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 66–69). 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 2006 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 problem almost overcome, Japan's financial system as a whole remained stable in fiscal 2006. The functioning of financial intermediation improved, and the system's robustness against shocks of various types, such as rises in market interest rates and higher credit risk, increased.

Banks' profits remained high. Looking at the net income of major banks and regional banks, that of

1. The criteria are publicized only in Japanese.

major banks in the first half of fiscal 2006 was slightly higher than in the same period the previous year, thus marking a record high for two consecutive years (Chart 1). Although the net income of regional banks decreased slightly in the first half of fiscal 2006, compared with a year earlier when it marked a record high, overall levels remained high.

Banks' capital increased steadily, while the amount of risk, for example, credit risk and interest rate risk in bond portfolios, was kept low on the whole. Banks' risk-taking capacity thus appeared to be on an increasing trend. Given the situation, lending attitudes were more accommodative and the outstanding amount of bank loans increased moderately (Chart 2). Moreover, banks carried out further diversification of borrowers and loan types, and were active in extending housing loans to households and syndicated loans to firms.

Since banks' high profit levels were to some extent dependent on a one-time factor, i.e., the reversal of allowances for loan losses, the improvement in core profitability remains an important business challenge for banks. In order to strengthen core profitability, it is important that banks accurately grasp customer needs as well as providing and expanding a range of financial services tailored appropriately to those needs. Banks have been starting to redesign their business models in the following areas: investment banking services to assist firms' reorganization; retail banking services targeting individuals with high net worth; and overseas operations to support internationally active Japanese firms.

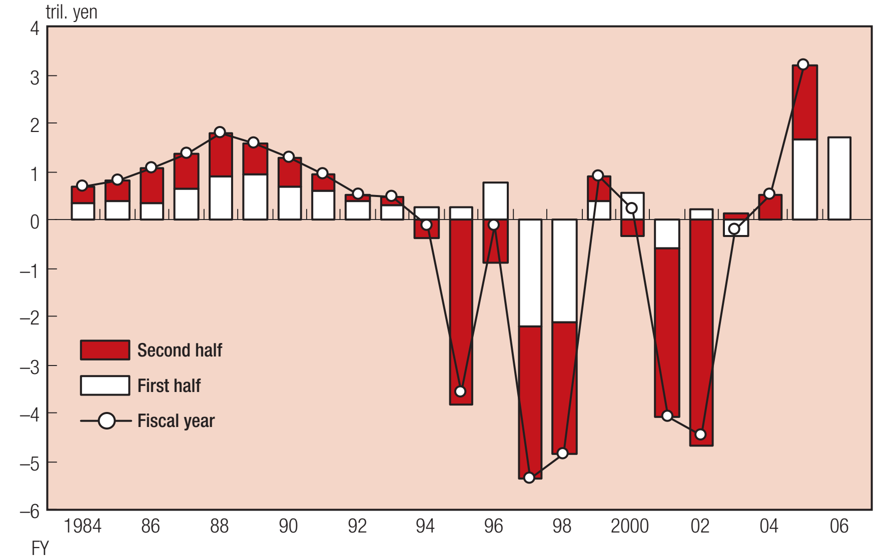
In addition to the provision and expansion of the range of financial services, banks need to improve their risk and business management. It also remains important for them to diversify channels for supplying credit, so as to make more effective use of funds from various investors, through the development 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, stable, and sound development of Japan's economy.

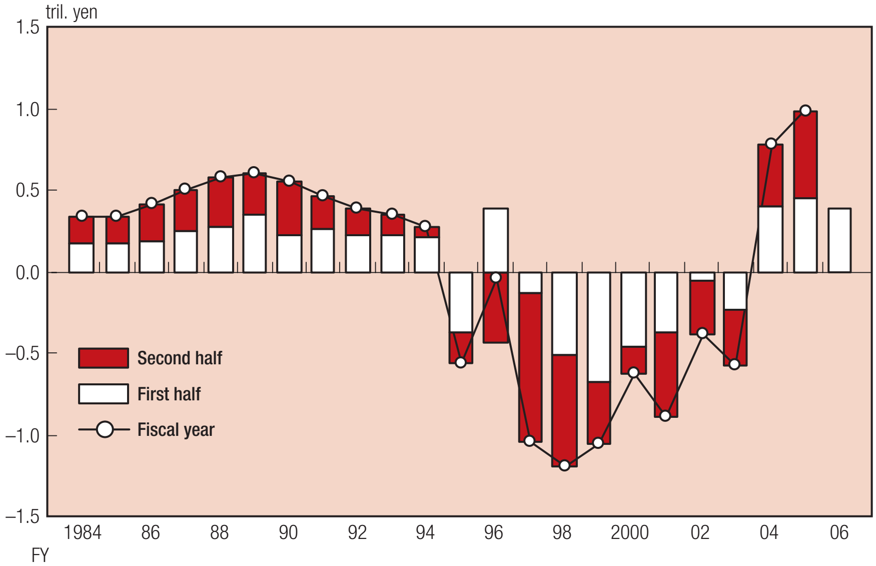
Chart 1

Net Income/Loss

(1) Major Banks[1]

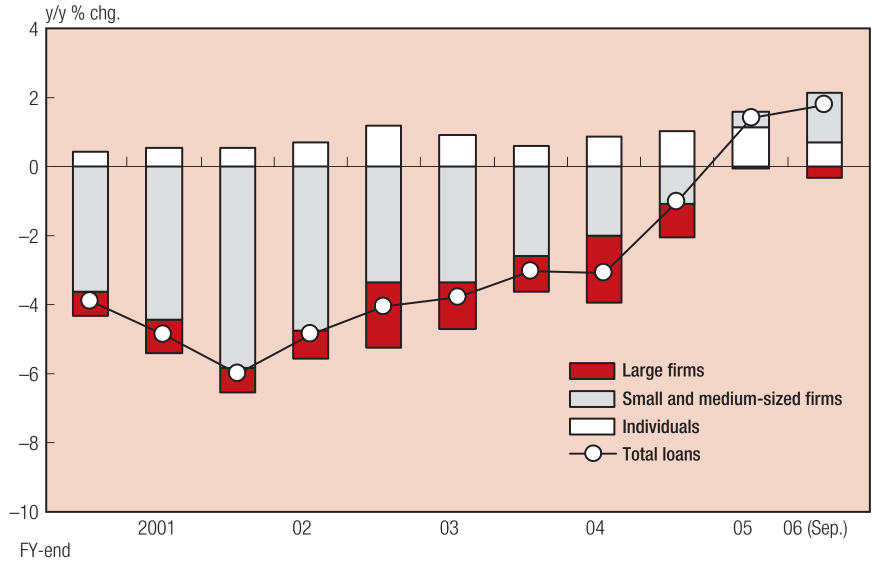


(2) Regional Banks[2]



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
Bank Loans Outstanding



III. The Bank's Measures concerning the Financial System

A. Overview

In fiscal 2006, the Bank took the following actions in line with its stance to support private-sector initiatives aimed at providing more efficient and advanced financial services via fair competition, while maintaining overall system stability.

In its on-site examinations and off-site monitoring, the Bank focused on encouraging financial institutions' efforts to strengthen their management of risks and business activities. 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. Through other activities such as seminars and workshops organized by the Bank's Center for Advanced Financial Technology (CAFT), the Bank exchanged views with financial institutions and developed a common understanding on issues relating to the financial system. The Bank released the *Financial System Report* twice a year, with the aim of enhancing research activity on the financial system and publishing research results in a more timely manner.

The Bank concluded or discontinued current account services contracts and lending facilities contracts with certain financial institutions in response to consolidation in the financial industry. It also began looking into establishing a guideline for sales of the stocks it had purchased from banks holding current accounts at the Bank in the period from November 2002 through the end of September 2004—purchases that were made in support of their efforts to reduce exposure to stock price fluctuation risk.

Furthermore, as part of its efforts to maintain the stability of the global financial system, the Bank continued to participate in discussions on international standards, including 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

In fiscal 2006, the Bank did not extend loans pursuant to Article 38 of the Bank of Japan Law, and as a result, at the end of the fiscal year, the amount of such loans remained at zero.

D. Loans to the Deposit Insurance Corporation of Japan (DICJ)

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 it was not necessary for the Bank to extend loans to the DICJ in fiscal 2006.

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.

On-site examinations are conducted under a contract (hereafter "examination contract") between the Bank and the institutions concerned.[2] 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."[3] 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 2006, the Bank had examination contracts with 535 institutions, including six city banks, 110 regional banks,[4] 63 foreign banks in Japan, 21 trust banks, 273 *shinkin* banks, and 42 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.

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2. 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.

3. 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.

4. The 110 regional banks comprise the 64 member banks of the Regional Banks Association of Japan and the 46 member banks of the Second Association of Regional Banks.

In on-site examinations, the Bank's examiners assess the whole range of financial institutions' assets and financial transactions in terms of their economic value and volatility (i.e., risk) as well as looking at financial institutions' own evaluations of the same. 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. More specifically, they check whether financial institutions have in place an effective framework for addressing such risks as credit risk, market risk, settlement risk, liquidity risk, and operational risk,[5] thus enabling them to respond to changes in the economic and financial environment appropriately given their particular risk profiles. The Bank's examiners also review and have in-depth discussions with financial institutions to assess whether appropriate internal control systems have been put in place. Such assessment is important because financial institutions' senior management needs to use these systems effectively to identify key management issues, including major risks, and take necessary steps to deal with them. After the examination, the Bank gives feedback on its findings to senior management at 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.[6]

2. On-site examinations conducted in fiscal 2006

In fiscal 2006, the Bank conducted on-site examinations, in line with its "On-Site Examination Policy for Fiscal 2006," which was decided by the Policy Board on April 7, 2006, at a total of 131 financial institutions: 43 domestically licensed banks, 73 *shinkin* banks, and 15 other institutions including securities companies and Japanese branches of foreign banks (Table 1).

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

Table 1

On-Site Examinations Conducted in Fiscal 2006

(1) Domestically Licensed Banks: 43 Examinations[1]

Financial institutions	Date of acceptance	Date of entry	Date of completion	Period of interruption	Transmission of result	Class of examination
Higo Bank	Feb. 24, 2006	Apr. 4, 2006	Apr. 19, 2006	—	May 19, 2006	Normal
Daishi Bank	Feb. 24, 2006	Apr. 5, 2006	Apr. 20, 2006	—	May 12, 2006	Normal
Oita Bank	Feb. 24, 2006	Apr. 5, 2006	Apr. 20, 2006	—	May 12, 2006	Normal
Kita-Nippon Bank	Feb. 24, 2006	Apr. 5, 2006	Apr. 20, 2006	—	May 15, 2006	Normal
Kagawa Bank	Feb. 24, 2006	Apr. 5, 2006	Apr. 20, 2006	—	May 10, 2006	Normal
Sumitomo Trust and Banking	Apr. 6, 2006	May 8, 2006	May 23, 2006	—	June 8, 2006	Normal
Michinoku Bank	Apr. 21, 2006	May 23, 2006	June 9, 2006	—	July 4, 2006	Normal
Bank of Iwate	Apr. 25, 2006	May 23, 2006	June 9, 2006	—	June 29, 2006	Normal
Hokkoku Bank	Apr. 21, 2006	May 23, 2006	June 9, 2006	—	June 26, 2006	Normal
Juroku Bank	Apr. 21, 2006	May 23, 2006	June 9, 2006	—	June 28, 2006	Normal
Kagoshima Bank	Apr. 21, 2006	May 23, 2006	June 9, 2006	—	June 27, 2006	Normal
Sumitomo Mitsui Banking	May 15, 2006	June 19, 2006	July 7, 2006	—	Aug. 1, 2006	Normal
Japan Net Bank	June 6, 2006	July 10, 2006	July 25, 2006	—	Aug. 22, 2006	Normal
Akita Bank	June 5, 2006	July 10, 2006	July 28, 2006	—	Aug. 23, 2006	Normal
Bank of Ikeda	June 6, 2006	July 10, 2006	July 28, 2006	—	Aug. 23, 2006	Normal
Shikoku Bank	June 5, 2006	July 10, 2006	July 28, 2006	—	Aug. 23, 2006	Normal
Bank of Fukuoka	June 5, 2006	July 10, 2006	July 28, 2006	—	Aug. 21, 2006	Normal
Chuo Mitsui Trust and Banking	July 27, 2006	Aug. 28, 2006	Sep. 15, 2006	—	Oct. 13, 2006	Normal
Mitsui Asset Trust and Banking	July 27, 2006	Aug. 28, 2006	Sep. 15, 2006	—	Oct. 13, 2006	Normal
Aomori Bank	July 25, 2006	Aug. 29, 2006	Sep. 14, 2006	—	Oct. 5, 2006	Normal
Joyo Bank	July 25, 2006	Aug. 29, 2006	Sep. 15, 2006	—	Oct. 6, 2006	Normal
Suruga Bank	July 27, 2006	Aug. 29, 2006	Sep. 15, 2006	—	Oct. 13, 2006	Normal
Bank of Nagoya	July 21, 2006	Aug. 29, 2006	Sep. 15, 2006	—	Oct. 3, 2006	Normal
SG Private Banking	July 25, 2006	Aug. 29, 2006	Sep. 15, 2006	—	Oct. 6, 2006	Normal
Higo Bank	Sep. 5, 2006	Oct. 16, 2006	Oct. 30, 2006	—	Nov. 20, 2006	Specific areas (operations and systems)
Shinsei Bank	Sep. 13, 2006	Oct. 16, 2006	Nov. 2, 2006	—	Nov. 22, 2006	Normal
Shinsei Trust & Banking	Sep. 21, 2006	Oct. 16, 2006	Nov. 2, 2006	—	Nov. 22, 2006	Normal
Toho Bank	Sep. 13, 2006	Oct. 16, 2006	Nov. 2, 2006	—	Nov. 28, 2006	Normal
Kumamoto Family Bank	Sep. 11, 2006	Oct. 16, 2006	Nov. 2, 2006	—	Nov. 29, 2006	Normal
State Street Trust and Banking	Sep. 12, 2006	Oct. 16, 2006	Oct. 27, 2006	—	Jan. 29, 2007	Normal
Master Trust Bank of Japan	Sep. 20, 2006	Nov. 13, 2006	Nov. 17, 2006	—	Jan. 31, 2007	Normal
Japan Trustee Services Bank	Oct. 17, 2006	Nov. 27, 2006	Dec. 1, 2006	—	Jan. 29, 2007	Normal
Mizuho Trust and Banking	Oct. 30, 2006	Dec. 4, 2006	Dec. 20, 2006	—	Jan. 22, 2007	Normal
Shiga Bank	Oct. 30, 2006	Dec. 5, 2006	Dec. 21, 2006	—	Jan. 25, 2007	Normal
Ibaraki Bank	Oct. 27, 2006	Dec. 5, 2006	Dec. 21, 2006	—	Jan. 22, 2007	Normal
Trust & Custody Services Bank	Oct. 12, 2006	Dec. 11, 2006	Dec. 15, 2006	—	Jan. 26, 2007	Normal
Hyakugo Bank	Dec. 12, 2006	Jan. 29, 2007	Feb. 2, 2007	—	Feb. 21, 2007	Specific areas (operations and systems)
Sony Bank	Dec. 12, 2006	Feb. 5, 2007	Feb. 19, 2007	—	Mar. 16, 2007	Normal
ShinGinko Tokyo	Dec. 12, 2006	Feb. 5, 2007	Mar. 23, 2007	Feb. 23, 2007 to Mar. 18, 2007	Apr. 18, 2007	Normal
Musashino Bank	Dec. 11, 2006	Feb. 6, 2007	Feb. 23, 2007	—	Mar. 13, 2007	Normal
Fukui Bank	Dec. 8, 2006	Feb. 6, 2007	Feb. 23, 2007	—	Mar. 26, 2007	Normal
Yamaguchi Bank	Dec. 11, 2006	Feb. 6, 2007	Feb. 23, 2007	—	Mar. 20, 2007	Normal
Okinawa Kaiho Bank	Dec. 11, 2006	Feb. 6, 2007	Feb. 23, 2007	—	Mar. 26, 2007	Normal

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

(2) *Shinkin* Banks: 73 Examinations[2]

Financial institutions	Date of acceptance	Date of entry	Date of completion	Period of interruption	Transmission of result	Class of examination
Monbetsu Shinkin Bank	Feb. 24, 2006	Apr. 5, 2006	Apr. 19, 2006	—	May 12, 2006	Normal
Morioka Shinkin Bank	Feb. 23, 2006	Apr. 5, 2006	Apr. 19, 2006	—	May 15, 2006	Normal
Ashikaga Oyama Shinkin Bank	Feb. 24, 2006	Apr. 5, 2006	Apr. 19, 2006	—	May 12, 2006	Normal
Saitamaken Shinkin Bank	Feb. 28, 2006	Apr. 5, 2006	Apr. 20, 2006	—	May 11, 2006	Normal
Kameari Shinkin Bank	Feb. 24, 2006	Apr. 5, 2006	Apr. 19, 2006	—	May 11, 2006	Normal
Awaji Shinkin Bank	Feb. 24, 2006	Apr. 5, 2006	Apr. 20, 2006	—	May 17, 2006	Normal
Fukuoka Hibiki Shinkin Bank	Feb. 28, 2006	Apr. 5, 2006	Apr. 20, 2006	—	May 18, 2006	Normal
Omuta Yanagawa Shinkin Bank	Feb. 24, 2006	Apr. 5, 2006	Apr. 18, 2006	—	May 17, 2006	Normal
Kitasorachi Shinkin Bank	Feb. 27, 2006	Apr. 12, 2006	Apr. 25, 2006	—	May 15, 2006	Normal
Yamato Shinkin Bank	Feb. 24, 2006	Apr. 12, 2006	Apr. 26, 2006	—	May 19, 2006	Normal
Karatsu Shinkin Bank	Apr. 21, 2006	May 22, 2006	June 7, 2006	—	June 23, 2006	Normal
Asahikawa Shinkin Bank	Apr. 24, 2006	May 23, 2006	June 9, 2006	—	June 30, 2006	Normal
Miyako Shinkin Bank	Apr. 21, 2006	May 23, 2006	June 9, 2006	—	June 28, 2006	Normal
Mizusawa Shinkin Bank	Apr. 21, 2006	May 23, 2006	June 7, 2006	—	June 29, 2006	Normal
IO Shinkin Bank	Apr. 21, 2006	May 23, 2006	June 9, 2006	—	June 29, 2006	Normal
Kanra Shinkin Bank	Apr. 21, 2006	May 23, 2006	June 9, 2006	—	June 29, 2006	Normal
Niigata Shinkin Bank	Apr. 21, 2006	May 23, 2006	June 9, 2006	—	June 29, 2006	Normal
Fukui Shinkin Bank	Apr. 21, 2006	May 23, 2006	June 9, 2006	—	June 29, 2006	Normal
Daifuku Shinkin Bank	Apr. 18, 2006	May 23, 2006	June 8, 2006	—	June 26, 2006	Normal
Ugo Shinkin Bank	Apr. 24, 2006	May 24, 2006	June 9, 2006	—	June 27, 2006	Normal
Kamo Shinkin Bank	Apr. 21, 2006	May 24, 2006	June 9, 2006	—	July 4, 2006	Normal
Aichi Shinkin Bank	Apr. 21, 2006	May 24, 2006	June 9, 2006	—	June 30, 2006	Normal
Matsumoto Shinkin Bank	June 5, 2006	July 10, 2006	July 28, 2006	—	Aug. 17, 2006	Normal
Toyama Shinkin Bank	June 6, 2006	July 10, 2006	July 28, 2006	—	Aug. 21, 2006	Normal
Osaka City Shinkin Bank	June 5, 2006	July 10, 2006	July 28, 2006	—	Aug. 22, 2006	Normal
Juso Shinkin Bank	June 5, 2006	July 10, 2006	July 28, 2006	—	Aug. 22, 2006	Normal
Takamatsu Shinkin Bank	June 5, 2006	July 10, 2006	July 28, 2006	—	Aug. 24, 2006	Normal
Fukuoka Shinkin Bank	June 5, 2006	July 10, 2006	July 28, 2006	—	Aug. 22, 2006	Normal
Tatebayashi Shinkin Bank	June 5, 2006	July 11, 2006	July 28, 2006	—	Aug. 21, 2006	Normal
Meguro Shinkin Bank	June 7, 2006	July 11, 2006	July 28, 2006	—	Aug. 15, 2006	Normal
Echizen Shinkin Bank	June 5, 2006	July 11, 2006	July 28, 2006	—	Aug. 18, 2006	Normal
Chiba Shinkin Bank	July 25, 2006	Aug. 28, 2006	Sep. 15, 2006	—	Oct. 6, 2006	Normal
Tochigi Shinkin Bank	July 24, 2006	Aug. 29, 2006	Sep. 15, 2006	—	Oct. 4, 2006	Normal
Adachi Seiwa Shinkin Bank	July 25, 2006	Aug. 29, 2006	Sep. 15, 2006	—	Oct. 5, 2006	Normal
Takinogawa Shinkin Bank	July 25, 2006	Aug. 29, 2006	Sep. 15, 2006	—	Oct. 5, 2006	Normal
Ogaki Shinkin Bank	July 24, 2006	Aug. 29, 2006	Sep. 15, 2006	—	Oct. 10, 2006	Normal
Shiga Chuo Shinkin Bank	July 27, 2006	Aug. 29, 2006	Sep. 15, 2006	—	Oct. 6, 2006	Normal
Nakahyogo Shinkin Bank	July 24, 2006	Aug. 29, 2006	Sep. 15, 2006	—	Oct. 6, 2006	Normal
Date Shinkin Bank	July 25, 2006	Aug. 30, 2006	Sep. 15, 2006	—	Oct. 10, 2006	Normal
Toei Shinkin Bank	July 25, 2006	Aug. 30, 2006	Sep. 15, 2006	—	Oct. 12, 2006	Normal
Takefu Shinkin Bank	July 26, 2006	Aug. 30, 2006	Sep. 15, 2006	—	Oct. 5, 2006	Normal
Hokkai Shinkin Bank	Sep. 12, 2006	Oct. 16, 2006	Nov. 2, 2006	—	Nov. 21, 2006	Normal
Ninohe Shinkin Bank	Sep. 12, 2006	Oct. 16, 2006	Nov. 2, 2006	—	Nov. 28, 2006	Normal
Shibata Shinkin Bank	Sep. 8, 2006	Oct. 16, 2006	Nov. 2, 2006	—	Nov. 22, 2006	Normal
Yaizu Shinkin Bank	Sep. 8, 2006	Oct. 16, 2006	Nov. 2, 2006	—	Nov. 29, 2006	Normal
Kakegawa Shinkin Bank	Sep. 11, 2006	Oct. 16, 2006	Nov. 2, 2006	—	Nov. 28, 2006	Normal
Seto Shinkin Bank	Sep. 12, 2006	Oct. 16, 2006	Nov. 2, 2006	—	Nov. 29, 2006	Normal

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

Financial institutions	Date of acceptance	Date of entry	Date of completion	Period of interruption	Transmission of result	Class of examination
Chita Shinkin Bank	Sep. 12, 2006	Oct. 16, 2006	Nov. 2, 2006	—	Nov. 24, 2006	Normal
Osaka Shoko Shinkin Bank	Sep. 8, 2006	Oct. 16, 2006	Nov. 2, 2006	—	Nov. 24, 2006	Normal
Nishihyogo Shinkin Bank	Sep. 11, 2006	Oct. 16, 2006	Nov. 2, 2006	—	Nov. 29, 2006	Normal
Nayoro Shinkin Bank	Sep. 11, 2006	Oct. 17, 2006	Nov. 2, 2006	—	Nov. 22, 2006	Normal
Akita Shinkin Bank	Sep. 11, 2006	Oct. 17, 2006	Nov. 2, 2006	—	Nov. 27, 2006	Normal
Chunichi Shinkin Bank	Sep. 11, 2006	Oct. 17, 2006	Nov. 2, 2006	—	Nov. 22, 2006	Normal
Asahi Shinkin Bank	Oct. 25, 2006	Dec. 4, 2006	Dec. 20, 2006	—	Jan. 29, 2007	Normal
Hakodate Shinkin Bank	Oct. 27, 2006	Dec. 5, 2006	Dec. 21, 2006	—	Jan. 29, 2007	Normal
Kitami Shinkin Bank	Oct. 27, 2006	Dec. 5, 2006	Dec. 21, 2006	—	Jan. 26, 2007	Normal
Hanamaki Shinkin Bank	Oct. 26, 2006	Dec. 5, 2006	Dec. 20, 2006	—	Jan. 26, 2007	Normal
Ueda Shinkin Bank	Oct. 26, 2006	Dec. 5, 2006	Dec. 20, 2006	—	Jan. 23, 2007	Normal
Kanazawa Shinkin Bank	Oct. 26, 2006	Dec. 5, 2006	Dec. 21, 2006	—	Jan. 19, 2007	Normal
Numazu Shinkin Bank	Oct. 26, 2006	Dec. 5, 2006	Dec. 20, 2006	—	Jan. 18, 2007	Normal
Kihoku Shinkin Bank	Oct. 26, 2006	Dec. 5, 2006	Dec. 20, 2006	—	Jan. 18, 2007	Normal
Kanonji Shinkin Bank	Oct. 26, 2006	Dec. 5, 2006	Dec. 20, 2006	—	Jan. 24, 2007	Normal
Kumamoto Shinkin Bank	Oct. 27, 2006	Dec. 5, 2006	Dec. 21, 2006	—	Jan. 23, 2007	Normal
Kosan Shinkin Bank	Dec. 13, 2006	Feb. 5, 2007	Feb. 22, 2007	—	Mar. 15, 2007	Normal
Johnan Shinkin Bank	Dec. 8, 2006	Feb. 5, 2007	Feb. 22, 2007	—	Mar. 19, 2007	Normal
Setagaya Shinkin Bank	Dec. 12, 2006	Feb. 5, 2007	Feb. 22, 2007	—	Mar. 13, 2007	Normal
Ichii Shinkin Bank	Dec. 11, 2006	Feb. 6, 2007	Feb. 23, 2007	—	Mar. 19, 2007	Normal
Toshun Shinkin Bank	Dec. 11, 2006	Feb. 6, 2007	Feb. 23, 2007	—	Mar. 16, 2007	Normal
Shimane Chuo Shinkin Bank	Dec. 13, 2006	Feb. 6, 2007	Feb. 22, 2007	—	Mar. 15, 2007	Normal
Bizen Shinkin Bank	Dec. 11, 2006	Feb. 6, 2007	Feb. 22, 2007	—	Mar. 26, 2007	Normal
Kure Shinkin Bank	Dec. 12, 2006	Feb. 6, 2007	Feb. 23, 2007	—	Mar. 26, 2007	Normal
Chikugo Shinkin Bank	Dec. 11, 2006	Feb. 6, 2007	Feb. 22, 2007	—	Mar. 16, 2007	Normal
Nishikyusyu Shinkin Bank	Dec. 11, 2006	Feb. 6, 2007	Feb. 23, 2007	—	Mar. 26, 2007	Normal

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

(3) Foreign Banks, Securities Companies, and Other Institutions: 15 Examinations[3]

Financial institutions	Date of acceptance	Date of entry	Date of completion	Period of interruption	Transmission of result	Class of examination
Shoko Chukin Bank	Feb. 23, 2006	Apr. 11, 2006	Apr. 26, 2006	—	May 18, 2006	Normal
Japan Post	Apr. 24, 2006	May 31, 2006	June 9, 2006	—	June 29, 2006	Normal
SMBC Friend Securities	June 7, 2006	July 10, 2006	July 27, 2006	—	Aug. 10, 2006	Normal
Société Générale	July 25, 2006	Aug. 29, 2006	Sep. 15, 2006	—	Oct. 6, 2006	Normal
Société Générale Securities	July 25, 2006	Aug. 29, 2006	Sep. 15, 2006	—	Oct. 6, 2006	Normal
Tokyo Tanshi	Sep. 14, 2006	Oct. 16, 2006	Oct. 20, 2006	—	Jan. 24, 2007	Normal
State Street Bank and Trust	Sep. 8, 2006	Oct. 16, 2006	Oct. 27, 2006	—	Jan. 29, 2007	Normal
UBS AG	Sep. 8, 2006	Oct. 17, 2006	Nov. 2, 2006	—	Nov. 22, 2006	Normal
UBS Securities	Sep. 14, 2006	Oct. 17, 2006	Nov. 2, 2006	—	Nov. 22, 2006	Normal
Central Tanshi	Sep. 15, 2006	Oct. 30, 2006	Nov. 13, 2006	—	Jan. 25, 2007	Normal
Central Tanshi Securities	Sep. 20, 2006	Oct. 30, 2006	Nov. 13, 2006	—	Jan. 16, 2007	Normal
Ueda Yagi Tanshi	Oct. 6, 2006	Nov. 22, 2006	Nov. 29, 2006	—	Jan. 23, 2007	Normal
ICAP Totan Securities	Oct. 26, 2006	Dec. 6, 2006	Dec. 12, 2006	—	Jan. 18, 2007	Normal
Metropolitan Bank and Trust	Dec. 11, 2006	Feb. 1, 2007	Feb. 7, 2007	—	Mar. 14, 2007	Normal
Bank of New York	Dec. 11, 2006	Feb. 19, 2007	Feb. 23, 2007	—	Mar. 15, 2007	Normal

Note: *3.* Chronologically listed in accordance with the date of entry.

3. On-site examination policy in fiscal 2007

The Bank made public on March 26, 2007, its "On-Site Examination Policy for Fiscal 2007," the text of which had been decided by the Policy Board on March 23. The major points are as follows.

On-Site Examination Policy for Fiscal 2007

I. Review of Fiscal 2006[1]

A. Introduction

During fiscal 2006, the Bank of Japan conducted on-site examinations at a total of 131 financial institutions: 43 domestically licensed banks, 73 *shinkin* banks, and 15 other institutions including securities companies and Japanese branches of foreign banks.

In conducting on-site examinations, in order to ease the burden on financial institutions, the Bank continued to reduce the number of sample borrowers extracted from financial institutions' overall loan portfolios for review by examination teams. The number of borrowers extracted reflected the quality of risk management at individual institutions.

B. The Condition of Japan's Financial System

This section provides a description of the condition of Japan's financial system and the risk management challenges faced by financial institutions, which the Bank observed through its on-site examinations and off-site monitoring.

1. Overview

The level of nonperforming loans (NPLs) at financial institutions has continued to decline. Profits are at high levels due to lower credit costs (i.e., write-offs and loan-loss provisions for NPLs), and capital adequacy has been strengthened.

With the recovery in their risk-taking capacity, financial institutions are showing greater willingness to extend credit both at home and abroad. Investments in a broad range of capital market instruments are also increasing. Additionally, financial institutions are expanding the range of financial services they provide to customers and are allocating more resources in new areas, as they aim to increase fee and commission income. Nonetheless, further strengthening of core profitability continues to be a key challenge.

Financial institutions have been making progress in dealing with changes in the economic and financial environment as well as modifications to the regulatory framework. Risk management continues to improve as more advanced methodologies are introduced. Challenges, however, remain.

Key risk management challenges identified during the Bank's on-site examinations and off-site monitoring are described in detail by major risk category below.

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

2. Credit risk

Overall credit risk has been decreasing due to the continued reduction in NPLs and low credit costs. However, NPL ratios remain at high levels at some regional financial institutions.

With regard to credit risk management, the quality of individual financial institutions' self-assessments of their assets has improved. The proportion of self-assessments that had to be corrected during on-site examinations decreased from the previous fiscal year. Moreover, as the economic expansion continues, the number of cases where banks' support for corporate revitalization is successful (i.e., where borrowers' credit ratings are upgraded) has increased at both major and regional financial institutions. At the same time, the Bank found that risk management at some financial institutions needed improvement. Problems identified include (1) insufficient screening before the extension of credit as well as inadequate monitoring of extended credits, (2) inappropriate assessment and management of real estate taken as collateral, and (3) lapses in the review of corporate restructuring plans submitted by troubled borrowers as well as inadequate advice to such borrowers.

In areas where financial institutions have become more active in extending credit, the Bank noted problems at some regional financial institutions with their screening criteria and monitoring processes for syndicated loans. There was an over-reliance on arrangers and agents for the management of these loans. With regard to non-recourse real estate loans, loan values were generally well below the value of the cash flow generated from the real estate. However, returns were declining and, in some cases, weaknesses in the assumptions for estimating future cash flows were identified. Financial institutions often use scoring models in screening mortgage loans and uncollateralized small business loans. The Bank found that many financial institutions are still in the process of developing internal databases and have not examined the appropriateness of their scoring models. For such institutions, there clearly is room for improvement in their pool-based credit risk management framework so as to better reflect borrowers' risk characteristics.

Internal credit rating systems and risk quantification tools form the basis for developing an advanced credit risk management framework. The internal credit rating systems of major banks are well established and are being used to assess the creditworthiness of borrowers and to manage lending. The quality of risk quantification is also improving. An increasing number of regional financial institutions are also enhancing their internal credit rating systems and are starting to quantify credit risk. However, some institutions have not introduced robust validation processes to their rating systems due to limitations of their databases, while at other institutions further improvements in the quality of risk quantification are called for.

Major banks have established specialized sections responsible for active credit portfolio management in order to step up their efforts to reduce concentration risk related to large exposures. As a result, the use of credit derivatives and sales of assets are growing. In addition, in order to increase flexibility in their active portfolio management while aiming to enhance their risk/return profiles, some major banks have started to transfer the authority to dispose of certain loans to the specialized sections.

3. Market risk

Throughout fiscal 2006, major banks continued to take a conservative approach regarding the interest risk exposure of their bond investment portfolios. Most regional financial institutions also maintained a cautious stance. However, at regional financial institutions whose securities investment/deposits ratio increased due to slow lending growth, the Bank identified a number of cases where there were deficiencies in risk management. Problems were noted, for example, in the setting of investment limits reflecting the financial strength of the institution, and in the procedures for internal reporting to senior management.

As for asset-liability management (ALM), major banks and advanced regional financial institutions are analyzing changes in profits and overall interest rate risk taking into account expected changes in interest rates and their possible effect on the maturity structure of assets and liabilities. Some regional financial institutions, on the other hand, are not sufficiently conducting such scenario analyses and need to improve their ALM framework, including the collection of necessary data.

While many financial institutions remained cautious about increasing the total amount of equity holdings, some have increased their equity holdings for investment purposes and others have slightly raised their strategic equity holdings with the aim of developing long-term business relationships. Regarding the risk management of equity holdings, there were some cases where financial institutions, when measuring risks, did not fully take into account the time needed to liquidate positions.

Many financial institutions have been increasing their investment in alternative products such as structured products, credit-related products, and hedge fund investments, with the aim of increasing profits and diversifying the risks of their investment portfolios. The Bank examined the risk management framework covering such products and identified the following weaknesses, mainly among regional institutions. Some had difficulties in identifying the risk profiles of complex products, obtaining sound market valuations and risk amounts. Additionally, others had difficulties in monitoring the changes in credit ratings of key assets included in structured products, and in monitoring the compliance of third-party fund managers with the investment contract.

4. Settlement and liquidity risks

No serious problems associated with daily funding were observed among financial institutions in an environment where monetary policy had been changed three times since March 2006. The Bank found, however, that some financial institutions needed improvements in their contingency plans for liquidity crises, for example, in the specificity of their plans and in the review of plans' effectiveness.

5. Operational risk[2]

The scope of financial institutions' business has further expanded, and together with the increase in outsourcing of operations and the adoption of more diverse employment practices, the environment surrounding operational risk management has changed substantially. Through its on-site examinations, the Bank assessed financial institutions' operational risk management, focusing on identifying risks inherent in their business processes and examining the

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

effectiveness of measures taken to manage them. The Bank found that some financial institutions still needed improvement in the following areas: (1) the development of an overall risk management framework for business operations, such as the introduction of a comprehensive set of internal rules and manuals and the establishment of an effective framework for checks and balances; (2) sufficient monitoring of actual business procedures at branches; (3) effective training to ensure that staff are capable of taking necessary corrective measures in the case of operational problems; and (4) effective control over third-party service providers.

As for the operation of computer systems, the number of large-scale malfunctions at financial institutions has been decreasing. However, as more institutions set up joint information and computer systems to reduce costs, problems at joint operational centers are occurring. The Bank's on-site examinations focused on reviewing the management of operational systems (including joint operational centers) of financial institutions in which a malfunction may have a large impact on the overall payment and settlement system, and on the management of projects aimed at computer system integration and joint system development. There were cases where financial institutions needed to improve, for example, monitoring of the progress in and their quality management of specific projects, and their control of third-party service providers. The Bank also identified a number of cases where substantial improvements in information security were needed.

In the area of business continuity arrangements, in addition to major banks and large foreign banks, an increasing number of other financial institutions have established back-up facilities (computer centers and offices). However, there was room for further improvements in business continuity arrangements by drawing up more specific timetables for the recovery of crucial business operations and by enhancing the effectiveness of business continuity arrangements through periodic drills.

II. On-Site Examination Policy for Fiscal 2007

A. Core Elements

The key aim of on-site examinations will continue to be the effective evaluation of the overall condition of financial institutions in order for the Bank to be ready to act as the lender of last resort. The Bank will also focus on supporting the efforts of financial institutions to improve their risk and business management and to provide financial services tailored to changes in the economic and financial environment and customer needs. These steps aim to contribute to the enhancement of the functioning and robustness of the overall financial system.

The risk profiles of financial institutions vary according to their business line-up and balance sheet structure, and consequently the appropriate risk management framework as well as the commensurate target level for risk management skills will also vary from institution to institution. The basic concept of the new capital adequacy framework (Basel II), which encourages individual financial institutions to make voluntary efforts to advance their risk management capabilities, also reflects such a spectrum. In the discussions during on-site examinations, the Bank will seek to examine and advise individual financial institutions giving due consideration to their risk profiles and risk management capabilities.

Through on-site examinations, the Bank will review and aim to have in-depth discussions with financial institutions to assess whether appropriate internal control systems have been put in place. Senior management needs to use these systems effectively to identify key management issues, including major risks, and take necessary steps to deal with them.

Based on the above principles, the following six points constitute the core elements of the Bank's on-site examinations in fiscal 2007.

1. Effective risk management in a changing economic and financial environment

The overall financial system remains stable at a time when the financial environment has been changing as economic activity, especially in the corporate sector, continues to expand. In fiscal 2007, the Bank will examine whether financial institutions have put in place an effective risk management framework which enables them to take on the challenges brought about by the changes in the economic and financial environment.

As for the management of market risk, the Bank will examine whether financial institutions are sufficiently prepared for possible fluctuations in interest rates and market prices. For instance, financial institutions need to conduct stress-testing that covers not only their investment portfolios, but also deposits and their loan portfolios. The results of such analyses should be reflected in investment policy guidelines and ALM strategies. Moreover, some financial institutions, especially among major banks, have started to increase equity holdings for investment purposes and/or strategic equity holdings aimed at developing long-term business relationships while the volatility of stock prices is rising. The Bank will examine whether financial institutions are appropriately managing the risks associated with their equity holdings, factoring in the objectives of their equity holdings and past experiences in the liquidation of positions.

The Bank will examine credit risk management systems, focusing on areas where financial institutions have become more active in extending credit. For example, real estate transactions are increasing in the metropolitan areas, and mergers and acquisitions (M&A) targeting Japanese firms are also growing. Financial institutions are actively extending credit in connection with such activities. In this environment, the Bank will check whether financial institutions have properly applied discounted cash flow (DCF) methods to evaluate the economic value of their loans, and whether they have developed management systems to prevent concentration in their overall credit portfolios. As for syndicated loan business, the Bank will examine whether financial institutions participating in the syndication recognize the existence of loss-sharing provisions in the loan contract and have established adequate risk management systems accordingly. As for uncollateralized small business loans and mortgage loans, concentrating on financial institutions which apply statistical rating models in their screening process, the Bank will examine whether they conduct ex post validation of the models using internal databases, manage such loans on a pooled basis reflecting borrowers' risk characteristics, and review their business and pricing strategies.

2. Effective risk management of complex financial assets and transactions

In recent years, an increasing number of non-bank companies, such as hedge funds, have become active in the financial intermediation process, both domestically and globally. Japanese financial institutions have also started to take part in the provision of funds not only through traditional bank lending, but also through various types of debt and equity investments.

Specifically, financial institutions are increasing their investments in various funds at home and abroad as well as in other capital market instruments, such as securitized products. They often aim at increasing their relative rate of return by using third-party investment management specialists. Many of these types of investments involve securities with complex risk profiles. They also involve a range of third-party specialists, such as fund managers and servicers, all playing a separate role in the overall investment process. As a result, financial institutions need to take a range of steps, such as holding individual discussions with these fund managers, in order to understand how investment decisions are made and how funds are being managed. Moreover, many regional financial institutions are evaluating the market value of alternative investment products and quantifying risks using systems and services provided by third parties. In these cases, the Bank will examine whether the financial institutions understand the risk profiles of these products and are proactively taking steps to manage the risks.

Through these examinations and discussions with financial institutions, the Bank, as the central bank, will aim to accumulate expertise on the possible risk contagion channels arising from the changes in financial intermediation mechanisms such as the increase in hedge funds' activity. The steps will help to meet the Bank's objectives of preventing the materialization of systemic risk and securing the robustness of the financial system.

3. Effective operational risk management framework

The scope of financial services provided by financial institutions has further expanded and more operations have been outsourced and/or are performed by temporary staff, while at the same time financial institutions need to provide a higher level of information security. In such an environment, it has become more difficult for financial institutions to conduct a comprehensive review of each and every element of their operations. Therefore, the Bank will examine (1) whether financial institutions have established management systems which allow them to identify potential major risks in their operational procedures and computer systems, (2) whether they have established an appropriate operational risk management framework and whether this is clearly set out in internal rules and manuals, and (3) whether operations actually comply with the framework.

4. Development and implementation of integrated risk management

In order for financial institutions to manage their business more efficiently, it is important for them to develop an integrated risk management framework covering relevant risks and to utilize this framework when reviewing their capital adequacy, evaluating risks and returns, and determining capital allocation. Some financial institutions, such as major banks, have already introduced such a risk management framework. At such institutions, the Bank will first examine the appropriateness of risk quantification as well as their overall capital adequacy. The Bank will also discuss with these financial institutions how to actually apply the integrated risk management framework in their business, such as when pricing financial products, reviewing the profitability of business units and transactions, and evaluating business performance. The Bank will also assess their risk management capabilities on a consolidated basis.

Other financial institutions are still in the process of implementing an integrated risk management framework. In such cases, the Bank will work with the institutions to develop a common understanding with their senior management and staff regarding the challenges and issues they face in introducing and implementing an integrated risk management framework. The principles outlined in the new capital adequacy framework (Basel II) will be used as a guideline.

The development and implementation of an integrated risk management framework will differ from institution to institution depending on business objectives, risk profiles, and operational structure. The Bank will ensure that discussions held in the examination process are flexible and reflect such variations.

5. Active credit portfolio management

If financial institutions objectively assess the risk/return profiles of their exposures, this allows them to optimize their credit portfolios through measures such as the active reshuffling of their loan assets, which in turn leads to a growth in loan sales and asset securitization and hence to the enhanced functioning of the financial system.

The Bank will, through its on-site examinations, review financial institutions' efforts toward introducing active credit portfolio management, taking into account their risk profiles. It also plans to hold discussions and work together with financial institutions to review and enhance the legal framework and business practices which provide the basis for effective active credit portfolio management strategies.

6. Ensuring smooth settlement and business continuity

Financial institutions are expected to manage their liquidity effectively and to provide smooth and secure payment and settlement operations. In order to prevent the materialization of systemic risk, the Bank will identify risks inherent in the overall payment and settlement system and also continue to examine financial institutions' liquidity risk management.

The Bank will continue to examine projects aimed at computer system integration and joint system development by multiple financial institutions. The Bank will also verify that the stability, reliability, and security of such systems are ensured, taking into account factors such as the complexity of systems and changes in system technology. In addition, the Bank, to ensure the smooth and stable operation of the overall payment and settlement system, will examine the system management framework at financial institutions, especially those with heavy payment flows via, for example, the Bank of Japan Financial Network System (BOJ-NET). Examinations will also cover other entities, including financial institutions' joint operation centers.

Regarding business continuity arrangements, the Bank will examine whether financial institutions have (1) set up necessary back-up facilities and arrangements, (2) established necessary business continuity plans, and (3) confirmed the effectiveness of such plans. The extent of these examinations will depend on the presence of the individual financial institution in the payment and settlement system. From the viewpoint of enhancing the effectiveness of business continuity plans, the Bank will also place emphasis on examining whether such plans are effectively tested through drills and updated according to the results of the drills. In addition, the Bank intends to hold in-depth discussions with financial institutions on business continuity plans in case of terrorist attacks and new types of pandemics, and on the further enhancement of infrastructures necessary for strengthening business continuity arrangements.

Based on the six core elements 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 2007.

B. General Principles for Practical Implementation

In conducting its on-site examinations in fiscal 2007, the Bank intends to maintain a close dialogue with financial institutions' senior management and work together to seek solutions for problems. This will enable financial institutions to use examinations as an opportunity to enhance their risk and business management frameworks taking into consideration their specific financial and business situation. In this process, the Bank will take further steps to coordinate the examinations with off-site monitoring and seminars hosted by the Center for Advanced Financial Technology. The Bank also intends, where necessary, to continue to exchange views through trilateral discussions with external auditors.

The Bank will continue to give due consideration to easing the burden of on-site examinations on financial institutions. Specifically, the Bank, taking into consideration the risk profile of each financial institution and its potential of impact on the financial system, plans to increase the number of targeted short-term examinations.

Furthermore, the Bank intends to make greater use of the online data exchange system in order to enhance the efficiency and data security of both on-site examinations and off-site monitoring.

F. Seminars and Workshops Organized by the Center for Advanced Financial Technology (CAFT)

The CAFT, established in the Financial Systems and Bank Examination Department in July 2005, organized the following events in fiscal 2006, providing opportunities for the Bank to share with financial institutions its views on important issues and possible solutions, as part of its support for their efforts to improve financial services.

1. Seminars and study groups

a. Seminars for all current account holders

The CAFT organized two large-scale seminars in Tokyo, targeting mainly financial institutions with current accounts at the Bank. The seminars' respective topics were (1) improvement of business continuity arrangements in the financial sector and (2) the current management of computer system-related risk and issues to be addressed.

b. Seminars for regional banks and *shinkin* banks

The CAFT held seminars for regional banks and *shinkin* banks at the Bank's Head Office and some of the Bank's branches. The seminars for regional banks covered topics such as improving integrated risk management and credit risk management. The seminars for *shinkin* banks covered topics such as market risk management and integrated risk management.

c. Seminar on the basics of market risk management

The CAFT held a seminar for regional financial institutions covering the basics of market risk management, including the quantification of market risk and appropriate frameworks for managing it.

d. Study groups on risk management techniques

The CAFT organized study groups comprising members of the Bank's staff as well as experts from outside the Bank in credit risk management, operational risk management, and credit portfolio management. Each study group released reports on its particular field, detailing the relevant risk management techniques currently employed at Japanese financial institutions and identifying areas for improvement. Papers on related topics were also released by the Financial Systems and Bank Examination Department.

2. International workshop

The CAFT held a multinational workshop on scenario analysis,[7] a topic that has recently been gaining recognition in the field of operational risk management, at which there was a lively exchange of opinions.

G. *Financial System Report*[8]

The Bank releases the *Financial System Report*, a periodical containing a comprehensive analysis and assessment of the stability and the functioning of Japan's financial system. In fiscal 2006, the Bank released the *Financial System Report* twice, in July 2006 and March 2007.

The *Financial System Report*, the first issue of which was in August 2005, was previously released once a year, in summer; however, in March 2007 the Bank decided to release it twice a year, every spring and fall. The decision to release it semiannually was aimed at further enhancing research activity on the financial system as well as providing more timely publication of research results. The first semiannual issue, the March 2007 issue, assessed the current state of Japan's financial system and analyzed its functioning and robustness. The next issue, which is to be published in the fall of 2007, is planned to provide a more comprehensive analysis of various issues related to the financial system, including the business strategies of Japanese financial institutions.

H. International Initiatives for Maintaining Financial System Stability

1. Discussions on international capital standards

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), which comprises central banks and supervisory authorities from the Group of Ten (G-10) countries, is one such important example.

In June 2004, the Committee released "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," the new capital adequacy framework (Basel II), which was endorsed by the central bank governors and the heads of the bank supervisory authorities in the G-10 countries. 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.

7. Scenario analysis is a risk management approach to analyzing the possible impact on financial institutions of events such as natural disasters including earthquakes and large-scale internal incidents including fraud and operational failures.
8. The full text in English is available at the Bank's web site (http://www.boj.or.jp/en/theme/finsys/fsys/index.htm).

In May 2006 the Committee announced that, after reviewing the results of its fifth Quantitative Impact Study of the impact of the revised framework on the minimum required capital of a wide range of banks across the world, it had decided to maintain the current calibration, thus completing the process of setting up the framework.

The Committee released "Core Principles for Effective Banking Supervision" in September 1997 and the supplementary "Core Principles Methodology" in October 1999 with the aim of encouraging countries, whether developing or developed, to establish effective systems of banking supervision, thereby ensuring the stability of the global financial system. In line with recent changes in risk management techniques and banking supervision, and after broad-based consultations open to all interested parties, the Committee released the revised version of these documents in October 2006.

Having completed setting up the new capital adequacy framework, following in-depth discussions in recent years, the Committee has been stepping up its efforts to tackle emerging issues so as to ensure the soundness of the global financial system, at the same time as continuing to emphasize the application and implementation of the framework. The Committee has also started to hold discussions concerning liquidity risk issues and the definition of regulatory capital.

Through its active participation in the Committee, the Bank has contributed to the formulation of international supervisory standards including Basel II. Moreover, the Bank continues to exchange views with the Financial Services Agency (FSA) and financial institutions to support the proper and smooth implementation of Basel II in Japan.

2. Other international initiatives

The Bank has also been participating in other international initiatives to maintain the stability of the global financial system. One of these initiatives is the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) Working Group on Banking Supervision. As part of this working group, the Bank has exchanged views with other members on a wide range of issues concerning banking supervision. It has also remained in close communication with other central banks with the aim of enhancing cooperation.