Financial System Policy

I. Financial System Stability and the Role of the Bank of Japan

One of the objectives of the Bank of Japan, as stipulated in Article 1, Paragraph 2 of the Bank of Japan Law, is to "ensure smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of an orderly financial system." To this end, the Bank provides safe and convenient settlement assets in the form of deposits in financial institutions' current accounts held at the Bank, and takes measures to enhance the safety and efficiency of the payment and settlement systems (see "The Bank's Other Operations" Section I on pages 84–85 for details). The Bank also takes the following measures to prevent systemic risk from materializing, that is, to ensure that a financial institution's inability to complete settlement of a transaction does not result in a chain of settlement failures at other institutions and thus disrupt the overall functioning of the financial system.

To begin with, the Bank selects the financial institutions with which it concludes current account services contracts based on publicized criteria.[1] It also strives to gain an accurate grasp of the financial conditions at these institutions and to encourage the maintenance of sound financial conditions through on-site examinations pursuant to Article 44 of the Bank of Japan Law and daily off-site monitoring (gathering and analyzing data on these institutions' financial conditions and business operations, without conducting actual examinations at their premises). Furthermore, the Bank, as the lender of last resort, will provide funds as necessary in the event that a financial institution faces a shortage of liquidity.

In response to the progress of financial globalization, the Bank, in close cooperation with foreign central banks and supervisory authorities, takes part in initiatives to maintain the stability of the global financial system, and to this end pursues the establishment of an international framework as well as an international exchange of information and opinions.

The following sections explain first the condition of and challenges facing the financial system during fiscal 2004 and, second, the specific measures taken by the Bank to maintain financial system stability.

II. The Condition of and Challenges Facing the Financial System

In fiscal 2004, the soundness and stability of the Japanese financial system as a whole recovered further, as a result of considerable progress in solving the nonperforming-loan (NPL) problem: financial institutions accelerated the removal of NPLs from their balance sheets, and their efforts to rehabilitate distressed borrower firms, including large ones, started to take effect. Under these circumstances, the full removal of

1. The criteria are publicized only in Japanese.

blanket deposit insurance was implemented as scheduled in April 2005 without major disruptions such as a substantial shift of funds between deposits at different financial institutions.

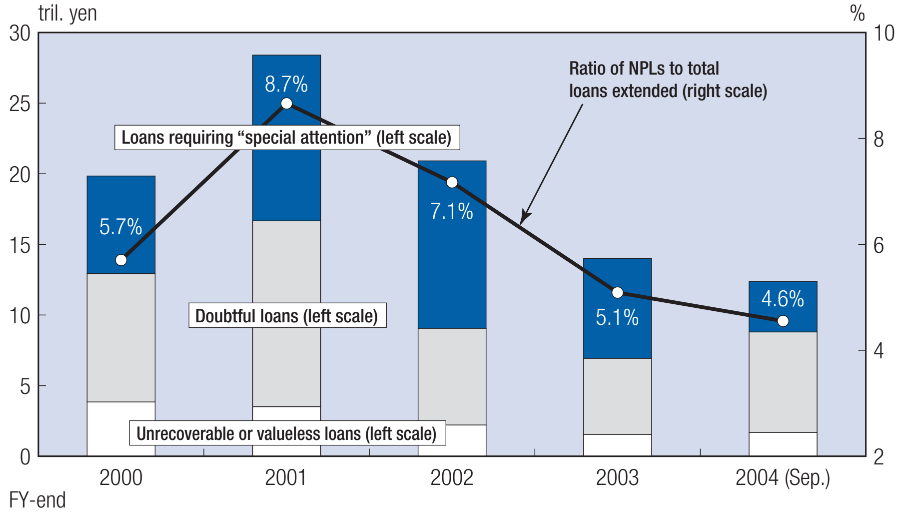
After the Bank released a report titled "Japan's Nonperforming Loan Problem" and the government proposed a set of comprehensive measures for solving the NPL problem in its "Program for Financial Revival" in October 2002, financial institutions and relevant entities cooperated to further improve their evaluation of the economic value of NPLs and to promote their early disposal, at the same time taking appropriate initiatives to support both corporate and industrial rehabilitation. As a result, the ratio of NPLs to the total amount outstanding of loans at major banks declined to 4.6 percent at the end of September 2004, and it seemed very likely that in fiscal 2004 major banks would achieve the target set by the government in the "Program for Financial Revival" of halving the NPL ratio from its level at the end of March 2002 (Chart 1 [1]). The NPL ratio at regional banks also started to show a clear declining trend (Chart 1 [2]). Meanwhile, there was significant progress in the rehabilitation of large borrowers, and the rehabilitation efforts of distressed firms in various regions began to bear fruit. Against this background, and also because of the economic recovery, banks' credit costs arising from write-offs and provisions for NPLs declined (Chart 2). At the same time, major banks' overall stockholdings fell significantly below the level of Tier I capital, as they made use of the Bank's stock purchasing program to prune their excessively large stockholdings (Chart 3).

With the decline in both credit risk and market risk from stock price fluctuations, and the easing of constraints on capital, thanks in part to the issuance of preferred stocks and subordinated debt, financial institutions gradually started to adopt more assertive business strategies. Specifically, they increased lending to corporate customers, especially small and medium-sized firms, repaid previous injections of public funds, conducted mergers with other financial institutions, and increased business alliances with other financial service providers such as nonbanks.

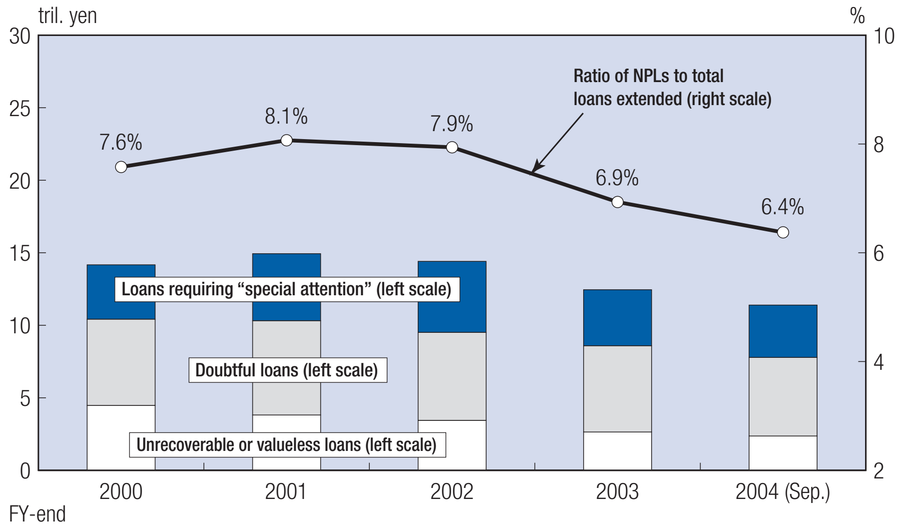
Following the full removal of blanket deposit insurance in April 2005, the generation of flexible and robust financial intermediation mechanisms to achieve smooth and efficient allocation of funds while maintaining overall system stability has become a key issue for the Japanese financial system. From this viewpoint, each financial institution should improve its management of risks and business activities, and needs to develop innovative services tailored appropriately to various customer needs. It is also important for financial institutions to diversify channels for supplying credit, so as to make use of various investors' funds, through the development of new markets for credit, such as those for liquidating loans or securitizing assets.

Chart 1
Nonperforming Loans (NPLs) Outstanding

(1) Major Banks[1]



(2) Regional Banks[2]

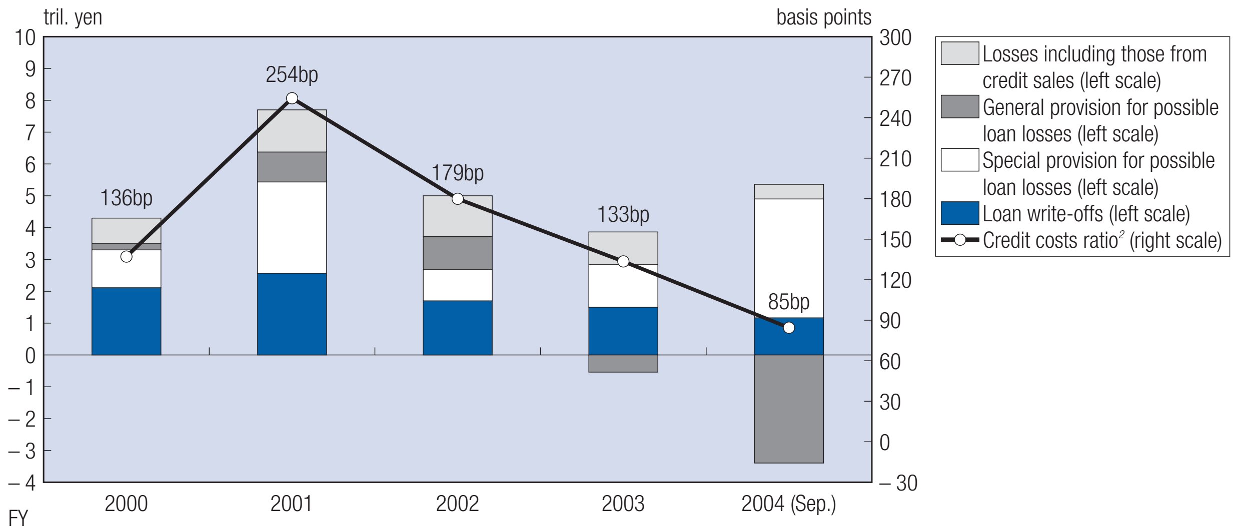


Notes: *1*. The total of 14 banks.
2. Member banks of the Regional Banks Association of Japan and the Second Association of Regional Banks.

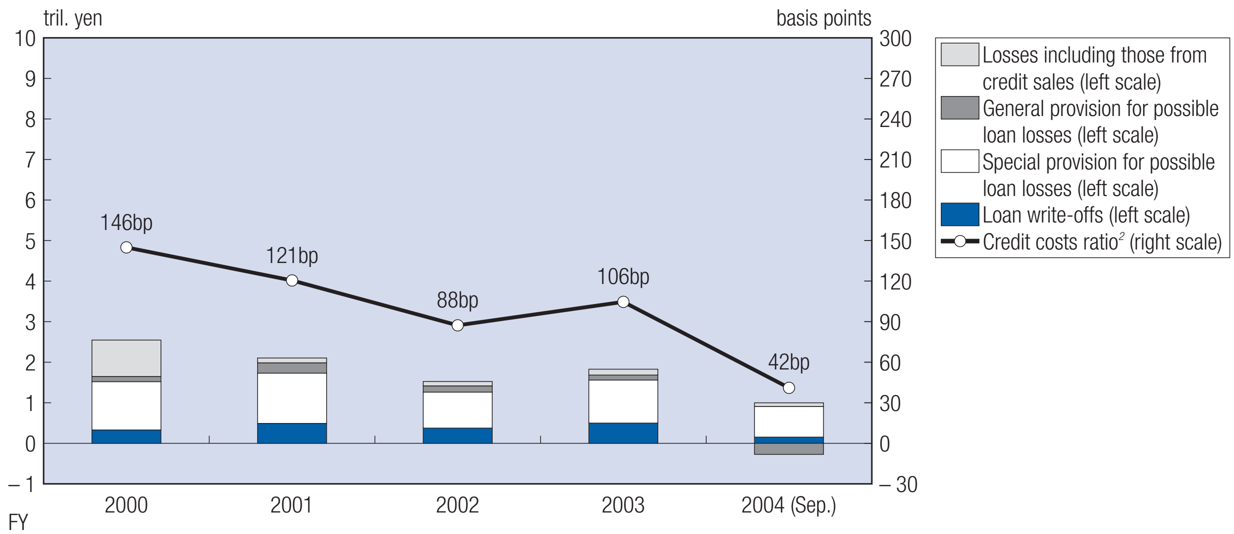
Chart 2

Breakdown of Major Banks' and Regional Banks' Credit Costs

(1) Major Banks[1]



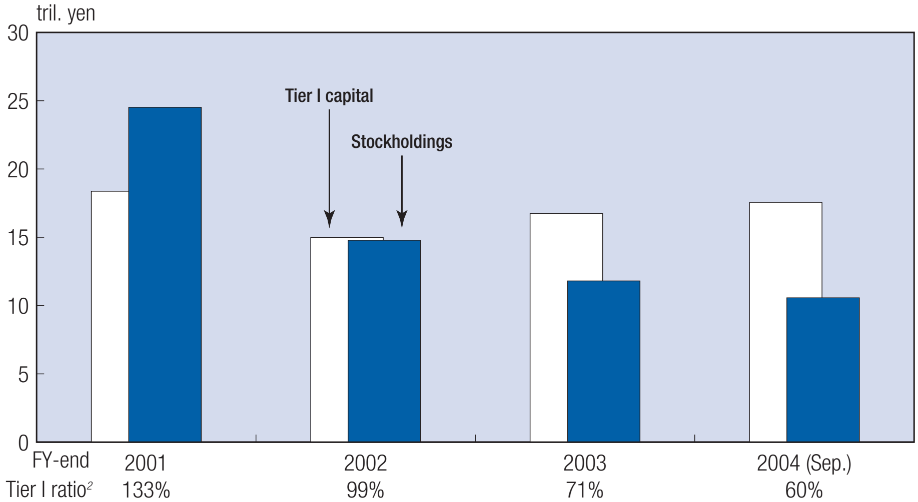
(2) Regional Banks[3]



Notes: *1.* The total of 14 banks.
2. Ratio of losses stemming from NPL disposals to average amount outstanding of loans in each period.
3. Member banks of the Regional Banks Association of Japan and the Second Association of Regional Banks.

Chart 3

Major Banks' Stockholdings and Their Ratio to Tier I Capital [1]



Notes: *1.* The total of 14 banks. Figures are on a consolidated basis.
Stocks for which market prices are available, excluding those held for the purpose of trading and stocks of subsidiaries and affiliates.
2. The ratio of banks' stockholdings to Tier I capital.

III. The Bank's Measures concerning the Financial System

A. Overview

By the end of fiscal 2004, the Bank had completed some crisis management measures, in response to favorable changes in conditions in the financial system as described earlier. The amount outstanding of loans extended under Article 38 of the Bank of Japan Law dropped to zero at the end of fiscal 2004, since all subordinated loans made to Minato Bank[2] were repaid before maturity and bankruptcy procedures for Yamaichi Securities were completed. Since November 2002, the Bank had been purchasing stocks held by commercial banks through its stock purchasing program in order to further promote their efforts to reduce their exposure to the risk of stock price fluctuations. Having broadly achieved the expected results, the Bank wound up the program on September 30, 2004.

In fiscal 2004, the Bank concluded or discontinued current account services contracts and lending facilities contracts with some financial institutions in response to consolidation in the financial industry. It also conducted on-site examinations and off-site monitoring of financial institutions that held current accounts at the Bank based on the "On-Site Examination Policy for Fiscal 2004."[3] Through its examinations and monitoring, the Bank assessed the financial institutions' measures with regard to NPL disposals, corporate rehabilitation, the establishment of risk management systems, and strengthening of their profitability.

Furthermore, as part of its efforts to maintain the stability of the global financial system, the Bank continued its participation in an initiative to substantially revise the international standard governing the capital requirement for financial institutions.[4]

Meanwhile, the Policy Board decided and released the text of "The Bank of Japan's Measures regarding the Financial System after the Full Removal of Blanket Guarantee of Deposits" on March 18, 2005.

B. The Four Principles Underlying the Bank's Extension of Special Loans to Maintain Financial System Stability

The Bank, as and when necessary, conducts business requisite to maintaining financial system stability, including extension of loans, pursuant to Article 38 of the Bank of Japan Law (hereafter the term "special loans" covers all such business).

The Bank extends special loans as the lender of last resort. This is to prevent the materialization of systemic risk by providing, in the absence of any other lender, liquidity as the lender of last resort to financial institutions suffering a shortage of liquidity so that they can repay deposits and/or honor outstanding contracts.

The Bank decides on the extension of special loans based on the following four principles, taking into account the nature and purpose of the lender of last resort function:

2. Midori Bank and Hanshin Bank merged on April 1, 1999, to become Minato Bank. Subordinated loans extended by the Bank of Japan to Midori Bank on January 29, 1996, were transferred to Minato Bank, and they were partly repaid on March 31, 2000, and December 30, 2003.
3. The policy was approved by the Policy Board on March 26, 2004.
4. The Basel Committee on Banking Supervision released its final draft of the new capital adequacy framework (Basel II) in June 2004.

Principle 1

There must be a strong likelihood that systemic risk will materialize.

Principle 2

There must be no alternative to the provision of central bank money.

Principle 3

All relevant parties are required to take clear responsibility to avoid moral hazard.

Principle 4

The financial soundness of the Bank of Japan itself must not be impaired.

These are generally applicable principles, and they will continue to be the key factors for the Bank in deciding, for each individual case, whether extension of a special loan is appropriate or not.

Extension of special loans is, in a broad sense, one of the "safety-net" measures aimed at averting a financial crisis. The decision to extend a special loan should therefore be made taking into account other safety net arrangements, such as the deposit insurance system. In this regard, it should be noted that the Deposit Insurance Law stipulates that the Deposit Insurance Corporation (DIC) provides the funds necessary for failed financial institutions (as defined in the law) to repay their deposits and continue in business. Thus, there should be no need for the Bank to extend special loans to failed financial institutions, except for circumstances in which measures are taken to protect all the liabilities of a failed financial institution so as to prevent a financial crisis, under Article 102 of the Deposit Insurance Law.

C. Provision of Loans to Failed Financial Institutions under Article 38 of the Bank of Japan Law

1. Overview

Of the loans extended by the Bank before April 2004 under Article 38 of the Bank of Japan Law, all subordinated loans made to Minato Bank were repaid on December 30, 2004, before maturity, at the instigation of Minato Bank itself.

The Bank ended the extension of special loans to Yamaichi Securities on January 26, 2005, with the completion of bankruptcy procedures for Yamaichi Securities. This occurred after the Bank had collected part of the funds following the transfer of a claim on Yamaichi Securities to the Japan Investor Protection Fund (JIPF), and after dividends from the bankruptcy procedures were paid to the Bank. The amount of special loans still outstanding on completion (111.1 billion yen) became uncollectible loans. The Bank transferred net income of 5.5 billion yen to the legal reserve in fiscal 2004 upon the approval of the Minister of Finance, in order to prevent impairment of its financial soundness due to losses arising from special loans to Yamaichi Securities. This represented the amount that should have been transferred from net income to the legal reserve if these loans had been collected (see "The Bank's Accounts," Section I.D on pages 127–128 for details).

On November 29, 2003, the Bank decided to provide liquidity, if necessary, to Ashikaga Bank, pursuant to Article 38 of the Bank of Japan Law. This followed the

Prime Minister's determination that it was necessary to place the bank temporarily under special public management under Article 102, Paragraph 1 of the Deposit Insurance Law. The Bank's measures were aimed at providing the bank with the minimum funds necessary to repay its deposits and continue in business, but as in the previous fiscal year, the Bank did not extend any loans to Ashikaga Bank in fiscal 2004.

At the end of fiscal 2004, the amount outstanding of loans extended under Article 38 of the Bank of Japan Law dropped to zero (Table 1).

2. Collection and termination of special loans extended to Yamaichi Securities

On November 25, 2004, the Bank received a request from Mizuho Corporate Bank (MCB) to transfer its claim to 1.882 billion yen of the loans extended to Yamaichi Securities to the JIPF, which had offered to buy the claim. The then Fuji Bank (currently MCB) had previously extended loans to Yamaichi Securities using funds originally provided by the Bank in the form of loans to the then Fuji Bank.

The offer from the JIPF was originally prompted by a government request on October 29, 2004, that the JIPF take over MCB's claim on Yamaichi Securities, pursuant to Article 43, Paragraph 2 of supplementary provisions in the Financial System Reform Law.

The Policy Board decided on November 26, 2004, to give approval to MCB's request. MCB was required to use the money received from transferring the claim to the JIPF in order to repay the loans extended to it by the Bank, thus allowing the Bank to collect loans in this amount.

The Bank received repayment of 1.882 billion yen from MCB, which was the amount the latter received for transferring its claim on Yamaichi Securities.

The Bank also received other payments including the dividends from the bankruptcy procedures. As a result, the total amount of loans to Yamaichi Securities collected by the Bank in fiscal 2004 reached 8.0 billion yen.

On January 26, 2005, the Bank ended the extension of special loans to Yamaichi Securities after bankruptcy proceedings for Yamaichi Securities had been judged completed by the Tokyo District Court. Special loans still outstanding to Yamaichi Securities at that time, in the amount of 111.1 billion yen, became uncollectible loans, and this amount was written off by withdrawing the Bank's provision for possible loan losses.

3. Final procedures for special loans extended to Yamaichi Securities

The Bank transferred net income of 5.5 billion yen to the legal reserve in fiscal 2004 to prevent impairment of its financial soundness due to losses arising from special loans to Yamaichi Securities, upon the approval of the Minister of Finance as prescribed by Article 53, Paragraph 2 of the Bank of Japan Law. This amount was calculated by multiplying uncollectible special loans to Yamaichi Securities of 111.1 billion yen by the required rate of 5 percent, as prescribed by Article 53, Paragraph 1 of the Law, and represented the amount that should have been transferred from net income to the legal reserve if these loans had been collected (see "The Bank's Accounts," Section I.D on pages 127–128 for details).

D. Loans to the Deposit Insurance Corporation (DIC)

Based on the terms and conditions laid down by the Policy Board, the Bank is able to extend loans to the DIC when it is short of funds necessary for operation. In April 2001, the DIC fully repaid the Bank its loans by refinancing them from private financial institutions. The DIC has since raised all the funds necessary for carrying out new business and for refinancing its existing liabilities from private financial institutions. For this reason, as in fiscal 2003, it was not necessary for the Bank to extend loans to the DIC in fiscal 2004.

E. Purchases of Stocks Held by Banks

1. Total amount of stocks purchased by the Bank

In the period from November 2002 through the end of September 2004, the Bank purchased stocks held by banks that hold current accounts with it, in order to further promote their efforts to reduce their exposure to the risk of stock price fluctuations. The Bank's purchase of stocks had been approved by the Minister of Finance and the Commissioner of the Financial Services Agency (FSA), in accordance with Article 43, Paragraph 1 of the Bank of Japan Law. The total value of stocks purchased by the Bank in the period amounted to 2,018.0 billion yen (Table 2).

2. Winding up of the stock purchasing program

The Bank wound up its stock purchasing program on September 30, 2004. During the purchasing period, banks had pruned their excessively large stockholdings considerably and made progress in their disposal of NPLs (see Section II on pages 54–58 for details). The Bank therefore concluded that its stock purchasing program had produced broadly the desired result.

F. Conduct of On-Site Examinations

1. On-site examinations and off-site monitoring of financial institutions

One of the Bank's objectives is to maintain financial system stability by providing financial institutions with liquidity and maintaining smooth and stable operation of payment and settlement systems. To achieve this objective, the Bank conducts on-site examinations and off-site monitoring of financial institutions to assess, for example, the state of their business operations, risk management, capital adequacy, and profitability.

On-site examinations are conducted under a contract (hereafter examination contract) between the Bank and the institutions concerned.[5] Article 44, Paragraph 1 of the Bank of Japan Law provides a clear legal basis for on-site examinations. It prescribes the purpose of such examinations and provides for an examination contract as follows: "The Bank of Japan may, for the purpose of appropriately conducting or preparing to conduct business prescribed by Articles 37 through 39, enter into a contract with financial institutions which become

5. The examination contract includes clauses covering the following:
(1) The required procedures, such as the Bank's obligation to notify financial institutions, in writing, of an on-site examination at least a month before the examination, except in special circumstances.
(2) An obligation on the Bank and financial institutions to maintain confidentiality with regard to information obtained through the on-site examination.
(3) An obligation on the Bank to give consideration to minimizing the burden on financial institutions in conducting on-site examinations.

the correspondents in such business regarding on-site examinations."[6] As determined by the Policy Board on February 17, 1998, financial institutions with which the Bank may conclude examination contracts are institutions that are included among those referred to in Article 44, Paragraph 1, and that also hold current accounts at the Bank. As of March 31, 2005, the Bank had examination contracts with 554 institutions, including seven city banks, 64 regional banks, 48 regional banks II, 68 foreign banks in Japan, 26 trust banks, 280 *shinkin* banks, and 42 securities companies. The Bank has also concluded separate contracts for on-site examinations with the holding companies of financial institutions that hold current accounts at the Bank, and may conduct on-site examinations to obtain additional information necessary to assess the business and financial conditions of such institutions.

In on-site examinations, the Bank's examiners assess financial institutions' evaluation of their assets, such as loans, and their management of various risks.

To assess their evaluation of loans, the Bank identifies both the proportion of nonperforming assets and the degree to which they are impaired by examining the following: financial institutions' assessments of borrowers' actual conditions and their internal credit rating systems; their self-assessments of the value of their assets, and loan write-offs and loan-loss provisions based on these; and their assessments of the rehabilitation plans of distressed borrowers. As for securities, examiners ascertain whether financial institutions' pricing/valuation is appropriate.

In assessing risk management, the Bank's examiners visit the premises of financial institutions subject to on-site examinations to interview executives and staff, and peruse ledgers and documents relating to transactions and other material. This enables the examiners to identify the various risks associated with an institution's operations and any problems in its risk management. More specifically, they check which areas of operations are exposed to such risks as credit risk, market risk, settlement risk, liquidity risk, and operational risk,[7] and whether these risks are properly identified and managed by the financial institution concerned. After the examination, the Bank gives feedback on its findings to the management of the financial institution and encourages action to tackle the identified problems.

Off-site monitoring is conducted through meetings and telephone interviews with executives and staff of financial institutions, as well as through analysis of various documents submitted by these institutions. The main objective of off-site monitoring is to examine the daily business operations and to evaluate the attendant risks at a wide range of institutions, as well as to appropriately assess the effects these have on the financial system as a whole. The Bank's on-site examinations and off-site monitoring are conducted so as to be mutually reinforcing in order to support its

6. Titles of Articles 37 through 39 are listed below.
Article 37: Temporary loans to financial institutions.
Article 38: Business contributing to the maintenance of an orderly financial system.
Article 39: Business contributing to smooth settlement of funds.

7. Operational risk covers risks that attend business operations in general, including those related to computer systems and business continuity.

effective implementation of its operations, including its essential role as the lender of last resort.[8]

G. On-Site Examinations Conducted in Fiscal 2004

In fiscal 2004, the Bank of Japan conducted on-site examinations, in line with the "On-Site Examination Policy for Fiscal 2004," at a total of 153 financial institutions: 46 domestically licensed Japanese banks, 67 *shinkin* banks, and 40 other institutions including securities companies and Japanese branches of foreign banks (Table 3).

The Bank decided to make public, annually, the names of the financial institutions examined on site and the timing of the examinations conducted in the previous fiscal year in the *Annual Review*. By means of this release, the Bank demonstrates that, as the central bank, it is keeping track of financial institutions' business management, with a view to securing public confidence in the financial system and to enhancing the transparency of its on-site examinations. The release covers the following.

a. The Bank's on-site examinations: the Bank's examinations of the business operations and the state of property of financial institutions that hold current accounts at the Bank based on contracts concluded with them, as prescribed by Article 44, Paragraph 1 of the Bank of Japan Law.

b. Items disclosed: (1) the name of each financial institution examined; (2) the day on which consent was received for on-site examination;[9] (3) the first day of on-site examination; (4) the last day of on-site examination; (5) any periods of adjournment that took place between the first and last days of on-site examination; (6) the day the Bank gives feedback on its findings from the on-site examination to the financial institution concerned; and (7) the type of on-site examination conducted, i.e., whether an ordinary or an area-specific on-site examination.

c. In exceptional cases the Bank may judge it appropriate not to disclose the above items for a particular on-site examination, in order to avoid possible negative repercussions for the financial system.

8. Information obtained from daily off-site monitoring is vital in identifying points to be focused on in an on-site examination, whose purpose is to obtain an accurate grasp of the condition of each financial institution that holds a current account at the Bank. Concurrently, findings from on-site examinations help the Bank to carry out effective off-site monitoring. Also, when the Bank identifies areas that need particular improvement through its on-site examination of an institution, the Bank requests it to make follow-up reports on a regular basis in its off-site monitoring.
9. The day the Bank receives formal consent from a financial institution in response to its prior notification regarding a pending on-site examination.

Table 1

Outstanding Loans under Article 38 of the Bank of Japan Law

bil. yen at the end of the month

Date		Amount outstanding
2004	Mar.	141.1
	Apr.	141.1
	May	141.1
	June	141.1
	July	141.1
	Aug.	141.1
	Sep.	141.1
	Oct.	140.3
	Nov.	138.4
	Dec.	111.1
2005	Jan.	0
	Feb.	0
	Mar.	0

Table 2

Total Amount of Stocks Purchased from Banks by the Bank of Japan

bil. yen at the end of the month

Date		Cumulative amount
2002	Dec.	150.0
2003	Mar.	1,160.4
	June	1,486.3
	Sep.	1,843.1
	Dec.	1,907.2
2004	Mar.	1,934.7
	June	1,980.9
	Sep.	2,018.0

Table 3

On-Site Examinations Conducted in Fiscal 2004

(1) 46 Domestic Banks[1]

Financial institutions	Date of acceptance	Date of entry	Date of completion	Period of interruption	Transmission of result	Class of examination
Aomori Bank	Feb. 20, 2004	Apr. 6, 2004	Apr. 21, 2004	——	May 13, 2004	Normal
Akita Bank	Feb. 23, 2004	Apr. 6, 2004	Apr. 21, 2004	——	May 14, 2004	Normal
Shikoku Bank	Feb. 19, 2004	Apr. 6, 2004	Apr. 21, 2004	——	May 20, 2004	Normal
Shimizu Bank	Feb. 19, 2004	Apr. 6, 2004	Apr. 21, 2004	——	May 13, 2004	Normal
First Bank of Toyama	Feb. 20, 2004	Apr. 6, 2004	Apr. 21, 2004	——	May 18, 2004	Normal
Saitama Resona Bank	Feb. 25, 2004	Apr. 13, 2004	May 21, 2004	Apr. 29, 2004 to May 18, 2004	June 30, 2004	Normal
Shinsei Bank	Mar. 2, 2004	Apr. 13, 2004	Apr. 28, 2004	——	June 11, 2004	Normal
Resona Bank	Mar. 3, 2004	May 17, 2004	June 1, 2004	——	June 30, 2004	Normal
Bank of Saga	Apr. 13, 2004	May 26, 2004	June 10, 2004	——	June 30, 2004	Normal
Joyo Bank	Apr. 14, 2004	May 26, 2004	June 10, 2004	——	July 1, 2004	Normal
Taiko Bank	Apr. 9, 2004	May 26, 2004	June 10, 2004	——	June 30, 2004	Normal
Mizuho Bank	May 20, 2004	June 3, 2004	June 4, 2004	——	July 13, 2004	Specific areas (operations and systems)
Gifu Bank	June 2, 2004	July 5, 2004	July 23, 2004	——	Aug. 20, 2004	Normal
Hyakugo Bank	June 3, 2004	July 12, 2004	July 28, 2004	——	Aug. 24, 2004	Normal
UFJ Bank	June 14, 2004	July 26, 2004	Aug. 27, 2004	Aug. 7, 2004 to Aug. 17, 2004	Sep. 30, 2004	Normal
Shimane Bank	July 15, 2004	Aug. 25, 2004	Sep. 9, 2004	——	Oct. 4, 2004	Normal
Senshu Bank	July 14, 2004	Aug. 25, 2004	Sep. 10, 2004	——	Oct. 6, 2004	Normal
Higashi-Nippon Bank	July 15, 2004	Aug. 25, 2004	Sep. 9, 2004	——	Oct. 4, 2004	Normal
Hokuetsu Bank	July 15, 2004	Aug. 25, 2004	Sep. 9, 2004	——	Sep. 30, 2004	Normal
Minato Bank	July 15, 2004	Aug. 25, 2004	Sep. 9, 2004	——	Sep. 30, 2004	Normal
Shonai Bank	Sep. 7, 2004	Oct. 12, 2004	Oct. 27, 2004	——	Nov. 22, 2004	Normal
Towa Bank	Sep. 7, 2004	Oct. 12, 2004	Oct. 29, 2004	——	Nov. 25, 2004	Normal
Ehime Bank	Sep. 8, 2004	Oct. 13, 2004	Oct. 29, 2004	——	Nov. 26, 2004	Normal
Chuo Mitsui Trust and Banking	Sep. 9, 2004	Oct. 13, 2004	Nov. 2, 2004	——	Nov. 18, 2004	Normal
Mitsui Asset Trust and Banking	Sep. 9, 2004	Oct. 13, 2004	Nov. 2, 2004	——	Nov. 18, 2004	Normal
Cititrust & Banking	Sep. 10, 2004	Oct. 18, 2004	Nov. 5, 2004	——	Nov. 26, 2004	Normal
NikkoCiti Trust and Banking	Sep. 10, 2004	Oct. 18, 2004	Nov. 5, 2004	——	Nov. 26, 2004	Normal
Norinchukin Trust and Banking	Sep. 7, 2004	Oct. 21, 2004	Oct. 27, 2004	——	Nov. 26, 2004	Normal
Japan Trustee Services Bank	Sep. 7, 2004	Oct. 27, 2004	Nov. 2, 2004	——	Nov. 18, 2004	Normal
Nishi-Nippon City Bank	Sep. 13, 2004	Oct. 28, 2004	Nov. 5, 2004	——	Nov. 29, 2004	Specific areas (operations and systems)
Shinwa Bank	Oct. 28, 2004	Nov. 30, 2004	Jan. 14, 2005	Dec. 22, 2004 to Jan. 10, 2005	Jan. 26, 2005	Normal
Daito Bank	Oct. 28, 2004	Nov. 30, 2004	Dec. 17, 2004	——	Jan. 21, 2005	Normal
Hokuto Bank	Nov. 1, 2004	Nov. 30, 2004	Dec. 17, 2004	——	Jan. 26, 2005	Normal
Tochigi Bank	Oct. 29, 2004	Dec. 1, 2004	Dec. 16, 2004	——	Jan. 24, 2005	Normal
Biwako Bank	Oct. 28, 2004	Dec. 1, 2004	Dec. 17, 2004	——	Jan. 18, 2005	Normal
Mizuho Trust and Banking	Nov. 2, 2004	Dec. 1, 2004	Dec. 16, 2004	——	Jan. 21, 2005	Normal
Trust & Custody Services Bank	Oct. 28, 2004	Dec. 10, 2004	Dec. 16, 2004	——	Jan. 21, 2005	Normal
Chiba Kogyo Bank	Dec. 21, 2004	Jan. 31, 2005	Feb. 18, 2005	——	Mar. 17, 2005	Normal
Fukuoka Chuo Bank	Dec. 21, 2004	Feb. 1, 2005	Feb. 17, 2005	——	Mar. 8, 2005	Normal
Mie Bank	Dec. 22, 2004	Feb. 1, 2005	Feb. 17, 2005	——	Mar. 9, 2005	Normal
Yamanashi Chuo Bank	Dec. 24, 2004	Feb. 1, 2005	Feb. 17, 2005	——	Mar. 22, 2005	Normal
Resona Bank	Nov. 2, 2004	Feb. 1, 2005	Feb. 9, 2005	——	Mar. 8, 2005	Specific areas (operations and systems)
Taisho Bank	Dec. 21, 2004	Feb. 2, 2005	Feb. 18, 2005	——	Mar. 16, 2005	Normal
Mizuho Corporate Bank	Dec. 22, 2004	Feb. 7, 2005	Feb. 28, 2005	——	Mar. 24, 2005	Normal
Nagano Bank	Dec. 21, 2004	Feb. 8, 2005	Feb. 24, 2005	——	Mar. 23, 2005	Normal
Tokushima Bank	Jan. 13, 2005	Feb. 21, 2005	Feb. 25, 2005	——	Mar. 22, 2005	Specific areas (operations and systems)

Note: *1.* Chronologically listed in accordance with the date of entry.

(2) 67 *Shinkin* Banks[1]

Financial institutions	Date of acceptance	Date of entry	Date of completion	Period of interruption	Transmission of result	Class of examination
Oshima Shinkin Bank	Feb. 23, 2004	Apr. 6, 2004	Apr. 20, 2004	——	May 20, 2004	Normal
Obihiro Shinkin Bank	Feb. 20, 2004	Apr. 6, 2004	Apr. 20, 2004	——	May 17, 2004	Normal
Kanuma Sogo Shinkin Bank	Feb. 20, 2004	Apr. 6, 2004	Apr. 20, 2004	——	May 18, 2004	Normal
Gifu Shinkin Bank	Feb. 20, 2004	Apr. 6, 2004	Apr. 20, 2004	——	May 18, 2004	Normal
Toyo Shinkin Bank	Feb. 19, 2004	Apr. 6, 2004	Apr. 20, 2004	——	May 24, 2004	Normal
Nagano Shinkin Bank	Feb. 20, 2004	Apr. 6, 2004	Apr. 20, 2004	——	May 17, 2004	Normal
Hamamatsu Shinkin Bank	Feb. 23, 2004	Apr. 6, 2004	Apr. 20, 2004	——	May 19, 2004	Normal
Tsuruoka Shinkin Bank	Feb. 9, 2004	Apr. 7, 2004	Apr. 20, 2004	——	May 14, 2004	Normal
Hirakata Shinkin Bank	Feb. 6, 2004	Apr. 7, 2004	Apr. 20, 2004	——	May 21, 2004	Normal
Sorachi Shinkin Bank	Apr. 9, 2004	May 19, 2004	June 1, 2004	——	June 21, 2004	Normal
Hokumon Shinkin Bank	Apr. 9, 2004	May 19, 2004	June 1, 2004	——	July 12, 2004	Normal
Anan Shinkin Bank	Apr. 9, 2004	May 21, 2004	June 3, 2004	——	June 21, 2004	Normal
Nishi Kyushu Shinkin Bank	Apr. 9, 2004	May 24, 2004	June 9, 2004	——	June 29, 2004	Normal
Kumamoto Chuo Shinkin Bank	Apr. 9, 2004	May 26, 2004	June 10, 2004	——	June 30, 2004	Normal
Sawayaka Shinkin Bank	Apr. 9, 2004	May 26, 2004	June 11, 2004	——	June 28, 2004	Normal
Seishin Shinkin Bank	Apr. 9, 2004	May 26, 2004	June 10, 2004	——	July 2, 2004	Normal
Setagaya Shinkin Bank	Apr. 9, 2004	May 26, 2004	June 11, 2004	——	July 1, 2004	Normal
Tano Shinkin Bank	Apr. 9, 2004	May 26, 2004	June 9, 2004	——	June 28, 2004	Normal
Toshun Shinkin Bank	Apr. 8, 2004	May 26, 2004	June 10, 2004	——	July 1, 2004	Normal
Hofu Shinkin Bank	Apr. 12, 2004	May 26, 2004	June 9, 2004	——	June 28, 2004	Normal
Iizuka Shinkin Bank	Apr. 9, 2004	June 23, 2004	July 6, 2004	——	Aug. 19, 2004	Normal
Hachinohe Shinkin Bank	Apr. 13, 2004	June 23, 2004	July 6, 2004	——	Aug. 9, 2004	Normal
Mizushima Shinkin Bank	Apr. 9, 2004	June 25, 2004	July 8, 2004	——	Aug. 19, 2004	Normal
Izu Shinkin Bank	June 3, 2004	July 6, 2004	July 23, 2004	——	Aug. 13, 2004	Normal
Gunma Shinkin Bank	June 3, 2004	July 6, 2004	July 23, 2004	——	Aug. 20, 2004	Normal
Tokyo City Shinkin Bank	June 2, 2004	July 6, 2004	July 23, 2004	——	Aug. 23, 2004	Normal
Mie Shinkin Bank	June 3, 2004	July 6, 2004	July 23, 2004	——	Aug. 10, 2004	Normal
Kashiwazaki Shinkin Bank	June 2, 2004	July 7, 2004	July 22, 2004	——	Aug. 19, 2004	Normal
Kyoto Shinkin Bank	June 2, 2004	July 7, 2004	July 23, 2004	——	Aug. 10, 2004	Normal
Sapporo Shinkin Bank	June 3, 2004	July 7, 2004	July 22, 2004	——	Aug. 20, 2004	Normal
Yokohama Shinkin Bank	June 3, 2004	July 7, 2004	July 23, 2004	——	Aug. 5, 2004	Normal
Showa Shinkin Bank	June 2, 2004	July 12, 2004	July 28, 2004	——	Aug. 20, 2004	Normal
Amami Oshima Shinkin Bank	May 10, 2004	July 20, 2004	Aug. 2, 2004	——	Aug. 20, 2004	Normal
Hiroshima Midori Shinkin Bank	May 10, 2004	July 21, 2004	Aug. 3, 2004	——	Sep. 24, 2004	Normal
Muroran Shinkin Bank	May 10, 2004	July 21, 2004	Aug. 3, 2004	——	Aug. 20, 2004	Normal
Suwa Shinkin Bank	July 22, 2004	Aug. 20, 2004	Sep. 2, 2004	——	Sep. 14, 2004	Normal
Aoki Shinkin Bank	July 14, 2004	Aug. 25, 2004	Sep. 10, 2004	——	Oct. 7, 2004	Normal
Koza Shinkin Bank	July 14, 2004	Aug. 25, 2004	Sep. 9, 2004	——	Oct. 4, 2004	Normal
Seibu Shinkin Bank	July 14, 2004	Aug. 25, 2004	Sep. 9, 2004	——	Oct. 5, 2004	Normal
Takayama Shinkin Bank	July 14, 2004	Aug. 25, 2004	Sep. 8, 2004	——	Sep. 28, 2004	Normal
Choshi Shinkin Bank	July 14, 2004	Aug. 25, 2004	Sep. 10, 2004	——	Oct. 8, 2004	Normal
Tono Shinkin Bank	July 14, 2004	Aug. 25, 2004	Sep. 9, 2004	——	Sep. 28, 2004	Normal
Hinase Shinkin Bank	July 14, 2004	Aug. 25, 2004	Sep. 10, 2004	——	Sep. 30, 2004	Normal
Toyota Shinkin Bank	July 14, 2004	Aug. 31, 2004	Sep. 15, 2004	——	Oct. 1, 2004	Normal
Sukagawa Shinkin Bank	July 20, 2004	Sep. 9, 2004	Sep. 24, 2004	——	Oct. 12, 2004	Normal
Hiratsuka Shinkin Bank	July 16, 2004	Sep. 15, 2004	Sep. 30, 2004	——	Nov. 8, 2004	Normal
Kawaguchi Shinkin Bank	Sep. 10, 2004	Oct. 13, 2004	Oct. 28, 2004	——	Nov. 16, 2004	Normal
Sagami Shinkin Bank	Sep. 14, 2004	Oct. 13, 2004	Oct. 28, 2004	——	Nov. 15, 2004	Normal
Shonan Shinkin Bank	Sep. 10, 2004	Oct. 13, 2004	Oct. 29, 2004	——	Dec. 3, 2004	Normal
Taihei Shinkin Bank	Sep. 10, 2004	Oct. 13, 2004	Oct. 28, 2004	——	Nov. 19, 2004	Normal
Miyagi Dai-ichi Shinkin Bank	Sep. 13, 2004	Oct. 13, 2004	Oct. 28, 2004	——	Nov. 16, 2004	Normal
Yuuki Shinkin Bank	Sep. 10, 2004	Oct. 13, 2004	Oct. 27, 2004	——	Nov. 17, 2004	Normal
Kawanoe Shinkin Bank	Sep. 13, 2004	Oct. 20, 2004	Nov. 2, 2004	——	Nov. 17, 2004	Normal
Otaru Shinkin Bank	Nov. 1, 2004	Dec. 1, 2004	Dec. 15, 2004	——	Jan. 24, 2005	Normal
Koto Shinkin Bank	Oct. 28, 2004	Dec. 1, 2004	Dec. 15, 2004	——	Jan. 20, 2005	Normal
Saikyo Shinkin Bank	Oct. 29, 2004	Dec. 1, 2004	Dec. 16, 2004	——	Jan. 20, 2005	Normal
Toyokawa Shinkin Bank	Oct. 29, 2004	Dec. 1, 2004	Dec. 16, 2004	——	Jan. 20, 2005	Normal

Financial institutions	Date of acceptance	Date of entry	Date of completion	Period of interruption	Transmission of result	Class of examination
Fukushima Shinkin Bank	Oct. 28, 2004	Dec. 1, 2004	Dec. 15, 2004	——	Jan. 17, 2005	Normal
Miura Fujisawa Shinkin Bank	Oct. 28, 2004	Dec. 1, 2004	Dec. 17, 2004	——	Jan. 26, 2005	Normal
Kumamoto Dai-ichi Shinkin Bank	Oct. 28, 2004	Dec. 8, 2004	Dec. 22, 2004	——	Jan. 25, 2005	Normal
Takaoka Shinkin Bank	Nov. 2, 2004	Dec. 8, 2004	Dec. 21, 2004	——	Jan. 21, 2005	Normal
Okazaki Shinkin Bank	Dec. 22, 2004	Feb. 1, 2005	Feb. 17, 2005	——	Mar. 9, 2005	Normal
Shiba Shinkin Bank	Dec. 21, 2004	Feb. 1, 2005	Feb. 17, 2005	——	Mar. 10, 2005	Normal
Tsurugi Shinkin Bank	Dec. 22, 2004	Feb. 1, 2005	Feb. 16, 2005	——	Mar. 9, 2005	Normal
Tokyo Shinkin Bank	Dec. 21, 2004	Feb. 1, 2005	Feb. 17, 2005	——	Mar. 11, 2005	Normal
Niikawamizuhashi Shinkin Bank	Dec. 22, 2004	Feb. 1, 2005	Feb. 16, 2005	——	Mar. 14, 2005	Normal
Miyazaki Shinkin Bank	Dec. 22, 2004	Feb. 1, 2005	Feb. 17, 2005	——	Mar. 14, 2005	Normal

Note: *1.* Chronologically listed in accordance with the date of entry.

(3) 40 Foreign Banks, Securities Companies, and Other Institutions[1]

Financial institutions	Date of acceptance	Date of entry	Date of completion	Period of interruption	Transmission of result	Class of examination
Bayerische Landesbank	Feb. 19, 2004	Apr. 1, 2004	Apr. 8, 2004	——	May 19, 2004	Normal
Morgan Stanley	Feb. 19, 2004	Apr. 6, 2004	Apr. 19, 2004	——	May 18, 2004	Normal
DEPFA Bank	Feb. 19, 2004	Apr. 15, 2004	Apr. 22, 2004	——	May 19, 2004	Normal
National Australia Bank	Apr. 14, 2004	May 19, 2004	May 26, 2004	——	June 29, 2004	Normal
Dresdner Bank	Apr. 14, 2004	May 26, 2004	June 8, 2004	——	June 28, 2004	Normal
Dresdner Kleinwort Wasserstein	Apr. 14, 2004	May 26, 2004	June 8, 2004	——	June 28, 2004	Normal
Marusan Securities	Apr. 12, 2004	May 26, 2004	June 4, 2004	——	June 29, 2004	Normal
DBS Bank	Apr. 12, 2004	June 3, 2004	June 10, 2004	——	June 29, 2004	Normal
WestLB	June 3, 2004	July 5, 2004	July 13, 2004	——	Aug. 20, 2004	Normal
Bank of China	June 1, 2004	July 7, 2004	July 26, 2004	——	Aug. 20, 2004	Normal
UFJ Tsubasa Securities	June 14, 2004	July 12, 2004	July 27, 2004	——	Aug. 17, 2004	Normal
Australia and New Zealand Banking Group	June 4, 2004	July 22, 2004	July 28, 2004	——	Aug. 23, 2004	Normal
Bayerische Hypo- und Vereinsbank	July 16, 2004	Aug. 24, 2004	Aug. 31, 2004	——	Oct. 12, 2004	Normal
Nikko Cordial Securities	July 14, 2004	Aug. 25, 2004	Sep. 10, 2004	——	Sep. 30, 2004	Normal
Nikko Citigroup	July 16, 2004	Aug. 25, 2004	Sep. 10, 2004	——	Sep. 30, 2004	Normal
OCBC Bank	July 16, 2004	Sep. 8, 2004	Sep. 15, 2004	——	Oct. 8, 2004	Normal
Central Tanshi Securities	Sep. 9, 2004	Oct. 5, 2004	Oct. 13, 2004	——	Nov. 12, 2004	Normal
Commonwealth Bank of Australia	Sep. 7, 2004	Oct. 13, 2004	Oct. 20, 2004	——	Nov. 18, 2004	Normal
First Commercial Bank	Sep. 7, 2004	Oct. 13, 2004	Oct. 20, 2004	——	Nov. 26, 2004	Normal
Shinkumi Federation Bank	Sep. 9, 2004	Oct. 14, 2004	Oct. 29, 2004	——	Nov. 25, 2004	Normal
Norinchukin Bank	Sep. 9, 2004	Oct. 14, 2004	Oct. 27, 2004	——	Nov. 26, 2004	Normal
Citibank	Sep. 13, 2004	Oct. 18, 2004	Nov. 5, 2004	——	Dec. 1, 2004	Normal
Toyo Securities	Sep. 9, 2004	Oct. 25, 2004	Nov. 2, 2004	——	Nov. 22, 2004	Normal
Bank of India	Sep. 6, 2004	Oct. 28, 2004	Nov. 5, 2004	——	Dec. 20, 2004	Normal
Bank of Communications	Sep. 6, 2004	Oct. 28, 2004	Nov. 5, 2004	——	Nov. 19, 2004	Normal
Sanpaolo IMI	Oct. 28, 2004	Nov. 25, 2004	Dec. 2, 2004	——	Jan. 20, 2005	Normal
Lloyds TSB Bank	Nov. 1, 2004	Nov. 25, 2004	Dec. 2, 2004	——	Jan. 20, 2005	Normal
Shinko Securities	Oct. 27, 2004	Dec. 1, 2004	Dec. 15, 2004	——	Jan. 19, 2005	Normal
Livedoor Securities	Oct. 28, 2004	Dec. 1, 2004	Dec. 14, 2004	——	Jan. 17, 2005	Normal
Lehman Brothers	Oct. 29, 2004	Dec. 8, 2004	Dec. 21, 2004	——	Jan. 24, 2005	Normal
Chang Hwa Commercial Bank	Oct. 28, 2004	Dec. 10, 2004	Dec. 17, 2004	——	Jan. 21, 2005	Normal
Bumiputra-Commerce Bank	Oct. 27, 2004	Dec. 10, 2004	Dec. 17, 2004	——	Jan. 21, 2005	Normal
International Commercial Bank of China	Dec. 21, 2004	Jan. 25, 2005	Feb. 1, 2005	——	Mar. 8, 2005	Normal
Royal Bank of Scotland	Dec. 28, 2004	Jan. 25, 2005	Feb. 1, 2005	——	Mar. 11, 2005	Normal
Osaka Securities Finance	Dec. 21, 2004	Jan. 26, 2005	Feb. 3, 2005	——	Mar. 9, 2005	Normal
ABN AMRO Securities	Dec. 22, 2004	Feb. 1, 2005	Feb. 16, 2005	——	Mar. 14, 2005	Normal
ABN AMRO Bank	Dec. 24, 2004	Feb. 1, 2005	Feb. 16, 2005	——	Mar. 14, 2005	Normal
Woori Bank	Dec. 21, 2004	Feb. 9, 2005	Feb. 17, 2005	——	Mar. 8, 2005	Normal
Banca di Roma	Dec. 22, 2004	Feb. 9, 2005	Feb. 17, 2005	——	Mar. 9, 2005	Normal
Chubu Securities Financing	Dec. 22, 2004	Feb. 16, 2005	Feb. 24, 2005	——	Mar. 16, 2005	Normal

Note: *1.* Chronologically listed in accordance with the date of entry.

H. On-Site Examination Policy in Fiscal 2005

On April 1, 2005, the Policy Board approved the "On-Site Examination Policy for Fiscal 2005," and made it public on April 4. The focal points are as follows.

On-Site Examination Policy for Fiscal 2005

I. Review of On-Site Examinations and Off-Site Monitoring of Financial Institutions in Fiscal 2004[1]

A. Number of Financial Institutions Examined

In fiscal 2004, the Bank of Japan conducted on-site examinations at a total of 153 financial institutions: 46 domestically licensed Japanese banks, 67 *shinkin* banks, and 40 other institutions including securities companies and Japanese branches of foreign banks.

B. Conditions in the Financial System Observed through On-Site Examinations and Off-Site Monitoring

1. Overview

The Bank conducted its on-site examinations and off-site monitoring in fiscal 2004, focusing on four core elements: (1) examining financial institutions' evaluation of assets with an emphasis on future cash flows; (2) promoting more sophisticated risk management systems; (3) promoting the development of multiple channels for credit provision; and (4) ensuring smooth settlement.

The Bank's view of the current conditions in the Japanese financial system obtained through its on-site examinations and off-site monitoring is as follows.

Overall, there has been considerable progress in financial institutions' disposal of nonperforming loans (NPLs) and the ratio of NPLs to total loans has decreased steadily, due to an increase in the removal of NPLs from balance sheets and financial institutions' efforts to rehabilitate distressed borrower firms. Financial institutions' profitability has been improving due mainly to a decline in credit costs (i.e., write-offs and loan-loss provisions for NPLs), thus enhancing their overall financial strength. During the process of NPL disposal, some financial institutions have strengthened their profitability and capital bases through consolidation and mergers. Others have reinforced their capital by issuing preferred stocks and subordinated debts. However, financial institutions still have some work to do in terms of their management of risks and business activities, and there is also further room for strengthening profitability.

Details of the main findings of on-site examinations and off-site monitoring by major risk category are as follows.

2. Credit risk

On the whole, there have been further improvements in financial institutions' credit risk management. Self-assessments of individual institutions' exposure to credit risk have generally become more accurate, and appropriate loan write-offs and loan-loss provisions were made based on these assessments. Thus, the quality of loan assets has improved. However, the Bank found that there were also examples of unsatisfactory risk management at some

1. Fiscal year in Japan starts in April and ends in March.

financial institutions such as the following: (1) estimates of borrowers' future cash flows were not reasonable; (2) a significant gap was found between the estimated value of pledged real estate and its actual disposal value; and (3) the setting of standard interest rates to be used for classifying loans as eligible for credits with relaxed lending conditions was not appropriate.

As for the rehabilitation of distressed firms, major banks have almost completed drawing up comprehensive rehabilitation plans for large borrowers, and the disposal of the large-scale NPLs, which has been a long-standing problem, is finally coming to an end. An increasing number of regional financial institutions have also started to make more determined efforts on this front, and their efforts are gradually bearing fruit. Financial institutions have started to employ a wide range of new methods for rehabilitating distressed firms, including cooperation with the Industrial Revitalization Corporation of Japan, and the use of spin-offs and debt equity swap (DES) arrangements. However, there were some cases where greater involvement of financial institutions was necessary in reviewing rehabilitation plans and in providing more effective managerial guidance to their borrowers.

An increasing number of financial institutions have developed more reliable methods for internal rating of credit risk and have been putting these into practice when quantifying risks. During its on-site examinations at financial institutions that have introduced such internal credit rating models, the Bank discussed with these institutions their estimates of expected losses (EL) and unexpected losses (UL), so as to assess the economic value of overall loan portfolios and the associated risks, and to get a clearer picture of risk profiles and future credit costs. As part of promoting the development of multiple channels for credit provision, the Bank held discussions with these financial institutions and shared insights especially on the importance of controlling levels of risk through active credit portfolio management, thereby strengthening profitability, taking into consideration capital adequacy and the risks and returns on individual loans.

Financial institutions have been actively engaged in extending new types of loans recently, such as syndicated loans, unsecured standardized loans to small firms based on credit scores, and non-recourse real estate loans. They have also been securitizing mortgages. During its on-site examinations, the Bank examined financial institutions' activities in these areas as well as their related risk management, and found cases where risk management was inadequate because models for evaluating loan portfolios collectively were not fully tested.

3. Market risk

Major banks have established methods for controlling risks under frameworks for integrated risk management. They have generally been wary of a possible rise in long-term interest rates and thus remained cautious with regard to bond investment throughout fiscal 2004. They also have sought to implement sounder integrated risk management practices under the circumstances where constraints on capital are easing, by enhancing the accuracy of risk quantification methods and by allocating more capital to cover risks associated with bond investment in preparation for a possible increase in interest rate risk.

Regional financial institutions, on the other hand, have on the whole become increasingly dependent on securities investment in order to improve their profitability, and it has therefore become all the more important for them to manage market risk properly. The Bank, however, found cases where risk management was inadequate, as sufficient measures for setting risk limits that reflect capital adequacy had not yet been taken.

Major banks have made further reductions in their stockholdings, so as to improve the stability of their businesses. Overall stockholdings of major banks have been kept below the level of their Tier I capital. The Bank found in its on-site examinations that there was room for improvement in assessing the economic value of non-listed preferred stocks, which are increasingly being acquired by financial institutions in the process of rehabilitating distressed borrower firms.

Financial institutions have been increasing their investment in structured bonds, real estate investment trusts, and hedge funds, so as to achieve higher yields. Examining financial institutions' risk management frameworks, using pricing models, the Bank found that a number of financial institutions had problems in assessing the economic value of such assets or in identifying and quantifying the associated risks.

4. Settlement and liquidity risks

Financial institutions have been cautious in their liquidity management on the whole, and no major settlement problems arose in their business operations. However, with market participants' confidence in Japanese banks improving due to progress in NPL disposal and strengthened profitability, major banks began to relax their cautious stance somewhat regarding yen-denominated assets after the start of 2005. They have also begun to take a slightly more active stance on investing in foreign currency denominated assets, reflecting better financing conditions.

The Bank found through its on-site examinations that there were some cases where financial institutions were insufficiently aware of settlement and liquidity risks and needed to improve stress analyses, draw more detailed contingency plans, and carry out actual drills.

5. Operational risk[2]

There has been a significant change in risk profiles of financial institutions' business operations, as financial institutions have on the one hand been streamlining their operations by centralizing operations at their headquarters and further outsourcing, and have begun on the other to offer new financial services. Operational risk management has therefore become increasingly important for them. Financial institutions need to make further efforts in order to control operational risk through measures such as implementing appropriate rules and manuals that reflect changes in actual operational procedures, ensuring that relevant staff members have the benefit of lessons learned from past experiences, and enhancing the functioning of internal audits.

On computer system management, there were fewer cases of large-scale malfunctions in fiscal 2004 compared to the previous fiscal year, but there were still cases where customers were affected. In some cases, preparations for integration or joint operation of computer systems were behind schedule. The Bank checked through its on-site examinations and off-site monitoring whether financial institutions' computer systems were being built and run appropriately, and found that there was room for improved management of both projects and the third parties to whom they have outsourced operations (outsourcees).

2. In this paper, operational risk covers risks that attend business operations in general including those related to computer systems and business continuity.

Arrangements for business continuity in case of disasters and system malfunctions have been improving gradually. A number of financial institutions experienced large-scale natural disasters such as typhoons and earthquakes in fiscal 2004, but they generally took appropriate measures to minimize the damage, as they were able to resume their business operations swiftly and run computer systems including automated teller machines (ATMs) smoothly. However, the Bank found through its on-site examinations that some financial institutions still needed to conduct better-organized drills and enhance the functioning of their back-up facilities.

The Bank also checked financial institutions' security measures for handling customer information and found that some of them needed to improve their risk management in this area.

II. On-Site Examination Policy for Fiscal 2005

A. Core Elements of the Bank's Policy on On-Site Examinations

The Bank released "The Bank of Japan's Measures regarding the Financial System after the Full Removal of Blanket Guarantee of Deposits" on March 18, 2005. In this paper, the Bank clarified its basic stance regarding financial system policy, specifying that it will shift its focus from crisis management to supporting private-sector initiatives toward providing more efficient and advanced financial services via fair competition, while maintaining overall system stability.

As detailed in the paper, the Bank will continue to ensure that it has an accurate grasp of the performance of financial institutions through its on-site examinations, so as to be ready to act as the lender of last resort. At the same time, the Bank will encourage financial institutions' efforts to improve their management of risks and business activities and to develop innovative services tailored to customer needs. In accordance with this basic stance, the Bank will contribute to enhancing the functioning and robustness of the overall financial system.

Based on the above principles, the Bank will conduct its on-site examinations in fiscal 2005, with the following five points providing the core elements.

1. Assessing the economic value and associated risk of financial institutions' assets and financial transactions

With financial services becoming increasingly diversified, it has become all the more important for financial institutions to properly assess the economic value and volatility (i.e., risk) of the whole range of their assets, not just their loan portfolios, as well as their financial transactions.

The Bank has been using the approach based on the discounted cash flow (DCF) method to assess appropriately the economic value of loan assets. It will continue to apply this approach to a wider range of loan assets and share the assessment results with the financial institutions concerned. In cases where a financial institution has especially high loan exposure to a particular firm, the economic value of the loan is affected by the financial institution's own balance-sheet conditions. In such cases, assessment of the economic value of the loan requires the financial institution to take this characteristic into account, and the Bank will be discussing with financial institutions how this can be done more accurately.

For financial institutions that have already introduced internal credit rating models, the Bank will quantify their expected losses (EL) and unexpected losses (UL), so as to assess the economic value of overall loan portfolios and the associated risks, giving due consideration to risks involved in credit portfolio concentration on particular borrowers and the effects of the business cycle. Based on these quantifications, the Bank will hold in-depth discussions with financial institutions on methods for controlling credit risk and setting interest rates, encouraging them to improve the performance of their internal credit rating models.

With regard to loans to small businesses, banks are increasingly pooling such assets in order to assess their economic value and manage the associated risks collectively. If such methods become more established for managing risks related to small borrowers, banks can control overall risk on loans to small businesses without being too risk averse because of less information on the borrowers compared to larger firms. Such methods are expected to enable financial institutions to contribute, through their lending activities, to businesses in regional economies and at the same time ensure that their own business conditions remain sound. With this prospect in mind, the Bank intends to use its on-site examinations to get a clearer picture of banks' pooling techniques for managing loans.

Turning to assets other than loans, the Bank has been assessing the economic value of financial institutions' assets for which market prices are available, such as listed securities, at market values, i.e., using the mark-to-market method. However, financial institutions have increased investment in assets for which market prices are not available, for example structured bonds, structured deposits and loans, privately placed real estate investment trusts, and non-listed preferred stocks. The Bank intends to assess the economic value of these assets and other newly developed financial products, utilizing pricing models, i.e., the mark-to-model method. The Bank will discuss with financial institutions ways of improving such models. Since the economic value of deferred tax assets may vary greatly depending on the level and volatility of financial institutions' own future profits, the Bank will also hold thorough discussions with them on assessing the value of deferred tax assets.

2. Enhancing integrated risk management

If financial institutions effectively utilize frameworks for integrated management of various risks including credit risk, market risk, and operational risk, they can obtain objective inputs to weigh the efficient use of their limited capital as well as the risks and returns on their assets. This will help them manage their overall business more rationally and efficiently. Through its on-site examinations, the Bank will encourage financial institutions to introduce and utilize such frameworks for integrated risk management, taking their specific financial and business conditions into full consideration.

To this end, the Bank will have in-depth discussions with financial institutions, such as major banks, that have already introduced frameworks for integrated risk management on how to further enhance techniques for quantifying risk and to expand the categories of risk that can be quantified. Getting a clearer picture of the correlations between risks will also be a topic for discussion.

As for financial institutions that have not yet introduced frameworks for integrated risk management, the Bank will seek to share understanding of risk management, and also support their efforts to introduce such frameworks by encouraging them to collect necessary data and establish measures to quantify risks. These points are consistent with the concept of the new capital adequacy framework, commonly known as Basel II. Meanwhile, the Bank will encourage regional financial institutions that are increasing securities investment to take due account of the amount of capital allocated as a buffer against credit and operational risks when allocating capital for securities investment, and also to set appropriate limits on the amount of securities investment and the associated risks given the size of their capital buffer.

Information disclosure by financial institutions, based on appropriate assessments of the economic value of their assets and the associated risks, and on integrated risk management, will make it easier for depositors and investors to evaluate how effectively financial institutions are managed and to assess the corresponding risks and returns on their investments. This is expected to improve the functioning of market discipline on financial institutions' management. From this viewpoint, the Bank will encourage financial institutions through its on-site examinations to further improve information disclosure regarding their risk management.

3. Promoting active credit portfolio management

Financial institutions may have stronger incentives to actively redeploy their assets so as to optimize their credit portfolios when they can more objectively assess the risks and returns on their assets using frameworks for integrated risk management. This will lead to greater activity in credit markets, such as markets for securitizing loans and other assets, and more diversified channels for credit provision, and thus result in the enhanced functioning of the financial system as a whole.

Through its on-site examinations, the Bank will therefore encourage financial institutions' efforts toward active credit portfolio management and will hold in-depth discussions with them on necessary measures, such as reviewing lending practices.

4. Ensuring smooth settlement

The Bank will continue to closely monitor how payments and settlements are interrelated in the financial system and identify any associated risks. Where necessary, the Bank will take relevant measures to provide liquidity. In its on-site examinations, the Bank will identify risks inherent in the overall payment and settlement system and also carefully examine financial institutions' liquidity management after the full removal of the blanket guarantee of deposits, with a view to preventing the materialization of systemic risk.

The Bank will examine project management at the financial institutions involved in large-scale integration of computer systems regarding core financial data scheduled in fiscal 2005. The Bank will also do this at other institutions involved in scheduled joint management of development and operation of computer systems. In addition, the Bank intends, where necessary, to check operators of clearing systems and outsourcees of financial institutions on site, to ensure the smooth operation of the overall payment and settlement system.

In preparation for large-scale natural disasters or terrorist attacks, the Bank will examine carefully whether business continuity arrangements would function adequately and whether channels for communication with the Bank have been properly established.

5. Enhancing security measures attending financial transactions

Ensuring the security of financial transactions is essential for maintaining the stability of the financial system and enhancing its functioning. Financial institutions have reaffirmed the importance of ensuring the security of financial transactions recently, with the diversification of financial services, sophistication of financial crimes such as use of counterfeit cash cards, and an increase in information leakage. Depositors and investors have become more concerned about the security of financial transactions. The Bank will therefore check through its on-site examinations whether financial institutions have established sufficient risk management systems in this regard, and request them to improve their systems where necessary. Specifically, the Bank will verify the following points: that guidelines on business operations in compliance with the relevant laws and regulations have been drawn up; that proper security measures have been taken for computer systems; and that internal inspections and audits have been functioning fully.

The Bank will support financial institutions' efforts to improve the functioning of their internal control governing the management of risks and business activities, taking their specific financial and business conditions into full consideration, by examining whether managerial decisions and business activities follow due process and whether these decisions are evaluated objectively *ex post*.

B. Practical Issues Relating to On-Site Examinations

In conducting its on-site examinations in fiscal 2005, the Bank intends to maintain a close dialogue with the management of financial institutions and seek solutions for various tasks, so that the Bank's on-site examinations help financial institutions enhance their management of risks and business activities. The Bank will also continue to exchange views with external auditors, where necessary, as well as financial institutions, regarding accounting issues.

The Bank will continue to give due consideration to easing the burden of on-site examinations on financial institutions. Specifically, the Bank will shift the focus of its on-site examinations from assessing financial institutions' evaluation of individual assets to examining their frameworks for risk management, based on the new on-site examination policy for fiscal 2005 and onward. This will result in reducing the number of loans extracted from financial institutions' overall loan portfolios so as to check the accuracy of their self-assessment in on-site examinations. In addition, the Bank will take a more flexible stance on the scope, size of examination teams, and duration of each on-site examination, depending on the financial and business conditions of each financial institution.

The Bank intends to expand the use of the online data exchange system so that data used in its on-site examinations can be exchanged more efficiently. The Bank will also start, in fiscal 2005, exchanging data through the infrastructure using extensible business reporting language (XBRL), which is considered to be one of the advantageous data formats for exchanging financial data. This will not only enhance efficiency in exchanging financial data for on-site examinations and off-site monitoring but also encourage private-sector initiatives for development of an advanced financial information network.

I. International Initiatives for Maintaining Financial System Stability

Besides measures taken to maintain the stability of the Japanese financial system, the Bank takes part in international efforts toward enhancing the soundness of financial institutions. The Bank's active participation in discussions held by the Basel Committee on Banking Supervision (Basel Committee) is one such important example. The Basel Committee has been working on the revision of the 1988 Basel Capital Accord, and in June 2004, released the new capital adequacy framework (Basel II) titled: "International Convergence of Capital Measurement and Capital Standards: a Revised Framework." This report is the result of the Basel Committee's work over recent years to secure international convergence on revisions to supervisory regulations governing the capital adequacy of internationally active banks. It marks a major revision of the original framework, and individual countries have responded by stepping up their preparations for implementing the new framework, which has already begun to be reflected in amendments to their own national supervisory regulations.

The Bank also participates in the Joint Forum established by the Basel Committee, the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS).

Through its active participation in the Basel Committee and the Joint Forum, the Bank contributes to the formulation of various supervisory standards and guidelines. It also makes use of ideas and views presented at these international forums in conducting on-site examinations and off-site monitoring. Moreover, the Bank has taken advantage of various occasions to exchange views with the FSA and financial institutions on how to ensure proper and smooth implementation of the new framework in Japan.

J. Release of the Bank's Measures regarding the Financial System after the Full Removal of Blanket Guarantee of Deposits

The Policy Board decided and released the text of "The Bank of Japan's Measures regarding the Financial System after the Full Removal of Blanket Guarantee of Deposits" on March 18, 2005. With this release, the Bank aimed to support private-sector initiatives toward providing more efficient and advanced financial services via fair competition, while maintaining overall financial system stability.

The Bank of Japan's Measures regarding the Financial System after the Full Removal of Blanket Guarantee of Deposits

I. Principles

The financial system in Japan has been regaining stability, and the blanket guarantee of deposits will be fully lifted on

April 1, 2005. Henceforth, financial institutions will be expected to amplify their efforts to develop innovative services tailored to customer needs, thus supporting economic activity. The Bank of Japan's basic stance regarding financial system policy must shift its focus in response to this changing environment: from crisis management to supporting private-sector initiatives toward providing more efficient and advanced financial services via fair competition, while maintaining overall system stability.

Ensuring financial system stability will be as essential as ever in the new financial environment. The Bank will continue to closely monitor developments regarding the soundness of financial institutions, their liquidity management, and related settlement risks. It is also important to pay attention to contingency planning for dealing with emergencies such as natural disasters or terrorist attacks. Should the stability of the financial system be threatened, the Bank will promptly implement measures, including those as the lender of last resort, to prevent the manifestation of systemic risks.

At the same time, looking ahead, the availability of more efficient and advanced financial services will be an important prerequisite for the sustainable and stable growth of Japan's economy. Under the rapidly changing environment surrounding the Japanese economy, it is necessary for financial intermediation mechanisms to be flexible and robust with more diversified channels for supplying credit, in order to achieve smooth and efficient allocation of funds and to reinvigorate the economy. Before such mechanisms are firmly established, however, a wide range of financial system-related challenges remain to be addressed: for example, reviewing lending practices, promoting more sophisticated risk management by financial institutions, and developing new markets for credit. As such an evolution of the financial system is realized, through the efforts of all interested parties, the impact of monetary policy should be more effectively transmitted throughout the economy.

In this context, the Bank will encourage financial institutions' efforts to improve their management of risks and business activities, through its on-site examinations and off-site monitoring. As a part of this process, the Bank will review its organization and strengthen its channels for communications to help financial institutions tackle the issues they face. The Bank will also review the services relating to current accounts that form the infrastructure of the financial system, and any other services, with a view to increasing transparency and efficiency.

In accordance with the above basic stance, the Bank will contribute to enhancing the functioning and robustness of the financial system in Japan.

II. Measures to Maintain Financial System Stability

A. The Lender of Last Resort Function

In order to ensure the stability of the financial system, it is necessary to prevent problems in business operations and management at individual financial institutions, should they ever happen, from negatively affecting the financial system as a whole, through a chain reaction of settlement failures or erosion of confidence in the system, and thereby leading to the manifestation of systemic risks. The Bank, therefore, seeks to ensure that it has an accurate grasp of the performance of financial institutions through its on-site examinations and off-site monitoring, and will provide liquidity as the lender of last resort when necessary.

The lender of last resort function is one of the basic roles of a central bank, and the Bank will continue to perform this function, as appropriate, based on the following general principles.

1. Extension of loans against collateral pursuant to Article 33 of the Bank of Japan Law

The Bank extends loans against collateral pursuant to Article 33 of the Bank of Japan Law under a Lombard-type lending facility, called the complementary lending facility, with a view to facilitating monetary operations and thus ensuring the smooth functioning and stability of financial markets. In addition, the Bank will continue, where appropriate, to extend loans against collateral in a timely and flexible manner to meet the specific needs arising from business operations of individual financial institutions, giving due consideration to financial market developments.

2. Extension of temporary loans pursuant to Article 37 of the Bank of Japan Law

On the condition that financial institutions are solvent, the Bank will continue to provide them with uncollateralized loans pursuant to Article 37 of the Bank of Japan Law in a timely manner, when contingencies, such as computer system problems, cause solvent financial institutions to experience an unexpected temporary shortage of funds for payment purposes and when loans are necessary to secure the smooth settlement of funds among financial institutions.

3. Extension of special loans to maintain financial system stability pursuant to Article 38 of the Bank of Japan Law

The Bank will, in cooperation with the government, take measures regarding the extension of special loans pursuant to Article 38 of the Bank of Japan Law in a timely and appropriate manner, while observing the Bank's four guiding principles for the extension of such loans.[1]

B. Contingency Planning for Emergencies including the Extension of Loans under Special Contracts

It is important for the Bank to enhance the mechanisms it has in place to ensure the smooth operation of the payment and settlement system and maintain financial market stability, when financial institutions face difficulties in business continuity due to emergencies such as natural disasters and terrorist attacks. The Bank has recently formulated a framework for extending loans in cases of emergency, called loans under special contracts. This enables the Bank, under contracts made in advance with financial institutions that hold current accounts at the Bank (current account holders), to furnish them with loans even in the absence of specific loan applications, when all standard channels of communication are disrupted by contingencies including disasters. The Bank will continue to examine a broad range of measures for dealing with emergencies such as natural disasters with a view to maintaining the stability of the financial system.

1. Principle 1: There must be a strong likelihood that systemic risk will materialize.
Principle 2: There must be no alternative to the provision of central bank money.
Principle 3: All relevant parties are required to take clear responsibility to avoid moral hazard.
Principle 4: The financial soundness of the Bank of Japan itself must not be impaired.

III. Measures to Enhance the Functioning of the Financial System

A. On-Site Examinations and Off-Site Monitoring

In its on-site examinations and off-site monitoring after the lifting of the blanket guarantee of deposits, the Bank will place more emphasis on enhancing the functioning and robustness of the overall financial system. To this end, the Bank will support financial institutions' efforts to put in place more sophisticated risk management and general management systems, with a view to providing innovative new services to meet customer needs.

1. Assessing the economic value and volatility of financial institutions' assets and financial transactions

The Bank will assess the economic value and volatility of financial institutions' whole range of assets—that is, assets not limited to their loan portfolios—and financial transactions, and share the results with the financial institutions concerned. This will enable the Bank to have in-depth discussions with financial institutions on their financial soundness, in other words, their capital adequacy, and on the key elements driving their business strategies, such as efficient capital utilization and the evaluation of risks and returns on assets, thus helping to identify suitable measures for addressing various issues faced by the financial institutions.

2. Integrated risk management

If financial institutions effectively utilize a framework for integrated risk management—assessing risks based on accurate assessments of the economic value of their total assets and financial transactions and the associated volatility and including settlement and operational risks—they can obtain objective inputs to weigh the efficient use of their limited capital as well as the risks and returns on their assets. This will help them manage their institutions more rationally and efficiently. Through its on-site examinations and off-site monitoring, the Bank will encourage financial institutions to introduce such an integrated risk management framework, taking their specific financial and business conditions into full consideration.

Financial institutions may have stronger incentives to actively redeploy their credit portfolios when they can more objectively assess the risks and returns on their assets. If this leads to greater activity in credit markets and more diversified channels for credit provision, the resulting enhanced functioning of the financial system as a whole will more robustly support Japan's economy.

These views of the Bank are consistent with the new capital adequacy framework, commonly known as Basel II, which is scheduled to come into effect from the end of fiscal 2006 in Japan and requires individual financial institutions to adopt measures to enhance the sophistication of their own risk management.

3. Improving the functioning of financial institutions' internal control and enhancing market discipline through information disclosure

Information obtained by integrated risk management, together with other information on business activities, serves as inputs for managing financial institutions. It is also important for financial institutions to establish a framework for internal control: making managerial decisions in accordance with due process and objectively evaluating the decisions *ex post*. In addition, further improvements in information disclosure by financial institutions, based on appropriate assessments of the economic value of their assets and the associated risks, will make it easier for depositors and investors to evaluate how effectively financial institutions are managed, and to assess the corresponding risks and returns on their investments. This is expected to enhance effective market discipline on financial institutions' management. Through its on-site examinations and off-site monitoring, the Bank will support the efforts made by financial institutions to improve the functioning of their internal control and also encourage improved disclosure with a view to enhancing market discipline.

B. Supporting Private-Sector Initiatives toward the Evolution of the Financial System

By reviewing its organization and strengthening its channels for communicating with financial institutions, the Bank will implement the following measures so that on-site examinations and off-site monitoring are conducted in accordance with the principles described above.

1. Establishing the Center for Advanced Financial Technology

The Bank will establish in its new Financial Systems and Bank Examination Department[2] a unit named the Center for Advanced Financial Technology. It will be in charge of (1) planning and coordinating measures to support the above-mentioned private-sector initiatives and, at the same time, ensuring the safety of financial transactions; (2) studying relevant developments in finance, including information security; and (3) developing more sophisticated techniques for on-site examinations and off-site monitoring.

2. Hosting open seminars on a regular basis

The Bank needs to ensure that as many financial institutions as possible share its understanding of the issues that need to be addressed in enhancing the availability of more efficient and advanced financial services. To this end, the Bank will host open seminars on a regular basis, mainly targeting the management and officers of financial institutions in Japan. The seminars will be the Bank's third direct channel of communication with financial institutions, in addition to on-site examinations and off-site monitoring.

Possible topics to be addressed by such seminars include (1) development and sharing of refined techniques to assess the economic value of financial institutions' assets, (2) issues related to lending practices, (3) managerial issues pertaining to financial information security and suggested solutions, (4) reviewing accounting principles in response to the evolution of financial services, and (5) changes in the conduct of on-site examinations and off-site monitoring and their implications.

3. Supporting refined financial data exchange

It is very important for investors to be able to collect and analyze financial data on firms efficiently. This is another prerequisite for enhancing the functioning of the financial system. In the private sector, some firms have already started to examine ways to establish a network system that enables straight-through processing (STP) of financial data, which allows the integrated transmission and analysis of financial data via electronic channels. With a view to facilitating the development of such advanced financial information network systems, the Bank has been studying and experimenting with the adoption of an infrastructure that uses extensible business reporting language (XBRL). This is

2. The new department will be established approximately by July 2005, by integrating the present Financial Systems Department and Bank Examination and Surveillance Department.

considered to be an advantageous file format for exchanging various types of financial data, for example, firms' financial statements. In fiscal 2005, the Bank will start exchanging financial data in XBRL format with financial institutions.

C. Reports on the Stability and Functioning of the Financial System

Microeconomic information gathered through on-site examinations and off-site monitoring will be analyzed from a macroeconomic perspective and utilized in the Bank's assessment of the stability and functioning of the overall financial system. The Bank will compile the results of its analysis and release regular reports, the contents of which will be mainly the Bank's assessment of the stability and functioning of the financial system and the measures being taken on this front.

IV. Review of the Bank's Other Business Operations

A. Current Account Services and the Complementary Lending Facility

The Bank selects current account holders, the financial institutions with which it enters into current account services contracts and lending facilities contracts, giving due consideration to one of the objectives stipulated in the Bank of Japan Law, specifically "to ensure smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of an orderly financial system." The Bank will review the procedures for selecting current account holders in order to enhance procedural transparency and appropriately support entry into financial business.

1. Greater disclosure regarding current account contracts and a smoother selection process for account holders

The Bank will disclose the rules for current account services, which is the basic contract for the services, and the list of current account holders. The Bank will disclose the application procedures for opening a current account with the Bank, including sample forms and the standard processing period, to make the selection process smoother.

2. Introduction of a notice period before terminating contracts for the complementary lending facility

The Bank currently terminates the contract with a financial institution using its complementary lending facility as soon as that institution's capital adequacy ratio falls below the required standard. In the future, however, the Bank will encourage and support financial institutions' efforts to restore their capital adequacy ratios, and will consider introducing a notice period in order to assess their efforts before terminating the contract.

B. Release of a List of On-Site Examinations Completed

The Bank will make public the names of the financial institutions examined on site and the timing of the examinations conducted in the previous fiscal year in the Bank's *Annual Review* in order to enhance the transparency of its on-site examinations.