On-Site Examination Policy for Fiscal 2024

1. Introduction

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

In conducting on-site examinations and off-site monitoring, it is becoming increasingly important to assess financial institutions' soundness and risk management in a swifter and more continuous manner and to monitor changes in the financial system as a whole in a timely fashion, in light of changes in the environment surrounding the financial system and various challenges faced by financial institutions.

In fiscal 2023, the Bank worked to strengthen the integration of on-site examinations and off-site monitoring by deepening information sharing between the on-site examination section and the off-site monitoring sections at the head office and branches. In addition, the Bank deepened coordination with the Financial Services Agency (FSA) through a wide range of initiatives, including joint surveys with the FSA targeting major financial institutions, and worked on monitoring the financial system in more detail.²

In the "On-Site Examination Policy for Fiscal 2024," the Bank outlines the situation of financial institutions' business management and risk management as assessed from on-site examinations and off-site monitoring in fiscal 2023. It also compiles issues key to conducting on-site examinations in fiscal 2024 and operations of on-site examinations while also taking into account recent changes in the environment. Moreover, with regard to off-site monitoring, while taking key issues in the on-site examination policy into

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 Topics of the joint surveys in fiscal 2023 include the following: the supervisory simultaneous stress testing based on common scenarios as well as joint surveys on foreign currency liquidity risk management and on cybersecurity management. Topics will be reviewed as appropriate in consultation with the FSA in line with their importance to the financial system.

account in order to ensure that off-site monitoring is well integrated with on-site examinations, the Bank will respond flexibly to changes in the environment.

2. On-Site Examinations in Fiscal 2023 and General Observations

(1) On-Site Examinations in Fiscal 2023

The Bank carried out on-site examinations of 67 financial institutions: 20 domestically licensed banks, 42 *shinkin* banks, and 5 other institutions, including securities companies as well as Japanese branches and subsidiaries of foreign banks.³ In fiscal 2022, the Bank partially resumed on-site examinations; that is, it visited financial institutions' premises while using remote methods. In fiscal 2023, the Bank resumed such examinations to a large degree and focused on hybrid-type examinations that combine remote methods.

Number of Financial Institutions Examined

(number of entities)

	Fiscal 2021	Fiscal 2022	Fiscal 2023
Domestically licensed banks	18	20	20
Shinkin banks	34	37	42
Other institutions	7	4	5
Total	59	61	67

(2) Issues Identified through On-Site Examinations and Off-Site Monitoring

Financial institutions' profitability and financial soundness, business management, as well as their risk management examined in on-site examinations and off-site monitoring in fiscal 2023, are as follows.

Profitability, Financial Soundness, and Business Management

Looking at financial institutions' financial soundness, their capital levels are adequate relative to the amounts of various types of risk taken on, and they have sufficient capacity

³ "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.

to absorb losses. The smooth functioning of financial intermediation has been maintained even amid the global tightening of financial conditions and the resultant various types of stress.

As for profitability, major financial institutions have increased the efficiency of their domestic deposit-taking and lending activities on the one hand, while on the other hand they have pushed ahead with inorganic growth strategies involving acquisitions and investments at home and abroad as well as continued to strengthen group-wide profitability across commercial banks, securities companies, trust banks, nonbanks, etc. belonging to the same holding company and to broaden their revenue sources.

A growing number of regional financial institutions have been working to increase business efficiency through, for example, consolidation of their branch networks (including so-called "branch-in-branch" consolidation) and reviews of their ATM networks and staff allocation, and enhance profitability by improving financial services such as non-interest services, in a situation where their core profitability has been pushed down due to structural factors such as a declining population and the prolonged low interest rate environment in Japan. Moreover, these institutions have been active in providing loans in areas of focus, such as leveraged buyout (LBO) financing.

Against this background, in terms of business management, there were some examples of financial institutions that had actively pursued risk taking and returns to shareholders that needed to strengthen their management of risk-weighted assets to ensure capital adequacy ratio levels, and that needed to refine their profit projections as well as sophisticate the management of them, which are prerequisites for increases in returns to shareholders. On the other hand, there were also some cases where business management, risk management, and business promotion were hampered by increasing personnel constraints.

Meanwhile, on the back of digitalization/digital transformation (DX), including the use of open application programming interfaces (APIs) and cloud computing, an increasing number of financial institutions have been improving the efficiency of their operations and enhancing non-face-to-face services for customers. Against this background, the Bank, together with the FSA, implemented a self-assessment survey for regional financial institutions and securities companies, etc. in fiscal 2023 to encourage them to make their own efforts to strengthen cybersecurity measures, returned the aggregated results to

financial institutions, and exchanged views with the relevant industry associations. Moreover, it was confirmed that a growing number of financial institutions have been addressing climate-related financial risks.

Credit Risk

Looking at financial institutions' credit provision, some major financial institutions have been focusing on financing for institutional investors, including investment funds, M&A financing, real estate-related lending, and sustainable finance, whereas some regional financial institutions are focusing on real estate-related lending, LBO financing, and "cross-border" lending. Moreover, both major and regional financial institutions have been actively providing financing support to firms and support for firms to improve their business conditions.

Against this background, although credit costs increased in fiscal 2020, due mainly to the pandemic, they have leveled out since then. Many financial institutions expected that credit costs would remain low on the whole, albeit increasing moderately. However, some regional financial institutions experienced risks building up as the loan-loss provision ratio for large borrowers with unfavorable business conditions was low relative to the amount of uncovered loans.

With regard to risk management, there were some cases where financial institutions had problems in understanding borrower firms' financial and funding conditions, analyzing their repayment capacity, and providing effective support for low-performing firms to improve their business conditions. In addition, issues have been found in terms of credit screening and monitoring of loans in areas on which financial institutions have focused. For example, regarding real estate-related lending, there were cases where cash flow projections and portfolio analyses were not sufficient. In terms of LBO financing, there were cases in which credit screening and monitoring were not keeping pace with the expansion in the business scope.

Market Risk

Looking at developments in securities investment, financial institutions have continued to maintain a restrained investment stance, due mainly to rising domestic and foreign interest rates and increased volatility. Moreover, some financial institutions, particularly regional ones, have sustained valuation losses on securities holdings, reducing their risk-taking capacity.

In terms of risk management, some financial institutions, especially regional ones, have suffered a substantial increase in valuation losses due to inadequate loss limit frameworks and responses to the breach of loss limits amid a decline in bond prices, mainly triggered by rising domestic and foreign interest rates. Moreover, some did not adequately examine their risk tolerance, with some not taking valuation losses into account in their framework for allocating capital and others not capturing the impact of stress on their distributable profits and their net asset values. In addition, there were many cases where the establishment of management frameworks has not kept pace with the broadening of risk taking, such as investments in foreign securities, corporate bonds, and investment funds.

Liquidity Risk

Major financial institutions have been making efforts to maintain funding stability by extending the maturity of foreign currency deposits, the stickiness of which is relatively high, and of FX and currency swap funding. Moreover, reflecting the failure of some banks in the United States, they have been examining the stickiness of deposits. In this context, the Bank has encouraged major financial institutions to consider issues such as the refinement of assumptions regarding the deposit runoff rate in their stress testing.

While many regional financial institutions have sufficient yen liquidity and have no problems in managing it, among those for which deposits have been declining as a trend, some have failed to sufficiently analyze the reasons and examine countermeasures, and others have not reviewed their emergency responses due to the downsizing of branch networks and the reduction of staff. As for foreign currency funding, some institutions, especially those that are highly dependent on short-term market funding, etc., were facing challenges in securing stable funding means in response to changes in their risk profiles and in strengthening their ability to respond in the event of stress.

In addition, some financial institutions that work on raising funds through internet deposits had issues with respect to the assumptions regarding deposit outflows in the event of stress.

Operational Risk⁴

With regard to computer system risks, while both major and regional financial institutions are increasingly using new digital technologies, cyber threats such as ransomware attacks are becoming more prevalent.

Against this background, there were some institutions that had inadequate risk management frameworks for the use of cloud computing, such as risk management standards and security settings. Moreover, regarding cybersecurity management, there were some cases where the investigation of potential vulnerabilities was inadequate, while in other cases, the security of data encryption was not sufficiently ensured. In addition, amid business collaborations with third parties and group companies increasing, there were cases in which the management of information security, including at these entities, and the management of outsourcees, such as cloud computing providers, were insufficient. At some major financial institutions, there was room for improvement in, for example, the effectiveness of cybersecurity management on a group and global basis.

As in fiscal 2022, the Bank looked into whether financial institutions were steadily improving their frameworks for anti-money laundering and counter-terrorism financing while sharing its awareness and perspectives with the FSA through the framework of coordination between the FSA's inspections and the Bank's on-site examinations. The examinations showed that, while institutions overall were taking steps to improve their frameworks, progress varied by financial institution, and there were some items, such as ongoing customer due diligence, where the achievement rate was relatively low.

3. On-Site Examination Policy for Fiscal 2024

On-site examination policy for fiscal 2024 is as follows (see attachment for more details on the key issues). Moreover, with regard to off-site monitoring, while taking key issues in the on-site examination policy into account in order to ensure that off-site monitoring is well integrated with on-site examinations, the Bank will respond flexibly to changes in the environment.

⁴ Operational risk refers to risks related to overall business operations, including, for example, risks related to business procedures, compliance, computer systems, and business continuity.

(1) Outlook for Profitability and Financial Soundness as well as Efficacy of Business Management

The Bank will examine (1) boards of directors and senior management's view of the external environment, including financial and economic conditions at home and abroad, (2) the feasibility of their medium- to long-term business strategies, (3) the outlook for profitability and financial soundness on that basis, and (4) the effectiveness of financial institutions' business management. In doing so, the Bank will pay particular attention to the following issues:

- The status of efforts to build a sustainable business model. This includes the status and feasibility of (1) efforts to strengthen top-line earnings, (2) measures to improve business efficiency, such as a review of branch networks and staff allocations and the reengineering of business processes, and (3) the use of digital technologies.
 - -- Through examinations of these issues, the Bank will continue dialogue with regional financial institutions on the status of implementing measures to support regional economies and strengthen their business foundations in coordination with off-site monitoring.
- For major financial institutions, the status and efficacy of efforts in a wide range of financial services through their global activities and group strategies.
- For regional financial institutions that have been pushing ahead with strengthening business foundations through business integration, enhancement of group-wide business activities, and especially business collaborations with other firms, the status and efficacy of such efforts.
 - -- With regard to regional financial institutions that are facing more severe staff constraints, the Bank will also examine the sufficiency of their business management and risk management, as well as the status of the framework for business promotion under these circumstances, and have dialogue with them on countermeasures.
- Profit outlook in light of expectations for yield curves and business strategies, such as regarding loans and deposits as well as securities investment under such circumstances.
 - -- The Bank will check these through profitability simulations, etc., based on the market outlook for domestic and foreign interest rates, the pass-through of these rates to loan and deposit interest rates and its feasibility, and the composition of financial institutions'

assets and liabilities, as well as have dialogue with financial institutions on countermeasures.

- Management of financial soundness mainly based on the increase in valuation losses on securities holdings and the amount of risk, including interest rate risk in the banking book (IRRBB).
- In the case of financial institutions for which there is concern about their future profitability and financial soundness, the effectiveness of risk-weighted asset management and capital policies including dividend distributions.
- Whether financial institutions identify and manage climate-related financial risks, their information disclosure, and their engagement with corporate customers.

(2) Status and Efficacy of Governance Framework

The Bank will examine the status and efficacy of financial institutions' governance framework necessary to ensure the effectiveness of business management and risk management. In doing so, it will pay particular attention to the following issues:

- In the case of financial institutions that have overseas branches and subsidiaries and financial holding companies, their business management commensurate with their group strategies, global activities, as well as financial regulatory and supervisory frameworks in different jurisdictions.
- The framework for the collection of the information necessary for effective business and risk management.

(3) Status of Various Risks and Risk Management Frameworks

The Bank will review current developments and future directions of various risks faced by financial institutions and then examine the effectiveness of their risk management. (In the on-site examinations, the Bank will avoid overlapping with joint surveys conducted with the FSA on subjects such as foreign currency liquidity risk management and cybersecurity management at some major financial institutions.) In doing so, the Bank will pay particular attention to the following issues:

Credit Risk

- Whether financial institutions ascertain borrowers' financial and funding conditions and
 portfolio characteristics, as well as changes therein. Moreover, whether their initial
 screening and interim management based on such information are appropriate, and the
 status of deliberations on methods for write-offs and loan-loss provisions (including the
 sufficiency of loan-loss provisions for large borrowers with unfavorable business
 conditions).
- Whether financial institutions are identifying borrowers that require support for improving their business conditions based on borrowers' financial conditions and loan coverage ratios, as well as the status of financial institutions' effective support for and management of their borrowers. (In particular, the status of drastic support measures to address management challenges for large borrowers with unfavorable business conditions.)
- Implementation of initial screening, interim management, and portfolio analysis of real
 estate-related loans and housing loans. Frameworks for credit screening and monitoring
 with regard to other areas of focus (financing for institutional investors and M&A
 financing at major financial institutions, LBO financing and "cross-border" lending at
 regional financial institutions, etc.).
- Estimation of future credit costs in light of default cases and financial and economic conditions, as well as the calculation of downside risks.

Market Risk

- Financial institutions' strategies for securities portfolios, mainly in light of the market outlook and gains/losses on securities holdings. Risk tolerance of their investment plans relative to their financial soundness and profits.
- Whether various risk and loss limits are consistent with financial soundness and profits.
 The efficacy of action plans at times of market turmoil.
- Whether financial institutions ascertain risks and have established risk management frameworks in line with the size and broadening of securities portfolios.

Liquidity Risk

- Whether financial institutions have developed risk management frameworks, such as strengthening funding bases and setting their risk appetite in line with their foreign currency balance sheet strategy, managing the funding gap based on their funding capacity in terms of different currencies, and developing and implementing liquidity stress testing and contingency funding plans.
- Whether the analysis of the underlying reasons for developments in deposits and countermeasures are effective, especially at financial institutions for which deposits have been declining as a trend, and whether, given the downsizing of branch networks and the reduction of staff, emergency responses are effective.
- Financial institutions' analysis of the stickiness of their deposits in response to interest
 rate fluctuations, etc., and policies for dealing with deposit outflows through online
 banking.

Operational Risk

- The effectiveness of measures to prevent computer system failures, as well as of recovery frameworks in the event of a failure. The appropriateness of management frameworks for large-scale projects such as the move toward open core banking systems.
- Whether financial institutions have ensured cybersecurity, including that of cloud computing, amid advances in digitalization and rising threat of cyberattacks.⁵ The effectiveness of measures to prevent cyber incidents and limit damage, as well as of recovery frameworks in the event of an incident.
- Whether financial institutions have developed operational frameworks, mainly in light of the review of branch networks and staff allocations.
- Whether financial institutions have developed frameworks for anti-money laundering and counter-terrorism financing.⁶

⁵ As for regional financial institutions, etc., the Bank, in its on-site examinations, will make use of the results of the self-assessment survey on cybersecurity management frameworks that it conducted in cooperation with the FSA.

⁶ The Bank will conduct examinations while sharing its awareness and perspectives with the FSA through the framework of coordination between the FSA's inspections and the Bank's on-site examinations.

4. Operations of On-Site Examinations

(1) Continuation of Hybrid-Type Examinations That Combine On-Site Examinations and Remote Methods

In fiscal 2023, the Bank resumed on-site examinations to a large degree; that is, it visited financial institutions' premises and focused on hybrid-type examinations that combine remote methods such as web conferencing. In fiscal 2024, it will continue with such hybrid-type examinations.

Specifically, during the "regular examinations," which take about three weeks and consist of a comprehensive examination and assessment of regional financial institutions' business conditions and risk management frameworks, the first two weeks or so will basically be spent conducting on-site examinations, while the last week or so will be spent conducting examinations using remote methods. However, depending on factors such as examinee institutions' circumstances, the Bank may adjust the relative length, etc. of on-site and remote examinations and/or may conduct examinations entirely on-site.

(2) Giving Consideration to Financial Institutions' Operational Burden and Improving Efficiency

While making use of the information obtained through off-site monitoring, the Bank efficiently conducts examinations (hereafter referred to both as on-site examinations and examinations using remote methods) based on a risk-based approach by deciding, in a flexible and efficient manner, the frequency, length, and scope of its examinations, as well as the documents to be submitted and the number of examiners involved on the basis of a comprehensive assessment of individual financial institutions, such as from the following perspectives: (1) the impact on the financial system of the materialization of risks inherent in financial institutions and (2) financial institutions' capital adequacy and profitability, as well as the degree of risk taking.

From fiscal 2022, in order to reduce the operational burden on examinee institutions and further improve the operational efficiency of examinations, the Bank has conducted "short-term examinations" of some regional financial institutions, and will continue with such examinations in fiscal 2024; "short-term examinations" are more concise examinations that

will take about two weeks and are based on a risk-based approach, in which operational risk management, etc. are excluded from the scope of the examination.

In addition, the Bank will continue to strengthen its coordination with the FSA by coordinating the planning of the FSA's inspections and the Bank's on-site examinations through the Joint Group for Coordinating FSA's Inspections and BOJ's On-Site Examinations and by sharing the findings of inspections and examinations. In conducting on-site examinations, the Bank will avoid overlapping with various joint surveys that it conducted with the FSA to take into account the operational burden on examinee financial institutions and enhance the efficiency of such examinations.

Moreover, the Bank will continue to share its awareness and strengthen cooperation with overseas regulators, mainly on issues regarding internationally active financial institutions.

(3) Gaining of Financial Institutions' Understanding

The Bank will work to enhance its communication with financial institutions being examined through a post-examination survey and interviews conducted after the examinations as necessary to gain their full understanding of and trust in the examination process and results. The Bank has constantly worked on improving on-site examination procedures by responding to opinions and requests gathered from examinee institutions, and it will continue with such efforts.

Moreover, through the regular exchange of views with members of the financial industry that started in fiscal 2021, the Bank intends to continue exchanging views on the operation of its examination and monitoring, while focusing on efforts to further strengthen coordination between the FSA and the Bank.

Issues Key to On-Site Examinations in Fiscal 2024

I. Outlook for Profitability and Financial Soundness as well as Business Management

The Bank will examine whether financial institutions are making necessary efforts from the perspective of both Subsections A and B below, in order to build a sustainable business model into the future.

In relation to this, in the on-site examinations, the Bank will examine whether financial institutions can ensure sustainable profits and maintain their financial soundness by conducting simulations of their profitability.

It will also conduct a profitability and financial soundness simulation under certain standard stress scenarios and discuss with the respective boards of directors and senior management their awareness of issues regarding profitability and financial soundness, as well as policies to improve these. As for some major financial institutions, the Bank, together with the FSA, will conduct supervisory simultaneous stress testing based on common scenarios as part of off-site monitoring to gain a deep understanding of risk profiles inherent in their business models, thereby developing a comprehensive perspective for evaluating their financial soundness. The Bank will also deepen dialogue with these financial institutions on their business challenges, such as the sophistication of risk management frameworks.

A. Efforts to Achieve Profits and the PDCA Cycle for Business Operations

The Bank will examine whether financial institutions, in order to achieve the profits that they should aim for, have appropriately established and operate a system (a so-called PDCA cycle for business operations) under which they formulate and implement business strategies and plans while accurately understanding the domestic and overseas business environment, examine the results, and review such strategies and plans in a timely manner in response to changes in the business environment.

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¹ Profits here are defined as pre-provision net revenue (PPNR, excluding profits and losses from investment trusts due to cancellations) minus credit costs.

The Bank will collect information on changes in the environment surrounding financial institutions' business in a forward-looking manner, including through off-site monitoring. For example, it will continue to examine a wide range of issues such as (1) uncertainties over financial and economic conditions at home and abroad, (2) geopolitical risks, (3) structural challenges faced by regional economies, (4) progress in information technology (IT), (5) developments in financial regulation and supervision at home and abroad, and (6) responses to climate change, including through the conduct of hearings on financial institutions' recognition of these issues and their innovative initiatives.

Based on such recognition of the environment, in the case of major financial institutions, the Bank will examine the following, in coordination with off-site monitoring: their global activities and group strategies (including those with regard to overseas branches and subsidiaries and inorganic growth) in light of changes in foreign currency funding conditions, international financial regulations, and financial regulatory and supervisory frameworks in different jurisdictions; efforts in a wide range of financial services, such as those for adapting to digitalization/DX; and business process reengineering aimed at raising business efficiency. It will then analyze the details of their efforts and effectiveness from the standpoint of group-wide profitability.

With regional economies facing structural factors such as the declining and aging population, it is important for regional financial institutions to continue to push ahead with efforts to support regional economies and strengthen their business foundations in order to firmly provide such support into the future. From this perspective, the Bank will examine the status and future feasibility of efforts to strengthen top-line earnings, such as loan and deposit income and income from fees and commissions, and of measures to improve business efficiency, such as a review of branch networks and staff allocations and the reengineering of business processes. In doing so, the Bank will focus on, for example, digitalization/DX and the effects of business alliances with firms from other industries. Moreover, as for regional financial institutions that are facing more severe staff constraints, mainly due to moves to contain costs and to recruitment difficulties, the Bank will also examine the sufficiency of their business management and risk management, as well as the status of the framework for business promotion under these circumstances, and have dialogue with them on countermeasures. With regard to regional financial institutions that

have been pushing ahead with strengthening business foundations through business integration and enhancement of group-wide business activities, such as in the form of holding companies, the Bank will examine the status of implementing such measures, as well as their effectiveness. Through these examinations, the Bank will continue dialogue with regional financial institutions on the status of implementing measures to support regional economies and strengthen their business foundations, as well as their future policies and challenges in coordination with off-site monitoring.

The Bank will examine the outlook for financial institutions' future profitability and financial soundness through profitability simulations, etc. In doing so, it will ascertain the outlook for future net interest income, etc., based on the market outlook for yield curves, taking into account financial institutions' repricing schedules of interest payment for assets and liabilities and the pass-through to loan and deposit interest rates and its feasibility. Moreover, regarding business strategies with regard to deposits and loans, securities investment, etc. on that basis, the Bank will hold in-depth discussions with financial institutions in coordination with off-site monitoring.

In addition, the Bank will confirm whether financial institutions' profit management is appropriate in employing the PDCA cycle for business operations. In the case of major financial institutions, the Bank will examine whether their company-wide financial goals are consistent with profitability management for each business division and client firm, as well as whether profit management is effective. In the case of regional financial institutions, the Bank will examine whether they have worked on basic matters such as ascertaining the profit outlook with a certain degree of accuracy. In addition, it will examine how regional financial institutions make use of efficiency indicators and how these institutions ascertain and analyze profitability based on the characteristics of their credit portfolios by sector, such as by region and borrower classification, while taking into account their profitability, financial soundness, and business scope.

B. Understanding of and Response to Risks Related to Business Strategies and Plans

The Bank will examine whether financial institutions accurately identify risks accompanying the implementation of their business strategies and plans, and whether such identification is leading to a review of these items. The Bank will pay particular attention

to whether financial institutions ascertain risks that take into account changes in their business environment and strategies, such as developments in financial markets, including domestic and foreign interest rates, geopolitical risks, and responses to climate change. Moreover, the Bank will examine whether financial institutions have an integrated risk management framework in place, including the treatment of valuation losses on securities holdings, that verifies if their risk taking is appropriate in relation to profits and equity capital.

In doing so, the Bank will examine whether financial institutions have analyzed the possible impact on equity capital and profits in the event of significant 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 respective boards of directors and senior management and the control functions of the relevant divisions in charge of such activity; (2) the comprehensiveness of scenarios and coverage of the subjects of the stress testing; (3) schemes to develop and verify models and data; and (4) frameworks to utilize test results for the PDCA cycle for business operations. In particular, the Bank will examine the impact of changes in domestic and overseas yield curves on valuation losses on securities holdings, losses on the redemption of mutual funds, and the amount of risk. Moreover, it will check how financial institutions have placed and managed IRRBB in their risk management framework, and have dialogue on their thinking behind core deposits. In addition, the Bank will examine whether financial institutions have analyzed the impact of changes in institutional frameworks, such as the Basel III finalization, on the capital adequacy ratios and have made use of such analysis in formulating business plans.

In the case of financial institutions for which there is concern about their future profitability and financial soundness, the Bank will focus its dialogue with the respective boards of directors and senior management on the balance between capital and risk-weighted assets to perform their financial intermediation function in a stable manner into the future, the framework to manage them, and their capital policies including dividend distributions. In off-site monitoring after the completion of on-site examinations, the Bank will maintain dialogue with the top management of such institutions.

Regarding Global Systemically Important Financial Institutions (G-SIFIs) and their equivalents, the Bank will examine the effectiveness of recovery plans and contingency plans.

With regard to climate change responses, the Bank will ascertain the progress and challenges regarding the following issues according to their size and characteristics: (1) the identification and management of climate-related financial risks (including quantitative assessments of transition and physical risks); (2) measures to enhance the quality and quantity of disclosure based on the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD); and (3) engagement with corporate customers in pursuit of decarbonization (including raising awareness among small and medium-sized firms, supporting efforts to measure greenhouse gas emissions, and enhancing products and services such as sustainability-linked loans and green loans). The Bank will also engage in in-depth dialogue with financial institutions on these issues in coordination with off-site monitoring.

II. Governance

A. Ensuring the Efficacy of Governance

The Bank, in the case of major financial institutions, will examine whether they have established group-based governance frameworks, including risk management and internal audits, that are appropriate for their initiatives to expand activities, such as through inorganic investment, and strengthen the cross-selling of services on a group-wide basis.

For regional financial institutions, the Bank will examine whether management policies are disseminated throughout the organization, communication within the organization regarding the assessment of risks is smooth, and a governance framework is in place that enables the organization to properly harness its organizational capabilities to achieve its business strategies and plans. In the case of holding companies to which regional financial institutions belong, the Bank will conduct a similar examination.

In the on-site examinations, the Bank will conduct interviews with external directors and other officers as necessary.

B. 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 scope and risks while understanding their roles within the group. On this basis, it 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 framework of communicating with the Bank in preparation for unexpected contingencies. Moreover, (4) it 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.

C. Proactive Business Management and Risk Management through Internal Audits

With regard to internal audits, the Bank -- depending on financial institutions' business scope and risk taking -- will examine (1) whether the institutions appropriately decide the scope of internal audits and allocate audit resources based on recent operations and risk taking, (2) whether they have verified the appropriateness of their business operations and properly made improvements reflecting the results of the audits, and, in particular, whether headquarters audits examine in depth the effectiveness of risk management and lead to the consideration of effective improvement measures while making use of outside experts' knowledge as necessary, and (3) whether the results and recommendations of such audits are utilized in their business. To improve the effectiveness of on-site examinations, the Bank will conduct hearings with the respective internal audit divisions before on-site examination, if necessary.

D. Information Management Frameworks Necessary for Business Management and Risk Management

Concerning the global and group-wide financial information and risk information required for the respective boards of directors and senior management to make appropriate business decisions, the Bank will examine, particularly for major financial institutions, (1) whether they have appropriately set up a framework for the collection of the necessary information, such as a management information system (MIS), (2) whether sufficient management resources are allocated to this end, and (3) whether the completeness, accuracy, and timeliness of information, etc. are appropriate. In doing so, the Bank also will confirm the status of responses with regard to institutional frameworks, such as international financial regulations.

III. Credit Risk Management

A. Credit Screening and Monitoring

For both major and regional financial institutions, it is important to conduct credit risk management that takes into account changes in financial and economic conditions as well as individual borrowers' conditions. Regional financial institutions in particular need to conduct credit risk management in consideration of structural challenges faced by regional economies, such as a declining population.

Given this situation, the Bank will examine whether financial institutions (1) appropriately ascertain borrowers' financial and funding conditions at the individual borrower level as well as changes therein, and analyze their repayment capacity, (2) analyze portfolio characteristics and changes, and (3) properly analyze cases of credit cost incurrence. Moreover, the Bank will also examine whether financial institutions accurately use these analyses in their initial screening and interim management of loans. In particular, it will carefully examine whether financial institutions sufficiently comprehend the business conditions of large borrowers that are low-performing or carry considerable business risks and whether their credit screening and monitoring are appropriate, including of the

accuracy of self-assessments. In doing so, the Bank will employ "line sheet reviews" (the same applies throughout this section).

Among major and regional financial institutions, some have been active in real estate-related lending, such as real estate investment trusts (REITs), non-recourse loans, and apartment loans, as well as housing loans. With regard to such financial institutions, the Bank will check the appropriateness of their initial screening, such as the examination of borrowers' cash flows and the collectability of loans in the event of stress, their interim management based on developments in asset values, rents, and interest rates, their risk analysis of their portfolios overall, and their risk-asset management including the impact of the Basel III finalization. The cash flow examination of loans with long loan terms is important not only for real estate-related loans such as apartment loans, but also for loans in various areas, such as project financing (for solar power generation, etc.).

Moreover, regarding regional financial institutions that are focusing on LBO financing and "cross-border" lending, the Bank will examine whether their credit screening and monitoring of such lending are appropriate in light of loan structures and borrower characteristics. As for major financial institutions, the Bank will examine (1) whether they are appropriately managing credit in areas where they have been increasing their efforts, such as financing for institutional investors, including investment funds, and M&A financing, as well as operations in other areas they have been focusing on, such as the origination and distribution of loan-related instruments, and (2) whether their headquarters have established global management and reporting rules and are appropriately monitoring them.

B. Outlook for Credit Costs (Write-Offs and Loan-Loss Provisions)

The Bank will examine future credit costs and downside risks -- taking into account financial and economic conditions in Japan and abroad, recent default cases, borrowers'

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² A line sheet review consists of (1) interviews with relevant divisions 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.

conditions both at the individual borrower level and the portfolio level, and the status of loan coverage ratios and loan-loss provision ratios -- and have dialogue with financial institutions on their accuracy. Moreover, the Bank will deepen its dialogue with financial institutions regarding the appropriate approach to calculating write-offs and loan-loss provisions, and exchange opinions with the accounting auditors of financial institutions as necessary. In particular, the Bank will engage in in-depth dialogue regarding large borrowers with unfavorable business conditions, including on the sufficiency of loan-loss provisions.

C. Support for Firms to Improve Business Conditions

The Bank will examine (1) whether financial institutions' headquarters and branches are cooperating and accurately identifying, for example, borrowers that require support to improve their business conditions, mainly taking account of individual borrowers' financial conditions and the status of loan coverage ratios and loan-loss provision ratios. In addition, the Bank will examine the status and efficacy of financial institutions' support for and management of these borrowers, including the following: (2) whether financial institutions adequately analyze the current business conditions and future prospects of borrowers and share an awareness of the business challenges with them; (3) whether these institutions' headquarters and branches are cooperating in terms of offering advice, recommendations, and support to help borrowers overcome challenges; (4) whether these institutions are providing support for business succession as necessary; and (5) with regard to borrowers with unstable business conditions, whether these institutions are making efforts toward more drastic solutions for business challenges by cooperating with other financial institutions and outside specialists. Regarding large borrowers continuing to have unfavorable business conditions in particular, the Bank will deepen dialogue with financial institutions to examine whether risks have built up; for example, whether they have continued to provide loans without making efforts toward devising more drastic solutions to address management challenges.

IV. Market Risk Management

A. Establishment of Management Frameworks Depending on Financial Institutions' Risk Taking

As described in Subsection 2. (2) in the main text (Issues Identified through On-Site Examinations and Off-Site Monitoring), issues have been found in terms of the effectiveness of financial institutions' risk management amid a decline in bond prices, mainly triggered by rising domestic and foreign interest rates. As a result, some financial institutions have incurred a large amount of valuation losses while others did not sufficiently ascertain the impact on their profitability and financial soundness.

Against this background, the Bank will confirm financial institutions' strategies for their securities portfolios, mainly in light of the market outlook and gains/losses on securities holdings. Moreover, it will examine whether financial institutions, when formulating investment plans, verify the tolerance of risks relative to their equity capital and profits in implementing their investment plans. In doing so, the Bank will examine whether they assess the impact that an increase in valuation losses would have on their distributable profits and net asset values through the implementation, for example, of stress testing. In addition, particularly in the case of financial institutions with broadening securities portfolios, the Bank will check management frameworks to ascertain whether risk factors are accurately identified and market values, risk amounts, etc., are monitored and measured at an appropriate frequency.

B. Appropriateness of Various Risk and Loss Limits, and Responses to Events Based on Loss-Cut Rules

The Bank will examine whether financial institutions set various risk and loss limits at the appropriate levels relative to their financial soundness and profits, whether these are properly reviewed, and whether action plans in case of a breach are considered. Moreover, the Bank will examine whether loss-cut rules are in place and functioning to allow for timely decisions on the appropriateness of continuing to hold securities when a mandatory consultation framework becomes requisite, such as in times of sudden changes in domestic and/or international markets, taking into account the future impact on their equity capital and profits.

V. Liquidity Risk Management

A. Foreign Currency Liquidity Risk Management

Given that internationally active major financial institutions have large amounts of foreign currency funding outstanding, the Bank will examine the following: (1) whether such financial institutions have set their risk appetite (such as in terms of the results of liquidity stress testing, the medium- to long-term funding ratio, etc.) in line with their foreign currency balance sheet strategy (such as with regard to whether they are planning to increase or decrease their foreign currency balance sheet and in respect to the gap between loans and deposits, the maturity gap in investment and funding, and profitability); (2) whether such financial institutions have set up a framework for managing their funding gap based on their funding capacity, in terms of different currencies, and have a liquidity buffer to cope with sudden outflows of funds; and (3) whether they have developed and implemented liquidity stress testing and contingency funding plans in a consistent manner on a group-wide basis, based on reasonable capital flow assumptions.

In off-site monitoring, the Bank will also continue to examine major financial institutions' efforts to strengthen foreign currency funding bases and increase the sophistication of their risk management while cooperating with the FSA and overseas regulators that exercise jurisdiction over major financial institutions. The Bank will conduct joint surveys with the FSA on some major financial institutions and avoid overlapping with such surveys in the on-site examinations. In the joint surveys, the Bank will examine the status of individual financial institutions' management of their overseas branches and subsidiaries and assumptions regarding the deposit runoff rate in liquidity stress testing.

Turning to regional financial institutions, particularly with regard to those that are highly dependent on short-term market funding, etc., as well as those that are actively investing in foreign currency-denominated assets, the Bank will examine whether they have secured stable funding means that take into account market liquidity of assets and have established risk management frameworks, such as conducting and utilizing stress testing and improving the effectiveness of emergency measures.

B. Yen Liquidity Risk Management

The Bank will examine the implementation of analyses of the stickiness of deposits in response to interest rate fluctuations, etc., as well as monitoring frameworks and policies for dealing with the risk of deposit outflows through online banking.

Moreover, with regard to regional financial institutions, the Bank will examine (1), especially at financial institutions for which deposits have been declining as a trend, whether they are analyzing the underlying reasons for developments in deposits and examining countermeasures, and (2) whether, given the downsizing of branch networks and staff reductions, they have established and/or reviewed frameworks to quickly secure liquidity reserves in an emergency.

VI. Operational Risk Management

A. Computer Risk Management Frameworks

Focusing on financial institutions' critical computer systems, the Bank will examine the effectiveness of (1) measures to prevent computer system failures, such as their computer system maintenance and the duplication of critical systems, and (2) recovery frameworks in the event of a failure, including the planning and training for contingencies. When doing so, the Bank will also examine financial institutions' computer systems from the perspective of whether their management is in line with the use of new technologies and services brought about by advances in digitalization/DX. Moreover, in light of the growing trend toward financial institutions' business collaborations with third parties, such as the use of cloud computing and API linkages, the Bank will examine whether they appropriately manage third parties, including existing outsourcee companies, in terms of the management of the development and operation of projects, a collaborative framework at times of system failures, and information security, such as with regard to customer data. Furthermore, regarding whether financial institutions, in large-scale projects such as the move toward open core banking systems, are managing the various projects and outsourcees appropriately, the Bank will examine this while also investigating outsourcees, and check deliberations for the next system (including joint systems to be used by regional financial institutions). In addition, the Bank will examine the effectiveness of financial institutions' IT governance -- their own and that of their group companies, etc. -- from the perspective of whether management resources are allocated to ensure both the efficacy of their overall system management, including cybersecurity, and efficiency with regard to their investment in computer systems.

B. Cybersecurity Management Frameworks

With regard to the status of cybersecurity management frameworks, the Bank -- while taking into account individual financial institutions' business scope (including the use of cloud computing) -- will examine (1) the appropriateness of the collection and sharing of information on developments in ever-changing cybersecurity threats, (2) the effectiveness of countermeasures against vulnerabilities, (3) the appropriateness of the management of access rights for important data such as customer information, and (4) the effectiveness of measures to prevent cyberattacks and limit damage caused by such attacks. Moreover, given that it is difficult to prevent cyberattacks completely, it will examine the effectiveness of frameworks and contingency plans to recover critical operations 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 the joint surveys with the FSA on some major financial institutions, the Bank will deepen its dialogue on (1) the development of group-wide global risk management frameworks, (2) improvement of cyber resilience, (3) the management of third parties including outsourcee companies, and (4) addressing changes in risk profiles. In conducting on-site examinations, the Bank will avoid overlapping with the joint surveys.

In cooperation with the FSA, the Bank will continue to implement a self-assessment survey on cybersecurity management frameworks, such as of regional financial institutions, and encourage them to ascertain their preparedness and strengthen their countermeasures.

C. Business Risk Management and Compliance Management Framework

Given that an increasing number of financial institutions have actively taken measures such as concentration of business operations and review of branch networks and staff allocations, the Bank will examine (1) whether financial institutions adequately recognize changes in the risk profiles of business procedures associated with recent developments and (2) whether these institutions, including their major group companies and third parties such as

their outsourcee companies and partners, have appropriately established and reviewed risk management frameworks in response to changes in risk profiles. Particularly in the case of financial institutions that focus on fee-based business activities, the Bank will examine (3) the status of their compliance management frameworks for sales of financial instruments and advisory services. It also will examine whether financial institutions identify risk management issues through understanding of the actual situation of operational processing and analysis of fraud and accidents, and take effective measures to address such issues.

D. Anti-Money Laundering and Counter-Terrorism Financing Controls

Given strong international requests to take measures specific to anti-money laundering and counter-terrorism financing, it is essential for financial institutions to steadily implement these measures to ensure the proper conduct of their business operations and to maintain their credibility. On this basis, in the on-site examinations, the Bank will continue to examine the status of frameworks in these areas while sharing its awareness and perspectives with the FSA through the framework of coordination between the FSA's inspections and the Bank's on-site examinations.

E. 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. The Bank will continue to examine whether business continuity management is reviewed appropriately in response to not only the pandemic but also natural disasters -- such as earthquakes, typhoons, and floods -- as well as cyber incidents, the latter two of which have occurred recently. In doing so, it will take account of individual financial institutions' business scope, as well as these institutions' presence in payment and settlement systems and in their respective business areas.³

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In the case of major financial institutions, etc., the Bank, given changes in the environment, such as increased dependence on IT systems and third parties, will conduct examinations also from the perspective of their operational resilience (the establishment of early recovery and continuity systems based on the assumptions that business operations may be disrupted even when all preventive measures have been taken) in the event of system failures, terrorism and cyberattacks, pandemics, natural disasters, etc.