March 29, 2010

Bank of Japan

On-Site Examination Policy for Fiscal 2010

1. On-Site Examination by the Bank of Japan

On-site examination is the examination that the Bank of Japan (hereinafter, the Bank) carries out by visiting the premises of financial institutions based on the contracts with them, in order to grasp their business operations and the state of the property (Article 44 of the Bank of Japan Act[1]). The Bank contributes to the stability of the financial system by examining financial institutions' risk management processes as well as reaching an informed judgment on their business activities and financial conditions, and, when necessary, urging improvement, through on-site examinations.

The Bank undertakes comprehensive analyses and assessments of developments in the financial system and takes such assessments into account in its policy conduct. The on-site examination program, through which the Bank can grasp the overall situation of financial institutions, is extremely useful also for macro-analyses and assessments of the financial system.

The Bank formulates an on-site examination policy every fiscal year based on the decision of the Policy Board.[2] The present document, "On-Site Examination Policy for Fiscal 2010," briefly reviews on-site examinations carried out in fiscal 2009 and outlines the basic approach and key issues in the conduct of on-site examinations in fiscal 2010. On the basis of the present document, the Bank will make every effort to conduct efficient and effective on-site examinations.

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[1] Article 44 of the Bank of Japan Act stipulates that on-site examinations are conducted "for the purpose of appropriately conducting or preparing to conduct the business prescribed in Articles 37 through 39."

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

2. Review of Fiscal 2009

(1) On-Site Examinations in Fiscal 2009

Japan's financial system generally remained stable in fiscal 2009 as global financial markets as a whole regained stability and domestic and overseas economies exhibited a modest recovery. Financial institutions' credit costs in fiscal 2009 declined from the previous year, as corporate performance, especially that of large firms, started to improve and the number of corporate bankruptcies decreased. There was also improvement in financial institutions' securities investment in fiscal 2009, in contrast to large losses in fiscal 2008, due to the return of stability to the stock market. As a result, many financial institutions registered net income in fiscal 2009, following net losses in fiscal 2008. However, their core profitability, measured by operating profits from core business, remained weak because of sluggish growth in lending and the decrease in interest margins on loans. Many financial institutions, particularly large institutions, boosted their capital, taking account of ongoing discussions on the strengthening of global capital requirements.

Against this backdrop, the Bank carried out on-site examinations of 112 financial institutions in fiscal 2009: 46 domestically licensed banks,[3] 47 *shinkin* banks, and 19 other institutions, including securities companies[4] and Japanese branches and subsidiaries of foreign banks.

Number of Financial Institutions Examined

	Fiscal 2007	Fiscal 2008	Fiscal 2009
Domestically licensed banks	39	52	46
Shinkin banks	66	46	47
Other institutions	14	30	19
Total	119	128	112

[3] "Domestically licensed banks" in this document refers to banks that are established and licensed under Japanese legislation, excluding the Bank and government-related organizations.

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

(2) General Observations

In the fiscal 2009 on-site examinations, the Bank reviewed financial institutions' quality of assets and challenges in risk management they faced, in light of the large credit costs and losses in securities investment in fiscal 2008. Although individual financial institutions reassessed risks and reviewed their loan and securities portfolios, many still needed further improvement in their risk management. The Bank also evaluated financial institutions' current and prospective capital strength as part of the on-site examination. Some financial institutions were found in need of additional capital to prepare for the possible realization of downside risks. Financial institutions generally formulated or reviewed business plans to reflect the evolving business environment, but a majority of them remained unsuccessful in establishing a clear plan to enhance their business opportunities and raise profitability.

Looking at financial institutions by type, regional financial institutions, with sluggish lending growth in their local economies, strived to extend business to other geographical areas and to generate more local demand for loans. However, there were some cases in which regional financial institutions were lagging behind in adapting their credit risk management program to these new challenges and incurred unexpected credit costs due to an insufficient understanding of borrowers' financial conditions. Moreover, the profitability of some regional financial institutions continued to rely on securities investment because these institutions were unable to strengthen their traditional lending business. Several needed to restructure their securities portfolios that carried unrealized losses, while aligning their risk appetite with their capital strength and upgrading their market risk management procedures.

Major financial institutions as well as foreign financial institutions, building on lessons learned in the global financial crisis, embarked on restructuring their business activities and risk management program but needed to ensure a unified group-wide approach across entities. Major financial institutions continued to face the challenge of reducing the market risk associated with stockholdings.

(3) Aspects of Risk Management Ascertained through On-Site Examinations

a. Credit Risk Management

Since the introduction in 1998 of the program for financial institutions' self-assessment of asset quality, financial institutions have constructed procedures for screening and managing credit risk. In the on-site examinations, the Bank checks the accuracy of financial institutions' self-assessment of credit risk. The on-site examinations conducted during fiscal 2009 confirmed that financial institutions' self-assessment was generally appropriate. Some institutions, however, showed an insufficient understanding of borrower firms' business conditions and inadequately applied self-assessment standards on loan assets. These institutions needed to review their basic procedures for screening and management as a precondition for smooth performance of their financial intermediation function.

With regard to financial institutions' support for corporate turnaround, some major financial institutions provided such support from a perspective of possible industry consolidation, while the support provided by some regional financial institutions relying on the active use of input from outside experts or in cooperation with local communities was bearing fruit. Nevertheless, financial institutions' role in assisting corporate turnaround as a whole was not sufficiently effective, and some institutions must strengthen their internal procedures for assisting in the preparation of restructuring plans for ailing borrowers and managing progress in these plans.

The share of mortgages in financial institutions' loan portfolios has grown over past years as many financial institutions aggressively expanded their mortgage business amid sluggish demand for corporate loans. With the severe employment and income situation, many financial institutions constructively dealt with requests from borrowers to discuss mortgage repayments and/or to modify mortgage terms. At the same time, these institutions faced the challenge to establish or strengthen risk management procedures for mortgages, including the collection of relevant data such as borrower attributes, the analysis of mortgage portfolios, and the effective use of the results of such analysis in the screening and management process.

In terms of overseas exposure, some major financial institutions revised their guidelines and credit criteria following the market turmoil amid the global financial crisis and the downturn in advanced economies. One challenge they faced was to ensure the effectiveness of strong credit exposure management at overseas entities and to tighten the coordination between their headquarters and overseas entities in risk management.

b. Market Risk Management

Following the global financial crisis, many financial institutions became cautious in investing in financial products with complex risk characteristics. Nevertheless, some financial institutions faced the challenge to restructure securities portfolios laden with significant unrealized losses, while others were exposed to greater interest rate risk due to greater investment in bonds with longer maturities.

Regarding market risk management, financial institutions have established basic procedures for the management of market risk, such as introducing a framework that sets exposure ceilings. However, some regional financial institutions still needed to improve the effectiveness of their market risk management in terms of (1) conducting risk assessments and consultations prior to investments, and (2) reporting and discussing actions upon a breach of risk ceilings and additional investments, along with enhanced involvement of the senior management. On the other hand, those financial institutions that averted massive losses had an adequate recognition of risks through daily data collection and the frequent analysis and assessment of market information.

With respect to market risk associated with stockholdings, major financial institutions started to take measures to reduce such risk, but the way in which such measures are implemented requires careful scrutiny. Many regional financial institutions, in contrast, did not have a clear stance on stockholdings, and even when guidelines for reducing market risk associated with their stockholdings were set out, not much progress had been made in defining criteria for choosing which stocks to retain and in actually choosing which stocks to sell. Finally, there were some cases where additional stock investments caused an increase in market risk.

As for the measurement of market risk, many financial institutions used value-at-risk. However, there was a need for them to conduct multifaceted risk assessments by strengthening supplementary monitoring to address the deficiencies and limitations of value-at-risk measures and by employing stress-testing.

c. Liquidity Risk Management

Although stability has returned to global financial markets, internationally active financial institutions in particular continuously need to conduct liquidity risk management that incorporates various stress scenarios.

Major financial institutions needed to improve their stress-testing with regard to foreign currency liquidity at domestic and overseas entities, and their management of commitment lines set for the provision of foreign currency liquidity. Foreign financial institutions needed to ensure both stable daily funding/liquidity management and effective liquidity contingency plans, and to have in place a system of information-sharing between entities in Japan and elsewhere, including the headquarters.

Regional financial institutions had no particular problems with respect to the management of daily funding. However, some of them needed to closely monitor changes in large deposits, improve the accuracy of funding projections, and develop indicators for the management of liquidity risk. Also, many regional financial institutions needed to set down clear criteria for determining crisis levels at times of emergency and to secure cash transportation at such times.

d. Operational Risk Management[5]

In general, financial institutions had put in place operational risk management and compliance systems. The on-site examinations, however, brought to light cases of (1) inadequate identification of risk resulting from the centralization of functions/operations at branch offices and changes in computer systems, and related flaws in internal rules and

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

regulations; and (2) insufficient planning and/or implementation of preventive measures for frauds, accidents, and operational errors.

Generally speaking, financial institutions had established risk management with regard to computer systems to ensure smooth operation, and the number of system failures was on a decreasing trend. Nevertheless, some financial institutions required improvements in their management of projects concerning transition to a shared system managed by outsourced firms and of customer information.

Development of business continuity arrangements at financial institutions was fully in progress, promoted by the active involvement of industry associations. Many institutions, however, needed to improve the effectiveness of business continuity plans through training. Formulation of basic plans to address the spread of novel influenza progressed at most financial institutions, with increased awareness of the need for such steps following the expansion of low-pathogenic H1N1 influenza infections.

e. Business Management

Financial institutions have steadily established internal audit systems, although often it was still necessary to improve the depth of audit of functions at the headquarters and the business of affiliated firms, the quality of verification of institutions' own credit and market risk management, and the utilization of audit results in financial institution management.

Regarding economic capital management, many financial institutions calculated aggregated risk, assessed their capital adequacy, and allocated capital to each risk type. Some regional financial institutions, however, still needed to improve the accuracy of measurement techniques and the effectiveness of action when risk exceeded the allocated capital, and to appropriately assess room for further risk-taking given the limitations of risk measurement.

Major financial institutions enhanced their stress-testing in order to address the limitations of risk measurement and risk management methods and to determine their risk tolerance and capital adequacy. Many regional financial institutions conducted stress-testing as well, but many of them failed to make full use of the results in their conduct of business because of the stress scenarios that did not reflect their risk profiles, shortcomings in their evaluation of stress-testing results, and insufficient involvement of the senior management in the stress-testing process.

3. On-Site Examination Policy for Fiscal 2010

(1) Basic Approach

The recovery in Japan's economy is likely to remain moderate in fiscal 2010 and is still subject to uncertainty. In this situation, Japanese financial institutions will have to improve their core profitability and, at the same time, manage risks appropriately in line with their type of business and risk profiles in order to ensure financial soundness.[6] Meanwhile, there is likely to be further progress in international discussions regarding the reform of financial regulation and supervision. Against such a backdrop and based on the challenges identified in fiscal 2009, the Bank will take the following points into account in the fiscal 2010 on-site examinations.

First, the Bank will check in detail the quality of assets, capital strength, and liquidity of individual financial institutions and also examine their business environment, business models, and governance structures, in order to evaluate accurately their business operations. With regard to capital strength, the Bank will make assessments that fully take into account the risks specific to each institution, utilizing techniques such as stress-testing. For financial groups that provide a variety of financial services, the Bank will check the business operations of the entire group. Through discussions with financial institutions in the process of such examinations, the Bank will encourage the maintenance of sound management while identifying potential risks in the entire financial system.

Second, as financial institutions continuously need to fulfill their role of efficient financial intermediation and support corporate and household activities, the Bank will check, and give advice on, their approaches to improving screening and management capabilities, which are necessary to perform the financial intermediation function, and their approaches

[6] The analysis and assessment of the situation of Japan's financial system and Japanese financial institutions is based on the March 2010 issue of the Bank's "Financial System Report."

to ensuring effective support of corporate turnaround.

Third, the Bank will assess financial institutions' risk management frameworks from a forward-looking perspective and give advice as necessary. More specifically, the Bank will check whether their risk management approaches address not only current risk profiles and asset quality but also future business, new risk-taking, and possible changes in the external environment, including the potential emergence of a situation of stress. In addition, the Bank will encourage individual financial institutions to establish an organizational structure that enables them to improve risk management in a flexible manner in line with changes in their risk profiles and in the economic and financial environment. As for financial groups that provide a variety of financial services, examinations of the entire group will be made; and as for internationally active financial institutions, their liquidity risk management on a global basis and unified management by the headquarters will be examined. The Bank will focus particularly on risk management in rapidly growing areas, such as exposures to emerging economies.

Fourth, in order to conduct efficient and effective on-site examinations, the Bank will continue to conduct "risk-based on-site examinations," which the Bank has used since fiscal 2008. It will utilize targeted on-site examinations, which limit the conduct of the examinations to certain risk areas for efficiency and effectiveness.

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

In conducting on-site examinations, the Bank, based on the aforementioned basic approach, focuses particularly on the following issues.

a. Credit Risk Management

Improving Screening and Management Capabilities

In order to be able to properly perform their role of financial intermediation, financial institutions must improve their capabilities of screening borrower firms and managing loans. Particularly in a situation where the outlook for corporate performance is highly uncertain and growth in regional economies has remained sluggish, it is all the more important for financial institutions to accurately assess borrower firms' business conditions through proper screening of borrower firms and managing of loans.

From these viewpoints, the Bank will examine more comprehensively each financial institution's basic screening and management capabilities and help to make improvements. Points that will be checked include (1) whether the examinee financial institution decides carefully on the appropriateness of loan extension based on a realistic assessment of borrower firms' business conditions, and (2) whether the follow-up monitoring by the institution is appropriate in terms of whether the examinee institution takes necessary measures in response to reassessments of firms' business conditions in a timely manner. The Bank will also check the effectiveness of the plan-do-check-act (PDCA) cycle in screening and management: (1) identifying the challenges in screening and management based on the analysis of actual bankruptcies; (2) developing mechanisms based on step (1); (3) monitoring the performance of the measures taken; and (4) taking additional measures necessary for improvement.

Improving the Effectiveness of Support for Corporate Turnaround

Support for corporate turnaround to contribute to an improvement in firms' soundness is an important business area for financial institutions. This is because such support may curb additional credit costs resulting from a decline in firms' creditworthiness and also lead to an increase in future interest income, eventually improving financial institutions' core profitability.

The Bank will examine the following points: (1) whether the examinee institution has established the necessary procedures to support corporate turnaround, including involvement of senior managers of the institution; (2) whether it is formulating plans and identifying practical steps for corporate turnaround with a sufficient understanding of firms' situation; and (3) whether it is evaluating the whole process and making efforts to improve it. In addition to examining these points, the Bank will give advice where necessary.

Establishing a Mortgage Loan Management Framework

There has been a steady increase in the share of mortgages in many financial institutions' loan portfolios while delinquency rates on mortgages have been on the rise against the backdrop of the severe employment and income situation. It has thus become all the more important for financial institutions to establish procedures for better mortgage management. The Bank will (1) assess the examinee institution's mortgage portfolio and (2) examine the institution's mortgage management framework to ensure proper analysis of changes in borrower attributes and delinquency rates and effective use of such analysis in screening and management. Based on such assessment, the Bank will make suggestions for improvement.

b. Market Risk Management

Ensuring a Thorough Verification of Risks When Formulating Portfolio Investment Plans

For financial institutions, it is important to recognize and verify risks when formulating securities investment plans. This especially applies to regional financial institutions, which tend to use a buy-and-hold strategy and which, given the sluggish growth in their lending, may increase portfolio investment again.

The Bank will ask senior managers of examinee institutions what performance they expect of securities investments and about their risk-taking stance, and will also examine the following points: (1) whether the examinee institution, when formulating investment plans and deciding on each investment, is verifying risks thoroughly and understands the impact of future market fluctuations on its profits and capital adequacy; (2) whether it has established a mechanism to control investment positions in line with its capital strength and the risk characteristics of its portfolio; and (3) whether it is analyzing and evaluating the risk characteristics of its portfolio periodically by utilizing techniques such as stress-testing, and shares the results widely within the institution. Regarding financial institutions that have incurred a large amount of unrealized losses, the Bank will discuss their plans to restructure these portfolios.

Ensuring Effective Risk Management

The recent global financial crisis has shown that a management framework confined to the setting of risk limits and loss ceilings is not sufficient for ensuring the effectiveness of market risk management, and that financial institutions should respond in a timely manner to changes in market developments and in the risk profiles of their portfolios. This is especially true in situations where there is a likelihood that an increase in market volatility can lead to a change in market trends. In such situations, enhancing risk management is crucial. This, in turn, is possible only when the risks are widely recognized across the institution.

In the on-site examinations, in addition to the involvement of the senior management in market risk management, the Bank will examine the following issues: (1) whether departments in charge, including the front office, are collecting multifaceted information about market and economic developments and are analyzing their impact on the portfolio; (2) whether sufficient reporting is made to the senior management and consultations among departments are made in a timely manner in response to changes in market conditions; and (3) whether a framework is in place whereby the effectiveness of risk management is verified and reviewed periodically.

While measurement of market risk using value-at-risk provides a basis for market risk management, what is also necessary is (1) the appropriate use of value-at-risk, taking into account its limitations, and (2) a variety of analyses and risk assessments to supplement it. The Bank will check these points.

Managing Market Risk Associated with Stockholdings

Managing market risk associated with stockholdings remains an important challenge for financial institutions, because fluctuations in stock prices have an enormous impact on their profits and capital strength.

The Bank, among other things, will examine (1) whether examinee institutions assess the benefits of their stockholdings in a rational manner and (2) whether they check the impact of fluctuations in stock prices on their profits and capital adequacy by utilizing techniques such as stress-testing. In addition, the Bank will encourage those financial institutions for which there is a high level of market risk associated with stockholdings relative to capital strength to reduce risk and enhance their capital base.

c. Liquidity Risk Management

The Importance of Understanding Liquidity Risk Profiles

The importance of liquidity risk management for financial institutions was reaffirmed by the recent global financial crisis.

The Bank will examine the size and characteristics of examinee institutions' liquidity risk in light of their business operations and structure of funding and investment. Moreover, it will check whether these institutions regularly gauge such risk.

Ensuring Stable Liquidity Management

Extensive involvement of the senior management is necessary in ensuring stable liquidity management, given that such management closely relates to all business operations that affect the amount of a financial institution's assets and liabilities.

The Bank will examine whether the senior management is involved in ensuring the following points: (1) the limit of risk tolerance has been set based on the examinee institution's financial condition and funding capacity, and a mechanism for monitoring and controlling risks has been established to observe this limit; (2) funding sources are diversified to ensure stable funding; and (3) information about funding conditions, such as developments in deposits and in markets, is shared widely within the organization on a day-to-day basis, so that the examinee institution is capable of responding promptly to changes in the environment.

Enhancing Capabilities to Respond to Stress Situations

In liquidity risk management, it is necessary to maintain the capability to respond to various stress situations.

The Bank will examine the following points: (1) whether the examinee institution verifies the sufficiency of liquefiable assets on the basis of stress scenarios that fully take account of liquidity risk profiles -- such as the risk of funding difficulties or of a drain of deposits and/or other funds; and (2) whether the examinee institution's liquidity contingency plan clearly stipulates the responses to various stress situations, whether the institution has established clear lines of responsibility and authority within the organization, whether the contingency plan sets out clear invocation and escalation procedures, and whether its effectiveness has been ensured through periodic reviews.

Global Liquidity Risk Management

With regard to internationally active financial institutions, the Bank will examine their global liquidity risk management framework including their overseas entities.

d. Operational Risk Management

Ensuring That an Autonomous Risk Management Cycle Is in Place

Amid rapid changes in financial institutions' business environment and business operations, it has become all the more important to establish a PDCA cycle that enables them to grasp and address risks and problems underlying their business operations.

To confirm the effectiveness of such a PDCA cycle, the Bank will check the following points: (1) how the examinee institution is identifying risks by using information regarding (a) changes in business operations, (b) frauds, accidents, operational errors, and system incidents, and (c) complaints and other problems; (2) whether it is taking additional risk management measures in response to the findings in (1), such as revising operational processes and internal rules, and enhancing computer system support; (3) whether it is monitoring operations and carrying out verification through internal audit; and (4) whether it is taking necessary measures for improvement.

In addition, for financial institutions with a key presence in payments and settlements and/or that provide settlement services to other financial institutions, the Bank will review how they manage operational risk related to settlement business.

Enhancing Computer System Risk Management

There are still system incidents that affect other financial institutions or require considerable time for recovery, although the number of such incidents as a whole is decreasing.

The Bank will continue to check the reliability, availability, and security of mission-critical systems. Taking into account the development of shared computer systems among regional financial institutions, the Bank will also examine the management of various projects, including the transition to the shared system managed by outsourced firms, and will also check the management of outsourced firms, visiting these firms and joint operation centers. Furthermore, for major financial institutions that are highly dependent on computer systems in the management information systems, the Bank will verify the functioning of their system from the perspective of reliability and timeliness of data.

Development of Business Continuity Arrangements

Development of business continuity arrangements is important, not only because it is an operational challenge for individual financial institutions, but also because smooth functioning of the payment and settlement system in Japan needs to be ensured.

The Bank will thus further encourage financial institutions to establish business continuity arrangements and ensure the effectiveness of the arrangements in the on-site examinations.[7] Especially regarding financial institutions with a key presence in the payment and

[7] In the on-site examinations, the Bank will refer to the report "Toward Effective Business Continuity Management: A Check List and Instructive Practices (Revised)," March 2010 (available only in Japanese).

settlement system, the Bank will (1) examine the sufficiency and consistency of the contents of business continuity plans and the effectiveness of these plans, including the securing of management resources, and (2) examine how well the PDCA cycle is employed in developing business continuity arrangements. As for other financial institutions, the Bank will check whether their business continuity arrangements conform to their type of business and regional presence, and will provide advice as necessary.

In addition, the Bank will examine financial institutions' business continuity arrangements developed as a precaution against the spread of high-pathogenic novel influenza, paying particular attention to the coverage of critical operations and the number of necessary staff.

e. Business Management

Effectiveness of Internal Audit

Internal audit plays an important role in ensuring financial institutions' appropriate conduct of business and in promoting proactive improvement of risk management.

In the on-site examinations, the Bank will evaluate the effectiveness of financial institutions' internal audit by examining the following: (1) whether financial institutions, based on their risk profiles, appropriately select business functions that are subject to internal audit and allocate audit resources to these functions; (2) whether audit of functions at the headquarters and the business of affiliated firms and of their credit and market risk management is conducted; and (3) whether the senior management of the examinee institution properly recognizes the importance of internal audit and takes measures for appropriate improvements based on audit results.

Business Management Based on an Optimal Balance between Capital Strength and Risks

In the management of financial institutions, it is important to find an optimal balance between capital strength and risk-taking.

In the on-site examinations, the Bank will examine (1) whether the senior management of the examinee institution regularly receives reports on the status of the institution's capital strength and risk exposure, and whether it discusses and takes appropriate actions based on the reports, and (2) whether the institution utilizes economic capital management and stress-testing appropriately and effectively in this process. Amid highly uncertain economic and financial conditions, stress-testing is a useful means of sharing widely within the organization information on the institution's risk profile. The Bank will thus encourage the introduction of stress-testing at those financial institutions that have not yet done so. As for those financial institutions that have already employed stress-testing, the Bank will check whether they, and particularly their senior management, have first clarified the objectives of the stress-testing and established a standard in evaluating the results, and then (1) set stress scenarios based on these objectives and the institution's risk profile, and (2) evaluate the results with a proper involvement of relevant divisions within the institution and utilize the results in making business decisions.[8]

f. Profitability and Capital Strength

Assessment of Profitability and Capital Strength

For financial institutions to fulfill their financial intermediation function in a stable manner, they need to improve their core profitability and reinforce capital.

In the on-site examinations, the Bank will grasp the financial soundness of examinee institutions by verifying their self-assessment of asset quality. In addition, the Bank will evaluate their current and prospective profitability and capital strength by applying several scenarios including stress conditions. As for the capital strength, the Bank will check in particular whether the examinee institution's capital is adequate as a buffer against potential losses in light of the characteristics and size of risks that may materialize, and the Bank and the institution will discuss the quality of capital as necessary. By these means, the Bank will encourage financial institutions to improve their core profitability and reinforce capital.

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[8] In the on-site examinations, the Bank will refer to "Principles for Sound Stress Testing Practices and Supervision" issued by the Basel Committee on Banking Supervision in May 2009.

(3) On-Site Examination Management

Starting with the fiscal 2008 on-site examinations, the Bank introduced "risk-based on-site examinations" reflecting improvements in the Bank's off-site monitoring capabilities. The frequency and the scope of such "risk based on-site examinations," as well as the number of examiners involved, will be determined on the basis of a comprehensive assessment from two perspectives: (1) the impact on the financial system that the materialization of risks for a particular financial institution would have; and (2) the financial soundness of the financial institution, such as its capital strength and the extent of risk-taking. As part of this process, the Bank will continue to utilize targeted on-site examinations that limit the scope of the examination to risk areas warranting special scrutiny. In addition, for trust banks, securities companies, and foreign financial institutions, the Bank will conduct on-site examinations that are more finely tailored to their business characteristics. As for internationally active financial institutions, the Bank will, when necessary, exchange views with foreign authorities and overseas headquarters.

The Bank will continue to strive to conduct efficient and effective on-site examinations and take appropriate actions to gain a full understanding from, and credibility with, examinees regarding the whole process of the examinations and the results. During fiscal 2009, the Bank took measures to improve (1) the functioning of the online system through which the documents concerning on-site examinations are exchanged, (2) the content of the survey on on-site examinations among examinees that the Bank conducts after the on-site examinations, and (3) the procedures allowing examinees to present their views following the examination.[9] In fiscal 2010, the Bank will make sure that these improvements remain valid and will review the documentation required in on-site examinations with due consideration of the operational burden on examinees.

[9] Examinees were previously required to attach the accounting auditor's opinion to other necessary documents submitted to the Bank, but now this is optional.