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Bank of Japan

On-Site Examination Policy for Fiscal 2019

1. On-Site Examination by the Bank of Japan

The Bank of Japan (hereafter, the Bank) formulates the on-site examination policy every fiscal year based on the decision of the Policy Board.[1] This document, "On-Site Examination Policy for Fiscal 2019," briefly reviews on-site examinations carried out in fiscal 2018 and outlines the basic approach and key issues in the conduct of on-site examinations in fiscal 2019. The Bank will conduct on-site examinations in fiscal 2019 on the basis of this document.

2. On-Site Examinations in Fiscal 2018 and General Observations

(1) On-Site Examinations in Fiscal 2018

The Bank carried out on-site examinations of 91 financial institutions in fiscal 2018: 29 domestically licensed banks, 54 *shinkin* banks, and 8 other institutions, including securities companies as well as Japanese branches and subsidiaries of foreign banks.[2]

Number of Financial Institutions Examined

(number of entities)

	Fiscal 2016	Fiscal 2017	Fiscal 2018
Domestically licensed banks	33	29	29
Shinkin banks	37	54	54
Other institutions	15	17	8
Total	85	100	91

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

[2] "Securities companies" in this document refers to firms that conduct securities-related business activities among those classified as Type I Financial Instruments Business in Article 28 of the Financial Instruments and Exchange Act.

(2) Issues Observed in On-Site Examinations

In the fiscal 2018 on-site examinations, the Bank reviewed financial institutions' business operations and asset quality, and examined the effectiveness of their business management and risk management. In particular, the Bank focused on ascertaining and assessing their profitability and framework for managing profitability given that the profitability of domestic deposit-taking and lending activities continues to decline due to structural factors such as the continuing decline in the population and the number of firms and to the prolonged low interest rate environment.

To strengthen their profitability, financial institutions have continued to actively take on risk -- in terms of credit risk, for example, through loans to middle-risk firms and real estate loans, and in terms of market risk, through investments in investment trusts and foreign securities, which involve a variety of risk factors. Moreover, in terms of business efficiency, an increasing number of financial institutions have started to make efforts toward improving efficiency such as reviews of branch networks and staff allocations as well as the utilization of digital technology. Major financial institutions have continued to strengthen group strategies and expand their overseas activities.

Financial institutions have continued to improve their business management and risk management frameworks. However, there were still cases where financial institutions (1) had not sufficiently examined and implemented a review of their management frameworks despite changes in their risk profiles in line with their more active risk taking in various areas, (2) had not sufficiently ascertained the medium-term profitability nor had they fully managed the profitability of various efforts (in terms of the balance of costs and risks on one hand and returns on the other) despite the continuing decline in profitability, (3) had not established frameworks that allow flexible decision making in the event of sudden changes in financial markets at home and abroad, and/or (4) had not sufficiently addressed cyber security issues.

Under these circumstances, financial institutions' capital levels are adequate relative to the amounts of various types of risk they undertake, and financial institutions have sufficient capacity to absorb losses. However, regional financial institutions' capital adequacy ratios have been declining moderately in recent years because making profits commensurate with the increase in risk assets has become difficult.

3. On-Site Examination Policy for Fiscal 2019

(1) Basic Approach

Financial institutions are expected to contribute to corporate and household economic activities, and ultimately to raising the growth potential at both the national and regional levels by ensuring the appropriate functioning of financial intermediation. To perform this role, financial institutions need to secure solid financial bases and to adopt a proactive approach toward risk taking based on clearly defined business strategies. For the purpose of achieving both in a balanced manner, it is essential for them to appropriately manage risks as well as secure profitability. Efforts such as these are particularly important for regional financial institutions, as domestic deposit-taking and lending activities -- for which profitability is on a declining trend, reflecting structural factors such as the persistent decline in the population and the number of firms -- account for a large share of their business.

Major financial institutions are proceeding with efforts to improve profitability by increasing the efficiency of their domestic deposit-taking and lending activities on the one hand, while on the other hand expanding their overseas activities, including through inorganic growth strategies involving acquisitions and investments, as well as further strengthening the cross-selling of services across commercial banks, securities companies, trust banks, etc., belonging to the same holding company. Major financial institutions, which are of systemic importance, have a greater need to secure a solid financial base and bolster their business management frameworks, taking changes in their business operations and risk profiles into account, and to prepare to respond to a stress event in an orderly manner.

Meanwhile, financial institutions, regardless of their type, have started to make strenuous efforts to promote digitalization, such as through the provision of new customer services utilizing digital technology and the reengineering of business processes to improve their management efficiency. An increasing number of financial institutions have been taking measures for cashless settlement, making use of cloud computing and artificial intelligence (AI), and introducing robotic process automation (RPA) for routine tasks. This spread of digitalization has the potential to significantly change the way a wide range of financial services are provided as well as the competitive environment for financial institutions, such as through entrants from other industries. Going forward, it is expected that financial institutions will respond positively to these developments and bring about an improvement in their profitability. At the same time, they need to strengthen their operational risk management frameworks, as cyber security and information management will be of increased importance resulting from the adoption of digital technology.

Against this background, and based on the challenges identified in the fiscal 2018 on-site examinations, the Bank intends to conduct the fiscal 2019 on-site examinations from the following perspectives.[3]

First, the Bank will ascertain and assess financial institutions' profitability and financial strength, including the prospects going forward, based on how the board of directors and senior management view the external environment, including financial and economic conditions at home and abroad, and what their medium- to long-term business strategies are. The Bank also will examine their stress resilience.

In doing so, the Bank will deepen its dialogue with the board of directors and senior management on (1) whether their view of medium- to long-term profitability is appropriate, and (2) whether they are taking appropriate measures to secure sustainable profits and ensure sufficient financial strength, including measures to increase non-interest income, to improve management efficiency, and to make strategic investment. In addition, the Bank will examine (3) the status of profit management frameworks as to whether financial institutions appropriately conduct risk-return analyses with regard to loans and securities investments as well as analyses of profitability by business sector and by region. Moreover, (4) given that credit costs have started to increase, the Bank will examine financial institutions' prospects for the incurrence of credit costs commensurate with changes in the financial and economic environment, etc., and then will deepen its dialogue with these institutions regarding appropriate methods of write-offs and loan-loss provisions. Furthermore, (5) the Bank will examine whether financial institutions appropriately assess the impact of various assumed stress events on equity capital and profits and thereby put countermeasures in place.

[3] In doing so, the *Financial System Report* will be referred to for analysis and evaluation of risks in the overall financial system in Japan.

Moreover, regarding financial institutions with recognized concerns about their future profitability and financial strength, the Bank will focus its dialogue with the board of directors and senior management on the capital levels necessary to perform their financial intermediation functions in a stable manner into the future as well as their management policies to secure such capital levels, including their capital policies for the utilization of unrealized gains on securities and dividend distributions. Further, the Bank will maintain dialogue with the top management of such institutions on these issues of profitability and financial strength in off-site monitoring after completion of on-site examinations.

Second, the Bank will review financial institutions' current and future risk profiles and then examine financial institutions' resilience against risks.

With regard to credit risk, the Bank will examine loans to middle-risk firms and real estate loans as many financial institutions have been making efforts to increase loans to these areas. With regard to market risk, the Bank will examine risks involved in securities portfolios as financial institutions have actively engaged in risk taking; for example, major financial institutions invest in foreign credit instruments such as collateralized loan obligations (CLOs) and regional financial institutions invest in investment trusts. With regard to operational risk, the Bank will examine, for example, the status of establishing frameworks for cyber security management and anti-money laundering controls, both of which have gained importance. Moreover, the Bank will examine risks in major financial institutions' overseas activities from a range of perspectives including credit risks and the stability of foreign currency funding.

Third, the Bank will examine the status and effectiveness of the governance framework necessary to ensure the effectiveness of business management and risk management, including holding companies' business management function and the function of internal audits. In particular, in the case of major financial institutions with global activities, the Bank will review their plans for inorganic growth strategies for overseas activities and group-wide business strategies; at the same time, it will focus on examining the governance framework and management information systems on a group-wide basis where holding company structures are being used.

Fourth, the Bank will maintain its basic policy, which is to conduct on-site examinations in a flexible and efficient manner in accordance with observed risks as well as their effects. On this basis, in addition to "regular on-site examinations," the Bank will conduct "targeted on-site examinations," which limit the scope of examinations. In fiscal 2019, the Bank will conduct the "targeted on-site examinations" that focus on the examination of profitability given the declining trend in regional financial institutions' profits. In doing so, it will include the management of credit risk or market risk in the scope of examinations, depending on the status of individual financial institutions' risk taking. Moreover, with regard to financial institutions that provide a wide range of financial services not only domestically but also internationally on a group basis, major group companies, including their overseas branches and subsidiaries, will be subject to the on-site examinations as necessary.

(2) Key Issues in the Conduct of On-Site Examinations

a. Profitability and Financial Strength

Securing of Sustainable Profits and Sufficient Financial Strength

In order to continue to stably perform financial intermediation functions into the future, it is important for financial institutions to maintain their financial strength by securing their profitability; that is, the ability to acquire sustainable profits.

Major financial institutions have stepped up their global activities and increasingly have been unifying the operations of domestic and international group firms. They also have been pushing ahead with strengthening group-wide profitability and diversifying their revenue sources, led by division headquarters of business areas that are common across group companies. In the on-site examinations, the Bank will examine, for example, their global activities, the functioning of their headquarters, efforts in a wide range of financial services, including their links with FinTech firms, and business process reengineering aimed at raising management efficiency. It will then ascertain and assess group-wide profitability. Moreover, the Bank will examine the status of preparations for the adoption of international financial regulations.

In the on-site examinations of regional financial institutions, the Bank will confirm whether the board of directors and senior management adequately ascertain that profits are sustainable and financial strength are sufficient over the medium to long term and have implemented measures to maintain and improve profits and financial strength. Moreover, the Bank will conduct simulations of regional financial institutions' profitability and ascertain and assess the sustainability of their profits and the sufficiency of their financial strength. Meanwhile, with regard to financial institutions with a large amount of unrealized losses on securities holdings, the Bank will confirm their policies to address the issue. In the on-site examinations of regional financial institutions belonging to a holding company, the Bank will deepen its dialogue with these institutions and the holding company regarding the status of implementing measures to produce positive effects of business integration, as well as the effectiveness and challenges of such measures.

The Bank also will examine whether both major and regional financial institutions appropriately assess the impact of various assumed stress events on equity capital and profits and thereby put countermeasures in place. In doing so, the Bank will confirm with the board of directors and senior management their awareness of issues regarding profitability and financial strength as well as policies to improve these, by presenting profitability and financial strength simulation results under certain standard stress scenarios. The Bank will deepen its dialogue with financial institutions by providing, as necessary, the results of its macro stress testing for individual financial institutions.

Enhancing Profit Management

In the on-site examinations of major financial institutions, the Bank will confirm the status of efforts to improve efficiency in domestic deposit-taking and lending activities, for which profitability is on a downward trend. The Bank also will examine these institutions' framework for profit management under, for example, the intensified competition with U.S. and European financial institutions and the rise in foreign currency funding costs.

For regional financial institutions, improving the profitability of domestic deposit-taking and lending activities has become a key management challenge, as such activities account for a large share of their business. In the on-site examinations, the Bank will examine whether financial institutions have established management frameworks to appropriately assess the profitability of their deposit-taking and lending activities, their regional strategies, and branch operations.

b. Governance

Business Management Based on an Optimal Balance between Equity Capital and Profitability on the One Hand and Risk Taking on the Other

To ensure the soundness of their business, it is important for financial institutions to analyze the impact of any materialization of risk on their equity capital and profits and, based on such analyses, systematically review their risk-taking policy and risk management frameworks.

Particularly in recent years, financial institutions have been experiencing a decline in profitability of domestic deposit-taking and lending activities, and have actively been increasing risk taking. Therefore, there has been an increasing need for financial institutions -- depending on their business scope, etc. -- to establish and appropriately operate frameworks (including a so-called risk-appetite framework) with involvement of the board of directors and senior management, to (1) clarify what profits they should aim at and what risks they should take, and thereby devise business strategies and plans, (2) continuously monitor the amount of risk, profits, and capital in implementing the plans, and (3) adjust management strategies and business plans in an appropriate and timely manner in response to changes in the environment.

In the on-site examinations, the Bank will examine whether financial institutions verify the adequacy of business strategies and plans, etc. through, for example, the use of asset-liability management (ALM) and risk allocation frameworks as well as profitability and efficiency management frameworks, and whether they conduct necessary reviews based on the verification results. The Bank will then encourage the establishment of Plan-Do-Check-Act (PDCA) cycles for business operations. It also will examine whether financial institutions develop business plans, manage their profits, and implement capital policies, including those for dividend distributions by appropriately taking capital costs into account, and will hold a dialogue with the board of directors and senior management on the direction of future operations. In doing so, the Bank will keep in mind the difference in characteristics between banks, which is corporations, and cooperative financial institutions, whose mission is to provide mutual assistance among their members.

The Bank also will examine whether financial institutions have analyzed the possible impact on equity capital and profits in the event of sudden changes in financial and economic conditions, including through the use of stress testing, and have considered appropriate responses. With regard to stress testing, the Bank will examine the following: (1) the involvement of the board of directors and senior management and the control functions of the relevant sections in charge of such activity; (2) the comprehensiveness of scenarios and coverage of the subjects of the stress testing; (3) the development of models and data and the verification systems for them; and (4) frameworks to utilize test results for business operations and the decision on management policies including risk-taking policies. Regarding Global Systemically Important Financial Institutions (G-SIFIs) and their equivalents, the Bank will examine the effectiveness of recovery plans and contingency plans.

With the focus of international discussions on financial regulation shifting from formulation to implementation, the Bank will confirm, as necessary, the status of planning and preparations for newly introduced regulations as well as responses to local regulations abroad.

Ensuring the Effectiveness of Governance

With regard to financial institutions' business management and risk management, in order to make them effective, the board of directors and senior management need to develop a framework of governance that is suitable for business strategies, the diversified contents of business, customer bases, risk profiles, etc., and ensure its effectiveness.

In the on-site examinations, the Bank, in the case of major financial institutions, will focus on examining whether they have established group-based governance frameworks that are appropriate for their initiatives to expand overseas activities and further strengthen the cross-selling of services across commercial banks, securities companies, trust banks, etc., belonging to the same holding company. Moreover, in the case of regional financial institutions, the Bank will focus on examining whether they have established governance frameworks that make it possible to appropriately control risk taking in their lending and securities investments and the promotion of management efficiency. In the on-site examinations of regional financial institutions belonging to a holding company, the Bank will examine the effectiveness of holding companies' business management function. When examining the effectiveness of governance, the Bank will conduct interviews with external directors and so forth as necessary.

Confirmation of the Governance Framework at Overseas G-SIFIs' Japanese Branches

With regard to overseas G-SIFIs' Japanese branches and subsidiaries, the Bank will examine whether they have established an appropriate management framework in line with their business and major efforts, while understanding the roles of their Japanese branches and subsidiaries within their group. On this basis, the Bank will examine (1) impacts on Japanese branches and subsidiaries under the assumption of stress events for the group as a whole and responses to them, and (2) the role of Japanese branches and subsidiaries within the recovery and resolution plans, including their involvement in these matters. Regarding those subsidiaries with corporate status in Japan, the Bank also will examine the support system provided by headquarters in the event of a deterioration in business conditions. If yen funding is managed by bases other than Japanese branches and subsidiaries, (3) the Bank will confirm the state of the management of the bases and their system of communicating with the Bank in preparation for unexpected contingencies. Moreover, (4) the Bank will conduct examinations, including the collection of information from their headquarters, of the impact on the Japanese financial system in the case of assumed stress events for the group as a whole.

Proactive Improvement of Risk Management with Internal Audits

Internal audits, by ascertaining and assessing business operations from a standpoint that is independent of operational divisions, the risk management division, etc., have an important function in the management of financial institutions in that they ensure that business is conducted properly and risk management is improved proactively.

In the on-site examinations, the Bank will examine the following: (1) whether the board of directors and senior management appropriately decide the scope of internal audits and allocate audit resources based on recent risk taking, etc.; (2) whether the internal auditors adequately audit businesses; and (3) whether the board of directors and senior management make the most of auditors' observations and recommendations regarding their business management. To improve the effectiveness of on-site examinations, the Bank will conduct hearings with internal audit sections before on-site examination, if necessary.

Establishment of Management Information Systems

It is important for financial institutions to appropriately set up and employ mechanisms to gather the information necessary to manage business operations and risks. For financial institutions that offer a wide range of financial services on a group basis at home and abroad, it is important to appropriately assess in a timely manner various kinds of information with regard to operating in multiple regions and business sectors.

In the on-site examinations, mainly with regard to major financial institutions, the Bank will examine, concerning the global and group-wide financial information and risk information required for the board of directors and senior management to make appropriate management decisions, (1) whether they have appropriately set up mechanisms to gather the necessary information, such as a management information system (MIS), (2) whether sufficient management resources are allocated to this end, and (3) whether the comprehensiveness, reliability, and timeliness of information are appropriate. In doing so, the Bank also will confirm the status of preparations for changes in institutional frameworks that could affect management, such as international financial regulations.

c. Credit Risk Management

Appropriate Credit Screening and Monitoring, and Establishment of a Framework Compatible with Lending Strategies

Given their increasingly active stance toward taking credit risks to improve profitability, financial institutions need to more appropriately assess the actual conditions of borrowers, and further ensure that credit screening and monitoring frameworks compatible with their lending strategies are in place. Moreover, given that credit costs have started to increase, it is important for financial institutions to examine such loans in terms of their profitability, taking into account a possible future increase in credit costs, etc.

In the on-site examinations, the Bank will focus its examination on sectors in which financial institutions have increased loans outstanding; such sectors for major banks include loans related to large cross-border M&As, and those for regional financial institutions include loans to middle-risk firms, real estate loans, and loans in prefectures other than their head offices are located. In doing so, the Bank will examine, including through selected loan reviews ("line sheet reviews"), (1) whether financial institutions properly assess the viability of borrowing firms' business in conducting credit screening, taking account of such factors as lending periods and business characteristics, and (2) whether they properly ascertain changes in business conditions of borrowers and their financial condition after loan extension. In addition, the Bank will examine (3) whether they conduct a review of the profitability of lending portfolios to these sectors.

Strengthening the Management of Credit Exposure with Respect to Overseas Activities

Major financial institutions are continuing to make efforts to expand their overseas activities. Moreover, some regional financial institutions have increased their overseas-related credit through, for example, lending to existing customers for their overseas business and joining syndicated loans. Against this background, some developments in overseas credit markets warrant attention in terms of risk management, such as the expansion of the markets for loan-related instruments -- including CLOs and leveraged loans -- and the relaxation of covenants. For this reason, it is increasingly necessary to strengthen the management of credit exposure with respect to overseas activities and ensure resilience to changes in financial and economic conditions abroad.

In the on-site examinations of major financial institutions that have focused on overseas-related credit, the Bank will examine (1) while making use of line sheet reviews, whether financial institutions have adequately conducted credit screening and monitoring of large exposures, mainly to non-Japanese firms, as they have focused on such areas in recent years; (2) whether they have appropriately managed their origination and distribution operations of loan-related instruments; (3) whether financial institutions' headquarters have set out rules for credit risk management, including reporting procedures that apply on a global basis and appropriately monitor the status of compliance with such rules; (4) whether the headquarters adequately review credit risk-taking policies on a global basis by making use of stress testing; and (5) whether they conduct appropriate profit management taking into account foreign currency funding costs. In the on-site examinations of regional financial institutions with particularly large foreign currency lending, the Bank will examine the status of their credit screening and monitoring, as well as their profitability that takes into account foreign currency funding costs.

Strengthening the Management of Large Exposures/Concentration Risk

In the on-site examinations, the Bank will examine (1) including through line sheet reviews, how financial institutions comprehend the actual conditions of large-lot borrowers, conduct credit screening and monitoring, including of the accuracy of self-assessments, and secure appropriate write-offs and loan-loss provisions. In addition, the Bank will examine (2) whether financial institutions properly ascertain the status of large exposures/concentration risk in their credit portfolios, using measures such as stress testing, and on this basis (3) whether financial institutions have developed frameworks to control large exposures/concentration risk, taking into account their equity capital, etc., and ensure their effectiveness.

Appropriate Write-Offs and Loan-Loss Provisions

It is increasingly important to accurately ascertain the prospects for future credit costs as these costs have started to increase amid the continued decline in financial institutions' core profitability. In the on-site examinations, including through line sheet reviews, the Bank will examine the prospects for the incurrence of credit costs that take into account the amounts of loans that are reasonably assumed to be defaulted or uncollectible based on financial institutions' credit stance, the risk characteristics of their credit portfolios, and financial and economic conditions. The Bank will then deepen its dialogue with financial institutions regarding the appropriate methods of write-offs and loan-loss provisions.

Support for Enhancing the Vitality of Firms

Financial institutions are expected to contribute to enhancing the vitality of firms by continuously supporting the efforts of borrowing firms to resolve their management challenges. In the on-site examinations, the Bank will examine (1) whether financial institutions adequately analyze the current business conditions and future prospects of the borrowing firms and share an awareness of the management challenges with them, and (2) whether financial institutions' headquarters and branches are cooperating in offering advice, recommendations, and support to help borrowers overcome challenges. Furthermore, the Bank will examine, (3) with regard to borrowers with unstable business conditions, whether financial institutions are making efforts toward more drastic solutions for management challenges by cooperating with other financial institutions and outside specialists.

d. Market Risk Management

Adequate Involvement of the Board of Directors and Senior Management in Market Risk Management

Financial institutions have taken an active stance toward taking market risks amid the prolonged low interest rate environment, and thus there has been an accumulation and growing complexity of market risks.

Major financial institutions have engaged in risk taking by investing in not only investment trusts but also foreign credit instruments such as CLOs and leveraged loans.

Regional financial institutions increasingly have been purchasing such products as multi-asset investment funds and other investment trusts, foreign bond ladder funds, privately placed real estate investment trusts (REITs), and structured bonds. Thus, the complexity and diversity of risk factors inherent in their securities portfolios have further increased, ranging from domestic and overseas interest rate risk to credit risk, stock price risk, and foreign exchange risk. Some regional financial institutions have started the securities investment that aims at realizing gains from trading. In terms of profits, the share of interest and dividend income from financial institutions' holdings of securities other than yen-denominated fixed rate bonds has been rising, and thus changes in global market conditions and in corporate earnings have an increased impact on financial institutions' overall profits through fluctuations in dividends on investment trusts and stocks. Furthermore, at a relatively large number of regional financial institutions, unrealized gains on securities have followed a downward trend as a result of successive sales of securities to realize gains, as well as the impact of recent changes in market conditions at home and abroad.

Under these circumstances, it is important for the board of directors and senior management to be accurately aware of the profitability of securities portfolios and risks involved in such portfolios by risk factor, and thereby take a lead in the establishment of a framework to appropriately manage risk taking based on equity capital and profitability.

In the on-site examinations, the Bank will examine whether financial institutions, with involvement of the board of directors and senior management, formulate risk-taking polices and investment plans by accurately ascertaining the risks associated with changes in realized gains/losses, unrealized gains/losses, and interest and dividends on securities, and by examining the tolerance of these risks relative to the financial institutions' equity capital and profits.

Market Risk Management Commensurate with Risk Profiles

Market risk management should be commensurate with the risk profiles and investment methods of securities portfolios and off-balance transactions.

In the on-site examinations, the Bank will examine the following: (1) whether financial institutions have developed risk management frameworks such as those for setting various limits and whether these are appropriately reviewed as necessary; (2) whether the risk management division monitors the market prices of securities, the amount of risk, and observance of various limits with proper granularity in accordance with the risk characteristics, investment methods, hedging policies, etc.; (3) whether frameworks of risk management are functioning effectively in line with stress scenarios; and (4) whether, in the event of sudden changes in financial markets at home and abroad, the board of directors and senior management receive reports on changes in risks and reach decisions

-- such as with regard to whether to cut losses -- in a timely manner based on the future impact of such changes on equity capital and profits.

e. Liquidity Risk Management

Liquidity Risk Management Commensurate with Risk Profiles

To ensure stable liquidity management, it is necessary for financial institutions to (1) ascertain the structure of their funding and investment portfolios and set appropriate risk limits and (2) establish a framework for monitoring and controlling risks to observe the limits. Moreover, it is necessary for them to (3) understand the funding conditions in normal times while establishing a framework to respond promptly to changes in the environment by ensuring sufficient liquidity reserves for emergencies. Further, (4) it is important for internationally active financial institutions to implement appropriate management of foreign currency liquidity risks, including local currency risks, as well as enhance stable funding bases, at their overseas branches and subsidiaries and at their financial groups as a whole.

In the on-site examinations, the Bank will examine the situation of liquidity risk management from the above-mentioned standpoint. In particular, with regard to internationally active financial institutions, the Bank will examine the following: (1) whether financial institutions appropriately and in a timely manner ascertain the current and prospective funding conditions in terms of different currencies and locations, as well as risk factors such as with regard to liquidity funding in times of stress, and (2) whether, for the financial group as a whole, they diversify periods and methods for stable foreign currency funding, as well as implement analyses of the stickiness of deposits by type of customer, deposit amount, and interest rate level. Moreover, the Bank will examine the sufficiency of stress testing and the effectiveness of liquidity contingency plans, including (3) whether the conduct of liquidity stress testing is consistent across the financial group and (4) whether financial institutions assume specific amounts of foreign currency outflow with the lapse of time, secure corresponding funding tools, and conduct an institutional review of their appropriateness.

Moreover, with regard to regional financial institutions, the Bank will examine their management of yen liquidity risk while confirming their deposit interest rate setting, depositor characteristics, balance of amounts outstanding of deposits, loans, and securities, holdings of highly liquid assets, etc., in light of the aging and shrinking of the population in their customer base. In addition, with regard to regional financial institutions that have become active investors in foreign currency-denominated assets, the Bank will examine as necessary the sufficiency of stress testing as well as the management of foreign currency liquidity risks, including the effectiveness of emergency responses, etc.

f. Operational Risk Management[4]

Establishment of Risk Management Frameworks Based on Advances in Digitalization

An increasing number of financial institutions, regardless of their type, have started to step up digitalization efforts to improve business efficiency and profitability. These efforts aim to reengineer business processes and provide new customer services, such as by making use of open application programming interfaces (APIs) and cloud computing and by introducing RPA. Some financial institutions have concentrated back-office operations by transferring those of branches to headquarters and operation centers. Financial institutions need to establish risk management frameworks in line with the changes in operational risk profiles resulting from these developments.

In the on-site examinations, the Bank will confirm (1) how financial institutions have placed digitalization progress in their business strategies and how they plan to make the most of such progress to reengineer business processes and/or develop new business. The Bank will then examine (2) whether financial institutions adequately recognize changes in the risk profiles of these business processes and (3) how they have established and reviewed risk management frameworks in response to changes in risk profiles from the perspective of both risks related to business procedures and those related to IT systems. In doing so, it also will examine (4) financial institutions' assessment of the cost-effectiveness of efforts to reengineer business processes and/or develop new business from a profitability perspective. In addition, the Bank will examine (5) the stability of processing of operations that would have a substantial impact on business

[4] In the on-site examinations, operational risk refers to risks related to overall business operations, including, for example, risks related to business procedures, compliance, IT systems, and business continuity.

management in the event of the materialization of risks, including in terms of compliance. It also will examine whether financial institutions identify risk management issues through assessments of the processing of operations and analysis of fraud and accidents, and take effective remedial steps against such events.

Establishment and Strengthening of Cyber Security Management Frameworks

It is increasingly important for financial institutions to ensure cyber security in providing customer services utilizing digital technology in a safe and stable manner.

In the on-site examinations, the Bank will examine whether financial institutions have put in place cyber security management frameworks, with the board of directors and senior management being adequately informed and involved. In this regard, the Bank also will examine (1) the appropriateness of the collection and sharing of information, and (2) the appropriateness of the management of access rights for important data such as customer information. The Bank will then examine the effectiveness of measures to prevent various types of cyberattacks and limit damage caused by such attacks on critical IT systems and external networks connected to these systems, taking into account individual financial institutions' businesses and their presence in the payment and settlement systems. Moreover, given that it is difficult to prevent cyberattacks completely, it will examine the effectiveness of frameworks and contingency plans in preparation for the occurrence of cyber incidents, the implementation of drills, and the review of management frameworks reflecting the outcomes of such drills. In doing so, the Bank also will examine, as necessary, the management of financial institutions' group companies and outsourced companies that have access to these institutions' important information.

Establishment and Strengthening of IT Risk Management Frameworks

To ensure the reliability and security of IT systems, financial institutions need to ensure not only cyber security but also the effectiveness of (1) measures to prevent IT system failures and recovery frameworks in the event of a failure, (2) project management, (3) information security management, and (4) management of outsourced companies.

In the on-site examinations, the Bank will examine the above-mentioned points focusing on critical IT systems and confirm the effectiveness of IT governance to ensure their effectiveness. In this regard, it also will examine whether financial institutions (1) conduct management corresponding to their use of new technologies and services, (2) have secured the effectiveness of management frameworks for confidential information pertaining to, for example, customers, and (3) allocate management resources appropriately.

Strengthening Anti-Money Laundering Controls

Given strong international requests to take measures specific to anti-money laundering and counter-terrorism financing, it is essential for Japanese financial institutions to steadily implement these measures to ensure the proper conduct of their business operations and also to maintain their credibility. In the on-site examinations, the Bank will examine whether financial institutions, with the appropriate involvement of the board of directors and senior management, have steadily developed frameworks in these areas by taking into account a possible impact in the event of the materialization of risks.

Enhancing the Effectiveness of Business Continuity Management

The development of effective business continuity management is important to ensuring financial institutions' critical operations, as well as the smooth functioning of the payment and settlement systems in Japan. For this reason, in the on-site examinations, the Bank will examine, taking account of individual financial institutions' types of business, as well as these institutions' presence in payment and settlement systems and in their respective regions, whether business continuity management is reviewed proactively in response to changes in the environment, such as those caused by natural disasters that have occurred recently, and these institutions' business operations.

(3) Operations of On-Site Examination

a. Enhancing of Efficiency and Effectiveness

The frequency, length, and scope of the Bank's on-site examinations, as well as the number of examiners involved, have been determined on the basis of a comprehensive assessment of individual financial institutions from two perspectives: (1) the impact on the financial system of the materialization of risks for a particular financial institution and

(2) the financial soundness of financial institutions, such as their capital adequacy and profitability, as well as the degree of risk taking.

In fiscal 2019, in addition to "regular on-site examinations" to comprehensively examine and assess -- through on-site visits over a period of about three weeks -- the business conditions and risk management frameworks of financial institutions, the Bank will conduct "targeted on-site examinations," which limit the scope of examinations, through on-site visits over a period of about one week. In fiscal 2019, the Bank will conduct the "targeted on-site examinations" that focus on the examination of profitability given the declining trend in regional financial institutions' profits. In doing so, the Bank will include the management of credit risk or market risk in the scope of examinations, depending on the status of individual financial institutions' risk taking. Moreover, with regard to financial institutions that provide a wide range of financial services on a group basis, the Bank will examine major group companies, as necessary, to ascertain the business conditions of a group as a whole. Furthermore, it will continue to focus on its examination of overseas branches and subsidiaries of such financial institutions, given the increased weight of international businesses.

b. Consideration of Administrative Burden and Understanding for Financial Institutions

Line sheet reviews are useful from the perspective of concretely understanding the actual situation of regional economies and changes in the behavior of financial institutions, and the Bank will continue with these in the fiscal 2019 on-site examinations, while taking into account the administrative burden on financial institutions.[5] Given that credit costs have started to increase, the Bank will conduct asset assessments to check the accuracy of self-assessments of financial institutions with certain issues regarding the quality of their assets, etc.

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[5] A line sheet review consists of (1) interviews with branch managers, etc., on the basis of documents ("line sheets") containing information on developments in the financial condition, developments in the borrowing and repayment situation, and future prospects of chosen individual borrowers, as well as the financial institution's self-assessment results, lending policy, etc., and (2) the understanding and assessment of the borrowers' business environment, such as developments in regional economies and industries, as well as its credit management practices, etc.

Since on-site examinations of financial institutions' branches are useful in ascertaining the governance of branches and the efficiency of branch management, the Bank will continue with on-site examinations of branches in fiscal 2019.[6] However, given the further concentration of business operations to headquarters and use of IT systems, in its on-site examinations of branches the Bank will not conduct examinations aimed at confirming operational accuracy, except in the case of branches that have particular problems such as incidents of fraud or accidents in business operations.

In addition, the Bank will keep striving to reduce the burden of on-site examinations by taking into consideration how busy financial institutions are, and by deciding, in a prioritized manner and based on the business challenges faced by individual financial institutions, the documents to be submitted beforehand, as well as the items to be examined at the time of on-site examinations.

Moreover, to further enhance the efficiency and effectiveness of on-site examinations, the Bank will continue to strengthen the linkage between its on-site examinations and its off-site monitoring, including of overseas offices. The Bank aims to share its awareness and strengthen cooperation with the Financial Services Agency, and with overseas regulators mainly on issues common to internationally active financial institutions.

The Bank will work to enhance its communication with institutions being examined and continue to take appropriate actions to gain their full understanding of and trust in the examination process and results. In the above process, it will improve on-site examination procedures by responding to opinions and requests gathered from examinee institutions through a post-examination survey. Following its on-site examinations, the Bank will revisit the financial institution as part of its efforts, conducting interviews as necessary.

[6] Through on-site examinations of branches, the Bank examines the actual situation of operational processing and risk management frameworks by questioning branch managers, managers, and staff in charge of actual operations, and confirms the understanding and the status of implementation of various measures directed by headquarters.