Monitoring Report on Regional Banks' Securities Investment Management

Overview

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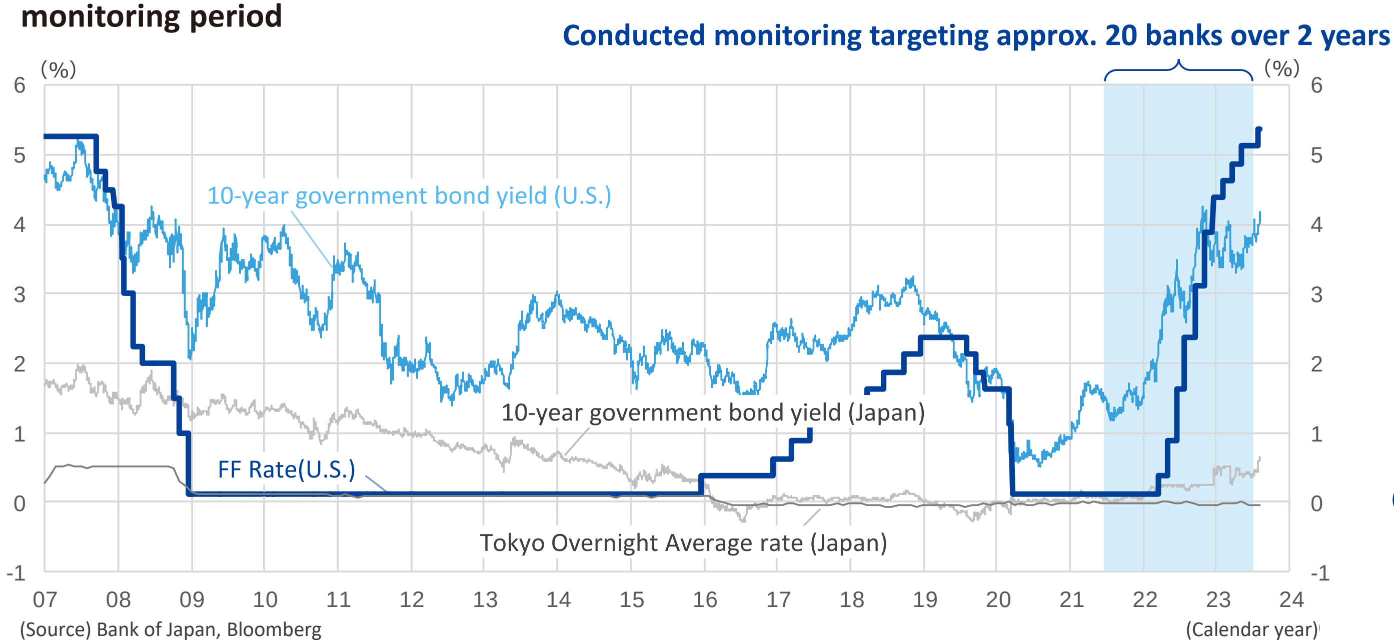
September 8, 2023

Financial Services Agency

Ⅰ. Purpose of the Report

- The Financial Services Agency (FSA), from the perspective of maintaining the stability of the financial system in Japan, conducts intensive monitoring of regional banks' securities investment, targeting those with large risk-taking in securities investment. The monitoring is carried out by the Monitoring Division of the Strategy Development and Management Bureau in collaboration with the Supervision Bureau and Local Financial Bureau **<Figure 1>.**
- Taking into account the business environment, scale, and characteristics of banks, we conduct monitoring based the following discussion points:
  - **A. Risk-taking commensurate with their financial strength and risk control capabilities.**
  - **B. Building effective investment and risk management systems commensurate with risk-taking.**
  - **C. Demonstrating effective risk governance.**
- The key findings and observations obtained from the monitoring include contents that can be useful for financial institutions other than the target regional banks (primarily those with large-scale risk-taking in securities investment), therefore, we have made them public.

<Figure 1> Long-term and short-term interest rates in Japan and the US and intensive monitoring period



(Source) Bank of Japan, Bloomberg

<Reference> Points at issue recognized by FSA

A. Risk-taking commensurate with their financial strength and risk control capabilities.

B. Building effective investment and risk management systems commensurate with risk-taking.

C. Demonstrating effective risk governance.

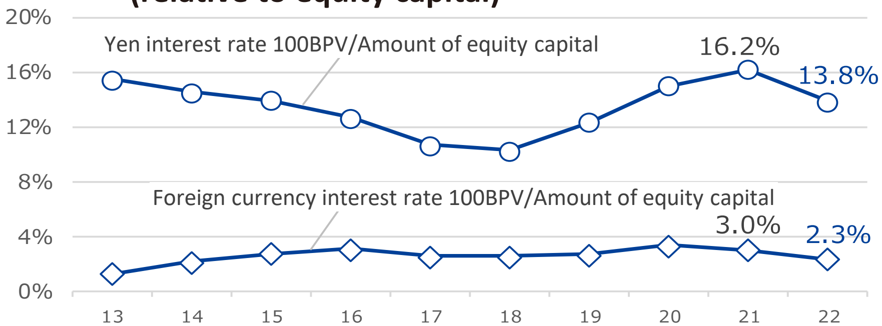
July 13, 2018 "Interim Report on Securities Investment Monitoring of Regional Banks"

(Note 1) Monitoring by FSA and local financial bureau puts emphasis on whether the risk governance and risk management system of the target bank functions effectively as a whole. Therefore, we do not request uniform measures across banks. Regional financial institutions often face various challenges and have some constraints on their management resources. Therefore, the individual discussion points presented in this document should not be used as a checklist in a formalistic manner, nor should the realization of particular risks immediately suggest inadequacies in the risk management system.

(Note 2) Financial strength refers to quantitative aspects, such as capital and earnings. Risk control ability includes qualitative aspects, such as the quality of the investment systems and risk management systems.

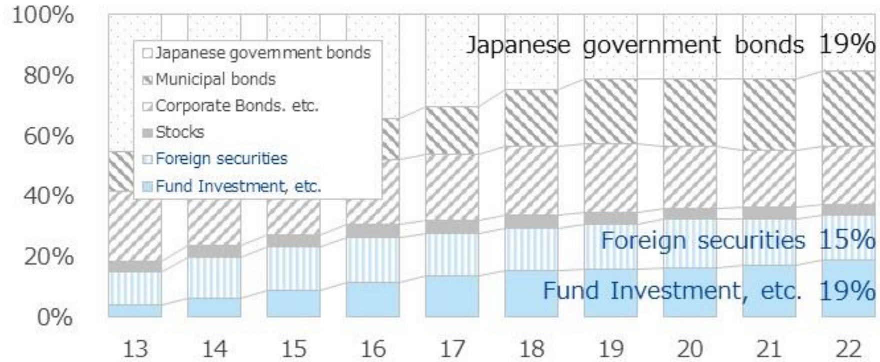
- Amidst a challenging banking business environment, regional banks have expanded the scale of their risk-taking in securities investment to secure fiscal term earnings at a certain level. This expansion has reached a considerable level **(Figure 2).** Specifically, there is a notable trend of increasing investment in relatively high-yielding foreign bonds and overseas interest-bearing funds, indicating an expansion of the risk-taking domain **(Figure 3).**
- Due to the reversal of ultra-loose monetary policies and rapid interest rate hikes by major central banks, primarily in the US and Europe, a decline in the value of securities held by regional banks **(Figure 4)** and an increase in bond sale losses **(Figure 5)** have been observed.

<Figure 2> The amount of interest rate risk on securities (relative to equity capital)



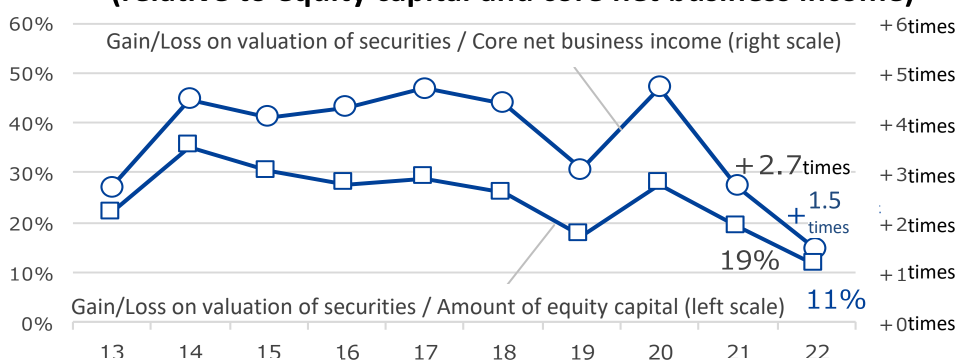
(Source) Financial Services Agency (End of the fiscal year)

<Figure 3> Composition of outstanding balance of securities



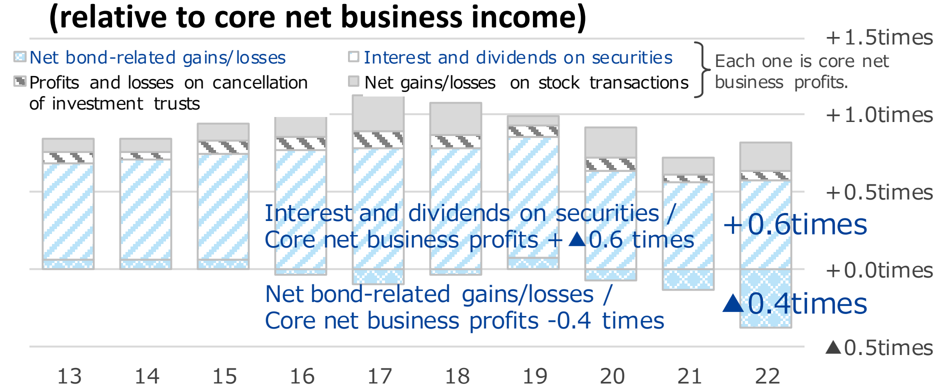
(Source) Financial Services Agency (End of the fiscal year)

<Figure 4> Profits and losses on valuation of securities (relative to equity capital and core net business income)



(Source) Financial Services Agency (End of the fiscal year)

<Figure 5> Securities-related profits and losses (relative to core net business income)



(Source) Financial Services Agency (End of the fiscal year)

(Note)
- Foreign currencies are only the US dollar and Euro for the amount of interest rate risk on securities after reflecting the effect of hedging. The amount of equity capital of the Uniform International Standard Bank is Common Equity Tier 1 (CET1).
- Profits and losses on valuation of securities include held-to-maturity bonds (accounting for approx. 5% of the total outstanding balance of securities).
- Core net business income and interest and dividends on securities exclude profits and losses on cancellation of fund investment.

II. Main Discussion Points in Monitoring A

■ The utmost importance lies in ensuring that **risk-taking in securities investment does not exceed the financial strength and risk control capabilities** of each bank. To achieve this, it is essential for each bank to maintain financial strength and risk control capabilities corresponding to the strategic positioning of securities investment.

- **From these perspectives, the FSA has conducted monitoring of regional banks and has engaged in dialogues with the first line of defense function (market department), the second-line function (risk management department), and management.**
- **As a result, it has been confirmed that, overall, the monitored entities maintain risks within a level commensurate with financial strength and risk control capabilities.**

A. Risk-taking Commensurate with Financial Strength and Risk Control Capabilities

Amidst significant changes in the financial environment driven by factors such as rising global inflation, regional banks are required to maintain their soundness and continue to fulfill their financial intermediation function in their local communities over the long term.

To maintain soundness, it is crucial for each bank, **under the leadership of its management**, to clarify **the strategic positioning and risk-taking approach** of securities investment based on its management philosophy.

The strategic positioning

Specifically, each bank needs to clarify whether it positions securities investment

✓ as **one of the core businesses** for maintaining the financial strength that supports its intermediation functions

✓ as **an operation for managing excess funds**

Risk-taking approach

Each bank should define the risk-taking domain and upper limit of securities investment in line with **its financial strength and risk control capabilities**, and **should maintain its risk-taking within them.**

Specifically, **B. Building Effective Investment and Risk Management Systems Commensurate with Risk-taking** on the next page is necessary.

■ In order to maintain risk-taking within the level commensurate with financial strength and risk control capabilities, **regional banks need to build effective investment management and risk management systems commensurate with risk-taking**, and each of the 1st line of defense (market department), the 2nd line of defense (risk management department), and management teams has a role to play.

- **The FSA has conducted monitoring of the following items, primarily engaging in dialogues with the department in charge.**
- **As a result, it has been confirmed that, overall, the monitored entities maintain reasonably effective investment management and risk management systems.**

B. Building Effective Investment and Risk Management Systems Commensurate with Risk-taking

<Main Items Discussed During Monitoring and the Promoters>

(Note) ● indicates a function that the line/team is considered to be primarily responsible for, and ○ indicates a related function. This is a summary of the general organization of roles.

Item		Function		
		1st Line	2nd Line	Management
1. Clarification of Risk-taking Policy Clarify risk-taking areas and policies, taking into account the strategic positioning and financial strength (capital and earnings) and risk volume, and establish a management system.	**(1) Consideration of Desirable Portfolio**	●	○	●
	(2) Developing a Management System Commensurate with Risk-taking	●	●	●
2. Clarification of Risk Tolerance Clarify the maximum risk amount and loss limits that can be tolerated in light of financial strength (capital and earnings) and establish a risk management system to control risks within those ranges.	**(1) Allocation and Management of Risk Capital**	○	●	●
	(2) Setting and Managing Loss Limits, etc.	○	●	●
3. Risk Management of Fund Investment , etc. Analyze and manage the risks in investment assets and asset management companies and fund returns to the same extent as possible as in the case where banks directly hold the assets.	**(1) Management of Risks Inherent in Assets invested through Funds**	●	●	○
	(2) Management of Risks Associated with the Asset Management Company	●	●	○
4. Utilization of Stress Testing Utilize scenario-based stress testing that reflects the risks recognized by management and the risk-taking policy, and evaluate the impact on future financial strength (capital and earnings).	**(1) Market/Integrated Stress Testing**	○	●	●
	(2) Foreign currency liquidity Stress Testing	●	●	○
5. Responding to Change in the Market Environment Formulate action plans to prepare for market fluctuations, conduct simulations to prepare for future swings in fiscal term earnings, and control risks.	**(1) Action Plan for maintaining Capital**	●	○	●
	(2) Preparation for the Risk of a Decline in Fiscal Term Earnings	●	○	●

- On the other hand, from the perspective of consistently ensuring soundness and sophisticating risk management to the extent that each bank is expected to demonstrate depending on its risk characteristics, some cases of concern and some recommended practices are recognized.

1. Clarification of Risk-taking Policy (Main Discussion Points)

- Under the leadership of the management team, banks need to take into account the strategic positioning of securities investment and the balance between financial strength (capital and earnings) and risk volume, and to clarify risk-taking areas and policies.
  And it is necessary to establish a management system for considering the desired portfolio composition from the perspective of risk and return, among other things, in order to ensure consistent investment operations in line with the clarified policies. **<Figure 6>**.
- It is necessary to develop the organizational structure (1st, 2nd, and 3rd line of defense) that enables the implementation of the policy, to clearly define the roles and authority of managers in each department, and to continue to work on securing and developing suitable human resources **<Figure 7>**.

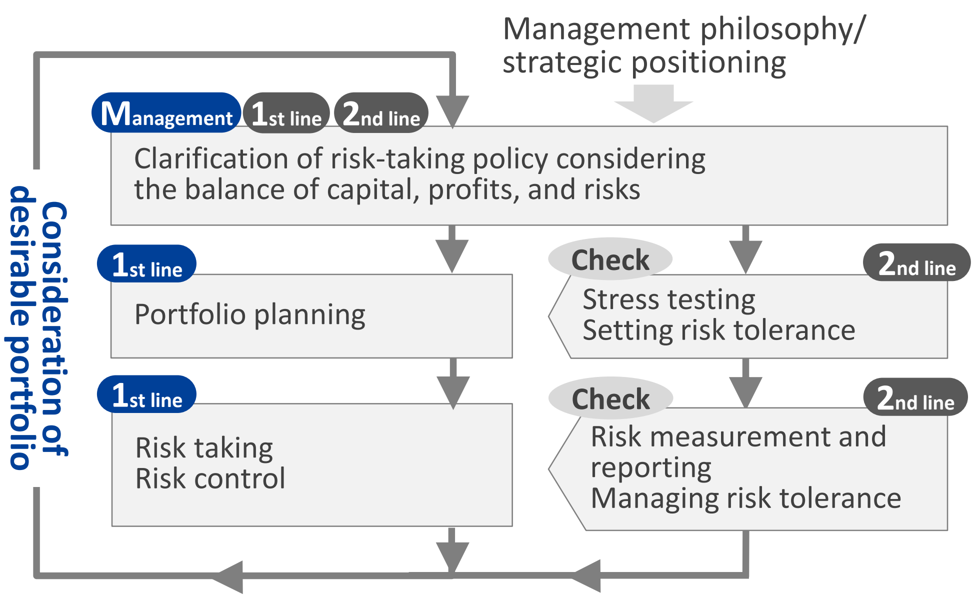
1 Consideration of Desirable Portfolio

- **Clarification of Risk-taking Policy**
- **Consideration of Desirable Portfolio**

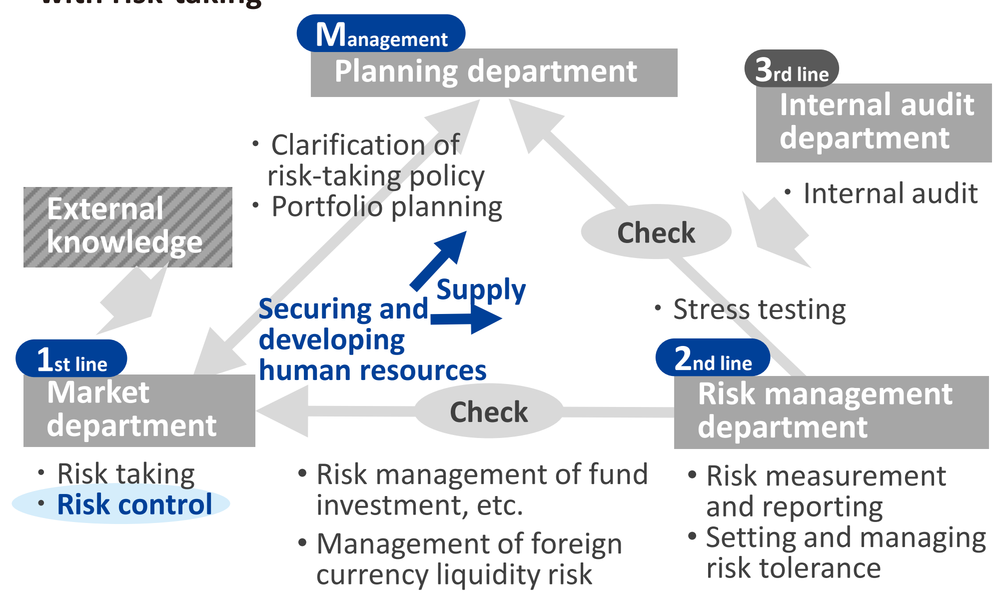
2 Developing a Management System Commensurate with Risk-taking

- **Clarification of the Risk-taking Policy and Organizational Structure**
- **Securing and Developing Suitable Human Resources**

<Figure 6> Utilization of the Risk Appetite Framework Concept



<Figure 7> Example of an organizational structure commensurate with risk-taking



(Note) Figures and tables are ideas (examples) from the authority, and it should be noted that the specific response method may change depending on the business environment, size, characteristics, etc. surrounding each bank.

1. Clarification of Risk-taking Policy (Concerns/Recommended practices)

■ The following cases of concern and recommended practices have been observed at the monitored banks:

1 Consideration of Desired Portfolio

Concerns

- The medium-to long-term policy for securities investment is unclear [a small number]
- Prioritizing short-term financial results over the medium- to long-term portfolio composition and risk-return discussions [a small number]
- While "diverse investment" and "diversification of assets" are stated as investment policies, quantitative verification of diversification effects and its application to risk management have not been carried out [a certain number]

Discussion points

- ➢ Clarification of Risk-taking Policy
- ➢ Consideration of Desirable Portfolio

Recommended practices

- Understanding the theoretically desired portfolio composition by utilizing external knowledge and considering its application to the bank's medium-term investment plan [a certain number]
- Considering the asset composition with attention to the increase in credit risk assets [a small number]
- In the case of setting up a tactical portfolio not based on a medium- to long-term perspective, managing it strictly separately from the core portfolio (e.g., core-satellite investment) [a small number]
- Clarifying the policy of not taking excessive risks in securities investment [a certain number]

2 Developing a Management System Commensurate with Risk-taking

Concerns

- In both front and middle offices, the number of employees is small in light of the amount and variety of risk-taking [a certain number]
- In the middle office in particular, efforts to secure and develop human resources with a view to skill inheritance are insufficient [a small number]

Discussion points

- ➢ Clarification of the Risk-taking Policy and Organizational Structure
- ➢ Securing and Developing Suitable Human Resources

Recommended practices

- Clearly separating the 1st, 2nd, and 3rd line of defense functions in terms of organization and responsible executive officers [almost all]
- Open recruitment and promotion from branches in the corporate / retail banking divisions to the market department front line (the 1st line of defense function) [almost all]
- Supply of human resources from the 1st line to the 2nd and 3rd line of defense functions [a certain number]
- Dispatch of trainees to major banks, asset management companies, and securities brokerage firms [almost all]

Recommended practices (common to 1 and 2)

- Positioning securities investment as an important business alongside lending and strengthening the management system for it [a certain number]

(Note) Note that this is an example of a medium-sized or larger regional bank, and the specific response method may vary depending on the business environment, size, characteristics, etc. surrounding each bank.

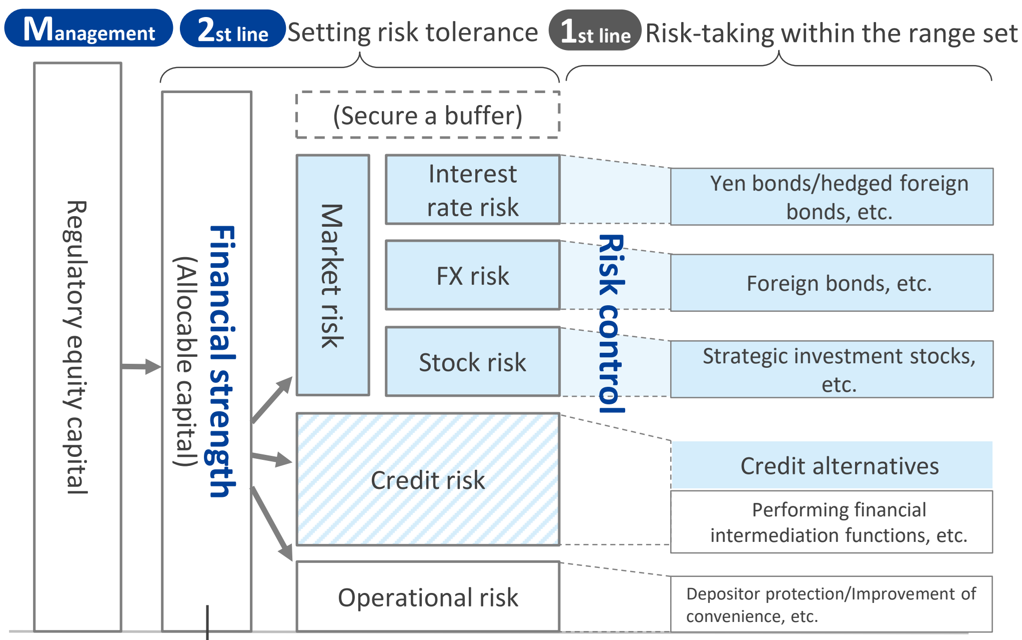
2. Clarification of Risk Tolerance (Main Discussion Points)

■ It is necessary to deepen the discussion about the maximum risk amount and loss limits that can be tolerated in light of financial strength (capital and earnings), clarify the basic concept when setting them, and periodically review them. In addition, it is necessary to establish a risk management framework for controlling risks within the range set, such as clearly defining the risk management actions (reporting system and authority) in case of exceeding or being likely to exceed this amount.

1 Allocation and Management of Risk Capital

- ➢ **Setting Risk Tolerance**
- ➢ **Buffer for Risk Capital Allocation**

<Figure 8> Example of allocation and management of risk capital



Banks subject to domestic standards should also adequately take into account the characteristics of their own risks and equity capital by, for example, appropriately considering the influence of net unrealized gains and losses on securities.

2 Setting and Managing Loss Limits, etc.

- ➢ **Ensuring Effective Functioning of Loss Limits**
- ➢ **Determining the Acceptable Level of Valuation Losses**

<Figure 9> Example of setting and managing loss limits, etc.

<Perspective of capital>

Even if losses on valuation are realized, whether they will be kept **within the range that can secure the amount of capital that management deems necessary**.

<Perspective of profits>

Considering the bank's overall business situation, whether unrealized losses are kept **within the range that can be absorbed by term earnings for certain periods.**

Setting contents	Basic concept	Management actions upon breaches, etc.
Alarm point 1 ▲〇〇 billion yen	• The loss can be covered by above-plan profits in service fees or cost reduction.	Implement 〇〇 after reporting to 〇〇
Alarm point 2 ▲〇〇 billion yen	• Term earnings for 〇 years	
Loss limit ▲〇〇 billion yen	• Term earnings for 〇 years • If it realizes, it will be equal to 〇% of capital adequacy ratio.	Implement 〇〇 after reporting to 〇〇

(Note) Figures and tables are ideas (examples) from the authority, and it should be noted that the specific response method may change depending on the business environment, size, characteristics, etc. surrounding each bank.

■ The following cases of concern and recommended practices have been observed at the monitored banks:

1 Allocation and Management of Risk Capital

Concerns

- The market risk amount exceeds the allocated market risk capital during the fiscal term due to larger market fluctuations [a small number]
- Insufficient consideration of the impact of net unrealized gains and losses for available-for-sale securities that have already occurred [a small number]

Discussion points

- ➢ **Setting Risk Tolerance**
- ➢ **Buffer for Risk Capital Allocation**

Recommended practices

- Securing a buffer as unallocated capital for the amount exceeding the regulatory minimum [a certain number]
- Verifying the sufficiency of the buffer through stress testing [a small number]
- Allocating risk capital taking into account the impact of net unrealized gains and losses for available-for-sale securities on allocable capital [a small number]

2 Setting and Managing Loss Limits, etc.

Concerns

- The concept of setting loss limits, etc. established in the past has become excessively conservative or non-conservative while the internal and external management actions change [a small number]
- Insufficiency of discussions on how much loss the bank as a whole can tolerate, without taking into account the current business and financial situation and market environment [a certain number]
- After breaching loss limits, etc., losses further increased until concrete risk management measures were implemented [a small number]
- Limits are only set for individual products, and loss limits, etc. for the entire portfolio are not set [a small number]

Discussion points

- ➢ **Ensuring Effective Functioning of Loss Limits**
- ➢ **Determining the Acceptable Level of Valuation Losses**

Recommended practices

- Setting limits considering fiscal term earnings for certain periods (core net income, etc.) [a certain number]
- Setting and managing limits for individual asset classes and products in addition to those for the entire portfolio [a certain number]
- Setting and managing loss limits, etc. at a level that can ensure a capital adequacy ratio equivalent to 8% even if losses on valuation of securities are all realized [a small number of banks, including banks subject to domestic standards]
- Close communication with outside directors and the internal audit department when loss limits, etc. are breached [a small number]

(Note) Note that this is an example of a medium-sized or larger regional bank, and the specific response method may vary depending on the business environment, size, characteristics, etc. surrounding each bank.

3. Risk Management of Fund investment, etc. (Main Discussion Points)

- Regarding fund investment, etc. that invest in multiple assets or in which the operator has great discretion, it is necessary to analyze and manage the risks and returns inherent in the assets invested and the asset management companies at the same level as possible when directly held.

1 Management of Risks Inherent in Assets invested through Funds

➢ Clarifying Investment Objectives

✓ Clarification of the purpose of holding securities in the form of fund investment, etc., considering the positioning of such investment in the bank's business strategies and the impact on its financial strength (capital and earnings)

➢ Monitoring and Reporting Risks
➢ Use in Risk Management

<Figure 10> Understanding sensitivities by risk factors

	Interest rate		Exchange		Exchange rate fluctuations		Cash etc.
	Yen	Dollar	Dollar	Euro	Share	Others	
Fund A	-	○○	○○	-	-	-	○○
Fund B	○○	-	○○	-	-	-	○○
:							

<Figure 11> Measurement of risk amount by each risk factor

	Risk amount
Bonds	○○○
Domestic bonds	○○
Foreign bonds	○○
Stock	○○○
Net investment stocks	○○
Strategic investment stocks	○○
Fund Investment	○○○
Index type	○○
Balance type	○○
Simple sum	○○○

	Risk amount
Interest rate	○○○
Yen's interest rate	○○
Dollar's interest rate	○○
Exchange	○○○
Dollar	○○
Euro	○○
Price fluctuations	○○○
Stock	○○
Others	○○
Correlation considerations	○○○

Correlation effect ○○%

2 Management of Risks Associated with the Asset Management Company

➢ Assessment and Selection of Asset Management Company

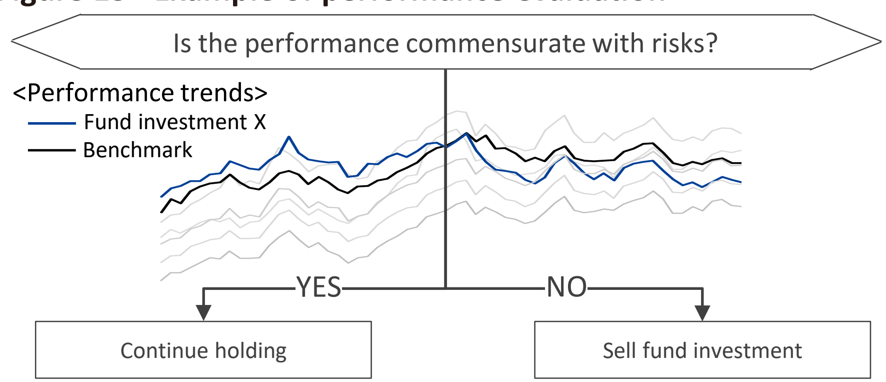
✓ Assessment (due diligence) of the asset management company's financial status, organizational structure for investment and risk management, investment policy, and investment performance

<Figure 12> Example of the due diligence check list

Management/ Financials	Nationality, history, number of employees, financial details, ESG policy, investor profiles, assets under management
Management system	Organization, human resources, frequency of market valuation, measurement method and validity of risk amount
Investment policy	Main investment asset classes, investment philosophy, investment strategy, specific investment method
Investment performance	Past track record (reasons of poor performance under market stress, etc.)

➢ Monitoring and Evaluation Compared with Benchmarks, etc.

<Figure 13> Example of performance evaluation



(Note) Figures and tables are ideas (examples) from the authority, and it should be noted that the specific response method may change depending on the business environment, size, characteristics, etc. surrounding each bank.

■ The following cases of concern and recommended practices have been observed at the monitored banks:

1 Management of Risks Inherent in Assets Invested through Funds

2 Management of Risks Associated with the Asset Management Company

Concerns

- Investing in products that are largely dependent on the discretion of the asset management company, such as multi-asset funds, without clarifying the purposes of investing in a fund vehicle [a small number]

1

- Despite investing in multi–asset funds or funds for which the asset management company has a large degree of discretion in allocation change, VaR is measured based on the net asset value records without consideration of correlation with assets held directly [a small number]
- A breakdown of risks, such as sensitivities and profits and losses on valuation of funds, across risk factors is not reported to the management team [a small number]

2

- Investing small amounts in different funds based on the same strategy and methods without sufficiently analyzing and selecting the risks associated with the asset management companies [a certain number]
- Insufficient assessment of fund performance, lacking factor analysis for each product (market factors, asset management company factors, etc.) [a certain number]
- Unclear action plans in case of performance deterioration, or continued holding of underperforming products without rational analysis [a certain number]

Discussion points

1

- ➢ **Clarifying Investment Objectives**
- ➢ **Monitoring and Reporting Risks**
- ➢ **Use in Risk Management**

2

- ➢ **Assessment and Selection of Asset Management Company**
- ➢ **Monitoring and Evaluation Compared with Benchmarks, etc.**

Recommended practices

1

- Clarifying the policy of not holding products for which analyzing risks by risk factors is difficult or setting an upper limit on the outstanding balance of products with complex risks [a small number]
- Setting risk management alarms according to the risk characteristics of the product [a small number]
- Reporting risk factor sensitivities, valuation gains and losses, and detailed information on underperforming funds at monthly ALM committee meetings, etc. [a certain number]

2

- Frequently communicating with the asset management companies and acquiring knowledge through those [a small number]
- Direct communication with overseas asset management companies [a small number]
- Reporting the results of performance evaluation compared to benchmarks, etc. at monthly ALM committees, etc. [a small number]

- Having a clear purpose for investing in a fund vehicle, such as enabling investment in product areas, strategies, and methods that cannot be assessed on their own [a certain number]

(Note) Note that this is an example of a medium-sized or larger regional bank, and the specific response method may vary depending on the business environment, size, characteristics, etc. surrounding each bank.

4. Utilization of Stress Testing (Main Discussion Points)

- In order to complement the framework of risk capital allocation and loss limit management based on statistical methods, it is expected that stress testing based on hypothetical scenarios that reflect the management's risk awareness and risk-taking policy is conducted to verify the future impact on financial strength (capital and earnings).
- When the amount of the foreign currency balance sheet (B/S) is expanded, it is necessary to enhance ~~sophisticate~~ foreign currency liquidity stress testing.

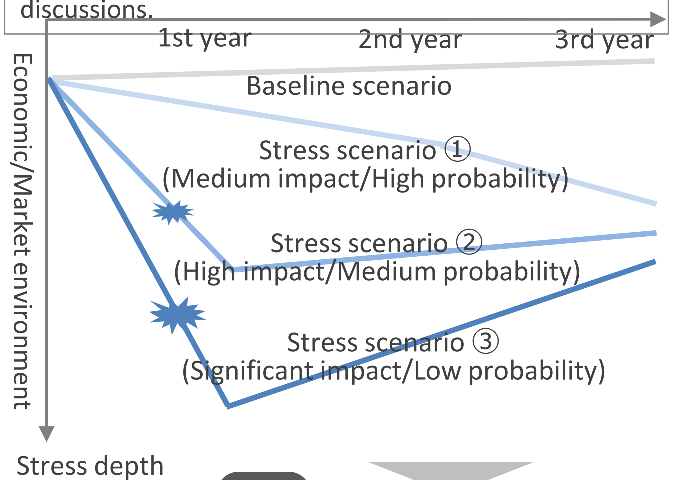
1 Market Stress Testing / Integrated Stress Testing

➤ Stress Scenario Development
➤ Selection of Stress Scenarios

<Figure 14> Example of creating a stress scenario

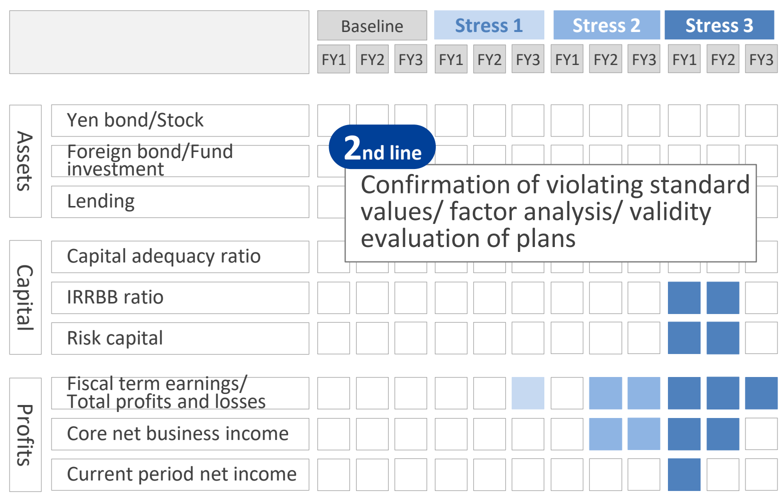
Management | 2nd line | 1st line

The management team should decide stress scenarios that are likely to have a serious impact on the sustainability of financial strength, after deep discussions.



➤ Verification of Future Financial Strength (capital/earnings)

<Figure 15> Example of use of stress test results



2nd line: Confirmation of violating standard values/ factor analysis/ validity evaluation of plans

2 Foreign Currency Liquidity Stress Testing

➤ Measurement of Survival Period

<Figure 16> Measurement of survival period

	T	1 M	2M	XM
Total assets				
Total funding costs				
Foreign currency deposits				
Interbank				
Bond repurchases				
Net balance				
Financing				
Commitment line contract				
Amount available for yen				
Balance after measures				

Confirmation of not only the current situation but also the **survival period**

Confirmation situation **after reflecting** the countermeasures

➤ Utilization of Stress Test Results

1st line
- ✓ Predictive management of events and signals (✸) that can be a trigger to realize stress scenarios

1st line
- ✓ More detailed fiscal term earnings simulation
- ✓ Development of action plans considering future vulnerabilities

➤ Development of Funding Countermeasures

(Clarification of trigger orders and responsible departments)

Also related to 5 Responses to environmental changes

(Note) Figures and tables are ideas (examples) from the authority, and it should be noted that the specific response method may change depending on the business environment, size, characteristics, etc. surrounding each bank.

4. Utilization of Stress Testing (Concerns/Recommended practices)

■ The following cases of concern and recommended practices have been observed at the monitored banks:

1 Market Stress Test / Integrated Stress Test

Concerns

- The reporting of scenarios and test results is objective, in itself, and there is a lack of perspectives, such as utilizing stress testing for identifying portfolio vulnerabilities and for judgment in times of rapid market changes [a certain number]
- The scenario narrative used for stress testing is just as per the original plan of the 2nd line, and the stress events that the management team and the 1st line recognize as having larger impacts or higher probabilities are insufficiently reflected [a certain number]
- The recent B/S is used as the base of the calculation, and the future risk appetite policy and portfolio composition changes are not reflected [a small number]

Discussion points

- ➢ **Stress Scenario Development**
- ➢ **Selection of Stress Scenarios**
- ➢ **Verification of Future Financial Strength (capital/profits)**

Recommended practices

Stress Scenario Development / Selection of Stress Scenarios

- Multiple sets of stress scenarios with horizons of over multiple future years (suitably 3 years) [a small number]
- Active involvement of the management team and executive directors [a small number]
- Developing scenarios based on cross-organizational discussions with related departments or at ALM committees [a certain number]
- Adding unfavorable scenarios based on the bank's own risk characteristics, such as an increase in foreign currency financing costs [a small number]

Verification of Future Financial Strength (capital/profits)

- Internal capital adequacy assessment at the end of the fiscal year [almost all regional banks]
- Evaluating the sustainability of profits and dividends [a certain number]
- Setting evaluation hurdles in stress testing at conservative levels (e.g. securing a capital adequacy ratio of 8% even if losses on valuation of securities are all realized) [a small number of banks, including banks subject to domestic standards]
- Checking the appropriateness of increasing investments when losses on valuation of securities are becoming larger (implementation of ad-hoc stress testing) [a small number]

- Considering risk-taking and risk reduction policies, and changes in portfolio composition, etc. over future years [a small number]

2 Foreign Currency Liquidity Stress Testing

Concerns

- Whereas the business policy is to expand the foreign currency B/S, only the current position is checked [a small number]
- Funding countermeasures have not been developed or are not effective (trigger priorities and responsible departments are unclear) [a small number]

Discussion points

- ➢ **Measurement of Survival Period, and Development of Funding Countermeasures**

Recommended practices

- Multiple sets of scenarios (a. externally caused stress, such as market turmoil, b. internally caused stress, such as bank downgrade, c. simultaneous occurrence of a and b) [a small number]
- Periodic measurement of survival period, which should be over 1 month, 3 months, etc. [a small number]
- Development of funding countermeasures having trigger priorities and responsible departments clearly defined [a small number]

(Note) Note that this is an example of a medium-sized or larger regional bank, and the specific response method may vary depending on the business environment, size, characteristics, etc. surrounding each bank.

■ It is necessary to formulate an action plan to prepare for market fluctuations and conduct simulations to prepare for future fluctuations in term earnings, and control risks.

1 Action Plan for Maintaining Capital

➢ Development of Action Plans in Preparation for Rapid Market Price

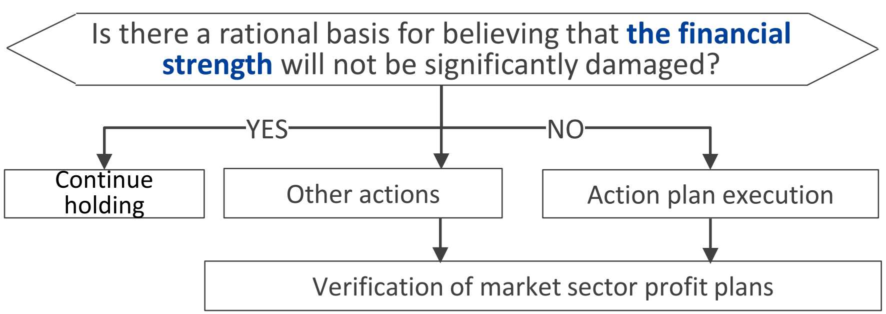
<Figure 17> Example of action plan development

	Pattern 1	Pattern 2	Pattern 3
Trigger criteria	○○○	○○○	○○○
Initial response	Short Japanese stocks	Short U.S. treasury note futures	
Actions on the day	Convened the extraordinary ALM committee and decided on specific measures		

Examples of specific response menus

	Added short futures	Interest rate swap	Bear fund purchase	Asset sale
Merit	○○○	○○○	○○○	○○○
Demerit	○○○	○○○	○○○	○○○

<Figure 18> Examples of a decision tree for taking actions



2 Preparation for the Risk of a Decline in Fiscal Term Earnings

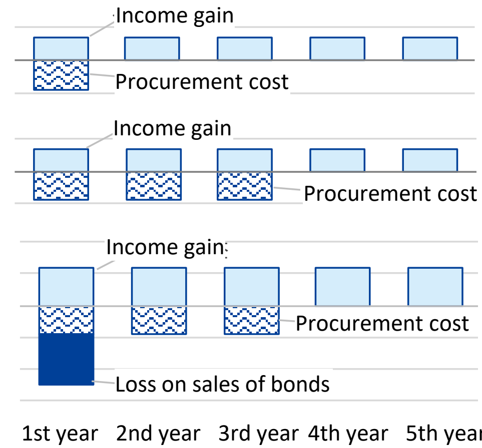
➢ Fiscal Term Earnings Simulation in Preparation for a Prolonged Negative Spread

<Figure 19> Example of term earnings simulation

When holding to maturity under the scenario of interest rates decreasing in early years

When holding to maturity under the scenario where high interest rates continue

When selling bonds in a negative carry situation, and in replacement, holding bonds with higher yields under the scenario where high interest rates continue



<Figure 20> Examples of materials for judgment when taking action

				Continue holding	Sell
Profitability	P/L	Securities-related profits and losses	Current fiscal term	**Negative carry**	**Realized loss**
			Subsequent fiscal terms	**Negative carry**	**Zero** (**Improvement** if replaced)
Soundness	B/S	Valuation gains and losses on securities		**Remain negative**	Improvement
		Core capital		Unchanging	**Negative**

(Note) Figures and tables are ideas (examples) from the authority, and it should be noted that the specific response method may change depending on the business environment, size, characteristics, etc. surrounding each bank.

■ The following cases of concern and recommended practices have been observed at the monitored banks:

1 Action Plan for Maintaining Capital

2 Preparation for the Risk of a Decline in Fiscal Term Earnings

Concerns

- Although the market environment has deviated from the assumptions for the business plan, specific discussions, such as revising the revenue plan have not been carried out [a small number]
- Despite the significant changes in the market environment, no agile risk control that considers both the economic value of equity and fiscal term earnings has been implemented [a small number]

1

- Risks associated with yield curve fluctuations have not been considered when developing plans for monitoring interest rate positions or hedging policies [a small number]
- Although various indicators are monitored using external knowledge, there is no early warning framework nor concrete action plans developed [a small number]

2

- An analysis of the impact of high foreign currency funding costs on net interest income has not been conducted or is insufficient, even though the situation where the foreign currency funding cost exceeds the Bank’s fiscal term earnings (negative carry) is expected to continue for the time being [a small number]

Discussion points

1 ➢ **Development of Action Plans in Preparation for Rapid Market Price**

2 ➢ **Fiscal Term Earnings Simulation in Preparation for a Prolonged Negative Spread**

Recommended practices

1

- There is an early warning framework in place with various indicators for monitoring the macro economics and the market environment set together with thresholds [a small number]
- Monitoring and analyzing factors that affect changes in correlation coefficients (situations where market correlation collapses) [a small number]
- Having multiple response patterns or action menus ready in preparation for sudden market changes [a small number]
- A framework for monitoring and factor analysis is in place in terms of the IRRBB (Interest Rate Risk in the Banking Book) ratio and ΔEVEs (Economic Value of Equity) by currency and by scenario [a small number]

2

- Addition of indicators that are expected to trigger an alert on any impacts on future term earnings (foreign currency funding costs, basis costs, etc.) for monitoring [a certain number]
- Understanding the impact of holding bonds in a negative carry situation through simulations based on multiple scenarios with the analysis horizon starting from the timing of interest rate hikes or rate cuts, and taking actions to improve the portfolio soundness [a small number]
- Trial analysis of future NII (term earnings) and ΔNII (fluctuation risk of term earnings) of all the banking accounts [a small number]

1 and 2

- Flexible risk control with substantial involvement of the management team with consideration given to the impact on financial strength [a small number]

(Note) Note that this is an example of a medium-sized or larger regional bank, and the specific response method may vary depending on the business environment, size, characteristics, etc. surrounding each bank.

II. Main Discussion Points in Monitoring C

■ The most important factor in ensuring that the effective investment and risk management systems in place match the risk-taking is for **the management team to take the lead in exercising risk governance.**

- **The FSA discussed with management teams for monitoring mainly from the following perspectives.**
- **In general, it has been recognized that risk governance is appropriately implemented at the regional banks that have been monitored to date.**

C. Demonstrating effective risk governance

Control by the management tram

<Figure 21> Examples of ideas for implementing risk governance

Mainly discussion points	Undesirable situations	Desirable situations
1. Clarification of risk-taking policy 2. Clarification of risk tolerance 3. Risk management of fund investment, etc.	**Partial** decision/verification • Excessive profit expectations and dependence on securities investment, etc.	**Organization-wide** decisions and risk evaluation • Does the company as a whole maintain a balance between each element, such as risk-taking vs. risk management, and earnings vs. capital?
1. Clarification of risk-taking policy 4. Utilization of stress testing	Risk evaluation focusing on **the past and the current situation** • Will the net income become negative this fiscal term? • Does it currently violate the minimum standards?	Risk evaluation with an eye on the **future** • Continue to secure profits commensurate with the risk? • What is the possibility of the minimum standards being breached in the future?
2. Clarification of risk tolerance 5. Responding to changes in the market environment	**Formalities** take precedence and response is delayed. • Discussion at ALM committee only after issues become materialized	**Substantial** involvement of management • Capture issues proactively and respond flexibly?