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Bank of Japan

On-Site Examination Policy for Fiscal 2023

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 conducting on-site examinations and off-site monitoring, it is becoming increasingly important to assess financial institutions' soundness and risk management in a swifter and more continuous manner and to monitor changes in the financial system as a whole in a timely fashion, in light of changes in the environment surrounding the financial system and various challenges faced by financial institutions.

In fiscal 2022, the Bank worked to strengthen the integration of on-site examinations and off-site monitoring by deepening information sharing between the on-site examination section and the off-site monitoring sections at the head office and branches. In addition, based on "Initiatives for Further Strengthening Coordination between the Financial Services Agency and the Bank of Japan" released in March 2021, the Bank deepened coordination with the Financial Services Agency (FSA) through a wide range of initiatives, including joint surveys with the FSA targeting major financial institutions, and worked on monitoring the financial system in more detail.[2,3]

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

2 See "Initiatives for Further Strengthening Coordination between the Financial Services Agency and the Bank of Japan" (March 22, 2021) at https://www.boj.or.jp/en/finsys/cofsa/rel210322c.pdf and "Progress in Initiatives for Further Strengthening Coordination between the Financial Services Agency and the Bank of Japan" (June 17, 2022) at https://www.boj.or.jp/en/finsys/cofsa/rel220617a.pdf.

3 Topics of the joint surveys in fiscal 2022 include the following: the supervisory simultaneous stress testing based on common scenarios as well as joint surveys on foreign currency liquidity risk management and on cybersecurity management were conducted, and the results of a pilot exercise of climate scenario analysis were released (see Subsection 2. (2)). Topics will be reviewed as appropriate in consultation with the FSA in line with their importance to the financial system.

In the "On-Site Examination Policy for Fiscal 2023," the Bank outlines the situation of financial institutions' business management and risk management as assessed from on-site examinations and off-site monitoring in fiscal 2022. It also compiles issues key to conducting on-site examinations in fiscal 2023 and operations of on-site examinations while also taking into account recent changes in the environment.

2. On-Site Examinations in Fiscal 2022 and General Observations

(1) On-Site Examinations in Fiscal 2022

The Bank carried out on-site examinations of 61 financial institutions: 20 domestically licensed banks, 37 *shinkin* banks, and 4 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 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] In fiscal 2022, the Bank partially resumed on-site examinations; that is, visited financial institutions' premises while continuing to use remote methods.

Number of Financial Institutions Examined

(number of entities)

	Fiscal 2020	Fiscal 2021	Fiscal 2022
Domestically licensed banks	18	18	20
Shinkin banks	14	34	37
Other institutions	5	7	4
Total	37	59	61

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

[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.

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

(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 2022, 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. The smooth functioning of financial intermediation has been maintained even under various types of stress since the outbreak of COVID-19, including supply constraints and rises in energy and raw material prices under the normalization of economic activity, the materialization of geopolitical risks, and the rise in foreign interest rates.

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 such as non-interest services, in a situation where their core profitability has been pushed down due to structural factors such as a declining population and the prolonged low interest rate environment in Japan. In this situation, some regional financial institutions have not sufficiently ascertained the impact that repayment of principal for effectively interest-free and fully guaranteed loans, which have increased substantially since the outbreak of COVID-19, will have on their future profitability. Moreover, some regional financial institutions have found it difficult to sufficiently take necessary measures in their business management and risk management due to staff shortages amid moves to curb expenses.

Furthermore, while some have entered into capital and business alliances with other financial institutions or with firms from other industries in order to strengthen their business foundations, there were some cases where regional financial institutions struggled with examining specific measures to stabilize profits or ensuring their risk communication with alliance partners.

Meanwhile, on the back of digitalization/digital transformation (DX), 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. Against this background, the Bank, together with the FSA, implemented a self-assessment survey for regional financial institutions to encourage them to make their own efforts to strengthen cybersecurity measures, returned the aggregated results to financial institutions, and exchanged views with the relevant industry associations. Moreover, with regard to climate-related financial risks, the Bank, in cooperation with the FSA, conducted a pilot exercise of climate scenario analysis targeting some major financial institutions, and the two entities jointly released the "Pilot Scenario Analysis Exercise on Climate-Related Risks Based on Common Scenarios." Many regional financial institutions are also working on raising awareness among small and medium-sized firms. Some regional financial institutions have begun to support efforts by their corporate customers to measure greenhouse gas emissions, while others are working on enhancing products and services such as sustainability-linked loans and green loans or conducting quantitative assessments and disclosures of transition and physical risks.

Credit Risk

Since the outbreak of COVID-19, financial institutions have continued to actively provide financing support to firms and households, including effectively interest-free and fully guaranteed loans. Some major financial institutions have been focusing on financing for institutional investors, including investment funds, M&A financing, and real estate-related lending, whereas some regional financial institutions are focusing on "cross-border" lending and real estate-related lending. Against this background, credit costs have leveled out since fiscal 2021, partly due to the rise in loan-loss provisions for industries heavily affected by the pandemic in fiscal 2020. However, there were 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 financial institutions have focused. Moreover, with regard to large borrowers having unfavorable business conditions since before the pandemic, some financial institutions experienced risks building up as they continued to provide loans without making efforts toward devising more drastic solutions to address management challenges and the loan-loss provision ratio was low relative to the amount of uncovered loans.

Market Risk

Although both major and regional financial institutions have been actively taking on market risk in recent years under the prolonged low interest rate environment, they have been somewhat cautious in light of changes in market conditions such as the rises in interest rates and volatility.

Against this background, some regional financial institutions have suffered a substantial increase in valuation losses due to inadequate responses to the breach of loss limits when prices of foreign bonds declined due in part to rising foreign interest rates, while others have failed to adequately examine their risk tolerance including the impact on their distributable profits. Moreover, there were also some regional financial institutions that did not sufficiently ascertain the impact on their future earnings of the risk of declining interest and dividend income or redemption losses due to falling prices of foreign bond investment trusts. Thus, many regional financial institutions were found to have issues in terms of the effectiveness of their risk management, such as the examination of their risk tolerance, including the analysis of downside scenarios, and the formulation of policies in the event of sudden changes in the market.

Liquidity Risk

As they expand their overseas business, major financial institutions are facing the challenge of achieving stable foreign currency funding based on appropriate foreign currency liquidity risk management. In addition to efforts to secure foreign currency deposits, the stickiness of which is relatively high, in the face of rising foreign interest rates, they are aiming to maintain funding stability by, for example, building up FX and currency swap funding. Moreover, they are continuing to work on refining their stress testing and developing data systems. While many regional financial institutions have sufficient yen liquidity and have no problems in managing it, some have not reviewed their emergency responses, mainly in response to staff reductions at branches. As for foreign currency funding, it is institutions that are highly dependent on short-term market funding, etc. that are particularly facing challenges in securing stable funding means in response to changes in their risk profiles and in strengthening their ability to respond in the event of stress.

Operational Risk[6]

With regard to computer system risks, while both major and regional financial institutions are increasingly using new digital technologies, cyber threats such as ransomware attacks are becoming more prevalent. With the use of cloud computing advancing, there were some institutions that had inadequate risk management frameworks, such as risk management standards and security settings. Moreover, regarding cybersecurity management, there were some cases where the investigation of potential vulnerabilities was inadequate, while in other cases, the security of data encryption was not sufficiently ensured. 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. With regard to cybersecurity management of some major financial institutions, there were challenges in improving the effectiveness of countermeasures against vulnerabilities and backup systems on a group and global basis.

The investigation of anti-money laundering and counter-terrorism financing measures began in earnest with the fiscal 2022 on-site 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, the Bank looked into whether financial institutions were steadily improving their frameworks for anti-money laundering and counter-terrorism financing. The examinations showed that, while institutions overall were taking steps to improve their frameworks, there were still some institutions that were

[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.

lagging behind, such as in terms of sufficient involvement of the boards of directors and senior management.

3. On-Site Examination Policy for Fiscal 2023

On-site examination policy for fiscal 2023 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 such as various business support fees, (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 digital technologies.
  -- 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 in coordination with off-site monitoring.
  -- With regard to regional financial institutions that are facing more severe staff constraints, mainly due to moves to contain costs and to recruitment difficulties, the Bank will also examine the sufficiency of their business management and risk management under these circumstances.
- 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) make loan and deposit projections and ascertain risks that take into account changes in their business environment, such as the impact of COVID-19, rises in energy and raw material prices, and repayment of principal for effectively interest-free and fully guaranteed loans (including early repayment), (2) examine the impact on their profits and equity capital, and (3) have put countermeasures in place.
- Financial institutions' financial soundness and profit management, mainly in light of the following factors that reflect changes in domestic and overseas yield curves and the rise in volatility: increased valuation losses on securities holdings and risk; the decline in interest and dividends on securities and negative interest spreads; losses on the redemption of mutual funds; and the impact on loan and deposit income.
  -- The Bank will check these through profitability simulations, etc., based on the composition and diversity of financial institutions' assets and liabilities.
- 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 dividend distributions that take into account valuation gains/losses on securities holdings. 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, global activities, as well as financial regulatory and supervisory frameworks in different jurisdictions.
- 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, mainly taking into account the impact of COVID-19, rises in energy and raw material prices, and repayment of principal and interest for effectively interest-free and fully guaranteed loans after the exemption period for interest payment. Moreover, whether they use such information (1) in their initial screening, (2) in considering methods for write-offs and loan-loss provisions (including the sufficiency of loan-loss provisions for large borrowers having unfavorable business conditions since before the pandemic), (3) in estimating future credit costs in light of refinancing guarantees for effectively interest-free and fully guaranteed loans as well as the expected shift to regular loans, and (4) in the calculation of downside risks.
- Whether financial institutions are identifying borrowers that require support for improving their business conditions, as well as the status of financial institutions' effective support for and management of their borrowers. In particular, the status of drastic support measures to address management challenges for large borrowers having unfavorable business conditions since before the pandemic.

- Credit screening of real estate-related loans and management of risk-weighted assets (including the impact of the Basel III finalization), as well as frameworks for credit screening and monitoring with regard to other areas of focus (financing for institutional investors and M&A financing at major financial institutions, "cross-border" lending at regional financial institutions, etc.).

Market Risk

- Whether financial institutions ascertain risks and have established risk management frameworks in line with the size and diversity of securities portfolios. 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 at times of market turmoil.

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.
- Whether financial institutions, particularly regional financial institutions that are highly dependent on short-term foreign currency market funding, etc., have secured stable means of foreign currency funding, and have established risk management frameworks, such as conducting and utilizing stress testing and improving the effectiveness of emergency measures.

Operational Risk

- Whether financial institutions have established management frameworks that cover third parties and group companies amid growing business collaborations with them.

- Whether financial institutions have ensured cybersecurity, including that of cloud computing, amid advances in digitalization and rising threat of cyberattacks.[7] Regarding computer risk 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. Moreover, the appropriateness of management frameworks for large-scale projects such as the move toward open core banking systems.
- Management of progress on whether financial institutions have developed frameworks for anti-money laundering and counter-terrorism financing.[8]

4. Operations of On-Site Examinations

(1) Full-Scale Resumption of On-Site Examinations While Taking Account of the COVID-19 Situation

While taking account of the COVID-19 situation, the Bank will resume on-site examinations in earnest; that is, visit financial institutions' premises, and focus on hybrid-type examinations that combine remote methods such as web conferencing.

Specifically, during the "regular examinations," which take about three weeks and consist of a comprehensive examination and assessment of regional financial institutions' business conditions and risk management frameworks, the first two weeks or so will basically be spent conducting on-site examinations, while the last week or so will be spent conducting examinations using remote methods. Moreover, depending on factors such as the pandemic situation and examinee institutions' circumstances, the Bank may adjust the relative length, etc. of on-site and remote examinations and/or may conduct examinations entirely on-site or using remote methods.

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[7] In the on-site examinations, the Bank will make use of the results of the self-assessment survey on regional financial institutions' cybersecurity management frameworks that it conducted in cooperation with the FSA.

[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.

(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.

From fiscal 2022, in order to reduce the operational burden on examinee institutions and further improve the operational efficiency of examinations, the Bank has conducted "short-term examinations" of some regional financial institutions, and will continue with such examinations in fiscal 2023; "short-term examinations" are more concise examinations 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, 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.

Attachment

Issues Key to On-Site Examinations in Fiscal 2023

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.[1] 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, including the framework for conducting stress testing.

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 (1) progress in information technology (IT), (2) the impact of COVID-19, supply constraints, and rises in energy and raw material prices, (3) structural challenges faced by regional economies, (4) developments in financial regulation and supervision at home and abroad, (5) the impact of geopolitical risks, (6) uncertainties over global financial and economic conditions, and (7) responses to climate change, 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/DX; 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, it is important for regional financial institutions to continue 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 (1) the impact of changes in yield curves and repayment of principal for effectively interest-free and fully guaranteed loans (including early repayment) on loan and deposit income, as well as (2) the status and future feasibility of efforts to strengthen top-line earnings, including net non-interest income such as various business support fees, and of 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/DX and the effects of business alliances with firms from other industries. Moreover, as for regional financial institutions that are facing more severe staff constraints, mainly due to moves to contain costs and to recruitment difficulties, the Bank will also examine the sufficiency of their business management and risk management under these circumstances. 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 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 whether their company-wide financial goals are consistent with profitability management for each business division and client firm, as well as whether profit management is effective. In the case of regional financial institutions, the Bank will examine whether they have worked on basic matters such as ascertaining the profit outlook with a certain degree of accuracy. In addition, it will examine (1) how regional financial institutions 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, while taking into account their profitability, financial soundness, and business scope.

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, including the treatment of valuation losses on securities holdings, 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, supply constraints, as well as rises in energy and raw material prices, developments in financial markets, responses to climate change, and geopolitical risks.

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. In particular, through profitability simulations, etc., the Bank will examine the appropriateness of financial institutions' financial soundness and profit management, mainly in light of the following factors that reflect changes in domestic and overseas yield curves and the rise in volatility: increased valuation losses on securities holdings and risk; the decline in interest and dividends on securities and negative interest spreads; losses on the redemption of mutual funds; and the impact on loan and deposit income. In addition, the Bank will examine whether financial institutions have analyzed the impact of changes in institutional frameworks, such as the Basel III finalization, on the capital adequacy ratios, and have made use of such analysis in formulating business plans.

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 ascertain the progress and challenges regarding the following issues according to their size and characteristics, while taking into account "Supervisory Guidance on Climate-related Risk Management and Client Engagement" published by the FSA: (1) the identification and management of climate-related financial risks (including quantitative assessments of transition and physical risks); (2) measures to enhance the quality and quantity of disclosure based on the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD); and (3) engagement with corporate customers in pursuit of decarbonization (including raising awareness among small and medium-sized firms, supporting efforts to measure greenhouse gas emissions, and enhancing products and services such as sustainability-linked loans and green loans). The Bank will also engage in in-depth dialogue with financial institutions on these issues in coordination with off-site monitoring. 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 exercise of the scenario analysis based on common scenarios, which was conducted by the FSA and the Bank with some major financial institutions in fiscal 2021 and 2022, 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, including financial services for which they are stepping up and expanding efforts, such as non-interest services, (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 completeness, accuracy, and timeliness of information, etc. 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, in addition to the impact of the pandemic, the impact of supply constraints and rises in energy and raw material prices will become more important.

Given this situation, 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 financial analysis at the individual borrower level and the portfolio level, as well as "line sheet reviews."[2] 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 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, among major and regional financial institutions, some have been active in real estate-related lending, such as real estate investment trusts (REITs), non-recourse loans, apartment loans, and housing loans. With regard to such financial institutions, the Bank will check whether they examine borrowers' cash flow in the initial screening while taking into account assumed stress events, whether they conduct careful interim management based on developments in asset values (including the management of individual loans and

[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.

portfolio analyses), and whether their risk asset management including the impact of the Basel III finalization is appropriate. The cash flow examination of loans with long loan terms is important not only for real estate-related loans such as apartment loans, but also, for example, for loans for solar power generation (including the examination of borrowers' accumulation of disposal costs).

Moreover, regarding regional financial institutions that are focusing on "cross-border" lending, the Bank will examine whether their credit screening and monitoring of such lending are appropriate. As for 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 M&A financing, 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.

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, borrowers' conditions both at the individual borrower level and the portfolio level, and the status of loan coverage ratios and loan-loss provision ratios -- and have dialogue with financial institutions on their accuracy. In doing so, the Bank will examine the outlook for credit costs, mainly in light of the impact that repayment of principal and interest for effectively interest-free and fully guaranteed loans after the exemption period for interest payment will have on borrowers' financial and funding conditions, as well as refinancing guarantees for such loans and the expected shift to regular loans. Moreover, the Bank will deepen its dialogue with financial institutions regarding the appropriate approach to calculating write-offs and loan-loss provisions, and exchange opinions with the accounting auditors of financial institutions as necessary. In particular, the Bank will engage in in-depth dialogue regarding large borrowers having unfavorable business conditions since before the pandemic, including on the sufficiency of loan-loss provisions.

C. Support for Firms to Improve Business Conditions

The Bank will examine (1) whether financial institutions are accurately identifying, for example, borrowers that require support to improve their business conditions, mainly taking account of the impact of supply constraints and rises in energy and raw material prices. 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; (4) whether these institutions are providing support for business succession as necessary; and (5) 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. Regarding large borrowers having unfavorable business conditions since before the pandemic in particular, the Bank will deepen dialogue with financial institutions to examine whether risks have built up; for example, whether they have continued to provide loans without making efforts toward devising more drastic solutions to address management challenges.

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), issues have been found in terms of the effectiveness of financial institutions' risk management amid a decline in prices of foreign bonds due in part to rising foreign interest rates. As a result, some financial institutions have incurred a large amount of valuation losses while others did not sufficiently ascertain the impact on their profitability and financial soundness.

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, 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 foreign currency liquidity risk, particularly with regard to regional financial institutions that are highly dependent on short-term market funding, etc., as well as those that are actively investing in foreign currency-denominated assets, the Bank will examine whether they have secured stable funding means that take into account market liquidity of assets and have established risk management frameworks, such as conducting and utilizing stress testing and improving the effectiveness of 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/DX. 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 outsourcee companies, in terms of the management of the development and operation of projects, a collaborative framework at times of system failures, and information security, such as with regard to customer data. Furthermore, regarding whether financial institutions, in large-scale projects such as the move toward open core banking systems, are managing the various projects and outsourcees appropriately, the Bank will examine this while also investigating outsourcees, and check deliberations for the next system (including joint systems to be used by regional financial institutions). In addition, 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 (including the use of cloud computing) -- will examine (1) the appropriateness of the collection and sharing of information on developments in ever-changing cybersecurity threats, (2) the effectiveness of countermeasures against vulnerabilities, (3) the appropriateness of the management of access rights for important data such as customer information, and (4) 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 including budgets and staff, and cooperation among business units), (2) the development of group-wide global frameworks (such as with regard to information gathering, defenses, 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 continue to implement a self-assessment survey on regional financial institutions' cybersecurity management frameworks and encourage them 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 monitoring of such measures. It is essential for financial institutions to steadily implement these measures 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 continue to 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.