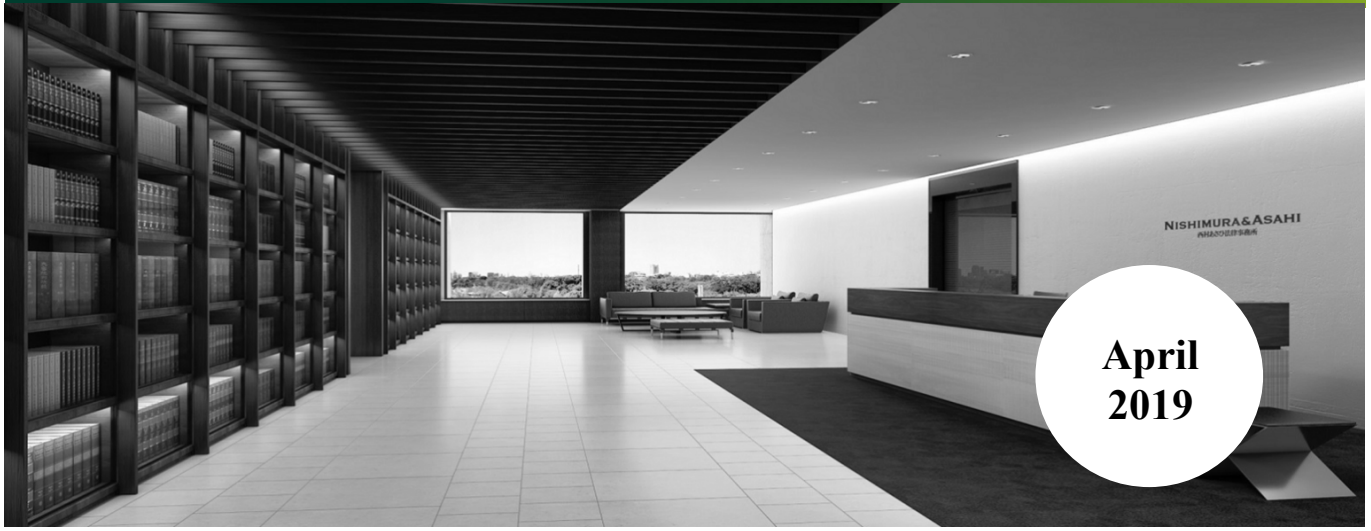


## Law Newsletter

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## Watching the Watchdog: What's Happening at Japan's Financial Services Agency - Japan's FSA is changing its conventional approach to supervision through proactive dialogue with financial firms.

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### 1. What topic will this paper discuss?

On June 29, 2018, the Financial Services Agency of Japan (the "JFSA") published a report (the "White Paper")<sup>1</sup> declaring the intention to abolish its inspection manuals and drastically alter its supervisory policy. Through the intended changes, the JFSA plans to institute more "substantial, holistic, and forward-looking" supervisory methods. In this paper, we will briefly explain what methods of supervision the JFSA used to employ, and how the JFSA intends to change them.

### 2. What was the JFSA's conventional method of supervision?

The JFSA was established in 2000, taking over responsibility from the Japanese Financial Supervisory Agency for regulating financial services markets and financial firms, such as banks, securities companies, and insurance companies.

By early 2000, the JFSA had established supervisory approaches which tended to focus on backward-looking compliance checks and asset quality reviews. Inspection manuals played an important role in such activities, providing JFSA employees with checklists for the periodic<sup>2</sup> and comprehensive onsite inspections it conducted of financial institutions.

The conventional inspections typically consisted of three stages. First, the JFSA would notify a financial firm of an impending inspection. Then JFSA inspection officers would utilize the aforementioned manuals to determine if the firm was duly abiding by (i.e. meeting the minimum standards of) the applicable laws and regulations. Finally, the JFSA would provide the inspected firm with an "inspection results notice" discussing issues they had agreed upon in advance.

<sup>1</sup> An official English translation is available at [https://www.fsa.go.jp/en/wp/supervisory\\_approaches\\_revised.pdf](https://www.fsa.go.jp/en/wp/supervisory_approaches_revised.pdf)

<sup>2</sup> Approximately once every three years

In the 2010s, the JFSA commenced efforts to change these initial approaches. It began to engage in more timely on-site inspections, focusing on important issues detected through daily monitoring. For instance, in 2013, it introduced "horizontal review," wherein it addressed problems regarded as common among certain groups of financial institutions.

However, the JFSA eventually recognized that relying excessively on such a formalistic and backward-looking approach often did not result in the desired level of compliance improvement within the target firms. In fact, the JFSA highlights some examples of this failure in the White Paper. For example, it notes that "Bankers would find it easier to defend lending decisions by referring to collateral and guarantees than by presenting bankers' own views on borrowers' future business prospects," "Brokers may spend more time creating evidence of compliance with product sales rules than listening to customers' life plans and needs," "Supervisors may spend most of their time criticizing specific past incidents of misconduct, but may fail to discuss whether firms meet the changing needs of the customers," "Supervisors may focus on loan-by-loan classification while overlooking key risks to the banks' sustainability," and "They may also focus on a specific incident of non-compliance, while failing to identify root causes and the reforms needed to address them."

### 3. How will the JFSA deal with these problems?

Now, the JFSA is trying to solve these problems by introducing more substantial, holistic, and forward-looking supervisory approaches.

The JFSA says that it will: pay more attention to a firm's overall governance, institutional culture, and internal control systems, instead of being overly focused on checklists provided by inspection manuals; point out firms' potential problems from a forward-looking perspective, even if firms seem to comply with the minimum standards at the moment; and have a more proactive dialogue with firms to encourage them to voluntarily explore best practices.

In the course of the reform, the JFSA decided that it would abolish inspection manuals at some point after April, 2019. The JFSA explained in the White Paper, "The purpose of the repeal is not to prohibit established business practices of financial institutions, but to support their own initiatives and creativity, building on their current business practices."

### 4. What is the purpose of the JFSA's discussion paper?

On October 15, 2018, the JFSA published a discussion paper (the "**Discussion Paper**")<sup>3</sup> on compliance risk management. The intent of the Discussion Paper was to start a dialogue between the JFSA and firms, pushing forward the policy changes noted in the White Paper. According to the White Paper, the JFSA will use such discussion papers as bases for dialogue while trying to develop a "common understanding of the new supervisory approaches between the Agency and financial institutions."

Interestingly, we can find some similarities between this JFSA dialogue-based approach and the approach found in the U.K. Financial Conduct Authority's (the "**FCA**") "5 Conduct Questions Programme." In the FCA program targeting conduct and culture in the wholesale banking sector, financial institutions discuss their experiences with the FCA, providing examples of both effective and ineffective practices identified through their implementation of the program.

The JFSA may be hoping that its dialogue approach will function in a manner similar to how the FCA program functions in the U.K., helping firms find best practices to manage compliance risks in Japan.

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<sup>3</sup> Only a Japanese version is available: [https://www.fsa.go.jp/news/30/dp/compliance\\_revised.pdf](https://www.fsa.go.jp/news/30/dp/compliance_revised.pdf) English translation is not available.

## 5. What's next?

According to the JFSA, it will publish what it learns through discussion with firms, including the best practices garnered through dialogue with financial institutions.

Of course, firms are not required to strictly adhere to the model practices shared by the JFSA. As the JFSA states in the White Paper, "The pursuit of the best business practices is a matter for each financial institution to find its own way, fitted to its own condition and circumstances, and there is no common solution or threshold to satisfy. Needless to say, the JFSA must distance itself from unduly biasing firms' business judgments by imposing what the JFSA believes to be the best practice."

Nonetheless, if best practice examples are shared by the JFSA, it would be highly advisable for financial firms to pay close attention, especially when dealing with vague ideas like "corporate culture," now that inspection-manual-based checklists are disappearing.

### *Japan's Financial Scene: The view from Tokyo*

*The "Japan's Financial Scene: The View From Tokyo" series is a sub-series of the Nishimura & Asahi Finance Law Newsletter. This sub-series provides a broad overview of Japanese financial regulation, as well as relevant tips and pointers. We hope that global financial professionals will find it useful for understanding some of the general, and even some of the complex, concepts of Japanese finance.*



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