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Bank of Japan

**The Bank of Japan's Measures regarding the Financial System
after the Full Removal of Blanket Guarantee of Deposits**

I. Principles

The financial system in Japan has been regaining stability, and the blanket guarantee of deposits will be fully lifted on April 1, 2005. Henceforth, financial institutions will be expected to amplify their efforts to develop innovative services tailored to customer needs, thus supporting economic activity. The Bank of Japan's basic stance regarding financial system policy must shift its focus in response to this changing environment: from crisis management to supporting private-sector initiatives toward providing more efficient and advanced financial services via fair competition, while maintaining overall system stability.

Ensuring financial system stability will be as essential as ever in the new financial environment. The Bank will continue to closely monitor developments regarding the soundness of financial institutions, their liquidity management, and related settlement risks. It is also important to pay attention to contingency planning for dealing with emergencies such as natural disasters or terrorist attacks. Should the stability of the financial system be threatened, the Bank will promptly implement measures, including those as the lender of last resort, to prevent the manifestation of systemic risks.

At the same time, looking ahead, the availability of more efficient and advanced financial services will be an important prerequisite for the sustainable and stable growth of Japan's economy. Under the rapidly changing environment surrounding the Japanese economy, it is necessary for financial intermediation mechanisms to be flexible and robust with more diversified channels for supplying credit, in order to achieve smooth and efficient allocation of funds and to reinvigorate the economy. Before such mechanisms are firmly established, however, a wide range of financial system-related challenges remain to be addressed: for example, reviewing lending practices, promoting more sophisticated risk management by financial institutions, and developing new markets for credit. As such an evolution of the

financial system is realized, through the efforts of all interested parties, the impact of monetary policy should be more effectively transmitted throughout the economy.

In this context, the Bank will encourage financial institutions' efforts to improve their management of risks and business activities, through its on-site examinations and off-site monitoring. As a part of this process, the Bank will review its organization and strengthen its channels for communications to help financial institutions tackle the issues they face. The Bank will also review the services relating to current accounts that form the infrastructure of the financial system, and any other services, with a view to increasing transparency and efficiency.

In accordance with the above basic stance, the Bank will contribute to enhancing the functioning and robustness of the financial system in Japan.

II. Measures to Maintain Financial System Stability

A. The Lender of Last Resort Function

In order to ensure the stability of the financial system, it is necessary to prevent problems in business operations and management at individual financial institutions, should they ever happen, from negatively affecting the financial system as a whole, through a chain reaction of settlement failures or erosion of confidence in the system, and thereby leading to the manifestation of systemic risks. The Bank, therefore, seeks to ensure that it has an accurate grasp of the performance of financial institutions through its on-site examinations and off-site monitoring, and will provide liquidity as the lender of last resort when necessary.

The lender of last resort function is one of the basic roles of a central bank, and the Bank will continue to perform this function, as appropriate, based on the following general principles.

1. Extension of loans against collateral pursuant to Article 33 of the Bank of Japan Law

The Bank extends loans against collateral pursuant to Article 33 of the Bank of Japan Law under a Lombard-type lending facility, called the complementary lending facility, with a

view to facilitating monetary operations and thus ensuring the smooth functioning and stability of financial markets. In addition, the Bank will continue, where appropriate, to extend loans against collateral in a timely and flexible manner to meet the specific needs arising from business operations of individual financial institutions, giving due consideration to financial market developments.

2. Extension of temporary loans pursuant to Article 37 of the Bank of Japan Law

On the condition that financial institutions are solvent, the Bank will continue to provide them with uncollateralized loans pursuant to Article 37 of the Bank of Japan Law in a timely manner, when contingencies, such as computer system problems, cause solvent financial institutions to experience an unexpected temporary shortage of funds for payment purposes and when loans are necessary to secure the smooth settlement of funds among financial institutions.

3. Extension of special loans to maintain financial system stability pursuant to Article 38 of the Bank of Japan Law

The Bank will, in cooperation with the government, take measures regarding the extension of special loans pursuant to Article 38 of the Bank of Japan Law in a timely and appropriate manner, while observing the Bank's four guiding principles for the extension of such loans.¹

B. Contingency Planning for Emergencies including the Extension of Loans under Special Contracts

It is important for the Bank to enhance the mechanisms it has in place to ensure the smooth operation of the payment and settlement system and maintain financial market stability, when financial institutions face difficulties in business continuity due to emergencies such as natural disasters and terrorist attacks. The Bank has recently formulated a framework for extending loans in cases of emergency, called loans under special contracts. This enables the Bank, under contracts made in advance with financial institutions that hold current accounts at the Bank (current account holders), to furnish them with loans even in

¹ Principle 1: There must be a strong likelihood that systemic risk will materialize.

Principle 2: There must be no alternative to the provision of central bank money.

Principle 3: All relevant parties are required to take clear responsibility to avoid moral hazard.

Principle 4: The financial soundness of the Bank of Japan itself must not be impaired.

the absence of specific loan applications, when all standard channels of communication are disrupted by contingencies including disasters. The Bank will continue to examine a broad range of measures for dealing with emergencies such as natural disasters with a view to maintaining the stability of the financial system.

III. Measures to Enhance the Functioning of the Financial System

A. On-Site Examinations and Off-Site Monitoring

In its on-site examinations and off-site monitoring after the lifting of the blanket guarantee of deposits, the Bank will place more emphasis on enhancing the functioning and robustness of the overall financial system. To this end, the Bank will support financial institutions' efforts to put in place more sophisticated risk management and general management systems, with a view to providing innovative new services to meet customer needs.

1. Assessing the economic value and volatility of financial institutions' assets and financial transactions

The Bank will assess the economic value and volatility of financial institutions' whole range of assets—that is, assets not limited to their loan portfolios—and financial transactions, and share the results with the financial institutions concerned. This will enable the Bank to have in-depth discussions with financial institutions on their financial soundness, in other words, their capital adequacy, and on the key elements driving their business strategies, such as efficient capital utilization and the evaluation of risks and returns on assets, thus helping to identify suitable measures for addressing various issues faced by the financial institutions.

2. Integrated risk management

If financial institutions effectively utilize a framework for integrated risk management—assessing risks based on accurate assessments of the economic value of their total assets and financial transactions and the associated volatility and including settlement and operational risks—they can obtain objective inputs to weigh the efficient use of their limited capital as well as the risks and returns on their assets. This will help them manage their institutions more rationally and efficiently. Through its on-site examinations and

off-site monitoring, the Bank will encourage financial institutions to introduce such an integrated risk management framework, taking their specific financial and business conditions into full consideration.

Financial institutions may have stronger incentives to actively redeploy their credit portfolios when they can more objectively assess the risks and returns on their assets. If this leads to greater activity in credit markets and more diversified channels for credit provision, the resulting enhanced functioning of the financial system as a whole will more robustly support Japan's economy.

These views of the Bank are consistent with the new capital adequacy framework, commonly known as Basel II, which is scheduled to come into effect from the end of fiscal 2006 in Japan and requires individual financial institutions to adopt measures to enhance the sophistication of their own risk management.

3. Improving the functioning of financial institutions' internal control and enhancing market discipline through information disclosure

Information obtained by integrated risk management, together with other information on business activities, serves as inputs for managing financial institutions. It is also important for financial institutions to establish a framework for internal control: making managerial decisions in accordance with due process and objectively evaluating the decisions *ex post*. In addition, further improvements in information disclosure by financial institutions, based on appropriate assessments of the economic value of their assets and the associated risks, will make it easier for depositors and investors to evaluate how effectively financial institutions are managed, and to assess the corresponding risks and returns on their investments. This is expected to enhance effective market discipline on financial institutions' management. Through its on-site examinations and off-site monitoring, the Bank will support the efforts made by financial institutions to improve the functioning of their internal control and also encourage improved disclosure with a view to enhancing market discipline.

B. Supporting Private-Sector Initiatives toward the Evolution of the Financial System

By reviewing its organization and strengthening its channels for communicating with financial institutions, the Bank will implement the following measures so that on-site examinations and off-site monitoring are conducted in accordance with the principles described above.

1. Establishing the Center for Advanced Financial Technology

The Bank will establish in its new Financial Systems and Bank Examination Department² a unit named the Center for Advanced Financial Technology. It will be in charge of (1) planning and coordinating measures to support the above-mentioned private-sector initiatives and, at the same time, ensuring the safety of financial transactions; (2) studying relevant developments in finance, including information security; and (3) developing more sophisticated techniques for on-site examinations and off-site monitoring.

2. Hosting open seminars on a regular basis

The Bank needs to ensure that as many financial institutions as possible share its understanding of the issues that need to be addressed in enhancing the availability of more efficient and advanced financial services. To this end, the Bank will host open seminars on a regular basis, mainly targeting the management and officers of financial institutions in Japan. The seminars will be the Bank's third direct channel of communication with financial institutions, in addition to on-site examinations and off-site monitoring.

Possible topics to be addressed by such seminars include (1) development and sharing of refined techniques to assess the economic value of financial institutions' assets, (2) issues related to lending practices, (3) managerial issues pertaining to financial information security and suggested solutions, (4) reviewing accounting principles in response to the evolution of financial services, and (5) changes in the conduct of on-site examinations and off-site monitoring and their implications.

² The new department will be established approximately by July 2005, by integrating the present Financial Systems Department and Bank Examination and Surveillance Department.

3. Supporting refined financial data exchange

It is very important for investors to be able to collect and analyze financial data on firms efficiently. This is another prerequisite for enhancing the functioning of the financial system. In the private sector, some firms have already started to examine ways to establish a network system that enables straight-through processing (STP) of financial data, which allows the integrated transmission and analysis of financial data via electronic channels. With a view to facilitating the development of such advanced financial information network systems, the Bank has been studying and experimenting with the adoption of an infrastructure that uses extensible business reporting language (XBRL). This is considered to be an advantageous file format for exchanging various types of financial data, for example, firms' financial statements. In fiscal 2005, the Bank will start exchanging financial data in XBRL format with financial institutions.

C. Reports on the Stability and Functioning of the Financial System

Microeconomic information gathered through on-site examinations and off-site monitoring will be analyzed from a macroeconomic perspective and utilized in the Bank's assessment of the stability and functioning of the overall financial system. The Bank will compile the results of its analysis and release regular reports, the contents of which will be mainly the Bank's assessment of the stability and functioning of the financial system and the measures being taken on this front.

IV. Review of the Bank's Other Business Operations

A. Current Account Services and the Complementary Lending Facility

The Bank selects current account holders, the financial institutions with which it enters into current account services contracts and lending facilities contracts, giving due consideration to one of the objectives stipulated in the Bank of Japan Law, specifically "to ensure smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of an orderly financial system." The Bank will review the procedures for selecting current account holders in order to enhance procedural transparency and appropriately support entry into financial business.

1. Greater disclosure regarding current account contracts and a smoother selection process for account holders

The Bank will disclose the rules for current account services, which is the basic contract for the services, and the list of current account holders. The Bank will disclose the application procedures for opening a current account with the Bank, including sample forms and the standard processing period, to make the selection process smoother.

2. Introduction of a notice period before terminating contracts for the complementary lending facility

The Bank currently terminates the contract with a financial institution using its complementary lending facility as soon as that institution's capital adequacy ratio falls below the required standard. In the future, however, the Bank will encourage and support financial institutions' efforts to restore their capital adequacy ratios, and will consider introducing a notice period in order to assess their efforts before terminating the contract.

B. Release of a List of On-Site Examinations Completed

The Bank will make public the names of the financial institutions examined on site and the timing of the examinations conducted in the previous fiscal year in the Bank's *Annual Review* in order to enhance the transparency of its on-site examinations.