

**Bank of Japan presents the summary of an article published in the May edition of its Quarterly Bulletin** BANK OF JAPAN, COMMUNICATION, 30/5/97.

**Checklist for Risk Management (Revised Edition)**

The English version of the Checklist published in the May 1997 issue of the *Bank of Japan Quarterly Bulletin* includes specific sample questions in addition to check points that were provisionally published in the November 1996 issue. The original Checklist written in Japanese has precedence over this English version.

**I. Objectives**

The Bank Supervision Department of the Bank of Japan initially compiled the Checklist for Risk Management (hereafter referred to as the former Checklist) in December 1987 to assist examiners in assessing the adequacy of risk management at individual banks during on-site examinations. The former Checklist was distributed to financial institutions under the Bank's supervision as a reference for checking and strengthening their risk management systems.

Amid the progress in financial liberalization and innovation that has taken place during the past several years, financial institutions have expanded the scope of their business activities, and this has enabled them to pursue higher returns by taking on risks freely while giving consideration to market rules. At the same time, this has led to a better understanding by financial institutions of the importance of maintaining the balance between risk and return by adequately assessing and controlling risk exposure. As a result, financial institutions are taking the initiative in strengthening and upgrading their risk management systems in order to secure financial safety and soundness.

With these changes in the environment surrounding financial institutions, the Bank of Japan has recognized the increased importance of adequately assessing any future threats to the safety and soundness of financial institutions. This implies nothing more than further strengthening and promotion of the same kind of examination focused on risk management as in the past. With this aim, the Bank Supervision Department has comprehensively revised the former Checklist (hereafter referred to as the new Checklist).

Like its predecessor, the new Checklist has been distributed to all banks subject to the Bank of Japan's supervision, as it is intended to assist banks in reviewing and strengthening their risk management systems based on the principle of self-responsibility, while serving as a guideline for bank examiners. As this revised document includes some points that will be equally useful to those financial institutions not subject to the Bank's supervision (such as some *shinkin* banks, credit cooperatives, agricultural cooperatives, and labor credit associations) and business enterprises, the new Checklist is presented in the *Quarterly Bulletin*.

**II. Major Features**

The most prominent feature of the new Checklist is the change in categorization. In view of the transformation of risk management emphasis from heightening recognition of risks in the former Checklist to the recent actual control of risks, the overall structure of the Checklist has been altered from the eight categories by type of risk in the former Checklist (credit risk, interest rate risk, foreign exchange risk, liquidity risk, operations risk, electronic data processing [EDP] risk, systemic risk, and management risk) to four categories by type of operation (management and internal controls, lending operations, market operations and asset and liability management [ALM], and business operations and EDP).

The Checklist has also been revised to reflect the important points in risk management acquired during the Bank's past on-site examinations, while giving due consideration to the various reports and guidelines of international organizations and foreign financial authorities, and to trading practices in Japan.

Concretely, the section on management and internal controls emphasizes basic management policy and strategy concerning risk management, while including items regarding legal compliance and countermeasures against disasters. This section is given the highest priority in the new Checklist.

Second, against the background of the increase in nonperforming assets accompanying the bursting of the "bubble" economy, the section on lending operations has been strengthened to reflect points important in the evaluation of creditworthiness and avoidance of credit concentration. At the same time, this section promotes comprehensive management of domestic, overseas, on-balance-sheet, and off-balance-sheet transactions, and includes general remarks foreseeing the introduction of a loan grading and review system, further contributing to the continued enhancement of risk management as a whole.

Third, the section on market operations and ALM has been expanded in content, as this section is the most strongly influenced by the progress in financial liberalization and innovation, namely, the rapid growth in derivatives transactions and the greater impact of ALM skills on profit/loss of financial institutions. This section incorporates numerous concepts from the Checklist for Risk Management on Derivatives Transactions, which was compiled and issued in April 1995, and reflects new risk management techniques and lessons learned from some of the recent financial incidents.

Fourth, with the development of EDP at financial institutions, more weight has been put on EDP in the section on business operations and EDP. Furthermore, to reinforce the importance of the accuracy of individual offices' work, this section has given as comprehensive a treatment as possible to such issues as new types of transactions accompanying progress in information technology (i.e., fund transactions using customers' computer terminals).