

**JFSA's Supervision
in the time of
Globalization and Market Integration
— Past, Present and Future —**

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I Past: The collapse of real estate bubble and JFSA's supervision

1. Collapse of the real estate bubble in 1990's

In 1990s, there was the collapse of real estate bubble and Japan was plagued with the non-performing loan problem.

- First phase
 - The balance sheets of borrower companies deteriorated, resulting from the real estate price collapse.
- Second phase
 - Deterioration in borrower profitability was mainly caused by stagnation in the real economy.
 - Borrower companies that were saddled with excessive debts fell into a state of debt overhang and became unable to invest actively.

I Past: The collapse of real estate bubble and JFSA's supervision

2. JFSA's priority during the crisis

- **JFSA was inaugurated in 2000**
 - JFSA conducted transparent and rule-based supervision focusing on ex-post checks.
- **Priority : cleaning up the mess of the past**
 - Identify non-performing loans accumulated over the years.
 - Inspectors to think only accurate photographs of the financial institutions' status.

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3. What we learned from the crisis

- Rebuilding solid balance sheet is important but not sufficient.
- A credible public safety net helps end the first phase promptly.
- We need stability and growth. Growth cannot be attained without financial stability, but focusing on stability only can lead to lasting damage.

I Past: The collapse of real estate bubble and JFSA's supervision

4. After stabilization of the crisis-----consumer protection and market integrity.

- After stabilization of the crisis, JFSA extended supervisory power to protect consumer and market integrity.
 - ⇒ Focus on restoring confidence in financial supervision, attaining financial stability and enhancing compliance with rules on consumer protection and market integrity.
 - ⇒ Frequent enforcement actions.
(someone called “Financial Sanctions Agency”)

II Present: Challenges JFSA's supervision faces after the crisis

Challenge 1 Supervisor's habit to indulge in form

- In attaining financial stability and enhancing compliance with rules on consumer protection, Supervisors had a habit to indulge in form while forgetting substances

- *Banks* might think lending based on collaterals rather than borrower's business prospects is easier.
- *Supervisors* have been meticulous about the past but timid in discussing the future.
- *Supervisors* might take a microscope view of the past misconduct and analyzed elements without having a holistic view.
- *Supervisors* may have the best priority on following legal compliance and realizing minimum soundness by checking whether banks satisfy the minimum standards.

II Present: Challenges JFSA's supervision faces after the crisis

Challenge 2 issues supervisors and banks face today are different from those in the past

- The issues supervisors and bankers face.....
 - ✓ Before...
banks can be profitable just taking deposit short and lending long.
 - ✓ Today...
 - demographic change,
 - low for long
 - new competition related to FinTechmake some of the past models unsustainable.
- It becomes more important for financial institutions to contribute to productivity improvement by exercising financial intermediation.
 - ✓ Before... banks failed mostly by the underwriting practices.
 - ✓ Today.... banks face new risks.

III Future: Transforming JFSA's Supervisory Approaches

- Dynamic supervision -

1. Regulator's goal and three balances for avoiding market and authority failure

1-1. Regulator's ultimate goal

- enhancing national welfare by contributing to the sustainable growth of the national economy and wealth.
- JFSA has to ensure that Agency's supervisory approaches are consistent with its ultimate goal, not just with intermediate goals.

1-2 . Competitive market and Market failure , authority failure

- Ideally speaking, this goal should be achieved by competitive market under free choice of users.
- However, there exist
 - ✓ **Market failure** (asymmetric information, prevalence of problems through the financial system network)
 - ✓ **Authority failure** (too much reliance on conventional examination of information provision by financial institutions to customers, Priority on regulatory compliance by financial institutions)

III Future: Transforming JFSA's Supervisory Approaches

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1-3. To avoid market failure and agent failure, supervision has to achieve three types of balances.

- Balance between financial stability and effective financial intermediation.
 - ✓ Financial system can propagate shocks through network among financial institutions.
 - ✓ We need effective financial intermediation to attain sustainable economy growth.
- Balance between consumer protection and consumer benefit.
 - ✓ There is asymmetry in the information held by bankers and consumers
 - ✓ Financial institutions should serve the best interest of their customers
- Balance between market integrity and market vigor.

III Future: Transforming JFSA's Supervisory Approaches - Dynamic supervision -

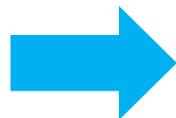
2. JFSA's new approach---Dynamic Supervision

Main points of the Dynamic Supervision

- From form to substance
 - ✓ **Form:** formal check under regulation (excessive reliance on collateral guarantee and legal compliance)
 - ✓ **Substance:** services corresponds to needs of customers or business of borrowers
- From past to the future
 - ✓ **Past:** check on the past temporary soundness (excessive reliance on balance sheet)
 - ✓ **Future:** sustainability of business model in the future
- From elements to a holistic view
 - ✓ **Elements:** response to a specific matter (focus on a specific asset assessment of financial institutions)
 - ✓ **Holistic view:** discussion on the truly important risks among the whole management in financial institutions

III Future: Transforming JFSA's Supervisory Approaches

- Dynamic supervision -



- In addition to securing financial institution's compliance with minimum requirements, JFSA should have dialogue with them on best practices. JFSA should shift from a framework dominated by static regulation to that complement by dynamic supervision.
- JFSA should update
 - ✓ our supervisory process and techniques
 - ✓ our organizational structure, human resource policies and information structure
 - ✓ inspection manuals and supervisory guidelines.

Thank you very much for listening.

Taking this opportunity,
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