On-Site Examination Policy for Fiscal 2022

1. Introduction

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

In recent years, the risk profiles of financial institutions have become increasingly complex, mainly against the backdrop of further financial and economic globalization, and the environment surrounding the financial system has changed substantially due in part to the impact of the COVID-19 pandemic and heightened geopolitical risks. Furthermore, financial institutions are facing new challenges, such as the need to decarbonize our society and the economy and adapt to digitalization. Under these circumstances, it has become essential to assess financial institutions' soundness and risk management in a swifter and more continuous manner, and it has also become increasingly important to monitor changes in the financial system as a whole in a timely fashion.

In March 2021, the Financial Services Agency (FSA) and the Bank released "Efforts toward Further Strengthening Coordination between the FSA and the Bank."² The aim of these efforts is to conduct higher-quality monitoring while reducing the burden on financial institutions by coordinating inspection and supervisory activities by the FSA with on-site examinations and off-site monitoring by the Bank.

Specifically, the Bank is working to strengthen the integration of on-site examinations and off-site monitoring by further deepening information sharing between the on-site examination section and the off-site monitoring sections at the head office and branches. In addition, the Bank is expanding joint surveys with the FSA targeting major financial

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 https://www.boj.or.jp/announcements/release_2021/rel210322c.htm/ (available only in Japanese).
institutions. The joint surveys are conducted separately from regular on-site examinations and consist of simultaneous surveys of some major financial institutions on important topics related to the financial system, making it possible to examine financial institutions by comparing them with each other.\(^3\)

In light of the above-mentioned changes in the environment surrounding the on-site examinations, the "On-Site Examination Policy for Fiscal 2022" has been expanded to include descriptions of initiatives linked with off-site monitoring, such as the joint surveys, while bearing in mind the organic coordination between on-site examinations and off-site monitoring.

2. On-Site Examinations in Fiscal 2021 and General Observations

(1) On-Site Examinations in Fiscal 2021

The Bank carried out on-site examinations of 59 financial institutions: 18 domestically licensed banks, 34 *shinkin* banks, and 7 other institutions, including securities companies as well as Japanese branches and subsidiaries of foreign banks.\(^4\) While the Bank conducted remote intensive interviews in place of on-site examinations in fiscal 2020, it has resumed on-site examinations in fiscal 2021 using remote methods, such as web and telephone conferencing, mainly in light of the examinee institutions' operational situation regarding the provision of financing support.\(^5\)

---

\(^3\) Topics of the joint surveys include the following: in addition to the existing supervisory simultaneous stress testing based on common scenarios, in fiscal 2021, joint surveys on foreign currency liquidity risk management and on cybersecurity management were newly conducted, and pilot exercises of climate scenario analysis were conducted. Topics will be reviewed as appropriate in consultation with the FSA in line with their importance to the financial system.

\(^4\) "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.

### Number of Financial Institutions Examined

<table>
<thead>
<tr>
<th></th>
<th>Fiscal 2019</th>
<th>Fiscal 2020</th>
<th>Fiscal 2021</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestically licensed banks</td>
<td>34</td>
<td>18</td>
<td>18</td>
</tr>
<tr>
<td>Shinkin banks</td>
<td>43</td>
<td>14</td>
<td>34</td>
</tr>
<tr>
<td>Other institutions</td>
<td>8</td>
<td>5</td>
<td>7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>85</td>
<td>37</td>
<td>59</td>
</tr>
</tbody>
</table>

Note: For fiscal 2020, the Bank conducted remote intensive interviews in place of on-site examinations.

(2) Issues Identified through On-Site Examinations and Off-Site Monitoring

Financial institutions' business management and financial soundness, as well as their risk management examined in on-site examinations and off-site monitoring in fiscal 2021, are as follows.

**Profitability and Financial Soundness**

Looking at financial institutions' financial soundness, we note first that their capital levels are adequate relative to the amounts of various types of risk taken on, and they have sufficient capacity to absorb losses. Despite the impact of the spread of COVID-19 on economic and financial conditions at home and abroad, the smooth functioning of financial intermediation has been maintained on the back of the positive effects of large-scale fiscal and monetary policy measures.

As for profitability, major financial institutions have increased the efficiency of their domestic deposit-taking and lending activities on the one hand, while on the other hand they have continued to expand their overseas activities, including through inorganic growth strategies involving acquisitions and investments, strengthen group-wide profitability across commercial banks, securities companies, trust banks, nonbanks, etc. belonging to the same holding company, and diversify their revenue sources.

A growing number of regional financial institutions have been working to enhance profitability by increasing business efficiency through, for example, consolidation of their branch networks (including so-called "branch-in-branch" consolidation) and reviews of their ATM networks and staff allocation, as well as by improving financial services, in a
situation where their core profitability has followed a downtrend due to structural factors such as a declining population and the prolonged low interest rate environment. There have also been capital and business alliances among financial institutions and with firms from other industries in order to further strengthen business foundations. On the other hand, amid the continued decline in profitability, some regional financial institutions have not sufficiently planned and implemented countermeasures.

Meanwhile, on the back of digitalization including the use of open application programming interfaces (APIs) and cloud computing, an increasing number of financial institutions have been improving the efficiency of their operations and enhancing non-face-to-face services for customers. Moreover, there has been growing interest in climate change in terms of finance, as seen in the increase in the number of not only major financial institutions but also regional ones that agree with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).

**Credit Risk**

Financial institutions are continuing to actively provide financing support to firms and households. Some major financial institutions have been focusing on financing for institutional investors, including investment funds, and hybrid loans, whereas some regional financial institutions are focusing on "cross-border" lending and lending to middle-risk firms. While credit costs increased in fiscal 2020 against this background, partly due to the rise in loan-loss provisions for industries heavily affected by the pandemic, they leveled out in fiscal 2021. There is uncertainty over the business prospects of borrowers and credit costs, however, as the future course of the pandemic and economic developments in Japan and abroad remain unclear. Whereas a wide range of financial institutions were reviewing their write-offs and loan-loss provisions as part of their credit management in line with borrower firms' financial conditions and future prospects, there were also some cases where financial institutions had problems in understanding borrower firms' financial and funding conditions, analyzing their repayment capacity, and providing effective support for low-performing firms to improve their business conditions, as well as in credit screening and monitoring of loans in areas on which regional financial institutions have focused (such as "cross-border" lending and lending to middle-risk firms).
**Market Risk**

Under the prolonged low interest rate environment, both major and regional financial institutions in Japan have been actively taking on market risk, particularly for overseas credit products and investment trusts, to search for yield. In this situation, some major financial institutions have diversified investment in overseas credit products such as collateralized loan obligations (CLOs) and bank loan funds, or increased alternative investments including private equity (PE) funds and hedge funds. Moreover, some institutions have incurred a fair amount of losses in prime brokerage business for institutional investors.

Meanwhile, given large-scale redemptions of bonds with higher coupon rates than those of recently issued bonds and a rise in demand for investment purposes due to the retention of deposits such as pandemic-related subsidies, regional financial institutions have continued to purchase such products as corporate bonds, foreign bonds, privately placed real estate investment trusts (REITs), and multi-asset investment trusts. As a result, the diversity of risk factors inherent in their securities portfolios has further increased. Under these circumstances, the establishment of a market risk management framework commensurate with changes in risk profiles, such as accurately ascertaining risk factors and examining risk tolerance, is considered a challenge at many financial institutions.

**Liquidity Risk**

As they expand their overseas business, major financial institutions are facing the challenges of achieving stable foreign currency funding based on appropriate foreign currency liquidity risk management, and they are working to diversify their funding instruments, such as increasing long-term market funding and attracting transaction account deposits, to refine their stress tests, and to develop data systems. While many regional financial institutions have sufficient liquidity in yen assets and have no problems in managing them, some that are actively making foreign currency investments in illiquid assets face challenges in the establishment and management of stable foreign-currency investment and funding structures.
**Operational Risk**

With regard to computer system risks, there were some major financial institutions that experienced multiple system failures that affected their customers. Moreover, while both major and regional financial institutions are increasingly using new digital technologies, cyber threats such as ransomware attacks are becoming more prevalent. In addition, amid business collaborations with third parties and group companies increasing, there were cases in which the management of information security, including at these entities, and the management of outsourcees, such as cloud computing providers, were insufficient.

3. On-Site Examination Policy for Fiscal 2022

On-site examination policy for fiscal 2022 is as follows (see attachment for more details on the key issues).

(1) Efficacy of Business Management regarding Profitability and Financial Soundness

The Bank will examine (1) boards of directors and senior management's view of the external environment, including financial and economic conditions at home and abroad, (2) the feasibility of their medium- to long-term business strategies, and (3) the effectiveness of financial institutions' business management regarding profitability and financial soundness on that basis. In doing so, the Bank will pay particular attention to the following issues:

- The status of efforts to build a sustainable business model. This includes the status and feasibility of (1) efforts to strengthen top-line earnings, including net non-interest income, (2) measures to improve business efficiency, such as a review of branch networks and staff allocations and the reengineering of business processes, and (3) the use of digitalization.

-- Through examinations of these issues, the Bank will deepen dialogue with regional financial institutions on the status of implementing measures to support regional economies and strengthen their business foundations, including the use of the "Special

---

6 Operational risk refers to risks related to overall business operations, including, for example, risks related to business procedures, compliance, computer systems, and business continuity.
Deposit Facility to Enhance the Resilience of the Regional Financial System" (hereafter referred to as "the Special Deposit Facility") in coordination with off-site monitoring.

- For major financial institutions, the status and efficacy of efforts in a wide range of financial services through their global activities and group strategies.
- For regional financial institutions that have been pushing ahead with strengthening business foundations through business integration, enhancement of group-wide business activities, and business collaborations with other firms, the status and efficacy of such efforts.
- Whether financial institutions (1) ascertain risks that take into account changes in their business environment and strategies, such as the impact of COVID-19 and the increase and diversification of their market investment, (2) examine the impact on their profits and equity capital, and (3) have put countermeasures in place.
- Whether financial institutions identify and manage climate-related financial risks, their information disclosure, and their engagement with corporate customers.

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.

(2) Status and Efficacy of Governance Framework

The Bank will examine the status and efficacy of financial institutions' governance framework necessary to ensure the effectiveness of business management and risk management. In doing so, it will pay particular attention to the following issues:

- In the case of financial institutions that have overseas bases and financial holding companies, their business management commensurate with their group strategies and global activities.
• The framework for the collection of the information necessary for effective business and risk management.

(3) Various Risks and Risk Management Frameworks

The Bank will review current developments and future directions of various risks faced by financial institutions and then examine the effectiveness of their risk management. (In the on-site examinations, the Bank will avoid overlapping with joint surveys conducted with the FSA on subjects such as foreign currency liquidity risk management and cybersecurity management at some major financial institutions.) In doing so, the Bank will pay particular attention to the following issues:

Credit Risk

• Whether financial institutions ascertain borrowers' financial and funding conditions at the individual borrower level and the portfolio level as well as changes therein, in a situation where the cumulative impact of the pandemic on firms' business as well as the impact of loan repayments on borrower firms' funding is becoming more important. Moreover, whether they use such information in their initial screening as well as in considering methods of write-offs and loan-loss provisions and estimating future credit costs and downside risks.

• Whether financial institutions are identifying borrowers that require support for improving their business conditions and those that require intensive monitoring (and whether there is a review of borrowers thus identified as necessary, bearing in mind that there may be changes due to the impact of the pandemic and other factors), as well as the status of financial institutions' effective support for and management of their borrowers.

• Frameworks for credit screening and monitoring with regard to areas of focus (financing for institutional investors at major financial institutions and "cross-border" lending and lending to middle-risk firms at regional financial institutions, etc.).

Market Risk

• Whether financial institutions ascertain risks and have established risk management frameworks in line with the increase and diversification of their risk taking. The tolerance
of these risks relative to their financial soundness and profits regarding their investment plans.

- Whether various risk and loss limits are consistent with financial soundness and profits. The efficacy of responses when, for example, a mandatory consultation framework becomes requisite based on loss-cut rules.
- Risk awareness of major financial institutions regarding their prime brokerage business.

**Liquidity Risk**

- Whether major financial institutions have strengthened funding bases and set their risk appetite in line with their foreign currency balance sheet strategy, and also have managed funding based on their funding capacity in terms of different currencies. Whether they have developed and implemented liquidity stress testing and contingency funding plans, and also have increased the sophistication of risk management.
- With regard to regional financial institutions that are actively making foreign currency investments in illiquid assets, including lending, their efforts toward stable foreign currency funding and whether they have established risk management frameworks such as stress testing and emergency measures.

**Operational Risk**

- Whether financial institutions have established management frameworks that cover third parties and group companies amid growing business collaborations with them.
- Regarding computer risk and cybersecurity management, the effectiveness of measures to prevent computer system failures and cyber incidents, as well as of recovery frameworks in the event of a failure.\(^7\)
- Management of progress on whether financial institutions have developed frameworks for anti-money laundering and counter-terrorism financing.\(^8\)

---

\(^7\) In cooperation with the FSA, the Bank will encourage regional financial institutions to conduct self-assessments of their cybersecurity management frameworks and make use of the results in the on-site examinations.

\(^8\) The Bank will conduct examinations while sharing its awareness and perspectives with the FSA through the framework of coordination between the FSA's inspections and the Bank's on-site examinations.
4. Operations of On-Site Examinations

(1) Thorough Measures to Prevent the Spread of COVID-19 and the Use of Remote Methods

The Bank will continue to actively employ remote methods such as web and telephone conferencing as part of its thorough measures to prevent the spread of COVID-19 and with a view to conducting examinations of financial institutions effectively and reducing the operational burden on examinee financial institutions. From this perspective, the Bank will, in principle, continue to conduct examinations using remote methods for the time being. Regarding the resumption of on-site examinations, these will be conducted mainly in hybrid form in conjunction with remote methods after ascertaining that the impact of the pandemic has subsided, and taking the situation faced by examinee financial institutions into account. Moreover, in addition to judging whether it is appropriate to conduct examinations based on the pandemic situation and examinee institutions’ circumstances, the Bank will continue to give utmost consideration to such institutions’ situation by adjusting the schedule and scope of examinations as necessary.

(2) Giving Consideration to Financial Institutions' Operational Burden and Improving Efficiency

While making use of the information obtained through off-site monitoring, the Bank efficiently conducts examinations (hereafter referred to both as on-site examinations and examinations using remote methods) based on a risk-based approach by deciding, in a flexible and efficient manner, the frequency, length, and scope of its examinations, as well as 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 2022, in order to reduce the operational burden on examinee institutions and further improve the operational efficiency of examinations, the Bank will conduct "short-term examinations." That is, in addition to "regular examinations," which take about three weeks and consist of a comprehensive examination and assessment of financial institutions'
business conditions and risk management frameworks, the Bank will conduct more concise examinations of some regional financial institutions that will take about two weeks and are based on a risk-based approach, in which operational risk management, etc. are excluded from the scope of the examination. In addition, for 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 the group as a whole. Moreover, with regard to financial institutions where international operations make up a large share of their business, the Bank will continue to focus on the examination of such institutions' overseas branches and subsidiaries.

In addition, the Bank will further strengthen its coordination with the FSA by coordinating the planning of the FSA's inspections and the Bank's on-site examinations through the Joint Group for Coordinating FSA's Inspections and BOJ's On-Site Examinations and by sharing the findings of inspections and examinations. In conducting on-site examinations, the Bank will avoid overlapping with various joint surveys that it conducted with the FSA to take into account the operational burden on examinee financial institutions and enhance the efficiency of such examinations.

Moreover, the Bank will continue to share its awareness and strengthen cooperation with overseas regulators, mainly on issues regarding internationally active financial institutions.

(3) Gaining of Financial Institutions' Understanding

The Bank will work to enhance its communication with financial institutions being examined through a post-examination survey and interviews conducted after the examinations as necessary to gain their full understanding of and trust in the examination process and results. The Bank has constantly worked on improving on-site examination procedures by responding to opinions and requests gathered from examinee institutions, and it will continue with such efforts.

Moreover, through the regular exchange of views with members of the financial industry that started in fiscal 2021, the Bank intends to continue exchanging views on the operation of its examination and monitoring, while focusing on efforts to further strengthen coordination between the FSA and the Bank.
Issues Key to On-Site Examinations in Fiscal 2022

I. Business Management regarding Profitability and Financial Soundness

The Bank will examine whether financial institutions are making necessary efforts from the perspective of both Subsections A and B below, in order to build a sustainable business model into the future.

In relation to this, in the on-site examinations, the Bank will examine whether financial institutions can ensure sustainable profits and maintain their financial soundness by conducting simulations of their profitability. It will also conduct a profitability and financial soundness simulation under certain standard stress scenarios and discuss 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. As for some major financial institutions, the Bank, together with the FSA, will conduct supervisory simultaneous stress testing based on common scenarios as part of off-site monitoring to gain a deep understanding of risk profiles inherent in their business models, thereby developing a comprehensive perspective for evaluating their financial soundness. The Bank will also deepen dialogue with these financial institutions on their business challenges, such as the sophistication of risk management frameworks.

A. Efforts to Achieve Profits and the PDCA Cycle for Business Operations

The Bank will examine whether financial institutions, in order to achieve the profits that they should aim for, have appropriately established and operate a system (a so-called PDCA cycle for business operations) under which they formulate and implement business strategies and plans while accurately understanding the domestic and overseas business environment, examine the results, and review such strategies and plans in a timely manner in response to changes in the business environment.

---

¹ Profits here are defined as pre-provision net revenue (PPNR, excluding profits and losses from investment trusts due to cancellations) minus credit costs.
The Bank will collect information on changes in the environment surrounding financial institutions' business in a forward-looking manner, including through off-site monitoring. For example, it will continue to examine a wide range of issues such as progress in information technology, changes in lifestyle due to the impact of COVID-19, structural challenges faced by regional economies, and developments in financial regulation and supervision at home and abroad, including through the conduct of hearings on financial institutions' recognition of these issues and their innovative initiatives.

Based on such recognition of the environment, in the case of major financial institutions, the Bank will examine the following, in coordination with off-site monitoring: their global activities and group strategies (including those with regard to overseas bases and inorganic growth) in light of changes in foreign currency funding conditions, international financial regulations, and financial regulatory and supervisory frameworks in different jurisdictions; efforts in a wide range of financial services, such as those for adapting to digitalization; and business process reengineering aimed at raising business efficiency. It will then analyze the details of their efforts and effectiveness from the standpoint of group-wide profitability.

With regional economies facing an increasingly severe situation due to structural factors such as the declining and aging population, regional financial institutions urgently need to push ahead with efforts to support regional economies and strengthen their business foundations in order to firmly provide such support into the future. From this perspective, the Bank will examine the status and future feasibility of efforts to strengthen top-line earnings, including net non-interest income, as well as measures to improve business efficiency, such as a review of branch networks and staff allocations and the reengineering of business processes. In doing so, the Bank will focus on, for example, digitalization and the effects of business alliances with firms from other industries. With regard to regional financial institutions that have been pushing ahead with strengthening business foundations through 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 such measures, as well as their effectiveness. Through these examinations, the Bank will deepen dialogue with regional financial institutions on the status of implementing measures to support regional economies and strengthen their business foundations, as well as their
future policies and challenges, including the use of the Special Deposit Facility, in coordination with off-site monitoring.

In addition, the Bank will confirm whether financial institutions' profit management is appropriate in employing the PDCA cycle for business operations. In the case of major financial institutions, the Bank will examine their profitability management, mainly in light of credit risk and funding costs, 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) and (2) how these institutions ascertain and analyze profitability based on the characteristics of their credit portfolios by sector, such as by region and borrower classification.

B. Understanding of and Response to Risks Related to Business Strategies and Plans

The Bank will examine whether financial institutions have an integrated risk management framework in place that accurately identifies risks accompanying the implementation of their business strategies and plans and verifies if such risk identification is appropriate in relation to the institution's profits and equity capital, and whether the results are leading to a review of business strategies and plans. The Bank will pay particular attention to whether financial institutions ascertain risks that take into account changes in their business environment and strategies, such as the impact of COVID-19, the increase and diversification of their market investment, and responses to climate change.

In doing so, 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 the PDCA cycle for business operations.

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 climate change responses, the Bank will engage in in-depth dialogue with financial institutions regarding the following issues while taking into account guidance including monitoring viewpoints, which the FSA is considering: (1) the identification and management of climate-related financial risks; (2) measures to enhance the quality and quantity of disclosure based on the TCFD recommendations; and (3) engagement with corporate customers in pursuit of decarbonization. In doing so, the Bank, mainly as part of its off-site monitoring, will encourage financial institutions to develop their climate scenario analyses in line with their size and characteristics, taking into account (1) the pilot exercises of the scenario analysis based on common scenarios, which are being conducted by the FSA and the Bank with some major financial institutions since fiscal 2021, as well as (2) international discussions on regulations, supervision, and risk management related to climate-related financial risks.

II. Governance

A. Ensuring the Efficacy of Governance

The Bank, in the case of major financial institutions, will examine whether they have established group-based governance frameworks, including risk management and internal audits, that are appropriate for their initiatives to expand overseas activities, such as through inorganic investment, and strengthen the cross-selling of services on a group-wide basis.

For regional financial institutions, the Bank will examine whether management policies are disseminated throughout the organization, communication within the organization regarding the assessment of risks is smooth, and a governance framework is in place that enables the organization to properly harness its organizational capabilities to achieve its business strategies and plans. 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.
B. 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 risks 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.

C. Proactive Business Management and Risk Management through Internal Audits

With regard to internal audits, the Bank -- depending on financial institutions' business scope and risk taking -- will examine (1) whether the institutions appropriately decide the scope of internal audits and allocate audit resources based on recent operations and risk taking, (2) whether they have verified the appropriateness of their business operations and properly made improvements reflecting the results of the audits, and, in particular, whether headquarters audits examine in depth the effectiveness of risk management and lead to the consideration of effective improvement measures while making use of outside experts' knowledge as necessary, and (3) whether the results and recommendations of such audits are utilized in their business. 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.
D. Information Management Frameworks Necessary for Business Management and Risk Management

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 with regard to institutional frameworks, such as international financial regulations.

III. Credit Risk Management

A. Credit Screening and Monitoring

While both major and regional financial institutions have been lending actively in response to firms' increased funding needs due to COVID-19, the cumulative impact of the pandemic on firms' business as well as the impact of loan repayments on borrower firms' funding will become more important.

Given these points, the Bank will examine whether financial institutions appropriately ascertain borrowers' financial and funding conditions at the individual borrower level and the portfolio level as well as changes therein, and analyze their repayment capacity. (The Bank will also employ "line sheet reviews." The same applies throughout this section.) Moreover, the Bank will examine whether financial institutions accurately use the information thus obtained and the analysis of past cases of credit cost incurrence in their initial screening and interim management of loans. In particular, it will carefully examine whether financial institutions sufficiently comprehend the business conditions of large

2 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.
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.

Moreover, with regard to major financial institutions, the Bank will examine (1) whether they are appropriately managing credit in areas where they have been increasing their efforts, such as financing for institutional investors, including investment funds, and hybrid loans, as well as operations in other areas they have been focusing on, such as the origination and distribution of loan-related instruments, and (2) whether their headquarters have established global management and reporting rules and are appropriately monitoring them.

Furthermore, with firms' pandemic-related demand for funds having generally subsided, some financial institutions have been active in real estate-related lending. Major financial institutions are focusing on REITs and non-recourse loans, while regional financial institutions have increased housing loans and apartment loans. The Bank will also examine financial institutions' risk management with regard to real estate-related lending while paying attention to trends in asset prices.

B. Outlook for Credit Costs (Write-Offs and Loan-Loss Provisions)

The Bank will examine future credit costs and downside risks -- taking into account financial and economic conditions in Japan and abroad as well as borrowers' conditions both at the individual borrower level and the portfolio level -- and have dialogue with financial institutions on their accuracy. Moreover, the Bank will deepen its dialogue with financial institutions regarding the appropriate approach to calculating write-offs and loan-loss provisions while taking into account changes in their credit portfolios, including those caused by the pandemic. It also will exchange opinions with the accounting auditors of financial institutions as necessary.

C. Support for Firms to Improve Business Conditions

Providing support for client firms to improve their business conditions is not only a role that society expects financial institutions to play but is also an important means by which the institutions can avoid an increase in their credit costs.
From this perspective, the Bank will examine (1) whether financial institutions are accurately identifying borrowers that require such support and those that require intensive monitoring, and whether there is a review of borrowers thus identified, bearing in mind that there may be changes due to the impact of the pandemic and other factors. In addition, the Bank will examine the status and efficacy of financial institutions' support for and management of these borrowers, including the following: (2) whether financial institutions adequately analyze the current business conditions and future prospects of borrowers and share an awareness of the business challenges with them; (3) whether these institutions' headquarters and branches are cooperating in terms of offering advice, recommendations, and support to help borrowers overcome challenges; and (4) 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.

IV. Market Risk Management

A. Establishment of Management Frameworks Depending on Financial Institutions' Risk Taking

As described in Subsection 2. (2) in the main text (Issues Identified through On-Site Examinations and Off-Site Monitoring), both major and regional financial institutions have been taking on risks in market investment. In particular, at regional financial institutions, given large-scale redemptions of bonds with higher coupon rates than those of recently issued bonds, investment in risky assets has been increasing. Amid this situation, in terms of profits, the share of interest and dividend income from their holdings of securities other than yen-denominated fixed rate bonds has also been rising, and changes in global market conditions and corporate earnings have had an increased impact on their overall profits. Moreover, changes in market conditions may have a significant impact on unrealized gains/losses on securities holdings.

Against this background, the Bank will examine financial institutions' management framework to determine whether they accurately ascertain the major risk factors within their securities portfolios and monitor and measure market prices, as well as the amount of risk, etc., with proper frequency, including through stress testing. Moreover, it will examine
whether financial institutions, when formulating investment plans, verify the tolerance of these risks relative to their equity capital and profits in implementing their investment plans, and whether they assess the impact that a downward revision of interest and dividend receipts would have on their profits.

In addition, with regard to major financial institutions, the Bank will examine whether they accurately ascertain the risks inherent in their business with investors, such as prime brokerage, and whether they appropriately manage those risks by setting exposure limits. As for multi-asset investment trusts held by many regional financial institutions, it is difficult to assess the risk characteristics of some of these investment trusts because their portfolios are rebalanced frequently. On this point, the Bank will examine whether they appropriately conduct the screening at the time of purchases and the interim management.

B. Appropriateness of Various Risk and Loss Limits, and Responses to Events Based on Loss-Cut Rules

The Bank will examine whether financial institutions set various risk and loss limits at the appropriate levels relative to their financial soundness and profits, and whether these are properly reviewed. Moreover, the Bank will examine whether loss-cut rules are in place and functioning to allow for timely decisions on the appropriateness of continuing to hold securities when a mandatory consultation framework becomes requisite, such as in times of sudden changes in domestic and/or international markets, taking into account the future impact on their equity capital and profits.

V. Liquidity Risk Management

A. Foreign Currency Liquidity Risk Management of Major Financial Institutions

Given that internationally active major financial institutions have large amounts of foreign currency funding outstanding, the Bank will examine the following: (1) whether such financial institutions have set their risk appetite (such as in terms of the results of liquidity stress testing, the medium- to long-term funding ratio, etc.) in line with their foreign currency balance sheet strategy (such as with regard to whether they are planning to increase or decrease their foreign currency balance sheet and in respect to the gap between loans and deposits, the maturity gap in investment and funding, and profitability); (2)
whether such financial institutions have set up a framework that limits funding based on their funding capacity, in terms of different currencies, and have a liquidity buffer to cope with sudden outflows of funds; and (3) whether they have developed and implemented liquidity stress testing and contingency funding plans in a consistent manner on a group-wide basis, based on reasonable capital flow assumptions.

In off-site monitoring, the Bank will also continue to examine major financial institutions’ efforts to strengthen foreign currency funding bases and increase the sophistication of their risk management while cooperating with the FSA and overseas regulators that exercise jurisdiction over major financial institutions. The Bank will conduct joint surveys with the FSA on some major financial institutions and avoid overlapping with such surveys in the on-site examinations. In the joint surveys, the Bank will deepen its dialogue with financial institutions on liquidity stress testing, particularly with regard to the exchange of funds between different currencies, analyses of the stickiness of deposits and assumptions regarding outflows of funds, as well as the frequency and timeliness of stress testing. Moreover, the dialogue will also focus on the link between financial institutions’ funding limits and liquidity buffers on the one hand and their risk appetite on the other, the sophistication of their intraday liquidity risk management, and the effectiveness of their contingency funding plans.

B. Liquidity Risk Management of Regional Financial Institutions

With regard to yen liquidity risk, the Bank will examine whether regional financial institutions (1) set appropriate risk limits in light of the structure of their funding and investment portfolios while taking into account the external environment, including the aging and shrinking of the population in their customer base, and develop a framework for risk monitoring, and (2) establish a framework to promptly secure liquidity reserves at the time of emergencies. As for regional financial institutions that are actively investing in foreign currency-denominated assets, the Bank will examine their efforts toward stable foreign currency funding that takes into account market liquidity of assets and whether they have established risk management frameworks such as stress testing and emergency measures.
VI. Operational Risk Management

A. Computer Risk Management Frameworks

Focusing on financial institutions' critical computer systems, the Bank will examine the effectiveness of (1) measures to prevent computer system failures, such as their computer system maintenance and the duplication of critical systems, and (2) recovery frameworks in the event of a failure, including the planning and training for contingencies. When doing so, the Bank will also examine financial institutions' computer systems from the perspective of whether their management is in line with the use of new technologies and services brought about by advances in digitalization. Moreover, in light of the growing trend toward financial institutions' business collaborations with third parties, such as the use of cloud computing and API linkages, the Bank will examine whether they appropriately manage third parties, including existing outsourcer companies, in terms of the management of the development and operation of projects and of information security, such as with regard to customer data. Furthermore, the Bank will examine the effectiveness of financial institutions' IT governance -- their own and that of their group companies, etc. -- from the perspective of whether management resources are allocated to ensure both the efficacy of their overall system management, including cybersecurity, and efficiency with regard to their investment in computer systems.

B. Cybersecurity Management Frameworks

With regard to the status of cybersecurity management frameworks, the Bank -- while taking into account individual financial institutions' business scope -- will examine (1) the appropriateness of the collection and sharing of information on developments in ever-changing cybersecurity threats, (2) the appropriateness of the management of access rights for important data such as customer information, and (3) the effectiveness of measures to prevent cyberattacks and limit damage caused by such attacks. 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 the joint surveys with the FSA on some major financial institutions, the Bank will deepen its dialogue, particularly on (1) governance (the commitment of the boards of directors and senior management, the securing of resources for departments specialized in cybersecurity, and cooperation among business units), (2) the development of group-wide global frameworks (such as with regard to information gathering, monitoring, responses, and drills with respect to cybersecurity threats), (3) the use of threat-led penetration testing (TLPT), (4) improvement of cyber resilience (such as through developing contingency plans for ransomware attacks), and (5) the management of third parties including outsourcee companies. In conducting on-site examinations, the Bank will avoid overlapping with the joint surveys.

In cooperation with the FSA, the Bank will encourage regional financial institutions to conduct self-assessments of their cybersecurity management frameworks to ascertain their preparedness and strengthen their countermeasures.

**C. Business Risk Management and Compliance Management Framework**

Given that an increasing number of financial institutions have actively taken measures such as 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 procedures associated with recent developments and (2) whether these institutions, including their major group companies and third parties such as their outsourcee companies and partners, have appropriately established and reviewed risk management frameworks in response to changes in risk profiles. Particularly in the case of financial institutions that focus on fee-based business activities, the Bank will examine (3) 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.

**D. Anti-Money Laundering and Counter-Terrorism Financing Controls**

Given strong international requests to take measures specific to anti-money laundering and counter-terrorism financing, the FSA has stepped up its efforts since the start of 2021, such
as releasing the revised "Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism." It is essential for Japanese financial institutions to steadily implement measures in line with such guidelines to ensure the proper conduct of their business operations and to maintain their credibility. On this basis, in the on-site examinations, the Bank will examine whether financial institutions have steadily developed frameworks in these areas while sharing its awareness and perspectives with the FSA through the framework of coordination between the FSA's inspections and the Bank's on-site examinations.

**E. 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 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.