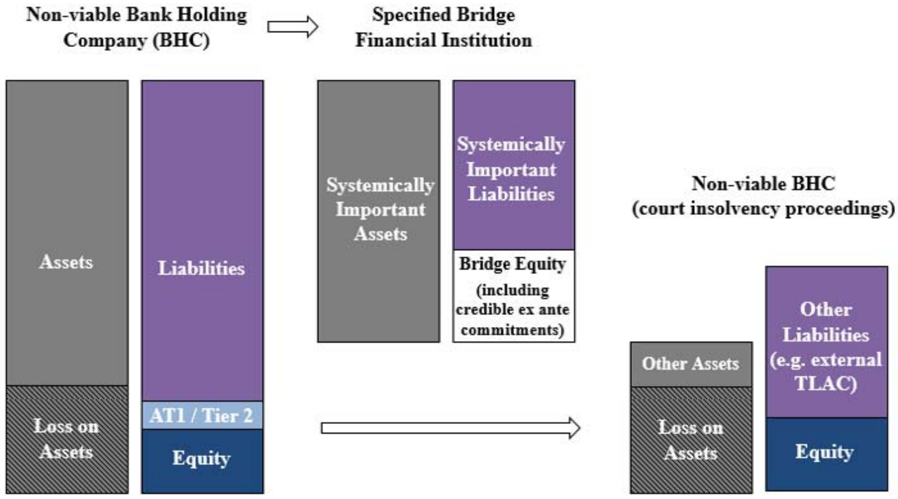
38 See http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf.

Box 3: Proposed framework for orderly resolution of Japanese G-SIBs

The April 2016 JFSA document describes its proposed framework for the orderly resolution of G-SIBs under the preferred Single Point of Entry (SPE) resolution strategy.[39] The intended procedure of orderly resolution for the Japanese G-SIBs under the SPE resolution strategy is as follows:

- Losses incurred at subsidiaries are absorbed by the top-tier bank holding company (BHC), which is the entity to which resolution tools will be applied. Losses are absorbed through the write-down and/or conversion of internal TLAC instruments issued by subsidiaries to the BHC.[40]
- Depending on the size of the losses absorbed by the BHC, the relevant authorities will determine that the conditions for entry into resolution have been met. This requires the BHC to become insolvent or likely to become insolvent, or to have suspended payments or be likely to suspend payments; and the Prime Minister – following deliberations by the FCRC – to confirm the necessity for Special Resolution Regime II under the measures for orderly resolution.
- At this point, the BHC is considered non-viable and Basel III eligible Additional Tier 1 and Tier 2 instruments issued by the BHC will be written off or converted into equity in accordance with their contractual terms.
- The systemically important assets and liabilities of the non-viable BHC are transferred with permission of the court to a Specified Bridge Institution incorporated (and fully owned) by the DICJ. The transfer is expected to take place over the resolution weekend. The assets and liabilities that are systemically important are determined on a case-by-case basis, with confirmation by the Commissioner of the JFSA (delegated authority from the Prime Minister).
- The Specified Bridge Institution may be capitalised through pre-funded commitments from the DICJ's deposit insurance fund reserves. The Specified Bridge Institution is expected to transfer its business to a private financial institution(s) within a period of two years.
- The non-viable BHC, including the remaining equity and the assets and liabilities not transferred to the Specified Bridge Institution, will enter into ordinary insolvency proceedings following the filing of a petition by the DICJ. Creditors of the non-viable BHC, including the holders of external TLAC, are expected to incur loss through the liquidation process.

A stylised balance sheet example of this procedure is shown below:



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[39] As described in the FSB's July 2013 *Guidance on Developing Effective Resolution Strategies* (http://www.fsb.org/wp-content/uploads/r_130716b.pdf) under the SPE strategy resolution powers are applied to the top of a group by a single national resolution authority.

[40] Certain internal TLAC instruments require a contractual or statutory trigger to ensure that they can be written down and/or converted to equity at the point of non-viability, as per Section 19 of the TLAC Term Sheet.

Application of the regime to non-bank financial institutions: While the amendments to the DIA expand the scope of the resolution framework to all financial institutions, including insurance companies and securities firms, there is at present no sector-specific adaptation to the resolution framework and the powers available under the regime. This reflects the fact that insurance companies have to date been resolved under the existing framework of bankruptcy. With regard to securities firms, recovery and resolution planning is being carried out for those firms that conduct large and complicated business operations, based on the use of resolution tools and strategies similar to those envisaged for banks.

Specific resolution tools are available for insurance companies under the Insurance Business Act. The powers available under this Act include the transfer of insurance portfolios to a financially sound insurer or bridge institution, restructuring of insurance contracts and conducting a run-off of existing contracts of an insurer in resolution. There are some conditions on the exercise of these powers. For example, the power to restructure insurance contracts cannot be exercised if more than 10% of policyholders raise an objection to the modification, and if the amount of the claims of those policyholders exceeds 10% of the total amount of claims subject to the restructuring. While the authorities point out that there have been no examples of these conditions being met in past resolution cases, this does not preclude the possibility that such an impediment may arise in the future.

Role of the court: Although the DIA confers the resolution authority extensive resolution powers, the courts retain an important role in the resolution process.

Under the measures for orderly resolution, the resolution powers in the DIA are exercisable without shareholder consent. However, court permission is required as a substitute for shareholder consent when implementing a reduction in the amount of stated capital, replacing management or transferring systemically important assets and liabilities to a bridge financial institution ("substituted permission"). The court does not have discretion to judge the necessity or adequacy of the application of the resolution tool, and only examines whether the conditions required under the DIA (e.g. with respect to insolvency or likely insolvency) are met. Shareholders and creditors are able to appeal against the court's decision, but the exercise of the right by the resolution authority cannot be overridden as a whole.

Once substituted permission has been granted and a transfer of systemically important assets and liabilities is carried out, the remaining assets and liabilities (i.e. those deemed not to be systemically important) in the failed financial institution are subject to insolvency proceedings. The court makes an order for the commencement of such insolvency proceedings upon receiving a petition from the DICJ.

The court also plays a central role in the recognition of foreign resolution actions (see sub-section on '*Legal framework for cross-border cooperation*' below).

Resolution funding: Financial assistance – generally provided by the DICJ – is available to support many of the resolution measures. Following the revisions to the DIA in June 2013, resolution funding may be extended to all types of financial institutions.

Under the first regime – failure resolution under limited coverage – the DICJ may provide financial assistance to support the P&A approach (e.g. donation of money, guarantee of liabilities, purchase of assets, subscription of shares or loss sharing). The Policy Board of the DICJ is required to consider the expected costs of the financial assistance compared to the expected costs of an insured deposit pay out, with a view to making an efficient use of the DICJ's funds ('least cost approach').

In cases where there is a systemic risk and the need for measures against financial crisis is confirmed, the DICJ can provide capital support to both solvent and insolvent deposit-taking institutions and liquidity support to solvent deposit-taking institutions. If the need for measures for orderly resolution is confirmed, the DICJ can provide funding to the institution (irrespective of whether it is solvent or not) for both recapitalisation and liquidity purposes. The DICJ can provide funding throughout the resolution process, for instance to support the transfer of systemically important assets and liabilities from a failed financial institution to a bridge institution, or to provide loans ahead of a transfer to pay any systemically important liabilities that become due.

The revised DIA stipulates that the Policy Board of the DICJ may make a determination to provide financial assistance as long as the amount of assistance does not exceed the amount necessary to effect the transfer in light of the financial conditions of the failed institution. This amendment seeks to address a recommendation in the FSAP that the regime should place greater emphasis on minimising resolution costs.

The activities of the DICJ are funded primarily by ex-ante deposit insurance premiums from banks. Financial assistance from the DICJ is funded through the issuance of bonds and borrowings up to the amount stipulated by Cabinet Orders for each of its different accounts. As of June 2016, the DICJ's funding totalled around JPY 2.1 trillion.[41] All of the DICJ's bond issuances and the large majority of its borrowings are backed by government guarantees.[42] Should the DICJ need to secure additional funding (e.g. if market funding is not available in sufficient quantity), it may borrow on a temporary basis from the BOJ. The general conditions for the facility to the DICJ are set forth in the BOJ's operational guideline as determined by the BOJ Policy Board (e.g. duration, loan rate). Under the operational guidelines, the BOJ requires the DICJ to obtain a government guarantee for the borrowing. This borrowing is for a period of six months and is renewable.

The revised DIA provides that losses incurred in the provision of resolution funding are recovered from the financial industry via ex-post contributions. The decision to impose these contributions is taken by the Prime Minister and the Minister of Finance, on the basis of a report from the DICJ. However, under Article 125 of the DIA the government may provide subsidies to the DICJ "if the costs of such operations are to be funded solely from the financial industry, the financial conditions of a financial institution would deteriorate significantly and it may cause an extremely serious hindrance to the maintenance of an orderly credit system in Japan or cause severe disruption in the financial market or any other financial system in Japan".

Cooperation and information sharing among authorities: There are no formal provisions or mechanisms for cooperation and information sharing among domestic authorities solely for resolution purposes. However, in practice, cooperation between the JFSA, MoF and the BOJ is facilitated through the FCRC and information is shared between the authorities when

[41] For more details, see http://www.dic.go.jp/english/e_katsudo/e_shikinchotatsu/index.html and the DICJ's 2015-16 annual report (http://www.dic.go.jp/english/e_shiryo/e_nenpo/e_2015-2016.pdf).

[42] The DICJ bond issuances and borrowings are subject to ceilings set out in the DIA, and are complemented by annual budgetary appropriations (approved by the Diet) for the amount guaranteed by the government.

necessary. In addition, in accordance with the National Government Organization Act, the MoF and JFSA are able to coordinate and share information by virtue of their institutional status as government authorities. The JFSA and MoF are also able to obtain information from the DICJ in their capacity as the supervisor of the DICJ. On its part, the DICJ is able to obtain information from the JFSA, MoF and BOJ when necessary through a specific provision in the DIA. These mechanisms for coordination and information sharing do not differ in respect of different types of financial institutions.

The authorities have the ability to share information with foreign authorities for resolution-related purposes, though one consideration prior to the sharing of information is whether the foreign authority in question has safeguards in place to protect the confidentiality of that information. At a practical level, the authorities have signed a number of cooperation agreements (as home authority for the three Japanese G-SIBs and as host authority for several other G-SIBs) that allow for the sharing of information between members of G-SIB Crisis Management Groups (CMGs), and memoranda of understanding have been agreed with some other authorities. CMG meetings have been held once a year for the three Japanese G-SIBs and one other systemically important financial institution.

Legal framework for cross-border cooperation: There are no formal powers for the resolution authority to recognise or support foreign resolution actions. Instead, the framework to recognise or give effect under Japanese law to a foreign resolution action is a judiciary procedure set out in the Act on Recognition of and Assistance for Foreign Insolvency Proceedings. The framework is based on the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvency [43] and has been implemented such that the scope extends to financial institutions. Under this framework the recognition of administrative resolution proceedings may not be possible.

The court is responsible for recognition and assistance proceedings for resolution measures taken by a foreign authority in respect of a foreign financial institution operating in Japan. If the trustee of a foreign insolvency proceeding applies for recognition in Japan, the court would recognise those proceedings and the measures taken by the foreign trustee. In principle, the court may not commence Japanese insolvency proceedings while the recognition is effective, as long as the court recognises that the foreign insolvency proceedings are the primary insolvency proceedings.

Under this framework, the court would apply a test to determine whether it is contrary to public policy in Japan to render a disposition of assistance for the foreign proceedings. A person who has an interest in a judicial decision concerning a recognition and assistance proceedings may file an immediate appeal against the judicial decision, though this would not suspend the order. If the appeal is upheld, the order would cease to be effective.

During the period between the filing of a petition and a recognition order, the court may order to have the foreign debtor's business and property in Japan administered by a provisional administrator ("provisional administration order"). As regards the timeframe, the Japanese

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[43] The UNCITRAL Model Law is a global framework that addresses coordination and recognition of cross-border insolvency actions. The Model Law provides mechanisms for facilitating access to courts in other countries; recognition of foreign proceedings; and assistance and relief to the foreign court and foreign representative. See http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html.

authorities have indicated that the order is expected to be issued on the same day as the petition is filed, although there are few historical precedents to evidence this. The court will apply the same standards to the recognition of resolution actions as for the recognition of normal foreign bankruptcy proceedings.

Although a recognition order may prevent the execution by creditors on the assets of the foreign institution located in Japan, there is no statutory framework to directly recognise a bail-in. The authorities have indicated that contractual recognition clauses could give effect to a bail-in, although it is not ruled out whether the court might find such clauses invalid on the grounds of violation of public policy or of the objectives of the national insolvency regime.

Recovery and resolution planning: At present, recovery and resolution planning (and, by extension, resolvability assessments) is carried out for the three Japanese G-SIBs and for D-SIBs as necessary. No recovery and resolution planning is carried out for insurance companies, as no such company has been designated as potentially systemically important in failure. As the resolution authority, the JFSA develops resolution plans and conducts resolvability assessments in coordination with the DICJ and the BOJ. The resolution plans are updated at least annually and following any significant changes in a firm's group structure or business.

The Japanese resolution framework includes an explicit power to require banks to adopt appropriate measures where necessary solely in order to improve their resolvability, though these powers have not yet been exercised.[44]

Lessons learned and issues to be addressed

The Japanese authorities have made progress in developing the resolution framework to address the FSAP recommendations and include the elements described in the *Key Attributes*. In particular, the June 2013 revisions to the DIA introduced a regime for 'orderly resolution' and expanded the scope of the regime to cover all financial institutions (banks, insurance and securities firms) as well as the holding companies and operating subsidiaries of such institutions and domestic branches of foreign banks. The orderly resolution regime provides two new measures at the disposal of the authorities, the application of which depends on the solvency of the financial institution in question.[45] It also provides a wide range of resolution powers, including those to: transfer assets and liabilities; establish a temporary bridge institution; and impose a temporary stay on the exercise of early termination rights. In a few cases, however, there remain discrepancies with the characteristics of the resolution powers set out in the *Key Attributes* (for example, there is no statutory bail-in power).

The authorities have also expanded the scope of recovery and resolution planning to include D-SIBs where necessary, and developed a preferred resolution strategy for the Japanese G-SIBs in their proposed framework for the orderly resolution of such firms. The resolution framework includes a well-developed funding framework with sizeable – both in magnitude and in comparison to other countries – pre-funded resources and clearly identified sources of

44 See Section IV and Annexes I-K of the FSB's March 2016 Second Thematic Review on Resolution Regimes (ibid) for further information on recovery and resolution planning and resolvability assessments in Japan.

45 The measures permit the provision of liquidity or capital enhancement through the special oversight of the DICJ (Special Resolution Regime I) for a solvent financial institution, or the transfer of systemically important assets and liabilities to a bridge or acquiring financial institution (Special Resolution Regime II) for an insolvent (or likely to become insolvent) financial institution.

funding, while the revised DIA introduces a provision that losses incurred in resolution funding be recovered from financial institutions through an ex-post levy.

Notwithstanding this progress, further work is needed to ensure that the resolution framework fully aligns with the *Key Attributes* and is perceived as credible by market participants. This includes: developing clear standards and detailed indicators on the choice of resolution measures; clarifying preferred resolution options and the need for temporary funding to generally be a last resort option; developing sector-specific adaptations to, and strategies based on, the resolution regime; and ensuring that court involvement does not compromise implementation of resolution measures.

Choice of resolution measures: The recently introduced orderly resolution regime, which applies to all types of financial institutions, includes two measures. Under Special Resolution Regime I, liquidity and capital support may be provided to a financial institution that is expected to remain a going concern (i.e. not insolvent) and under the special oversight of the DICJ. Under this option, shareholders' equity may only be diluted and only liabilities with contractual triggers tied to a Common Equity Tier 1 (CET1) ratio of 5.125% (or higher) of risk-weighted assets may be written down and/or converted to equity. On the other hand, Special Resolution Regime II envisages a wider imposition of losses on shareholders and certain creditors (i.e. those holding liabilities that are deemed not to be systemically important) in respect of a financial institution that is insolvent or likely to become insolvent.

The *Key Attributes* require timely and early entry into resolution before a firm is balance sheet insolvent. Accordingly, Special Resolution Regime II may be applied to a firm that is likely to become insolvent. However, for such a firm the authorities could also choose to apply Special Resolution Regime I or, in the case of a deposit-taking institution, a DICJ capital injection as part of the measures against financial crisis, both of which may protect all liability holders. The determination of which measure/regime to take is made on a case-by-case basis, and there are no clear standards or detailed indicators to guide the authorities' decision prior to insolvency. This creates uncertainty as regards the circumstances under which the Prime Minister would confirm the necessity for Special Resolution Regime II. Moreover, the concept of likely insolvency under Special Resolution Regime II is not clearly elaborated.

The flexibility allowed by the current framework has fed market perceptions that a pre-emptive recapitalisation (rather than orderly resolution) is the authorities' preferred option for a failing SIFI. For example, the credit ratings for debt issued by the Japanese G-SIBs (at both the operating bank and holding company levels) still incorporate government support, reflecting the view of the major credit rating agencies that pre-emptive capital and liquidity injections remain the preferred method of the authorities to deal with failing but still solvent financial institutions. Other market data, such as the fact that spreads of those banks' debt instruments have not substantially changed following the DIA amendments or the JFSA's publication of the preferred SPE strategy for Japanese G-SIBs, also seem to support this view.[46]

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[46] Indicators used in the empirical literature to assess the effectiveness of resolution reforms have largely focused on the implicit public subsidies of SIBs, based on market prices and credit ratings of those firms. See, for example, "Estimating the extent of the 'too big to fail' problem — a review of existing approaches" by Siegert and Willison (http://www.bankofengland.co.uk/financialstability/Documents/fpc/fspapers/fs_paper32.pdf, April 2015, Bank of England Financial Stability Paper No. 32).

The authorities express support for the objectives of resolution reforms that are included in the *Key Attributes*, and point out that the JFSA's recent publication of the approach to introduce the TLAC standard clearly states that a SPE resolution strategy based on Special Resolution Regime II is the preferred resolution strategy for Japanese G-SIBs. They note, however, that limiting their flexibility under the current framework may increase the time or cost of resolution actions, and that experience with public support during the crisis in the late 1990s has been positive in that public financial assistance was generally recouped (albeit over time) while financial stability and credit to the economy were maintained.

There seems to be therefore an apparent discrepancy between market expectations and the authorities' intentions concerning the actions to be taken in the event of a failing SIFI. Affecting market expectations is an objective of resolution reforms, so as to reduce moral hazard and to ensure that SIFIs internalise the systemic risks to which they give rise. The authorities should address this discrepancy and seek to dispel market perceptions by being more explicit, in terms of their implementation guidance and in public communication, about the factors that will determine the choice of resolution measures. This includes clarifying those instances in which measures for orderly resolution (as opposed to measures against financial crisis) will likely be undertaken; and elaborating on the concept of likely insolvency of a failing financial institution so as to better align it with the intent of the *Key Attributes* for timely entry into resolution and also to clarify the differences between the application of Special Resolution Regimes I and II.

- ***Recommendation 4*: *To provide greater clarity to market participants, strengthen the credibility of the resolution framework and ensure timely entry into resolution, the authorities should develop transparent and formal guidance on the choice of resolution measures that: (a) clarifies the differences between the measures against financial crisis and the measures for orderly resolution; and (b) elaborates on the concept of likely insolvency under Special Resolution Regime II (e.g. by setting out clear standards or detailed indicators) .***

Resolution funding: Japan's resolution framework provides the authorities with a well-developed system of resolution funding for both recapitalisation and liquidity support that, following the revisions to the DIA, also applies to non-bank financial institutions. Financial assistance from the DICJ is funded through the issuance of bonds and borrowings, the large majority of which are government guaranteed. This is complemented by temporary backstop funding by the BOJ, and by a provision in the revised DIA that any costs incurred by the authorities in the provision of resolution funding are recovered from the financial industry, consistent with the *Key Attributes*. Article 125 of the DIA provides that the government may cover part of those costs, though the condition for such coverage is strictly limited under the Act.

The *Key Attributes* require that the provision of temporary funding by the authorities should include a determination that private sources of funding have been previously exhausted or cannot achieve the objectives of orderly resolution.[47] However, the conditions specified under

[47] *Key Attribute* 6.4 provides that "Any provision by the authorities of temporary funding should be subject to strict conditions that minimise the risk of moral hazard, and should include (i) a determination that the provision of temporary funding is necessary to foster financial stability and will permit implementation of a resolution option that is best able to achieve the objectives of orderly resolution and that private sources of

the current framework do not seem sufficiently strict to ensure that this is met. Special Resolution Regime I imposes losses only on holders of instruments with certain contractual triggers, while Special Resolution Regime II imposes losses on unsecured and uninsured creditors only to the extent that the liabilities are not deemed "systemically important". There is at present no guidance or clarity on which assets and liabilities should be considered systemically important. This decision is made on a case-by-case basis, based on a consideration of whether the close-down, rather than transfer, of the business relevant to the assets and liabilities would cause severe disruption in the financial system. Moreover, the possibility of government support under Article 125 of the DIA, while strictly limited, raises the question of whether costs incurred in the provision of resolution funding would be fully recovered from the financial industry.

A possible way to address this issue under the current framework would be for the authorities to communicate (e.g. in the form of a policy statement) their intention to rely in the first instance on private sources of funds to cover the losses from the failure of a financial institution, and that any financial assistance is expected to be eventually recovered from the industry**.**

- ***<u>Recommendation 5</u>: To minimise the gaps between market expectations and the authorities' intentions regarding the provision of temporary funding in resolution, the authorities should clarify in public communication that: (a) they intend to rely in the first instance on private sources of funds to cover the losses from the failure of a financial institution; and (b) any such funding by the authorities is expected to eventually be recovered from the industry in line with the Key Attributes.***

***Sector-specific adaptations to the resolution regime*:** As noted above, the 2013 amendments to the DIA expanded the scope of the resolution regime to cover all financial institutions as well as their holding companies and operating subsidiaries, regardless of their size or systemic importance. Few other FSB jurisdictions have implemented a cross-sectoral resolution regime, so this represents a substantial enhancement to Japan's resolution framework.

At present, there is no sector-specific adaptation with regard to the resolution framework and the powers available under the regime. For example, there are no conditions for entry into resolution that are specific to insurers and, while some specific resolution tools are available for such companies, these are conferred under a separate Act and are subject to certain conditions (e.g. requirements for policyholder consent). Recovery and resolution planning is not yet being carried out for insurance companies, reflecting the fact that insurance companies in Japan have to date been resolved under the existing framework of bankruptcy. With regard to securities firms, recovery and resolution planning is being carried out for those firms that conduct large and complicated business operations, based on the use of resolution tools and strategies similar to those envisaged for banks.

funding have been exhausted or cannot achieve these objectives; and (ii) the allocation of losses to equity holders and residual costs, as appropriate, to unsecured and uninsured creditors and the industry through ex post assessments, insurance premiums or other mechanisms".

Policy work is ongoing at the international level on resolution strategies and tools for non-bank financial institutions.[48] Drawing on this work, the authorities should consider the need for adaptations to the resolution regime in order to develop strategies and tools for any non-bank SIFIs that may be systemically important in failure. This could include, for example, resolution objectives and conditions for entry into resolution that are specific to non-bank SIFIs, and amendments to existing resolution powers for such institutions (e.g. those conferred under the Insurance Business Act for insurance companies) to ensure that the exercise of those powers is not contingent on the cooperation of policyholders.

- ***Recommendation 6*: The authorities should consider developing sector-specific adaptations to, and strategies based on, the resolution regime for non-bank financial institutions that could be systemic in failure, building on the ongoing international policy work.**

Requirement for court approval to implement certain resolution actions: Although the resolution framework confers the resolution authority a wide range of powers, the courts retain an important role in the resolution process, for both domestic and foreign resolution proceedings.

For example, in the context of a domestic resolution proceeding court involvement is required at two stages: (i) court approval as a substitute for shareholder consent when transferring systemically important assets and liabilities to a bridge financial institution ("substituted permission"); and (ii) court order to commence bankruptcy proceedings against the failed financial institution. The court does not have the discretion to judge the necessity or adequacy of the application of the resolution tool. Nevertheless, there is a risk that the requirement for court approval could delay the implementation of the resolution action, particularly with respect to the transfer of systemically important assets and liabilities, which the authorities expect to take place over the resolution weekend.

In the context of a foreign financial institution operating in Japan, the framework to recognise or give effect under Japanese law to a foreign resolution action is a judiciary procedure. Under this framework, the recognition of administrative foreign resolution proceedings may not be possible. According to the authorities, the order of court recognition could be issued on the same day as the petition is filed. However, there are few historical precedents to evidence this.

Given this, the authorities may wish to reconsider the role of the court in relation to domestic and foreign resolution proceedings. As regards the former, in the absence of a change to the resolution framework the authorities should take steps to ensure that the time required for court proceedings will not compromise the effective implementation of resolution measures. This could include, for example, interaction with the court as part of resolution planning to gain a better understanding of the timing of the process and the information that the court may require in advance of any possible actions. As regards the latter, the authorities could consider

[48] For example, the FSB finalised guidance in June 2016 on resolution strategies and plans for systemically important insurers. See http://www.fsb.org/wp-content/uploads/Final-guidance-on-insurance-resolution-strategies.pdf.

developing an administrative regime for the recognition of foreign resolution actions, as is currently the case in some other jurisdictions.[49]

- ***Recommendation 7*: *As part of resolution planning, the authorities should take into account the court involvement in the resolution process – particularly for the transfer of systemically important assets and liabilities to a bridge financial institution – so as to ensure that it will not compromise the timely and effective implementation of resolution measures.***

[49] For example, the resolution regimes in Singapore and the European Union (EU) provide powers for the resolution authority to recognise or support a foreign resolution action. In the EU, resolution authorities may only refuse recognition on specified grounds (e.g. where recognition or enforcement of foreign resolution proceedings would be contrary to national law, or where such proceedings would have adverse domestic financial stability effects).

Annex 1: Structure of the financial system and recent developments[50]

Regulatory framework

The JFSA was created in 2000 by the Act for Establishment of the Financial Services Agency. The JFSA is the integrated financial regulator and its mandate is to ensure the stability of Japan's financial functions, seek to protect deposit holders, insurance policyholders, negotiable securities investors and other similar parties, and aim for smooth financial operations.

In the case of BOJ, Article 1 of the Bank of Japan Act defines its purpose as being to issue banknotes and to carry out currency and monetary control as the central bank of Japan and to ensure smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of stability in the financial system. Article 2 stipulates that currency and monetary control by the Bank of Japan shall be aimed at achieving price stability, thereby contributing to the sound development of the national economy

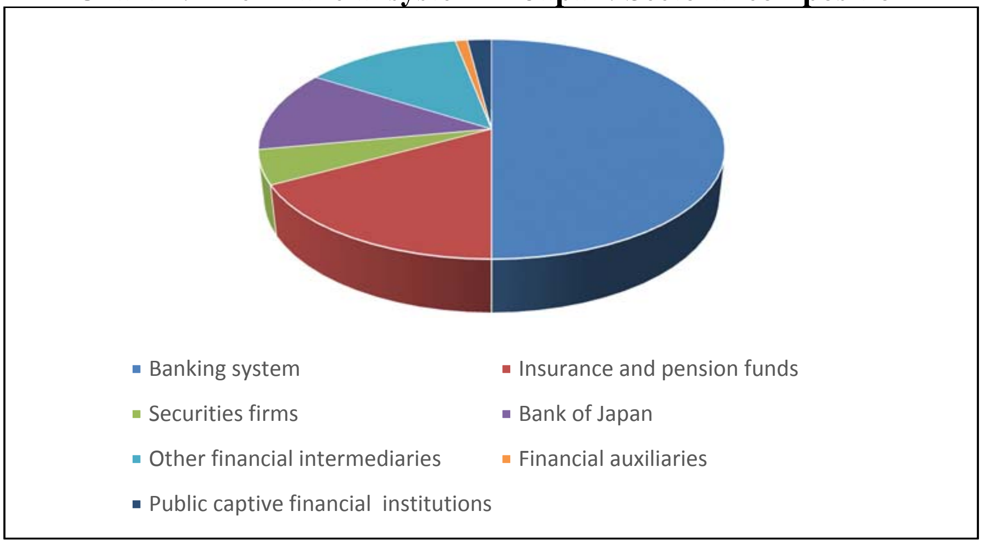
The DICJ was set up in 1971. Under the Deposit Insurance Act, the DICJ is mandated to establish the deposit insurance system in Japan and to contribute to the maintenance of stability of the financial system in order to protect depositors and others and ensure the settlement of funds related to failed financial institutions.

The Ministry of Finance is mandated to conduct activities to ensure healthy fiscal conditions, realise suitable and fair taxation, suitably implement customers operations, properly manage the National Treasury, maintain trust in the currency, and ensure stable foreign exchange.

Overview of the financial system

The Japanese financial system is bank-dominated, with banks comprising about 50% of total system assets as of March 2016. Insurance and pension funds comprised 17% of total assets, while securities firms accounted for 5% of assets (Chart 1).

Chart 1: The financial system in Japan: Sectoral composition



50 Based on information provided by the Japanese authorities.

The banking sector primarily consists of 10 major banks (including three mega-banks), 105 regional banks and 256 *shinkin*[51] banks (Table 1).[52] The total assets of major banks stood at JPY 671 trillion as of 31 March 2016, while the total assets of regional banks and *shinkin* banks were JPY 370 trillion and JPY 147 trillion respectively.

Table 1: Japanese banking system – share by asset size

Institution	**Share of total banking sector assets *(as of 31 March 2016)***
Major banks	45%
of which: three mega-banks	35%
Regional banks	24%
Shinkin banks	10%
Others	22%
Total	**100**

Source: Bank of Japan.

Banks headquartered in Japan account for 97% of banking sector assets. Foreign banks include 50 branches and 4 local subsidiaries (Citibank Japan, SBJ Bank, New York Mellon Trust Bank, State Street Trust Bank).[53]

Domestic rules based on the Basel II, II.5 and III standards were published by the JFSA in March 2006, May 2011 and March 2012 respectively. The Basel III standards came into effect in March 2013 (to be fully phased-in by 2019) and apply to 17 internationally active banks, including the three mega-banks.

The capital adequacy ratio for internationally active banks (calculated on a consolidated basis) stood at 16.2% as on 31 March 2016, while the Tier 1 capital ratio was 13.4%. These two ratios for domestic banks and *shinkin* banks are available only for end of fiscal-2012, and stood at 11.8% and 9.6% and at 13% and 12.4% respectively. Common equity Tier1 capital ratio as on

[51] *Shinkin* banks are cooperative regional banks serving small and medium-sized enterprises and local residents.

[52] Based on the classification in the BOJ's FSR (https://www.boj.or.jp/en/research/brp/fsr/data/fsr160422a.pdf). The 10 major banks comprise Mizuho Bank, The Bank of Tokyo-Mitsubishi UFJ, Sumitomo Mitsui Banking Corporation, Resona Bank, Saitama Resona Bank, Mitsubishi UFJ Trust and Banking Corporation, Mizuho Trust and Banking Company, Sumitomo Mitsui Trust Bank, Shinsei Bank, and Aozora Bank. The 105 regional banks comprise the 64 member banks of the Regional Banks Association of Japan (Regional banks I) and the 41 member banks of the Second Association of Regional Banks (Regional banks II). The 256 *shinkin* banks are those banks that hold current accounts at the Bank of Japan. Other (specialized) banking institutions include Trust Banks, Japan Post Bank and the Norinchukin Bank.

[53] For a recent overview of financial indicators on the Japanese banking sector, see Annex 3 of the June 2016 BCBS assessment of the Basel III G-SIB framework and review of the D-SIB framework in Japan (http://www.bis.org/bcbs/publ/d371.pdf).

31 March 2016 for internationally active banks stood at 12%, while core capital ratios as on 31 March 2016 for domestic and *shinkin* banks stood at 10.8% and 13% respectively.

As of 31 March 2016, the banking sector had extended loans of JPY 634 trillion, with major banks accounting for nearly 50% of the total. JPY 81 trillion of the advances made by the major banks was in foreign currency. Advances made by regional banks was JPY 235 trillion and those by *shinkin* banks was JPY 67 trillion. The loan portfolio comprises corporates (64%, including lending to financial institutions and for real estate at about 8% and 16% respectively) and individuals (27%). The credit quality has been improving, with non-performing loan (NPL) ratios declining in recent years. The NPL ratio as of 31 March 2016 stood at 1% for major banks and at 2.3% for regional banks; the ratio was 5.4% for *shinkin* banks as at end-2014.

Investments by Japanese major banks in JGBs have been falling in recent years, from JPY 82 trillion at end-2014 to JPY 61 trillion at end-2015. Over the same period, JGB investments by regional banks fell from JPY 40 trillion to JPY 36 trillion, and by *shinkin* banks from JPY 9.5 trillion to JPY 9 trillion. Foreign currency-denominated foreign bondsby major banks rose from JPY 31 trillion at end-2014 to JPY 35 trillion in end-2015.

The core profitability of Japanese banks has been on a declining trend in recent years, mainly as a result of narrowing domestic lending spreads given the low interest rate environment. For the fiscal year 2015, the interest margin for major banks stood at 0.95%; for regional banks and *shinkin* banks, the interest margin was 1.29% and 1.7% respectively. Return on total assets for 2015 was 0.49% for major banks, 0.43% for regional banks and 0.30% for the *shinkin* banks.

The life insurance sector in Japan is dominated by 15 major insurance companies and Japan Post Insurance. The major life insurance entities had a solvency margin ratio of 943% as of 31 December 2015, while the solvency margin ratio of Japan Post Insurance stood at 1,568%. The solvency margin of Japan's major non-life insurance entities ranged between 700-800%. The profitability of the insurance sector has been declining given the interest rate environment. In response, insurance companies (as well as most other institutional investors) have been reallocating their investments away from domestic bonds toward riskier assets, including foreign-denominated bonds.

The net income of securities firms in Japan has also declined in recent years (Table 2).

Table 2: Profitability of Japanese securities firms (in JPY million)

	Mar.13	Mar.14	Mar.15	Mar.16
Operating Income	580,729	1,172,228	994,033	857,326
Ordinary Income	605,518	1,189,069	1,019,063	895,269
Net Income	456,935	914,410	724,889	623,989

Source: Japan Securities Dealers Association.

Annex 2: The 2006-07 “mini-bubble” in the Japanese real estate market[54]

Japan experienced a period of overheating in the real estate market during 2006-2007. This “mini-bubble” was more evident in the commercial segment of the property market, but also appeared in the residential segment (Charts 1, 2). The growth in land prices, which was driven by a search for yield and decline in risk premiums, was evident only for the three major metropolitan areas (Tokyo, Nagoya and Osaka); prices in other regions remained broadly stable. The price surge was accompanied by a substantial decrease in cap rates (expected returns): for example, in the Tokyo business district they decreased from 5-6% in 2003 to 3.7-4.5% in 2006-2007.

Higher demand for real estate in Japan was to a great extent caused by growing purchases by real estate investment trusts (J-REITs). REITs were funding those purchases from Japanese banks, mainly through non-recourse loans. The real estate sector accounted for about 20% of banks’ total corporate loan portfolio. The annual growth rate of loans to real estate reached 10% in 2006 (Chart 3), while corporate loans in general only grew by 1-2%.

Chart 1

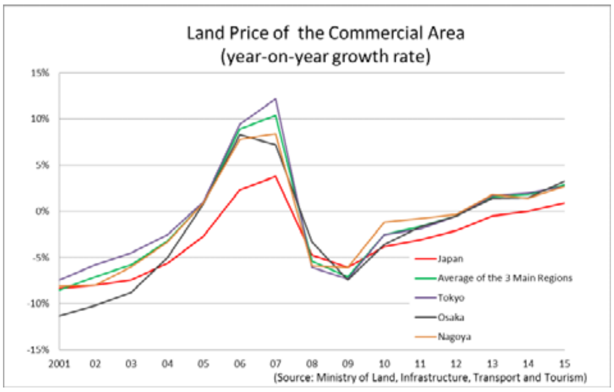


Chart 2

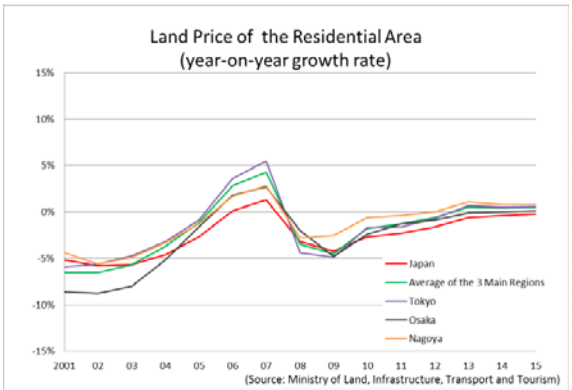
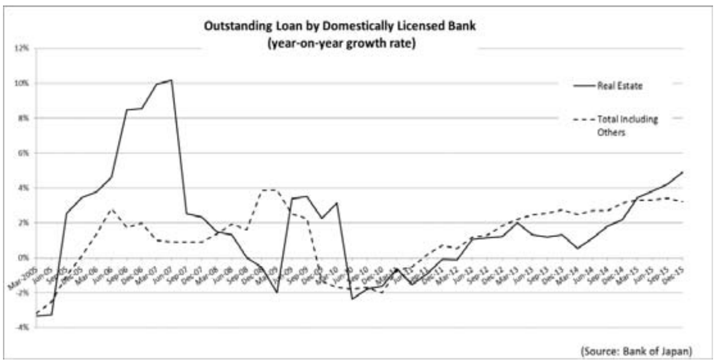


Chart 3



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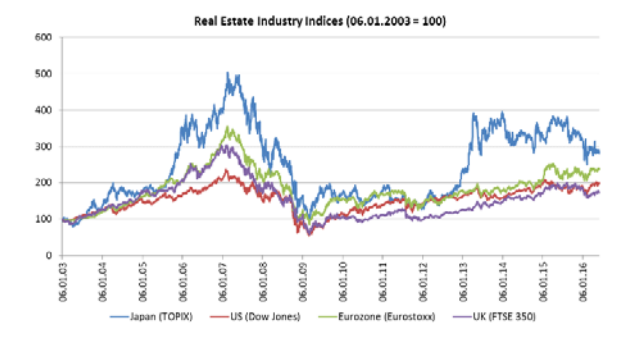
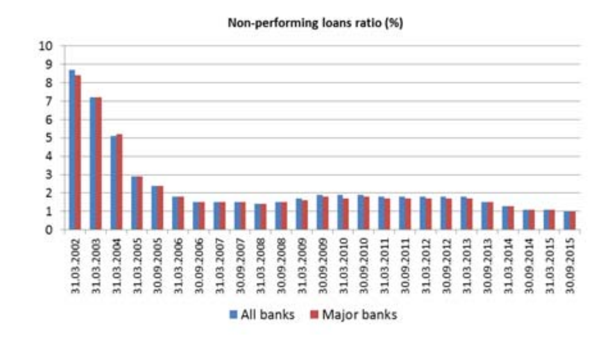
[54] Based on information provided by the Japanese authorities.

Given these conditions, the JFSA closely monitored inflows to the real estate market and price trends. As part of this effort, during October-November 2006 it conducted interviews with banks regarding their investments and loans to J-REITs, and concluded that expectations of future rent increase were the major source of price growth. The JFSA disclosed the results from the interviews as an update of its annual supervisory policy in December 2006, and called on banks to implement rigorous risk management. This was followed by public communication that stressed potential overheating in the property market in articles by senior JFSA officials.

Chart 4

In addition, the JFSA took administrative actions – such as issuing directives to suspend some business activities against trust banks – when it confirmed through its inspection and report request that they liquidated and securitised real estates (trust property) without conducting sufficient due diligence. The JFSA also took administrative actions against investment trust management firms operating J-REITs when it confirmed their insufficient due diligence through the inspection of the Securities and Exchange Surveillance Commission.

The decline in real estate prices coincided with the start of the US subprime mortgage crisis and similar trends in other developed markets (Chart 5). It remains an open question whether the recommendations of the authorities would have been enough to curb the market growth had global trends been different. Notwithstanding this, Japanese banks did not experience a substantial deterioration in credit quality during the financial crisis (Chart 6).

Chart 5	Chart 6
	

Annex 3: Comparison of resolution measures

<table>
<tr><th></th><th colspan="2">Failure Resolution Under Limited Coverage (DIA, Chapters III - VI)</th><th colspan="3">Measures Against Financial Crisis (DIA, Chapter VII)</th><th colspan="2">Measures For Orderly Resolution (DIA, Chapter VII-2)</th></tr>
<tr><th></th><th>Insurance Approach</th><th>P&A Approach</th><th>Measures under Item I</th><th>Measures under Item II</th><th>Measures under Item III</th><th>Special Resolution Regime I</th><th>Special Resolution Regime II</th></tr>
<tr><td rowspan="2">Triggers</td><td colspan="2" rowspan="2">(i) A financial institution is unable to satisfy its obligations in full with its assets
(ii) A financial institution is likely to suspend repayment of deposits, etc.
(iii) A financial institution has suspended repayment of deposits, etc.
(iv) A financial institution notifies that a situation is likely to arise in which it is unable to satisfy its obligations in full with its assets
(v) The requirements set forth in DIA are satisfied</td><td colspan="3">(i) The deliberations by the FCRC are concluded
(ii) Confirmation by the Prime Minister that the maintenance of an orderly credit system in Japan or in a certain region where the financial institution conducts its business may be extremely seriously hindered barring the measures against financial crisis</td><td colspan="2">(i) The deliberations by the FCRC are concluded
(ii) Specified confirmation by the Prime Minister that severe disruption in Japan's financial market and any other financial system may be caused barring the orderly resolution measures</td></tr>
<tr><td>The financial institution is neither insolvent, nor has suspended repayment of deposits, nor is likely to suspend repayment of deposits</td><td>The financial institution is insolvent or has suspended repayment of deposits, or is likely to suspend repayment of deposits</td><td>The financial institution is insolvent and has suspended repayment of deposits, or is likely to suspend repayment of deposits.
Confirmation of Measures Under Item III may not be given unless the Prime Minister finds that the Measures Under Item II cannot prevent the hindrance</td><td>The financial institution is not insolvent.</td><td>The financial institution is insolvent or likely to become insolvent, or has suspended payment of obligations, or is likely to suspend payment of obligations.</td></tr>
<tr><td>Scope of institutions</td><td colspan="2">Deposit-taking financial institutions</td><td colspan="2">Deposit-taking financial institutions</td><td>Banks</td><td colspan="2">(i) Deposit-taking financial institutions; (ii) Insurance companies; (iii) Securities companies; (iv) Holding companies; and (v) operating subsidiaries and domestic branches of foreign banks</td></tr>
<tr><td>Measures</td><td>(i) Payment of insured deposits
(ii) Liquidation of the failed deposit-taking financial institution</td><td>(i) Placement of the failing institution under the control of a financial administrator
(ii) Transfer of insured deposits and corresponding assets to an acquiring/bridge bank
(iii) Provision of financial assistance up to the cost of paying the insured deposits</td><td>Capital injection</td><td>(i) Transfer of important assets and liabilities (at least including all deposits)
(ii) Financial assistance for acquiring/bridge institution
(iii) Purchase of assets</td><td>Acquisition of the failed bank by the DICJ as a special crisis management (temporary nationalisation)</td><td>(i) Special oversight by the DICJ
(ii) Liquidity supply and debt guarantees
(iii) Capital injection
(iv) Purchase of assets</td><td>(i) Special oversight by the DICJ
(ii) Specified management by the DICJ
(iii) Transfer of systemically important assets and liabilities
(iv) Specified financial assistance to assist specified merger
(v) Additional financial assistance for resolution process
(vi) Loans to fulfil the obligations of systemically important contracts
(vii) Purchase of assets</td></tr>
<tr><td>Scope of protection</td><td colspan="2">Only insured deposits</td><td>All liabilities</td><td>All deposit liabilities</td><td>All liabilities</td><td>All liabilities</td><td>Only systemically important liabilities</td></tr>
<tr><td>Funding</td><td colspan="2">Ex ante deposit insurance fund</td><td colspan="3">Ex post recovery from the deposit-taking financial institutions</td><td colspan="2">Ex post recovery from the industry</td></tr>
</table>

Annex 4: Measures for orderly resolution

	SPECIAL RESOLUTION REGIME I (Specified Measures Under Item (i))	**SPECIAL RESOLUTION REGIME II** (Specified Measures Under Item (ii))
	Following the deliberations of the FCRC the measures for orderly resolution are implemented with the Prime Minister's specified confirmation.	
JFSA / Prime Minister (PM)	• Specified confirmation that severe disruption in Japan's financial market and any other financial system may be caused barring the orderly resolution measures • Puts the financial institution under special oversight • Orders the financial institution to prepare a management plan if necessary • Decides capital injection	• Specified confirmation that severe disruption in Japan's financial market and any other financial system may be caused barring the orderly resolution measures • Puts the financial institution under special oversight • Puts the financial institution under special management if necessary (Injunction Ordering Specified Management) • Orders the financial institution to prepare a management plan if necessary • Approves business transfer, etc. through granting specified authorisation of eligibility • Expresses opinions on the timing of the court ruling or order and other matters to the court, when the insolvency proceedings are filed against a financial institution
DICJ	• Oversees and supervises the financial institution • Gives advices, instructions or recommendations for ensuring the implementation of management plan • Provides liquidity support and debt guarantees • Underwrites certain types of financial instruments if the financial institution is in the process of restructuring either on its own or with the help of a third party investor • Applies to the Prime Minister jointly with the financial institution for capital injection	• Controls the financial institution by representing it, managing its assets, executing its business operations and is responsible for resolution procedures • Provides loans to avoid market turmoil or a drop in the value of the financial institution's credit claims and other assets. • Transfers the systemically important assets and liabilities to the acquiring/bridge institution • Provides financial assistance to ensure fulfilment of systemically important obligations
Financial Institution	• Under the special oversight of the DICJ • Still operative/Not insolvent • Prepares a management plan upon the Prime Minister's order • Applies to the Prime Minister with the DICJ for liquidity support and debt guarantees • Applies to the DICJ for capital injection support with an improvement plan • Fulfil the obligation of systemically important contracts	• Under the special oversight of the DICJ • Under the specified management of the DICJ • Not operative / insolvent or likely to become insolvent • Applies to the Prime Minister jointly with the acquiring/bridge institution for financial assistance to support transfer of systemically important assets and liabilities
Court		• Substitutes extraordinary resolution of shareholder's meeting (Substituted Permission) • Approves the transfer of systemically important assets and liabilities • Judgment on immediate appeal by the shareholders against the Substituted Permission • Makes a judgment on objection by each creditor on the transfer of their claims from the financial institution to the acquiring/bridge financial institution • Grants approval for the commencement of bankruptcy proceedings against the failed financial institution

Annex 5: Follow-up of other key FSAP recommendations

This Annex presents the follow-up actions reported by the authorities to key FSAP recommendations that are not covered in sections 2 and 3. The actions mentioned below have not been evaluated as part of the peer review and are presented solely for purposes of transparency and completeness.

Recommendations	***Steps taken to date and actions planned (including timeframes)***
Enhancing the quality and effectiveness of prudential and supervisory framework	
Review the FSA's regulatory mandate and evaluate the adequacy of its supervisory skills and resources	The Financial Services Agency (JFSA) published the *Strategic Directions and Priorities* (2015) last September, clarifying our missions amid the global change of the economy. The JFSA precisely addresses issues surrounding financial institutions through having close dialogues and sharing principles with them in order to encourage their originality and ingenuity. In addition, the JFSA aims at ensuring sustainable growth of business activities and the economy, and at contributing to increases in national welfare through efficient and effective financial intermediation, stability in the financial system, and market integrity and transparency of financial institutions. In addition, the JFSA aims to publish its review report by the end of June 2016, which ensures the continuous process for reviewing what the JFSA has done so far based on the *Strategic Directions and Priorities.* The *Strategic Directions and Priorities* also aims at enhancing the staff's skills. The JFSA is now redesigning an appropriate performance review mechanism. In addition, the JFSA encourages staff members to broaden their perspectives and skills by gaining experience at international institutions, foreign supervisory authorities, companies and universities, and by recruiting external staff (including senior advisory staff) from the private sector. As an institutional arrangement among agencies, the JFSA exchanges views and shares information with the Bank of Japan (BOJ) and the Ministry of Finance (MOF) at every level of professions. The monthly JFSA-MOF-BOJ meetings on international financial market developments and the Council for Cooperation on Financial Stability, which are held on a regular basis between senior officials of relevant authorities, are good examples. Lastly, as for the adequacy of resources, the JFSA has succeeded in increasing the number of staff members by 22 in the 2015 fiscal year.
Move towards a more formalized risk-based framework for assessing financial institutions' vulnerability and for prioritizing supervisory intensity	*JFSA's Financial Monitoring Policy* (2014) highlights the analysis of the following things with forward-looking supervisory perspectives when reviewing the risk management framework of financial institutions. 1) Impact by the global economy and market trends in terms of the safety and soundness of the Japanese financial system and financial institutions

	2) Impact of the business and behavior of financial institutions on the Japanese economy and markets. This risk-based monitoring policy framework is taken over to the *Strategic Directions and Priorities* (2015) with a more enhanced review process in the form of the PDCA cycle. The launched directions (2015) function as benchmarks for review (*PLAN*), the JFSA evaluates the progress and achievement of the policies in the review report based on the benchmarks (*CHECK*), and then reflects the results of the evaluation in the next policy paper (*ACT* and *PLAN*). Through this review process, the JFSA corresponds to changes in domestic and global economic and market environments both from the macro viewpoint of securing the whole financial system and from a micro viewpoint of assessing individual financial groups, especially highlighting their risk management strategies. In this regard, as an internal reform in the JFSA, the Macro-Prudential Policy Office was set out in 2015 to improve the quality of its market analysis. Such enhanced analysis contributes to more risk-based supervision by the JFSA. The BOJ reinforces coordination of macro-prudential and micro-prudential activity in order to prevent the financial system from becoming destabilized. The BOJ draws on various micro information obtained from on-site examinations and off-site monitoring of individual financial institutions both in assessing their financial soundness and in gauging and analyzing risks in the entire financial system. The results of the analysis and assessment are widely covered in the *Financial System Report* (hereafter the *Report*), which is released semi-annually. The BOJ uses the results of the analysis set out in the *Report* in planning policy to ensure stability in the financial system and for providing guidance and advice to financial institutions through off-site monitoring and on-site examinations. For example, the results are reflected in the "On-site Examination Policy" as 'Key Issues in the Conduct of On-site Examinations.' Moreover, the BOJ makes use of the results in international regulatory and supervisory discussions. In relation to the conduct of monetary policy, the macro assessment of financial system stability is also regarded as an important input for the BOJ in assessing risks in economic and price developments from a medium- to long-term perspective.
Raise minimum capital ratios for domestically-active banks closer to those required of internationally-active banks and	Minimum capital ratios are 4% for domestically active banks. The definition of the capital is 'core capital' that mainly consists of common stock and internal reserves, and by substance corresponds to CET 1, which is high-quality capital. This means that the requirement is high enough compared to the level of CET 1 required for internationally active banks, which is 4.5%. Therefore, it can be said that the minimum capital ratios for domestically active banks are already at a sufficient and prudent level.

align capital buffers with the materiality of risks	Moreover, average core capital ratios of domestically-active banks that mainly consist of regional banks are 10.20% for regional banks (as of March 2016), which considerably exceeds regulatory requirements, and their financial soundness has been maintained.
Strengthen supervisory requirements on large exposure limits for banks	In accordance with the recommendation at previous IMF-FSAP, the *Banking Act* was revised to extend the scope of transactions including, in principle, interbank transactions, the commitment line and derivative trading within the framework for large exposure limit. The large exposure framework was strengthened, by which total exposure values to a single counterparty (a group exposure) or to a counterparty related to such a group have become limited to 25% of the bank group capital from 40%. In this regard, relevant laws and regulations will be revised after remaining issues are resolved regarding the treatment of exposures on Qualified Central Counterparties (QCCPs) relevant to clearing activities and on interbank relevant to monetary policy in the framework of "Supervisory Framework for measuring and controlling large exposures" published by the BCBS (2014).
Encourage stronger risk management by financial institutions, including through improved internal governance, and enhanced role for company auditors and audit committees	In the *Strategic Directions and Priorities* (2015) published last September, the JFSA encourages internationally active banks to have more robust risk management systems, highlighting the following viewpoints: i) the enhancement of risk management systems and business management systems in order to respond promptly to economic and market volatilities, ii) reduction of the amount of equities held for business relationship purposes, iii) capital buffers for stress resilience, and iv) development of group governance. Especially for iv) above, *JFSA's Comprehensive Guidelines for Supervision* requires the G-SIBs to establish more robust governance systems taking into account their size, complexity, cross-jurisdictional activity, and interconnectedness. Based on these suasions, the G-SIBs have been gradually transforming their governance structure to a governance system with a committee with more external directors or appointed independent external directors. In fact, among the three major banking groups, Mizuho Financial Group and Mitsubishi UFJ Financial Group have changed their structure to companies with a committee structure, and Sumitomo Mitsui Financial Group plans to do so in the future on condition of gaining approval at the shareholders meeting. The BOJ examines financial institutions' resilience against risks through its on-site examination and off-site monitoring. Specifically, it examines whether the board of directors is properly involved in ensuring that (1) risk

	awareness is sufficiently shared when formulating business strategies or plans, (2) risk-taking policies compatible with the financial institutions' financial bases are formulated and risk management frameworks suitable to such policies are developed, (3) risk-taking policies or risk management frameworks are reviewed in response to changes in the external environment, and (4) risk management is effective. The BOJ also examines the functioning of bodies such as the board of directors, including various committees, the board of auditors, and internal audits. In the On-Site Examination Policy (2016), the following issues are particularly highlighted. In ensuring the effectiveness of internal control, the BOJ examines: (1) whether the board of directors has provided risk management frameworks and oversees the implementation appropriately; (2) whether senior management executes operations in accordance with the risk-taking policy determined by the board of directors and manages risks; and (3) whether senior management provides reports appropriately so that the board of directors can oversee the risk management practice. In doing so, the BOJ also examines (4) the effectiveness of the group-wide business management of financial institutions, including overseas branches and subsidiaries, which offer a wide range of financial services on a group basis. For proactive improvement of risk management with internal audits, the BOJ examines: (1) whether the board of directors appropriately decides the scope of internal audits and allocates audit resources based on the risk assessment; (2) whether the internal auditors adequately audit businesses, including those of overseas entities and subsidiaries; and (3) whether the board of directors makes the most of auditors' recommendations regarding their business management.
Strengthen securities firm oversight through expanded and more risk-based inspection programs, extended auditing requirements, and improvements to the registration process	The JFSA and the SESC have been working on integration of on-site inspection and off-site monitoring. We collected and analyzed monitoring information through interviews with individual firms, and such monitoring information has been utilized for a risk-based approach more effectively and enabled us to operationalize efficient and effective on-site inspection. Especially for smaller firms, the JFSA and SESC have started a thorough review system into the status of firms' business and management based on registered information provided by them. The SESC will check and examine the status based on the said registered report.
Explore mechanisms to strengthen governance arrangements for the selection of	The JFSA revised the *Banking Act* and the *Insurance Business Act* in June 2013 to require an auditor of banks and insurers to have enough knowledge and experience to precisely, fairly and efficiently conduct an audit. Also, the revision enabled the JFSA to direct banks and insurers to replace their accounting auditor if the banks or insurers violate an ordinance, an administrative action or the public interest.

auditors and the protection of their independence	In addition, the JFSA revised the *Ordinances for Enforcement of the Banking Act* and the *Ordinances for Enforcement of the Insurance Business Act* in March 2014 to require banks and insurers to report the appointment and resignation of an auditor or an accounting auditor to the JFSA. Furthermore, the *Comprehensive Guidelines for Supervision* stipulates that the JFSA will review how banks make use of external audit; such as properly rotate the auditor. **Introduction of Japan's Corporate Governance Code (2015)** Japan formulated the Corporate Governance Code last year and this Code came into effect in June 2015. This code includes key principles which contribute to an effective corporate governance framework in Japan. [Selection of auditors] The Code establishes the principle of selection of auditors as follows: -Principle 3.2 External Auditors External auditors and companies should recognize the responsibility that external auditors owe toward shareholders and investors, and take appropriate steps to secure the proper execution of audits. -Supplementary Principles 3.2.1 The kansayaku board should, at minimum, ensure the following: i) Establish standards for the appropriate selection of external auditor candidates and proper evaluation of external auditors; and ii) Verify whether external auditors possess necessary independence and expertise to fulfill their responsibilities. [Kansayaku and Kansayaku Board] *In Japan, the corporate auditors are "Kansayaku" and an auditor board is a "Kansayaku Board" The Code includes the principle for protection of auditors and emphasizes the importance of their role and responsibility as follows: -Principle 4.4 Roles and Responsibilities of Kansayaku and the Kansayaku Board Kansayaku and the kansayaku board should bear in mind their fiduciary responsibilities to shareholders and make decisions from an independent and objective standpoint when executing their roles and responsibilities including

<table>
<tr><td></td><td>the audit of the performance of directors' duties, appointment and dismissal of external auditors and the determination of auditor remuneration. Although so-called "defensive functions," such as business and accounting audits, are part of the roles and responsibilities expected of kansayaku and the kansayaku board, in order to fully perform their duties, it would not be appropriate for kansayaku and the kansayaku board to interpret the scope of their function too narrowly, and they should positively and proactively exercise their rights and express their views at board meetings and to the management.

-Supplementary Principle

4.4.1 Given that not less than half of the kansayaku board must be composed of outside kansayaku and that at least one full-time kansayaku must be appointed in accordance with the Companies Act, the kansayaku board should, from the perspective of fully executing its roles and responsibilities, increase its effectiveness through an organizational combination of the independence of the former and the information gathering power of the latter. In addition, kansayaku or the kansayaku board should secure cooperation with outside directors so that such directors can strengthen their capacity to collect information without having their independence jeopardized.</td></tr>
<tr><td>Strengthen disclosure requirements for nonbanks, including on assumptions used to measure assets/liabilities and on risk exposures including cross holdings, cross-border, and concentration risks</td><td>The JFSA revised the Ordinance for Enforcement of the Insurance Business Act to enhance disclosure for some reinsurance contracts in October 2015.</td></tr>
<tr><td>Review the prompt corrective action framework for banks and examine the desirability of raising the trigger points for action</td><td>In light of Basel III, the trigger points of the prompt corrective action for internationally active banks were revised to refer to the ratio of CET 1 and Tier 1 in addition to the total capital ratio. The new framework came into force on March 31, 2013, followed by a transitional period, and now it is fully enforced (see below).

<table>
<tr><td>Category</td><td>Former Standards</td><td>Current Standards
(Mar. 31, 2015 -)</td><td>Measures to be taken
(Unchanged)</td></tr>
<tr><td>Exception from category</td><td>$8\% \leq TCR$</td><td>$4.5\% \leq CET1$
$6\% \leq T1$
$8\% \leq TCR$</td><td>———</td></tr>
</table>
</td></tr>
</table>

		Category 1	$4\% \leq TCR < 8\%$	$2.25\% \leq CET1 < 4.5\%$ $3\% \leq T1 < 6\%$ $4\% \leq TCR < 8\%$	Request to submit a reasonable improvement plan to secure sound management, and an order for its implementation
		Category 2	$2\% \leq TCR < 4\%$	$1.13\% \leq CET1 < 2.25\%$ $1.5\% \leq T1 < 3\%$ $2\% \leq TCR < 4\%$	An order pertaining to measures which contribute to equity capital adequacy
		Category 2-2	$0\% \leq TCR < 2\%$	$0\% \leq CET1 < 1.13\%$ $0\% \leq T1 < 1.5\%$ $0\% \leq TCR < 2\%$	An order to select any of the measures intended to ensure the adequacy of equity capital, drastically reduce business, merge, or abolish banking and to implement the measure pertaining to said selection
		Category 3	$TCR < 0\%$	$CET < 0\%$ $T1 < 0\%$ $TCR < 0\%$	An order to suspend all business or a portion thereof
	TCR: Total Capital Ratio				
Provide for explicit supervisory approval of major investments by banks or of changes in their controlling ownership	**<u>Major investments by banks</u>** The *Banking Act* stipulates that banks shall obtain authorization from the JFSA or notify the JFSA prior to ownership of companies. In addition, the scope of subsidiaries which banks acquire is, in principle, limited to businesses including banking and solicitation for banking businesses. Moreover, banks are, in principle, prohibited by the Act to acquire or hold voting rights greater than 5% in a domestic company which operates an unsolicited business with a bank. Therefore, the regulatory framework in Japan is in place to segregate the risks caused by non-banking businesses. **<u>Changes in their controlling ownership</u>**				

	In assessing applications for the authorization of major shareholdings by banks, the JFSA fully examines whether the requirements are satisfied, especially concerning item 1 to 4 below, which are stipulated in *Comprehensive Guidelines for Supervision.* In addition, a close interview process with applicants is also ensured at the assessment phase. 1) Whether there is the risk that sound and appropriate business operations by a bank will be impaired in light of funds for acquisition of voting rights in a bank, the purpose of holding them or any other matters; 2) Whether there is the risk that sound and appropriate business operations by a bank will be impaired in light of the status of the applicant's property and income and expenditure; 3) Whether the applicant sufficiently understands the public nature of the banking business and has sufficient social credibility in light of its personnel structure; and 4) Whether the applicant takes measures to cut off the risk that the bank's operating base will be destroyed by the applicant's collapse, especially if the bank and applicant share business infrastructure.
Clarify the co-decision process for institutions co-supervised by FSA and a Ministry, and strengthen FSA supervision of government-owned financial institutions	In principle, the extent of supervisory powers concerning co-supervision by the JFSA and other ministries is stipulated in the acts specific to the financial institutions. Taking the case of Norinchukin Bank, which is a central bank of agricultural bank-cooperatives, for instance, any arrangements for co-supervision are stipulated in the *Norinchukin Bank Act*. Basically, the JFSA and the Ministry of Agriculture, Forestry and Fisheries (MAFF) jointly supervise the Bank in almost all matters but independent interventions to the Bank are ensured in respective agencies. In a particular case, the JFSA has exclusive power to intervene by conducting an on-site investigation concerning issues specific to the financial soundness of the Bank. In other cases, consistent arrangements are similarly ensured among related ministries and agencies. Concerning government-owned financial institutions, such as Japan Finance Corporation (JFC), the JFSA has a delegated power of on-site inspections in lieu of the MOF.
Enforce the existing provisions on exposures to related parties more vigorously	Pursuant to the *Banking Act,* a bank shall not, in principle, undertake transactions with a specified related person, such as a subsidiary or a fellow subsidiary, based on giving preferred terms to them in order to prevent impairment of soundness of a bank and to protect customers' interest by such conflicts of interest. In addition, banks shall properly establish a system for supervising such transactions and take any other measures necessary pursuant to the Act.

	Based on the Act, the principles of arm's-length and protection of costumers' interest are consistently stipulated in the *Comprehensive Guidelines for Supervision* to effectively operate on-site and off-site monitoring for examining the related parties.
Enhance the required solvency margin for insurers to account for all material risks	The JFSA revised the notification pursuant to the *Insurance Business Act* to exclude a part of commission for some reinsurance contract from the solvency margin requirement in October 2015.
Revise corporate governance and suitability requirements to strengthen independent oversight of banks and insurers	**<u>Implementation of Corporate Governance Code</u>** Japan formulated the Corporate Governance Code last year and it came into effect in June 2015. The code includes key principles that contribute to the effective corporate governance framework in Japan. **(Kansayaku and the Kansayaku board)** *In Japan, the corporate auditors are "Kansayaku" and an auditor board is a "Kansayaku Board" In the Corporate Governance Code, there are principles to enhance the independence of Kansayaku and Kansayaku Boards. In those principles, the importance of the roles and responsibilities is also emphasized. 【Principle 4.4 Roles and Responsibilities of Kansayaku and the Kansayaku Board】 Kansayaku and the kansayaku board should bear in mind their fiduciary responsibilities to shareholders and make decisions from an independent and objective standpoint when executing their roles and responsibilities including the audit of the performance of directors' duties, appointment and dismissal of external auditors and the determination of auditor remuneration. Although so-called "defensive functions," such as business and accounting audits, are part of the roles and responsibilities expected of kansayaku and the kansayaku board, in order to fully perform their duties, it would not be appropriate for kansayaku and the kansayaku board to interpret the scope of their function too narrowly, and they should positively and proactively exercise their rights and express their views at board meetings and to the management. 【Supplementary Principle 4.4.1】 Given that not less than half of the kansayaku board must be composed of outside kansayaku and that at least one full-time kansayaku must be appointed in accordance with the *Companies Act*, the kansayaku board should, from the perspective of fully executing its roles and responsibilities, increase its effectiveness through an organizational combination of the independence of the former and the information gathering power of the latter. In addition,

	kansayaku or the kansayaku board should secure cooperation with outside directors so that such directors can strengthen their capacity to collect information without having their independence jeopardized. **(Independent Directors)** In the Corporate Governance Code, Principle 4.7 prescribes four aspects of the roles and responsibilities of independent directors. In addition, Principle 4.8 proposes measures to effectively utilize independent directors. 【Principle 4.7 Roles and Responsibilities of Independent Directors】 Companies should make effective use of independent directors (*), taking into consideration the expectations listed below with respect to their roles and responsibilities: i) Provision of advice on business policies and business improvement based on their knowledge and experience with the aim to promote sustainable corporate growth and increase corporate value over the mid- to long-term; ii) Monitoring of the management through important decision-making at the board including the appointment and dismissal of the senior management; iii) Monitoring of conflicts of interest between the company and the management or controlling shareholders; and iv) Appropriately representing the views of minority shareholders and other stakeholders in the boardroom from a standpoint independent of the management and controlling shareholders. *Independent director: The listing rules of securities exchanges provide that the outside directors, as defined in the *Companies Act*, are independent directors where they satisfy independence criteria of securities exchanges and the company determines that they do not have the possibility of conflicts of interest with its shareholders. 【Principle 4.8 Effective Use of Independent Directors】 Independent directors should fulfill their roles and responsibilities with the aim of contributing to sustainable growth of companies and increasing corporate value over the mid- to long-term. Companies should therefore appoint at least two independent directors that sufficiently have such qualities. Irrespective of the above, if a company in its own judgement believes it needs to appoint at least one-third of directors as independent directors based on a broad consideration of factors such as the industry, company size, business characteristics, organizational structure and circumstances surrounding the company, it should disclose a roadmap for doing so.

	(Independence Standards for Independent Directors) In order to identify the independence of independent directors in substance, listed companies need to establish their own independence standards, taking into account their business environments while considering "standards" provided by financial exchanges. In addition, the disclosure will lead to more reasonable independence standards through encouraging dialogues between listed companies and the market. Considering these points, principles concerning the establishment and disclosure of independent standards are stipulated in the code. 【Principle 4.9 Independence Standards and Qualification for Independent Directors】 Boards should establish and disclose independence standards aimed at securing effective independence of independent directors, taking into consideration the independence criteria set by securities exchanges. The board should endeavor to select independent director candidates who are expected to contribute to frank, active and constructive discussions at board meetings. **<u>Enhancement of Kansayaku' s requirement and Enhancement of the authority of Kansayaku boards</u>** The *Banking Act* and *Insurance Business Act* were amended in June 2013. These new amendments required Kansayaku to have enough knowledge and experience to perform audit duties more fairly and efficiently. In addition, the amendment of the *Companies Act* and the *Ordinance for Enforcement of the Companies Act* has been enforced since May 2015. Owing to this amendment, Kansayaku boards have the authority to determine the content of proposals on election or dismissal regarding a financial auditor. The amendment has also clarified systems to ensure the appropriate business operations of group of enterprises and to support Kansayaku's activities. **<u>Improvement of the function of outside directors</u>** The amendment of the *Companies Act* has been enforced since May 2015. For the purpose of enhancing the corporate governance of stock companies, the *Companies Act* was amended to improve the function of outside directors. The amendment includes (i) creating a new type of stock companies, i.e. the Company with a Supervisory Committee, (ii) imposing the obligation to explain at the shareholder meeting why it is not appropriate to have an outside director on certain stock companies and (iii) strengthening qualification requirements for outside directors. **<u>Initiatives to strengthen corporate governance in financial institutions</u>**

Large financial institutions, mainly the three major bank groups are taking initiatives to strengthen the framework of their boards of directors in order to improve their group governance. These initiatives include the adoption of companies with three committees and increasing the number of outside directors and diversification of outside directors.

As for the three major bank groups, Mizuho Financial Group and Mitsubishi UFJ Financial Group have already shifted to companies with a committee, and Sumitomo Mitsui Financial Group also declared its transition to a company with three committees. As for major insurers, two of the four have already shifted to companies with three committees (Meiji Yasuda Life Insurance Company, Sumitomo Life Insurance Company.)

In addition, some financial institutions pursue more efficient measures to improve the governance framework, and some examples are given below.

(1)Focus the agenda of the board of directors on critical issues of group management and secure more time to mainly discuss the mid-term business strategy,

(2) Establish a system to support outside directors and provide training opportunities continuously,

(3) Evaluate the effectiveness of the board by making use of outside consulting firms

Moreover, in terms of improving the effectiveness of audit by a Kansayaku board and Audit committee, financial institutions address the following initiatives.

(1) Exchange views on the improvement of governance between audit committee members and outside directors who are not audit committee members.

(2) Strengthen collaboration between the Kansayaku board, Audit committee, internal auditing division, and external audits.

Planned Actions

The JFSA has conducted the Horizontal Review since 2013 and focused on governance as one of the important themes. The role and responsibility of the board of directors, Kansayaku board and Audit committee, internal audit and outside auditor are important in ensuring that financial institutions establish an effective governance framework. The JFSA will continuously monitor the effectiveness of those frameworks.

For the purpose of following up the prevalence and adoption of Japan's Stewardship Code and Japan's Corporate Governance Code as well as further improving the corporate governance of all listed companies, the JFSA

	established the "Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code". Through the discussion in this council, we intend to improve the governance of all listed companies, including financial institutions.
Revise the valuation method for insurance liabilities to account for risks over the full time horizon of insurance contracts	In order to address the risk of overall insurance liability, the JFSA requested the Institute of Actuaries of Japan to consider extending the term of cash flow analysis of the Standard of Practice from ten years in Oct 2012. In addition to the ten years term analysis, the Institute revised the Standard of Practice for Appointed Actuaries of Life Insurance Companies in March 2015 to newly establish an analysis over the full time horizon. The Standard of practice is certified by the JFSA's notification pursuant to the Insurance Business Act as a sound actuarial practice for maintaining the solvency margin.
Complete the development of a methodology for risk-rating insurers and adopt a more formalized system for the internal review of risk assessments	The JFSA revised the *Comprehensive Guidelines for Supervision of Insurance Companies* in February 2014 to require insurers to develop a comprehensive risk management system and implement solvency self-assessment. Also, the JFSA requests all insurers to submit the Own Risk and Solvency Assessment report from 2015.
Establish more comprehensive assessments of individual securities firms (risk scoring or profiling) to guide supervisory intensity and on-site inspections	The JFSA and the SESC have been working on the integration of on-site inspection and off-site monitoring. We collected and analyzed monitoring information through interviews with individual firms, and such monitoring information has been utilized for a risk-based approach more effectively and enabled us to perform efficient and effective on-site inspection. Especially for smaller firms, the JFSA and SESC have started a thorough review system into the status of firms' business and management based on registered information provided by them. The SESC will check and examine the status based on the said registered report.
Further develop and clarify cooperation arrangements among domestic authorities with respect to FMIs in normal circumstances and in times of stress	For financial instruments clearing organizations and fund clearing organizations, based on the *Financial Instruments and Exchange Act*, the JFSA may seek the BOJ's opinions when deemed necessary in order to conduct administrative measures and the JFSA shall consult with the MOF when it is considered that market derivative transactions or the maintenance of an orderly financial system may be significantly affected if administrative measures are conducted. Moreover, for all types of FMIs, the supervisory guidelines stipulate that the JFSA shall have close cooperation with relevant ministries, and with the BOJ in daily supervision, including sharing information and exchanging opinions as appropriate. In parallel with the regulatory supervision, BOJ oversees FMIs operated by the private sector to ensure the safety and efficiency of payment and settlement arrangements in Japan under the *Bank of Japan Act* and the *Bank of Japan Policy on Oversight of Financial Market*

	Infrastructures adopted by its policy board and published in March 2013. The Policy stipulates that the BOJ shall cooperate and coordinate with the FSA by exchanging information and views as necessary.
Further improve clarity of assessments against the CPSS-IOSCO standards	The JFSA has broad powers to encourage Japanese FMIs (e.g. JSCC etc.) to observe the Principles for FMIs (PFMIs). It requires such FMIs to publish the results of self-assessment as compared to the PFMIs. In addition, the JFSA conducts its own assessment and review process, while, pursuant to the Supervisory Guidelines, the JFSA should hold interviews with CCPs regarding the status of their compliance with the PFMIs. The BOJ also assesses the FMIs against the PFMIs periodically. The JFSA and the BOJ share the assessments and views from each perspective to ensure consistency.
Strengthen pension supervision in cooperation with other financial supervisors on risks that could affect both the pension system and financial stability more broadly	In October 2014, the Government Pension Investment Funds (GPIF) changed its benchmark portfolio by way of altering its intermediate business plan. Before, 60% of its benchmark portfolio was comprised of domestic bonds, 12% domestic equity, 11% foreign bonds, and 12% foreign equity. Now, domestic bonds comprise 35% of the total benchmark portfolio, domestic equity 25%, foreign bonds 15%, and foreign equity 25%. In addition, on March 11th, 2016, the Ministry of Health, Labour and Welfare submitted a bill to reform the governance system of GPIF to establish the decision-making body with a counsel system of highly skilled experts in the area of economy, finance and asset management.
Strengthening / Bolstering Crisis Management Arrangements	
Explore mechanisms to strengthen custody arrangements for collective investment Schemes	In December 2014, the JFSA revised the *Guideline of Disclosure of Information, etc. on Regulated Securities* in order to clarify that an asset manager has to describe in the disclosure documents such as the Securities Registration Statement, the measures which ensure that the interests of investors will not be adversely affected in the case that the asset manager executes a transaction which could potentially allow the asset manager to adversely affect the interests of investors in order for the asset manager itself or another party to obtain interests. (*Guideline of Disclosure of Information, etc. on Regulated Securities, B-I-(3)*)
Investigate the need to implement segregation and portability of customers' positions and collateral in JGBCC	JGBCC was merged into JSCC in October 2013 and JSCC took over the clearing service of OTC trade of JGB from JGBCC. Regarding the clearing service of OTC trade of JGB in JSCC, JSCC does not provide a client clearing service but only propriety trade. If a trust bank is a clearing member, each trust asset is separately managed in its trust account. The *Financial Instruments and Exchange Act* requires clearing members of JSCC to manage customer assets segregated at the customer level and to be audited by a third person. Furthermore, the segregation systems of clearing members are also inspected by the JFSA and reviewed by Japan Securities Dealers Association. The investor protection fund is also established and designed to protect customer assets.

Consider including in the licensing criteria for exchanges a detailed assessment of the robustness of IT systems by independent experts	The criteria for examination of licenses pursuant to Articles 82 of the *Financial Instruments and Exchange Act* are as follows: (i) the provisions of the articles of incorporation, the operational rules and the brokerage contract rules conform to laws and regulations, and are sufficient for achieving fair and smooth sales and purchase of Securities and Market Transactions of Derivatives on the Financial Instruments Exchange Market, as well as for protection of investors; (ii) the applicant for license has a personnel structure sufficient for appropriately operating the Financial Instruments Exchange Market; or (iii) the applicant for license will be organized as a Financial Instruments Exchange in such a manner that conforms to the provisions of this Act. Given these criteria, the Prime Minister shall examine the articles of incorporation, etc., a personnel structure and an organization.
Supporting Private Sector Growth	
Unwind and better target selected public support measures, including some credit guarantees and SME support measures, as economic recovery takes hold	The *SME Finance Facilitation Act* expired on March 31, 2013. Prior to this, with an aim to support self-reliant efforts by borrowing companies, the JFSA revised the *Comprehensive Guidelines for Supervision of Major Banks, etc.* and *Comprehensive Guideline for Supervision of Small- and Medium-Sized and Regional banks* in March 2013 and thereby called for the financial institutions to propose best-suited solutions which are tailored to the life stages, etc. of their customer companies rather than to serve as a mere loan provider. One of the examples of the solutions by a financial institution which is set forth in the guidelines as regards the customer companies that are in need of business turnaround and change in business types is to consider the use of DES, DDS, DIP finance, and debt forgiveness. Another example shown in the guidelines with regard to nonviable customer companies is to carry out a solution that is truly desirable for a customer company itself and other related parties rather than to accept applications to change the lending conditions, etc. In addition, the *Strategic Directions and Priorities* (2015) issued by the JFSA contain a description to the same effect, thereby encouraging the efforts by financial institutions. On the other hand, the emergency guarantee terminated, which was introduced in 2008 as a countermeasure against the economic slowdown following the failure of Lehman Brothers by expanding business types covered by item 5 (depressed industries) of the safety net guarantee; and then the credit guarantee system has been back

	to normal since March 2014. Since then, the responsibility sharing system introduced in 2007, in which financial institutions bear 20% of the risks, has been coming into common use. Moreover, discussions are underway concerning the credit guarantee system among the experts in the Finance Working Group of the Small and Medium Enterprise Policy Making Council set up under the Small and Medium Enterprise Agency and the JFSA attends the Working Group meetings as an observer. The Working Group set out a draft proposal, which suggests the future directions of approaches to the credit guarantee system. For example, the draft proposal suggests a reform toward the system which would encourage the financial institutions to grasp the life stage of their borrowing companies in a careful manner and give both the borrowing companies and financial institutions an incentive to continue their efforts towards business improvement. For another example, the draft proposal calls for considering the review of the safety net guarantee system, after closely looking into the status of use of the system, from the perspective of not undermining the sound development and renewal of businesses in the medium and long term.
Develop an effective strategy to establish a stronger regional and cooperative bank sector, including through private sector-led consolidation	Financial institutions are facing a harsh business environment including the declining and aging population in local areas and the low interest rate. Under these circumstances, it is more important for them to review the sustainability of their business models and strengthen their business management systems so that they could ensure their soundness and continuously exercise their financial intermediation function. Against this backdrop, the JFSA set the following strategy in the *Strategic Directions and Priorities* (2015). In order for financial institutions to develop sustainable business models, the JFSA reviews the following points: i) whether they establish adequate revenue management systems which take into account the profitability and features of each business by departments, segments and regions; ii) whether they conduct quantitative and qualitative analyses of the impact on their business from the expansion of business areas and changes in the business environment; iii) how they implement their basic policies of managing concentration risks and manage limits on the size of concentration risks; iv) how they set their stress scenarios, action plans based on the findings from stress tests and criterion for execution of action plans; and v) whether they establish adequate systems for securities investment in a manner appropriate to their policies on securities investment.

	Based on the main potential risks of each financial institution, the JFSA encourages financial institutions to consider and operate capital policies toward having a more sound financial base so that they can fully exercise their financial intermediation function such as supporting business revitalization even in a case where the interest rate environment and the economic trend change. As for cooperative financial institutions, central institutions for them play important roles in advising their affiliated institutions to improve risk management and business analyses, and also in strengthening their financial base. Therefore, the JFSA reviews how the central institutions adequately fulfil such roles and it supervises cooperative financial institutions through close cooperation with the central institutions including a review of strengthening financial grounds. The shrinking population and customer base -- in addition to the low interest rate environment -- is exacerbating the problem of low profitability of regional banking (BOJ, Financial System Report, April 2016). Thus, it has become increasingly important for regional financial institutions to stabilize and improve their long-term profitability while helping to raise the growth potential of local areas. Considering those, in view of the importance of ensuring the stability and improvement of their profitability, the BOJ focuses on assessments of their medium to long-term profitability and discussions on future business plans based on these assessments. At the same time, the BOJ is reinforcing the efforts of regional financial institutions to further support regions and firms, as well as to improve their financial tools and risk management practices. At seminars and other events, the BOJ also engages in themes that will contribute to the strengthening of financial intermediation functioning and business management practices (seminars and workshops during fiscal 2015: (1) large-scale seminars pertaining to support for start-up firms, agri-finance, and corporate governance reform; (2) workshops on the advancement of financial technology and management through the utilization of IT; (3) regional seminars and workshops on the financing of public-private partnerships (PPPs), support for start-up firms, profit management, and business strategies utilizing IT). In addition, with the objective of enhancing communication of financial stability issues with concerned parties, the BOJ publishes the following Financial System Report Annex Series, which supplements the Financial System Report by providing more detailed analysis and insight into challenges faced by regional financial institutions (available only in Japanese). ・"Efforts by Regional Finance in the Face of a Population Decline," Financial System Report Annex Series, May 2015 (available in Japanese only).

	・"Financial Results for Japan's Banks and Shinkin Banks for Fiscal 2014," Financial System Report Annex Series, July 2015 (available in Japanese only). ・"Recent Developments in Loan-Loss Provision Calculation by Regional Financial Institutions," Financial System Report Annex Series, August 2015 (available only in Japanese). ・" Tasks and Challenges regarding Regional Financial Institutions' Loans for the Housing Rental Business and Credit Management: Findings of Survey Results," Financial System Report Annex Series in March 2016 (available in Japanese only). ・ "Regional Financial Institutions' Securities Investment and Their Challenges for Risk Management," Financial System Report Annex Series, March 2016 (available only in Japanese).
Advance the momentum for full privatization of GFIs (including Japan Post); strengthen GFI supervision, including inspection frequency	Shares in the three Japan Post units (Japan Post Holdings, Japan Post Bank, and Japan Post Insurance) were listed on the first section of Tokyo Stock Exchange in November 2015. In accordance with the above progress in the privatization process, the JFSA encourages Japan Post Bank and Japan Post Insurance to i) enhance their capabilities for asset management and risk management, ii) sell financial instruments through efficient use of a nation-wide post system network, and iii) collaborate with other financial institutions in order to enhance their corporate values. Currently, in-depth policy dialogues have been made among the JFSA and respective units in Japan Post to effectively address and operationalize these issues.
Strengthen credit discipline by introducing a schedule for gradually reducing the coverage of credit guarantees, in line with international norms	An improved sharing mechanism in publicly supported credit guarantees system was introduced in 2007, in which Credit Guarantee Corporations (CGCs) offer, in principle, 80% of credit guarantees and call for undertakings of the remaining 20% of counterparty risks by financial institutions (cf. the private portion, which was risk-free since full coverage was guaranteed by CGCs). The working groups under the Council for Small and Medium Enterprise Policy in Small and Medium Enterprise Agency (SMEA) has been considering how elaborate the current credit enhancement system is and whether the coverage ratio of credit guarantees should be reduced.
Encourage SME restructuring through wider use of debt-equity swaps and more flexibility in the release of personal guarantees in voluntary workouts and debtor-in-possession	The JFSA revised the *Comprehensive Guidelines for Supervision of Major Banks, etc.* and *Comprehensive Guideline for Supervision of Small- and Medium-Sized and Regional banks* in March 2013 and thereby called for the financial institutions to propose best-suited solutions which are tailored to life stages, etc. of their customer companies rather than to serve as a mere loan provider. One of the examples of the solutions by a financial institution which is set forth in the guidelines as regards the customer companies that are in need of business turnaround and change in business types is to consider the use of DES, DDS, DIP finance, and debt forgiveness.

bankruptcies procedures	The *Banking Act* provided that a bank, etc. and its subsidiaries shall not hold in total more than 5% of voting rights in a domestic non-financial company with the exception that voting rights acquired and held through a debt-equity swap were allowed to be held up to 50% for less than one year. However, this exception was not consistent with the practice where business reconstruction plans are normally scheduled between three to five years. For this reason, the *Banking Act* was amended in June 2013. With the amendment, voting rights acquired and held through a debt-equity swap are allowed to be held up to 100% for less than three years (or five years for SMEs) as long as the swap is done in cases with the involvement of a court (corporate reorganization proceedings, civil rehabilitation proceedings, special conciliation proceedings, etc.) or cases pertaining to Turnaround ADR proceedings, and thus the use of debt-equity swaps is promoted. In addition, although personal suretyships endorsed by business owners would contribute to facilitating business disciplines and credit enhancement, significant challenges are faced in the process of business restructuring under a distressed situation due to disincentives by owners for proactive actions. In accordance with such problems, the guidance paper (*Guidelines for Personal Guarantees Provided by Business Owners* (2013)) was materialized under collaboration between the Japan Chamber of Commerce and Industry (JCCI) and the Japanese Bankers Association (JBA), which promotes the legitimate actions for signing suretyship contracts by owners and facilitates the restructuring of principal debts in a fair and prompt manner. The JFSA is encouraging financial institutions to utilize the guidelines with the aim of supporting early revitalization of business.
Encourage further market-based financing (including venture capital) to improve risk assessments and access to capital by start-up companies	In line with the policies in the *Strategic Directions and Priorities* (2015), the JFSA encourages firms to utilize a variety of tools for fundraising, such as crowdfunding, venture capital and IPOs with view to sustainable growth of the economy. For instance, "funds programs tailored for skilled investors" (generally called "specially permitted businesses for qualified institutional investor, etc."), which many venture funds typically use, require to take appropriate actions to prevent investors' inconvenience in accordance with the *Financial Instruments and Exchange Act* revised in 2015. For investors' convenience, this revised act alleviated investors' entry criteria into the venture funds if they establish their appropriate governance structure, etc.
Strengthen credit infrastructure by encouraging broader use of collaterals and asset-based	Densai.net Co., Ltd., which is one of the Electronic Monetary Claim Recording Institutions (EMCRIs) in Japan, came into service in February 2013. Almost all Japanese banks participate in it. Therefore, it enables private companies to transfer/discount their accounts receivables easily, like bill receivables.

lending, and develop a wider coverage and information sharing on current credit registries	Also, in February 2013, the JFSA made it clear by revising the *Inspection Manual for Deposit-Taking Institutions* that Electronically Recorded Monetary Claims (ERMCs) which meet certain requirements similar to those for "Commercial bills of certain settlement" are treated as superior collaterals in order to promote the active utilization of ABL secured by ERMCs
Consider further improvements to the framework for new products and capital markets in order to support growth-enhancing sectors	The JFSA has been working on various policies to attain the transformation of the flow of funds under the capital market reforms stipulated in the *Strategic Directions and Priorities* (2015). As one of its initiatives, the JFSA is currently reviewing how crowdfunding is effectively used through the public hearing process. An option which we are currently considering is to allow a certain amount of small equity investments to be settled by credit cards in crowdfunding to enhance users' convenience. In addition, with a view to supporting asset formation for households and facilitating the supply of risk money for economic growth, the JFSA introduced NISA (Nippon Individual Savings Account) in January 2014. NISA, which gives individual investors a tax exemption on dividends and capital gains derived from listed shares and investment trusts, is an effective tool for small regular investment. As of the end of December 2015, the number of NISA accounts was about 10 million, and the total amount of investment was about 6.4 trillion yen. Furthermore, the JFSA introduced "Junior NISA" in 2016, which enables minors (people under the age of 20) to open a specially-designed NISA account.