

# Financial Supervisory Approaches ~ Promoting Global Financial City Tokyo ~

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# Inspection and Supervisory Approaches at Time of the FSA's Inception

- Since its inception in 1998, the Financial Services Agency (initially, the Financial Supervisory Agency, both "FSA") has dealt with various issues related to the financial crisis and has significantly changed its inspection and supervision approaches as outlined below. Such approaches have worked to solve one of the major prevailing issues - non performing loans accumulated over many previous years.

## Major Issues at the Time

- ✓ Restoration of public trust and impaired confidence in financial supervision
- ✓ Bringing non-performing loans issue to an end
- ✓ Enhancement of compliance with minimum standards to protect customers



## Inspection and Supervision Approaches at Inception

- Rule-based supervision focusing on ex post checks
- Devotion to stringent asset classification and provisioning
- Reinforcement of legal and compliance rules

⇒ With these changes, non performing loans accumulated over many previous years were cleaned up and minimum customer protection was secured.

# From “*Form/Backward-looking/Individual Elements*” to “*Substance/Forward-looking/Holistic View*”

- Mechanically repeating established approaches which have proved effective may provide perverse incentives to bankers.

## Form

- Focusing more on the existence of collateral and guarantees and on preparing evidence for compliance with rules

## Backward-looking

- Focusing on the soundness of balance sheets and past compliance violations

## Individual elements

- Focusing on individual asset assessments, failing to investigate the root causes of problems and discussing the necessary countermeasures

## Substance

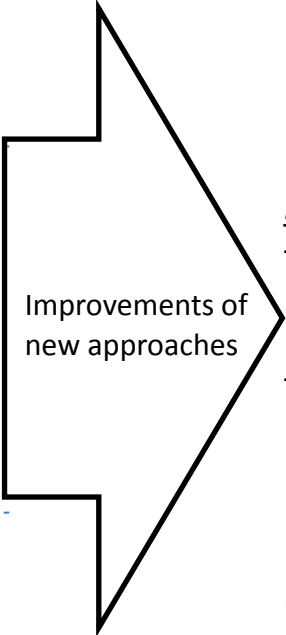
- Focusing on whether high-quality financial services (best practices) are being provided, rather than whether the minimum standard is being formally met

## Forward-looking

- Focusing on whether the sustainability of business models is ensured, rather than just checking soundness at times in the past
- Focusing on whether the balance between “Risk and Profits” is attained, in addition to “risk and capital adequacy”

## Holistic view

- Focusing on whether responses to truly important problems are successful, rather than just responding to specific individual problems



Improvements of  
new approaches

# Realizing Market Vigor and the Accumulation of the Household Assets as well as Securing Market Fairness and Transparency

## Issues

### Households

- ✓ Majority of financial assets held in cash and deposits
- ✓ Poor investment performance
- ✓ Lack of the experience of investment success and financial literacy

### Distributors (Banks, Securities Firms, Insurance firms, etc.)

- ✓ Improper management attitudes with priority on earning high fee incomes resulting in absence of customer orientation
- ✓ Customers not effectively informed of the commission fees and the risks of the financial products they purchase

### Institutional Investors (Asset Owners, Asset Managers)

- ✓ Enhancement of investment and risk management techniques to fit to the scale and nature of the asset profile
- ✓ Lack of constructive engagement with investee firms and long term investment based on the assessment of the values of individual companies

### Market • Economy

- ✓ Insufficient supply of risk money
- ✓ Issue of developing a direct finance market
- ✓ Limited presence of global asset managers and intermediaries in Japan

## Key Measures

- Establishment and promotion of new NISA program
- Practical investment education
- Establishment of principles for customer-oriented business conduct to ensure that financial institutions fulfill fiduciary duties
- Enhanced disclosure on commission fees
- Improved explanatory materials on the risks of financial products
- Promotion of voluntary disclosure of financial institutions' policies on customer-oriented business
- Amendment of the stewardship code to encourage institutional investors to engage in constructive discussions with investee firms in the best interest of ultimate beneficiaries
- Strengthening governance and management of conflict of interest at asset management firms
- Solicitation to and checks of asset managers by asset owners (e.g., pension funds)
- Review appropriate regulatory options to deal with high speed algorithmic trading

## Future Vision

### Households

- ✓ Realization of more stable asset growth by promoting long term, regular, diversified investments

### Distributors (Banks, Securities Firms, Insurance firms etc.)

- ✓ Creation of high quality financial products and services to truly serve customers
- ✓ Easier comparisons and a well-informed choice of financial products for purchase decisions

### Institutional Investors (Asset Owners, Asset Managers)

- ✓ Enhancement of stability of returns through advanced investment and risk management techniques
- ✓ Increase in the firm value through constructive engagement with investee firms

### Market • Economy

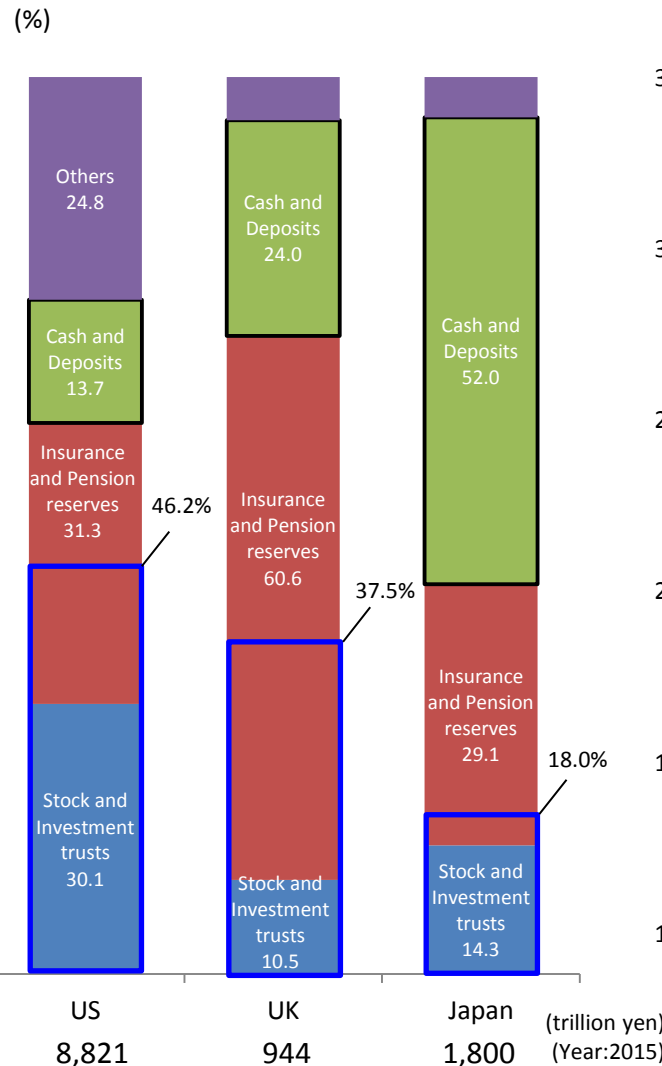
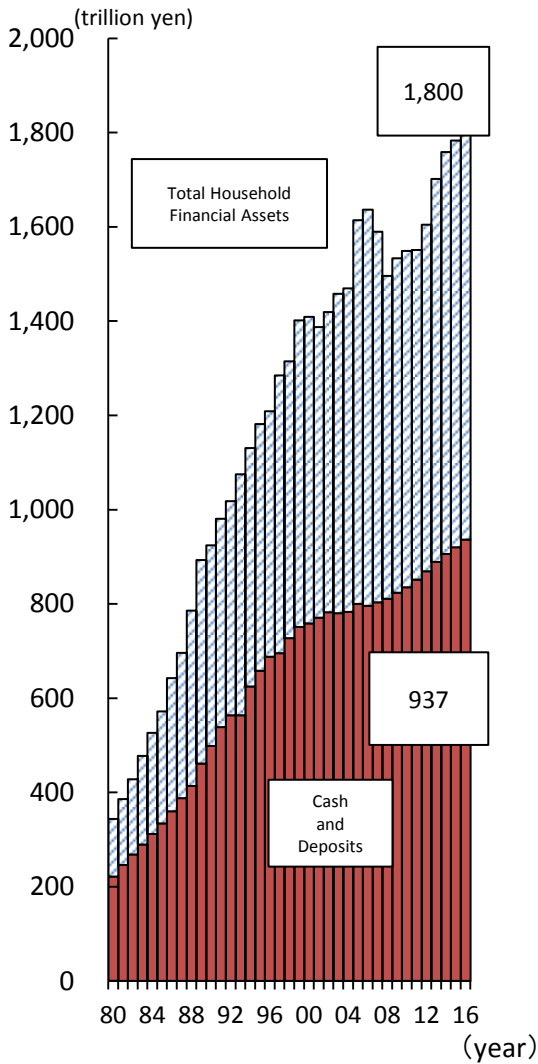
- ✓ Appropriate supply of risk money
- ✓ Development of in-depth equity and bond markets
- ✓ Vitalization of markets by clustering of global financial institutions (inflow of high-quality market information, aggregation of highly skilled financial professionals)

# Household Financial Assets in US, UK and Japan

Growth of Japan's household financial assets

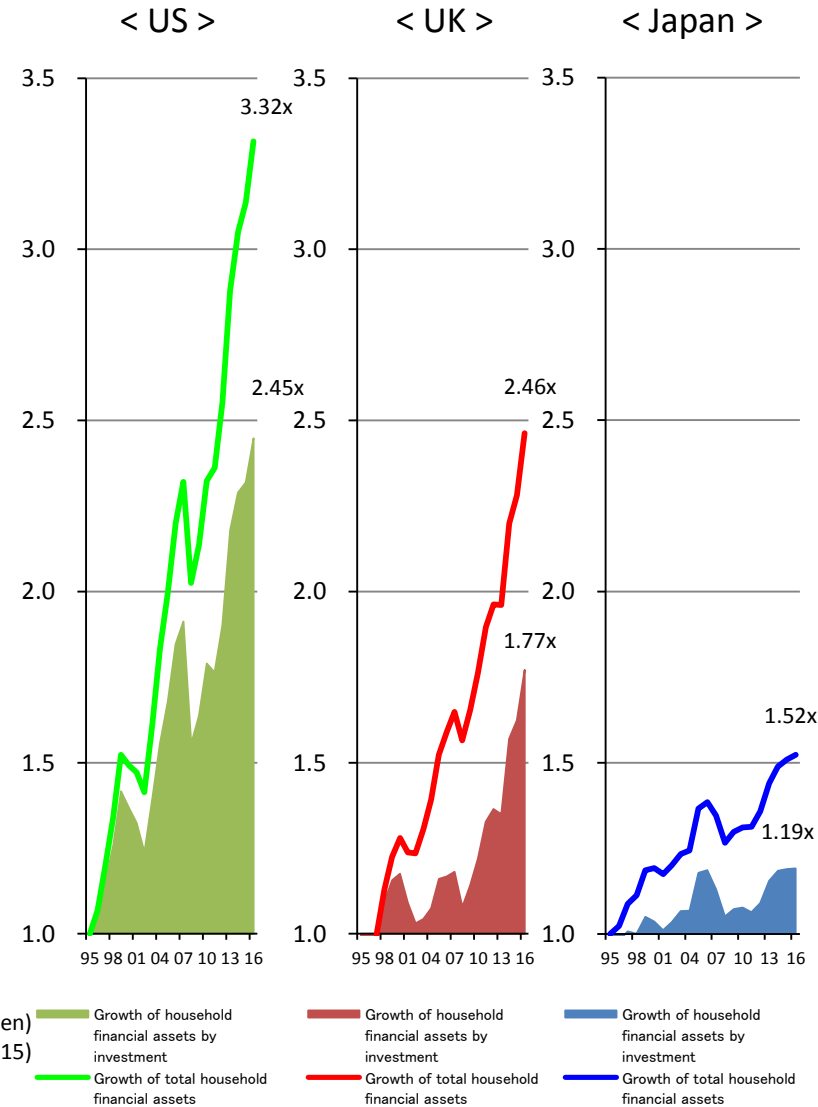
Composition of household financial assets

Growth of household financial assets



□ means share of Stock and Investment trusts including indirect investment via Insurance and Pension reserves.

Note: Exchange rates at the end of 2016 (\$1=116.9JPY, £ 1=144.2JPY).  
Source: FRB, BOE and BOJ



Note: Base years are 1995(US, Japan) and 1997(UK).  
Source: FRB, BOE and BOJ

## Ten largest investment trusts in Japan and US

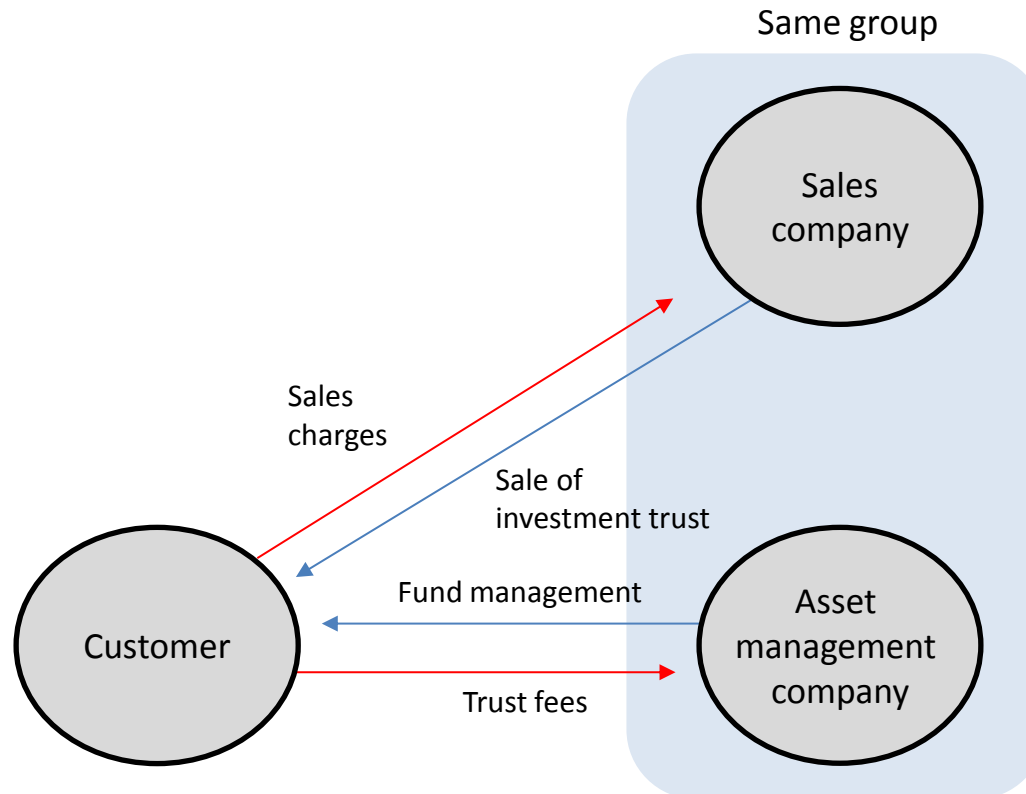
	Rank	Mar.16	Mar.11	Mar.06
Japan	1	US-REIT fund A	Highly-rated Bond fund (developed economies)	Highly-rated Bond fund (developed economies)
	2	Global REIT fund A	Lower-rated Bond fund (global)	Global Bond fund A
	3	US-REIT fund B	Highly-rated Bond fund (global) A	US-Bond fund
	4	Global Equity fund	Highly-rated Bond fund (global) B	Mixed assets Balanced fund (global) A
	5	Lower-rated Bond fund (US)	Global Equity fund	Global Bond fund B
	6	Highly-rated Bond fund (developed economies)	Emerging economies' Bond fund A	Highly-rated Bond fund(global) C
	7	US-REIT fund C	US-REIT fund B	Japanese Equity fund
	8	US-REIT fund D	Emerging economies' Bond fund B	Global Equity fund
	9	Global REIT fund B	Global Bond fund A	Mixed assets Balanced fund (global) B
	10	Emerging economies' Equity fund	Mixed assets Balanced fund (global) A	Mixed assets Balanced fund (global) C

	Rank	Mar.16	Mar.11	Mar.06
US	1	US-Equity index fund A	US-Bond fund	US-Equity fund A
	2	US-Equity index fund B	US-Equity fund A	US-Equity index fund C
	3	Global Equity index fund (excluding US)	US-Equity index fund A	US-Bond fund
	4	US-Equity index fund C	Global Equity fund (excluding US)	Global Equity fund C
	5	US-Equity fund A	US-Equity index fund C	Global Equity fund (excluding US)
	6	US-Bond index fund A	US-Equity index fund B	Global Equity fund D
	7	Global Equity fund (excluding US)	Global Equity fund B	Mixed assets Balanced fund (US)
	8	US-Equity fund B	Global Equity fund A	Global Equity fund B
	9	Global Equity fund A	US-Equity fund B	US Equity index fund A
	10	US-Bond index fund B	US-Bond index fund A	US Equity fund A

Source: QUICK and published data from US asset management firms

# Typical Transactions Involving the Risk of Conflict of Interest

- Cases wherein the sale and management of investment trusts is conducted within the same corporate group



[Cases involving conflict of interest]

- When a sales company recommends to customers the products of an asset management company within the same group, prioritizing profits of the group instead of the interests of the customers

## [Establishment of New NISA for Dollar Cost Averaging Investment]

- Improve tax benefit scheme to promote households' small size long term, regular, diversified investments
- ⇒ New NISA available from January 2018
  - ✓ Annual maximum investment amount: Yen 400,000, non taxable holding period: 20 years, possible investment period: 20 years, total non taxable amount: Yen 8 million
- ⇒ Eligible products narrowed down to investment trusts that are **long term, regular and diversified**.

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## [Establishment of principles for customer-oriented business conduct to ensure that financial institutions fulfill fiduciary duties]

- It is important for financial institutions to conduct customer-oriented operations in order to realize stable household asset growth
- ⇒ Based on discussions by the Financial System Council's Working Group on Financial Markets, "Principles Concerning Customer-Oriented Business Conduct" was established on March 30 (principles-based approach)
- ⇒ It is important for financial institutions not to focus only on complying with rules. They should provide better financial products and services through sound competition in order to make the "principles" establish substantially. Therefore, "visualization" of the financial businesses measures, monitoring by the authority, and active involvement of the clients should be promoted

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## [Promotion of Practical Investment Education]

- Households need to gain practical investment knowledge (effectiveness of long term, regular, diversified investments)
  - ✓ Approximately 70% have not received financial investment education, of which 2/3 believe that "investment knowledge is unnecessary"
- ⇒ Produce practical investment education materials for novice investors
- ⇒ Discuss and review methods to ensure investors **can make easy, well-informed product comparisons** when purchasing investment trusts and other financial products



# Existing NISA and New NISA

## Existing NISA

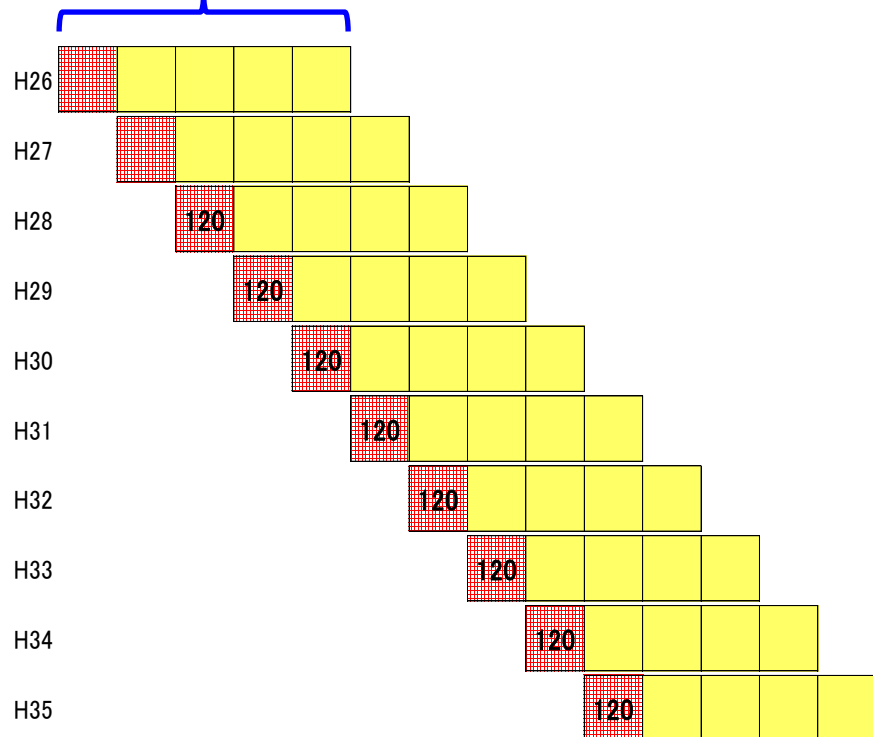
- Annual investment amount: up to Yen 1.2 mil.
- Non taxable period: **5 years**
- Total non taxable amount : **Yen 6 mil.** (Yen 1.2 mil x 5 years)

## New NISA (from Jan. 2018)

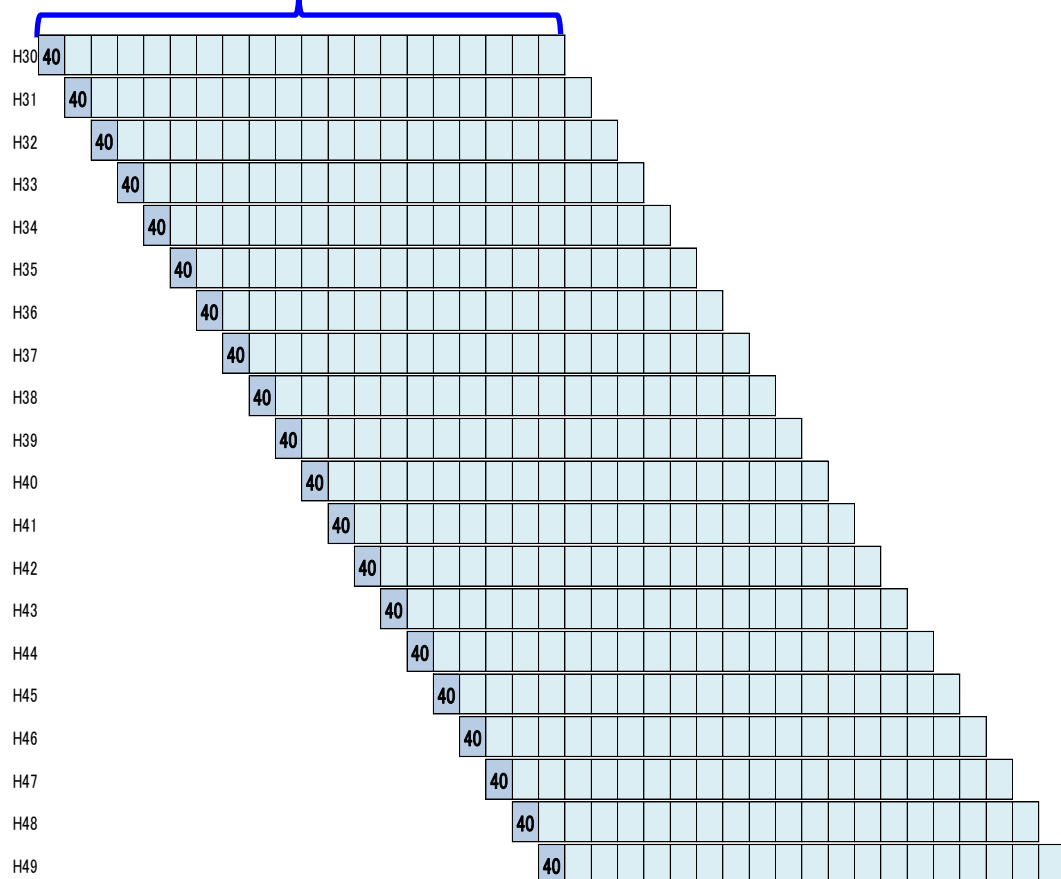
- Annual investment amount: up to Yen 0.4 mil.
- Non taxable period : **20 years**
- Total non taxable amount : **Yen 8 mil.** (0.4 mil Yen × 20 years)

Can choose either one

5 years



20 years



All existing investment trusts (approx. 5,400 products)

- The majority of existing investment trusts are not suitable for long term, regular and diversified investments.
- New NISA excludes the below products' types:
  - short term investment (trust period of 80% of total is less than 20 years)
  - high commission fees (average sales/distribution fees 2.5%)
  - monthly dividend pay-outs (90% of popular products)
  - with leverage (price volatility 2-3x the Nikkei 225 index)

## Eligibility Criteria for New NISA (approx. 50 existing products are eligible)

- **General rule: general index investment trusts (passively managed) are the base components of the products**  
(e.g.) products that diversify investments in domestic and international equity and bond indices, Nikkei 225 Index
- For **actively managed investment trusts, those continuously supported and selected by investors with stable asset size growth** are eligible as an exception
- **Submission of a report to FSA necessary**
- **Sales / distribution commissions: 0%**
- **Annual trust fees capped** (e.g. domestic index investment trust 0.5%); only limit to low trust fee products
- **Annual notification of trust fee amount provided to investors**
- Distribution companies **shall explain and publicly disclose important information on the products' characteristics in light of the customers' attributes**

**As most existing investment trusts would not be eligible, investment trust firms are expected to establish high quality products to meet new NISA criteria**

# “Principles Concerning Customer-Oriented Business Conduct” -Overview-

1. Development and Publication of Policy Concerning Customer-Oriented Business Conduct



2. Pursuit of Customers' Best Interests

3. Appropriate Management of Conflicts of Interest

4. Clarification of Fees and Expenses

5. Easily Understandable Provision of Important Information

6. Provision of Services Suited to Each Customer

7. Frameworks for Motivating Employees Appropriately and Other Measures

# Corporate Governance Reform Maturing Approaches

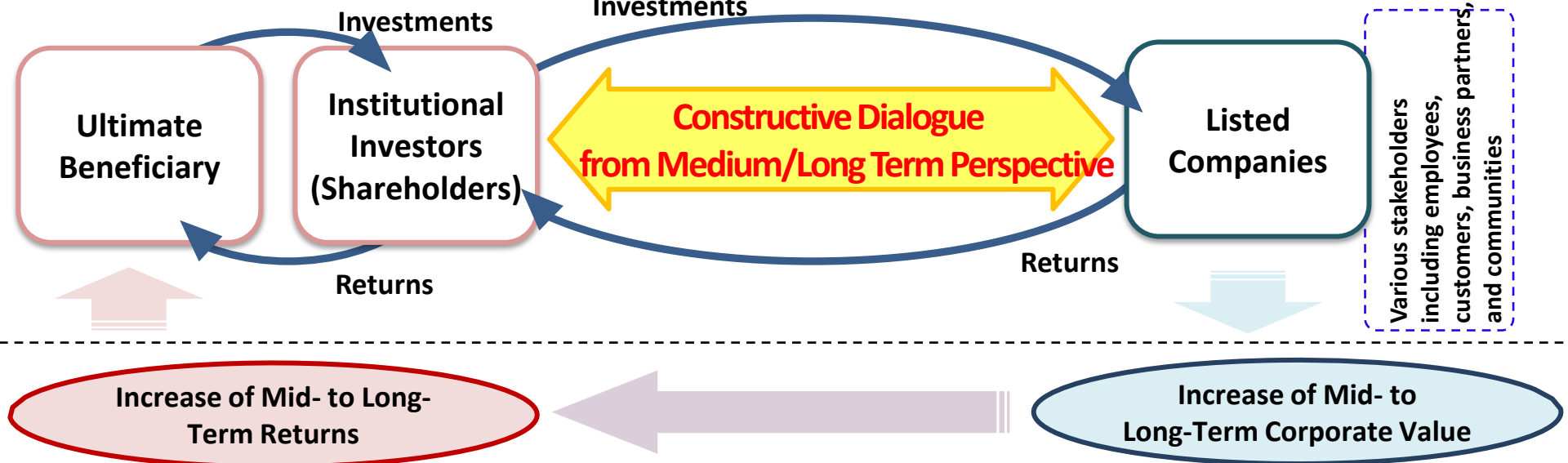
## Corporate Governance Reform Approaches Employed to Date

- Codes were developed as part of the Japan Revitalization Strategy executed by the Abe Administration
  - **“Stewardship Code”** finalized in February 2014
    - ⇒ Principles that require institutional investors (pension funds and their asset managers) to engage with investee companies from a medium, long term perspective to promote their sustainable growth.
  - **“Corporate Governance Code”** finalized in March 2015 .
    - ⇒ Principles that require **publicly listed firms** to appropriately engage with **various stakeholders (shareholders, employees, customers, vendors and communities)** to **improve medium to long term earnings and profits** through effective management strategies.

Companies and investors engage in constructive dialogue from a medium-long term perspective

**Stewardship Code**  
(Principles for institutional investors)

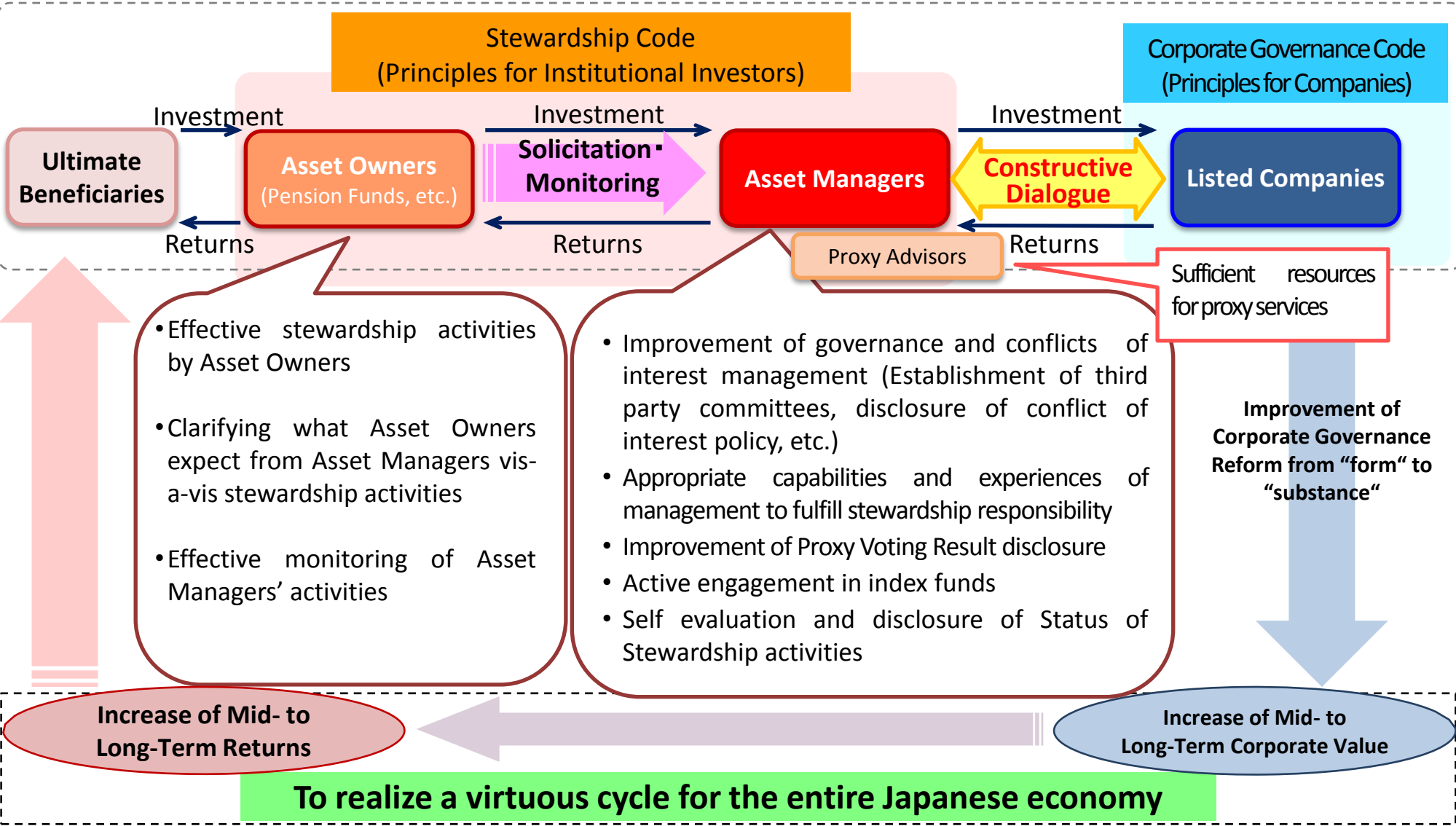
**Corporate Governance Code**  
(Principles for companies)



To realize a virtuous cycle for the entire Japanese economy

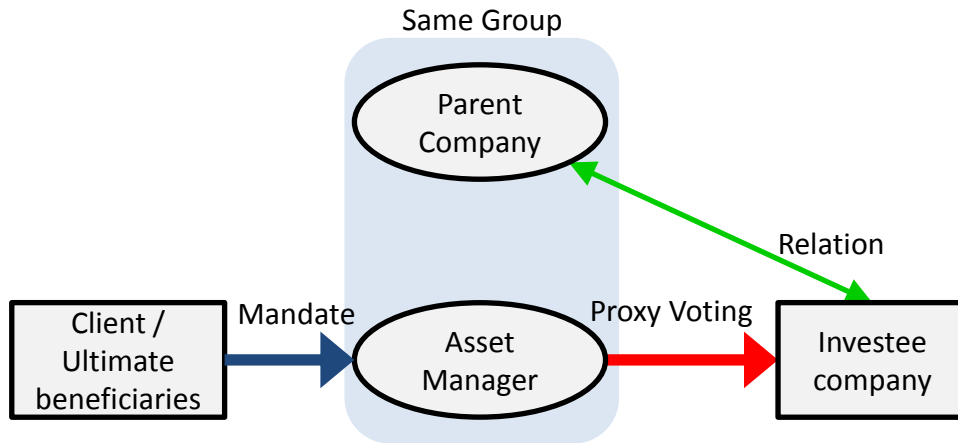
# Major Issues of the Stewardship Code Revision

- It is important to improve constructive dialogue between investors and companies for evolving corporate governance reform from “form” to “substance.”
- To strengthen governance and conflict of interest management for asset managers, and clarify the role of asset owners such as pension funds.



# Strengthening of Asset Management Firms' Governance and Conflict of Interest Management

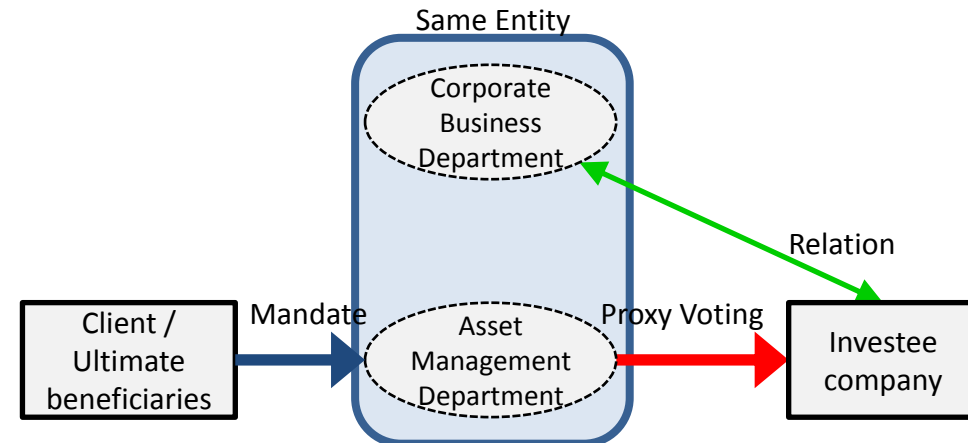
Case 1: The case of a group of companies that includes a parent company engaged in corporate business and an asset manager within the same group.



【 The circumstances may give rise to conflicts of interest 】

The circumstances of the asset manager putting the intentions of the parent company engaged in corporate business ahead of the interests of the client/ultimate beneficiaries, when exercising the voting rights of the investee company.

Case 2 : The case of a company engaged in both corporate business and asset management within the same entity.



【 The circumstances may give rise to conflicts of interest 】

The circumstances of the asset management department putting the intentions of the corporate business department engaged in business including financing service, stock transfer agency service and corporate sales ahead of the interests of the client/ultimate beneficiaries, when exercising the voting rights of the investee company.

(Source) The First Council of Experts on the Stewardship Code, Secretariat Explanation Materials 3

## Proposed Stewardship Code Revision

Guideline 2—2 (Abbreviating) **Asset managers should identify specific circumstances that may give rise to conflicts of interest which may significantly influence the exercise of voting rights and/or dialogue with companies and set out and disclose specific policies on measures to avoid such conflicts and effectively eliminate such influences to secure interest of clients and beneficiaries.**

Guideline 2—3 **Asset managers should establish governance structures such as independent boards of directors and third party committees for decision-making or oversight of voting,** in order to secure the interests of clients and beneficiaries and prevent conflicts of interest.

Guideline 2—4 **The management of asset managers should recognize that they themselves have important roles and responsibilities in strengthening the governance of asset managers and managing conflicts of interest, and should take action on such issues.**

# “Financial Market Entry Consultation Desk”

“Japan Revitalization Strategy 2016” (excerpt from June 2016 Cabinet Decision)

## ⑤ Improving Convenience and Revitalizing Japan’s Financial and Capital Markets

- Establish a one-stop consultation desk within FSA to give advice to foreign asset managers and owners looking to establish a business base in Japan. It will collaborate with the Tokyo Metropolitan Government’s operated “**Financial One-stop Support Service**” and “**Tokyo One-Stop Business Establishment Center**” to offer various support including advice on business incorporation, living support, etc.



Given the above,

- To encourage foreign financial service firms (asset management firms) to establish bases in Japan, launched a “Financial Market Entry Consultation Desk” on April 1, that provides one-stop consultation services regarding financial regulations and necessary registration procedures to operate in Japan’s financial markets
- Support foreign financial service firms’ Japan entry in cooperation with TMG’s “Financial One-Stop Support Service,” that provides advice on procedures to establish businesses (e.g. business incorporation but excluding financial regulations)

# Joint Consultation Scheme by Tokyo Metropolitan Gov. and the FSA

The joint consultation service welcomes any inquiry from foreign financial business operators to establish a business base in Tokyo

Foreign financial firm considering establishing a base in Japan

Consultation   Support • Advice

## – Tokyo Metropolitan Gov. –

### ➤ Setting up an office in Tokyo

#### *Financial One-Stop Support Service*

E-mail: [financial-desk@bdc-tokyo.org](mailto:financial-desk@bdc-tokyo.org)

Tel: +81 - 3 - 6269 - 9981

- ✓ Professional business consultant to process your inquiry
- ✓ Advice on how to incorporate your business in Tokyo
- ✓ Living support (introduction of English-speaking hospitals and international schools)
- ✓ Introduction of capable attorneys and financial aid for consultation

URL: <http://www.bdc-tokyo.org/?cat=3>

## – FSA –

### ➤ Registration to the FSA

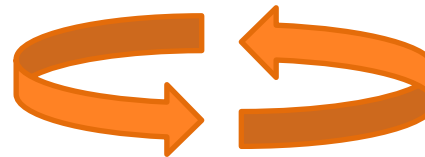
#### *Financial Market Entry Consultation Desk*

E-mail: [marketentry@fsa.go.jp](mailto:marketentry@fsa.go.jp)

Tel: +81 - 3 - 3506 - 7109

- ✓ Inquiries regarding registration procedures and interpretations of financial regulations
- ✓ Constant follow-up toward registration as an authorized financial business operator

URL: <http://www.fsa.go.jp/en/policy/marketentry/index.html>



**Joint consultation and a variety of support menus for prospective market entrants through close cooperation**



# The Goals of Financial Administration

(Shift from “Emphasize on stability” to “Compatibility of stability and growth”)

- Focusing on stability, protection, integrity and transparency

- Focusing on the balance among (i) stability and intermediation, (ii) protection and benefit, and (iii) integrity/transparency and vigor
- Securing consistency with ultimate goals

