March 30, 2021

Bank of Japan

On-Site Examination Policy for Fiscal 2021

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]

With a view to preventing the spread of COVID-19 and reducing the operational burden on examinee institutions striving to provide financing support to firms and households, the Bank temporarily ceased its on-site examinations in fiscal 2020 and instead conducted intensive interviews with examinee institutions using remote methods, such as web and telephone conferencing, in place of such examinations (hereafter referred to as "remote intensive interviews"). Based on the risk profiles of examinee institutions, the Bank focused on examining how COVID-19 affected their business, such as in terms of providing financing support to firms and households and management of credit and market risk.[2] In doing so, the Bank gave sufficient consideration to the operational burden on examinee institutions to help them focus on their financing support.

This document, "On-Site Examination Policy for Fiscal 2021," briefly reviews remote intensive interviews conducted in fiscal 2020 and, in light of the recent situation of the spread of COVID-19 and of the examinee institutions' provision of financing support, outlines the basic approach and key issues in the conduct of examinations of financial institutions in fiscal 2021, which will be resumed using remote methods. The Bank will conduct on-site examinations in fiscal 2021 on the basis of this document.

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[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] See "Guideline for Conducting On-Site Examinations in Response to COVID-19" released on June 30, 2020.

2. Remote Intensive Interviews in Fiscal 2020 and General Observations

(1) Remote Intensive Interviews in Fiscal 2020

The Bank conducted remote intensive interviews with 37 financial institutions: 18 domestically licensed banks, 14 *shinkin* banks, and 5 other institutions, including securities companies as well as Japanese branches and subsidiaries of foreign banks.[3]

Number of Financial Institutions Examined/Interviewed

(number of entities)

	On-site examinations		Remote intensive interviews
	Fiscal 2018	Fiscal 2019	Fiscal 2020
Domestically licensed banks	29	34	18
Shinkin banks	54	43	14
Other institutions	8	8	5
Total	91	85	37

(2) Issues Identified in Remote Intensive Interviews

In response to the spread of COVID-19, financial institutions have been actively providing financing support for firms and households under the large-scale fiscal and monetary policy measures and flexible regulatory and supervisory actions taken by the government and the Bank. These institutions have smoothly provided such support, despite the restrictions on movement and face-to-face services to prevent the spread of COVID-19, partly due to the increased flexibility of branch operations, including working arrangements, and the widespread adoption of remote work through the enhancement of IT infrastructures.

On the other hand, credit costs have been increasing. This mainly is because a growing number of financial institutions have increased loan-loss provisions, as there is uncertainty over the business prospects of borrowers who have suffered significant declines in their

[3] "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.

business due to the impact of COVID-19, thereby causing concern over their repayment capacity. Credit costs could increase considerably given the prolonged spread of COVID-19, although such costs will greatly depend on the future course of the infection and economic activity. Regarding credit risk management, some financial institutions did not fully ascertain the changes in the risk of their credit portfolios in terms of borrowers' repayment capacity. Moreover, there continued to be cases where financial institutions had an insufficient understanding of the financial condition of borrowers; for example, loans were downgraded from normal to "de facto bankrupt" or below due to the detection of window-dressing.

In terms of market risk management, there were quite a few cases where the losses on securities holdings breached the thresholds set in the loss-cut rule and the triggers for consultation in March 2020, when market conditions faced a sudden change due to the COVID-19 outbreak. However, at many financial institutions, the respective boards of directors and senior management were involved in an appropriate manner in decisions on whether to continue to hold securities. There were also cases where some financial institutions, although increasing investments in risky products amid the continued redemptions of bonds with higher coupon rates than those of recently issued bonds, did not manage market risk sufficiently based on the risk characteristics of these products.

With regard to foreign currency liquidity risk management, major financial institutions, which have been expanding their overseas activities, saw a sharp increase in foreign currency-denominated lending due to the drawdown of committed lines in March 2020 triggered by the COVID-19 outbreak, while funding such as through the CD and CP markets temporarily deteriorated. However, there were no major disruptions to foreign currency funding, partly due to the swift expansions of U.S. dollar liquidity swap line arrangements by six central banks and of the U.S. dollar funds-supplying operations by the Bank. This experience showed once again that it is extremely important for financial institutions to continue to strengthen stable foreign currency funding bases and increase the sophistication of their foreign currency liquidity risk management.

Financial institutions' capital levels are adequate relative to the amounts of various types of risk taken on, and they have sufficient capacity to absorb losses. In addition, even though the real economy has been under severe downward pressure due to the spread of COVID-

19, the smooth functioning of financial intermediation has been maintained on the back of the implementation of large-scale fiscal and monetary policy measures.

However, the capital adequacy ratios of regional financial institutions are likely to continue to follow a downtrend, reflecting the decline in their core profitability. Against this background, to increase business efficiency, a growing number of financial institutions have been working to reengineer business processes through, for example, substantial consolidation of their branch networks, reviews of their ATM networks and staff allocation, and active use of digital technology. There has been an increase in capital and business alliances among financial institutions and with firms from other industries in order to further enhance their financial services and improve business efficiency.

3. On-Site Examination Policy for Fiscal 2021

(1) Resumption of On-Site Examinations and Strengthening of Coordination with the Inspections by the Financial Services Agency (FSA)

The Bank conducted remote intensive interviews in place of on-site examinations in fiscal 2020. Meanwhile, examinee institutions' operational burden for providing financing support has been reduced, given that the number of loan guarantees approved by credit guarantee corporations peaked in mid-2020 and has been on a downtrend since then, and that the growth of domestic lending by financial institutions has slowed down recently. Therefore, the Bank will resume on-site examinations in fiscal 2021.

When they resume, in order to prevent the spread of COVID-19, the Bank will continue to make active use of remote methods such as web and telephone conferencing. Once resumed, the Bank will assess whether it is appropriate to conduct examinations, mainly in light of COVID-19 trends and examinee institutions' operational burden, and will give the utmost consideration to the situation faced by these institutions by, for example, adjusting schedules as necessary. Moreover, as in previous fiscal years, the Bank will conduct on-site examinations in a flexible and efficient manner in accordance with financial institutions' risk situation, profitability, and financial soundness.

In addition, in order to further enhance the efficiency and effectiveness of on-site examinations, the Bank will strengthen its coordination with the FSA through the Joint

Group for Coordinating FSA's Inspections and BOJ's On-Site Examinations, which was established by the two entities in December 2020. Specifically, in addition to coordinating the planning of the FSA's inspections and the Bank's on-site examinations, these two entities will share the findings of inspections and examinations and streamline the framework used for financial institutions' data submission. With regard to major financial institutions, the Bank, in coordination with the FSA, will conduct horizontal reviews of supervisory simultaneous stress testing based on common scenarios, of foreign currency liquidity risk management, and of cybersecurity about once a year as part of off-site monitoring, and will also conduct joint surveys with the FSA as necessary.[4] In conducting on-site examinations, the Bank will avoid overlapping with the aforementioned joint initiatives to take into account the operational burden on major financial institutions and enhance the efficiency and effectiveness of such examinations.

(2) Basic Approach

Financial institutions are expected to contribute to corporate and household economic activities, and ultimately to a rise in the growth potential at both the national and regional levels by ensuring the appropriate functioning of financial intermediation. In particular, with the spread of COVID-19 exerting strong downward pressure on the real economy, it has become increasingly important for financial institutions to smoothly perform their financial intermediation function. In order for them to play this role, while maintaining the right balance between securing a solid financial base and taking risk, they -- with involvement of the respective boards of directors and senior management -- need to accurately grasp changes in current circumstances, analyze the impact of any materialization of risk on their equity capital and profits and, based on such analyses, review their risk-taking policy and risk management frameworks.

In this context, even before the COVID-19 outbreak, regional economies in particular were already in an increasingly severe situation due to the impact of structural factors such as a declining population. This situation has been strongly affecting regional financial institutions. If their profitability declines further, due mainly to the impact of COVID-19,

[4] Since fiscal 2019, the FSA and the Bank have been conducting joint surveys on overseas credit investment/lending and on the use of LIBOR.

the smooth functioning of financial intermediation could be impaired. The Bank has introduced the "Special Deposit Facility to Enhance the Resilience of the Regional Financial System" (hereafter referred to as "the Special Deposit Facility") as a three-year temporary measure, with the aim of strengthening the business foundations of regional financial institutions so that they may smoothly fulfill their financial intermediation function and provide appropriate support to regional economies into the future. In conducting on-site examinations, the Bank will deepen its dialogue with regional financial institutions regarding their initiatives to support economic activity in their respective business areas.

Major financial institutions have been pushing ahead with strengthening group-wide profitability and diversifying their revenue sources by increasing the efficiency of their domestic deposit-taking and lending activities on the one hand, while on the other hand expanding their overseas activities, including through inorganic growth strategies involving acquisitions and investments, as well as further strengthening the cross-selling of services across commercial banks, securities companies, trust banks, nonbanks, etc. belonging to the same holding company. Major financial institutions that are of systemic importance both at home and abroad have a greater need to secure a solid financial base and bolster their business management frameworks, so that they can sufficiently review their business operations and support client firms affected by the COVID-19 pandemic.

An increasing number of financial institutions, regardless of their type, have been taking measures toward implementing cashless payment and making use of open application programming interfaces (APIs), cloud computing, and artificial intelligence (AI). Moreover, in response to the spread of COVID-19, financial services that were previously provided face-to-face have become available online, and remote work arrangements such as working from home have been promoted and become more widespread. This has led to further advances in the digitalization of financial institutions' business. Going forward, financial institutions are expected to respond more proactively to these developments and bring about an improvement in their profitability. At the same time, as a result of their use of digital technology and increased cooperation in financial services with firms from other industries, the importance of cybersecurity and information management is also rising. In particular, given the growing number of large-scale cyberattacks worldwide in recent years, financial institutions need to increase their operational resilience; that is, their ability to carry out critical business operations even under a cyberattack.

In addition, close attention also should be paid to how well prepared financial institutions are for the permanent cessation of LIBOR projected for the end of 2021, how their business will be affected by developments surrounding climate change issues, sustainable development goals (SDGs), and environmental, social, and governance (ESG) issues, all of which are gaining increased global interest, and how prepared financial institutions are for the potential impact of these developments.

Against this background, and based on the issues identified in remote intensive interviews in fiscal 2020, the Bank intends to conduct the fiscal 2021 on-site examinations from the following perspectives.[5]

First, the Bank will examine the effectiveness of financial institutions' business management regarding their profitability and financial soundness, based on the view of the respective boards of directors and senior management regarding the external environment, including financial and economic conditions at home and abroad, and these institutions' medium- to long-term business strategies.

In doing so, while taking into account the uncertainty regarding COVID-19, the Bank will deepen its dialogue with the respective boards of directors and senior management on (1) whether their view of their institutions' medium- to long-term profitability and financial soundness is appropriate, and (2) whether they are taking appropriate measures on that basis, such as measures to increase net non-interest income and improve business efficiency, as well as strategic investments. The Bank also will examine the role of digitalization in their business strategies and how they plan to make the most of it to reengineer business processes and/or develop new business. In addition, the Bank will examine (3) whether they have appropriately established profit management frameworks to conduct risk-return analyses with regard to loans and securities investments as well as analyses of profitability by business sector and region. Moreover, (4) given that increases in credit costs have become even more pronounced and the impact of the pandemic is likely to more fully

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

materialize going forward, the Bank will examine financial institutions' prospects for the incurrence of loan losses and will deepen its dialogue with these institutions regarding appropriate methods of write-offs and loan-loss provisions. Furthermore, (5) the Bank will examine whether financial institutions appropriately ascertain the impact of various assumed stress events on equity capital and profits and put countermeasures in place.

In the case of financial institutions for which there is concern about their future profitability and financial soundness, the Bank will focus its dialogue with the respective boards of directors and senior management on the capital levels necessary to perform their financial intermediation function in a stable manner into the future and on their business policies to secure such capital levels, as well as their capital policies for the utilization of unrealized gains on securities and dividend distributions. In off-site monitoring after the completion of on-site examinations, the Bank will maintain dialogue with the top management of such institutions on the challenges regarding their profitability and financial soundness and concrete measures to address them.

Regarding the permanent cessation of LIBOR, wide-ranging responses within a limited time frame are required. Thus, the FSA and the Bank will conduct joint surveys on how well prepared financial institutions are for the LIBOR cessation, including process management. The Bank will take into account the findings and confirm these institutions' preparedness with on-site examinations, as necessary. Moreover, it will examine the role of climate change issues, SDGs, and ESG issues in financial institutions' business and their efforts in these areas, such as the use of stress testing.

The second perspective is that the Bank will review current developments and future directions of financial institutions' risk profiles and then examine the effectiveness of their risk management.

In terms of credit risk, with both major and regional financial institutions focusing on providing financing support to client firms affected by the COVID-19 pandemic, the Bank -- while taking into account the uncertainty regarding the infection -- will examine whether their screening and monitoring of such support, including the provision of equity support, are appropriate and look at changes in the risk characteristics of credit portfolios. With regard to market risk, the Bank will examine risks involved in securities portfolios, given that major financial institutions hold large amounts of foreign credit instruments such as collateralized loan obligations (CLOs) and bank loan funds, and regional financial institutions have continued to actively take on risk by investing in securities including corporate bonds, foreign bonds, and multi-asset investment trusts. With regard to operational risk, the Bank will examine, for example, the status of frameworks for cybersecurity management and anti-money laundering controls, both of which have gained in importance. Given that major financial institutions have continued to hold large amounts of overseas assets, the Bank will examine the appropriateness of their foreign currency liquidity risk management.

Third, the Bank will examine the status and efficacy of financial institutions' governance framework necessary to ensure the effectiveness of business management and risk management.

Specifically, the Bank will examine their framework for the collection of the information necessary for effective business and risk management, as well as the functionality of internal audits important to ensuring the appropriateness of business operations. In the case of financial holding companies and major financial institutions with global activities, the Bank will examine their group-based business management and the management of their overseas bases, respectively, by covering their major group companies, including overseas bases, as necessary.

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

a. Business Management

Securing of Sustainable Profits and Sufficient Financial Soundness

The Bank will examine whether financial institutions acquire sustainable profits and maintain their financial soundness, even with the impact of the COVID-19 pandemic, by conducting simulations of their profitability. In doing so, it will confirm with the respective boards of directors and senior management their awareness of issues regarding profitability and financial soundness, as well as policies to improve these, by presenting profitability and financial soundness simulation results under certain standard stress scenarios. The Bank will deepen its dialogue with financial institutions by providing, as necessary, the results of its macro stress testing for individual financial institutions.

In the case of major financial institutions, the Bank will examine the status of, for example, their global activities and group strategies, efforts in a wide range of financial services, including those for adapting to digitalization, and business process reengineering aimed at raising business efficiency. It will then ascertain and assess group-wide profitability. Moreover, the Bank will examine the status of implementation of international financial regulations.

In the case of regional financial institutions, the Bank will confirm whether the respective boards of directors and senior management adequately ascertain that, over the medium to long term, profits are sustainable and financial soundness is sufficient, and whether they have implemented measures to achieve those goals, taking into account the impact of the pandemic on their business areas. In doing so, the Bank will examine the status of implementing measures such as (1) the strengthening of credit management under the pandemic, (2) credit cost reduction due to the support for client firms to improve their business conditions, (3) an increase in net non-interest income, and (4) optimization of branch operations and staff allocations. Moreover, the Bank will focus on, for example, (5) provision of new financial services and a fundamental increase in business efficiency, both brought about by digitalization, (6) the effects of business alliances with firms from other industries, and (7) policies in response to the broadening of the scope of banking business, which is under consideration. With regard to financial institutions with a large amount of unrealized losses on securities holdings, the Bank will confirm their policies to address the issue. In the on-site examinations of regional financial institutions that have been pushing ahead with business integration and enhancement of group-wide business activities, such as in the form of holding companies, the Bank will examine the status of implementing measures to produce positive effects of such efforts, as well as their effectiveness.

Moreover, as for financial institutions that have used the Special Deposit Facility, the Bank will confirm the status of implementing measures to support regional economies and strengthen their business foundations.

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

The Bank will examine whether financial institutions -- depending on their business scope, etc. -- appropriately establish and operate frameworks (including a so-called risk-appetite framework) to (1) clarify what profits they should aim at, what risks they should take, and what capital adequacy ratios they should maintain, and thereby devise business strategies and operational plans, (2) continuously monitor the amount of risk, profits, and capital in implementing the plans, and (3) adjust business strategies and operational plans in an appropriate and timely manner in response to changes in the environment, such as caused by the COVID-19 pandemic.

The Bank also will examine whether financial institutions develop operational plans, manage their profits, and implement capital policies, including those for dividend distributions, by appropriately taking capital costs into account, and will hold a dialogue with the respective boards of directors and senior management on future directions. In doing so, the Bank will keep in mind the difference in characteristics between banks, which are public companies with shareholders, and cooperative financial institutions, which have the mission of providing mutual assistance among their members.

Moreover, the Bank will examine whether financial institutions have analyzed the possible impact on equity capital and profits in the event of significant changes in financial and economic conditions, including through the use of stress testing, and have considered appropriate responses. With regard to stress testing, the Bank will examine the following: (1) the involvement of the respective boards of directors and senior management and the control functions of the relevant divisions in charge of such activity; (2) the comprehensiveness of scenarios and coverage of the subjects of the stress testing; (3) schemes to develop and verify models and data; and (4) frameworks to utilize test results for business operations and the decision on business policies. The Bank will deepen its dialogue with those major financial institutions that are subject to supervisory simultaneous stress testing based on common scenarios jointly conducted by the FSA and the Bank, in light of the stress testing results. In conducting on-site examinations, the Bank will avoid overlapping with said stress testing to take into account the operational burden on major financial institutions and enhance the efficiency and effectiveness of such examinations.

Regarding Global Systemically Important Financial Institutions (G-SIFIs) and their equivalents, the Bank will examine the effectiveness of recovery plans and contingency plans.

With regard to financial regulations, the Bank will confirm, as necessary, preparedness for international regulations that are moving toward the implementation phase, as well as responses to local regulations abroad.

Enhancing Profit Management

In the case of major financial institutions, the Bank will examine their risk-return analyses and profitability management, mainly in light of funding costs and of credit risk that incorporates the impact of the COVID-19 pandemic, focusing on their overseas activities.

In the case of regional financial institutions, the Bank will examine (1) how they make use of efficiency indicators such as the overhead ratio (OHR) in their business planning, (2) how the framework for profit management of branches functions, and (3) how these institutions ascertain and analyze profitability that, for example, takes into account credit risk, based on the characteristics of their credit portfolios by region and borrower classification. The Bank also will examine, (4) in the case of regional financial institutions that have set indicators related to net non-interest income as their business targets, whether the Plan-Do-Check-Act (PDCA) cycles toward their achievement have been functioning effectively.

Preparedness for the Permanent Cessation of LIBOR

Through joint surveys by the FSA and the Bank, the two entities confirm the progress mainly on the transition of contracts and the agreement on alternative rates for LIBOR, including process management, with regard to derivative contracts, corporate loans, and corporate bonds that are referencing LIBOR. Based on the survey results, in the on-site examinations of financial institutions for which there is concern about a delay in their preparations for LIBOR cessation, the Bank will examine whether they have worked for improvements.

b. Governance

Ensuring the Efficacy of Governance

The Bank, in the case of major financial institutions, will examine whether they have established group-based governance frameworks that are appropriate for their initiatives to expand overseas activities and strengthen the cross-selling of services on a group-wide basis. In the case of regional financial institutions, the Bank will examine whether they have established governance frameworks that make it possible to appropriately control risk taking in their lending and securities investments and increase business efficiency. In the case of holding companies to which regional financial institutions belong, the Bank will conduct a similar examination.

In the on-site examinations, the Bank will conduct interviews with external directors and other officers as necessary.

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 scope and their major initiatives while understanding their roles within the group. On this basis, it 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 role of 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 a 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 framework of communicating with the Bank in preparation for unexpected contingencies. Moreover, (4) it will conduct examinations, including the collection of information from their headquarters, of the impact on the Japanese financial system in the case of assumed stress events for the group as a whole.

Proactive Improvement of Business Management and Risk Management through Internal Audits

With regard to internal audits, the Bank will examine the following: (1) whether the respective boards of directors and senior management appropriately decide the scope of internal audits and allocate audit resources based on recent risk taking, etc.; (2) whether the respective internal audit divisions adequately perform audits in terms of the appropriateness of business operations; and (3) whether the boards of directors and senior management 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 the respective internal audit divisions before on-site examination, if necessary.

Establishment of Information Management Frameworks

Concerning the global and group-wide financial information and risk information required for the respective boards of directors and senior management to make appropriate business decisions, the Bank will examine, particularly for major financial institutions, (1) whether they have appropriately set up a framework for the collection of the necessary information, such as a management information system (MIS), (2) whether sufficient management resources are allocated to this end, and (3) whether the comprehensiveness, reliability, and timeliness of information are appropriate. In doing so, the Bank also will confirm the status of responses to changes in institutional frameworks that could affect these institutions' business, such as international financial regulations.

c. Credit Risk Management

Appropriate Credit Screening and Monitoring under the COVID-19 Pandemic

The spread of COVID-19 has led both major and regional financial institutions to increase loans to meet growing demand for corporate financing. With regard to such loans, the Bank will examine, including through selected loan reviews ("line sheet reviews"[6]), (1) whether financial institutions properly ascertain changes in business conditions of borrowers and their financial condition after loan execution and (2) whether these institutions, at the time of credit screening, make loan decisions based on the impact of the recent pandemic and the effects of economic measures, as well as the prospects for borrowers' business conditions after COVID-19 subsides. In addition, the Bank will examine (3) financial institutions' analysis on risk characteristics of credit portfolios that takes into consideration the increase in loans to support corporate financing and (4) the status of improvement in financial institutions' initial screening and interim management of their loans based on the characteristics of credit cost incurrence and analysis of reasons behind such incurrence. In doing so, the Bank will place particular focus on examination of sectors in which financial institutions have increased loans outstanding: for major financial institutions, such sectors include loans related to large cross-border mergers and acquisitions (M&As), while those for regional financial institutions include loans to middle-risk firms and real estate loans.

Strengthening the Management of Foreign Credit Exposure

Major financial institutions have high levels of foreign credit exposure as a result of their efforts to enhance overseas activities. The breakdown of overseas loans by credit rating shows investment-grade loans (BBB and above) account for about 70 percent, indicating that the overall credit quality of the overseas loan portfolios has remained high. However, borrowers include firms in industries that have been heavily affected by the spread of COVID-19, and the number of downgrades of leveraged loans, which carry relatively high risk, increased particularly in March 2020, reflecting the COVID-19 outbreak. Moreover, some regional financial institutions have increased their foreign credit exposure through, for example, lending to client firms for their overseas business and joining syndicated loans. Given these developments, in the case of major financial institutions, the Bank will examine (1), while making use of line sheet reviews, whether these institutions have

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[6] A line sheet review consists of (1) interviews with relevant divisions 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 (2) the understanding and assessment of the borrowers' business environment, such as developments in regional economies and industries, as well as its credit management practices, etc.

adequately conducted credit screening and monitoring, mainly for sectors that seem to have relatively high risk; (2) whether they have appropriately managed their origination and distribution operations of loan-related instruments; (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; and (4) whether the headquarters adequately review credit risk-taking policies on a global basis by making use of stress testing. In the case of regional financial institutions with large amounts of loans denominated in foreign currencies and investment in foreign credit instruments, the Bank will examine the status of frameworks for credit screening and monitoring, depending on the risk characteristics of individual institutions.

Strengthening the Management of Large Exposure/Concentration Risk

The Bank will examine (1) through line sheet reviews whether financial institutions sufficiently comprehend the business conditions of large borrowers that are low-performing or carry considerable business risks and whether their credit screening and monitoring are appropriate, including of the accuracy of self-assessments. In addition, it will examine (2) whether financial institutions properly ascertain the status of large exposure/concentration risk in their credit portfolios, using measures such as stress testing, and on this basis (3) whether financial institutions have developed frameworks to control large exposure/concentration risk, taking into account their equity capital, etc., and ensure their effectiveness.

Appropriate Write-Offs and Loan-Loss Provisions

It is increasingly more important to accurately ascertain the prospects for future credit costs amid the continued decline in financial institutions' core profitability while also taking into account the impact of the COVID-19 pandemic. In the on-site examinations, while making use of line sheet reviews as necessary, the Bank will examine the prospects for the incurrence of loan losses that take into account the amounts of loans that are reasonably assumed to be defaulted or uncollectible, based on financial institutions' credit stance, the characteristics of the incurrence of credit costs, the risk characteristics of their credit portfolios, and financial and economic conditions. The Bank will then deepen its dialogue with financial institutions regarding the appropriate approach to calculating write-offs and loan-loss provisions in view of the recall of the FSA's financial inspection manual. It also will exchange opinions with the accounting auditors of financial institutions as necessary.

Support for Resolving Firms' Business Challenges

Financial institutions are expected to provide continuous support for borrowers' efforts to resolve their business challenges. In particular, in a phase where the economy recovers from the COVID-19 pandemic, it will become more essential to provide assistance with firms' core business and financing, including that aimed at facilitating their business reforms, such as through business restructuring and succession as well as M&As. In the case of regional financial institutions, part of the reason for increases in credit costs in recent years has been the delay in improvement of business conditions for low-performing firms that have received protracted support from these institutions. In addition, regional financial institutions are expected to support firms in their response to significant changes in the environment, as they have recently coped with changes in people's lifestyles and worked on digitalization, both triggered by the spread of COVID-19. Given this situation, the Bank will examine (1) whether regional financial institutions adequately analyze the current business conditions and future prospects of borrowers and share an awareness of the business challenges with them, and (2) whether these institutions' headquarters and branches are cooperating in terms of offering advice, recommendations, and support to help borrowers overcome challenges. Furthermore, the Bank will examine, (3) with regard to borrowers with unstable business conditions, whether these institutions are making efforts toward more drastic solutions for business challenges by cooperating with other financial institutions and outside specialists.

d. Market Risk Management

Formulation of Investment Plans Based on Appropriate Risk Assessment

Major financial institutions have engaged in risk taking by investing in not only investment trusts but also foreign credit instruments such as CLOs, bank loan funds, and private equity funds. Overseas credit markets have regained stability, partly due to the positive impact of policy actions by governments and central banks, after undergoing large adjustments, including the sharp widening of credit spreads in March 2020. However, substantial re-adjustments in financial markets can induce large losses for major financial institutions in Japan.

Meanwhile, given large-scale redemptions of bonds with higher coupon rates than those of recently issued bonds, regional financial institutions have continued to increase the duration of yen-denominated bondholdings and to purchase such products as corporate bonds, foreign bonds, privately placed real estate investment trusts (REITs), structured bonds, and multi-asset investment trusts. As a result, the complexity and diversity of risk factors inherent in their securities portfolios have further increased, ranging from domestic and overseas interest rate risk to credit risk, stock price risk, real estate-related risk, and foreign exchange risk. In terms of profits, the share of interest and dividend income from regional financial institutions' holdings of securities other than yen-denominated fixed rate bonds has been rising, and an increasing number of these institutions have put more emphasis on realizing gains from trading securities. Against this background, changes in global market conditions and corporate earnings have an increased impact on regional financial institutions' overall profits through fluctuations in dividends on investment trusts and stocks and through realized gains/losses. Furthermore, at a relatively large number of regional financial institutions, unrealized gains on securities have followed a downward trend as they have been realizing gains successively.

In the on-site examinations, the Bank will examine whether financial institutions formulate risk-taking policies and investment plans by accurately ascertaining risks involved in securities portfolios by risk factor and then examining the tolerance of these risks relative to the financial institutions' equity capital and profits.

Market Risk Management Commensurate with Risk Profiles

On the basis of the risk profiles, investment methods, and hedging rules of securities portfolios and off-balance transactions at financial institutions, the Bank -- while also taking into account responses made in March 2020, when there was a sudden change in market conditions -- will examine the following: (1) whether financial institutions have developed risk management frameworks such as those for setting various limits and appropriately review them as necessary; (2) whether the respective risk management divisions monitor the market prices of securities, the amount of risk, and observance of various limits with proper frequency; (3) whether stress testing is functioning effectively; and (4) whether, in the event of sudden changes in financial markets at home and abroad, the respective boards of directors and senior management receive reports on changes in risks and reach decisions -- such as with regard to whether to cut losses -- in a timely manner based on the future impact of such changes on equity capital and profits.

It is difficult to assess the risk characteristics of some multi-asset investment trusts with portfolios that are rebalanced frequently. For financial institutions with large exposure to such investment trusts, the Bank will examine whether they accurately analyze the performance and risk characteristics of each investment trust, and whether, on that basis, they appropriately conduct the screening at the time of purchases and the interim management, such as a regular review of asset management strategies for each investment trust.

e. Liquidity Risk Management

Liquidity Risk Management Commensurate with Risk Profiles

The Bank will examine, in order for financial institutions to ensure stable liquidity management, whether they (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. The Bank also will examine whether they (3) understand the funding conditions in normal times and establish a framework to promptly secure liquidity reserves at the time of emergencies.

Given the large amount outstanding of foreign currency funding at internationally active major financial institutions, the Bank -- taking account of the experience of March 2020, when financial markets became volatile due to the spread of COVID-19 and market funding for foreign currency funds deteriorated temporarily -- will examine the following: (1) whether financial institutions ascertain the current and prospective funding conditions in terms of different currencies and locations, as well as funding capacity on a stock basis; (2) whether, for the financial group as a whole, they are pushing ahead with diversifying periods and methods for stable foreign currency funding; and (3) whether they implement analyses of the stickiness of deposits by type of customer, deposit amount, and interest rate level. Moreover, the Bank will examine the sufficiency of stress testing and the effectiveness of liquidity contingency plans, including (4) whether the conduct of liquidity stress testing is consistent across the financial group, (5) whether financial institutions ascertain and manage foreign currency liquidity risks at outsourced companies, and (6) whether they assume specific amounts of foreign currency outflow with the lapse of time, secure corresponding funding tools, and review their appropriateness.

Regarding foreign currency liquidity risk management of major financial institutions, the Bank, in coordination with the FSA, will conduct horizontal reviews about once a year as part of off-site monitoring. In conducting on-site examinations, the Bank will avoid overlapping with said reviews to take into account the operational burden on major financial institutions and enhance the efficiency and effectiveness of such examinations.

With regard to regional financial institutions, the Bank will examine their management of yen liquidity risk while confirming their deposit interest rate setting, depositor characteristics, balance of amounts outstanding of deposits, loans, and securities, holdings of highly liquid assets, etc. in light of 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 the status of foreign currency liquidity risk management, including the setting of the appropriate risk limits based on funding structure, the establishment of the frameworks for risk monitoring and control, and the diversification of funding providers.

f. Operational Risk Management[7]

Establishment of Risk Management Frameworks Based on Advances in Digitalization and Expansion in Fee-Based Business and Other Activities

Given that the spread of COVID-19 has led an increasing number of financial institutions to actively take measures such as digitalization initiatives, concentration of business operations, and review of branch networks and staff allocations, the Bank will examine (1) whether financial institutions adequately recognize changes in the risk profiles of business

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

procedures and computer systems associated with recent developments and (2) whether these institutions -- not only examinee institutions but also their major group companies and their outsourced companies -- have appropriately established and reviewed risk management frameworks in response to changes in risk profiles. 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. Particularly in the case of financial institutions that focus on fee-based business activities, the Bank will examine (4) the status of their compliance management frameworks for sales of financial instruments and advisory services. It also will examine whether financial institutions identify risk management issues through understanding of the actual situation of operational processing and analysis of fraud and accidents, and take effective measures to address such issues.

Establishment and Strengthening of Cybersecurity Management Frameworks

The Bank will examine the status of cybersecurity management frameworks, with a particular focus on (1) the appropriateness of the collection and sharing of information on developments in ever-changing cybersecurity threats, 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 computer systems and external networks connected to these systems, taking into account individual financial institutions' business scope and their presence in the payment and settlement systems, as well as the widespread adoption of remote work in response to the COVID-19 pandemic. Moreover, given that it is difficult to prevent cyberattacks completely, it will examine the effectiveness of frameworks and contingency plans to recover critical operations in preparation for the occurrence of cyber incidents, the implementation of drills, and the review of management frameworks reflecting the outcomes of such drills. In doing so, the Bank also will examine, as necessary, the management of financial institutions' group companies and outsourced companies that have access to these institutions' important data.

The Bank, in coordination with the FSA, is considering conducting horizontal reviews of the status of cybersecurity management frameworks of major financial institutions as part of off-site monitoring. In conducting on-site examinations, the Bank will avoid overlapping with said reviews to take into account the operational burden on major financial institutions and enhance the efficiency and effectiveness of such examinations.

Establishment and Strengthening of Computer Risk Management Frameworks

The Bank will examine, focusing on financial institutions' critical computer systems, the effectiveness of (1) measures to prevent computer system failures and recovery frameworks in the event of a failure, (2) project management, (3) information security management, and (4) management of outsourced companies. It also will confirm the efficacy of IT governance, including the appropriate allocation of management resources to ensure the effectiveness of the above-mentioned items. In this regard, it also will examine whether financial institutions (5) conduct risk management corresponding to their use of new technologies and services. Particularly in the case of financial institutions that use cloud computing for the establishment of core computer systems and the analysis on customer data, the Bank will examine whether their management from a user's viewpoint is appropriate.

Strengthening Anti-Money Laundering and Counter-Terrorism Financing Controls

Given strong international requests to take measures specific to anti-money laundering and counter-terrorism financing, it is essential for Japanese financial institutions to steadily implement these measures to ensure the proper conduct of their business operations and to maintain their credibility. On this basis, the Bank will examine whether financial institutions have steadily developed frameworks in these areas by taking into account a possible impact in the event of the materialization of risks.

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. The spread of COVID-19 led financial institutions to enhance IT infrastructures aimed at promoting remote work and to increase flexibility of branch operations, including working arrangements. This has helped to ensure the continuation of important operations despite the restrictions on movement and face-to-face services to prevent the spread of COVID-19. The Bank will continue to examine whether business continuity management is reviewed appropriately in response to not only COVID-19 but also natural disasters -- such as earthquakes, typhoons, and floods -- as well as cyber incidents, the latter two of which have occurred recently. In doing so, it will take account of individual financial institutions' business scope, as well as these institutions' presence in payment and settlement systems and in their respective business areas.

(4) Operations of On-Site Examination

a. Enhancing of Efficiency and Effectiveness

While making use of the information obtained through off-site monitoring, including of overseas offices, the Bank decides, in a flexible and efficient manner, the frequency, length, and scope of its on-site examinations, as well as the items to be examined, the documents to be submitted, and the number of examiners involved on the basis of a comprehensive assessment of individual financial institutions, such as from the following perspectives: (1) the impact on the financial system of the materialization of risks inherent in financial institutions and (2) financial institutions' capital adequacy and profitability, as well as the degree of risk taking. In fiscal 2020, the Bank conducted intensive interviews with examinee institutions using remote methods in place of on-site examinations. The Bank will continue to actively use such methods as necessary to conduct examinations of financial institutions effectively and reduce the operational burden on these institutions.

The Bank will enhance the efficiency and effectiveness of on-site examinations by further strengthening its coordination with the FSA, such as through the Joint Group for Coordinating FSA's Inspections and BOJ's On-Site Examinations. Moreover, it will continue to aim at sharing its awareness and strengthening cooperation with overseas regulators, mainly on issues regarding internationally active financial institutions.

b. Prevention of the Spread of COVID-19 and Consideration of Operational Burden on Financial Institutions

The Bank, taking into account the most recent situation regarding COVID-19 and with a view to preventing the spread of the infection, will take necessary measures, such as those in terms of scheduling, in conducting on-site examinations while giving the utmost consideration to the situation faced by examinee institutions. It will carefully assess the need to visit financial institutions' premises based on the situations they face. The Bank primarily will conduct examinations of these institutions by remote methods until the spread of COVID-19 is considered to have subsided.

With regard to financial institutions that provide a wide range of financial services on a group basis, the Bank will continue to examine major group companies, as necessary, to ascertain the business conditions of a group as a whole. As for financial institutions that have a high share of international businesses in their overall business operations, it also will continue to focus on its examination of such institutions' overseas branches and subsidiaries. The Bank will conduct examinations of these institutions by remote methods until the spread of COVID-19 is considered to have subsided.

c. Gaining of Financial Institutions' Understanding

The Bank will work to enhance its communication with financial institutions being examined through a post-examination survey to gain their full understanding of and trust in the examination process and results. It will improve on-site examination procedures by responding to opinions and requests gathered from examinee institutions. As part of these efforts, the Bank, following its on-site examinations, will conduct interviews through web conferencing and other means, as necessary.