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FSA's Financial Monitoring Report highlights risk governance's importance

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Executive Summary

A year has passed since the FSA adopted a new approach to examining financial institutions. In July 2014, the FSA released a Financial Monitoring Report summarizing the results of its new approach to date. The report focuses especially on risk governance, including compliance and risk-data analysis.

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A full year has passed since Japan's Financial Services Agency (FSA) adopted a new approach to examining financial institutions pursuant to its new Financial Monitoring Policy[1]. The FSA launched its new financial monitoring regime in the aim of alleviating the burden imposed on financial institutions by its previous examination procedures. Under the new regime, the FSA collects and analyzes information through means other than on-site examinations (e.g., off-site meetings). However, when I asked financial institutions about the FSA's new approach, not all reported a reduction in workload. While some said that their workload associated with on-site examinations had been reduced, others felt that preparation for the off-site meetings imposed an even heavier burden.

On July 4, 2014, the FSA released a Financial Monitoring Report[2] (FM Report) on the results of its financial monitoring over the preceding year. Following is an analysis of the FSA's intentions based on the FM Report.

Overview of Financial Monitoring Report

The FM Report's first chapter discusses economic and market developments relevant to financial institutions. The remainder of the report critiques financial institutions' management. In particular, the report cites issues that should be addressed in each financial subsector and presents numerous examples of financial institutions' practices based on the results of horizontal reviews[3] conducted in the course of financial monitoring.

In previous reports on financial examination results, the FSA typically cited examples of deficiencies[4]. In the FM Report, by contrast, the FSA tried to highlight success stories. In this respect, the FM report is extremely instructive. Since the advent of financial liberalization, Japanese financial regulators had become much less

NOTE

1) In September 2013, the FSA unveiled a Financial Monitoring Policy, a new policy for examining financial institutions. Previously, the FSA mainly conducted on-site examinations, but under its new policy it places more priority on collecting information in advance and interviewing financial institution personnel.

2) Highlights of the report are available in English at http://www.fsa.go.jp/en/news/2014/20140731-1/01.pdf.

3) The FSA reviewed certain themes common to multiple financial institutions and recommended best practices in the aim of promoting improvement throughout the financial sector.

4) http://www.fsa.go.jp/news/26/ginkou/20140730-1/01.pdf (in Japanese only).

Exhibit: Overview of Financial Monitoring Report

Title	Summary
Chapter I. Overview of financial system	
1. Economic and market trends relevant to financial sector	Japanese economy continues to gradually recover but financial institutions must be vigilant against changes in interest-rate levels/volatility
2. Financial institutions' response	Banks' deposits, outstanding loans, reserves on deposit at BOJ and investment trust holdings are growing; JGB holdings are decreasing
3. Management trends among depository institutions	Although credit costs are in a downtrend, core business profits are in decline
Chapter II. Overview of financial monitoring by subsector	
1. Three megabank groups	Megabanks are pursuing integrated group management, particularly cooperation between banks and brokerages
2. Regional banks	With nationwide loans outstanding expected to shrink, business growth driven by quantitative expansion of loan books may not be feasible
3. Foreign banks	Deficiencies include poor communication between Japan-based management and FSA and inadequate controls over outsourcing
4. Insurers	Monitoring of insurance product sales by customer segment is inadequate
Chapter III. Horizontal review by theme	
1. Governance	Recruitment of management personnel capable of meeting current demands is a challenge
2. Internal controls against antisocial forces and money laundering	Although antisocial forces and money laundering are closely related, information sharing is limited in some cases
3. Investment trust sales business	Financial institutions have started to recognize that earning sales commissions from fund switching may be a problem
4. IT governance	Efficiency of management and monitoring of outsourcing service providers (e.g., joint data centers) needs to be improved
Chapter IV. FSA initiatives	
1. Cooperation with foreign regulators	Supervisory colleges, information exchange with foreign regulators, etc.
2. Collection and utilization of information	Established intelligence project team to collect information
3. Upgrading of examiners' expertise	Formed specialized teams by business/risk category and commence cooperation with examiner-in-chief (EiC) team
4. Initiatives to qualitatively improve examinations	Increased operational flexibility (e.g., allowed extensions of examination periods, deployment of additional examiners)

Source: Excerpted from FSA's Financial Monitoring Report (July 2014) by NRI

transparent in terms of the specifics of their thinking. Publication of the horizontal reviews' results sheds light on what the FSA considers to be priorities and best practices. It goes without saying, however, that whatever the practice, it is important for financial institutions to fully assimilate the practice in a manner compatible with their own respective organizations.

However, I felt that most of the practices discussed in the FM Report do not rise to the level of "best practices," partly because the report covered the new monitoring regime's first year. For example, on the topic of nonexecutive directors, the report mentioned practices to augment support staff required by nonexecutive directors but it did not clearly identify best practices.

Risk governance expected of financial institutions

The FM Report focused especially on risk governance, including compliance and risk-data analysis.

For example, the report stated that it is important for the three megabank groups' holding companies to strengthen their governance to parity with overseas financial holding companies, including G-SIFIs[5]. The megabanks groups comprise companies that fulfill various financial functions, but if their holding companies' management is staffed solely by officers and employees of one group company (e.g., a banking subsidiary), the holding company's management may not be adequately cognizant of the operational attributes of other group companies (e.g., trust banking subsidiaries). In such an event, risk analysis that fails to adequately consider all group companies would be a concern. It is therefore advisable for the megabanks groups to staff their holding companies with officers and employees from all major group companies who understand their respective companies' risks. Such an approach should facilitate group risk analysis and other governance functions.

5) Global Systemically Important Financial Institutions.

The FM report's section on regional banks was quite critical in its tone. It noted that earnings management is generally fundamental to managing the company but some regional banks do not even have an adequate understanding of their own profitability, the foundation of risk governance. Regional banks should seriously self-reflect in response to such harsh criticism of their current management deficiencies.

Importance of data infrastructure to support risk governance

In conducting risk governance, it is essential to have IT infrastructure to store risk data to ascertain and analyze the actual state of a financial institution's operations. During the global financial crisis that erupted in 2008, a major gap emerged between companies with adequate risk-data management and companies without it. In response, G-SIFIs, including the Japanese megabanks, are currently building risk data infrastructure with standardized data formats.

Building this data collection infrastructure entails identifying, extracting, aggregating and storing voluminous risk data globally dispersed among group companies. This process requires extremely detailed data correction procedures to rectify duplications and omissions and adjust for differences in data's timeframes and/or units of measure. Building data collection infrastructure is thus extremely labor-intensive, but such efforts are expected to pay off commensurately. For example, the infrastructure will not only enable financial institutions to ascertain and analyze their own risk governance status, it will enable data reported to financial regulators by all Japanese financial institutions to be aggregated and utilized as Japan risk data. On a global basis, national authorities will be able to track global financial systemic risk[6] by aggregating their financial risk data with other countries'.

6) In November 2013, researchers and practitioners from industry, academia and government in a number of fields including economics, finance and financial informatics formed the Financial Networks Research Initiative, a scientific research group that aims to deepen knowledge and research findings related to financial systemic risk.

If such a sophisticated risk-data processing system had existed at the time of the global financial crisis, outcomes would have very likely been different. Efforts to build at least a portion of this global data processing infrastructure are now well and truly underway.

about NRI

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