Financial System Policy

I. Financial System Stability

One of the objectives of the Bank of Japan, as stipulated in Article 1, Paragraph 2 of the Bank of Japan Law, is to "ensure smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of an orderly financial system." To this end, the Bank provides safe and convenient settlement assets in the form of deposits in financial institutions' current accounts held at the Bank, and takes measures to enhance the safety and efficiency of the payment and settlement systems (see "The Bank's Other Operations" Section I on pages 74–76). The Bank also takes the following measures to prevent systemic risk from materializing, that is, to ensure that a financial institution's inability to complete settlement of a transaction does not result in a chain of settlement failures at other institutions and thus disrupt the overall functioning of the financial system.

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

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

The following sections explain first the condition of and challenges for the financial system during fiscal 2005 and, second, the specific measures taken by the Bank to maintain financial system stability.

II. The Condition of and Challenges for the Financial System

With the nonperforming-loan (NPL) problem almost overcome, confidence in the Japanese financial system was restored both at home and abroad in fiscal 2005. The full removal of blanket deposit insurance was implemented as scheduled in April 2005 without major disruption. Subsequently, the financial system has been generally stable, with the economy remaining on a recovery trend.

1. The criteria are publicized only in Japanese.

At the end of September 2005, the ratio of NPLs to the total amount outstanding of loans at major banks declined further: by the end of March 2005 all major banks had achieved the target set in October 2002 by the government in the "Program for Financial Revival" of halving the NPL ratio from its level at the end of March 2002. The NPL ratio at regional banks also remained on the declining trend (Chart 1).

Banks' credit costs arising from write-offs and provisions for NPLs declined further reflecting continuing progress in NPL disposal and large transfers from provisions for possible loan losses due to an improvement in business conditions at firms. Credit costs of major banks were recorded as negative at the semiannual book closings in September 2005 (Chart 2).

Banks' net income, having turned positive at the end of the fiscal year in March 2005, then recorded its highest-ever level for a semiannual period in September 2005. The rise in net income was due to the increase in fees received, for example, from selling investment trusts and private pension policies, in addition to the decline in credit costs.

Meanwhile, major banks' overall stockholdings remained significantly below the level of Tier I capital (Chart 3). Furthermore, constraints on financial institutions' activities due to capital adequacy concerns have eased further, reflecting the decline in credit costs due to improved loan portfolios, increased profits, and wider means of raising capital. Against this background, bank lending stopped declining and started to increase in fiscal 2005, as the lending stance of financial institutions became more active and credit demand in the private sector stopped declining.

Moreover, as constraints on financial institutions' activities due to capital adequacy concerns have eased, financial institutions have begun to display increased dynamism in their business strategies. Specifically, they have accelerated the speed of repaying previous injections of public funds, have increased new investment, have conducted mergers with other financial institutions, and have increased business alliances with other financial service providers such as nonbanks.

Going forward, the key issue for the Japanese financial system has become to support the economy through the generation of flexible and robust financial intermediation mechanisms to achieve an efficient allocation of funds while maintaining overall system stability. In an environment where new financial services are being developed to take advantage of changes such as the globalization of the economy and financial markets, deregulation, and innovation in financial engineering, financial institutions face more complicated and diverse risks. Under these circumstances, each financial institution should improve its management of risks and business activities, and needs to develop innovative services tailored appropriately to various customer needs.

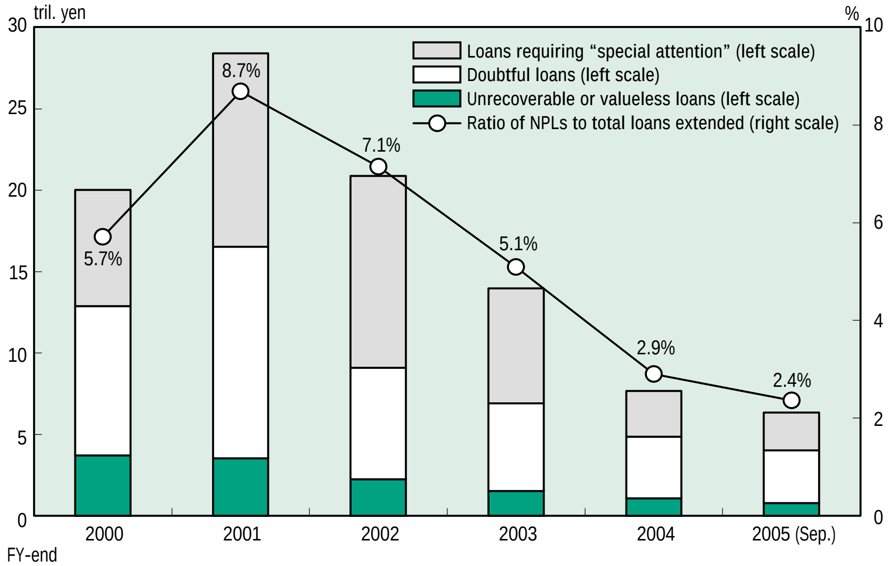
It also remains important for financial institutions to diversify channels for supplying credit, so as to make use of various investors' funds, through the development of new markets for credit, such as those for liquidating loans and securitizing assets.

Making available more efficient and advanced financial services in this way is considered to be a vital prerequisite for the sustainable and stable growth of Japan's economy.

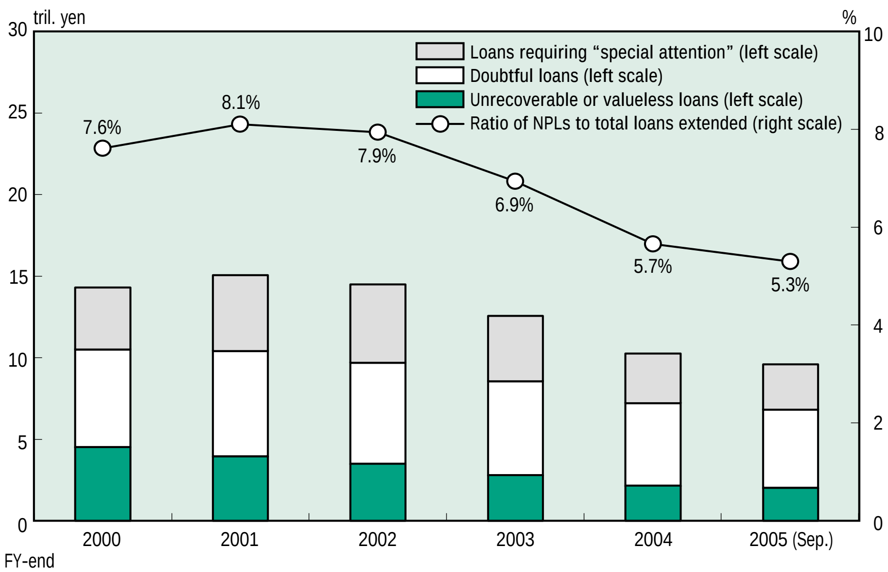
Chart 1

Nonperforming Loans (NPLs) Outstanding

(1) Major Banks[1]



(2) Regional Banks[2]

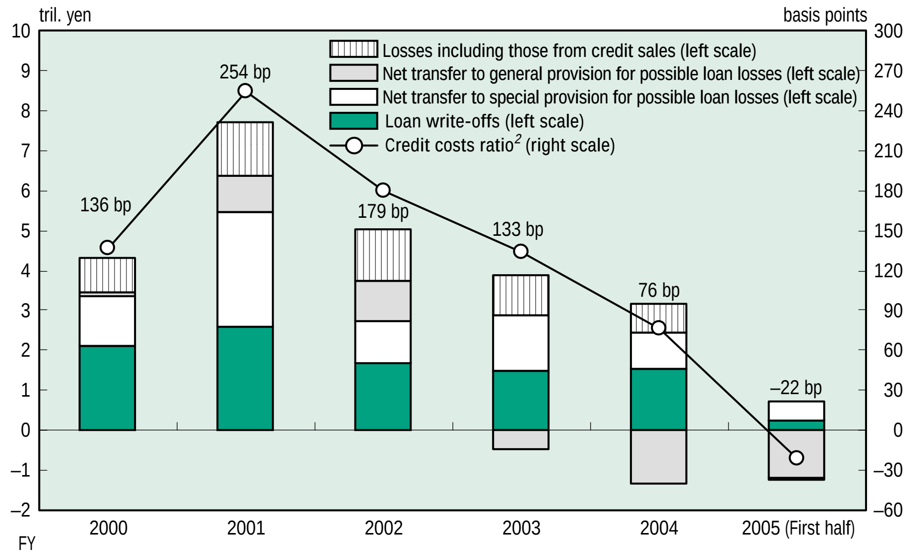


Notes: *1*. The total of 12 banks.
2. Member banks of the Regional Banks Association of Japan and the Second Association of Regional Banks.

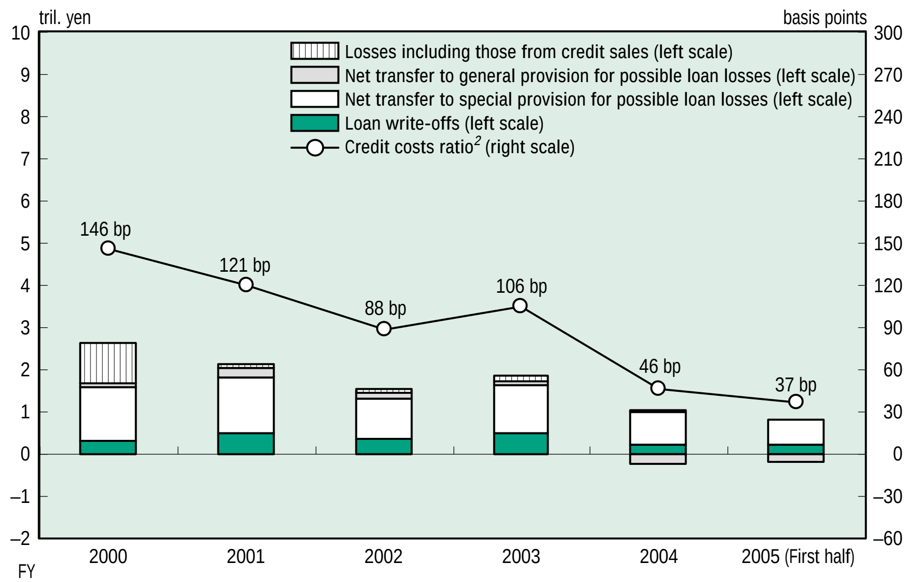
Chart 2

Breakdown of Major Banks' and Regional Banks' Credit Costs

(1) Major Banks[1]



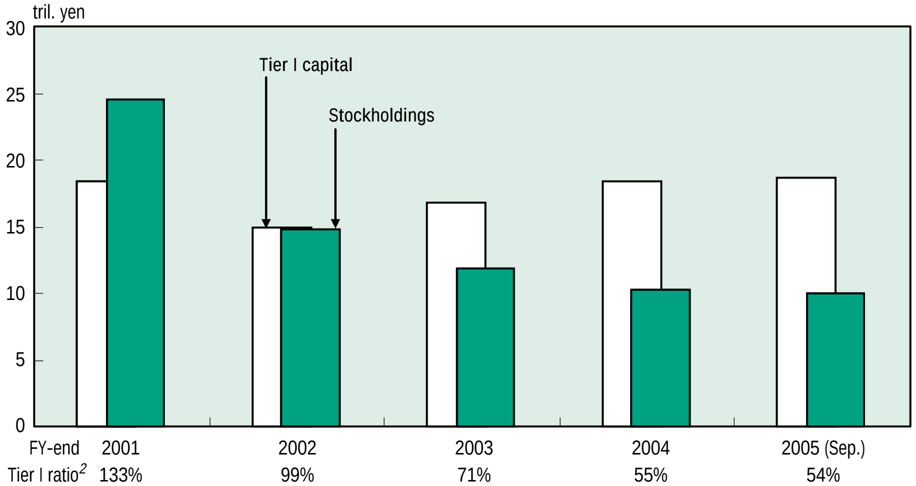
(2) Regional Banks[3]



Notes: 1. The total of 12 banks.
2. Ratio of losses stemming from NPL disposals to average amount outstanding of loans in each period.
3. Member banks of the Regional Banks Association of Japan and the Second Association of Regional Banks.

Chart 3

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



Notes: *1*. The total of 12 banks. Figures are on a consolidated basis.
Stocks for which market prices are available, excluding those held for the purpose of trading and stocks of subsidiaries and affiliates.
2. The ratio of banks' stockholdings to Tier I capital.

III. The Bank's Measures concerning the Financial System

A. Overview

On March 18, 2005, the Bank released "The Bank of Japan's Measures regarding the Financial System after the Full Removal of Blanket Guarantee of Deposits," the text of which was decided by the Policy Board on the same day (see *Annual Review 2005*, "Financial System Policy" Section III.J on pages 76–81). In this paper, the Bank clarified its basic stance regarding financial system policy, specifying that it would shift its focus from crisis management to supporting private-sector initiatives aimed at providing more efficient and advanced financial services via fair competition, while maintaining overall system stability. This stance is incorporated in the fourth strategic goal, "Enhancing the Functioning of the Financial System," adopted in the Bank's "Medium-Term Strategic Framework for Fiscal 2005–2009" and the "Action Plans for Fiscal 2005."

In fiscal 2005, the Bank took the following actions in line with this stance.

The Bank established the Center for Advanced Financial Technology (CAFT) in the Financial Systems and Bank Examination Department,[2] with a view to supporting

2. The Financial Systems and Bank Examination Department was established in July 2005 by merging the Financial Systems Department and the Bank Examination and Surveillance Department.

financial institutions' efforts to improve financial services through activities such as organizing seminars. In its on-site examinations and off-site monitoring, the Bank focused on encouraging financial institutions' efforts to improve their management of risks and business activities and to develop innovative services tailored to customer needs. At the same time, the Bank continued to ensure that it had an accurate grasp of the performance of financial institutions through its on-site examinations, so as to be ready to act as the lender of last resort. Making use of its analysis of microeconomic information gathered through on-site examinations and off-site monitoring, the Bank began compilation and release of the Financial System Report to evaluate the stability and functioning of the financial system and to explain the Bank's policy. Meanwhile, the Bank revised its business operations regarding the selection of account holders and concluded or discontinued current account services contracts and lending facilities contracts with certain financial institutions in response to consolidation in the financial industry. The Bank also terminated the availability of credit under the special loan scheme to Ashikaga Bank, pursuant to Article 38 of the Bank of Japan Law (see the next section for details on the special loan scheme).

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

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

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

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

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

Principle 1

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

Principle 2

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

Principle 3

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

Principle 4

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

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

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

C. Loans under Article 38 of the Bank of Japan Law

On November 29, 2005, the Bank terminated the availability of credit under the special loan scheme pursuant to Article 38 of the Bank of Japan Law to Ashikaga Bank, because the Bank ultimately found the funding situation of Ashikaga Bank to be quite stable.[3] There was no actual extension of loans during the period when the scheme was in place, as Ashikaga Bank was able to raise the necessary funds on its own. Since the termination of the above, there have been no cases where credit has been made available under the scheme pursuant to Article 38 of the Bank of Japan Law, as of the end of fiscal 2005.

In the event, the Bank did not actually extend loans pursuant to Article 38 of the Bank of Japan Law in fiscal 2005, and as a result, at the end of the fiscal year, the amount of such loans remained at zero for the second consecutive year.

D. Loans to the Deposit Insurance Corporation of Japan

Based on the terms and conditions laid down by the Policy Board, the Bank is able to extend loans to the DICJ when it is short of funds necessary for operation. In April 2001, the DICJ fully repaid the Bank its loans by refinancing them from private financial institutions. The DICJ has since raised all the funds necessary for carrying out new business and for refinancing its existing liabilities from private financial institutions. For this reason, as in fiscal 2004, it was not necessary for the Bank to extend loans to the DICJ in fiscal 2005.

E. On-Site Examinations and Off-Site Monitoring

1. Overview

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

3. On November 29, 2003, the Bank decided to make liquidity available to Ashikaga Bank in order to support the continuation of its business. This special loan scheme was to remain in place when the temporary nationalization continued and, in addition, the scheme was deemed necessary by the Bank.

On-site examinations are conducted under a contract (hereafter examination contract) between the Bank and the institutions concerned.[4] Article 44, Paragraph 1 of the Bank of Japan Law provides a clear legal basis for on-site examinations. It prescribes the purpose of such examinations and provides for an examination contract as follows: "The Bank of Japan may, for the purpose of appropriately conducting or preparing to conduct business prescribed by Articles 37 through 39, enter into a contract with financial institutions which become the correspondents in such business regarding on-site examinations."[5] As determined by the Policy Board on February 17, 1998, financial institutions with which the Bank may conclude examination contracts are institutions that are included among those referred to in Article 44, Paragraph 1, and that also hold current accounts at the Bank. As of the end of fiscal 2005, the Bank had examination contracts with 542 institutions, including six city banks, 64 regional banks, 47 regional banks II, 66 foreign banks in Japan, 21 trust banks, 277 *shinkin* banks, and 41 securities companies. The Bank has also concluded separate contracts for on-site examinations with the holding companies of financial institutions that hold current accounts at the Bank, and may conduct on-site examinations to obtain additional information necessary to assess the business and financial conditions of such institutions.

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

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

In assessing risk management, the Bank's examiners visit the premises of financial institutions subject to on-site examinations to interview executives and staff, and peruse ledgers and documents relating to transactions as well as other relevant material. This enables the examiners to identify the various risks associated with an institution's operations and any problems in its risk management. More specifically, they check which areas of operations are exposed to such risks as credit risk, market risk, settlement risk, liquidity risk, and operational risk,[6]

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

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

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

and whether these risks are properly identified and managed by the financial institution concerned. After the examination, the Bank gives feedback on its findings to the management of the financial institution and encourages action to tackle the identified problems.

Off-site monitoring is conducted through meetings and telephone interviews with executives and staff of financial institutions, as well as through analysis of various documents submitted by these institutions. The main objective of off-site monitoring is to examine the daily business operations and to evaluate the attendant risks at a wide range of institutions, as well as to appropriately assess the effects these have on the financial system as a whole. The Bank's on-site examinations and off-site monitoring are conducted so as to be mutually reinforcing in order to support its effective implementation of its operations, including its essential role as the lender of last resort.[7]

2. On-site examinations conducted in fiscal 2005

In fiscal 2005, the Bank conducted on-site examinations, in line with its "On-Site Examination Policy for Fiscal 2005," which was decided by the Policy Board on April 1, 2005, at a total of 160 financial institutions: 42 domestically licensed Japanese banks, 73 *shinkin* banks, and 45 other institutions including securities companies and Japanese branches of foreign banks (Table 1).

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

Table 1

On-Site Examinations Conducted in Fiscal 2005

(1) 42 Domestically Licensed Japanese Banks[1]

Financial institutions	Date of acceptance	Date of entry	Date of completion	Period of interruption	Transmission of result	Class of examination
Eighteenth Bank	Mar. 7, 2005	Apr. 6, 2005	Apr. 21, 2005	—	May 13, 2005	Normal
Daisan Bank	Mar. 3, 2005	Apr. 6, 2005	Apr. 21, 2005	—	May 20, 2005	Normal
Howa Bank	Mar. 4, 2005	Apr. 6, 2005	Apr. 21, 2005	—	May 24, 2005	Normal
Miyazaki Bank	Mar. 2, 2005	Apr. 6, 2005	Apr. 21, 2005	—	May 12, 2005	Normal
Bank of Yokohama	Mar. 2, 2005	Apr. 6, 2005	Apr. 21, 2005	—	May 18, 2005	Normal
JSF Trust and Banking	Mar. 8, 2005	Apr. 7, 2005	Apr. 20, 2005	—	May 17, 2005	Normal
Aozora Bank	Mar. 11, 2005	Apr. 22, 2005	May 17, 2005	May 2, 2005 to May 6, 2005	June 8, 2005	Normal
Aozora Trust Bank	Mar. 11, 2005	Apr. 22, 2005	May 17, 2005	May 2, 2005 to May 6, 2005	June 9, 2005	Normal
Mizuho Bank	Mar. 15, 2005	May 9, 2005	May 27, 2005	—	July 1, 2005	Normal
Bank of Kochi	Apr. 18, 2005	May 24, 2005	June 8, 2005	—	June 30, 2005	Normal
Saikyo Bank	Apr. 19, 2005	May 25, 2005	June 9, 2005	—	June 30, 2005	Normal
Sendai Bank	Apr. 19, 2005	May 25, 2005	June 9, 2005	—	June 30, 2005	Normal
Chikuho Bank	Apr. 18, 2005	May 25, 2005	June 9, 2005	—	June 23, 2005	Normal
Hiroshima Bank	Apr. 18, 2005	May 25, 2005	June 9, 2005	—	June 27, 2005	Normal
Bank of Tokyo–Mitsubishi	June 7, 2005	July 4, 2005	July 19, 2005	—	Aug. 5, 2005	Specific areas (operations and systems)
UFJ Bank	June 7, 2005	July 4, 2005	July 19, 2005	—	Aug. 9, 2005	Specific areas (operations and systems)
Ashikaga Bank	June 6, 2005	July 5, 2005	July 12, 2005	—	July 25, 2005	Normal
Shinkin Trust Bank	June 8, 2005	July 6, 2005	July 28, 2005	—	Aug. 25, 2005	Normal
Chugoku Bank	June 8, 2005	July 6, 2005	July 22, 2005	—	Aug. 5, 2005	Normal
Tohoku Bank	June 6, 2005	July 6, 2005	July 22, 2005	—	Aug. 19, 2005	Normal
Fukushima Bank	June 6, 2005	July 11, 2005	July 29, 2005	—	Aug. 24, 2005	Normal
Momiji Bank	June 7, 2005	July 11, 2005	July 29, 2005	—	Aug. 23, 2005	Normal
IY Bank	July 28, 2005	Aug. 29, 2005	Sep. 9, 2005	—	Sep. 29, 2005	Normal
Aichi Bank	July 21, 2005	Aug. 30, 2005	Sep. 14, 2005	—	Oct. 11, 2005	Normal
Awa Bank	July 20, 2005	Aug. 30, 2005	Sep. 14, 2005	—	Oct. 14, 2005	Normal
Hachijuni Bank	July 21, 2005	Aug. 30, 2005	Sep. 14, 2005	—	Oct. 5, 2005	Normal
Iyo Bank	July 21, 2005	Sep. 1, 2005	Sep. 16, 2005	—	Oct. 7, 2005	Normal
Bank of Nagasaki	Sep. 12, 2005	Oct. 18, 2005	Nov. 2, 2005	—	Nov. 24, 2005	Normal
Nishi-Nippon City Bank	Sep. 13, 2005	Oct. 18, 2005	Nov. 2, 2005	—	Nov. 24, 2005	Normal
Hokuriku Bank	Sep. 12, 2005	Oct. 18, 2005	Nov. 2, 2005	—	Nov. 30, 2005	Normal
Bank of the Ryukyus	Sep. 14, 2005	Oct. 18, 2005	Nov. 2, 2005	—	Nov. 24, 2005	Normal
Credit Suisse Trust and Banking	Sep. 13, 2005	Oct. 19, 2005	Nov. 2, 2005	—	Nov. 24, 2005	Normal
Bank of Kyoto	Sep. 9, 2005	Oct. 31, 2005	Nov. 16, 2005	—	Dec. 5, 2005	Normal
Kanagawa Bank	Nov. 1, 2005	Dec. 1, 2005	Dec. 16, 2005	—	Jan. 19, 2006	Normal
Kansai Urban Banking	Oct. 31, 2005	Dec. 1, 2005	Dec. 16, 2005	—	Jan. 17, 2006	Normal
77 Bank	Oct. 31, 2005	Dec. 1, 2005	Dec. 16, 2005	—	Jan. 16, 2006	Normal
Shokusan Bank	Nov. 1, 2005	Dec. 1, 2005	Dec. 16, 2005	—	Jan. 16, 2006	Normal
Hokkaido Bank	Nov. 1, 2005	Dec. 5, 2005	Dec. 21, 2005	—	Jan. 27, 2006	Normal
Mitsubishi UFJ Trust and Banking	Dec. 13, 2005	Jan. 23, 2006	Feb. 7, 2006	—	Mar. 1, 2006	Normal
Tokyo Tomin Bank	Dec. 16, 2005	Feb. 1, 2006	Feb. 16, 2006	—	Mar. 14, 2006	Normal
Yachiyo Bank	Dec. 14, 2005	Feb. 1, 2006	Feb. 16, 2006	—	Mar. 17, 2006	Normal
Hyakujushi Bank	Dec. 15, 2005	Feb. 2, 2006	Feb. 17, 2006	—	Mar. 27, 2006	Normal

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

(2) 73 *Shinkin* Banks[2]

Financial institutions	Date of acceptance	Date of entry	Date of completion	Period of interruption	Transmission of result	Class of examination
Tsuyama Shinkin Bank	Mar. 3, 2005	Apr. 5, 2005	Apr. 19, 2005	—	May 13, 2005	Normal
Abukuma Shinkin Bank	Mar. 3, 2005	Apr. 6, 2005	Apr. 20, 2005	—	May 17, 2005	Normal
Arai Shinkin Bank	Mar. 3, 2005	Apr. 6, 2005	Apr. 20, 2005	—	May 16, 2005	Normal
Ome Shinkin Bank	Mar. 3, 2005	Apr. 6, 2005	Apr. 21, 2005	—	May 19, 2005	Normal
Osaka Kousei Shinkin Bank	Mar. 3, 2005	Apr. 6, 2005	Apr. 20, 2005	—	May 18, 2005	Normal
Karasuyama Shinkin Bank	Mar. 2, 2005	Apr. 6, 2005	Apr. 20, 2005	—	May 17, 2005	Normal
Kitagunma Shinkin Bank	Mar. 2, 2005	Apr. 6, 2005	Apr. 20, 2005	—	May 16, 2005	Normal
Hanno Shinkin Bank	Mar. 3, 2005	Apr. 6, 2005	Apr. 21, 2005	—	May 17, 2005	Normal
Kuwana Shinkin Bank	Apr. 21, 2005	May 25, 2005	June 8, 2005	—	June 30, 2005	Normal
Kofu Shinkin Bank	Apr. 19, 2005	May 25, 2005	June 8, 2005	—	June 27, 2005	Normal
Sano Shinkin Bank	Apr. 18, 2005	May 25, 2005	June 7, 2005	—	June 21, 2005	Normal
Sugamo Shinkin Bank	Apr. 18, 2005	May 25, 2005	June 9, 2005	—	July 5, 2005	Normal
Takasaki Shinkin Bank	Apr. 18, 2005	May 25, 2005	June 8, 2005	—	June 24, 2005	Normal
Chunan Shinkin Bank	Apr. 19, 2005	May 25, 2005	June 7, 2005	—	June 20, 2005	Normal
Tsu Shinkin Bank	Apr. 19, 2005	May 25, 2005	June 7, 2005	—	July 8, 2005	Normal
Esashi Shinkin Bank	Apr. 19, 2005	June 23, 2005	July 6, 2005	—	Aug. 4, 2005	Normal
Seino Shinkin Bank	Apr. 18, 2005	June 23, 2005	July 6, 2005	—	Aug. 8, 2005	Normal
Aomori Shinkin Bank	Apr. 18, 2005	June 24, 2005	July 7, 2005	—	Aug. 8, 2005	Normal
Shimanami Shinkin Bank	June 6, 2005	July 5, 2005	July 22, 2005	—	Aug. 5, 2005	Normal
Kyoto Hokuto Shinkin Bank	June 6, 2005	July 6, 2005	July 22, 2005	—	Aug. 11, 2005	Normal
Too Shinkin Bank	June 7, 2005	July 6, 2005	July 21, 2005	—	Aug. 9, 2005	Normal
Tomakomai Shinkin Bank	June 9, 2005	July 6, 2005	July 21, 2005	—	Aug. 19, 2005	Normal
Noto Kyouei Shinkin Bank	June 7, 2005	July 6, 2005	July 21, 2005	—	Aug. 5, 2005	Normal
Banshu Shinkin Bank	June 6, 2005	July 6, 2005	July 22, 2005	—	Aug. 19, 2005	Normal
Sawara Shinkin Bank	June 8, 2005	July 13, 2005	July 28, 2005	—	Aug. 18, 2005	Normal
Komatsugawa Shinkin Bank	May 23, 2005	July 20, 2005	Aug. 2, 2005	—	Aug. 22, 2005	Normal
Ube Shinkin Bank	May 23, 2005	July 21, 2005	Aug. 3, 2005	—	Aug. 24, 2005	Normal
Bisai Shinkin Bank	May 20, 2005	July 22, 2005	Aug. 4, 2005	—	Aug. 24, 2005	Normal
Abashiri Shinkin Bank	July 22, 2005	Aug. 24, 2005	Sep. 6, 2005	—	Sep. 15, 2005	Normal
Ishinomaki Shinkin Bank	July 22, 2005	Aug. 24, 2005	Sep. 6, 2005	—	Oct. 12, 2005	Normal
Towada Shinkin Bank	July 20, 2005	Aug. 24, 2005	Sep. 6, 2005	—	Sep. 15, 2005	Normal
Iwata Shinkin Bank	July 21, 2005	Aug. 30, 2005	Sep. 14, 2005	—	Oct. 7, 2005	Normal
Johoku Shinkin Bank	July 21, 2005	Aug. 30, 2005	Sep. 15, 2005	—	Oct. 13, 2005	Normal
Tokyo Bay Shinkin Bank	July 21, 2005	Aug. 30, 2005	Sep. 15, 2005	—	Oct. 11, 2005	Normal
Nishio Shinkin Bank	July 22, 2005	Aug. 30, 2005	Sep. 14, 2005	—	Oct. 4, 2005	Normal
Yamanashi Shinkin Bank	July 20, 2005	Aug. 30, 2005	Sep. 15, 2005	—	Oct. 11, 2005	Normal
Alupuschuo Shinkin Bank	July 21, 2005	Aug. 31, 2005	Sep. 14, 2005	—	Oct. 6, 2005	Normal
Joetsu Shinkin Bank	July 21, 2005	Aug. 31, 2005	Sep. 14, 2005	—	Oct. 4, 2005	Normal
Tonami Shinkin Bank	July 20, 2005	Sep. 21, 2005	Oct. 5, 2005	—	Oct. 17, 2005	Normal
Nara Chuo Shinkin Bank	July 21, 2005	Sep. 21, 2005	Oct. 5, 2005	—	Oct. 19, 2005	Normal
Fuji Shinkin Bank	July 21, 2005	Sep. 21, 2005	Oct. 5, 2005	—	Oct. 24, 2005	Normal
Amagasaki Shinkin Bank	Sep. 12, 2005	Oct. 18, 2005	Nov. 2, 2005	—	Nov. 25, 2005	Normal
Kagoshima Sogo Shinkin Bank	Sep. 12, 2005	Oct. 18, 2005	Nov. 2, 2005	—	Nov. 22, 2005	Normal
Kawasaki Shinkin Bank	Sep. 12, 2005	Oct. 18, 2005	Nov. 2, 2005	—	Nov. 22, 2005	Normal
Shizuoka Shinkin Bank	Sep. 12, 2005	Oct. 18, 2005	Nov. 2, 2005	—	Nov. 25, 2005	Normal
Ehime Shinkin Bank	Sep. 12, 2005	Oct. 19, 2005	Nov. 2, 2005	—	Nov. 24, 2005	Normal
Kushiro Shinkin Bank	Aug. 26, 2005	Oct. 25, 2005	Nov. 8, 2005	—	Nov. 22, 2005	Normal

(2) 73 *Shinkin* Banks[2] (continued)

Financial institutions	Date of acceptance	Date of entry	Date of completion	Period of interruption	Transmission of result	Class of examination
Handa Shinkin Bank	Aug. 26, 2005	Oct. 26, 2005	Nov. 9, 2005	—	Nov. 21, 2005	Normal
Kibi Shinkin Bank	Aug. 26, 2005	Oct. 28, 2005	Nov. 11, 2005	—	Nov. 22, 2005	Normal
Uwajima Shinkin Bank	Oct. 31, 2005	Dec. 1, 2005	Dec. 14, 2005	—	Jan. 20, 2006	Normal
Kamiichi Shinkin Bank	Nov. 1, 2005	Dec. 1, 2005	Dec. 15, 2005	—	Jan. 20, 2006	Normal
Kitaiseueno Shinkin Bank	Oct. 31, 2005	Dec. 1, 2005	Dec. 15, 2005	—	Jan. 26, 2006	Normal
Shibetsu Shinkin Bank	Nov. 1, 2005	Dec. 1, 2005	Dec. 14, 2005	—	Jan. 17, 2006	Normal
Shingu Shinkin Bank	Nov. 1, 2005	Dec. 1, 2005	Dec. 15, 2005	—	Jan. 13, 2006	Normal
Tamashima Shinkin Bank	Nov. 1, 2005	Dec. 1, 2005	Dec. 14, 2005	—	Jan. 17, 2006	Normal
Tokyo Sankyo Shinkin Bank	Oct. 31, 2005	Dec. 1, 2005	Dec. 15, 2005	—	Jan. 20, 2006	Normal
Yamaguchi Shinkin Bank	Nov. 2, 2005	Dec. 1, 2005	Dec. 15, 2005	—	Jan. 19, 2006	Normal
Tottori Shinkin Bank	Oct. 31, 2005	Dec. 2, 2005	Dec. 16, 2005	—	Jan. 23, 2006	Normal
Nihonmatsu Shinkin Bank	Nov. 2, 2005	Dec. 6, 2005	Dec. 20, 2005	—	Jan. 18, 2006	Normal
Tsuruga Shinkin Bank	Dec. 15, 2005	Jan. 25, 2006	Feb. 7, 2006	—	Mar. 3, 2006	Normal
Hagi Shinkin Bank	Dec. 15, 2005	Jan. 25, 2006	Feb. 8, 2006	—	Feb. 21, 2006	Normal
Hata Shinkin Bank	Dec. 15, 2005	Jan. 25, 2006	Feb. 7, 2006	—	Feb. 17, 2006	Normal
Isurugi Shinkin Bank	Dec. 14, 2005	Feb. 1, 2006	Feb. 15, 2006	—	Mar. 6, 2006	Normal
Onga Shinkin Bank	Dec. 15, 2005	Feb. 1, 2006	Feb. 15, 2006	—	Mar. 10, 2006	Normal
Kurayoshi Shinkin Bank	Dec. 15, 2005	Feb. 1, 2006	Feb. 15, 2006	—	Mar. 14, 2006	Normal
Shirakawa Shinkin Bank	Dec. 14, 2005	Feb. 1, 2006	Feb. 15, 2006	—	Mar. 3, 2006	Normal
Hekikai Shinkin Bank	Dec. 15, 2005	Feb. 1, 2006	Feb. 16, 2006	—	Mar. 6, 2006	Normal
Mito Shinkin Bank	Dec. 14, 2005	Feb. 1, 2006	Feb. 16, 2006	—	Mar. 10, 2006	Normal
Sanjyo Shinkin Bank	Dec. 14, 2005	Feb. 2, 2006	Feb. 16, 2006	—	Mar. 8, 2006	Normal
Shiba Shinkin Bank	Jan. 13, 2006	Feb. 21, 2006	Feb. 28, 2006	—	Mar. 22, 2006	Specific areas (operations and systems)
Fujinomiya Shinkin Bank	Dec. 16, 2005	Feb. 22, 2006	Mar. 7, 2006	—	Mar. 24, 2006	Normal
Yonezawa Shinkin Bank	Dec. 15, 2005	Mar. 1, 2006	Mar. 15, 2006	—	Apr. 4, 2006	Normal
Chuei Shinkin Bank	Dec. 15, 2005	Mar. 16, 2006	Mar. 30, 2006	—	Apr. 12, 2006	Normal

Note: *2*. Chronologically listed in accordance with the date of entry.

(3) 45 Foreign Banks, Securities Companies, and Other Institutions[3]

Financial institutions	Date of acceptance	Date of entry	Date of completion	Period of interruption	Transmission of result	Class of examination
Kookmin Bank	Mar. 2, 2005	Apr. 5, 2005	Apr. 12, 2005	—	May 20, 2005	Normal
Union de Banques Arabes et Francaises	Mar. 3, 2005	Apr. 5, 2005	Apr. 12, 2005	—	May 23, 2005	Normal
Japan Securities Finance	Mar. 9, 2005	Apr. 7, 2005	Apr. 20, 2005	—	May 17, 2005	Normal
Mizuho Securities	Mar. 11, 2005	Apr. 18, 2005	Apr. 28, 2005	—	May 23, 2005	Normal
Royal Bank of Canada	Mar. 3, 2005	Apr. 20, 2005	Apr. 27, 2005	—	May 20, 2005	Normal
Korea Development Bank	Mar. 9, 2005	Apr. 20, 2005	Apr. 27, 2005	—	May 20, 2005	Normal
Cosmo Securities	Apr. 19, 2005	May 20, 2005	May 31, 2005	—	July 1, 2005	Normal
Chinatrust Commercial Bank	Apr. 18, 2005	May 24, 2005	May 31, 2005	—	July 1, 2005	Normal
United Overseas Bank	Apr. 19, 2005	May 24, 2005	May 31, 2005	—	July 4, 2005	Normal
Japan Bond Trading	Apr. 18, 2005	May 30, 2005	June 7, 2005	—	June 21, 2005	Normal
Norinchukin Bank[4]	Apr. 21, 2005	June 1, 2005	June 8, 2005	—	June 27, 2005	Normal
Kosei Securities	Apr. 18, 2005	June 8, 2005	June 14, 2005	—	July 1, 2005	Normal
Goldman Sachs	May 2, 2005	June 8, 2005	June 21, 2005	—	July 12, 2005	Normal

(3) 45 Foreign Banks, Securities Companies, and Other Institutions[3] (continued)

Financial institutions	Date of acceptance	Date of entry	Date of completion	Period of interruption	Transmission of result	Class of examination
Bank of Nova Scotia	Apr. 18, 2005	June 8, 2005	June 15, 2005	—	July 15, 2005	Normal
Hana Bank	Apr. 19, 2005	June 8, 2005	June 15, 2005	—	July 1, 2005	Normal
Korea Exchange Bank	June 7, 2005	July 5, 2005	July 12, 2005	—	Aug. 22, 2005	Normal
National Bank of Pakistan	June 6, 2005	July 5, 2005	July 12, 2005	—	Aug. 26, 2005	Normal
Shinkin Securities	June 8, 2005	July 6, 2005	July 28, 2005	—	Aug. 25, 2005	Normal
Shinkin Central Bank	June 7, 2005	July 6, 2005	July 28, 2005	—	Aug. 25, 2005	Normal
State Bank of India	June 6, 2005	July 21, 2005	July 28, 2005	—	Aug. 26, 2005	Normal
Industrial Bank of Korea	June 6, 2005	July 21, 2005	July 28, 2005	—	Aug. 22, 2005	Normal
Chohung Bank	July 21, 2005	Aug. 29, 2005	Sep. 2, 2005	—	Oct. 18, 2005	Normal
Nomura Securities	July 22, 2005	Aug. 30, 2005	Sep. 14, 2005	—	Oct. 7, 2005	Normal
Calyon	July 20, 2005	Aug. 31, 2005	Sep. 14, 2005	—	Oct. 7, 2005	Normal
Calyon Capital Markets Asia	July 20, 2005	Aug. 31, 2005	Sep. 14, 2005	—	Oct. 7, 2005	Normal
Shinhan Bank	July 21, 2005	Sep. 12, 2005	Sep. 22, 2005	—	Oct. 14, 2005	Normal
Credit Suisse	Sep. 13, 2005	Oct. 19, 2005	Nov. 2, 2005	—	Nov. 24, 2005	Normal
Credit Suisse First Boston Securities	Sep. 12, 2005	Oct. 19, 2005	Nov. 2, 2005	—	Nov. 24, 2005	Normal
Toronto-Dominion Bank	Sep. 21, 2005	Oct. 19, 2005	Oct. 26, 2005	—	Dec. 12, 2005	Normal
Rokinren Bank	Sep. 15, 2005	Oct. 19, 2005	Nov. 2, 2005	—	Nov. 22, 2005	Normal
Ichiyoshi Securities	Sep. 12, 2005	Oct. 24, 2005	Nov. 2, 2005	—	Dec. 5, 2005	Normal
Wachovia Bank, National Association	Sep. 12, 2005	Nov. 4, 2005	Nov. 11, 2005	—	Dec. 8, 2005	Normal
Socius Securities	Sep. 12, 2005	Nov. 10, 2005	Nov. 16, 2005	—	Dec. 5, 2005	Normal
Banco do Estado de Sao Paulo	Nov. 1, 2005	Nov. 24, 2005	Dec. 1, 2005	—	Jan. 19, 2006	Normal
Tokai Tokyo Securities	Nov. 1, 2005	Dec. 1, 2005	Dec. 15, 2005	—	Jan. 19, 2006	Normal
BNP Paribas	Oct. 31, 2005	Dec. 5, 2005	Dec. 20, 2005	—	Jan. 19, 2006	Normal
BNP Paribas Securities	Oct. 31, 2005	Dec. 5, 2005	Dec. 20, 2005	—	Jan. 19, 2006	Normal
ING Bank N.V.	Oct. 31, 2005	Dec. 9, 2005	Dec. 16, 2005	—	Jan. 24, 2006	Normal
Okasan Securities	Dec. 15, 2005	Feb. 1, 2006	Feb. 15, 2006	—	Mar. 3, 2006	Normal
Bangkok Bank	Dec. 15, 2005	Feb. 1, 2006	Feb. 8, 2006	—	Mar. 14, 2006	Normal
Rabobank Nederland	Dec. 14, 2005	Feb. 1, 2006	Feb. 8, 2006	—	Mar. 14, 2006	Normal
Standard Chartered Bank	Dec. 17, 2005	Feb. 16, 2006	Feb. 23, 2006	—	Mar. 17, 2006	Normal
Philippine National Bank	Dec. 14, 2005	Feb. 16, 2006	Feb. 23, 2006	—	Mar. 16, 2006	Normal
Daiwa Securities	Jan. 23, 2006	Feb. 20, 2006	Mar. 10, 2006	—	Mar. 27, 2006	Normal
Daiwa Securities SMBC	Jan. 23, 2006	Feb. 20, 2006	Mar. 10, 2006	—	Mar. 27, 2006	Normal

Notes: *3*. Chronologically listed in accordance with the date of entry.
4. For administrative reasons, part of the on-site examination (normal class) scheduled for fiscal 2004 was carried over to fiscal 2005.

3. On-site examination policy in fiscal 2006

The Bank made public on April 17 its "On-Site Examination Policy for Fiscal 2006," the text of which had been decided by the Policy Board on April 7, 2006.[8] The major points are as follows.

On-Site Examination Policy for Fiscal 2006

I. Review of On-Site Examinations and Off-Site Monitoring of Financial Institutions in Fiscal 2005[1]

A. Number of Financial Institutions Examined

In fiscal 2005, the Bank of Japan conducted on-site examinations at a total of 160 financial institutions: 42 domestically licensed Japanese banks, 73 *shinkin* banks, and 45 other institutions including securities companies and Japanese branches of foreign banks.

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

The Bank released a paper in March 2005 entitled "The Bank of Japan's Measures regarding the Financial System after the Full Removal of Blanket Guarantee of Deposits." In this paper, the Bank clarified its intention to shift its focus in financial system policy from crisis management to supporting private-sector initiatives aimed at providing more efficient and advanced financial services via fair competition, while maintaining overall system stability. Under this policy, the Bank conducted on-site examinations and off-site monitoring in fiscal 2005 with a view to encouraging financial institutions' efforts to improve their management of risks and business activities, while standing ready to act as the lender of last resort.

Conditions in the financial system and management issues faced by financial institutions observed through on-site examinations and off-site monitoring are as follows.

1. Overview

There has been further progress in financial institutions' disposal of nonperforming loans (NPLs). The ratio of NPLs to total loans has continued to decrease. Financial institutions' profits have largely increased mainly due to a decline in credit costs (i.e., write-offs and loan-loss provisions for NPLs). In addition, their overall financial strength has been improving as some financial institutions have been raising more funds in capital markets. Under these conditions, financial institutions have been expanding credit at home and abroad and also seeking opportunities for new financial services and business by making cross-sectoral investments and business alliances. Meanwhile, financial institutions have been gradually making progress in advancing their management of risks and business activities although they still face some challenges. Moreover, there is room for further improvement in strengthening the profitability of their core business.

1. The fiscal year in Japan starts in April and ends in March.

8. The original version in Japanese was released on April 12, 2006.

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

2. Credit risk

On the whole, there have been further improvements in financial institutions' credit risk management and in the quality of loan portfolios.

Self-assessments by individual financial institutions of their exposure to credit risk have become more accurate, and the practice of conducting write-offs and setting aside loan-loss provisions in line with those assessments is taking hold. As for corporate restructuring, financial institutions including regional institutions have been making continuous efforts, and these seem to be bearing fruit. Risk management at some financial institutions still needed improvement in the following areas: (1) assessment of borrower firms on a corporate-group basis and estimation of their future cash flows; (2) a gap between the estimated value of real estate taken as collateral and its actual disposal value, especially in the regional economy where land prices have been falling; and (3) review of corporate restructuring plans submitted by borrower firms and insufficient provision of advice with regard to actions laid out in the plans.

An increasing number of financial institutions have developed more reliable internal rating systems and have been quantifying credit risks based on such methods. The Bank, in its on-site examinations, quantified risks taken by financial institutions, which had already established such internal credit rating systems, and discussed the risk profiles of their credit portfolios and future credit costs. The Bank found that there was room for improvement, mainly at regional financial institutions, in terms of the performance of methods for internal rating and risk quantification. The Bank also found that there were still various management issues in utilizing methods, for example, for the allocation of risk capital under the integrated risk management framework and for the setting of lending rates corresponding to the borrowers' creditworthiness.

With regard to active credit portfolio management, some institutions such as major banks, which had almost finished the disposal of large NPLs, began to shift to more effectively controlling concentration in their overall credit portfolios, including performing loans with normal returns.

Financial institutions have become more willing to extend loans as constraints on capital have eased. Reflecting this tendency, lending rates have continued to decrease and new types of loans such as mortgages, uncollateralized loans to small and medium-sized businesses based on credit scores, syndicated loans, and non-recourse real estate loans, have been expanded. With regard to credit pools of small loans such as mortgages and uncollateralized loans to small and medium-sized businesses, the Bank through its on-site examinations found that there were some cases where improvement in risk assessment of such loans was needed by better grasping changes in borrower characteristics and sufficiently reviewing scoring models. As for syndicated loans and non-recourse real estate loans, the Bank found some problems with estimation of future cash flows, assessment of collateral values, and setting of covenants.

3. Market risk

Major banks have established methods for controlling risk within their integrated risk management framework. Throughout fiscal 2005, they generally maintained a cautious stance on investment with a view to containing the amount of interest rate risk within capital allocated, while at the same time they continued to enhance the accuracy of risk quantification methods.

Regional financial institutions, on the other hand, have generally expanded securities investment in order to improve their profitability, and it has therefore become all the more important for them to manage market risk properly. The Bank, however, found cases at quite a few financial institutions where risk management efforts were needed in terms of quantifying risks and setting risk limits in accordance with their capital adequacy.

All major banks have kept their stockholdings below the level of their Tier I capital, and they have almost completed curtailing their stockholdings. The risks associated with financial institutions' stockholdings have increased to some extent, as these institutions have stopped reducing their stockholdings and the volatility of the stock market has risen.

Many financial institutions have been increasing their investment in structured bonds, real estate funds, and hedge funds so as to achieve higher returns. The Bank examined the risk management frameworks associated with such investment using pricing models in some cases, and found that some financial institutions had problems related to establishing the principles for individual investment decisions and to confirming whether investment decisions comply with such principles, as well as to the identification and quantification of the associated risks.

4. Settlement and liquidity risks

Since the full removal of blanket guarantee of deposits at the beginning of fiscal 2005, neither a large shift in deposits nor trouble related to financial institutions' liquidity management has occurred. No serious problems have occurred with the payment and settlement operations of financial institutions, although some troubles associated with securities transactions have been observed. The Bank found through its on-site examinations, however, that there were some cases where financial institutions needed further improvement in monitoring the funding conditions, implementing stress analyses, drawing more detailed contingency plans, and carrying out practical drills, although they have not actually experienced any specific problems under the accommodative financial environment.

The market reputation of major banks, including their creditworthiness, greatly improved as their profits and financial strength recovered. Thus, their stance on domestic currency funding has returned to normal. Foreign currency funding has also been smooth, and there has been an active expansion of investment assets.

5. Operational risk[2]

The characteristics of financial institutions' operational risk have been changing greatly. On the one hand, financial institutions have been further automating and streamlining their operations by centralizing operations at their headquarters and increasing outsourcing. And, on the other hand, they have begun to take active steps to offer new financial services. The number of incidents, accidents, or other problems has been on an uptrend. In particular, cases involving large-scale embezzlement and leaking of confidential information came to light in fiscal 2005. Operational risk management has therefore become increasingly important. Financial institutions need to enhance internal control through efforts such as (1) implementing appropriate rules and manuals, (2) enforcing systems for checking and authorizing operations through staff training, and (3) enhancing the functioning of internal audits. Meanwhile, throughout fiscal 2005, various measures were taken to deal with new types of financial crimes such as counterfeit automated teller machine (ATM) cards or "phishing." Some financial institutions, however, were slow in implementing necessary measures.

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

There was a decline in the number of large-scale malfunctions of computer systems in fiscal 2005, despite the fact that large-scale system integration and joint system development and operation among two or more financial institutions were carried out. However, there were increases in the incidence of smaller system troubles causing customers inconvenience at regional financial institutions and their joint operational centers, and there were major system troubles arising from securities transactions. The Bank checked through its on-site examinations whether financial institutions' computer systems were being developed and run appropriately, and found that there was room for improving information security and management of third parties to whom they have outsourced operations (outsourcees).

There has been gradual progress in business continuity arrangements. However, the Bank found that there were still many financial institutions which needed improvement in establishing back-up facilities and in conducting emergency drills regularly.

II. On-Site Examination Policy for Fiscal 2006

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

The Bank will focus on encouraging financial institutions' efforts to improve their management of risks and business activities and to develop innovative services tailored to customer needs, thereby contributing to the enhancement of the functioning and robustness of the overall financial system. At the same time, the Bank will continue to ensure that it has an accurate grasp of the performance of financial institutions through its on-site examinations, so as to be ready to act as the lender of last resort.

Given the recent changes in the economic and financial situation, it is all the more important for financial institutions to manage risks and business activities with an emphasis on the future outlook, taking into consideration various uncertainties related to, for example, business performance in the corporate sector, market interest rates, and asset prices. The Bank will have in-depth discussions with each financial institution on management issues on this front, and support its efforts toward finding appropriate solutions.

Based on the above principles, the Bank will conduct its on-site examinations in fiscal 2006, with the following five points providing the core elements.

1. Assessing the economic value and risk associated with assets and financial transactions

Given the dynamic changes in the economic situation, it has become even more important for financial institutions to properly assess the whole range of their assets and financial transactions in terms of their economic value and volatility (i.e., risk) in order to control risks appropriately.

As for loan assets, the Bank will broadly apply the approach based on the discounted cash flow (DCF) method and work to develop a common understanding with financial institutions regarding the assessed economic value and risk involved in assets including new types of loans such as syndicated loans and non-recourse real estate loans. In doing so, the Bank will discuss with these institutions the process for setting lending rates and how they can better advise borrower firms to improve their financial conditions in cases where the economic value of these institutions' assets has decreased.

For financial institutions that have already established internal credit rating systems, the Bank will verify the accuracy of such systems. The Bank will also evaluate risks involved in credit portfolio concentration as well as the effects of the business cycle on the associated risks, and then discuss methods for controlling credit risk and setting lending rates, based on the quantification and analysis of expected losses (EL) and unexpected losses (UL) in financial institutions' credit portfolios.

With respect to credit pools of small loans, such as mortgages and uncollateralized loans to small and medium-sized businesses which financial institutions have been expanding, the Bank will examine how financial institutions have developed the systems for managing the associated risks on a collective basis. This will include compiling data such as borrower characteristics, portfolio monitoring, and setting lending rates.

Turning to assets other than loans, the Bank will assess the economic value of financial institutions' assets as follows: (1) assess the economic value of assets for which market prices are available, such as listed securities, by using the mark-to-market approach; and (2) assess the economic value of assets for which market prices are not available, for example, structured bonds, structured deposits and loans, privately placed real estate funds, and hedge funds in which financial institutions have invested increasingly, by utilizing pricing models, i.e., the mark-to-model approach, where necessary.

2. Developing and utilizing integrated risk management

It is important for financial institutions to develop an integrated risk management framework covering credit risk, market risk, and operational risk and to utilize it for their business management, when they review their capital adequacy, evaluate risks and returns on assets, and determine efficient capital allocations. This will help their business to become even more rational and efficient. In its on-site examinations, the Bank will encourage financial institutions to develop and utilize an integrated risk management framework, taking their specific financial and business conditions into consideration.

Specifically, the Bank will hold in-depth discussions on topics such as how to further improve methods for integrated risk management and how to utilize risk-adjusted indicators for business management, with financial institutions, particularly with major banks that have already been developing such risk management systems. Meanwhile, with respect to financial institutions that have not yet introduced an integrated risk management framework, the Bank will work together to develop a common understanding of integrated risk management. These points are consistent with the concept of the new capital adequacy framework, Basel II. The Bank will also support financial institutions' efforts to develop integrated risk management frameworks by encouraging them to collect necessary data and to establish measures to quantify risks.

Considering the possibility of future interest rate fluctuations, it is becoming increasingly important for financial institutions to appropriately control interest rate risk within an integrated risk management framework. In its on-site examinations, the Bank will carefully examine financial institutions' interest rate risk management systems. At the same time, the Bank will examine whether capital is being efficiently allocated and used, as a buffer for taking additional risks, based on factors such as changes in the economic value and risks associated with individual asset holdings. The Bank will also examine whether management decisions on investment strategies are being made through appropriate internal procedures based on the assessment of the associated risk in proportion to financial institutions' capital bases. In relation to interest rate risk, the Bank will also have in-depth discussions on the following: (1) awareness of the interest rate risk associated with banking account transactions such as deposits and loans; (2) the possibility of changes in asset and liability structure caused by interest rate fluctuations; and (3) the effects of such changes and measures for controlling interest rate risk.

Information disclosure by financial institutions, based on appropriate assessment of the economic value of their assets and the associated risks, will make it easier for depositors and investors to evaluate the management capabilities of financial institutions and to assess the corresponding risks and returns on their investments. This is expected to improve the functioning of market discipline on financial institutions' management. From this viewpoint, the Bank will encourage financial institutions to further improve information disclosure regarding their risk management.

3. Active credit portfolio management

If financial institutions acquired the ability to more objectively assess risks and returns on their assets under an integrated risk management framework, they would be able to control risks involved in credit portfolio concentration as well as overall risks and returns on their credits, and thereby optimize their credit portfolios through measures including active reshuffling of their assets. This would lead to increased activity in credit markets, such as markets for securitizing loans and other assets, and to more diversified channels for credit extension, and hence to the enhanced functioning of the entire financial system.

From this viewpoint, the Bank will, through its on-site examinations, support financial institutions' efforts toward active credit portfolio management and hold in-depth discussions with them on necessary measures, such as reviewing legal frameworks and business practices.

4. Ensuring smooth settlement and business continuity

Taking into consideration the probable change in the financial environment after the termination of the quantitative easing policy, financial institutions are expected to manage their liquidity more effectively and to implement their payment and settlement operations smoothly. In its on-site examinations, the Bank will identify risks inherent in the overall payment and settlement system and also carefully examine financial institutions' liquidity management, with a view to preventing the materialization of systemic risk.

The Bank will continue to monitor projects aimed at computer system integration and joint system development and operation among two or more financial institutions. The Bank will also verify the stability of such systems and the level of safety regarding information security, in light of factors such as changes in financial institutions' computer system structure and the technology that forms the basis for the structure. In addition, the Bank intends, where necessary, to check operators of clearing systems and financial institutions' outsourcees to ensure smooth operation of the overall payment and settlement system.

Financial institutions need to make further efforts to establish more extensive business continuity arrangements for emergencies, namely, natural disasters and terrorist attacks, where they will not be able to continue their normal business operations. Specifically, the Bank intends to hold in-depth discussions on establishing effective business continuity arrangements and coordination with the Bank with operators of clearing systems as well as financial institutions that have a strong presence in financial markets or that function as hub parties in the settlement system whose business disruptions would have a serious impact on financial markets.

5. Establishing internal controls

It is important that financial institutions have in place internal control systems and that they are functioning effectively, in order to achieve advanced risk management and efficient business management. Effectively functioning internal control systems are also essential in enhancing security in financial transactions by ensuring appropriate business operations and dealing with financial crimes.

The Bank will support financial institutions' efforts to establish internal control systems through its on-site examinations by giving due consideration to their specific financial and business conditions. Specifically, the Bank will identify risks associated with financial institutions' management and operations, examine the functioning of control activities such as segregation of power and responsibility as well as internal authorization procedures, and discuss the effectiveness of monitoring activities such as internal audits.

Based on the five core elements as outlined above, the Bank has prepared a list of key points by major risk category which it will focus on in its on-site examinations in fiscal 2006.

B. Practical Issues Relating to On-Site Examinations

In conducting its on-site examinations in fiscal 2006, the Bank intends to maintain a close dialogue with management at financial institutions and jointly seek solutions for problems, so as to provide financial institutions with an opportunity to enhance their management of risks and business activities. In this process, the Bank will take measures to make effective use of the functions of off-site monitoring and the seminars hosted by the Center for Advanced Financial Technology. The Bank also intends, where necessary, to continue to exchange views regarding accounting issues with external auditors and financial institutions.

The Bank will continue to give due consideration to easing the burden of on-site examinations on financial institutions. Specifically, based on the "On-Site Examination Policy for Fiscal 2006," the Bank will further shift the focus of its on-site examinations from the assessment of individual assets to that of their risk management framework. Along with this shift, the Bank will reduce the number of samples extracted from financial institutions' overall loan portfolios based on the condition of their risk management. In addition, the Bank will take a more flexible approach to the scope and duration of on-site examinations, and the size of examination teams, depending on the financial and business conditions at each financial institution.

Furthermore, the Bank intends to make greater use of the online data exchange system so that data used in its on-site examinations and off-site monitoring can be exchanged more efficiently and safely. The Bank introduced in fiscal 2005 extensible business reporting language (XBRL) for exchanging financial data between financial institutions and the Bank. The Bank will expand the range of package data files collected through XBRL in order to make the exchange of financial data more efficient and to encourage the development of an advanced financial information network.

F. The Establishment of the Center for Advanced Financial Technology

The Bank established the CAFT on July 8, 2005, in the Financial Systems and Bank Examination Department, to support the initiatives of private financial institutions toward adopting more advanced financial services. Its responsibilities are as follows: (1) planning and formulating measures encouraging financial institutions to adopt more advanced financial services and to ensure the security of all transactions; (2) conducting the research into advanced financial technologies and financial information security necessary to achieve this; and (3) developing advanced techniques for on-site examinations and off-site monitoring.

In order to fulfill these responsibilities, the CAFT carries out the following three activities. First, it researches and develops advanced risk management techniques, and publishes the findings. Second, it organizes seminars targeting mainly businesspeople, including managers at financial institutions. And third, it organizes training programs for the staff of the Bank's Financial Systems and Bank Examination Department and of the Bank's branches. Seminars organized by the CAFT are viewed as a third channel through which the Bank can communicate with financial institutions in addition to on-site examinations and off-site monitoring. Seminars serve as an opportunity for the Bank to share with financial institutions its viewpoints on the issues that need to be addressed in supporting their efforts to improve financial services as well as its viewpoints on possible solutions.

There are two basic principles employed in running the CAFT. First, its approach should be fully coordinated with on-site examinations and off-site monitoring so as to be practical for financial institutions' managers and their operations. Second, it aims both to engage in cutting-edge research and development of financial technologies, and to improve the level of risk management at a wide range of financial institutions, including regional ones.

G. Financial System Report[9]

The Bank released the first issue of the Financial System Report on August 10, 2005, the launch of which had been previously announced in "The Bank of Japan's Measures regarding the Financial System after the Full Removal of Blanket Guarantee of Deposits," released on March 18, 2005. The annual Financial System Report provides analysis and assessment of the state of the overall financial system and describes policy measures taken for financial system stability, as a part of the Bank's measures to enhance the functioning of financial intermediation.

H. International Initiatives for Maintaining Financial System Stability

The Bank takes part in international efforts toward enhancing the soundness of financial institutions and maintaining the stability of the global financial system. The Bank's active participation in discussions held by the Basel Committee on Banking Supervision (Basel Committee) is one such important example. In June 2004, the Committee released the new capital adequacy

9. The full text in English is available at the Bank's web site (http://www.boj.or.jp/en/type/ronbun/fsr/index.htm).

framework (Basel II) entitled "International Convergence of Capital Measurement and Capital Standards: A Revised Framework." This framework is the result of the Committee's work over recent years to secure international convergence regarding revisions to supervisory regulations governing the capital adequacy of internationally active banks. In July 2005, the Committee issued two supplementary documents to Basel II: "Guidance on Paragraph 468 of the Framework Document," and "The Application of Basel II to Trading Activities and the Treatment of Double Default Effects." In addition, the Committee, in close cooperation with financial institutions, began in October 2005 to work on the fifth Quantitative Impact Study, which aimed to evaluate the impact of the revised framework across a wide range of banks globally.

The Bank also participates in the Joint Forum established by the Basel Committee, the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS), which deals with cross-sectoral issues, including the supervision of financial conglomerates.

Through its active participation in the Basel Committee and the Joint Forum, the Bank contributes to the formulation of various supervisory standards and guidelines. It also makes use of ideas and views presented at these international forums in conducting on-site examinations and off-site monitoring. Moreover, the Bank continues to exchange views with the Financial Services Agency (FSA) and financial institutions to support the proper and smooth implementation of the new capital adequacy framework in Japan.