March 25, 2014

Bank of Japan

On-Site Examination Policy for Fiscal 2014

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 to comprehend financial institutions' business operations and the state of their property by visiting their premises based on 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 assessing the business activities and financial conditions of financial institutions with accounts at the Bank, 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 (macroprudential framework). The on-site examination program, through which the Bank can comprehend the overall situation of financial institutions, is extremely useful also for macro-analyses and assessments of the financial system.[2]

The Bank formulates the on-site examination policy every fiscal year based on the decision of the Policy Board.[3] This document, "On-Site Examination Policy for Fiscal 2014," briefly reviews on-site examinations carried out in fiscal 2013 and outlines the basic approach and key issues in the conduct of on-site examinations in fiscal 2014. On the basis of this

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[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] For details on the relationship between on-site examinations and macroprudential initiatives, see "The Bank of Japan's Initiatives on the Macroprudential Front," October 2011, Bank of Japan.

[3] 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).

document, the Bank will make every effort to conduct efficient and effective on-site examinations.

2. On-Site Examinations in Fiscal 2013 and General Observations

(1) On-Site Examinations in Fiscal 2013

The Bank carried out on-site examinations of 110 financial institutions in fiscal 2013: 29 domestically licensed banks,[4] 55 *shinkin* banks, and 26 other institutions, including securities companies[5] and Japanese branches and subsidiaries of foreign banks.

Number of Financial Institutions Examined

	Fiscal 2011	Fiscal 2012	Fiscal 2013
Domestically licensed banks	26	31	29
Shinkin banks	29	47	55
Other institutions	13	20	26
Total	68	98	110

(2) General Observations

In the fiscal 2013 on-site examinations, the Bank sought to adequately comprehend financial institutions' business operations and the state of their property and reviewed the effectiveness of risk management conducted in accordance with their risk profiles. As Japan's economy continued to recover moderately, financial institutions' capital strength and loan portfolios improved as a whole, and individual financial institutions continued to improve their risk management. However, with regard to financial institutions' current and future profitability and capital strength, the core profitability of many institutions was on a

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

[5] "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.

downtrend, and some institutions did not have a clear plan on how to enhance their business base and strengthen profitability. Some were found in need of additional capital to prepare for the possible materialization of downside risks. Regarding risk management, due to insufficient involvement of senior management, some financial institutions needed to improve their risk management processes in accordance with changes in their risk profiles.

3. On-Site Examination Policy for Fiscal 2014

(1) Basic Approach

Financial institutions are expected to contribute to corporate, individual, and regional economic activities, by ensuring the appropriate functioning of financial intermediation. To perform this role in a stable manner, it is important for them to steadily conduct risk management in accordance with their risk profiles and continue to maintain sound management under clearly defined business strategies.

Against this background and based on the challenges identified in the fiscal 2013 on-site examinations, the Bank will take the following points into account in the fiscal 2014 on-site examinations.

First, the Bank will continue to carefully assess financial institutions' business operations and the state of their property and examine senior management's risk awareness. Specifically, the Bank will check financial institutions' business strategies and comprehend their current and future risk profiles, including the quality of their asset portfolios and the structure of assets and liabilities, by assessing their assets and examining their securities investments and new businesses or operations. With regard to financial institutions that have increased their overseas loans and foreign securities investment, the Bank will check both the composition of their assets and liquidity in foreign currencies. Taking into account the various efforts by financial institutions to improve profits in a situation where their core profitability has been on a downtrend, the Bank, through the on-site examinations, will make profit forecasts under several scenarios and assess the adequacy of financial institutions' capital strength. The Bank will then confirm how well senior management is aware of the financial institution's risk profile, future profitability and capital strength, and liquidity, and give advice as necessary.

Second, through the on-site examinations, the Bank will examine financial institutions' resilience against risks with a view to encouraging financial institutions to conduct risk management suitable to their type of business and risk profile. Specifically, the Bank will examine the effectiveness of financial institutions' risk management, and will check whether the senior management is involved in ensuring that (1) risk awareness is sufficiently shared when formulating business strategies or plans, (2) risk-taking policies compatible with the financial institution's capital strength are formulated and risk management processes suitable to such policies are developed, and (3) risk-taking policies are reviewed or risk management is improved in response to changes in the external environment. The Bank will also examine the functioning of bodies such as the board of directors, the board of auditors, various committees, and internal audits. In addition, with respect to major financial institutions, the Bank will check their stress-testing methods and their measures to respond to crises.

Third, the Bank will continue to carefully confirm, and give advice as necessary on, financial institutions' credit screening and monitoring capabilities, which are the basis of their ability to properly perform their financial intermediation function. In particular, for sectors or regions to which financial institutions have recently extended loans actively, the Bank will examine whether financial institutions properly assess the viability of borrowing firms' business taking account of their risk characteristics, including types of credit and developments in financial markets and industries. In order for financial institutions to support borrowing firms' efforts to resolve their management challenges and thereby enhance the vitality of these firms, the Bank will also check whether financial institutions are making effective suggestions to borrowing firms and are taking appropriate measures to manage credit risk.

Fourth, the Bank will conduct its on-site examinations more efficiently, through on-site visits of about three weeks and under the framework of "risk-based on-site examinations" employed since fiscal 2008. The Bank will strive to comprehend the actual business conditions of financial groups that provide a variety of financial services through group entities. For globally active financial groups, it will continue to conduct on-site examinations on the risk management of their overseas entities. Furthermore, the Bank will strengthen on-site examinations of the headquarters of other financial institutions that have increased overseas exposures to check how well they comprehend the situation of borrowing firms' overseas business operations. To enhance the effectiveness of on-site examinations, the Bank, when necessary, will interview examinee institutions' internal audit divisions before visiting their premises and will continue to strengthen the seamless coordination between its on-site examinations and off-site monitoring.

(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. Moreover, it will check and examine various aspects of financial institutions appropriately by taking account of the type of their business and their risk-taking attitude.

a. Business Management

Effectiveness of Corporate Governance

In order to ensure the effectiveness of risk management, it is necessary for corporate governance mechanisms to function well at financial institutions.

In the fiscal 2013 on-site examinations, the Bank found some cases where insufficient involvement of senior management in risk management and inadequate functioning of the board of directors and various committees led to a range of challenges in risk management. Moreover, some financial institutions did not sufficiently comprehend the actual business conditions of operations by subsidiaries or needed to improve their framework for managing group-wide business operations.

In the fiscal 2014 on-site examinations, the Bank will check the following aspects: senior management's awareness of risk profiles and risk-taking policies; the position of stakeholders in the management of the institution; business strategies in light of the above; disclosure policies; managerial decision-making processes; and oversight processes. For financial groups that provide a variety of financial services, the Bank will check the business management framework of the entire group including overseas branches, subsidiaries, and brother-sister entities.

Moreover, the Bank will examine the following, mainly from the perspective of risk management: (1) whether bodies such as the board of directors, the board of auditors, various committees, and internal audits are functioning effectively; and (2) whether awareness of risks, including specialized areas, is shared throughout the entire financial institution in the formulation of business strategies or plans, and whether financial institutions have developed risk management frameworks that are compatible with risk-taking policies including the expansion of overseas business operations. In addition, the Bank will examine (3) whether financial institutions are conducting reviews of risk-taking policies and making improvements in risk management in response to changes in the external environment.[6]

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

It is important for financial institutions to strike the right balance between profit/capital strength and risk-taking in order to ensure the stable functioning of financial intermediation.

In the fiscal 2013 on-site examinations, the Bank found that many financial institutions, particularly small ones, needed to make improvements in capturing the impact of changes in interest rates on their profit/capital strength, while they worked on measures to strengthen their profitability. In addition, there was still room for improvement at some institutions in setting stress scenarios in accordance with their risk profiles and utilizing the test results in their business judgment.

In the fiscal 2014 on-site examinations, the Bank will examine the following: (1) whether financial institutions appropriately check the balance struck between risk exposure and profit/capital strength; and (2) whether financial institutions analyze this balance by

[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.

applying a medium-term perspective and by assuming various scenarios comprising risk transmission channels including the impact of changes in interest rates, making use of asset-liability management (ALM), the framework for allocated risk capital, and stress-testing.[7] The Bank will also examine (3) whether financial institutions appropriately report to their senior management the results of these analyses and examinations, and whether they take necessary actions such as formulating ALM policies and hedging risks. In particular, the Bank will examine (4) the stress-testing methods and their measures to respond to crises such as the business contingency plans of global systemically important financial institutions (G-SIFIs) and major financial institutions that are deemed to be in an equivalent category.

Development of Management Information Systems

As business operations and asset portfolios grow increasingly diverse and complex, it has become important for financial institutions to appropriately set up and employ mechanisms to gather institutionally the information necessary to manage business operations and risks. Since overseas business operations have been expanding, there is a greater necessity for financial institutions to appropriately assess in a timely manner counterparty and payment/settlement risks that extend over various business operations and regions.

In the fiscal 2014 on-site examinations, the Bank will examine (1) whether major and regional financial institutions have appropriately set up management information systems (MISs) including an information infrastructure, and (2) whether the reliability and timeliness of information gathered through the MISs are ensured.

Proactive Improvement of Risk Management with Internal Audits

Internal audits provide a basis for ensuring the proper conduct of business operations and play an important role in promoting the proactive improvement of risk management. For this reason, senior management needs to be fully aware of the importance of internal audits and to ensure their effectiveness.

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[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.

In the fiscal 2013 on-site examinations, the Bank found that, while financial institutions were improving their internal audit frameworks to ensure their effectiveness, many institutions needed to improve their discussions on audit results, their institutional use of audit recommendations, and their selection of the scope of internal audits taking account of their risk profiles.

In the fiscal 2014 on-site examinations, the Bank will examine the following: (1) whether financial institutions' senior management ensures that the necessary audit resources and the appropriate audit framework are in place and, after institutional deliberations on audit results, makes the most of auditors' recommendations regarding their business management; (2) whether financial institutions, after conducting proper risk management taking account of the actual conditions of business operations and changes in the external environment, appropriately decide the scope of internal audits and allocate audit resources; (3) whether functions at the headquarters, overseas entities, the business of affiliated firms, and their credit/market risk management are adequately audited; and (4) whether financial institutions have established a post-audit monitoring framework and put it into practice.

b. Credit Risk Management

Appropriate Credit Screening and Monitoring, and Establishing a Framework Compatible with Lending Strategies

Financial institutions are expected to contribute to corporate, individual, and regional economic activities, through the proper functioning of financial intermediation. For this purpose, it is important for financial institutions to appropriately assess the business conditions of borrowing firms in terms of credit screening and follow-up monitoring, and ensure that credit screening and monitoring frameworks compatible with their lending strategies are in place.

In the fiscal 2013 on-site examinations, the Bank found that a growing number of financial institutions were adopting a strategy of increasing loans to growing business areas, seeking new borrowing firms in regions outside their home prefectures, or increasing loans to firms categorized in the lower "normal" category or in the "need attention" category. However, many of these institutions insufficiently comprehended borrowing firms' business conditions or did not establish sufficient credit screening and monitoring frameworks compatible with the new lending strategies.

In the fiscal 2014 on-site examinations, the Bank will carefully examine the following: (1) whether financial institutions properly conduct credit screening of borrowing firms based on sufficient research and analysis of the business conditions of these firms; and (2) whether financial institutions have developed follow-up monitoring frameworks in order to promptly comprehend changes in the creditworthiness of borrowing firms. In particular, for sectors or regions to which they have recently extended loans actively, the Bank will examine (3) whether financial institutions properly assess the viability of borrowing firms' business through credit screening taking account of their risk characteristics such as types of loans and developments in markets and industries, and (4) whether they conduct an institutional review on the appropriateness of their pricing taking account of the risks.

Support for Enhancing the Vitality of Firms

Financial institutions are expected to contribute to enhancing the vitality of firms by continuously supporting borrowing firms' efforts to resolve their management challenges.

In the fiscal 2013 on-site examinations, the Bank found that, with the active involvement of their senior management, some financial institutions were successful in supporting firms' efforts to resolve their management challenges. However, the Bank still found insufficiency among many financial institutions in terms of selecting which firms to support, or in giving advice and guidance suitable to borrowing firms' management challenges.

In the fiscal 2014 on-site examinations, the Bank will examine whether financial institutions' senior management is actively involved in ensuring (1) that financial institutions support borrowing firms' initiatives toward concrete solutions for their management challenges, based on an adequate comprehension of the business conditions of borrowing firms and a sharing of the recognition of such challenges; and, in particular, (2) that financial institutions have taken initiatives toward more drastic solutions for management challenges faced by borrowing firms whose business conditions are unstable and implemented appropriate credit risk management measures in cooperating with relevant parties such as other financial institutions and outside specialists, in order to ensure further improvements in the business conditions and business turnarounds of these firms. In these regards, the Bank will provide advice as necessary.

Strengthening the Management of Credit Concentration Risk

As financial institutions' core profitability has been on a downtrend, the deterioration of large exposures has a great impact on their financial results. For this reason, proper control of credit concentration risk has grown in importance.

In the fiscal 2013 on-site examinations, the Bank found that financial institutions on the whole had made further efforts to reduce concentration risk. However, some financial institutions failed to comprehend the business conditions of borrowing firms that breached the credit ceiling set by the financial institution, or failed to make plans to reduce their exposure to such firms, resulting in an increase in their large credit exposure. Some other financial institutions needed to make improvements in comprehensively monitoring credit exposure, which included not just loans but also, for example, corporate bonds.

In the fiscal 2014 on-site examinations, the Bank will examine whether the senior management is adequately involved in ensuring that (1) the importance of managing credit risk associated with large-lot borrowing firms is fully recognized and the state of concentration risk within the loan portfolios, including credit risk inherent in market investments in, for example, corporate bonds, is assessed appropriately; (2) concentration risk is restrained or reduced by setting up a management framework for large exposures in view of financial institutions' profits and capital strength; and (3) financial institutions comprehend the business conditions of borrowing firms with large concentration risk, and formulate effective plans for reducing the risk when necessary.

Strengthening the Risk Management of Loans for Real Estate Leasing

In the fiscal 2013 on-site examinations, the Bank found that some financial institutions continued to focus on extending loans for real estate leasing and housing loans, and had actively extended such loans. However, with regard to extending loans for real estate leasing, many financial institutions insufficiently conducted credit screening or follow-up monitoring taking account of risks arising from long-term cash flows. Regarding housing loans, many financial institutions needed to revise their screening criteria based on the analysis of the characteristics of borrowers that were delinquent or in default.

In the fiscal 2014 on-site examinations, the Bank will examine financial institutions that are active in extending loans for real estate leasing and housing loans with regard to the following: (1) whether these financial institutions have set screening criteria appropriate to the risk characteristics of each type of loan; and (2) whether they appropriately comprehend changes in the quality of their loan portfolios and review their screening criteria based on the analysis of the characteristics of borrowers. In particular, the Bank will examine the following points: (3) for loans for real estate leasing, whether financial institutions appropriately conduct credit screening and risk management after the extension of loans, taking account of the occupancy situation of real estate properties, changes in rental income, and other factors; and (4) for housing loans, whether financial institutions appropriately comprehend and analyze credit costs including those borne by affiliated mortgage insurers, in view of the relationship between loan age and default probability, in addition to the characteristics of borrowers, and institutionally review such analyses, including the profitability of such loans. Furthermore, the Bank will check whether financial institutions make use of the results of such analyses in their business management, for example, in reviewing screening criteria and setting loan interest rates, and will provide advice as necessary.

Strengthening the Management of Overseas Credit Exposure

In the fiscal 2013 on-site examinations, the Bank found that, while major financial institutions had actively expanded their global business with the aim of strengthening their profitability and increased their overseas exposure, some of them needed to make improvements in developing risk management frameworks on a global basis. At some regional financial institutions, challenges were observed in comprehending the business conditions, including the financial situation, of overseas subsidiaries of their borrowing firms.

In the fiscal 2014 on-site examinations of major financial institutions with large overseas exposure, the Bank will conduct in-depth research on the quality of overseas exposure by examining the institutions' self-assessment of their exposure. The Bank will then examine (1) whether these financial institutions, based on changes in loan portfolios, have put in place an adequate framework for credit screening and risk management for areas on which they focus, and for the management of large exposures as well as an early warning system for monitoring their exposure mainly to foreign firms; (2) whether their headquarters have set out rules for credit risk management including reporting procedures that apply on a global basis and appropriately monitor the status of compliance with such rules; and (3) whether headquarters adequately review credit risk-taking policies on a global basis by making use of stress-testing. The Bank will also check whether regional financial institutions comprehend the business conditions of borrowing firms with major overseas businesses.

c. Market Risk Management

Adequate Involvement of Senior Management in Market Risk Management

With loan-to-deposit ratios remaining on a declining trend, managerial profit expectations with regard to market investments have remained high at many regional financial institutions. It has become even more important for senior management to be fully aware of market risk associated with securities portfolios and to be adequately involved in deciding on risk-taking policies, developing risk management frameworks, and examining the investment situation, taking into account the optimal balance between profit/capital strength and risks.

In the fiscal 2013 on-site examinations, the Bank found that many major financial institutions and regional banks had established overall risk management frameworks compatible with their risk-taking policies. On the other hand, some financial institutions, especially small ones, did not sufficiently examine their risk-taking policies based on their capital strength or did not adequately assess risks at the institutional level when formulating or revising their investment plans.

In the fiscal 2014 on-site examinations, the Bank will examine (1) whether the senior management has clearly set out risk-taking policies and formulates investment plans under which prospective changes in portfolios and profits are considered, and (2) whether the senior management has developed risk management processes such as a system of checks and balances for the front office and a framework for monitoring the various limits to ensure market investments are made in line with risk-taking policies and investment plans. The Bank will also examine (3) whether financial institutions hold discussions at various committees and reach adequate decisions in a timely manner based on reports on market developments and risks.

Conduct of Risk Management Compatible with Investment Strategies and Methods

With yields on securities declining, a growing number of financial institutions have increased their credit risk-taking in markets or have sought profits from short-term purchases and sales of securities. It has become even more important for financial institutions to conduct risk management in accordance with the risk profiles of their securities portfolios and changes in investment methods.

In the fiscal 2013 on-site examinations, the Bank found some cases where financial institutions had increased the outstanding amount of their foreign securities holdings or invested in stock investment trusts and recorded capital gains on cancellations. However, many regional financial institutions still failed to manage risk in accordance with the risk profiles of new investment products and methods while diversifying investment products and methods, or showed inadequacies in ensuring the effectiveness of such frameworks as loss limits for responding to a possible deterioration in the market environment.

In the fiscal 2014 on-site examinations, the Bank will examine (1) whether financial institutions appropriately identify and analyze the risks of individual financial products such as their credit risk, foreign exchange risk, risk stemming from investment schemes, and market liquidity risk, in addition to interest rate risk; (2) whether the risk management division appropriately monitors, with adequate frequency, the market prices of securities, the amount of risk associated with securities holdings, and the observance of the various limits in accordance with the risk characteristics and investment methods; and (3) whether the adequacy and limitations of risk measuring methods are examined regularly through, for example, the conduct of backtesting, and necessary measures are taken.

Ability to Respond to Stress Situations

Given the lessons learned from developments in global financial markets in recent years, it is important for financial institutions to maintain the ability to respond to various stress situations at all times in their market risk management.

In the fiscal 2013 on-site examinations, the Bank found that, while financial institutions continued to work on establishing frameworks for stress-testing, some institutions needed to make improvements in conducting various kinds of stress-testing that take account of the risk characteristics of their portfolios or in utilizing the results of such testing.

In the fiscal 2014 on-site examinations, the Bank will examine (1) whether financial institutions, with the involvement of senior management, conduct stress-testing assuming various risk transmission channels; and (2) whether financial institutions assess the results of stress-testing at the institutional level and make use of the results in order to change market investment and risk management frameworks.

Managing Market Risk Associated with Stockholdings

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

In the fiscal 2013 on-site examinations, the Bank found some cases where financial institutions needed to make improvements in assessing the benefits of stockholdings in their business relationships, or in working on plans to reduce stockholdings.

In the fiscal 2014 on-site examinations, regarding financial institutions presumed to be taking on large market risk associated with stockholdings relative to their capital strength, the Bank will examine whether they assess appropriately the benefits of stockholdings in their business relationships and the impact of fluctuations in stock prices on their profits and capital strength, and whether senior management and relevant divisions within the institution share such an assessment. When necessary, the Bank will encourage such financial institutions to take steps toward reducing risk.

d. Liquidity Risk Management[8]

Liquidity Risk Management Based on Risk Profiles

Liquidity management is closely linked to all business operations of financial institutions. Therefore, to ensure stable liquidity management it is necessary for financial institutions, with the adequate involvement of senior management, to sufficiently understand the liquidity risk profiles associated with their funding and investment portfolios, and to encourage relevant divisions to adequately share information.

In the fiscal 2013 on-site examinations, the Bank found that, while no financial institutions had faced major difficulty in yen funding, some institutions' liquidity risk management was insufficient in terms of the analysis of liquidity risk taking account of changes in the funding base in the medium to long term. As for foreign currencies, while financial institutions gradually expanded their foreign currency balance sheets due to an increase in, for example, foreign securities investment, the monitoring and analysis of foreign currency funding was insufficient at some financial institutions.

In the fiscal 2014 on-site examinations, the Bank will examine whether the senior management is involved in ensuring that (1) risk profiles have properly been assessed with regard to both domestic and foreign currency liquidity; (2) risk limits have been set in accordance with financial conditions and the funding capability of the financial institution, and a mechanism for monitoring and controlling risks has been established to observe the limits; (3) information about funding conditions, such as developments in deposits and other markets, is being shared within the institution on a day-to-day basis, so that it is possible to respond promptly to changes in the environment; and (4) deliberations are made to ensure a

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

stable future funding base.

Ability to Respond to Stress Situations

In liquidity risk management, it is important to maintain the ability to respond to various stress situations at all times.

In the fiscal 2013 on-site examinations, the Bank found many cases where liquidity stress-testing scenarios were inadequate or the preparation or review of liquidity contingency plans was insufficient.

In the fiscal 2014 on-site examinations, the Bank will examine the following points: (1) whether financial institutions conduct stress-testing that fully takes account of liquidity risk profiles -- such as the risk associated with the size and term structures of funding and investment in both domestic and foreign currencies, the liquidity of assets, the stability in funding, and their own creditworthiness -- and verify the sufficiency of liquid assets and emergency funding measures; and (2) whether the effectiveness of financial institutions' liquidity contingency plans is ensured.

Global Liquidity Risk Management

Given the ongoing rise in the overseas credit exposure of internationally active financial institutions, it is increasingly important for such institutions to implement appropriate management of foreign currency liquidity at their overseas entities and within their financial group.

In the fiscal 2013 on-site examinations, the Bank found that some financial institutions needed to improve the framework for global risk management such as monitoring funding of overseas entities or preparing liquidity contingency plans.

In the fiscal 2014 on-site examinations of these institutions, the Bank will examine the following: (1) whether financial institutions appropriately and in a timely manner comprehend current and prospective funding conditions in terms of different currencies and entities, ensuring smooth risk communication between the headquarters and each overseas entity; (2) whether they diversify, across their financial group as a whole, funding sources for the stable procurement of foreign currencies and examine this diversification carefully; and (3) whether the conduct of stress-testing and the preparation of liquidity contingency plans are consistent across their financial group.

e. Operational Risk Management[9]

Ensuring the Effectiveness of Proactive Risk Management Cycles

Amid changes in financial institutions' business environment and business operations as well as the increased significance of compliance, it has become important to operate a plan-do-check-act (PDCA) cycle that enables financial institutions to appropriately identify and address significant risks underlying their business operations and IT systems as well as to verify and further improve the effectiveness of responsive measures.

In the fiscal 2013 on-site examinations, the Bank found that financial institutions on the whole had made progress in setting up operational risk management frameworks, but many financial institutions still faced challenges in identifying significant operational risks by examining operational processes, analyzing the causes of fraud and accidents, and implementing effective remedial steps to prevent such events from reoccurring. In particular, at some financial institutions, the Bank found that they needed to improve their operational risk management frameworks for business areas on which they focused, such as sales of riskier investment products, or that risk awareness of senior management and firm-wide measures were inadequate. In addition, the Bank found that some financial institutions failed to properly deal with business transactions involving antisocial forces.

In the fiscal 2014 on-site examinations, the Bank will examine (1) whether senior management appropriately comprehends the risk profiles in terms of business operations and compliance, and reviews the risk management framework based on changes in the business environment and business strategies or initiatives to expand into new business

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

areas; (2) whether financial institutions properly identify significant risks in business operations and IT systems through the examination of operational processes and the analysis of patterns in operational incidents and IT system failures, and make necessary improvements; and (3) whether financial institutions analyze risk management issues underlying operational risk events such as fraud and accidents, and take effective remedial steps against such events.[10]

Establishment and Strengthening of IT Risk Management Frameworks

In order to ensure the reliability and security of financial institutions' IT systems, it is important for senior management to develop and improve risk management frameworks on the basis of a proper awareness of risk.

In the fiscal 2013 on-site examinations, the Bank found that, as financial institutions made progress in improving IT risk management frameworks, their dependence on IT-related contractors had grown, and some financial institutions needed to make improvements in their management frameworks, including the management of contractors, with regard to the recovery from IT system failures or to information security.

In the fiscal 2014 on-site examinations, the Bank will examine whether senior management is involved in ensuring that (1) adequate preventive measures against failures in critical IT systems are being taken, for example, by responding to changes in demand for customer services and through risk assessment and case studies on failures; (2) procedures and plans to promptly recover critical IT systems are effective in containing the impact of a system failure; and (3) financial institutions' management of various system development projects, including the transition to a multi-tenant shared general ledger system, is adequate. The Bank will also examine (4) whether financial institutions appropriately take preemptive measures for information security and establish a framework to contain the expansion of damage associated with information security to which customers and financial institutions are exposed, including illegal withdrawals of customer deposits, operation interference, and

[10] In the on-site examinations, the Bank will refer to the report "Changes in the Environment Surrounding Operational Risk Management and Future Challenges," August 2011 (available only in Japanese).

information fraud, given some cases of new types of fraud.[11] In these cases, the Bank will examine the effectiveness of the frameworks for managing contractors that are developing, operating, and managing IT systems.

Strengthening of Business Continuity Arrangements and Enhancement of Their Effectiveness

The development of business continuity arrangements is critical to ensure not only that individual financial institutions meet operational challenges, but also that the smooth functioning of the payment and settlement systems in Japan is maintained.

In the fiscal 2013 on-site examinations, the Bank found that many financial institutions had made progress in improving business continuity arrangements by, for example, adding new disaster scenarios. However, at many financial institutions, there was room for improvement in the effectiveness of their business continuity arrangements by securing necessary resources, such as staff, alternative facilities, and IT systems, or by conducting drills.

In the fiscal 2014 on-site examinations, the Bank will examine, taking account of each financial institution's type of business and regional presence, the degree of involvement of financial institutions' senior management in improving business continuity arrangements, the sufficiency and consistency of business continuity plans, and the effectiveness of these plans, including the securing of necessary resources, and will continue to encourage financial institutions to further strengthen their business continuity arrangements and to enhance the effectiveness of the arrangements.

In addition, the Bank will examine whether financial institutions have ensured the effectiveness of their business continuity arrangements to respond to any spread of highly pathogenic new influenza.

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[11] In the on-site examinations, the Bank will refer to the report "Toward Effective System Failure Management: Points to Note," February 2012 (available only in Japanese).

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 fiscal 2013 on-site examinations, the Bank found that many financial institutions had secured sufficient capital strength, but some were found in need of additional capital to prepare for the possible materialization of downside risks, as their core profitability was on a downtrend.

In the fiscal 2014 on-site examinations, the Bank will assess the financial conditions of financial institutions by verifying their self-assessment of asset quality. The Bank will also make profit forecasts under several scenarios including downside risks, and assess the adequacy of financial institutions' capital strength. On this basis, the Bank will examine senior management's recognition regarding the assessment of the adequacy of both the quality and quantity of their capital, and capital policies based on this assessment as well as future managerial issues, including initiatives to improve profitability. The Bank will provide advice on these matters as necessary. Moreover, the Bank will continue to conduct necessary research on the conformity of financial institutions with overseas entities to changes in international regulations and supervision.

(3) On-Site Examination Management

The basic approach of the Bank's on-site examinations is to intensively and comprehensively investigate and assess, through on-site visits over a period of about three weeks, the business conditions and risk management frameworks of financial institutions holding accounts with the Bank. In this regard, the Bank will continue to conduct "risk-based on-site examinations," which have been implemented since fiscal 2008, from the perspective of taking measures in a flexible and effective manner based on the risk conditions of financial institutions. The frequency, length, and scope of such 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 of the materialization of risks for a particular financial institution holding an account with the Bank; and (2) the financial soundness of the financial institution, such as its capital strength and the degree of risk-taking. In fiscal 2014, the Bank will step up its efforts to further strengthen the development and operation of this framework to conduct its on-site examinations efficiently and effectively.

The Bank aims to assess, via on-site examinations, the business conditions of financial groups that provide a variety of financial services through group entities. It will also conduct on-site examinations of overseas entities of financial groups whose performance and risk-taking activities abroad have a greater impact on financial institutions that have accounts with the Bank. With regard to G-SIFIs, the Bank will check the progress in formulating measures, such as recovery planning and the establishment of MISs, required under the international regulatory and supervisory framework.

To further enhance the effectiveness of on-site examinations, the Bank, when necessary, will interview examinee institutions' internal audit divisions to comprehend the institutions' risk profiles and other facts before visiting their premises (prehearings). It will also continue to strengthen the seamless coordination between its on-site examinations and off-site monitoring.

The Bank will work to enhance its communication with examinee institutions and continue to take appropriate actions to gain their full understanding of and trust in the examination process and results. In the above process, the Bank will improve on-site examination procedures by responding to opinions and requests gathered from examinee institutions through a post-examination survey.