March 15, 2013

Bank of Japan

On-Site Examination Policy for Fiscal 2013

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 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 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] This document, "On-Site Examination Policy for Fiscal 2013," briefly reviews on-site examinations carried out in fiscal 2012 and outlines the basic approach and key issues in the conduct of on-site examinations in fiscal 2013. 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. Review of Fiscal 2012

(1) On-Site Examinations in Fiscal 2012

The Bank carried out on-site examinations of 98 financial institutions in fiscal 2012: 31 domestically licensed banks,[4] 47 *shinkin* banks, and 20 other institutions, including securities companies[5] and Japanese branches and subsidiaries of foreign banks.

Number of Financial Institutions Examined

	Fiscal 2010	Fiscal 2011	Fiscal 2012
Domestically licensed banks	38	26	31
Shinkin banks	43	29	47
Other institutions	19	13	20
Total	100	68	98

(2) General Observations

In the fiscal 2012 on-site examinations, the Bank sought to adequately comprehend financial conditions of financial institutions and reviewed challenges in risk management they faced, including preparation against tail risks,[6] taking account of the experience of the Great East Japan Earthquake and the global financial market environment. While individual financial institutions continued to seek to improve their risk management, there still was

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[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.

[6] Tail risks refer 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.

room for improvement in the effectiveness of risk management due to insufficient involvement of senior management. In particular, many financial institutions needed to improve (1) their monitoring arrangements for coping with changes in risk profiles and (2) the support for corporate turnarounds. Regarding the preparation against tail risks, there was room for improvement in setting stress scenarios and utilizing stress test results -- although progress was observed in terms of the response to computer system failures and the development of business continuity arrangements, and frameworks for stress-testing have become well established.

The Bank also evaluated financial institutions' current and prospective profitability 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 materialization 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 base and raise profitability.

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

a. Business Management

There were some cases where governance in risk management was not appropriate among financial institutions that needed to improve the effectiveness of various types of risk management, as evidenced by the insufficient involvement of senior management in risk management and the inadequate functioning of various committees such as the board of directors.

Many financial institutions conducted stress-testing in preparation against tail risks. However, there is still room for improvement at these institutions in setting stress scenarios in accordance with their risk profiles and utilizing the test results in their business judgment.

With regard to the establishment of management information systems (MISs) -- that is, information-gathering mechanisms necessary to effectively carry out business judgment and risk management -- business expansion outpaced the establishment of information infrastructures at some financial institutions. In order to manage global business and risk appropriately, the challenge lies in establishing an appropriate information infrastructure.

Financial institutions have been improving their internal audit frameworks to ensure their effectiveness. However, challenges were observed in making institutional use of audit results, including post-audit monitoring of improvements in audit issues and audit recommendations to senior management.

b. Credit Risk Management

As for the credit screening and monitoring process, many financial institutions still insufficiently comprehended borrower firms' business conditions. There were some cases where financial institutions overlooked inappropriate accounting by borrower firms and where financial institutions needed to improve credit risk management focused on signs of change in the creditworthiness of global firms. Moreover, an increasing number of regional financial institutions have adopted a strategy of increasing loan extension to growing business areas or seeking new borrower firms in regions outside their home prefectures, but many of them had not established a sufficient credit screening and monitoring framework compatible with the new lending strategies.

With regard to financial institutions' support for corporate turnarounds, while the establishment or strengthening of corresponding frameworks generally made progress, there were many cases where measures to achieve corporate turnarounds were not sufficiently effective and needed to be improved in terms of the involvement of financial institutions' senior management or control and guidance by financial institutions' headquarters. Specifically, there were cases where borrower firms' actual performance diverged substantially from corporate turnaround plans, with no prospects for the firms' plans to succeed, or where borrower firms repeatedly revised their plans after failing to achieve them, indicating that many financial institutions needed to examine such plans more adequately, review the plans' progress, and offer advice and guidance based on the management challenges faced by borrower firms.

Regarding credit concentration risk, some regional financial institutions increased their large credit exposure by actively extending loans to large firms such as in metropolitan areas. However, they needed to make improvements in monitoring not just loans but also, for example, corporate bonds or in reacting to breaches of exposure ceilings.

In a situation where growth in loans to firms had been sluggish, many financial institutions actively expanded loans to households and loans for real estate leasing. As competition among financial institutions became particularly intense in housing loans, many financial institutions needed to improve the analysis of the characteristics of borrowers that were delinquent or in default, as well as the analysis of the relationship between loan vintage and default probability, and to revise their screening criteria for housing loans based on such analyses. In terms of loans for real estate leasing, including apartment loans, some financial institutions needed to improve their screening criteria or follow-up monitoring. Furthermore, some financial institutions needed to make improvements in identifying and analyzing risk associated with consumer loan products.

c. Market Risk Management

Many regional financial institutions aimed to raise yields on securities by extending the duration of bonds or expanding the investment universe in products with credit risk such as corporate bonds and credit-linked notes, and a growing number of regional financial institutions have sought profits from short-term purchases and sales of securities.

In this situation, regarding market risk management, the senior management of many financial institutions was not adequately involved in formulating risk-taking policies and investment plans, and some institutions increased market investments without sufficiently examining possible effects on prospective portfolios and profits. In addition, many financial institutions failed to manage risk in line with the risk profiles of new investment products and methods while diversifying investment products and methods. Furthermore, quite a few financial institutions continued to show inadequacies in such frameworks as loss limits for responding to a possible deterioration in the market environment.

With respect to market risk associated with stockholdings, some financial institutions either did not adequately assess the benefits of stockholdings in their business relationships or showed deficiencies in reviewing the progress of reduction plans, including reports to senior management.

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 of liquidity risk based on the characteristics of their funding and investment. At many financial institutions, emergency measures assuming stress scenarios were inadequate, and thus they needed to prepare or review the substance of liquidity stress-testing or liquidity contingency plans. As for foreign currencies, the significance of ensuring stable funding was amplified further as major financial institutions continuously expanded the extension of overseas loans, and there was room for these institutions to improve the framework for global risk management such as monitoring funding of overseas entities. It was necessary for some regional financial institutions to improve their frameworks for monitoring and stress-testing of foreign currencies funding, while they gradually expanded their assets denominated in foreign currencies due to an increase in foreign bond investment.

e. Operational Risk Management[7]

Financial institutions have worked to ensure the effectiveness of proactive operational risk management cycles. However, some financial institutions needed to improve the functioning of operational risk management divisions in terms of setting up operational risk management systems for areas on which they focused, such as the extension of loans or sales of riskier investment products, and in identifying potential risks within the operational processes. An increase in major incidents was observed at some small financial institutions due to weaker checks and balances in operational processes as a result of sales-concentrated staff allocation or streamlined branch operations with a smaller number of staff.

As for risk management with regard to computer systems, although frameworks for dealing with computer system failures were generally improved, some financial institutions' senior

[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.

management still showed an insufficient degree of involvement in such risk management and of risk awareness. Some institutions needed to improve their management of projects and contractors. In addition, regarding information security, financial institutions needed to take information security measures, given the new types of fraud.

Financial institutions have made progress in improving business continuity arrangements based on the experience of the Great East Japan Earthquake by, for example, including tsunamis and planned rolling blackouts in their disaster scenarios, boosting resources such as staff and emergency goods, and adding in-house power generation facilities. However, examination of the effectiveness of business continuity arrangements was insufficient at many financial institutions in terms of validating the procedures for operating the off-site back-up system by conducting drills.

3. On-Site Examination Policy for Fiscal 2013

(1) Basic Approach

In order to ensure the appropriate functioning of financial intermediation, it is important for financial institutions to steadily conduct risk management in line with their risk profiles and continue to maintain sound management under clearly defined business strategies. Moreover, financial institutions need to prepare for tail risks, that is, risks with an extremely low probability of materializing, but that potentially result in huge losses when they do materialize. 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 2012, the Bank will take the following points into account in the fiscal 2013 on-site examinations.

First, the Bank will continue to carefully assess the financial conditions of individual financial institutions and examine their resilience against risks. Specifically, the Bank will grasp the current and prospective risk profiles of the quality of financial institutions' asset 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 confirm 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 prospective profits, capital strength, and liquidity under several scenarios and give advice as necessary. In the above process, the Bank will examine whether financial institutions comprehend and monitor from a medium-term perspective the effects on profits of the structure of assets and liabilities, and whether necessary measures are reviewed. With regard to tail risks, the Bank will check financial institutions' conduct of stress-testing as well as the development and effectiveness of risk management related to computer systems and business continuity arrangements.

Second, the Bank will more carefully confirm, and give advice as necessary on, financial institutions' credit screening and monitoring capabilities, as well as the effectiveness of their corporate turnaround support arrangements, which are essential for them to properly perform their financial intermediation function. Regarding financial institutions' support for corporate turnarounds, the Bank will examine whether financial institutions (1) sufficiently comprehend the business conditions of small and medium-sized firms, (2) suggest solutions in accordance with borrower firms' management challenges, and (3) take measures in terms of credit risk management in an appropriate manner. As for particular industrial sectors or regions to which financial institutions have actively extended loans, the Bank will also examine whether financial institutions appropriately conduct credit screening and monitoring of firms given risk characteristics, types of credit, and developments in financial markets and industries, and will check whether follow-up monitoring frameworks have been developed to promptly detect changes in borrower firms' creditworthiness.

Third, through the on-site examinations, the Bank will encourage financial institutions to conduct risk management suitable to their type of business and risk profiles, and will examine their governance of risk management. Specifically, taking into account the various efforts by financial institutions to increase profits amid a decline in core profitability, the Bank will check in its on-site examinations whether the senior management is involved in ensuring that (1) risk awareness is sufficiently shared when formulating business strategies and profit plans; (2) risk management processes compatible with risk-taking policies are developed; and (3) risk-taking policies are reviewed or risk management is improved in line with changes in their risk profiles and the external environment. The Bank will give advice on these issues as necessary. The Bank will also examine the functioning of the board of directors, the board of auditors, various committees, and internal audits.

Fourth, the Bank will continue to conduct "risk-based on-site examinations," which the Bank has used 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. The Bank will also 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 borrower 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 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 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 in the formulation of business strategies or profit targets, 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 risk profiles and the external environment.[8]

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 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 applying a medium-term perspective and by assuming various scenarios comprising risk transmission channels, making use of asset-liability management (ALM), the framework for allocated risk capital, and stress-testing.[9] The Bank will also examine (3) whether financial

[8] 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.

[9] 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.

institutions appropriately report to their senior management the results of these analyses and whether they take necessary actions such as formulating ALM policies, hedging risks, and business contingency planning.

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 on-site examinations, the Bank will examine (1) whether major and regional financial institutions have appropriately set up 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.

In the on-site examinations, the Bank will examine the following: (1) whether financial institutions' senior management properly recognizes the importance of internal audits, ensures that the necessary audit resources and the appropriate audit framework are in place, and makes the most of auditors' recommendations regarding their business management; (2) whether financial institutions, based on their assessment of risk profiles, 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

Effective Initiatives toward Providing Support for Corporate Turnarounds

Financial institutions are required to continue to provide support to enhance the effectiveness of corporate turnarounds even after the expiration of the Act Concerning Temporary Measures to Facilitate Financing for Small and Medium-Sized Enterprises (SMEs), etc. -- the SME Financing Facilitation Act -- by encouraging them to prepare and carry out corporate turnaround plans.

In the on-site examinations, the Bank will examine whether the senior management is actively involved in ensuring that (1) financial institutions, based on an adequate comprehension of the business conditions of small and medium-sized firms, appropriately examine the rationality and feasibility of corporate turnaround plans and monitor the progress of the plans; and (2) financial institutions encourage borrower firms whose performance has diverged from the corporate turnaround plan to review those turnaround plans in a timely manner based on an analysis of the factors underlying the divergence and of the prospects for improvement in business conditions, and give effective advice on improving business management. 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 provided any solutions based on the management challenges faced by borrower firms and implemented credit risk management measures from a medium-term perspective by cooperating with relevant parties such as other financial institutions and outside specialists. In these regards, the Bank will provide advice as necessary.

Enhancing Credit Screening and Monitoring through Strengthened Assessment of Borrower Firms' Business Conditions as well as Establishing a Framework Compatible with Lending Strategies

In order to ensure the proper functioning of financial intermediation, it is important for financial institutions to appropriately assess the business conditions of borrower firms in terms of both credit screening and follow-up monitoring.

In the on-site examinations, the Bank will check the credit screening and monitoring of financial institutions more carefully, taking the current severe business environment into account. Specifically, the Bank will examine the following: (1) whether financial institutions properly conduct credit screening of borrower 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 grasp changes in the creditworthiness of borrower firms. Furthermore, as for industrial sectors and regions to which they actively extend loans, the Bank will examine (3) whether financial institutions have developed credit screening and follow-up monitoring frameworks based on risk characteristics, the type of loans, and developments in markets and industries, and whether they review the appropriateness of these frameworks on an institutional basis.

Strengthening the Management of Credit Concentration Risk

As regional financial institutions' core profitability has declined, the deterioration of large exposures has a greater impact on their financial results. Furthermore, some regional financial institutions have increased their exposure to large-lot borrower firms or to certain industrial sectors.

In the 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 borrower firms is fully recognized and the state of credit concentration risk within the loan portfolios, including credit risk inherent in market investments in, for example, corporate bonds, is assessed appropriately; and (2) credit concentration risk is restrained or reduced by setting up a management framework for large exposures in view of financial institutions' profits and capital strength.

Strengthening the Risk Management of Housing Loans

Many financial institutions have continued to focus on extending housing loans, and their share in loan portfolios has increased further. Some financial institutions have become active in extending loans for real estate leasing and consumer loans.

In the on-site examinations, the Bank will examine financial institutions that are active in extending housing and other 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. The Bank will also examine the following points: (3) for housing loans, whether financial institutions accurately grasp and analyze credit costs including those borne by affiliated mortgage insurers, in view of the relationship between loan vintage and default probability; (4) for loans for real estate leasing, whether financial institutions appropriately conduct risk management after the extension of loans by regularly checking the occupancy situation of real estate properties and changes in rental income; and (5) for consumer loans, whether financial institutions have developed processes for identifying risk associated with the offered products and for analyzing the risk. 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

Major financial institutions have actively expanded their global business with the aim of strengthening their profitability, and their overseas exposure has increased. Some regional financial institutions have taken an active stance in establishing overseas offices or extending foreign currency-denominated loans, along with borrower firms' business expansion overseas.

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 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 borrower 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 grown at many regional financial institutions. It has become even more important for the senior management to be fully aware of market risk associated with securities portfolios and be adequately involved in deciding on risk-taking policies, developing risk management frameworks, and examining the investment situation.

In the 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; and (4) whether they conduct stress-testing assuming various risk transmission channels and review market investments and risk management as necessary.

Conduct of Risk Management Compatible with Investment Strategies and Methods

With yields on securities declining, some financial institutions have increased their credit risk-taking in markets such as by investing in corporate bonds and credit-linked notes, while others have resumed investing in structured notes. A growing number of financial institutions 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 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 limitation of risk measuring methods are examined regularly through the conduct of backtesting and stress-testing, and necessary measures are taken.

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 on-site examinations, the Bank will examine (1) whether financial institutions 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 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[10]

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 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 at all times.

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 both domestic and foreign currencies, the liquidity of assets, the stability in funding, and their own 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

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

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 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 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; (2) whether they diversify, across their financial group as a whole, funding sources for the stable procurement of foreign currency and examine this diversification carefully; and (3) whether the conduct of stress-testing and the preparation of liquidity contingency plans is consistent across their financial group.

e. Operational Risk Management

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 computer systems as well as to verify and further 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 review, with the involvement of senior management, their operational risk management framework to keep it in line with changes in risk profiles stemming from the expansion of new businesses or the increase in overseas business operations; (2) whether the operational risk management division examines the adequacy of the assessment of significant potential risks in business operations and computer systems and makes 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.[11]

Senior Management's Risk Awareness with Regard to the Computer System and the Establishment of 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, given the increased dependence on contractors to which computing operations have been outsourced.

In the on-site examinations, the Bank will examine -- by visiting the contractors and joint system operation centers -- whether the senior management is involved in ensuring that (1) adequate preventive measures against failures in critical computer 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 computer systems are effective in containing the impact of a computer system failure; and (3) financial institutions' management of various system development projects, including the transition to a shared computer system, and their management of contractors is adequate. And (4), the Bank will examine whether financial institutions take appropriate countermeasures, such as through the use of variable passwords, digital credentials, firewalls, and antivirus software, against risks associated with information security to which customers and financial institutions may be exposed, given some cases of new types of fraud.[12]

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[11] 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).

[12] In the on-site examinations, the Bank will refer to the report "Toward Effective System Failure

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.

In the on-site examinations, the Bank will continue to encourage financial institutions to improve their business continuity arrangements based on lessons from the Great East Japan Earthquake and to enhance the effectiveness of the arrangements. In particular, regarding financial institutions with a key presence in the payment and settlement systems, the Bank will examine 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 staff, alternative facilities, computer systems, and other 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.[13]

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.

Management: Points to Note," February 2012 (available only in Japanese).

[13] 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).

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 scenarios. In the above process, the Bank will carefully examine the effects of securities portfolios on prospective profitability due to the materialization of interest rate risk. 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 continue to 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, 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 accounts with the Bank; and (2) the financial soundness of the financial institution, such as its capital strength and the degree of risk-taking.

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 global systemically important financial institutions (G-SIFIs), the Bank will check the progress in formulating new 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 grasp the institutions' risk profiles and other facts before visiting their premises (prehearings). It will also strengthen the seamless coordination between its on-site examinations and off-site monitoring.

The Bank will work to further 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.