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Bank of Japan

On-Site Examination Policy for Fiscal 2020

1. On-Site Examination by the Bank of Japan

The Bank of Japan (hereafter, the Bank) formulates the on-site examination policy every fiscal year based on the decision of the Policy Board.[1] This document, "On-Site Examination Policy for Fiscal 2020," briefly reviews on-site examinations carried out in fiscal 2019 and outlines the basic approach and key issues in the conduct of on-site examinations in fiscal 2020. The Bank will conduct on-site examinations in fiscal 2020 on the basis of this document.

2. On-Site Examinations in Fiscal 2019 and General Observations

(1) On-Site Examinations in Fiscal 2019

The Bank carried out on-site examinations of 85 financial institutions in fiscal 2019: 34 domestically licensed banks, 43 *shinkin* banks, and 8 other institutions, including securities companies as well as Japanese branches and subsidiaries of foreign banks.[2]

Number of Financial Institutions Examined

(number of entities)

	Fiscal 2017	Fiscal 2018	Fiscal 2019
Domestically licensed banks	29	29	34
Shinkin banks	54	54	43
Other institutions	17	8	8
Total	100	91	85

[1] The Bank of Japan Act stipulates that "the content of a contract concerning on-site examinations" and "important matters concerning the implementation of on-site examinations for each business year" shall be determined by the Policy Board (Article 15, paragraph 2, item v).

[2] "Securities companies" in this document refers to firms that conduct securities-related business activities among those classified as Type I Financial Instruments Business in Article 28 of the Financial Instruments and Exchange Act.

(2) Issues Observed in On-Site Examinations

In the fiscal 2019 on-site examinations, the Bank reviewed financial institutions' business operations and asset quality and examined the effectiveness of their business management and risk management. In particular, it focused on ascertaining and assessing their medium- to long-term profitability and financial soundness given that the profitability of their domestic deposit-taking and lending activities continues to decline due to structural factors such as the continuing declines in population and number of firms, as well as to the prolonged low interest rate environment.

To improve their profitability, major financial institutions have continued to strengthen their group strategies and expand their overseas activities. Regional financial institutions (1) have been actively taking on risk in terms of both credit and market risk, for example, through loans to middle-risk firms and real estate loans, and through investments in investment trusts and foreign securities, which involve a variety of risk factors. They (2) also have been making efforts to increase net non-interest income by enhancing revenues from fee-based business activities such as mergers and acquisitions (M&As) for business succession and services supporting households' wealth accumulation in response to the rise in longevity.

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.

Against this background, financial institutions have continued to improve their business management and risk management frameworks. However, there were cases where (1) financial institutions had not sufficiently reviewed their management frameworks, despite changes in their risk profiles due to their more active risk taking in various areas, (2) despite the continuing decline in their profitability, they had not sufficiently ascertained their medium-term profitability and implemented countermeasures to the decline, (3) they had not established frameworks that allow flexible decision making in the event of sudden changes in financial markets at home and abroad, and (4) they were not keeping up with cybersecurity measures and information management in response to advances in digitalization.

Major financial institutions have been expanding their overseas activities, and therefore it has become important to conduct foreign currency liquidity management, including of local currencies other than the U.S. dollar, as well as credit risk management based on the increase in connectedness with overseas credit cycles. At regional financial institutions, credit costs remain low but their increase has become more pronounced. Slackness in credit screening and monitoring has started to become evident at some regional financial institutions; for example, there are downgrades of loans from normal loans to "de facto bankrupt" loans or below and other instances in which credit costs arose because of their insufficient understanding of borrowers' financial condition. The downgrading of borrower classification has continued to be observed for low-performing firms that have received protracted support from financial institutions.

Meanwhile, financial institutions' capital levels are adequate relative to the amounts of various types of risk they undertake, and financial institutions have sufficient capacity to absorb losses. However, regional financial institutions' capital adequacy ratios have been declining moderately in recent years and are likely to continue their downward trend going forward, because making profits commensurate with the increase in risk assets has been difficult.

3. On-Site Examination Policy for Fiscal 2020

(1) Basic Approach

Financial institutions are expected to contribute to corporate and household economic activities, and ultimately to raising the growth potential at both the national and regional levels by ensuring the appropriate functioning of financial intermediation. To perform this role, it is essential for financial institutions to secure solid financial bases and adopt a proactive approach toward risk taking based on clearly defined business strategies. For the purpose of achieving both in a balanced manner, financial institutions, with involvement of the board of directors and senior management, need to 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. Efforts such as these are particularly important for regional financial institutions, where domestic deposit-taking and lending activities account for a large share of business and for which both profitability and capital adequacy ratios are on a declining trend.

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, taking changes in their business operations and risk profiles into account, as well as prepare to respond to a stress event in an orderly manner.

An increasing number of financial institutions, regardless of their type, have been taking measures for cashless settlement, making use of open application programming interfaces (APIs), cloud computing, and artificial intelligence (AI), and introducing robotic process automation (RPA) for routine tasks. This spread of digitalization has started to significantly change the way financial services are provided as well as the competitive environment for financial institutions, such as through entrants from other industries. 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, the importance of cybersecurity and information management is increasing. Financial institutions need to strengthen their cyber risk management frameworks since cyberattacks have actually been targeting financial institutions and have increased sophistication.

In addition, close attention also should be paid to how financial institutions will be prepared for the permanent discontinuation of LIBOR projected for the end of 2021, and how the business of financial institutions will be affected by developments surrounding climate change issues, social development goals (SDGs), and environmental, social, and governance (ESG) issues, all of which are gaining global interest. The Bank also will pay close attention to how the evolving situation regarding the novel coronavirus will affect financial institutions' business operations and various risks.

Against this background, and based on the challenges identified in the fiscal 2019 on-site examinations, the Bank intends to conduct the fiscal 2020 on-site examinations from the following perspectives.[3]

First, the Bank will examine the effectiveness of financial institutions' business management regarding their profitability and financial soundness, based on the view of the board 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, the Bank will deepen its dialogue with the board of directors and senior management on (1) whether their view of their medium- to long-term profitability and financial soundness is appropriate, and (2) whether they are taking appropriate measures on this basis, such as measures to increase net non-interest income and improve business efficiency, as well as strategic investments. The Bank also will confirm how financial institutions have placed 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 the more pronounced increases in credit costs and the recall of the financial inspection manual of the Financial Services Agency (FSA) of Japan, 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 commensurate with changes in the financial and economic environment, etc. 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.

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

In the case of financial institutions with recognized concerns about their future profitability and financial soundness, the Bank will focus its dialogue with the board of directors and senior management on the capital levels necessary to perform their financial intermediation functions 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.

The Bank also will examine preparedness for the permanent discontinuation of LIBOR, including process management, given that wide-ranging responses within a limited time frame are required. The Bank will confirm the role of climate change issues, SDGs, and ESG issues in financial institutions' business and their efforts in these areas.

Second, the Bank will review current developments and future directions of financial institutions' risk profiles and then examine the effectiveness of their risk management.

With regard to credit risk, the Bank will examine whether financial institutions' screening and monitoring are appropriate and how the risk characteristics of credit portfolios are analyzed, focusing on the sectors where financial institutions have been making strong commitments: overseas loans such as those related to large cross-border M&As and leveraged loans at major financial institutions, and loans to middle-risk firms and real estate loans at regional financial institutions. With regard to market risk, the Bank will examine risks involved in securities portfolios as financial institutions have actively engaged in risk taking; for example, major financial institutions invest in foreign credit instruments such as collateralized loan obligations (CLOs) and bank loan funds, and regional financial institutions invest in securities such as 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 importance. Given the increases in major financial institutions' overseas assets, the Bank will examine the appropriateness of their foreign currency liquidity risk management. It should be noted that, most recently, due to the concerns about the spread of the novel coronavirus, domestic and overseas financial markets have been unstable and uncertainty over future economic developments has grown. Against this background, the Bank will examine whether financial institutions ascertain the business conditions of borrowers in an appropriate and timely manner and take effective measures for their business challenges, as well as whether these institutions' market risk management frameworks function sufficiently in response to changes in financial markets at home and abroad.

Third, the Bank will examine the status and effectiveness of financial institutions' governance framework that is necessary to ensure the effectiveness of business management and risk management. In this regard, 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.

Fourth, the Bank's basic policy is to conduct on-site examinations in a flexible and efficient manner in accordance with observed risks, as well as the status of financial institutions' profitability and financial soundness. In addition, the Bank, taking into account the recent situation regarding the novel coronavirus and with a view to preventing the spread of the infection, will take necessary measures in conducting on-site examinations while giving the utmost consideration to the situation faced by examinee institutions. Meanwhile, with regard to globally operating major financial institutions, major group companies, including their overseas branches and subsidiaries, will be subject to the on-site examinations as necessary.

(2) 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 by conducting simulations of their profitability. In doing so, the Bank will confirm with the board 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 board 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. In doing so, the Bank will focus on their efforts in terms of, for example, credit cost reductions due to the strengthening of credit management, an increase in net non-interest income, optimization of branch operations and staff allocations, as well as provision of new financial services and a fundamental increase in business efficiency, both brought about by digitalization. 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 belonging to a holding company, the Bank will examine the status of implementing measures to produce positive effects of business integration, as well as the effectiveness of such measures.

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.

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 board 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 sudden 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 board 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.

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

With the focus of international discussions on financial regulations shifting from formulation to implementation, the Bank will confirm, as necessary, preparedness for newly implemented international regulations 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 that take into account credit risk and funding costs, focusing on their overseas activities.

In the case of regional financial institutions, the Bank will examine (1) how these institutions 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 Discontinuation of LIBOR

The Bank will examine whether financial institutions have established a framework for deliberation on the permanent discontinuation of LIBOR. It also will examine whether these institutions appropriately assess the number and amounts outstanding of derivative contracts, corporate loans, and corporate bonds that are referencing LIBOR and then make steady progress, including in terms of process management, on responses with regard to computer systems, accounting, and risk management as well as progress on preparations for contract replacement and for agreement on replacement rates for LIBOR.

b. Governance

Ensuring the Effectiveness 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 board 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 internal audit division adequately performs audits; and (3) whether the board 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 internal audit division 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 board 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, and Establishment of Frameworks Compatible with Lending Strategies

The Bank will examine, including through selected loan reviews ("line sheet reviews"[4]), sectors in which financial institutions have increased loans outstanding -- for major financial institutions, such sectors include loans related to large cross-border M&As, while those for regional financial institutions include loans to middle-risk firms and real estate loans -- as to (1) whether financial institutions properly assess the viability of borrowers' business in conducting credit screening, taking account of such factors as lending periods and business characteristics, and (2) whether they properly ascertain changes in business conditions of borrowers and their financial condition after loan execution. In addition, the Bank will examine (3) financial institutions' analysis on risk characteristics of credit portfolios in these sectors 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.

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[4] A line sheet review consists of (1) interviews with branch managers, etc. on the basis of documents ("line sheets") containing information on developments in the financial condition, developments in the borrowing and repayment situation, and future prospects of chosen individual borrowers, as well as the financial institution's self-assessment results, lending policy, etc., and (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.

Strengthening the Management of Foreign Credit Exposures

Major financial institutions have committed to focusing on leveraged loans and loans to non-investment-grade firms as part of their efforts to enhance their overseas activities. Moreover, some regional financial institutions have increased their foreign credit exposures through, for example, lending to existing customers for their overseas business and joining syndicated loans. Against this background, some developments in overseas credit markets warrant attention in terms of risk management, such as the relaxation of covenants in leveraged loans and the rise in leverage ratios. For this reason, in the case of major financial institutions, the Bank will examine (1) while making use of line sheet reviews, whether financial institutions have adequately conducted credit screening and monitoring, mainly for loans to non-Japanese firms, as they have focused on such sectors in recent years; (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 on-site examinations 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 their credit screening and monitoring.

Strengthening the Management of Large Exposures/Concentration Risk

The Bank will examine (1) through line sheet reviews how financial institutions comprehend the business conditions of borrowers with large exposures, conduct credit screening and monitoring, including of the accuracy of self-assessments, and secure appropriate write-offs and loan-loss provisions. In addition, it will examine (2) whether financial institutions properly ascertain the status of large exposures/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 exposures/concentration risk, taking into account their equity capital, etc., and ensure their effectiveness.

Appropriate Write-Offs and Loan-Loss Provisions

It is increasingly important to accurately ascertain the prospects for future credit costs amid the continued decline in financial institutions' core profitability. In the on-site examinations, through line sheet reviews, 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.

Support for Resolving Firms' Business Challenges

Financial institutions are expected to provide continuous support for borrowers' efforts to resolve their business challenges. In the case of regional financial institutions in particular, given that part of the reason for increases in credit costs in recent years is the delay in improvement of business conditions for low-performing firms that have received protracted support from regional financial institutions, the Bank will examine (1) whether these 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 and bank loan funds.

Given large-scale redemptions of bonds with higher coupon rates than those of recently issued bonds, an increasing number of regional financial institutions have been increasing the duration of yen-denominated bondholdings and purchasing such products as foreign bonds, privately placed real estate investment trusts (REITs), structured bonds, and multi-asset investment products. 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 polices 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 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 risk management division monitors 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 board 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 products with portfolios that are rebalanced frequently. For financial institutions with large exposures to these products, the Bank will examine whether they accurately ascertain changes in the risk characteristics, and on this basis appropriately conduct the screening at the time of purchases and the interim management.

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 financial institutions, the Bank, while identifying the impact of international financial regulations, 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 and (5) whether financial institutions assume specific amounts of foreign currency outflow with the lapse of time, secure corresponding funding tools, and review their appropriateness.

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 and the establishment of the frameworks for risk monitoring and control.

f. Operational Risk Management[5]

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

Given that an increasing number of financial institutions have taken measures such as use of digital technology, concentration of business operations, and review of staff allocations, the Bank will examine (1) whether financial institutions adequately recognize changes in the risk profiles of business 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) compliance risks associated with 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.

[5] 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.

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, 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. Moreover, given that it is difficult to prevent cyberattacks completely, it will examine the effectiveness of frameworks and contingency plans in preparation for the occurrence of cyber incidents, the implementation of drills, and the review of management frameworks reflecting the outcomes of such drills. 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 information.

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 effectiveness 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 also 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. For this reason, the Bank will examine, taking account of individual financial institutions' business scope, as well as these institutions' presence in payment and settlement systems and in their respective business areas, whether business continuity management is reviewed appropriately in response to, for example, the recent increase in the frequency of natural disasters such as earthquakes, typhoons, and floods, as well as the spread of new infectious diseases.

(3) Operations of On-Site Examination

a. Enhancing of Efficiency and Effectiveness

The frequency, length, and scope of the Bank's on-site examinations, as well as the number of examiners involved, have been determined on the basis of a comprehensive assessment of individual financial institutions, including 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, in addition to "regular on-site examinations" to comprehensively examine and assess -- through on-site visits over a period of about three weeks -- the business conditions and risk management frameworks of financial institutions, the Bank will introduce new "short-term on-site examinations," which exclude such examinations as of operational risks, through on-site visits over a period of about two weeks. With regard to financial institutions that provide a wide range of financial services on a group basis, the Bank will examine major group companies, as necessary, to ascertain the business conditions of a group as a whole. Given the increased weight of international businesses, it also will continue to focus on its examination of such institutions' overseas branches and subsidiaries.[6]

b. Consideration of Administrative Burden and Understanding for Financial Institutions

Line sheet reviews are useful from the perspective of concretely understanding the actual situation of regional economies and changes in the behavior of financial institutions, and the Bank will continue with these in the fiscal 2020 on-site examinations, while taking into account the administrative burden on financial institutions. Given that increases in credit costs have become more pronounced, the Bank will examine the accuracy of self-assessments of financial institutions, particularly those with certain issues regarding the quality of their assets, etc.

Since on-site examinations of financial institutions' branches are useful in ascertaining the governance of examinee institutions and the efficiency of branch management, the Bank will continue with on-site examinations of branches in fiscal 2020. However, taking into account the administrative burden on branches, it will not conduct examinations aimed at confirming operational accuracy except in the case of financial institutions that have particular problems, such as incidents of fraud or accidents in business operations.

The Bank also will keep striving to reduce the burden of on-site examinations by taking into consideration how busy financial institutions are and by deciding, in a prioritized manner and based on the business challenges faced by individual financial institutions, the documents to be submitted beforehand, as well as the items to be examined at the time of on-site examinations. In addition, the Bank, taking into account the recent situation regarding the novel coronavirus 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.

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

Moreover, to further enhance the efficiency and effectiveness of on-site examinations, the Bank will continue to strengthen the linkage between its on-site examinations and off-site monitoring, including of overseas offices. It also will focus on awareness-raising activities through such initiatives as holding seminars for financial institutions regarding cybersecurity. The Bank aims to share its awareness and strengthen cooperation with the FSA, as well as with overseas regulators mainly on issues common to internationally active financial institutions.

The Bank will work to enhance its communication with 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 revisit the financial institution and conduct interviews, as necessary.