March 25, 2009
Bank of Japan

On-Site Examination Policy for Fiscal 2009

1. On-site Examination by the Bank of Japan

On-site examination is the examination which the Bank of Japan (hereinafter, the Bank) carries out by visiting the premises of the financial institutions based on the contracts with them, in order to grasp their business operations and the state of the property (Article 44 of the Bank of Japan Act[1]). The Bank will contribute to the financial system stability by gauging each individual financial institution's business conditions, verifying their risk management and encouraging its improvement when necessary, through on-site examinations.

Amid the intensified global financial crisis, the importance has been reaffirmed for a central bank, which provides market liquidity and has the function of the lender of last resort, to have various communication channels with financial institutions, to accurately recognize the challenges of the financial system from micro- and macro-perspectives, and to carry out proper policy responses. The on-site examination is one of the important parts of the Bank's conduct of the policies and operations.

The Bank formulates an on-site examination policy every fiscal year based on the decision of the Policy Board[2]. This "On-Site Examination Policy for Fiscal 2009," describes basic concepts and the focus in conducting on-site examination in fiscal 2009, as well as the on-site examinations carried out in fiscal 2008. Based on the policy, the Bank intends to conduct efficient and effective on-site examinations.

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1 Article 44 of the Bank of Japan Act stipulates that on-site examination is conducted "for the purpose of appropriately conducting or preparing to conduct the business prescribed in Articles 37 through 39."

2 The Bank of Japan Act stipulates that "the contents of a contract concerning on-site examinations and important matters concerning the implementation of on-site examinations for each business year" must be determined by the Policy Board. (Article 15, paragraph (2), item (v))

2. Review of Fiscal 2008

(1) On-site Examinations in Fiscal 2008

In fiscal 2008, the turmoil in global financial markets and deterioration in domestic and overseas economies substantially influenced financial institution management[3]. Volatile stock markets and foreign exchange markets forced financial institutions to post large realized and unrealized losses on securities including stocks and structured bonds. In addition, the rapid deterioration of domestic and global economies increased credit costs of financial institutions through the decline in the corporate sector's performance and the increase in bankruptcies. Consequently, the declining trend in net profits of domestic banks became more clear, and some banks, whose capital adequacy ratio declined, bolstered their capital in order to ensure future management flexibility including lending. Meanwhile, the heightened awareness of counterparty risks by market participants in the short-term money markets substantially affected the volume of transactions and the formation of interest rates.

Against such a backdrop, the Bank carried out on-site examinations of 128 financial institutions in fiscal 2008: 52 domestically licensed banks, 46 *shinkin* banks, and 30 other institutions, including securities companies and Japanese branches of foreign banks.

Number of Financial Institutions Examined

	FY 2006	FY 2007	FY 2008
Domestic banks	43	39	52
Shinkin banks	73	66	46
Other institutions	15	14	30
Total	131	119	128

[3] Regarding an assessment of the state of Japan's financial system in fiscal 2008, refer to "Financial System Report" published by the Bank in March 2009.

(2) Challenges of Risk Management Conditions Ascertained through On-site Examinations

a. Credit Risk Management

In the first half of fiscal 2008, many financial institutions marked a rapid increase in credit costs. While financial institutions had improved their screening capability since the introduction of the self-assessment process in 1998, the corporate sector's performance had deteriorated at an unprecedented pace due to the economic downturn both at home and abroad. In some cases, there was some room for improvement in financial institutions' basic screening capability such as gauging firms' actual business conditions. In those cases, the screening capability of branches has been declining, partly due to the constraints on personnel composition as the decrease in mid-level officers, and the guidance of the screening department over branches was insufficient.

While financial institutions beefed up their support of corporate revival when corporate performance was deteriorating, after experiencing the economic expansion, such move appears to have somewhat receded. Some financial institutions, with weak corporate revival support in their headquarters, which delegate the support mostly to their branches, did not examine the corporate revival procedures based on the actual conditions of borrowers, and thus could not effectively support borrowers. By contrast, other financial institutions effectively supported corporate revival through various ways based on the actual conditions of borrowers including utilizing external institutions.

Credit concentration risk surfaced markedly at financial institutions which concentrated their exposure on certain sectors or large borrowers, due to the worsening business conditions of the sectors or the borrowers. At those institutions, they did not have full awareness of concentration risk, or did not establish a framework to reduce concentration risk.

In terms of specific loan products, at financial institutions that have a relatively high proportion of mortgages in their lending, the enhancement of necessary loan portfolio analysis of residential mortgages remained an issue. In terms of syndicated loans, at some regional financial institutions, there was the need to bolster the validity check and associated follow-up management of the contract clauses including covenants. In arranger business, there was room for improvement in risk management among major financial institutions.

In terms of overseas exposure, while major financial institutions had substantially increased the outstanding amount of foreign credits, there were some institutions in which the quality of a part of the portfolio being deteriorated, owing to the serious downturn in overseas economies. At those institutions, headquarters' involvement in credit exposure management of their overseas bases needed to be addressed.

Frameworks for internal rating and credit risk measurement were progressing at many financial institutions. However, there were some financial institutions that needed to improve the accuracy of internal rating and credit risk measurement.

b. Market Risk Management

As the strains in global financial markets continued, many financial institutions were forced to incur large realized and unrealized losses on securities including stocks and structured bonds. One reason is that the stock prices plunged and market liquidity lowered at a rapid pace beyond financial institutions' expectations. However, there were some institutions in which the necessary processes for market risk management were not taken and thus the framework for risk control did not work effectively. At those institutions, the limit which adequately took into account the possibility of future market fluctuations was not set when devising investment strategies, or analysis and consideration were not thoroughly carried out when the risks surfaced. In addition, some institutions revealed challenges on the governance front in that the management, who put a high priority in pursuing profits, decided additional investments without enough internal consultation, or, by contrast, the management was not actively involved in risk management.

In terms of organization structure related to securities investment and management including the separation of front and middle offices, some financial institutions, mainly regional financial institutions, did not secure an effective mechanism of mutual supervision.

With respect to market risk associated with stockholdings, awareness for the risk had been subsiding amid the increasing trend of stock prices in the past few years. Against such a backdrop, there were cases in which strategic stockholdings were not reduced as planned, or the examination of the holding limit consistent with the risk allowance for strategic stockholdings was not carried out.

As for investments in products which have complex risk characteristics including securitized products and structured products, there were cases that proper measures were not taken, based on the understanding of those products' risk characteristics. For example, risk analysis at the time of purchase was not adequate, or, by relying only on external ratings, monitoring of the underlying assets was not sufficient even when the unrealized losses had been increasing.

Steps had been steadily taken to measure market risk, and institutions utilizing it for risk management had been increasing in number. However, the measurement of market liquidity risk remained a challenge for a part of securitized products, and in some cases, especially at regional financial institutions, the frequency of measurement and verification by a back test were not sufficient.

c. Liquidity Risk Management

Due to the strains in global financial markets, internationally active financial institutions were forced to manage their business with more attention to liquidity risk than before.

Against such a backdrop, foreign financial institutions faced challenges in reporting on liquidity management to headquarter, oversea bases, and other Japan bases, and in stress-testing methods. Japan's major financial institutions also needed improvement in terms of formulating liquidity contingency plans that assume various stress scenarios.

By contrast, regional financial institutions had no substantial problem with respect to the management of daily funding. However, there were cases in which the effectiveness of the cash supplying system in the event of liquidity crisis was not secured.

d. Operational Risk Management[4]

In the area of operational risk management and compliance, the cases have been identified mainly in the regional financial institutions where operations are conducted in a way that could cause accidents and problems with their clients due to flaws in internal rules, and the strict compliance of internal rules was not ensured due to senior officers' insufficient check capability. At those institutions, challenges remained in terms of the PDCA cycle: (1) identification of risk including utilization of the information on accidents, operational errors, and complaints; (2) improvement of internal rules based on the risk identification; (3) implementation of operational guidance and training; and (4) internal inspections or auditing. In addition, even in major financial institutions, there was room for improvement in terms of compliance concerning investment banking business and customer management.

Risk management of computer systems was generally established to ensure smooth operation. However, system incidents occurred at some financial institutions that implemented conversion to

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4 In this document, operational risk refers to risks related to overall business operations, including, for example, risks related to business procedure, computer systems, and business continuity.

a shared system, and there was still room for improvement in terms of project management including system renewal or the management of outsourcee companies.

As for business continuity arrangements, major financial institutions steadily established business continuity plans and conducted training, although challenges remained in securing management resources and maintaining the consistency of plans for an organization as a whole. By contrast, for other financial institutions, while the recognition of the necessity of developing business continuity arrangements prevailed, not a few institutions just started to work on developing a framework, and there were problems in terms of effectiveness of business continuity plans. Formulation of plans to address a new type of influenza pandemic remained as a future challenge.

e. Integrated Risk Management and ALM

Regarding integrated risk management, some major financial institutions carried out efficient capital management by utilizing the techniques for management of risks and returns. Many financial institutions were at the stage where they allocated capital to each risk category and verified the capital adequacy. To allocate capital that is consistent with risk-taking strategies and to examine measures when risk exceeds the allocated capital have remained as a future challenge.

Only a few financial institutions were placing stress-testing as an important element for business judgment.

With respect to ALM, major banks and a part of regional financial institutions carried out operations aiming at risk-hedging and improvement in returns, while forecasting a future course of interest rates. Other regional financial institutions stayed at a stage of confirming the interest rate risk situation and the short-term profit outlook. To conduct a simulation of medium- and long-term profits, taking into account future changes in assets and liabilities as well as potential market fluctuations, has remained as a challenge.

3. On-Site Examination Policy for Fiscal 2009

(1) Basic Concepts

As described in Chapter 2, in fiscal 2008, securing the soundness of management was an important objective for many financial institutions, reflecting the impairments of the portfolio such as loans and securities. In the process of the portfolio being impaired, the state of risk management was questioned once again, and the problems underlying in the financial institutions' business strategies and business characteristics were identified. Those became the risk factors in ensuring financial system stability.

Japan's economy in fiscal 2009 is subject to great uncertainty under the continued instability of global financial markets, and the environment surrounding financial institutions management is likely to be more daunting. Against such a backdrop, the fiscal 2009 on-site examination will especially take into account the following points, based on the challenges identified in fiscal 2008.

First, the Bank will check in detail the quality of assets, capital strength and liquidity of each individual institution, and grasp precisely their actual management conditions. On those bases, the Bank will encourage maintenance of sound management through discussions with financial institutions, which will lead to securing the stability of the entire financial system.

Second, as financial institutions are expected to exert stably the financial intermediation function and support corporate and individual activities on the financial front, the Bank will verify and give advice to the development of a basic credit management system necessary to exert the financial intermediation function and to the approaches to ensure the effectiveness of supporting corporate revival.

Third, the Bank will confirm the financial institutions' medium- and long-term directions of management, based on the management bases and business models at the on-site examination in addition to the off-site monitoring. At the on-site examination of a financial institution that has a distinct business model, the Bank will also check whether there are incentives for excessive risk-taking inherited in the business model, and grasp the risk that could spread to the entire financial system. For a financial group that provides, as a whole, a variety of financial services and operates a large scope of businesses, the Bank will check the management policy and the risk management system of the entire group.

Fourth, the Bank will encourage financial institutions to carry out appropriate risk management in line with their business and risk characteristics, and the following points will especially be stressed in the examination for fiscal year 2009.

First of all, amid the surge in various types of risks, a financial institution's governance needs to function effectively to make an appropriate and sensible business judgment corresponding to changes in the external environment. The Bank will examine, in addition to the risk management framework and the state of development of organizations, (1) the management's risk recognition and risk preference, as well as their active involvement in risk management; (2) an information transmission mechanism and internal communication necessary for appropriate business judgment; and (3) functioning of the managing board, the board of directors, auditors, and the internal auditing sections.

Next, in assessing the risk management system, the Bank will make an assessment incorporating the future factors as much as possible by taking into consideration the future plan for risk-taking and responses to changes in the external environment, downside risks, as well as the current risk taken and quality of assets. In making the assessment, the Bank will carry out in-depth discussions with financial institutions by utilizing the techniques such as scenario analysis and stress-testing.

For internationally active financial institutions, the Bank will also focus on checking the global risk management system. Especially, emphasis will be placed on the verification of liquidity risk management, and the verification of the overseas assets and non-resident assets of Japan's financial institutions will be conducted in more detail than before. In addition, the management system in the headquarters on overseas branches, and risk measurement and monitoring on a global base will be confirmed.

Risk measurement including value at risk has shown its limits in the process of the current global financial crisis. However, the risk measurement techniques will continue to be useful as one of the methods of risk management as long as it is appropriately used upon recognizing its limits. Based on such recognition, the Bank will continue to encourage the introduction and utilization of risk measurement techniques as a basic method. In doing so, the Bank will have discussions with each financial institution reflecting its specific situation, the appropriate use of measurement techniques considering its limits, and implementation of supplementary management in case where it is difficult to introduce the method due to the limits of data collection or resource constraints.

(2) Focus in Conducting On-site Examination

In conducting on-site examinations, the Bank especially values the following points based on the aforementioned basic concepts and the current business conditions financial institutions now face.

a. Credit Risk Management

Basic Framework for Screening and Management

The Bank will examine each financial institution's basic framework for screening and management necessary to exert the financial intermediation function properly. Those include whether the financial institution is carrying out detailed screening in line with reality upon a precise understanding of the business situations of the firms and whether the financial institution is conducting appropriate follow-up management, that is, taking necessary measures by grasping timely the changes in business conditions of the firms.

Measures to Improve Effectiveness of Support for Corporate Revival

With the rapid decline in corporate performance, the importance of support for corporate revival has been growing from a viewpoint of supporting firms by financial institutions and maintaining the quality of financial institutions' credit portfolios. The Bank will verify and advise a financial institution whether it is implementing practical revival methods with a sufficient understanding of the firms' situations and making efforts to diversify the revival methods, in addition to establishing the system of corporate revival.

Strengthening Overseas Portfolio Management based on Global Financial Situation

The financial turmoil triggered by the U.S. subprime mortgage problem has also had a huge impact on many economies. The Bank will examine in detail the credits to various areas and debtors during the verification of self-assessment of overseas credits. In addition, the Bank will review each individual financial institution's global credit management system, such as whether the systems for screening and management at overseas bases are sufficiently established, whether the headquarters appropriately monitors those systems and whether it properly controls the credit risk including overseas credit on a global base.

Recognizing and Controlling Credit Concentration Risk

In some financial institutions, the credit concentration risk has materialized and led to a significant increase in credit costs. The Bank will share the recognition of the risk originated from credit concentration by employing stress-testing and then examine whether the management system for controlling credit concentration risk has been established.

Establishment of the System for Mortgage Loan Management based on Economic Conditions

Although mortgages have relatively a small risk as they are diversified in small-lots, their proportion in the credit portfolio has risen in many financial institutions. In addition, considering that some financial institutions have eased the credit management standards, including those of borrower attributes, as the loan competition has become severe, and that the economic environment and employment have been recently deteriorating, mortgage management is one of the fields that are required to be enhanced. In addition to the examination of the portfolio of mortgages, the Bank will verify the risk management system for mortgages from the viewpoints of whether the factors including changes in borrower attributes and the delinquency rate are analyzed and utilized in screening and management.

b. Market Risk Management

Governance for Effective Risk Management

In the recent process of increase in securities losses, there were some cases in which the framework for market risk management such as risk limits and the loss ceiling did not necessarily function effectively. In the on-site examination, in addition to the state of development of the framework and the organization structure for risk management, the Bank will verify whether the governance necessary for effective market risk management is established in; (1) the management's market risk recognition and risk preference, and their active involvement in risk management; (2) an information transmission mechanism and internal communication necessary for appropriate business judgment on market investment; and (3) functioning of the managing board, the board of directors, and various committees.

Sufficiency of Risk Review in the Decision Process of Investment Policy

It is important to assume various changes in the market environment when devising investment strategies. The Bank will examine whether a financial institution, in devising its investment strategies, carries out multifaceted analysis on the possible changes in securities portfolio and investment performance associated with the financial market fluctuations, and check their impact on capital adequacy and profits. Especially, regarding the products with complex risk characteristics, the Bank will verify whether, at the beginning of investment, the financial institution carries out sufficient risk analysis and properly grasp the impact of stress in the risk factors, including interest rates, foreign exchange rates, stock prices and credit spreads, on prices.

Management of Market Risk Associated with Stockholdings

Although financial institutions currently hold less stocks than those in the early 2000s, how to cope with market risk associated with stockholdings remains an important challenge for financial institution management, as seen in the substantial realized and unrealized losses stemming from the recent decline in stock prices. The Bank will examine whether a financial institution sets a certain limit on stockholdings by assuming the stressed situation and whether it holds enough capital against market risk fluctuations. In addition, for a financial institution whose level of market risk associated with stockholdings is high, compared with its capital strength, the Bank will discuss medium- and long-term approaches for risk reduction.

Measurement and Evaluation of Market Risk

The measurement of market risk by methods such as value at risk is useful, as it not only enables proper securities investment consistent with the risk but also can be utilized for hedge operations. However, in the process of the recent global financial crisis, the limits of risk measurement were revealed in some areas as seen in the facts that market fluctuations greatly exceeded the risk amount based on the past price fluctuations, and that it was difficult for some products to factor market liquidity risk into the risk measurement. While the Bank will encourage financial institutions to introduce risk measurement techniques as the basic method of market risk management, the Bank will examine whether financial institutions fully understand the limits of risk measurement and they capture the risk from various angles, such as the results of stress-testing, macroeconomic analysis, and analysis of actual trading examples, without relying only on single risk measuring outcome. The Bank will also check whether the prices of securities and derivatives are properly evaluated and the system for verifying those prices is established.

c. Liquidity and Payment and Settlement Risk Management

Liquidity Risk Management based on the Situation of Financial Markets

For internationally active major financial institutions, the Bank will request that an appropriate level of liquidity risk management system including that of foreign currencies be established. Examples of the system are (1) setting and verifying the appropriate risk tolerance based on businesses and risk characteristics, (2) establishing the governance for liquidity risk management and (3) formulating robust and effective liquidity contingency plans that incorporate various stress scenarios[5].

For foreign financial institutions, taking factors such as Japan bases' businesses and their position in each financial group into consideration, the Bank will make inquiries on the global liquidity management system as well as liquidity management at Japanese local bases.

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[5] The Bank will also refer to the "Principles for Sound Liquidity Risk Management and Supervision" issued by The Basel Committee on Bank Supervision in September 2008.

Counterparty Risk Management

As the market risk and the credit risk have heightened, the importance of management of counterparty risk that arises from derivative trading has been increasing. In the on-site examination, the Bank will examine the basic management of counterparty risk, such as counterparty screening and associated follow-up management, exposure ceiling management and exposure measurement.

d. Operational Risk Management

Ensuring PDCA cycle

With regard to operating procedures and compliance, it is important to ensure the PDCA cycle, that is: (1) identifying the risks by using the information of inside and outside of a financial institution, accidents, operational errors and complaints; (2) developing a organization, computer system and internal rules based on the aforementioned identification; (3) monitoring the performance of operations; and (4) conducting necessary measures for improvement. In the on-site examination, the Bank will examine not only the performance of operational procedures but also whether the PDCA cycle is secured, taking into account the self-assessment of financial institutions.

Computer System Risk Management According to Changing Environment

The outsourcing of computer systems and conversion to a shared system development among several regional financial institutions have been prevailing. In the on-site examination, the Bank will examine the management of outsourcee companies including re-outsourcee and the management of various projects including the conversion to the shared system development, in conjunction with the investigation of the outsourcee companies and joint operation centers.

Development of Business Continuity Arrangements Based on Specific Conditions of Each Financial Institution

Establishing an effective business continuity arrangement has become one of the most important management issues for financial institutions. In the on-site examination, upon confirming the institution’s posture toward the development of the arrangements, the Bank will encourage the improvement of the business continuity arrangements based on specific conditions of each financial institution. Especially, for those financial institutions with their great presence in the payment and settlement system, the Bank will conduct in-depth examinations of the sufficiency and consistency of the contents of the business continuity plans and their effectiveness including securing management resources, carry out discussions focusing on interdependencies with other firms' business continuity plans, in view of street-wide exercises. For the rest of the financial institutions, the Bank will confirm the priority sequence of business continuity in terms of management challenges, and provide necessary advice in line with the level of the establishment of the business continuity plan.

In addition, with respect to the business continuity plan assuming a scenario of a new influenza, the Bank will encourage the establishment of appropriate arrangements upon confirmation of the state of its development.

e. Business Administration

Importance of Internal Audit

Internal audit plays an important role in effectively functioning internal control, which is a basis for ensuring the soundness of financial institution management. In the on-site examination, with regard to a financial institution's internal audit, the Bank will examine whether the financial institution conducts audit taking into account the major risks, whether audit results are properly reported to the management, and whether the results are properly followed up. In addition, the Bank will confirm whether the management appropriately assesses the functioning of internal audit and make improvements as necessary.

Ensuring Capital Adequacy under Integrated Risk Management

In the on-site examination, the Bank regards the issue of integrated risk management as a useful communication tool to discuss with financial institutions on risk profiles and capital adequacy. The Bank will confirm the framework of integrated risk management and how it is utilized, including the appropriateness of risk measurement, the monitoring system and the response when the risk exceeds the limits. For those financial institutions that are developing integrated risk management, the Bank will discuss the issues to be considered in the introduction and utilization as well as the procedures for developing the framework.

Utilizing Stress-Testing

Stress-testing is an important measure that complements the limits of risk measurement and confirms financial institutions' risk tolerance and capital adequacy. For those financial institutions with advanced utilization of integrated risk management, the Bank will confirm[6] the method of stress-testing and the utilization of its results, which includes whether cross-organizational stress-testing is conducted by factoring in market developments and financial institution’s intrinsic stress and the results are reflected in the decision making by the management. For the rest of the financial institutions, the Bank will discuss the setting of stress scenarios based on risk characteristics and, when necessary, will encourage them to entrench stress-testing.

f. Profit and Capital Strength

Assessment of Profitability and Capital Strength

For financial institutions to conduct stable operations such as lending and securities investment, it is critical to ensure core profitability and reinforce capital.

In the on-site examination, the Bank will grasp the financial conditions of financial institutions on the basis of asset-assessment results. In addition, the Bank will evaluate the current and future profitability and capital strength by assuming several scenarios including stress conditions. Based on the results of those evaluations, the Bank, when necessary, will discuss strengthening of profitability and measures to reinforce capital adequacy.

(3) On-site Examination Management

From the fiscal 2008 on-site examination, against a background of improvements in the analytical capability of off-site monitoring, the Bank introduced “risk-based on-site examinations.” In them, the frequency, the scope, and the number of examiners will be prioritized based on a comprehensive assessment from two perspectives; (1) the impact that each individual financial institution’s risks would have on the financial system, should they surface, and (2) actual management conditions of the financial institution, such as its capital strength and the state of risk-taking.

Specifically, for major financial institutions that have a substantial impact on the financial system, on-site examinations will be enhanced by utilizing off-site information in response to rapid changes in the surrounding environment and businesses, the increasingly complex risk characteristics associated with such changes, and the evolution of risk management methods. For financial institutions that have a relatively small influence on the financial system and are soundly

[6] The Bank will also refer to the consultative paper "Principles for sound stress testing practices and supervision" issued by The Basel Committee on Bank Supervision in January 2009.

operated and managed with sufficient capital strength relative to the risk amount, the Bank will basically grasp the financial institutions' business and risk conditions through off-site monitoring, and, based on the information obtained, will conduct on-site examinations in an agile manner. In such cases, the Bank will utilize targeted on-site examinations that the scope to the risk areas that warrant special scrutiny.

The Bank will continue to strive for conducting efficient on-site examinations and gain thorough understanding from examinees about their results. Specifically, the Bank will review the required documents for on-site examinations considering the operational burden of examinees, and intends to improve the function of the online system through which the documents concerning on-site examinations are exchanged. In addition, the Bank will improve[7] the procedures for arrangements that examinees can present their opinions after the examination. Moreover, with regard to the "survey of on-site examinations" conducted on the examinees after the on-site examination period, the Bank will make better use of it upon enriching its contents.

7 For example, the Bank has made it compulsory to attach auditor's view to the examinee's opinion, but will revise to make it voluntary.