April 12, 2006
Bank of Japan

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 (see Table below).

Table Number of Financial Institutions Examined in Recent Years

	Fiscal 2003	Fiscal 2004	Fiscal 2005
Domestically licensed Japanese banks	50	46	42
***Shinkin* banks**	69	67	73
Other institutions including securities companies and Japanese branches of foreign banks	21	40	45
Total	140	153	160

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.

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

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.

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.

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.

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

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 (see Attachment).

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.

Attachment

Key Points for On-Site Examinations in Fiscal 2006 by Risk Category

Credit Risk

- Verify that economic value and volatility, i.e., risks, of the whole range of financial institutions' assets -- that is, not just their loan assets -- as well as their financial transactions are assessed properly, and that risk management is appropriately based on such assessments. Also examine whether financial institutions have in place internal control systems that ensure such risk management and whether they are functioning effectively.

  -- Assess loan assets in terms of their economic value and associated risks, including new types of loans such as syndicated loans and non-recourse real estate loans, by applying broadly the approach based on the discounted cash flow (DCF) method.

  -- Discuss 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 financial institutions' assets has decreased.

  -- As for credit pools of small loans, for example, mortgages and uncollateralized loans to small and medium-sized businesses, examine risk management systems for accumulating related data including borrower characteristics and discuss the process for setting lending rates.

  -- Evaluate economic value of loan assets purchased from the credit market and review overall risk management systems with regard to trading of loans.

- Examine whether financial institutions have established systems to collect and check data that form the basis for internal credit rating systems. Also evaluate the accuracy of such systems, by looking at differences between estimates and actual records of default in the past. These points are consistent with the concept of the new capital adequacy framework, Basel II.

  -- For financial institutions that have not yet introduced internal credit rating systems, work together to develop a common understanding of credit risk management practices and support their efforts to develop and utilize such systems by encouraging data collection, taking due account of financial and business conditions of individual institutions.

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

-- Verify the adequacy of the various risk parameters on which the above estimate is based, by examining, for example, actual records of borrower default and collateral disposal, as well as assessment of borrower firms treated on a corporate-group basis.

- Develop a common understanding of active credit portfolio management with financial institutions, taking due account of their financial and business conditions. Also discuss the measures necessary to promote such active portfolio management including objective assessment of risks and returns on assets, appropriate review of legal frameworks and business practices, and enhancement of market infrastructure.

- Evaluate whether financial institutions properly assess the disposal value of pledged real estate, taking due account of records for auctions and discretionary sales of similar properties, financial institutions' stances with regard to disposal, and the results of on-site reviews of pledged real estate. Verify, where necessary, that financial institutions are appropriately assessing the value of real estate with soil contamination and other risk factors.

Market Risk

- Verify that economic value and volatility, i.e., risks, of the overall assets other than loans and financial transactions are assessed properly, and that risk management is appropriately based on such assessment. Also examine whether financial institutions have in place internal control systems that ensure such risk management, and whether they are functioning effectively.

- Examine how financial institutions assess and manage interest rate risk. Also verify that investment decisions are being made through appropriate internal procedures based on an objective assessment of the size of risks and expected returns, taking their capital bases into consideration.

-- Examine how financial institutions develop and operate asset liability management (ALM), considering the possibility of the changes in their asset and liability structure which may be caused by probable interest rate fluctuations in the future. Also discuss awareness of the estimated holding periods for demand deposits and the interest rate sensitivity of various assets and liabilities, as well as methods for estimating them.

-- Verify that financial institutions manage interest rate risk associated with mortgage lending in light of the characteristics of their credit portfolio, considering the possibility, for example, that borrowers will refinance with different products or make prepayments under various scenarios for the interest rate.

- As for such assets as structured bonds, structured deposits and loans, privately placed real estate funds, and hedge funds, verify systems for risk quantification and related risk management by type of product as well as the principles for individual investment decisions and associated internal procedures.

-- In examining systems for quantification and management of risks by type of product, confirm that financial institutions properly assess the economic value of each product, using pricing models where necessary.

- Review systems for the quantification and management of the risks involved in stock investment, by taking into account the holding period and the time needed to liquidate. Verify that investment decisions are being made through appropriate internal procedures based on the objective assessment of the size of risks and expected returns, taking individual financial institutions' capital bases into consideration.

Settlement and Liquidity Risks

- Examine whether financial institutions' awareness of settlement and liquidity risks takes adequate account of possible changes in the financial environment. Then, examine whether financial institutions have established appropriate risk management, and also have in place internal control systems that ensure such risk management, and whether they are functioning effectively.

-- Examine financial institutions' management of settlement and liquidity risks for both yen and foreign currencies based on stress analyses. Also examine the effectiveness of financial institutions' contingency plans in the event of funding difficulties.

-- Carefully examine the settlement and liquidity risk management of financial institutions which function as hub parties in the overall funds and securities settlement, or whose transactions are concentrated with only a few particular counterparties, so as to prevent systemic disruptions.

Operational Risk

(1) Operational risk associated with business operations
• Examine whether financial institutions, while restructuring their operational systems and proceeding to offer new financial services, have established appropriate business operations and risk management, and also have in place internal control systems that ensure such business operations and risk management and whether they are functioning effectively. • Check, when necessary, outsourcees on site, when these are entrusted with core business operations, development and maintenance of computer systems, and handling of important certificates such as banknotes, bills, and other securities. • Support financial institutions' efforts to achieve more advanced operational risk management by helping improve their systems for collecting and analyzing data for the quantification of risks, when they are making efforts in risk quantification such as planning to implement Advanced Measurement Approach (AMA) under the new capital adequacy framework, Basel II.
(2) Computer systems
• In order to ensure stable operation of payment and settlement systems, examine whether financial institutions have developed and are operating computer systems and risk management appropriately, and whether they have in place internal control systems that ensure such business operations and risk management, and whether they are functioning effectively. • With respect to system integration and joint management of system development and operation by two or more financial institutions, examine whether financial institutions' computer systems are developed and run appropriately and also whether the institutions have in place contingency plans to respond appropriately in the event of system failures. • With a view to ensuring stable operation of the payment and settlement system as a whole, examine, where necessary, whether operators of clearing systems are designing and operating their systems appropriately, as it is possible for risks to become concentrated at clearing systems. • With the increasing prevalence of both open and network systems, verify that the development and operation of such systems are conducted appropriately by financial institutions, including monitoring of outsourcees.

(3) Business continuity arrangements

- With the aim of enforcing the business continuity capability of the financial system as a whole, examine whether each financial institution has established the necessary business continuity arrangements corresponding to the impact of its operational disruption on the financial system.
  - -- Examine business continuity plans from the following perspectives: (1) whether the risks which could cause operational discontinuity, such as natural disasters, system troubles, dysfunctions of public infrastructure, terrorist attacks, and pandemics have been identified; (2) whether crucial business operations which should be given priority in terms of business continuity have been specified, and whether an expected timetable for recovery has been drawn up; and (3) whether financial institutions' coordination with relevant external counterparties has been established.
  - -- Confirm that periodic drills and constant reviews of plans are conducted so as to maintain the effectiveness of business continuity arrangements.
  - -- Hold in-depth discussions, with operators of clearing systems as well as financial institutions which have a significant presence in financial markets or function as hub parties in the settlement system, regarding the establishment of more extensive business continuity arrangements.

(4) Security measures attending financial transactions

- Examine whether financial institutions have in place internal control systems and whether they are functioning effectively, including whether they have drawn up rules related to compliance, implemented effective training programs, and conducted internal audits, with a view to enhancing security in financial transactions by ensuring appropriate business operations and dealing with financial crimes.
- Verify that information security is managed adequately. Also examine whether protection of customer information is being handled appropriately in accordance with the relevant laws and regulations.
- Concerning sophisticated financial crimes, such as those involving the use of counterfeit cards, "phishing," and spyware, verify that management has decided its stance on these issues and that appropriate measures have been taken, while gathering the latest information in the field.

Financial Strength and Integrated Risk Management

- Review financial institutions' projections with respect to earnings and financial strength by conducting simulations based on expected risks and returns.

  -- In doing so, evaluate the profitability of loan business on a credit cost deducted basis. Also assess the impact of future interest rate fluctuations on financial institutions' earnings.

  -- Discuss how the economic value of deferred tax assets should be assessed and recorded on financial institutions' balance sheets, taking financial institutions' future profits and their volatility into account.

- To make integrated risk management more effective, discuss, taking due account of financial and business conditions of each institution, techniques for quantifying risk, categories of quantifiable risk, and utilizing these results in financial institutions' business management.

  -- For financial institutions that have not yet introduced integrated risk management frameworks, work together to develop a common understanding of integrated risk management, taking due account of individual institution's financial and business conditions. These points are consistent with the concept of the new capital adequacy framework, Basel II. Also support their efforts to develop integrated risk management frameworks by encouraging them to collect necessary data and to establish measures to quantify risks.

  -- Discuss the use of stress tests to manage financial institutions' business, where necessary.

- Review whether financial institutions' allocation of capital to business units and their assessment of each unit's profitability are being made in line with an integrated risk management framework.

- Discuss ways to improve disclosure of information, namely on risk management, the economic value of financial institutions' assets and associated risks, and the operation of integrated risk management.

- Discuss with financial institutions whether they are able to raise additional capital needed to, for example, finance new profit opportunities and repay public funds.

- Verify whether internal control systems have been in place and are functioning effectively to achieve management goals.

-- Identify risk profiles of financial institutions based on their internal environments for controlling, for example, business lineups, and verify the functionality of control activities including segregation of power and responsibility and internal procedures in line with associated risks. Also examine whether monitoring activities such as internal inspections within each branch and internal audits are conducted appropriately.