April 8, 2011
Bank of Japan

On-Site Examination Policy for Fiscal 2011

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 of financial institutions' business operations and the state of the property by visiting their premises based on the contracts with them (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 the 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 2011," briefly reviews on-site examinations carried out in fiscal 2010 and outlines the basic approach and key issues in the conduct of on-site examinations in fiscal 2011. On the basis of the present document, the Bank will make every effort to conduct efficient and effective

---

[1] Article 44 of the Bank of Japan Act stipulates that "the Bank of Japan may, for the purpose of appropriately conducting or preparing to conduct the business prescribed in Articles 37 through 39, conclude a contract with financial institutions, etc. which would be the counterparty in such business concerning on-site examinations."

[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" shall be determined by the Policy Board (Article 15, paragraph 2, item v).

on-site examinations.

2. Review of Fiscal 2010

(1) On-Site Examinations in Fiscal 2010

The Bank carried out on-site examinations of 100 financial institutions in fiscal 2010: 38 domestically licensed banks,[3] 43 *shinkin* banks, and 19 other institutions, including securities companies[4] and Japanese branches and subsidiaries of foreign banks.

Number of Financial Institutions Examined

	Fiscal 2008	Fiscal 2009	Fiscal 2010
Domestically licensed banks	52	46	38
Shinkin banks	46	47	43
Other institutions	30	19	19
Total	128	112	100

(2) General Observations

In the fiscal 2010 on-site examinations, the Bank, as in the previous year, thoroughly 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 accumulated after the recent global financial crisis. Although individual financial institutions restructured their loan and securities portfolios and took actions to improve their risk management, many needed to enhance the effectiveness of their risk management.

The Bank also evaluated financial institutions' current and prospective profitability and capital strength as part of the on-site examination. Many financial institutions secured

[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.

sufficient capital strength by boosting capital and accumulating retained earnings. However, some financial institutions were found in need of additional capital to prepare for the possible realization of downside risks. Moreover, some institutions were left unequipped with a clear plan as to how to enhance their business and raise profitability.

(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 2010 confirmed that financial institutions' self-assessment was generally appropriate, but that many institutions had insufficient understanding of borrower firms' business conditions. A number of institutions were faced with the sudden bankruptcy -- partly due to the recent global financial crisis and ensuing weakness in corporate performance -- of borrower firms that had been classified as "normal" or "need attention." These institutions needed to enhance their capabilities to screen borrower firms and manage loans.

With regard to financial institutions' support for corporate turnarounds, many financial institutions made progress in strengthening their internal procedures and some institutions began to achieve certain success as their divisions in charge actively provided support to borrower firms. Nevertheless, financial institutions' role in assisting corporate turnarounds as a whole was not sufficiently effective, and financial institutions needed to assist borrower firms in the preparation of corporate turnaround plans that are appropriate to their business conditions and to closely manage progress in these plans.

The share of residential mortgages in financial institutions' loan portfolios has continued to grow over the past years as many financial institutions aggressively expanded their residential mortgage business amid sluggish demand for corporate loans. While credit costs arising from residential mortgages remained at low levels, the residential mortgage portfolios of a number of financial institutions were prone to deterioration in quality from higher delinquency rates and subrogation rates. In view of this, these institutions needed to strengthen risk management procedures for residential 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.

With regard to credit rating systems, many financial institutions have introduced such systems, but in some cases the accuracy of these systems was insufficient or their use in the analysis of portfolios was inadequate. These institutions needed to examine the validity of their systems and make them useful for portfolio analysis, and to effectively use the results of such analysis in the screening and management process.

b. Market Risk Management

Many financial institutions remained cautious about investing in financial products with complex risk characteristics, and their portfolios were mainly composed of domestic bonds. In this situation, regional financial institutions in particular were increasingly exposed to greater interest rate risk.

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 and loss limits. At many regional financial institutions, however, effective risk management is not ensured, mainly due to insufficient involvement of senior management. For example, at many of these institutions, there remained considerable room for improvement in the analysis and verification of risks as well as the reporting to senior management, and discussion on how to respond to growing losses from market fluctuations and breaches of ceilings and limits often did not occur in a flexible and sufficiently timely manner. Moreover, amid growing interest rate risk, problems were also observed in grasping the effects of interest rate fluctuations on profits/losses and capital adequacy.

With respect to market risk associated with stockholdings, many financial institutions needed to clarify the criteria for holding stocks and to assess the benefits of stockholdings, and even if they had worked out guidelines for reducing market risk associated with stockholdings, some had made inadequate efforts to reduce such risk.

c. Liquidity Risk Management

Although liquidity risk in both yen and foreign currencies has been subdued, financial institutions continuously need to conduct liquidity risk management that incorporates various stress scenarios.

Major financial institutions and foreign financial institutions needed to improve the specifics of their stress scenarios, and some institutions needed to work on ensuring the effectiveness of liquidity contingency plans.

Regional financial institutions had no particular problems with respect to the management of daily funding, although many needed to set up response procedures in line with a particular crisis level in an emergency and to secure cash transportation at such times.

d. Operational Risk Management[5]

Financial institutions have generally made progress in building autonomous risk management cycles to address the risks inherent in their business operations and computer systems as well as changes in the business environment. In some cases, financial institutions were slow in setting up an operational risk management system that corresponded to changes in risk profiles stemming from the centralization of functions/operations at operation centers or from the sale of financial products with relatively high risks. In other cases, financial institutions had taken insufficient measures for effective risk analysis such as control self-assessments (CSAs).

As for risk management with regard to computer systems, some financial institutions needed to improve their mechanisms for monitoring operations at outsourcing firms after they moved to a shared computer system managed by an outsourcing firm and reduced the number of their own systems specialists.

Overall, financial institutions made progress in the development of business continuity

---

[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.

arrangements. Some institutions, however, needed to improve the effectiveness of business continuity plans in terms of (1) identifying disaster scenarios, (2) estimating the number of staff necessary to carry out critical business operations, and (3) conducting institution-wide drills. Meanwhile, most financial institutions made progress in the formulation of plans to address the spread of novel influenza.

e. Business Management

Financial institutions have steadily established internal audit systems. Some institutions, however, needed to improve the depth of audit of operations at the headquarters and affiliated firms, as well as the quality of verification of their credit and market risk management.

Many financial institutions have also already introduced economic capital management and have begun to examine whether aggregate risk remains within their capital buffer. Moreover, given the limitations of risk measurement, major financial institutions enhanced their stress-testing. Many regional financial institutions conducted stress-testing as well, but often employed stress scenarios that did not sufficiently conform to their risk profiles and showed shortcomings in the evaluation of stress test results and insufficient involvement of senior management in the stress-testing process, so that the results were frequently not reflected in their conduct of business.

3. On-Site Examination Policy for Fiscal 2011

(1) Basic Approach

The outlook for the business environment of financial institutions continues to be subject to various uncertainties and in particular the effects of the Great East Japan Earthquake on financial institutions warrant close monitoring. Against this backdrop and based on the challenges identified in fiscal 2010, the Bank will take the following points into account in the fiscal 2011 on-site examinations, in which the Bank will give the utmost consideration to the effects of the earthquake on financial institutions' business operations.

First, the Bank will intend to adequately grasp individual financial institutions' financial soundness, including the quality of their assets and their liquidity profiles. In doing so, the Bank will assess borrowers' creditworthiness, duly taking into account the specific circumstances of each financial institution, including the impact of the earthquake. Moreover, the Bank will assess financial institutions' capital strength utilizing techniques such as stress-testing. Furthermore, through these assessments, the Bank will seek to ensure the continued sound management of financial institutions while identifying potential risks in the financial system.

Second, through the on-site examinations, the Bank will encourage financial institutions to conduct risk management suitable to their type of business and risk profiles, and in fiscal 2011 it will particularly strengthen the examination of their governance of risk management. Specifically, the Bank will examine and, if necessary, give advice to examinee financial institutions on the following points: (1) senior management's risk awareness, risk appetite, and involvement in risk management; (2) the framework for institution-wide information sharing and its development to promote risk communication; and (3) the role performed by the board of directors, the board of auditors, various committees, and internal audits. In addition, the Bank will encourage individual financial institutions to establish an organizational structure that enables them to improve risk management in line with changes in their risk profiles and the external environment.

Third, the Bank will continue to examine and give advice on financial institutions' approaches to improving screening and management capabilities necessary to perform their financial intermediation function, and the support they provide for corporate turnarounds. Furthermore, in order to ensure that financial institutions fulfill their financial intermediation function in a continuous and stable manner, the Bank will examine and provide advice as necessary on financial institutions' view on the adequacy of both the quality and quantity of their capital and capital policies based on this view, as well as the direction of their corporate management including strategies to achieve higher profitability.

Fourth, 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. To enhance the effectiveness of on-site examinations, the Bank will strengthen the seamless coordination between its on-site examinations and off-site monitoring, strive to grasp the actual business conditions of financial groups including overseas entities, and, when necessary, request examinee financial institutions to do an internal follow-up on the results of the Bank's on-site examinations.

(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. Business Management

Structure and Effectiveness of Corporate Governance

In order to ensure effectiveness of risk management, it is necessary for financial institutions to secure sufficient functioning of corporate governance to make sound business decisions in response to changes in the external environment.

In the on-site examinations, the Bank will check the following aspects: senior management's risk appetite; managerial concerns of various stakeholders; business strategies with regard to these aspects; disclosure policy; the managerial decision-making process; and the oversight process.

For financial groups that provide a variety of financial services, the Bank will check the business management framework of the entire group including overseas entities.

Moreover, the Bank will examine the following, mainly from the perspective of risk management: (1) whether the board of directors and various committees are functioning effectively; (2) whether risk awareness is widely shared throughout the entire institution; and (3) whether improvements in risk management to respond to changes in risk profiles and the external environment are being actively pursued.[6]

Business Management Based on Assessments of Capital Strength and Risks

In the management of financial institutions, it is important to strike the right 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 tools such as 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 institution 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 set stress scenarios based on these objectives and each institution's risk profile, and evaluate the results with a proper involvement of relevant divisions within the institution and utilize the results in making business decisions.[7]

Development of Management Information Systems

With their business operations and portfolios becoming ever more diverse and complex, it has become important for financial institutions to set up and appropriately employ mechanisms to gather, for the institution as a whole, the information necessary to manage business operations and risks.[8]

---

[6] In the on-site examinations, the Bank will refer to the "Principles for Enhancing Corporate Governance" issued by the Basel Committee on Banking Supervision in October 2010.

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

[8] Frameworks for gathering the information necessary to effectively implement business

In the on-site examinations, the Bank will examine (1) whether major and regional financial institutions have appropriately set up information-gathering mechanisms, including an information infrastructure, and (2) whether the reliability and timeliness of information gathered through these mechanisms are ensured.

Effectiveness of Internal Audits

Internal audits play 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 examine 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 adequately; 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.

b. Credit Risk Management

In the on-site examinations, the Bank will continue to check financial institutions' capabilities of screening borrower firms and managing loans by examining their self-assessment of their asset quality, and encourage improvements in these capabilities. In doing so, the Bank will examine the creditworthiness of borrower firms affected by the earthquake, while duly taking into consideration the difficulties financial institutions face in grasping the business conditions of borrower firms and the length of time needed for those firms to recover, given the magnitude of the damage from the earthquake. The Bank will focus on the following points in the on-site examinations for fiscal 2011.

---

management and risk management are called "management information systems" (MISs).

Adequacy of Corporate Turnaround Plans and Effectiveness of Support for Corporate Turnarounds

With the corporate environment -- especially for small and medium-sized firms -- continuing to be severe, financial institutions are increasingly modifying lending terms.

In the on-site examinations, the Bank will examine corporate turnaround plans prepared in this situation in terms of (1) whether such plans are consistent with borrower firms' business conditions, and (2) whether financial institutions conduct appropriate follow-up monitoring. (3) In addition, based on the assessment of the plans' feasibility, the Bank, if necessary, will examine financial institutions' future measures, including possible revisions of such plans. And (4), the Bank will examine whether financial institutions have been building structures to improve the effectiveness of support for corporate turnarounds, including the involvement of senior management, and, if necessary, will make suggestions to help ensure that financial institutions smoothly perform their function as financial intermediaries.

Residential Mortgage Portfolio Analysis and Its Use

There has been a steady increase in the share of residential mortgages in many financial institutions' loan portfolios. However, given the continuing severe employment and income situation, delinquency rates and subrogation rates on mortgages have been on the rise.

In the on-site examinations, the Bank will assess financial institutions with large residential mortgages exposures in terms of (1) whether they are fully aware, through the analysis of borrower attributes, of the quality of, and possible future changes in, their loan portfolio, and (2) whether they are effectively using the results of such analysis in the screening and management process. Based on such assessment, the Bank will make suggestions for improvement.

Measures to Ensure Effective Credit Rating Systems

Although many financial institutions have made progress in the introduction of credit rating systems, the sudden bankruptcy of borrower firms classified as "normal" or "need attention" as a result of the recent global financial crisis and ensuing weakness in corporate performance has shown that in some cases such credit rating systems were insufficiently accurate.

In the on-site examinations, the Bank will examine (1) whether financial institutions verify the validity of their credit rating systems and make necessary improvements, and (2) whether they conduct portfolio analyses using the systems and effectively use the results of such analyses in their screening and management processes.

Effective Management of Overseas Credit Exposure

Some major financial institutions are increasing their overseas exposure, reflecting the strong demand for funds particularly in emerging economies and the expansion overseas, especially in Asia, of existing borrower firms.

In the on-site examinations of major financial institutions with large overseas exposure, the Bank will conduct in-depth research of the nature of overseas exposure by examining institutions' self-assessment of their exposure. The Bank will then check (1) whether such financial institutions have put in place sufficient procedures for screening and managing credit risk at overseas entities, (2) whether their headquarters appropriately monitor such procedures, and (3) whether the headquarters adequately control credit risk on a global basis.

c. Market Risk Management

The Bank will examine financial institutions' market-related operations and their understanding and management of market risk profiles for financial products with complex risk characteristics by verifying their self-assessment. The Bank will focus on the following points in the on-site examinations for fiscal 2011.

Risk Appetite and Risk Management Procedures

Senior management needs to be explicit about the institution's risk appetite in the management of its market portfolio and, based on this, formulate investment plans and develop and carry out risk management procedures.

In the on-site examinations, the Bank will examine what return senior management expects from investment portfolios and whether it is sufficiently aware of the risks involved. In addition, the Bank will examine (1) whether senior management has clearly spelled out its risk appetite and has shared it across the institution, and (2) whether the formulation of investment plans, individual investment decisions, and the setting up and implementation of risk management procedures are based on the risk appetite.

Risk Communication

The recent global financial crisis has shown that in order to respond to market developments and changes in risk profiles in a timely manner, it is important to gather and analyze information about market risk, and to communicate such information, for example through discussion on appropriate responses, with the senior management closely involved.

In the on-site examinations, the Bank will check (1) whether financial institutions gather a wide range of information on market and economic developments, conduct risk analyses based on the information gathered, and sufficiently share those results across the institution; and (2) whether, taking those results into account, consultations among related parties on investment portfolios take place in a timely and adequate manner.

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 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 financial institutions with a high level of market risk associated with stockholdings relative to their capital strength to reduce risk and enhance their capital base.

d. Liquidity Risk Management

The Bank checks financial institutions' liquidity risk management procedures by conducting both off-site monitoring and on-site examinations.[9] In the on-site examinations of financial institutions, the Bank will examine the senior management's involvement in liquidity risk management, the framework for institution-wide information sharing and actual risk communication, financial institutions' capability to respond to stress situations, and their global liquidity risk management.

Senior Management's Involvement and Risk Communication

Liquidity management is closely linked to all business operations that affect a financial institution's assets and liabilities. Therefore, to ensure stable liquidity management, extensive involvement of the senior management and adequate information sharing across relevant divisions within the institution are necessary.

The Bank will examine whether the senior management is involved in ensuring that (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; and (2) information about funding conditions, such as developments in deposits and in markets, is shared widely within the institution on a day-to-day basis, so that the examinee institution is capable of responding promptly to changes in the environment.

Capabilities to Respond to Stress Situations

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

---

[9] For details, see "Liquidity Risk Management in Financial Institutions Following the Global Financial Crisis," July 2010, Bank of Japan.

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 it, 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

Internationally active financial institutions need to implement appropriate liquidity management within the financial group upon having fully recognized the risks concerning funding in local markets and funding through intra-group accommodation.

In the on-site examinations of these institutions, the Bank will examine their global liquidity risk management framework including their overseas entities.

e. Operational Risk Management

In the on-site examinations, the Bank will examine how financial institutions grasp their operational risk profile and how they manage operational risk. In addition, there are likely to be widespread revisions in computer system management and business continuity arrangements among financial institutions following the earthquake, and the Bank will provide advice as necessary on such moves. The Bank will focus on the following points in the on-site examinations for fiscal 2011.

Effectiveness of Autonomous Risk Management Cycles

Amid rapid changes in financial institutions' business environment and business operations, it has become all the more important to establish the plan-do-check-act (PDCA) cycle that enables them to grasp and address risks and problems underlying their business operations and computer systems.

To confirm the effectiveness of the PDCA cycle, the Bank will check particularly the following points: (1) how the examinee institution is identifying risks by using information regarding (a) changes in operational procedures caused by altered business operations, (b) the occurrence of frauds, accidents, operational errors, and system failures, 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 payment and settlement systems and/or that provide settlement services to other financial institutions, the Bank will review how they manage operational risk related to settlement business.

Senior Management's Risk Awareness with Regard to Computer Systems and the Development of Risk Management Frameworks

In order to ensure the reliability and security of financial institutions' computer systems, it is important to develop and improve risk management frameworks on the basis of an adequate awareness of risk on the part of senior management.

The Bank will examine (1) whether financial institutions' senior management adequately recognizes risks associated with the development and operation of computer systems, (2) whether necessary risk management frameworks including the prevention of computer system failures have been put in place on the basis of the awareness of such risks, and (3) whether risk management frameworks are reviewed, if necessary, in line with changes in risks and the environment in which financial institutions operate.

Responses to Computer System Failures

There continue to occur failures of mission-critical systems at financial institutions that affect their clients and other institutions and that require considerable time to resolve. In case of a computer system failure, it is important that, through the involvement of senior management, the spread of the impact be contained and computer systems be restored promptly by gathering and analyzing information and conducting discussions of responses in an appropriate manner.

The Bank will examine (1) whether the process of gathering and analyzing information and of discussing responses in case of a computer failure is explicitly set out, and (2) whether the effectiveness of this process is regularly checked and reviewed as necessary through drills.

Risk Management of Shared Computer Systems

With regional financial institutions increasingly relying on shared computer systems, the management of firms to which computing operations have been outsourced and of joint operation centers is of growing importance.

The Bank will examine financial institutions' management of various projects, including the transition to a shared system managed by outsourcing firms, as well as their management of outsourcing firms, by visiting these firms and joint operation centers.

Development of Business Continuity Arrangements

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

The Bank will thus encourage financial institutions to establish business continuity arrangements and ensure the effectiveness of the arrangements in the on-site examinations.[10] Especially regarding financial institutions with a key presence in the payment and settlement systems, the Bank will examine the sufficiency and consistency of the contents of business continuity plans and the effectiveness of these plans, including the

[10] 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).

securing of management resources. As for other financial institutions, the Bank will examine 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 continue to 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.

f. Profitability and Capital Strength

Assessment of Profitability and Capital Strength

For financial institutions to continue 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 situations. On this basis, the Bank will examine and provide advice as necessary on financial institutions' view on the adequacy of both the quality and quantity of their capital and capital policies based on this view, as well as the direction of their corporate management including strategies to achieve higher profitability.

(3) On-Site Examination Management

The Bank will continue to conduct "risk-based on-site examinations," which have been implemented since fiscal 2008. The frequency and 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 degree of risk-taking. As part of this process, the Bank will continue to utilize targeted on-site examinations, which limit the conduct of the examinations to certain risk areas.

In fiscal 2011, to further enhance the effectiveness of on-site examinations, the Bank will make greater use of information gathered through off-site monitoring and will strengthen the seamless coordination between its on-site examinations and off-site monitoring. The Bank will also intend to grasp the business conditions of financial groups providing a variety of financial services, including their overseas entities. As for internationally active financial institutions, the Bank will, when necessary, exchange views with foreign authorities and overseas headquarters. For trust banks, securities companies, and foreign financial institutions, the Bank will conduct on-site examinations that are adequately tailored to their business characteristics.

Moreover, the Bank, when necessary, will interview examinee institutions' internal audit divisions to grasp risk profiles and other facts before visiting their premises. When on-site examinations detect important management issues of a financial institution, the Bank has been asking the examinee institution to report on subsequent progress to the Bank's division that conducts off-site monitoring in line with Article 9, paragraph 2 of the On-site Examinations Agreement.[11] This framework remains in place, but in addition, even when the situation does not call for such reporting, the Bank will now request examinee institutions whose business and risk management leaves large room for improvement to conduct internal follow-ups and will urge them to make autonomous improvements.

The Bank will take appropriate actions to gain examinee institutions' full understanding of and trust in the examination process and results. Specifically, the Bank will work to reduce the operational burden for examinee institutions and improve procedures of on-site examinations by responding to opinions and requests gathered from examinee institutions through the post-examinations survey. Moreover, the Bank will review the documentation required in on-site examinations, giving due consideration to the operational burden

[11] Article 9, paragraph 2 of the On-site Examinations Agreement states, "For the period outside of the on-site examinations other than that prescribed in the preceding Paragraph, the BOJ may request that the Financial Institution furnish reports or documents regarding its business operations and financial condition within the scope necessary to ascertain such matters through the on-site examinations."

imposed on examinee institutions.

Furthermore, in the fiscal 2011 on-site examinations, the Bank will give the utmost consideration to the effects of the earthquake on financial institutions' business operations.