March 13, 2018

Bank of Japan

On-Site Examination Policy for Fiscal 2018

1. On-Site Examination by the Bank of Japan

The Bank of Japan (hereafter, the Bank) formulates the on-site examination policy every fiscal year based on the decision of the Policy Board.[1] This document, "On-Site Examination Policy for Fiscal 2018," briefly reviews on-site examinations carried out in fiscal 2017 and outlines the basic approach and key issues in the conduct of on-site examinations in fiscal 2018. The Bank will conduct on-site examinations in fiscal 2018 on the basis of this document.

2. On-Site Examinations in Fiscal 2017 and General Observations

(1) On-Site Examinations in Fiscal 2017

The Bank carried out on-site examinations of 100 financial institutions in fiscal 2017: 29 domestically licensed banks, 54 *shinkin* banks, and 17 other institutions, including securities companies as well as Japanese branches and subsidiaries of foreign banks.[2]

Number of Financial Institutions Examined

(number of entities)

	Fiscal 2015	Fiscal 2016	Fiscal 2017
Domestically licensed banks	30	33	29
Shinkin banks	36	37	54
Other institutions	12	15	17
Total	78	85	100

[1] 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).

[2] "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.

(2) Issues Observed in On-Site Examinations

In the fiscal 2017 on-site examinations, the Bank reviewed financial institutions' business operations and asset quality, and examined the effectiveness of their business management and risk management. In particular, given financial institutions' business environment in recent years, the Bank focused on ascertaining and assessing their profitability and framework for managing profitability.

Financial institutions' equity capital is generally adequate relative to the amount of risk taken, and their capacity to absorb losses continues to be high. Under these circumstances, many financial institutions have accelerated their risk-taking stance to strengthen their profitability by, for instance, increasing loans to middle-risk borrowers and investment in foreign securities and investment trusts involving complex risks. Moreover, efforts to improve management efficiency are gradually spreading, although to different degrees across financial institutions. Nevertheless, on the whole, the declining trend in profitability has not come to a halt, reflecting the prolonged low interest rate environment as well as structural factors such as the increasing competition among financial institutions and the declining population.

Against this background, financial institutions have continued to improve their business management and risk management frameworks. However, there were many financial institutions that (1) had not considered and implemented a review of their management frameworks despite changes in their risk profiles in line with their more active risk taking in various areas, and/or that (2) had not established frameworks that allow flexible decision making in the event of sudden changes in financial markets at home and abroad. Moreover, (3) a considerable number of financial institutions had not objectively examined whether efforts to raise profitability were producing the expected results in terms of income, efficiency, and so forth.

3. On-Site Examination Policy for Fiscal 2018

(1) Basic Approach

Financial institutions are expected to contribute to corporate and household economic activities, and ultimately to raising the growth potential at both the national and regional levels by ensuring the appropriate functioning of financial intermediation. To perform this role, financial institutions need to adopt a proactive approach toward risk taking based on solid financial bases and clearly defined business strategies. At the same time, in order to maintain the soundness of their management, it is essential for them to appropriately manage risks as well as secure profitability. Moreover, the low profitability of domestic deposit-taking and lending activities due to structural factors such as the continuing decline in population and the number of firms represents a "chronic stress" that is common to Japanese financial institutions. Against this background, the importance of the efforts mentioned above is increasing especially for regional financial institutions, which have a heavy reliance on domestic deposit-taking and lending activities.

Moreover, efforts to provide new customer services utilizing IT and other means as well as efforts to reengineer business processes to improve the management efficiency of financial institutions, are gradually spreading, although to different degrees across financial institutions. Going forward, these proactive efforts are expected to improve profitability.

Against this background, and based on the challenges identified in the fiscal 2017 on-site examinations, the Bank intends to conduct the fiscal 2018 on-site examinations from the following perspectives.[3]

First, the Bank will confirm how the board of directors and senior management of financial institutions view the external environment, including financial and economic conditions, and examine their medium- to long-term business strategies based on their views. The Bank will then review the financial institutions' current and future risk profiles through examining their loans, securities investments, and new businesses. In particular, in addition to loans to middle-risk borrowers, which many financial institutions have been making efforts to increase, the Bank will examine the risks from real estate-related loans, which have continued to grow at a relatively high pace. Moreover, regarding market

[3] In doing so, the *Financial System Report* will be referred to for analysis and evaluation of risks in the overall financial system in Japan.

investment, the Bank will examine risks involved in securities portfolios by risk factor, taking into account the diversification of investment products and the rise in foreign currency funding costs. Further, the Bank will examine risks in financial institutions' overseas businesses from a range of perspectives including credit risks and the stability of foreign currency funding.

Second, the Bank will ascertain and assess financial institutions' profitability in light of their business strategies and profiles. In doing so, the Bank will deepen its dialogue with the board of directors and senior management on the importance of taking appropriate measures to secure sustainable profits in the medium to long term, including from non-interest income. In addition, the Bank will check the board of directors and senior managements' understanding and assessment of the profitability of various efforts (in terms of the balance of costs and risks on one hand and returns on the other), such as the provision of new customer services utilizing IT and other means, as well as business process reengineering to improve management efficiency. Furthermore, the Bank will examine the status of business management frameworks to systematically comprehend and assess these efforts. Meanwhile, regarding financial institutions with recognized concerns about their future profitability, the Bank will deepen its dialogue with them to improve their profitability and maintain dialogue with their top management in off-site monitoring after completion of on-site examinations.

Third, the Bank will examine financial institutions' resilience against risks and stress based on their risk profile and profitability. Specifically, the Bank will examine whether the board of directors and senior management are properly involved in ensuring that (1) risk awareness is sufficiently shared when formulating business strategies or plans; (2) risk-taking policies are consistent with the financial institutions' equity capital and profitability, and risk management frameworks are adequate for such policies; (3) risk-taking policies and risk management frameworks are reviewed in response to changes in the external environment; (4) risk management is effective; and (5) the impact of various assumed stress events on equity capital and profits is assessed and countermeasures are put in place. In particular, with many financial institutions actively increasing risk taking in their market investment, the Bank will continue to focus on the examination of market risk management. Moreover, it will examine the provision of new customer services utilizing IT and other means, as well as the response to changes in operational risk profiles as a result of business process reengineering, from the perspective of both risks related to business procedures and those related to IT systems.

Fourth, the Bank will continue to conduct on-site examinations based on the same framework as in fiscal 2017. That is, the basic policy will be to continue with examinations in a flexible and efficient manner in accordance with observed risks as well as their effects, and in addition to "regular on-site examinations," the Bank will continue to conduct "targeted on-site examinations" to efficiently and effectively ascertain and assess the profitability of regional financial institutions and examine market risk management, by limiting the scope of examinations to such areas. Moreover, with regard to financial institutions that provide a wide range of financial services not only domestically but also internationally on a group basis, the Bank will comprehend and examine the actual situation of the management of major group companies, including their overseas branches and subsidiaries, and the functioning of governance of the whole group.

(2) Key Issues in the Conduct of On-Site Examinations

a. Profitability

Securing of Sustainable Profits

In order to continue to stably perform financial intermediation functions in the future, it is important for financial institutions to maintain the sustainability of their business by securing profitability, or the ability to acquire sustainable profits.

In the fiscal 2018 on-site examinations, principally with regard to major financial institutions, the Bank will ascertain and assess financial institutions' profitability by examining their international business strategy and their efforts in a wide range of financial services, including their links with FinTech firms, aimed at diversifying the profit sources of the whole group, and business process reengineering aimed at raising management efficiency.

On the other hand, with regard to regional financial institutions, where domestic deposit-taking and lending activities form their core business, the Bank will conduct a simulation of their future profitability while taking into account the effects of "chronic stress" caused by structural issues, and will ascertain and assess whether they have the ability to attain sustainable profits over the medium to long term. The Bank will then confirm with the board of directors and senior management their awareness of issues for profitability and policies to improve it, based on the prospects for regional economies and for their customer bases. As a result, regarding those with recognized concerns about their future profitability, the Bank will deepen its dialogue with them to improve their profitability, in view of a wide range of factors such as the appropriateness of profit management, and the feasibility of measures to increase profits and improve management efficiency.

b. Governance

Business Management Based on an Optimal Balance between Equity Capital and Profitability on the One Hand and Risk Taking on the Other

To ensure the soundness of their business, it is important for financial institutions to analyze the impact of any materialization of risk on their equity capital and profits and, based on such analyses, systematically review their risk-taking policy and risk management frameworks. In particular, with the focus of international discussions on financial regulation shifting from formulation to implementation, financial institutions need to respond to newly introduced regulations.

In the fiscal 2018 on-site examinations, with regard to stress testing at major financial institutions, the Bank will examine the following: (1) involvement of the board of directors and senior management and the control functions of the relevant sections in charge of such activity; (2) comprehensiveness of scenarios and coverage of the subjects of the stress testing; (3) development of models and data and the verification systems for them; and (4) frameworks to utilize test results for business operations and the decision on management policies including risk-taking policies. In doing so, the Bank will also engage in a dialogue with financial institutions based on international discussions on the use of stress testing. The Bank will then confirm the awareness of the board of directors and senior management with regard to assessing the sufficiency of the quality and quantity of equity capital and the capital policy based on this assessment. In doing so, it will take into account the responses to international financial regulations and provide necessary advice. The Bank will also examine progress with the establishment of the framework for controlling risk taking and risk management comprehensively, including the risk appetite framework and the use of the framework for business management. Regarding Global Systemically Important Financial Institutions (G-SIFIs) and their equivalents, the Bank will examine the effectiveness of recovery plans and contingency plans. In addition, it will confirm as necessary responses to local regulations abroad and Brexit, as well as preparations for the adoption of Basel III.

With regard to regional financial institutions, the Bank will use simulations of future profits (see 3. (2) a) to assess the medium- to long-term trend of their equity capital and profitability. Based on this, the Bank will confirm the awareness of the board of directors and senior management regarding the assessment of the sufficiency of the quality and quantity of equity capital and the capital policy based on such assessment, as well as other issues for business management, and provide the necessary advice. In addition, by examining (1) whether the adequacy of business strategies and plans, risk-taking policy, and risk management frameworks is verified by financial institutions through, for example, the conduct of simulations of profits on a voluntary and regular basis, the management of profits, and the use of frameworks of asset-liability management (ALM) and risk capital allocation, and (2) whether necessary reviews are conducted based on the verification results, the Bank will encourage the establishment of PDCA cycles for business operations. In addition, it will examine (3) whether they have analyzed the possible impact on equity capital and profits in the event of sudden changes in financial and economic conditions, including through the use of stress testing, and considered appropriate responses. Meanwhile, (4) with regard to financial institutions that have established frameworks for controlling risk taking and risk management comprehensively, the Bank will examine progress with the use of such frameworks for business management.

Ensuring the Effectiveness of Governance[4]

To ensure the effectiveness of business management and risk management for financial institutions, the board of directors and senior management need to develop a framework of governance that is suitable for business strategies, the diversified contents of business, customer bases, risk profiles, etc., and ensure its effectiveness. For this purpose, in the on-site examinations, the Bank will examine the following: (1) whether the board of directors and senior management appropriately oversee business management and risk management frameworks; (2) whether senior management executes and manages operations in accordance with the policies determined by the board of directors or other relevant bodies; and (3) whether senior management appropriately provides reports to the board of directors and other relevant bodies. In doing so, the Bank also will (4) conduct interviews with external directors and so forth, as necessary, to deepen dialogue on the effectiveness of governance. Moreover, it also will (5) examine the effectiveness of financial institutions' group-wide business management and risk management, including their overseas branches and subsidiaries, as well as holding companies' business management function.

Confirmation of the Governance Framework at Overseas G-SIFIs' Japanese Branches

With regard to overseas G-SIFIs' Japanese branches and subsidiaries, the Bank will examine whether they have established an appropriate management framework in line with their business and major efforts, while understanding the roles of their Japanese branches and subsidiaries within their group. On this basis, the Bank will examine (1) impacts on Japanese branches and subsidiaries under the assumption of stress events for the group as a whole and responses to them, and (2) the situations for Japanese branches and subsidiaries within the recovery and resolution plans, including their involvement in these matters. Regarding those subsidiaries with corporate status in Japan, the Bank also will examine the support system provided by headquarters in the event of deterioration in business conditions. If yen funding is managed by bases other than Japanese branches and subsidiaries, (3) the Bank will confirm the state of the management of the bases and their

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[4] In the on-site examinations, the Bank will refer to the "Corporate governance principles for banks" issued by the Basel Committee on Banking Supervision in July 2015.

system of communicating with the Bank in preparation for unexpected contingencies. Moreover, (4) the Bank will conduct examinations, including the collection of information from their headquarters, of the impact on the Japanese financial system in the case of expected stress events for the group as a whole.

Proactive Improvement of Risk Management with Internal Audits

Internal audits provide a basis for ensuring the proper conduct of financial institutions' business operations, and the board of directors and senior management need to ensure their effectiveness. In addition, the internal auditors need to evaluate the effectiveness of the various control functions and report to the board of directors or other relevant bodies as appropriate from an independent and objective standpoint. Therefore, in the on-site examinations, the Bank will examine the following: (1) whether the board of directors or other relevant bodies appropriately decide the scope of internal audits and allocate audit resources; (2) whether the internal auditors adequately audit businesses; and (3) whether the board of directors or other relevant bodies make the most of auditors' observations and recommendations regarding their business management. To improve the effectiveness of on-site examinations, the Bank will conduct hearings with internal audit sections before on-site examination, if necessary.

Development of Management Information Systems

It is important for financial institutions to appropriately set up and employ mechanisms to gather the information necessary to manage business operations and risks. For financial institutions that offer a wide range of financial services on a group basis at home and abroad, it is important to appropriately assess in a timely manner various kinds of information with regard to operating in multiple regions and business sectors.

In the fiscal 2018 on-site examinations, mainly with regard to major financial institutions, the Bank will examine, concerning the global and group-wide financial information and risk information required for the board of directors or other relevant bodies to make appropriate management decisions, (1) whether they have appropriately set up mechanisms to gather the necessary information, such as a management information system (MIS), and (2) whether the comprehensiveness, reliability, and timeliness of information are appropriate. In doing so, the Bank also will confirm the status of preparations for changes in regulations such as Basel III that could affect management.

c. Credit Risk Management

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

Given their increasingly active stance toward taking credit risks to improve profitability, financial institutions need to more appropriately assess the actual conditions of borrowers, and further ensure that credit screening and monitoring frameworks compatible with their lending strategies are in place. Moreover, given that lending periods tend to become longer amid the continuing low interest rate environment, it is important for financial institutions to examine such loans in terms of their profitability, taking into account possible future changes in credit costs, etc.

In the fiscal 2018 on-site examinations, the Bank will examine, including through selected loan reviews ("line sheet reviews"), (1) the appropriateness of credit screening, (2) the status of follow-up monitoring frameworks, and (3) the appropriateness of measures to comprehend and respond to the actual conditions of high-risk borrowers. In particular, the Bank will focus on its examination of business sectors and regions in which financial institutions are easing their lending stances, such as loans to middle-risk borrowers. In doing so, the Bank will examine (4) whether financial institutions properly assess the viability of borrowing firms' business in conducting credit screening and management, taking account of such factors as lending periods and business characteristics, and (5) whether they conduct a review of the profitability of lending portfolios to these business sectors and regions. In addition, (6) in cases where lending periods are becoming longer, the Bank will deepen its dialogue with financial institutions on their views regarding their profitability, taking into account possible future changes in credit costs, etc.

Strengthening the Management of Credit Exposure with Respect to Overseas Businesses

Major financial institutions are continuing to make efforts to expand their overseas businesses. Moreover, some regional financial institutions have increased their overseas-related credit through, for example, lending to existing customers for their overseas business and joining syndicated loans. With U.S. dollar short-term money market interest rates being on an uptrend, it has become increasingly important for financial institutions to manage credit exposures with respect to businesses overseas.

In the fiscal 2018 on-site examinations of major financial institutions with large overseas exposures, the Bank will examine (1) the system to manage credit exposures, including through selected loan reviews ("line sheet reviews"). The Bank also will examine, for example, the following: (2) whether financial institutions have put in place an adequate framework for credit screening and management for areas on which they have focused recently -- such as cross-border M&A-related credit -- and for the management of large exposures, mainly to non-Japanese firms; (3) whether financial institutions' 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; (4) whether the headquarters adequately review credit risk-taking policies on a global basis by making use of stress testing; and (5) whether they conduct appropriate profit management taking into account foreign currency funding costs. In the on-site examinations of regional financial institutions, the Bank will examine the credit screening and monitoring frameworks of financial institutions with particularly large foreign currency lending, as well as their profitability, taking into account foreign currency funding costs.

Strengthening the Management of Large Exposures/Concentration Risk

Financial institutions' equity capital and profits may be significantly affected by a worsening of the business conditions of large-lot borrowers, or by the materialization of risks in their credit portfolios with common risk characteristics, such as the same industries. For this reason, in the on-site examinations, the Bank will examine the following in particular: (1) whether financial institutions properly ascertain the status of large exposures/concentration risk, using measures such as stress testing, and (2) whether financial institutions have developed frameworks to control large exposures/concentration risk, taking into account their equity capital, etc., while ensuring their effectiveness.

Support for Enhancing the Vitality of Firms

Financial institutions are expected to contribute to enhancing the vitality of firms by continuously supporting the efforts of borrowing firms to resolve their management challenges. For this reason, in the on-site examinations, the Bank will examine (1) whether financial institutions adequately analyze the current business conditions and future prospects of the borrowing firms and share an awareness of the management challenges concerning the borrowers with them, and (2) whether financial institutions' headquarters and branches are cooperating in offering advice, recommendations, and support to help borrowers overcome challenges. Furthermore, the Bank will examine, with regard to borrowers with unstable business conditions, (3) whether financial institutions are making efforts toward more drastic solutions for management challenges by cooperating with other financial institutions and outside specialists.

d. Market Risk Management

Adequate Involvement of the Board of Directors and Senior Management in Market Risk Management

Financial institutions have taken an increasingly active stance toward taking market risks and need to develop risk management frameworks that correspond to the accumulation and growing complexity of market risks. In this regard, it has become more important for the board of directors and senior management to be accurately aware of the profitability and risks associated with securities portfolios and off-balance transactions, and to take a lead in ensuring that risk taking is appropriate, taking into account equity capital and profitability.

In the fiscal 2018 on-site examinations, the Bank will examine the following: (1) whether the board of directors and senior management have clearly set out risk-taking policies, thereby having investment plans formulated in view of the optimal balance between risks on the one hand and equity capital and profitability on the other; (2) whether the board of directors and senior management have developed risk management frameworks in accordance with these policies and plans; and (3) whether these investment plans and management frameworks are appropriately reviewed as necessary with involvement of the board of directors and senior management. Moreover, the Bank will also examine (4) whether, in the event of sudden changes in financial markets at home and abroad, the board of directors and senior management receive reports on changes in risks and reach decisions in a timely manner based on the impact of such changes on equity capital and profits.

Conduct of Risk Management Compatible with Investment Strategies and Methods

The targets and methods of market risk management need to be in line with the risk profiles of the securities portfolios and off-balance transactions and investment methods. In particular, regional financial institutions should ascertain and manage risks appropriately, given that an increasing number of them have become active in purchasing financial products in which they have no investment experience, including financial products with relatively complex risks such as privately placed investment trusts and REITs, as well as structured products.

In the fiscal 2018 on-site examinations, the Bank will examine the following: (1) whether financial institutions appropriately identify and analyze risks, by looking at each risk factor involved in their securities and portfolios as a whole, such as their interest rate risk as well as their credit risk, stock price risk, and foreign exchange risk; (2) whether the risk management division monitors the market prices of securities, the amount of risk, and observance of various limits with proper granularity in accordance with the risk characteristics, investment methods, hedging policies, etc.; and (3) whether the adequacy and limitations of the risk-measuring methods are examined regularly through, for example, the conduct of back testing, and whether necessary measures are taken.

In doing so, the Bank also will examine, as necessary, whether frameworks of risk management will function effectively in line with stress scenarios.

e. Liquidity Risk Management

Liquidity Risk Management Based on Risk Profiles

To ensure stable liquidity management, it is necessary for financial institutions to (1) ascertain the structure of their funding and investment portfolios and set appropriate risk limits and (2) establish a framework for monitoring and controlling risks to observe the limits. Moreover, it is necessary for them to (3) understand the funding conditions in normal times while establishing a framework to respond promptly to changes in the environment by ensuring sufficient liquidity reserves for emergencies. Further, (4) it is important for internationally active financial institutions to implement appropriate management of foreign currency liquidity risks, including local currency risks, as well as enhance stable funding bases, at their overseas branches and subsidiaries and at their financial groups as a whole.

In the fiscal 2018 on-site examinations, the Bank will examine the situation of liquidity risk management from the above-mentioned standpoint. In particular, with regard to internationally active financial institutions, the Bank will examine the following, taking into account the rise in foreign currency funding costs in recent years: (1) whether financial institutions appropriately and in a timely manner ascertain the current and prospective funding conditions in terms of different currencies and locations, and (2) whether, for the financial group as a whole, they diversify periods and methods for stable foreign currency funding and implement analyses of the stickiness of deposits. Moreover, the Bank will examine the sufficiency of stress testing and the effectiveness of liquidity contingency plans, including (3) whether the conduct of liquidity stress testing is consistent across the financial group and (4) whether financial institutions assume specific amounts of foreign currency outflow with the lapse of time, secure corresponding funding tools, and conduct an institutional review of their appropriateness.

Moreover, with regard to regional financial institutions, the Bank will examine whether they analyze trends in deposits to be inherited based on the aging and shrinking of the population in their customer base. In addition, with regard to regional financial institutions that have become active investors in foreign currency-denominated assets, the

Bank will examine as necessary the sufficiency of stress testing as well as the management of foreign currency liquidity risks, including the effectiveness of emergency responses, etc.

f. Operational Risk Management[5]

Establishment of Risk Management Frameworks Based on Advances in the Utilization of IT and Other Means

Financial institutions are stepping up efforts to review their business processing frameworks through business process reengineering and to provide new customer services utilizing IT and other means in order to improve business efficiency and profitability. Financial institutions need to establish risk management frameworks in line with the changes in operational risk profiles resulting from these developments.

In the fiscal 2018 on-site examinations, the Bank will examine (1) whether financial institutions adequately recognize changes in the risk profiles of their business processes resulting from efforts to reengineer business processes and/or develop new business utilizing IT and other means. In addition, the Bank will examine (2) the establishment and review of risk management frameworks in response to these changes from the perspective of both risks related to business procedures and those related to IT systems. In doing so, it also will examine (3) financial institutions' assessment of the cost-effectiveness of efforts to reengineer business processes and/or develop new business from a profitability perspective. In addition, the Bank will examine (4) the stability of processing of operations that would have a substantial impact on business management in the event of the materialization of risks, including in terms of compliance. It also will examine whether financial institutions identify risk management issues through assessments of the processing of operations and analysis of fraud and accidents, and take effective remedial steps against such events.

[5] In on-site examinations, operational risk refers to risks related to overall business operations, including, for example, risks related to business procedures, compliance, IT systems, and business continuity.

Establishment and Strengthening of Cyber Security Management Frameworks

With cases of cyberattacks increasing, it is important for financial institutions to ensure cyber security in providing customer services utilizing IT in a safe and stable manner.

In the fiscal 2018 on-site examinations, the Bank will examine whether financial institutions have put in place cyber security management frameworks, with the board of directors and senior management being adequately informed and involved. In this regard, the Bank also will examine (1) the appropriateness of the collection and sharing of information, and (2) the appropriateness of the management of access rights for important data such as customer information. The Bank will then examine the effectiveness of measures to prevent various types of cyberattacks and limit damage caused by such attacks on critical IT systems and external networks connected to these systems, taking into account individual financial institutions' businesses and presence in the payment and settlement systems. Moreover, given that it is difficult to prevent cyberattacks completely, it will examine the effectiveness of frameworks and contingency plans in preparation for the occurrence of cyber incidents, the implementation of drills, and the review of management frameworks reflecting the outcomes of such drills.

Establishment and Strengthening of IT Risk Management Frameworks

To ensure the reliability and security of IT systems, financial institutions need to ensure the effectiveness of (1) measures to prevent IT system failures and recovery frameworks in the event of a failure, (2) project management, (3) information security management, and (4) management of contractors.

In the fiscal 2018 on-site examinations, the Bank will examine the above-mentioned points focusing on critical IT systems and confirm the effectiveness of IT governance to ensure their effectiveness. In this regard, it also will examine whether financial institutions (1) conduct management corresponding to their use of new technologies and services, (2) have secured the effectiveness of management frameworks for confidential information pertaining to, for example, customers, and (3) allocate management resources appropriately.

Enhancing the Effectiveness of Business Continuity Management

The development of effective business continuity management is important to ensuring financial institutions' critical operations, as well as the smooth functioning of the payment and settlement systems in Japan. For this reason, in the on-site examinations, the Bank will examine, taking account of each financial institution's types of business, as well as these institutions' presence in payment and settlement systems and in their respective regions, whether business continuity management is reviewed proactively in response to changes in the environment and business operations.

(3) Operations of On-Site Examination

a. Enhancing of Efficiency and Effectiveness

The frequency, length, and scope of the Bank's on-site examinations, as well as the number of examiners involved, have been determined on the basis of a comprehensive assessment of each financial institution from two perspectives: (1) the impact on the financial system of the materialization of risks for a particular financial institution and (2) the financial soundness of financial institutions, such as their capital adequacy and profitability, as well as the degree of risk taking.

In fiscal 2018, just as in fiscal 2017, in addition to "regular on-site examinations" to comprehensively examine and assess -- through on-site visits over a period of about three weeks -- the business conditions and risk management frameworks of financial institutions, the Bank will conduct "targeted on-site examinations" that will limit the scope of examinations to profitability and market risk management for on-site visits over a period of about one week. Moreover, with regard to financial institutions that provide a wide range of financial services on a group basis, the Bank will examine major group companies, as necessary, to ascertain the actual business conditions of a group as a whole. Furthermore, it will continue to focus on its examination of overseas branches and subsidiaries of such financial institutions, given the increased weight of international businesses.

b. Consideration of Administrative Burden and Understanding for Financial Institutions

Line sheet reviews are useful from the perspective of concretely understanding the borrowers' business environment, such as the actual situation of regional economies, and changes in the behavior of financial institutions, and the Bank will continue with these in the fiscal 2018 on-site examinations.[6] However, the Bank will strictly limit the number of borrowers selected for line sheet review in consideration of the administrative burden on financial institutions. Given that the accuracy of self-assessments has improved on average, the Bank will no longer conduct asset assessments to check the accuracy of self-assessments, with the exception of financial institutions with certain issues regarding the quality of their assets, etc.[7]

Since on-site examinations of financial institutions' branches are useful in ascertaining the governance of branches and the efficiency of branch management, the Bank will continue with on-site examinations of branches in fiscal 2018.[8] However, given the further concentration of business operations to headquarters and use of IT systems, in its on-site examinations of branches the Bank will not conduct examinations aimed at confirming operational accuracy, except in the case of branches that have particular problems such as incidents of fraud or accidents in business operations.

In addition, the Bank will keep striving to reduce the burden of on-site examinations by taking into consideration how busy financial institutions are, and by deciding, in a

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6 A line sheet review consists of interviews with branch managers, etc., on the basis of documents ("line sheets") containing information on developments in the financial condition, developments in the borrowing and repayment situation, and future prospects of chosen individual borrowers, as well as the financial institution's self-assessment results, lending policy, etc., and the assessment of the borrowers' business environment, such as developments in regional economies and industries, as well as its credit management practices, etc.

7 The Financial Services Agency has announced that it will repeal the financial inspection manual, which sets out the guidelines for self-assessment of financial institutions, after the end of fiscal 2018. The Bank will consider how to handle the asset assessment in the on-site examinations from fiscal 2019 onward taking into account discussions at the Financial Services Agency.

8 Through on-site examinations of branches, the Bank examines the actual situation of operational processing and risk management frameworks by questioning branch managers, managers, and staff in charge of actual operations, and confirms the understanding and the status of implementation of various measures directed by headquarters.

prioritized manner and based on the business challenges faced by individual financial institutions, the documents to be submitted beforehand, as well as the items to be examined at the time of on-site examinations.

Moreover, to further enhance the efficiency and effectiveness of on-site examinations, the Bank will continue to strengthen the linkage between its on-site examinations and its off-site monitoring, including of overseas offices. The Bank aims to share its awareness and strengthen cooperation with the Financial Services Agency, and with overseas regulators mainly on issues common to internationally active financial institutions.

The Bank will work to enhance its communication with institutions being examined and continue to take appropriate actions to gain their full understanding of and trust in the examination process and results. In the above process, it will improve on-site examination procedures by responding to opinions and requests gathered from examinee institutions through a post-examination survey. Following its on-site examinations, the Bank will revisit the financial institution as part of its efforts, conducting interviews as necessary.