Provisional Translation
As January 2018

Summary Points from

Progress and Assessment of the Strategic Directions and Priorities 2016-2017

Financial Services Agency

October 2017

Progress and Assessment of the Strategic Directions and Priorities 2016-2017: Its Roles in the JFSA's PDCA cycle

- This document lists key elements of the JFSA's *Progress and Assessment of the Strategic Directions and Priorities 2016-2017* ("the Report"), which outlines the analysis on Japan's financial system and the challenges identified during the program year 2016 (July 2016 to June 2017).

- The Report is published as a part of the JFSA's PDCA cycle. The *Strategic Directions and Priorities* corresponds to the "Plan" stage of the cycle. The Report plays a role in the "Check" stage by reviewing the progress made during the year. The JFSA is committed to repeating the PDCA cycle for continuous enhancement of the quality of regulation and supervision.

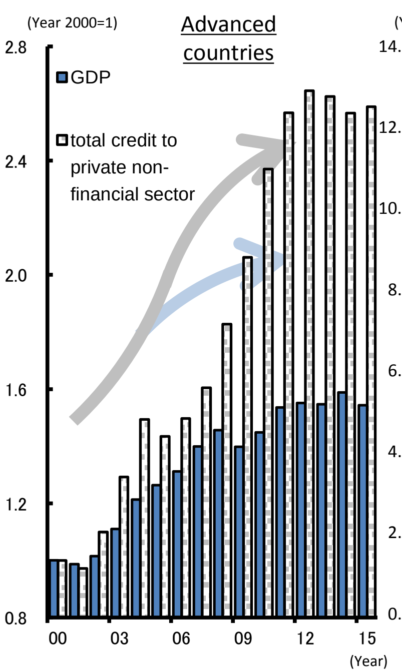
- *The Strategic Directions and Priorities 2017-2018* for program year 2017 (July 2017 to June 2018) will reflect findings and observations of the Report.

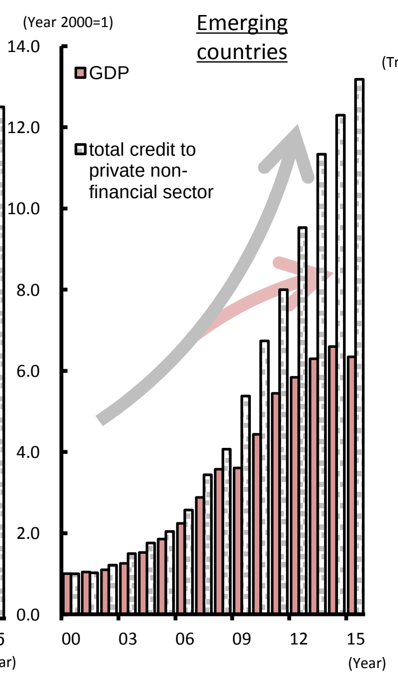
Contents

I-1. Global economy and financial markets

- Credit provided to the private non-financial sector is growing at a faster pace than the global economic growth.
- The non-bank sector is expanding, whereas advanced countries' banking sector shrinks partly due to tightening of financial regulations.
- Prices of risky assets continue to rise, and market volatility remains at a historically low level.
- While the global economy is recovering, close attention should be paid to impacts of possible future changes in the interest rates.

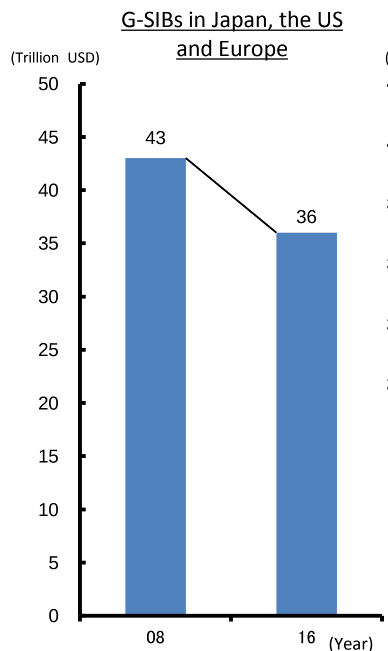
GDP and credit to private non-financial sector



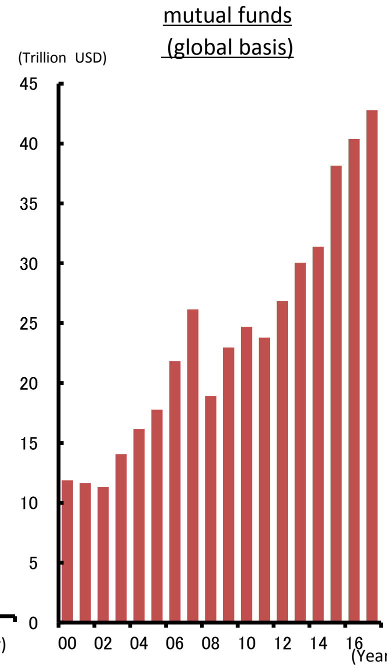


(Note 1) Advanced countries consists of Japan, the US, the UK, Germany and France. Emerging countries consists of Brazil, Russia, China, and India.
(Note 2) GDP is a sum of respective nominal GDPs (converted to USD).
(Source) UN, BIS

Assets of banking and non-bank sector

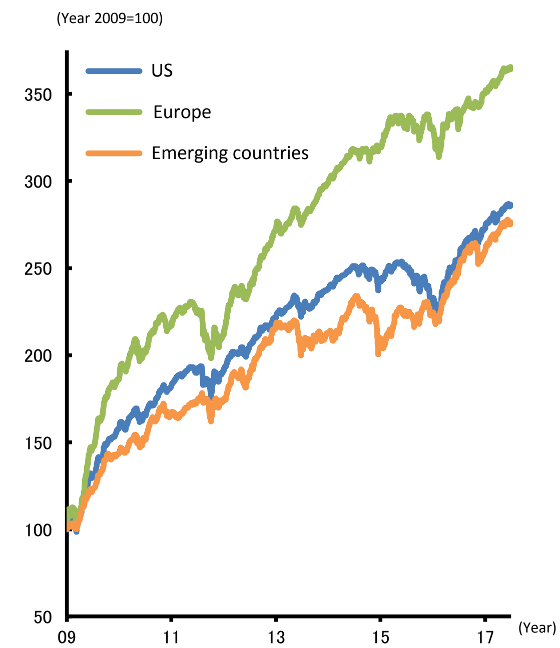


(Note) The 2008 data of G-SIBs in Japan are as of the end of March 2009.
(Source) Bloomberg



(Note) Definition of data were changed in 2015.
(Source) Investment Company Institute

High-yield bond prices

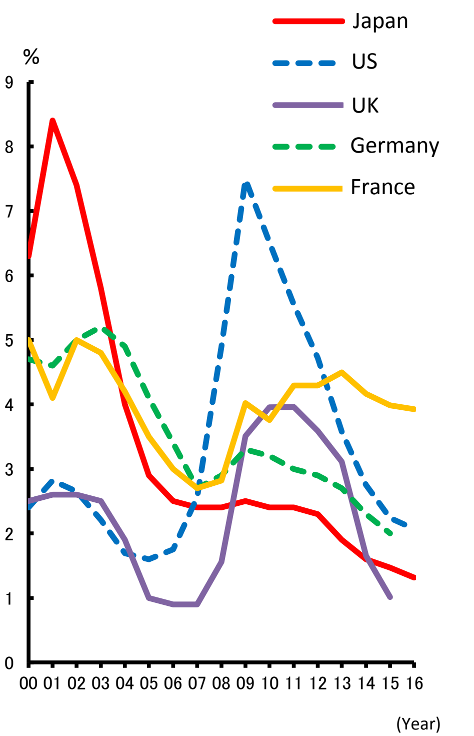


(Note) Data are high yield bond indices calculated by Bloomberg.
(Source) Bloomberg

I-2. Banking sector in Japan

- The ratio of non-performing loans is low, compared to both historical and other countries' levels.
- Banks' domestic net interest income, which is the primary source of revenue, continues to decline due to the shrinking interest margin on loans. This raises a concern on the sustainability of banks' current business models.
- JPY interest rate risk is growing at regional financial institutions.
- Interest rate risk management is a key issue to prepare against uncertainties in the global economy and markets.

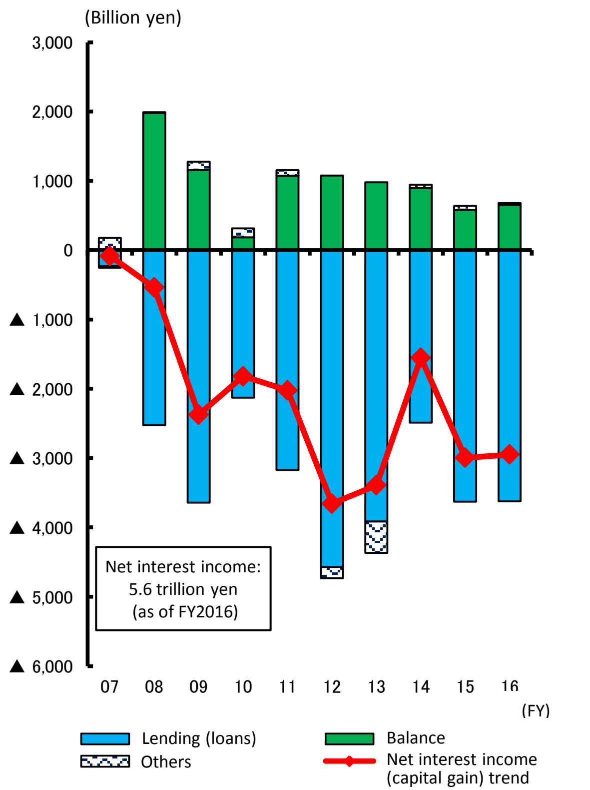
Ratio of non-performing loans



(Note) Japan's data are on a fiscal year basis.
(Source) CEIC

Composition of net interest income

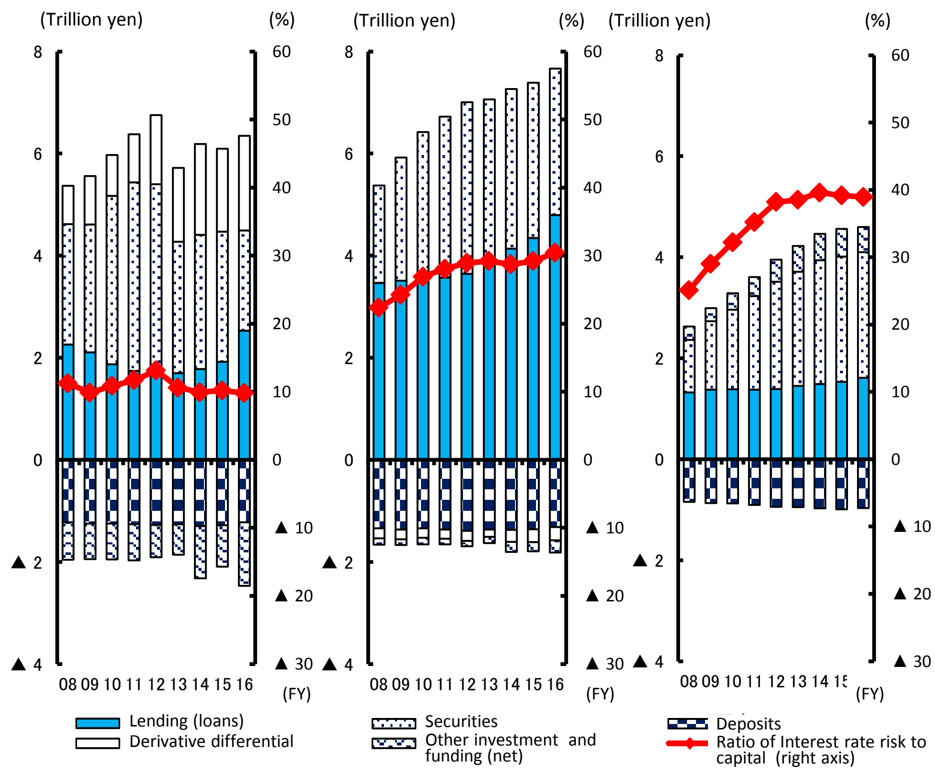
Major banks (domestic business) + Regional banks



(Source) JFSA

JPY interest rate risk

Major banks, etc. | Regional banks | *Shinkin* and *Shinkumi* banks

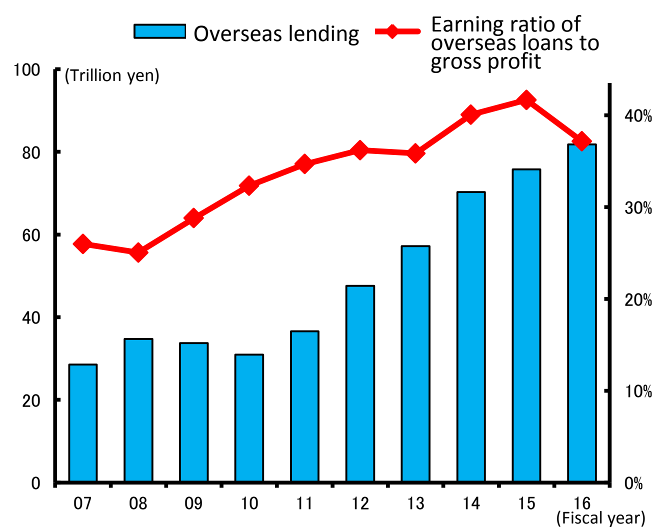


(Note) JRY interest rate risk: Yen bonds 100BPV/Capital
(Source) JFSA

I-3. Three Mega-bank groups

- The capital and revenue levels are stable. Meanwhile, as their overseas businesses rapidly grow, the groups face a challenge, to ensure timely exposure management and secure stable foreign currency funding to keep up with changing global economic and market environments.
  As domestic lending increases under the assumption of continued low interest rate environment, the groups need appropriate loan screening and appropriate credit portfolio management.
- Given the growth of business alliances among group companies, it is increasingly important to manage their conflicts of interests and prevent abuse of a superior bargaining position. With the initiative of the groups' holding companies, it is vital that the customer-oriented business model is shared as the core value within the groups.
- It is important for the groups to further enhance their governance so that they can adequately respond to changes in the business environment including technological innovation.
- The ratio of shareholdings to equity capital remains higher than that of major US and European banks. Reduction of stock price fluctuation risk is needed.

Overseas lending and earning ratio to gross profit

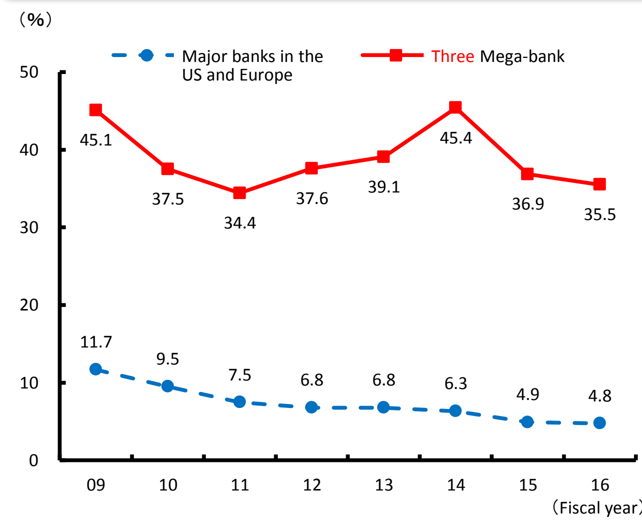


(Note1) Overseas lending: the lending by the banks' international business divisions (average balance outstanding).
(Note2) Earning ratio of overseas lending: the ratio of international business divisions profit to the gross profit.
(Source) Disclosure documents of the Three Mega banks.

USD funding cost

(Note) USD funding cost: the exchange cost incurred in converting JPY to USD through short-term (3 months) foreign exchange swaps.
(Source) Bloomberg

Ratio of shareholding to equity capital



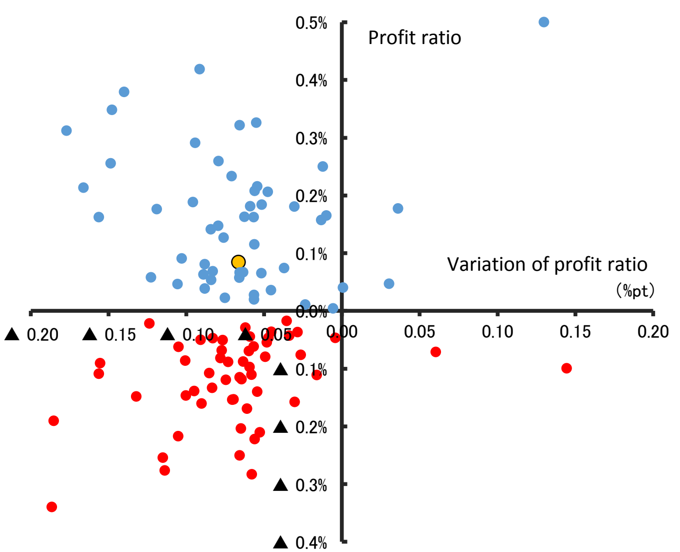
(Note1) Ratio of shareholding to equity capital: outstanding of shareholding (market value) / Tier 1 (as of fiscal-year ends)
(Note2) The major banks in the US and Europe are 23 banks of G-SIBs excluding four China's banks and three Japan's Mega-bank groups.
(Source) Disclosure documents of respective institutions.

I-4. Regional banks (1/2)

- Regional banks' balance sheets are sufficiently sound. However, due to shrinkage of loan margins, the number of regional banks with losses in their core businesses (i.e. lending and fee businesses) is increasing.
- Some regional banks are trying to secure short-term profit by increasing investments in high-risk securities and real estate loans (including loans to the housing rental business).
- While more regional banks may have concerns about the sustainability of their current business model, there are increasing number of banks that have initiated their reforms.

Profit of customer services (From March 2015 to March 2017)

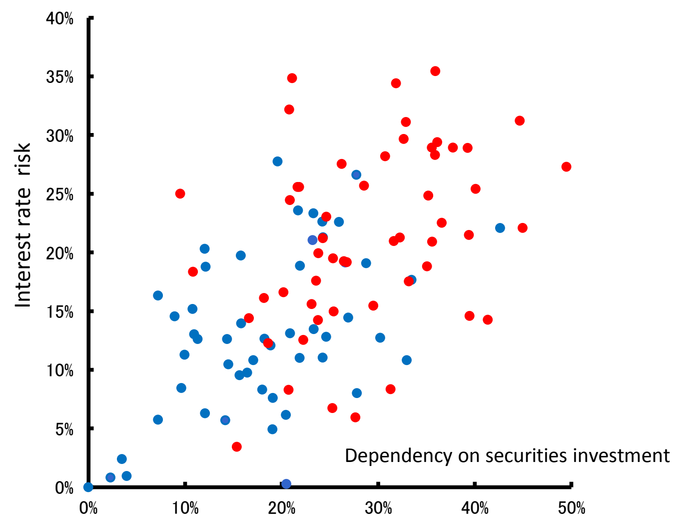
Most of the regional banks recorded declines in profits of their core business as of March 2017, and the half of regional banks recorded losses.



(Note 1) The yellow dot (●) is the average of 106 regional banks.
(Note 2) Profit ratio: (loan outstanding x difference in interests rates for depositors and borrowers + net income from fees and commissions – operating costs) / deposits (average balance outstanding)
(Source) JFSA

Interest rate risk and dependency on securities investments（As of March 2017)

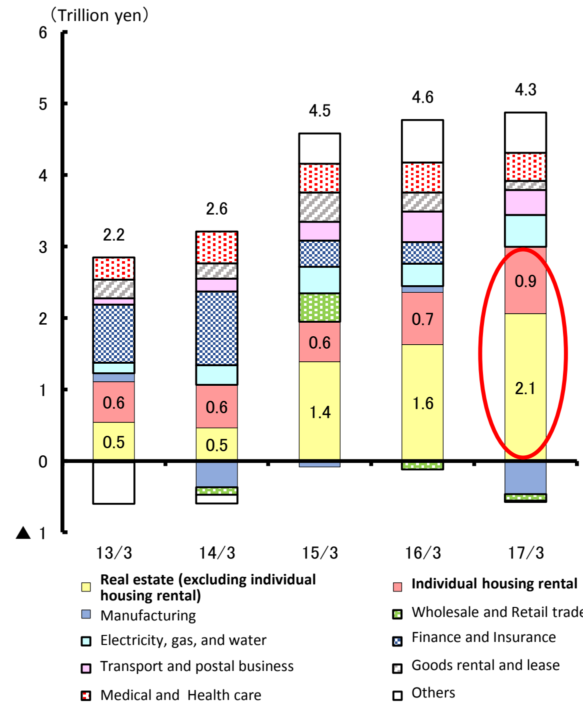
Many of the regional banks that recorded negative profits from the core business are becoming more dependent on securities investments. Consequently, the interest rate risk increases.



Red marker: Banks that recorded negative profit ratio of customer services (as of March 2017)
Blue marker: Banks that recorded positive profit ratio of customer services (as of March 2017)
(Note1) Dependency on securities investments = interests and dividends on securities / (gross business profits – five bond accounts*)
*Five bond accounts comprises gain on sale of bonds; profit on maturity; loss on sale of bonds; loss on maturity; write off of bonds.
(Note2) Interest rate risk: (Yen bonds and foreign bonds 100BPV) / Capital
(Source) JFSA

Composition of annual growth of corporate loans

The increase in outstanding of corporate loans is mostly derived from real estate loans (including loans to the housing rental business).



(Source) JFSA

I-4. Regional banks (2/2)

- According to a survey by the JFSA (to which 8,901 client companies answered),
  - Banks generally lack efforts to meet the needs of client companies with low credit ratings.
    - ✓ The lower a client company's debtor classification is, the less frequently a bank visits the company.
    - ✓ 40% answered that banks will not provide loans without securing collateral or guarantee.
    - ✓ 30% of the companies which faced a funding problem in the past year answered that they received no particular support from banks.
  - Banks with a moderate decline of loan yields have a higher reputation from client companies with respect to both understanding clients' businesses and providing effective consulting services.
  - The most frequently cited reason for choosing government-affiliated financial institutions over private ones is the favorable borrowing terms.

Assessment by debtor on main-banks' efforts

Items	Overall	Normal debtor (upper class)	Normal debtor (lower class)	Debtor under caution and the below
Visits by main-bank are rare or none at all	18%	9%	16%	**29%**
Main-bank does not provide loan without collaterals and personal guarantees	**40%**	**23%**	39%	**54%**
Client companies that experienced a cash-flow problem over the past year but did not received particular support from main-bank	**31%**	18%	26%	**37%**

(Source) JFSA

Reason for choosing transaction with government-affiliated financial institutions

Reasons	Response rate
1. More favorable borrowing terms at government-affiliated financial institutions	**59%**
2. Needs to diversify funding sources	42%
3. Higher expertise of staff at government-affiliated financial institutions	9%

Reasons	Response rate
4. Recommendation from private financial institutions	8%
5. Private financial institutions not supportive	**7%**
6. Marketing activities of government-affiliated financial institutions more active	7%

(Source) JFSA

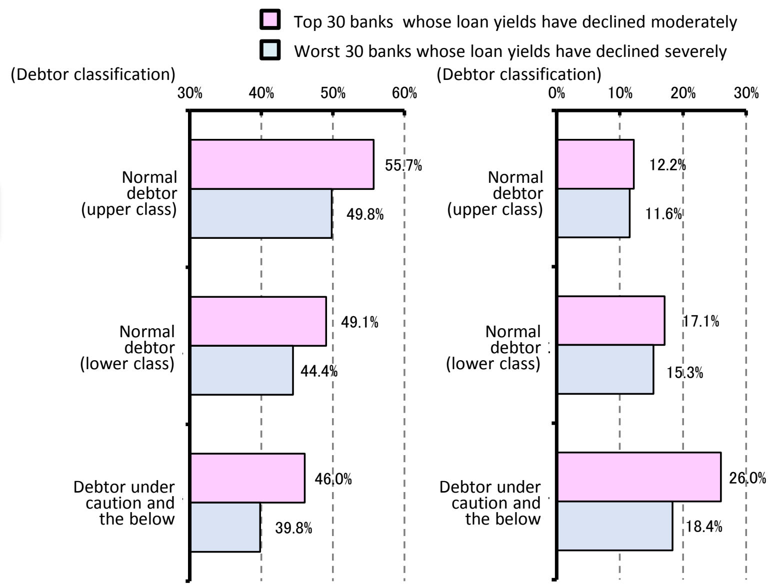
Distinctive features of top 30 banks whose loan yields have declined moderately (from March 2013 to March 2017)

<Understanding of issues on clients' businesses>

Q: Does your bank listen to your business concerns?

<Effectiveness of consulting services>

Q: Do you think consulting services provided by your bank effective?



(Source) JFSA

I-5. Real estate loans to the housing rental business and banks' consumer loans

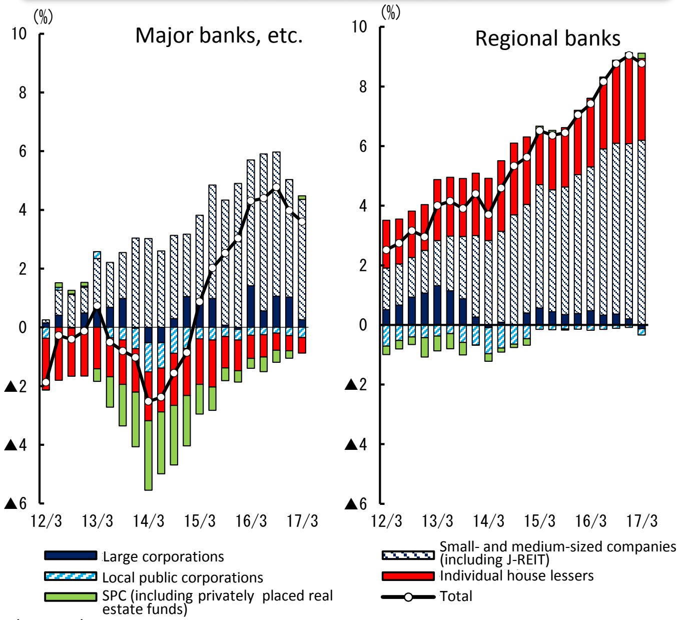
(Real estate loans to the housing rental business)

- The loans are increasing, especially at regional banks, mostly used as a landlords' tax-saving measure of inheritance tax. As the buildings become older, however, a rising number of borrowers face difficulty in covering repayment costs with revenue from the rent. Financial institutions should appropriately evaluate risks (e.g. the risks of interest rate rise, more vacant rooms and a rent decline) and make a plain explanation to loan applicants.

(Consumer loans by banks)

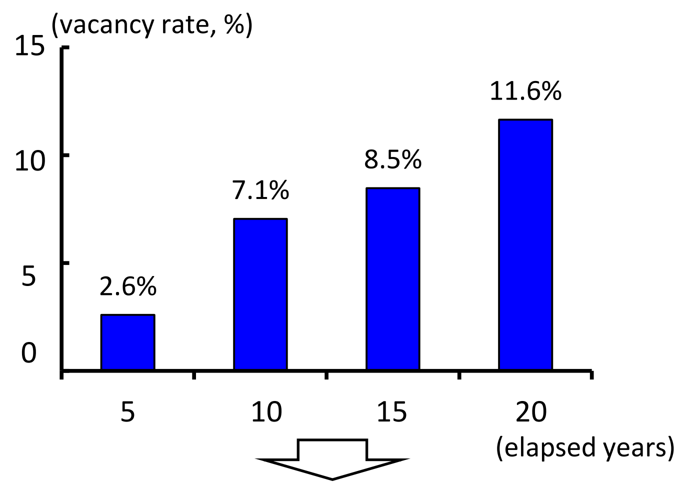
- Banks have been criticized for excessive provision of consumer loans under a low interest environment. They are responding to such criticism in accordance with the voluntary guideline issued by the Japan Bankers Association.
- The JFSA:
  - will act promptly to ensure that banks resolve problems related to their consumer loan business, considering the purpose of the Money Lending Act (i.e. aiming at preventing multiple debts);
  - will examine in detail how banks are conducting the consumer loan business; and
  - have commenced a telephone help desk to reach out and directly collect information from customers.

Composition of annual growth of real estate loans



(Source) BOJ

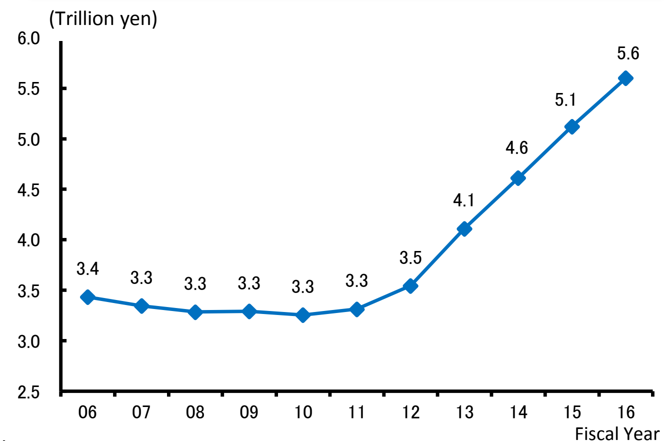
Elapsed years of real estate loans to the housing rental business and vacancy rates



Deficits of housing rental business rise as the buildings become older.

(Source) JFSA, sample survey of real estate loans to the housing rental business provided by regional banks.

Banks' consumer loans and credit outstanding



(Note) The "consumer loans and credit outstanding" are the total of overdraft loans, emergency loans and cash advances.

(Source) BOJ

II-1. Realizing the long-term and diversified investment

- The growth of Japan's household financial assets is far lower than that of the US over the past 20 years. (Japan : 1.54x, the US : 3.32x)
  - ✓ Big difference between Japan and US in the composition of household asset (In the US, corporate equities and mutual funds consist of 46.2% of total asset, while in Japan, cash and deposits are predominant with a share of 51.7%).
  - ✓ The share of corporate equities and mutual funds in the US households used to be at the same level as the current share in Japan. In the US, the 401 (k) plan and the IRA have promoted diversification of household asset.

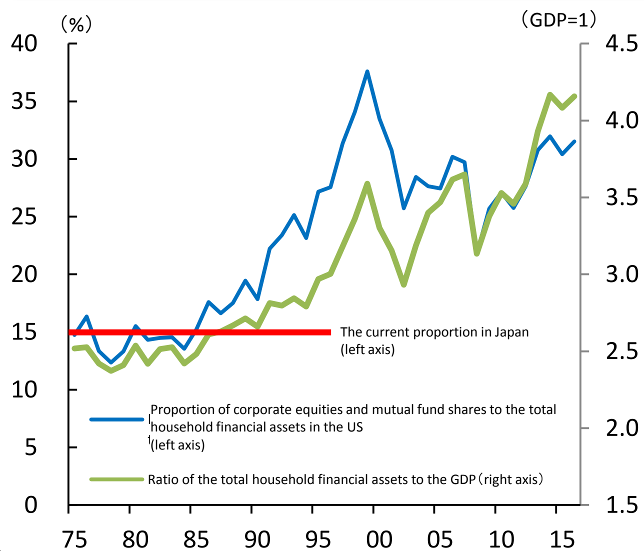
    (Note) The 401(k) plan is a defined-contribution pension plan involving employer contributions, and the IRA is a defined-contribution pension plan using individual retirement accounts.
- Japan needs to encourage long-term and diversified investment to steadily build household asset.

Household financial assets in Japan and the US

		Japan	US
Balance	Year 2016 (A)	15.5 trillion USD	75.85 trillion USD
	Year 1995 (B)	11.5 trillion USD	22.8 trillion USD
	Growth rate (A/B)	1.54x	3.32x
Growth rate of balance in relation to investment return compared with that in 1995		1.20x	2.45x
Ratio of cash and deposits		51.7%	13.7%
Ratio of securities and investment trust funds (indirect holdings through pension plan and insurance)		18.6% (3.7%)	46.2% (16.1%)
Ratio of earned wage to property income under household income		8:1	3:1

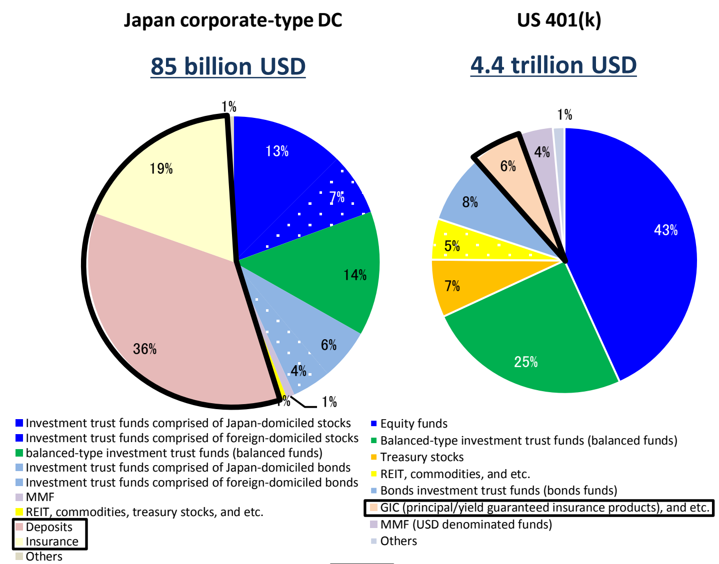
(Note 1) Unless stated, figures reflect the data as of the end of 2016.
(Note 2) Exchange rates are as follows; (1 USD = JPY 102.9 as of the end of 1995, 1 USD = JPY 116.9 as of the end of 2016)
(Note 3) Growth rate of the US gross balance is calculated based on USD-denominated figures.
(Note 4) Earned wage income does not include actual wage/salary (compensation) received by solo proprietors. Property income does not include capital gains and/or latent (unrealized) gains from financial assets and real estates.
(Source) BOJ, FRB, Bureau of Economic Analysis, Cabinet Office (Japan)

Proportion of corporate equities and mutual fund shares to total household financial assets in the US



(Note) Proportion of corporate equities and mutual fund shares represents direct holding of those assets but excludes indirect holding via pension funds and insurance policies.
(Source) FRB, Bureau of Economic Analysis

Asset allocations of Japan corporate-type DC and US 401(k)

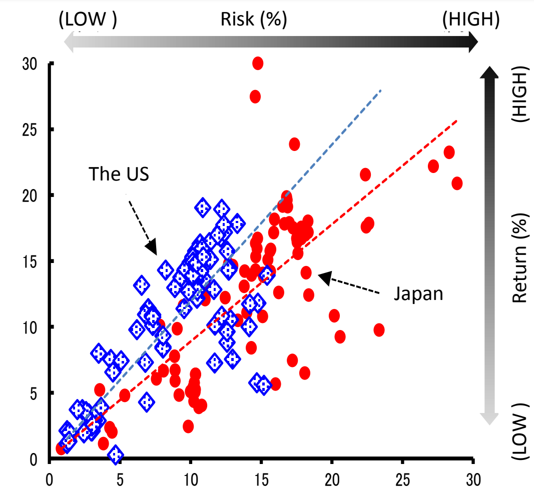


(Note 1) Items in thick-bordered box are principal-guaranteed.
(Note 2) Japan's asset allocation and assets under management (net asset value: NAV) reflect the data as of March-end 2016.
(Note 3) The US asset allocation reflects the data as of the end of 2014. Asset under management reflects the balance as of the end of 2015. NAV was converted to JPY at the exchange rate of 120.06 JPY/1 USD as of the end of 2015.
(Source) ICI/EBRI, Liaison council meeting of DC plan administrator

II-2. Customer-oriented asset management and intermediation

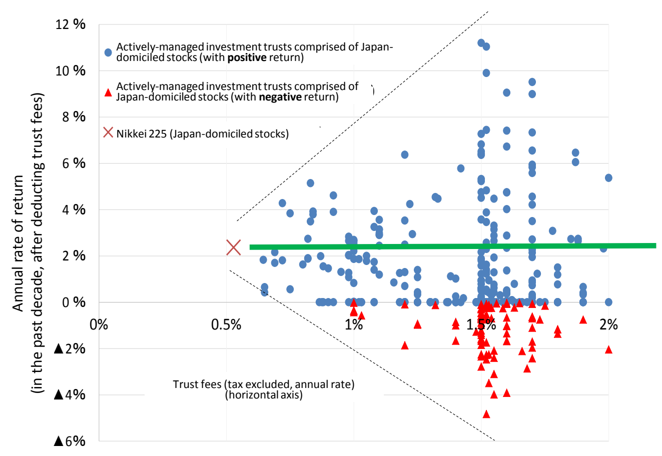
- Retail sales of investment trusts in Japan are prone to have the following features:
  (a) The return is low relative to the risk, compared to the US.
  (b) Few actively-managed investment trusts are delivering good return.
  (c) Many investment trusts are theme-based products, which are difficult for investors to make a reasonable judgement to buy/sell.
  (d) High turnover (fast cycle of purchases and sales of investment trusts). (e) Expensive sales commissions and trust fees.
  (f) Close relationship between brokers and asset management companies.
- Some financial institutions are shifting to a more customer-oriented business model. Furthermore, there are more investment trusts fulfilling the requirements for Installment Investing NISA (new NISA specialized in dollar-cost averaging), with low fees and suitable for long-term investment.

Risk and return of top 100 investment trusts of Japan and the US



(Note 1) Data of Japan and the US indicate respective top 100 stocks (issues) (that exceed five years from their establishment) in terms of NAV as of May-end of 2017.
(Note 2) Japanese investment trusts indicate publicly offered investment trusts except ETF, DCIO (defined contribution investment only), and wrap/SMA (separately managed account) . US investment trusts indicate publicly offered investment trusts excluding ETF, DCIO (defined contribution investment only), and MMF.
(Note 3) Risk is standard deviation (annualized rate basis) of monthly return for the past five years. Return is the total return for the past five years (annualized rate basis).
(Note 4) Dotted line in the chart is a trend line.
(Source) Bloomberg

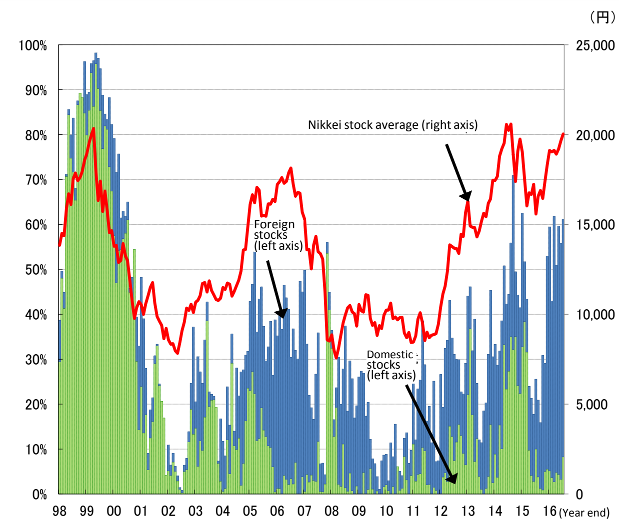
Trust fees and return of actively-managed investment trusts



The return of **71%** of actively managed investment trust funds comprised of Japan-domiciled stocks is **lower** than that of Nikkei 225 ETF.

(Note 1) Data are 281 actively managed funds in which fund managers mainly manage domestic stocks that have sustained over a decade excluding DCIOs.
(Note 2) As to "fund of funds," trust fees include trust fees of underlying funds.
(Source) QUICK, Bloomberg

Share of equity investment trusts to total sales of investment trusts and Nikkei stock average



(Note) Data are samples from top 50 funds that recorded net increase (sampling period from December 1998 through June 2017).
(Source) Japan Investment Trust Association

II-3. Enhancing corporate value through engagements of asset owners and asset managers

- The revised Stewardship Code has contributed to change the behaviors of major domestic institutional investors. For example, some investors have started to disclose voting records for each investee company.
- To enable bold decision making in line with their capital cost, rather than to pile up retained earnings, the JFSA will encourage companies, through constructive engagement with institutional investors,
  - to develop business strategies for improving capital efficiency; and
  - to improve the quality of CEOs and boards of directors.

II-4. Market surveillance

- The number of unfair transactions (e.g. insider trading and market manipulation) and inappropriate disclosure by listed companies have increased.
- In response to changes in market structure due to globalization of financial transactions and development of IT technologies, the Securities and Exchange Surveillance Commission will:
  - engage in market surveillance with a forward-looking approach based on the analysis of the market environment from the macro viewpoint, and point out the root causes of problems, and;
  - enhance the market surveillance system, and review and upgrade the investigation methods.

II-5. Improving the quality of disclosure, accounting standards and audit

- For transforming the flow of funds and vitalizing the financial market, it is critical that information necessary for making investment decisions should be sufficiently disclosed in a timely, fair and accessible manner. The JFSA has introduced fair disclosure rules and initiated discussions to consider how listed companies should enhance information disclosure.
- The JFSA has also taken steps to improve the quality of accounting standards so that financial statements appropriately reflect corporate activities, and to secure appropriate audits through developing the Audit Firm Governance Code.

III-1. FinTech, cyber security, and high-speed trading

FinTech

- In line with FinTech innovation, financial businesses could shift from a "B to C" model to a "C to B" model. Given this possible change, it is necessary to make it more customer-friendly by promoting financial services innovation while ensuring customer protection.

- In light of FinTech innovation, the JFSA has taken the following measures:
  - ✓ Amended the Banking Act for promoting open innovation between financial institutions and FinTech companies while ensuring customer protection;
  - ✓ Developed a framework to support FinTech companies to promote practical application of innovative IT technologies;
  - ✓ Promoted the improvement of settlement, including more efficient processes in companies; and
  - ✓ Strengthened the international network by establishing a framework for cooperation with foreign authorities on FinTech.

Cyber security

- The JFSA has done a cross-sectoral survey and carried out the first financial industry-wide exercise (Delta Wall).
  - ✓ These results have been fed back to the financial industry to enhance their capability to deal with cyber incidents.

High-speed trading

- The JFSA has introduced a new regulation to require institutions engaging in high-speed trading to register, maintain proper risk control and report to the JFSA.
  - ✓ By smooth implementation of the new regulation, the JFSA could grasp high-speed trading in practice, to ensure integrity, transparency and stability of the market.

III-2. Global regulatory reforms, building global network

Global regulatory reforms

■ The JFSA's proposals include

- Attaining both growth and stability
- Assessing the impact of reforms

➡ international initiative has started

- Shifting the focus from static regulation to dynamic supervision
- Developing supervisory approaches to promote effective financial intermediation

Active contribution to improve global standards of audit through the IFIAR

■ In April 2017, the IFIAR* opened its secretariat office in Tokyo and held a plenary meeting.

* International Forum of Independent Audit Regulators

■ In December 2016, the Japan Network for IFIAR** was established to support the secretariat and contribute to audit quality improvement worldwide by raising awareness on audit quality in Japan.

** Comprised of stakeholders of audits in Japan.

■ This is a model case for active involvement in global financial regulatory agendas.

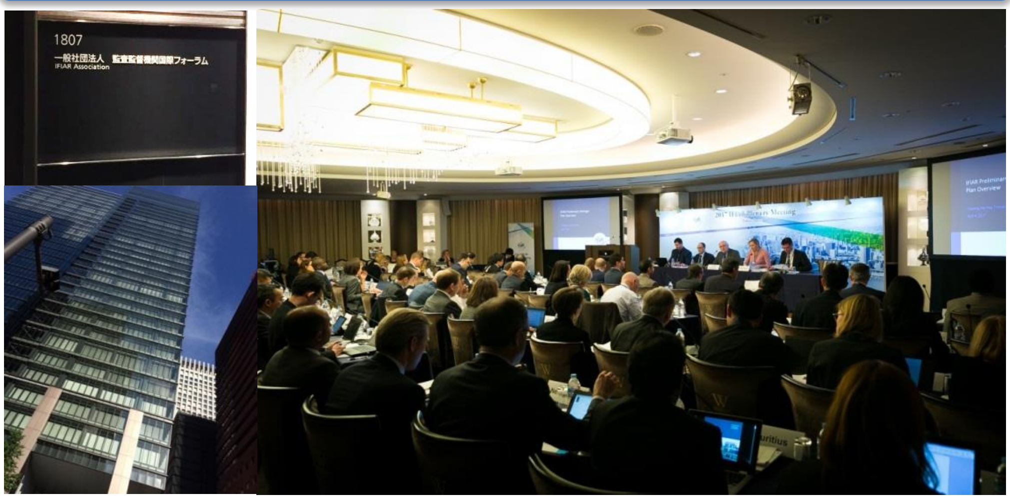
Global network and cross-border cooperation

■ The JFSA had agreements with foreign authorities to strengthen cooperation in the FinTech field and supervision.

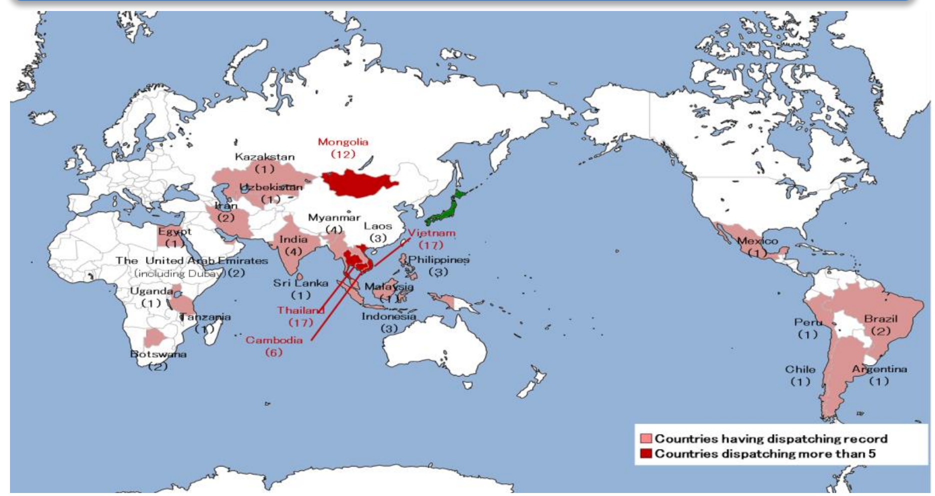
■ The Global Financial Partnership Center (GLOPAC) :

- invites officials from the authorities in emerging countries and provides training programs (88 participants from 25 countries and regions),
- maintains and strengthens the network of officials participated in the past.

IFIAR : Permanent Secretariat and Plenary Meeting (April 2017 in Tokyo)



GLOPAC : Participants from emerging countries



IV-1. Supervisory reform

- The Advisory Group on Supervisory Approaches published a report titled "Transforming the JFSA's supervisory approaches." The report recommended that supervision should be reformed so as to shift emphasis from "Form" to "Substance" and outlined challenges to be tackled in order to carry out the reform.
- The JFSA will explore a new approach to supervision taking into account the report and examine specific measures through dialogues with a broad range of stakeholders.

IV-2. Reform of the JFSA

- The measures will be implemented in order to transform the JFSA into an organization capable of self-evolution to respond to rapidly changing environments.

(1) Decision-making process open to external opinions

✓ Utilize a "monitoring post for financial administration" system with which independent private sector experts seek opinions from financial institutions and other stakeholders and deliver them to the JFSA.

✓ Establishment of various advisory groups.

(2) Revision of human resources management policies

✓ Identify the capabilities required for respective levels and skills required for individual posts.

(3) Organizational reform from the following viewpoints

(i) strengthening the strategic planning function; (ii) improving the expertise of staff;

(iii) enhancing the capability to plan policies (including market regulation) and to respond to FinTech; and

(iv) integrating on-site/off-site monitoring of each financial sector.