March 29, 2004
Bank of Japan

On-Site Examination Policy for Fiscal 2004

I. Review of On-Site Examinations and Off-Site Monitoring of Financial Institutions in Fiscal 2003

A. Overview

In fiscal 2003, the Bank of Japan conducted on-site examinations at a total of 140 financial institutions: 50 domestically licensed Japanese banks, 69 *shinkin* banks, and 21 other institutions including securities companies and Japanese branches of foreign banks (see Table below).

Table Number of Financial Institutions Examined in Recent Years

	Fiscal 2001	Fiscal 2002	Fiscal 2003
Domestically licensed Japanese banks	33	38	50
***Shinkin* banks**	78	67	69
Other institutions including securities companies and Japanese branches of foreign banks	9	10	21
Total	120	115	140

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

The following are observations about conditions in the Japanese financial system and tasks related to the management of financial institutions obtained through on-site examinations and off-site monitoring in fiscal 2003.

1. Overview

The Bank released "Japan's Nonperforming Loan Problem" in October 2002, clarifying fundamental principles that contribute to overcoming the nonperforming-loan (NPL) problem and enhancing the functioning of the financial system: (1) the appropriate evaluation of the economic value of NPLs and the promotion of their quick disposal based on such evaluation; and (2) the enhancement of profitability of both firms and financial institutions. The Bank confirmed in its on-site examinations and off-site monitoring in fiscal 2003 that the measures being taken by financial institutions have generally been in line with these fundamental principles.

There has been progress in the disposal of NPLs, particularly among major banks, where determined efforts have steadily borne fruit. The overall volume of NPLs at regional banks has also been declining, although there have been some variations in the pace of disposal across individual institutions. Financial institutions' profitability has been increasing partly due to a decline in credit costs, i.e., write-offs and provisions for NPLs. On the other hand, the Bank found that there remain tasks for financial institutions in management of various risks, and also that there is room for further improvement in securing stable profitability and sufficient financial strength.

The following are the main findings by major risk category, obtained by on-site examinations and off-site monitoring.

2. Credit risk

Financial institutions' credit risk management has generally been improving. Self-assessments of individual institutions' exposure to credit risk have gradually become more accurate, and loan write-offs and loan-loss provisions have been made based on such assessments. Major banks, in particular, have come to calculate the value of their loans using the discounted cash flow (DCF) method and make appropriate provisioning against loan losses accordingly. However, there were also examples of unsatisfactory risk management: especially cases in which (1) loan-loss provisions had not been calculated appropriately; (2) there was a significant gap between the estimated value of collateral and its actual disposal value; and (3) estimated future cash flow employed in the DCF method was not reasonable.

An increasing number of financial institutions have been taking measures to rehabilitate distressed firms, and most financial institutions have established and increased the number of personnel in sections specializing in corporate rehabilitation. As a result, some firms have been upgraded in terms of their borrower categories. However, there were more than a few cases where further improvements were required: in particular, the process for reviewing rehabilitation plans drawn up by borrower firms was unsatisfactory at some institutions, and there were also cases where actual measures to support borrowers were not clear.

Financial institutions have also made progress in developing more reliable methods for internal rating of credit risk. In its examinations, the Bank analyzed the nature of the risks inherent in financial institutions' overall loan portfolios using the data on their borrowers, and assessed their risk management procedures, their stances with regard to loan portfolio management, and their prospective credit costs. The Bank had thorough discussions, particularly with major banks, on the sophistication of their tools for measuring credit risk. An overall improvement has also been observed in this area, but there were cases where financial institutions needed to further accumulate and compile historical data, enhance the robustness of the methods, and make better use of measured credit risk in setting interest rates for loans.

3. Market risk

Turning to market risk, the importance of managing interest rate risk was reaffirmed by financial institutions after they experienced large fluctuations in long-term interest rates over a short period of time in 2003. In this respect, major banks have already introduced procedures to quantify the amount of risk with the application of Value-at-Risk, i.e., the probable maximum loss calculated by statistical methods, and then to set risk limits in advance. The management of financial institutions is expected to make appropriate decisions, paying due attention to their capital bases particularly when the market environment is changing rapidly and hence risks are more pronounced. In order to ensure swift and appropriate decision making in a volatile market environment, there is still room for improving the integrated risk management methods and promoting the effective use of capital.

Major banks have been reducing their stockholdings steadily by various means, including the stock purchase facility offered by the Bank, and overall stockholdings are now below the level of Tier I capital. As a result, market risk of their stockholdings has also decreased, and major banks have less constraint on capital, allowing them to reallocate it to other risks such as credit risk and interest rate risk.

Regional financial institutions have become increasingly dependent on securities investment to pursue profitability, as demand for loans has remained weak. Some of the regional financial institutions have been actively investing in hybrid financial products, which use derivatives, seeking higher yields. It has therefore become increasingly important for them to manage market risk more thoroughly. However, the Bank's on-site examinations revealed that risk management at some institutions is still unsatisfactory.

The Bank also had in-depth discussions with major banks on how to evaluate the economic value of assets for which market prices are not available, such as non-listed preferred stocks.

4. Operational risk*

Financial institutions have continued to streamline their operations at their operational bases, promoting measures such as automation. At the same time, they have been under constant pressure to provide new financial services. Operational risk management has therefore become increasingly important for them. In spite of this trend, the Bank found that risk management at some institutions was insufficient and required improvement: for example, appropriate rules and practices that reflect actual operational procedures have not been sufficiently implemented, and the segregation of responsibility for operations and risk management was still unsatisfactory.

Major banks have started to take measures aimed at quantifying operational risk, before the implementation of the New Capital Accord proposed by the Basel Committee on Banking Supervision. Through its on-site examinations, the Bank held thorough discussions with major banks on developing arrangements and tools for

* In this paper, operational risk covers those that attend business operations in general.

measuring operational risk, and on how to use the results to motivate improvements in operational efficiency and the reduction of operational risk.

Computer system malfunctions on a large scale once again occurred at some financial institutions in fiscal 2003. Integration and joint operation of computer systems among financial institutions continued to take place, and the Bank therefore made active use of on-site examinations and off-site monitoring to assess whether financial institutions' computer systems were being appropriately built and their operations managed to prevent the recurrence and minimize damages of malfunctions.

In July 2003, the Bank reiterated the importance of establishing arrangements for business continuity in case of disasters or system malfunctions. The Bank assessed financial institutions' arrangements for business continuity through its on-site examinations and off-site monitoring, and found that some financial institutions were still insufficient, for example, in securing back-up facilities and conducting practical drills. These financial institutions should therefore make further efforts to improve their business continuity arrangements.

In spite of a financial institution failure, systemic risk did not materialize in fiscal 2003. Reputational risk related to the financial strength of institutions, however, did materialize, leading to the withdrawal of deposits by customers. This has encouraged financial institutions to reconsider the importance of liquidity management.

II. On-Site Examination Policy for Fiscal 2004

A. Core Elements of the Bank’s On-Site Examination Policy

With the scheduled date for the full removal of blanket deposit insurance in April 2005 drawing closer, Japanese financial institutions continue to be confronted with two important tasks: one is to resolve the NPL problem as soon as possible; and the other is to pursue both profitability and financial strength so that they can cover the prospective credit costs that may constantly arise from their businesses. The Bank will identify and clarify the management issues facing financial institutions through its on-site examinations, and discuss thoroughly with them the best way to address these issues.

Looking beyond the full removal of blanket deposit insurance, the financial system as a whole needs to change so that it can provide efficiently new financial services demanded by households and firms, and hence firmly support Japan's economic activity through enhanced financial intermediation. In this context, the main task facing the Japanese financial system is no longer simply to restore its functioning but to reform and promote sophistication of its functions. Through its on-site examinations, the Bank will support financial institutions’ initiatives in this respect.

Based on the above thinking, the following four points comprise the core elements of the Bank’s policy in conducting its on-site examinations in fiscal 2004.

1. Examining financial institutions’ evaluation of assets with an emphasis on future cash flows

Accurate evaluation of their assets is essential for financial institutions’ businesses. The credit risk management of financial institutions has been generally improving in this regard, but the Bank will continue to conduct thorough examinations both of institutions’ evaluations of their borrowers’ actual conditions, and of their self-assessment. Assessments of the rehabilitation plans of distressed borrowers will also be subject to strict scrutiny.

In its on-site examinations, the Bank aims to check whether financial institutions accurately estimate future cash flows of borrowers and business projects, taking due account of various uncertainties lying ahead. Where improvements or deterioration in future cash flows can be expected with a reasonable degree of certainty, the Bank will assess borrowers' conditions and the possibility of rehabilitation of business projects, placing emphasis on future cash flows rather than the records of financial conditions.

In addition, the Bank will also verify the accuracy of the evaluation of assets for which market prices are not available, for example non-listed preferred stocks acquired by financial institutions in the process of rehabilitation of borrowers, focusing on future cash flows for the relevant assets. As for deferred tax assets, given that their value and impact on financial institutions' capital position can vary depending on institutions' future profits and the volatility of future profits, the Bank will hold thorough discussions with financial institutions, carefully assessing whether forecasts of future profits and their volatility are reasonably estimated.

2. Promoting more sophisticated risk management systems

As for market risk, following the development in long-term interest rates in the middle of 2003, the Bank will encourage financial institutions to further improve their market risk management, allocating their capital as a buffer, for example, so that they can be prepared against interest rate fluctuation in the future. The Bank also intends to verify that financial institutions investing in hybrid financial products appropriately assess the risks inherent in such assets. In addition, the Bank will examine whether decisions on the optimal level of investment are made through appropriate internal procedures, taking account of individual institutions' financial strength.

Regarding liquidity risk, the Bank's quantitative easing policy has ensured that ample liquidity has been provided in the financial market as a whole. However, with the full removal of blanket deposit insurance approaching and given the potential damage associated with reputational risk in today's information-oriented society, liquidity management has become more important for individual financial institutions. In its on-site examinations, the Bank will assess carefully how financial institutions are managing liquidity risk.

It has also been increasingly important for financial institutions to integrate their management of the various kinds of risks with which they are confronted, such as credit risk, market risk, and operational risk. The integrated assessment of risks enables financial institutions to accurately evaluate the adequacy of their capital, and therefore enables them to make use of their capital and other resources more efficiently, by allocating them to businesses where they expect to earn sufficient profits to compensate for the accompanying risks. The sophistication of integrated risk management by financial institutions contributes not only to improving their own profitability but also to enhancing the functioning of the financial system as a whole.

In its examinations, the Bank will, when necessary, encourage financial institutions to introduce arrangements for accumulating historical data and developing methods for quantifying risks. These are essential for integrated risk management. The Bank intends to focus particularly on financial institutions' management of credit risk and operational risk, and support their efforts to improve their risk management, with a view to preparing for the implementation of the proposed New Basel Capital Accord.

3. Promoting the development of multiple channels for credit provision

Looking beyond the full removal of blanket deposit insurance and toward the establishment of a new financial system better capable of offering firm support to Japan's economy, it is essential to develop a more efficient framework for credit provision where the funds of a wide range of investors other than financial institutions can be appropriately utilized. In other words, the development of multiple channels for credit provision is crucial. To this end, financial institutions are expected to actively promote the repackaging and liquidation of existing loans as well as to originate new loans and evaluate their values appropriately. These efforts will contribute to developing credit markets, such as markets for liquidating loans or securitizing assets, and furthermore strengthen the credit provision function of the financial system as a whole.

On the other hand, from the viewpoint of financial institutions, the above framework will allow them to actively repackage and rearrange their individual loans, taking account of their capital conditions and the risks and estimated returns from individual loans, so that they can earn sufficient profits to compensate for the risks in their overall credit portfolio. This is what is meant by proactive management of the credit portfolio, and this will improve financial institutions' profitability. The Bank will use its on-site examinations to encourage financial institutions' initiatives toward promoting the expansion of the channels for credit provision and establishing more active loan portfolio management.

4. Ensuring smooth settlement

The Bank has been monitoring closely chains of influence among financial market transactions and settlements and identifying any associated risks. When necessary, the Bank has taken relevant measures swiftly to provide sufficient liquidity. In its examinations, the Bank will continue to identify any problems inherent in the financial system, with a view to preventing the materialization of systemic risk.

In addition, during on-site examinations the Bank will discuss with financial institutions their arrangements for business continuity and measures to reinforce their cooperation with the Bank in the event of an emergency in which they are unable to continue normal business operations due, for example, to computer system failures and disasters.

Based on the four core elements as outlined above, the Bank has prepared a list of key points by major risk category which it will focus on in its on-site examinations in fiscal 2004 (see attachment).

The Bank will utilize observations obtained through on-site examinations and off-site monitoring in formulating not only policy for financial system stability but also its monetary policy, thereby contributing actively to the further revitalization of the Japanese economy.

B. Practical Issues Relating to On-Site Examinations

In conducting on-site examinations in fiscal 2004, the Bank intends to share its findings fully with the management of financial institutions, maintaining a close dialogue, so that the results of on-site examinations can help promote appropriate management at the financial institutions concerned. The Bank will also exchange views with external auditors if necessary as well as financial institutions, regarding accounting issues.

Other practical issues worthy of note regarding the Bank's examinations in fiscal 2004 are as follows. First, the Bank will continue to flexibly determine the frequency, duration, and scope of each on-site examination based on the situations at individual financial institutions. Second, it will make use of shortened on-site examinations that focus on specific risk categories where necessary. Third, in order to ease the burden of on-site examinations on financial institutions, the Bank will reduce the number of documents that it requires financial institutions to submit in advance, and also introduce an online communication system through which related data can be transferred more smoothly. And fourth, the Bank plans to conduct pilot tests with some major banks on an online data exchange system using a new computer language, to achieve further efficiency in the compilation and transmission of financial data related to on-site examinations and off-site monitoring.

Attachment

Key Points of On-Site Examinations in Fiscal 2004 by Risk Category

Credit risk

- Examine financial institutions' evaluation of borrowers and business projects, placing emphasis on prospects of future cash flows rather than the records of their financial conditions.
- Examine the reliability of financial institutions' internal rating of credit risk, in view of the implementation of the proposed New Basel Capital Accord.
- Evaluate whether financial institutions properly assess disposal value of pledged real estate, taking due account of records for auctions and discretionary sales, their stances with regard to disposal, and the results of on-site inspections of collateral.
- Estimate the magnitude of financial institutions' unexpected losses, and assess credit risk inherent in the overall loan portfolio on this basis.
- Examine whether financial institutions take appropriate measures with respect to loans to large borrowers based on the quantification of the effect of the credit risk volatility on their overall businesses.
- Assess financial institutions' credit risk management and their stances with regard to loan portfolio management by analyzing borrowers' financial data collectively.
- Examine whether financial institutions manage risks collectively and make appropriate provisions with respect to standardized loans to small businesses and individuals that they are expanding recently.
- Examine the possibility of distressed borrowers' rehabilitation and verify that financial institutions' measures for borrowers eligible for rehabilitation are appropriate.
- Discuss with financial institutions the active use of credit markets, such as those for liquidating loan assets, in order to promote appropriate setting of interest rates and prices on their loans and other assets.
- Examine financial institutions' measures for proactive credit risk management using financial engineering techniques, such as credit derivatives, as well as a wide range of credit market functions.
- Discuss with financial institutions how to make new lending practices prevalent, such as debtor-in-possession finance and the attachment of covenants to loan contracts.
- Examine whether financial institutions appropriately assess credit costs and make use of such assessments in managing their loan assets, setting interest rates, and pricing non-listed preferred stocks acquired in the process of corporate rehabilitation.

Market risk

- Examine how financial institutions assess and manage interest rate risk, and verify that investment decisions are made through appropriate internal procedures, based on an objective assessment of the size of risks, taking account of their financial strength.
- Continue to check major banks' efforts to reduce market risk of their stockholdings.
- Use pricing models to assess the value of hybrid financial products held by financial institutions, particularly regional institutions, in order to examine the accuracy of their evaluation of the risks of their securities investment.
- Examine financial institutions' efforts to provide variable-rate deposits and other financial products that contribute to controlling interest rate risk, and discuss how to disperse interest rate risk throughout the economy.
- Examine whether there are business operations and market practices that need improvement so as to prevent financial shocks from spreading via market transactions between financial institutions.

Settlement and liquidity risks

- Examine financial institutions' management of settlement and liquidity risks for both yen and foreign currencies.
- Examine the effectiveness of financial institutions' contingency plans in the event of funding difficulties.
- Verify whether financial institutions' risk management measures to address reputational risk are satisfactory. The measures examined include everyday measures to enhance market participants' and depositors' confidence, for example, improving disclosure of information regarding the financial strength of the institutions, and contingency arrangements.
- Examine contingency arrangements of relevant parties, in view of the forthcoming introduction of new private-sector settlement systems, for example, the book-entry transfer system for corporate bonds operated by Japan Securities Depository Center.
- Assess financial institutions' business continuity plans and arrangements to cooperate with the Bank in preparation for possible damage to their operational sites or large-scale disaster.
- Examine the settlement profiles of funds and securities transactions, and consider the possible effects of disruptions in settlements on the overall financial market.

Operational risk

- Examine whether financial institutions appropriately manage operational risk accompanying the streamlining of operations as part of their restructuring efforts, such as concentration and outsourcing of back-office processing, and the shift of audit functions to branches.
- Examine whether financial institutions appropriately operate and manage risks associated with new businesses that are expected to enhance their profitability, such as Internet banking, and sales of investment trusts, insurance, and other financial products.
- Identify the state of progress at financial institutions in the sophistication of operational risk management and, where necessary, request them to compile more data and improve their analytical abilities.
- Assess financial institutions' preparedness against advanced financial crimes.

Computer system risk

- Examine, in order to ensure the stable operation of settlement systems, whether financial institutions implement adequate measures to maintain the safety and reliability of their computer systems and to prevent the recurrence of system failure.
- Continue to examine whether financial institutions' arrangements for the development and operation of their computer systems, as well as their contingency plans in the event of system malfunctions are adequate, given that there are an increasing number of cases of system integration and outsourcing or joint management of both system development and operation.
- Check whether financial institutions appropriately manage risks related to information security as systems connected with the Internet are increasing.

Financial strength and integrated risk management

- Examine whether: the amount of loan write-offs and loan-loss provisions are sufficient; provisioning is carried out appropriately based on the discounted cash flow method; and the registered amount of deferred tax assets is reasonable.
- Estimate financial institutions' future credit costs taking into account the likelihood of changes in borrower categories and the economic conditions in their business areas. Also evaluate their earnings forecasts, based on projections under several future economic scenarios.
- Evaluate financial institutions' financial strength by accurately assessing the economic value of assets that are subject to change in line with their business conditions.
- Request financial institutions, where necessary, to improve integrated risk management systems and to make necessary arrangements to this end, such as accumulating data, developing the methods for measuring risks, and establishing systems to review the accuracy of risk measurement models.
- Review whether the framework for integrated risk management is used effectively in allocating economic capital to, assessing the profitability of, and providing incentives to, business divisions.
- Continue to discuss with financial institutions how to improve internal auditing procedures by, for example, introducing risk-specific auditing measures and plans, closer monitoring of business units, and ensuring appropriate involvement of management in the internal auditing process, with a view to supporting their efforts to develop and enhance the sophistication of the function of the internal audit.
- Discuss with financial institutions whether they can raise capital if a shortage of capital prevents them from pursuing new business opportunities.