**March 30, 2012**

**Bank of Japan**

# On-Site Examination Policy for Fiscal 2012

## 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 the business activities and financial conditions of the financial institutions with the 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 grasp 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] The present document, "On-Site Examination Policy for Fiscal 2012," briefly reviews on-site examinations carried out in fiscal 2011 and outlines the basic approach and key issues in the conduct of on-site examinations in fiscal 2012. On the basis

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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).

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

## 2. Review of Fiscal 2011

### (1) On-Site Examinations in Fiscal 2011

The Bank carried out on-site examinations of 68 financial institutions in fiscal 2011: 26 domestically licensed banks,[4] 29 *shinkin* banks, and 13 other institutions, including securities companies[5] and Japanese branches and subsidiaries of foreign banks. Following the Great East Japan Earthquake in March 2011, the Bank gave due consideration to the effects of the disaster on financial institutions' business operations; for example, the Bank called off scheduled on-site examinations at financial institutions that suffered from the disaster or were subject to planned rolling blackouts.

**Number of Financial Institutions Examined**

| | Fiscal 2009 | Fiscal 2010 | Fiscal 2011 |
|---|---|---|---|
| Domestically licensed banks | 46 | 38 | 26 |
| *Shinkin* banks | 47 | 43 | 29 |
| Other institutions | 19 | 19 | 13 |
| Total | 112 | 100 | 68 |

### (2) General Observations

In the fiscal 2011 on-site examinations, the Bank managed to adequately comprehend financial conditions of financial institutions and reviewed challenges in risk management they faced, taking account of the effects of the Great East Japan Earthquake and growing

[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.

strains in global financial markets resulting from the European debt problem. While individual financial institutions continued to make efforts to improve their risk management, there still was room for improvement in the effectiveness of risk management. In addition, room for improvement was seen with regard to financial institutions' stress-testing as well as risk management measures to cope with the changes associated with the introduction of new businesses or computer systems.

The Bank also evaluated financial institutions' current and prospective profit and capital strength as part of the on-site examinations. Many financial institutions secured sufficient capital strength, but some were found in need of additional capital to prepare for the possible realization of downside risks. While the profitability of many financial institutions has been on a downtrend, some do not have a clear plan on how to enhance their business and raise profitability.

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

#### a. Business Management

The Bank reviewed the adequacy of financial institutions' governance, such as senior management's involvement in the risk management and organizational structure, through on-site examinations.[6] Many financial institutions needed to improve their governance as their senior management and relevant divisions did not share risk awareness in such specialized areas as market risk and computer system risk.

As for stress-testing, many financial institutions still failed to set adequate stress scenarios and better use stress test results to improve their business management. On the other hand, some financial institutions, owing to appropriate involvement of their senior management, were prompt in responding to changes in the business environment, with relevant divisions gathering information, formulating stress scenarios, and effectively utilizing the test results in their business judgment.

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[6] For details on the Bank's examinations of financial institutions' governance of risk management, see the second point noted in Section 3 (1) below.

With regard to the establishment of management information systems, information-gathering mechanisms necessary to effectively carry out business judgment and risk management, challenges remained including development of information infrastructures.

Financial institutions have steadily been establishing an internal audit framework. However, financial institutions needed to improve the range and depth of audits of the headquarters as well as post-audit monitoring of audit issues, given limited audit resources, particularly the number and expertise of auditors.

**b. Credit Risk Management**

As for the credit screening and monitoring process, many financial institutions still needed to improve their comprehension of borrower firms' business conditions. In particular, while there was a growing number of borrower firms whose actual performance was diverging substantially from corporate turnaround plans and hence might well fail to achieve the plans, some financial institutions had not appropriately changed the classification of such borrowers. Moreover, many financial institutions that actively extended loans outside their home prefectures had not established a sufficient credit screening and monitoring framework for such loans.

With regard to financial institutions' support for corporate turnarounds, many financial institutions made progress in strengthening their internal procedures, and some achieved success by becoming closely involved in helping borrower firms to prepare and carry out drastic restructuring plans. Nevertheless, financial institutions' efforts in assisting corporate turnarounds as a whole were not sufficiently effective, and many needed to improve the process of selecting borrower firms, preparing corporate turnaround plans, and reviewing the progress of such plans.

Some regional financial institutions have tended to increase their large credit exposure. In terms of risk management, they needed to make improvements in both establishing a framework to contain large credit exposure and reacting to breaches of exposure ceilings.

Many financial institutions actively expanded their housing and apartment loan business and some rapidly increased the volume of apartment loans. In terms of risk management, many financial institutions needed to revise their screening criteria for housing loans, based on an analysis of the characteristics of borrowers that were delinquent or in default, as well as the relationship between loan vintage and default probability. Some financial institutions needed to set screening criteria for apartment loans or improve their follow-up monitoring.

**c. Market Risk Management**

Many financial institutions, particularly regional ones, have increased interest rate risk exposure even further. Moreover, some became active in short-term securities trades with the aim of maintaining profits.

Regarding market risk management, the senior management of many financial institutions failed to make their risk-taking policies clear or needed to improve the review processes for the policies and the associated analysis/assessment of risk. Moreover, in many cases risk management was unsuited to risk characteristics of financial products they held and investment schemes, or their risk communication needed to be improved in order to ensure the institution-wide sharing of market information and risk analysis results. Furthermore, quite a few financial institutions showed inadequacies in such frameworks as loss limits, for responding to possible market disruptions.

With respect to market risk associated with stockholdings, some financial institutions did not adequately assess the benefits of stockholdings or were insufficiently aware of risk regarding the effects on their profits and capital strength associated with stockholdings, or lacked an effective plan for reducing such risks.

**d. Liquidity Risk Management**

While no financial institutions faced major difficulty in yen funding, some institutions' liquidity risk management was insufficient in terms of analysis based on risk profiles, for example, recognition of the effects on their future liquidity of a drain of deposits held at relatively high interest costs. With regard to the response to stress situations, many financial institutions still needed to prepare or reestablish liquidity contingency plans. In addition, many financial institutions, including regional ones, needed to enhance their liquidity monitoring and stress-testing associated with foreign currencies. For some financial institutions, problems were observed with their headquarters' liquidity risk management for overseas entities.

**e. Operational Risk Management**[7]

Most financial institutions have made progress in making proactive operational risk management cycles function. However, many financial institutions needed improvement in the following areas: (1) identifying weaknesses in their risk management that might result in frauds and accidents, and taking remedial steps; (2) identifying potential operational risks; and (3) setting up operational risk management systems that reflect operational changes stemming from the introduction of new businesses or from the centralization of operational functions.

Financial institutions' senior management has increased its awareness of the necessity of strengthening risk management with regard to computer systems. Some financial institutions' senior management, however, still showed insufficiency in risk awareness and involvement in development/operation management of computer systems. Moreover, problems were observed in the analysis of computer system failures, the analysis and assessment of potential risk, and the examination of the effectiveness of computer system contingency plans through the use of drills.

Many financial institutions have made efforts to improve their effectiveness of business continuity arrangements based on the experience of the Great East Japan Earthquake. In some cases, however, there was room for improvement in formulating disaster scenarios and prioritizing critical business operations, ensuring business continuity arrangements including necessary staff resources, and checking the effectiveness of business continuity plans by conducting drills.

[7] 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.

## 3. On-Site Examination Policy for Fiscal 2012

### (1) Basic Approach

In view of the high uncertainty in global financial markets, as well as the experience of the Great East Japan Earthquake in 2011, financial institutions need to better prepare for tail risk[8] that results in huge losses despite an extremely low probability of occurrence. In terms of the functioning of financial intermediation, financial institutions should ensure that they maintain credit underwriting discipline and improve the effectiveness of support for corporate turnarounds. Financial institutions with overseas entities also need to steadily conform to changes in international regulations and supervision. Against this background and based on the challenges identified in fiscal 2011, the Bank will take the following points into account in the fiscal 2012 on-site examinations.

First, the Bank will carefully assess the financial conditions of individual financial institutions and examine their resilience against risks, including tail risk. Specifically, the Bank will check the current and prospective risk profiles of financial institutions' portfolios and the structure of assets and liabilities by assessing institutions' 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. The Bank will then check how well senior management is aware of changes in risk profiles, how the institutions as a whole assess risks, and how they manage risks. It will also assess through the on-site examinations the adequacy of their profit, capital strength, and liquidity under several scenarios and give advice as necessary. With regard to tail risk, the Bank will check financial institutions' conduct of stress-testing with various scenarios comprising risk transmission channels. As for risk management related to computer systems and business continuity arrangements, the Bank will assess financial institutions' preventive measures against computer system failures and their ability to respond to unpredictable events.

8 Tail risk refers to risks arising from "tail events" on the tail of the probability distribution, that is, events that occur very rarely. Recent events that may be considered tail events include the Great East Japan Earthquake and the global financial crisis triggered by the Lehman shock.

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 including measures against tail risk, and will continue to examine their governance of risk management. Specifically, the Bank will examine and, if necessary, give advice to financial institutions, on the following points: (1) senior management's awareness of risk including tail risk, risk-taking policies, and involvement in risk management including specialized areas; (2) the framework for institution-wide information sharing and its development to promote risk communication; (3) the emergency framework for appropriate information gathering, decision making, and delegation of authority; and (4) functioning of 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 examine in detail and give advice as necessary on financial institutions' credit screening and monitoring capabilities, as well as the effectiveness of their corporate turnaround support arrangements, that are necessary to properly perform the financial intermediation function. In fiscal 2012, given the increase in borrower firms whose actual performances diverged substantially from corporate turnaround plans, the Bank will examine financial institutions' assessment of the possibility of realizing corporate turnarounds, the adequacy of measures taken to strengthen the support for corporate turnarounds, and the adequacy of their credit risk management. Moreover, 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 in regard to financial institutions' view of the adequacy of both quality and quantity of their capital, as well as on the future path of their corporate management, including strategies to strengthen their profitability. For financial institutions with overseas entities, the Bank will check their conformity to changes in international regulations and supervision.

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 scope of the examinations to certain risk areas. 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 strengthen on-site examinations of their overseas entities. To enhance the effectiveness of on-site examinations, the Bank, when necessary, will interview examinee institutions' internal audit divisions before visiting their premises (prehearings) 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 financial institutions to ensure that their corporate governance mechanisms function adequately, thus enabling them to make appropriate and 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 awareness of risks, including tail risk, and risk-taking policies; managerial concerns of various stakeholders; 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 the board of directors and various committees are functioning effectively; (2) whether awareness of risks, including specialized areas, is shared throughout the entire financial institution; (3) whether financial institutions have established emergency frameworks for appropriate information gathering, decision making, and delegation of authority; and (4) whether improvements in risk management to respond to changes in risk profiles and the external environment are being proactively pursued.[9]

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

Given that the profitability of growing number of financial institutions has decreased, it is important to strike the right balance between profit/capital strength and risk-taking.

In the 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 they conduct adequate stress-testing involving scenarios that comprise various risk transmission channels paying attention to tail risk, given the highly uncertain economic and financial conditions.[10] In the above process, (3) the Bank will check whether financial institutions are fully aware of the characteristics of "core deposit modeling" as well as the limitations of quantitative risk modeling such as value-at-risk (VaR), and employ a variety of risk analysis methods. And (4), on these bases, the Bank will examine whether financial institutions appropriately report to their senior management the results of these analyses and whether they take necessary actions such as formulating asset-liability management policy, hedging risks, and business contingency planning.

***Development of Management Information Systems***

As business operations and portfolios grow increasingly 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

[9] 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.

[10] 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.

risks.[11] Following the global financial crisis, financial institutions have recognized the need to appropriately assess counterparty risk and payment/settlement risk that extend over various business operations and regions.

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

In the on-site examinations, the Bank will examine the following: (1) whether financial institutions' senior management properly recognizes the importance of internal audits and ensures the necessary audit resources; (2) whether financial institutions, based on their risk profiles, appropriately decide the scope of internal audits and allocate audit resources; (3) whether functions at the headquarters, 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**

***Effectiveness of Corporate Turnaround Plans and Adequate Credit Risk Management Measures***

Financial institutions have continued to provide support for corporate turnarounds under the Act Concerning Temporary Measures to Facilitate Financing for Small and Medium-Sized Enterprises (SMEs), etc. -- the SME Financing Facilitation Act -- by responding to requests by small and medium-sized borrower firms to modify lending terms, and by encouraging

[11] Frameworks for gathering the information necessary to effectively implement business management and risk management are called management information systems (MISs).

them to prepare and carry out corporate turnaround plans. However, in the current severe business environment, the performance of a growing number of small and medium-sized borrower firms has deviated from the plans.

In the on-site examinations, the Bank will examine the following: (1) whether financial institutions have established practical frameworks to verify the adequacy of corporate turnaround plans and monitor the progress of the plans; and (2) whether they encourage borrower firms to review turnaround plans in a timely manner based on an accurate analysis of the divergence between the actual performance and the turnaround plans. And (3), for borrower firms whose performance has diverged from the corporate turnaround plan by a wide margin, the Bank will check whether financial institutions have appropriately assessed the possibility of achieving corporate turnarounds and taken additional steps, such as strengthening the support for the turnarounds and implementing credit risk management measures including provisioning for loan losses in light of the borrower firms' actual conditions. In these regards the Bank will provide advice as necessary.

***Strengthening Credit Screening and Monitoring as well as Screening Procedures Appropriate to Lending Strategies***

As for credit screening and monitoring capabilities necessary for financial institutions to perform financial intermediation functions, many continued to insufficiently assess the business conditions of firms in terms of both credit screening and follow-up monitoring. An increasing number of regional financial institutions have adopted the strategy of extending loans outside their home prefectures, but there are cases in which borrower firms have gone bankrupt soon after loans were extended, suggesting that credit screening criteria were incompatible with the new lending strategies.

In the on-site examinations, the Bank will examine the following: (1) whether financial institutions properly conduct credit screening and follow-up monitoring of borrower firms, including setting and revising credit ratings, based on sufficient information and analysis of the business conditions of borrower firms; and (2) whether financial institutions review the adequacy of screening criteria systematically when exploring new geographic regions or when extending new types of loans, such as for mergers and acquisitions.

### *Strengthening Management of Credit Concentration Risk*

As regional financial institutions' operating profits from core business have declined, the deterioration of large exposures might considerably affect their profitability. Furthermore, some regional financial institutions have increased their exposure to large borrower firms or to certain industrial sectors.

In the on-site examinations, the Bank will examine (1) whether senior management is fully aware of the importance of managing credit risk associated with large borrower firms and properly comprehends the state of credit concentration risk within the loan portfolios; and (2) whether the financial institutions are avoiding or reducing credit concentration risk by setting up a management framework for large exposures in view of their capital strength.

### *Strengthening the Risk Management of Housing and Apartment Loans*

Many financial institutions have continued to focus on extending housing loans, and their share in loan portfolios has increased further. Some regional financial institutions have become active in extending apartment loans.

In the on-site examinations, the Bank will examine financial institutions that are active in extending housing and apartment 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 grasp changes in the quality of their loan portfolios based on the analysis of the characteristics of borrowers and review their screening criteria. And (3), for housing loans, the Bank will examine whether financial institutions accurately grasp and analyze credit costs including those borne by affiliated mortgage insurers, in view of relationship between loan vintage and default probability. 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.

***Effective Management of Overseas Credit Exposure***

Some major financial institutions have actively expanded their global business with the aim of strengthening their profits, and their overseas exposure has been increasing against the background of demand for funds in emerging economies and expansion in overseas businesses by Japanese firms.

In the 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 at overseas entities sufficient procedures for credit risk management in terms of large exposures and loans showing signs of deterioration; (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 control credit risk on a global basis by making use of stress-testing.

**c. Market Risk Management**

***Clarification of Risk-Taking Policies by Senior Management and Appropriate Business Management***

As their loans to deposits ratio steadily declines, many regional financial institutions are taking on interest rate risk even more actively in line with growing managerial profit expectations concerning market risk. Moreover, some institutions have diversified their risk-taking strategies and become involved, for example, in short-term securities trades. It has become even more important for regional financial institutions' senior management to make their institutions' risk-taking policy clear and manage market risk properly based on their risk profiles.

In the on-site examinations, the Bank will examine managerial profit expectations from market risks and the risk awareness of senior management. The Bank will then examine (1) whether senior management has clearly spelled out its risk-taking policies and such policies are adequately shared across the institution; (2) whether investment plans are formulated based on the risk-taking policies and individual investment decisions are made based on a sufficient understanding of risk; and (3) whether financial institutions appropriately manage risk after transactions through, for example, the follow-up monitoring of investment products' market prices, risk calculations, and creditworthiness of issuers.

***Ability to Promptly Respond to Changes in the Market Environment***

Given the uncertainty in global financial markets, financial institutions need to strengthen their ability to respond promptly to changes in the market environment. It is important to ensure effective market risk management, with the involvement of senior management, by gathering and analyzing information about domestic/overseas market developments and market risks, and by communicating such information across the institution, for example, through discussion on appropriate responses.

In the on-site examinations, the Bank will examine the following: (1) whether financial institutions have gathered sufficient information on market and economic developments, conducted stress-testing based on a variety of scenarios that comprise risk transmission channels, and shared these analyses internally; and (2) whether they have set limits to contain the spread of risks/losses and effectively manage such limits through smooth communication.

***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.

In the on-site examinations, the Bank will examine (1) whether financial institutions assess appropriately the benefits of their stockholdings and the impact of fluctuations in stock prices on their profits and capital adequacy, and whether senior management and relevant divisions within the institution share such risk assessment. In addition, (2) the Bank will encourage financial institutions with a high level of market risk associated with stockholdings relative to their capital strength to reduce risk. Furthermore, (3) the Bank will examine whether financial institutions with plans to reduce their stockholdings properly monitor the progress of such plans, with the close involvement of senior management.

### d. Liquidity Risk Management[12]

#### *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 involvement of senior management, to sufficiently understand the characteristics of liquidity risk associated with their funding and investment portfolios, and to encourage relevant divisions to adequately share information.

In the 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; and (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.

#### *Ability to Respond to Stress Situations*

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

In the 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

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

both domestic and foreign currencies, the liquidity of assets, the stability in funding, and their creditworthiness -- and also verify the sufficiency of liquid assets and emergency funding measures; and (2) whether financial institutions' liquidity contingency plans clearly stipulate the responses to various stress situations, whether such plans clearly assign authority and responsibilities within the institution, whether they set out clear invocation and escalation procedures, and whether the effectiveness of these plans has been ascertained through internal audits and periodic drills.

***Global Liquidity Risk Management***

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

In the on-site examinations of these institutions, the Bank will examine the following: (1) whether they 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; and (2) whether the conduct of stress-testing and the preparation of liquidity contingency plans is consistent across their financial group.

**e. Operational Risk Management**

***Effectiveness of Proactive Risk Management Cycles***

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

In the on-site examinations, the Bank will examine the effectiveness of the PDCA cycle from the following perspectives: (1) whether financial institutions appropriately analyze risk management issues underlying operational risk events such as frauds and accidents, and take remedial steps against such events; (2) whether they examine the adequacy of the assessment of potential risks in business operations and computer systems through the supervisory function of head offices and internal audits, and make necessary improvements; and (3) whether they review their operational risk management system to keep it in line with changes in risk profiles stemming from the introduction of new businesses or the centralization of operational functions.[13]

***Senior Management's Risk Awareness with Regard to the Computer System and the Development of Failure Management Frameworks***

In order to ensure the reliability and security of financial institutions' computer systems, it is important for the senior management to develop and improve risk management frameworks on the basis of a proper awareness of risk. Risk management, with regard to computer system failures, includes in particular the establishment of sufficient preventive measures, procedures to contain the impact of a computer system failure, and procedures to recover computer systems promptly.

In the on-site examinations, the Bank will examine (1) whether financial institutions adequately take preventive measures against a failure in computer systems that are under development, as well as the stable and long-standing systems, through risk assessment based on changes in demand for customer services and case studies on failures; and (2) whether they have established effective processes for discussing responses and recovery plans in case of a computer system failure.[14]

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[13] 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).

[14] 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).

***Management of Projects such as the Transition to a Shared Computer System and Contractor Management***

As regional financial institutions rely increasingly on shared computer systems, it has become ever more important for them to appropriately manage, with the involvement of their senior management, both projects and contractors to which computing operations have been outsourced.

In the on-site examinations, the Bank will examine the adequacy of financial institutions' management of various system development projects, including the transition to a shared computer system, as well as their management of the contractors, by visiting the contractors and joint system operation centers.

***Development of an Information Security System***

Financial institutions have suffered from fraudulent activities, in which criminals obtain money from legitimate customers by either luring them to a phishing web site or using a spoofed email. Moreover, financial institutions have faced obstructions to their operations caused by massive data attacks on their web sites. In this situation, financial institutions need to take specific countermeasures by appropriately recognizing the risk posed by these threats and incorporating response procedures into their system security policies.

In the on-site examinations, the Bank will examine (1) whether financial institutions appropriately take countermeasures regarding the risks customers face, for example, by providing them with variable passwords and electronic authentication; and (2) whether they take appropriate countermeasures, such as through the use of firewalls, against operation interference or computer viruses to which they may be exposed.

***Development of Business Continuity Arrangements Based on Lessons from the Great East Japan Earthquake***

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.

Following the Great East Japan Earthquake, an increasing number of financial institutions have been reviewing the disaster scenarios in their business continuity arrangements to take account of disasters that are wider in scale and have longer-term impacts than previously assumed, disruptions to public utilities including planned rolling blackouts, and tsunamis. In the on-site examinations, the Bank will check financial institutions' review process and corresponding measures. In particular, regarding financial institutions with a key presence in the payment and settlement systems, the Bank will examine the sufficiency and consistency of business continuity plans and the effectiveness of these plans, including the securing of necessary staff, alternative facilities, computer systems, and other 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 provide advice as necessary.[15]

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.

### 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 assess the financial conditions of financial 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

[15] In the on-site examinations, the Bank will refer to the reports "Toward Effective Business Continuity Management: A Check List and Instructive Practices (Revised)," March 2010, and "Business Continuity Plans That Worked Effectively When the Great East Japan Earthquake Hit and Those That Needed Improvement," January 2012 (both available only in Japanese).

scenarios. On this basis, the Bank will examine and provide advice as necessary on financial institutions' view of the adequacy of both the quality and quantity of their capital, asset-liability control and capital policies based on this view, as well as the future path of their corporate management to achieve higher profitability. Moreover, the Bank will conduct necessary research on the conformity of financial institutions with overseas entities to the changes in international regulations and supervision.

**(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 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 scope of the examinations to certain risk areas.

In recent years, an increasing number of financial institutions have provided a variety of financial services through group entities, and the group-wide performances and risk-taking activities have had a greater impact on financial institutions that have accounts with the Bank. Therefore, the Bank aims to assess the business conditions of financial groups through on-site examinations. It will also strengthen on-site examinations of overseas entities of financial groups with regard to their risk management abroad. With regard to global systemically important financial institutions (G-SIFIs), the Bank will check responses for the new measures, such as recovery planning, to be required under the international regulatory and supervisory framework.

Moreover, to further enhance the effectiveness of on-site examinations, the Bank, when necessary, will interview examinee institutions' internal audit divisions to grasp 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 take appropriate actions to gain examinee institutions' full understanding of and trust in the examination process and results. In fiscal 2011, the Bank reduced the operational burden imposed on examinee institutions by broadly reviewing the number of items of materials required before on-site examinations and improving the reporting method of such materials. In fiscal 2012, the Bank will continue to improve on-site examination procedures by responding to opinions and requests gathered from examinee institutions through a post-examination survey.