Risk Management Systems Checklist

(Common Items)

This checklist contains check points that are common to all types of risk. It is to be used by inspectors in the inspection of financial institutions.

The check points covered in this list are basic aspects of risk management that should naturally be engaged in as part of financial-institution management. The list focuses particularly on the awareness and practices of the directors of the institution themselves. Should director awareness be lacking, this in itself poses a serious management risk to the institution, so the emphasis in this list is on the quality of the institution's directors. (Obviously, senior management and auditors should also be aware of the items contained in this checklist.)

Inspectors will inspect the risk management systems of the institution using this checklist and the checklists for individual risks.

This checklist applies to all deposit-taking financial institutions, including the foreign offices of Japanese banks (foreign branch offices, foreign subsidiaries, and foreign liaison offices, etc., though whether or not to include these offices in the inspection will be determined in light of applicable laws and ordinances, including applicable foreign-country laws and ordinances) and the Japan offices of foreign banks. In inspections of cooperative financial institutions, inspectors should be aware that cooperative financial institutions are only required to select external auditors in limited cases.

Notes on the use of this manual in inspections

This manual is only a handbook to be used by inspectors in the inspection of financial institutions. It is expected that, as part of their efforts to ensure sound and proper operations and in accordance with the principle of self-responsibility, individual financial institutions will fully exercise their creativity and innovation to voluntarily create their own detailed manuals. These institutional manuals should make note of the content of this manual and be adapted to the size and nature of the institution.

The check points in this manual represent criteria to be used by inspectors in evaluating the risk management systems of financial institutions. They do not constitute direct statutory obligations to be achieved by institutions. Care must be taken that the manual is not employed in a manner that is mechanical and unvarying. There may be cases in which the letter of the checklist description has not been fulfilled, but the institution has nonetheless taken measures that are, from the perspective of ensuring the soundness and appropriateness of its operations, rational, and these measures are equivalent in their effects to the descriptions for the check point or are sufficient given the size and nature of the institution. In such cases, the institution's measures should not be deemed inappropriate.

Inspectors will therefore need to engage in full discussion of relevant points with financial institutions during on-site inspections.

Explanation of check points

1. Unless explicitly stated otherwise, items expressed in the question form such as “does the institution” or “is the institution” are minimum standards that are expected of all financial institutions. Inspectors, as they go through their checklists, need to fully verify the effectiveness of these items.

2. Unless explicitly stated otherwise, items worded in the form of “it would be desirable that” constitute “best practice” for all financial institutions. Inspectors need only confirm these items.

3. Items that are a combination of the two represent minimum standards for internationally active banks (those financial institutions calculating their capital adequacy ratios according to the Basle standards) but serve only as best practices for other financial institutions (those calculating their capital adequacy ratios according to domestic standards).

Distinction between “board of directors” and “board of directors etc.”

1. Items that are defined as roles of the “board of directors” are items for which the board of directors itself needs to determine all essential matters. This does not, however, preclude the board of directors from delegating consideration of draft documents to the management committee or similar bodies.

2. The phrase “board of directors etc.” includes the board of directors, the management committee, the business steering committee, and similar bodies. Items that are defined as roles of the “board of directors etc.” would ideally be determined by the board of directors itself, but may be delegated to the management committee etc. provided that there has been a clear delegation of this authority from the board of directors, the management committee etc. has kept minutes of its proceedings and other materials that would allow after-the-fact confirmation, and there are adequate internal controls in place, e.g., the results are reported to the board of directors, and auditors are allowed to participate in the management committee etc.

Item	Risk Management System Check Point	Explanation of Risk Management Check Points	Remarks
I. Management oversight and the control culture 1. Awareness of directors and role of board of directors (Principle 1)	(1) Representative directors' understanding of risk	(1) Do the representative directors understand the nature of various risks? Are they able to allocate resources appropriately in line with strategy? Do they have systems in place that are able to provide dynamic management of risks?	Note: The principles referred to in parentheses correspond to the principles articulated by the Basle Committee on Banking Supervision in "Framework for Internal Control Systems in Bank Organizations." (See attachment.)
	(2) Functions of the board of directors as the body making decisions on business-execution and supervising director activities	(2) 1) Do the directors, from the perspectives of checking and restraining unilateral actions of the representative directors in the execution of business activities, facilitating appropriate business execution and, maintaining and improving the trust of the financial institution, take active part in the decision-making process of the board of directors and in the supervision of business execution by directors? 2) Do the directors fulfill their good stewardship obligations and good faith obligations in the execution of business based on substantive discussions from the perspective of strengthening the institution's base of trust? 3) Does the board of directors position the formulation of corporate ethics, as defined by social responsibilities, public duties, and similar considerations, as a priority task and does it erect systems to achieve this? 4) Does the board of directors discuss, not only ways to promote business, but also compliance issues related to the management and operation of the institution?	(2)
	(3) Minutes etc. of board of directors meetings	(3) Does the board of directors: 1) Keep minutes of its meetings? 2) Store minutes of its meetings for the period of time as specified by law? 3) Create base documents from which can be determined the nature of the items on its agenda?	

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		4) Store the documents described in the above question for the same period of time as the minutes of board of directors meetings? 5) Create minutes of board of directors meetings and base documents that record risk-related decisions by the representative directors, and allow varification of the status of various risks and problems related thereto, and reports of improprieties and other problems?	
	(4) Establishment of management philosophies	(4) Does the board of directors clearly articulate management philosophies based on the overall targets etc. towards which the financial institution is working? Does it provide a clear business plan based on the philosophies and does it communicate this plan to the organization as a whole?	
	(5) Articulation of strategic goals based on management philosophies etc. for the institution as a whole	(5) Does the board of directors clearly articulate the degree of risk to be taken and the level of profits to be sought, and other similar strategic goals? Do the strategic goals of individual divisions place so much priority on securing profits that risk management is neglected? Are goals communicated and known throughout the organization?	
	(6) Directors' understanding and awareness of risk management	(6) Do directors understand the locus and type of risks to which the institution is exposed? Do they understand the techniques that are used to measure, monitor, and manage various risks, and is it aware of the importance of risk management? Do directors in charge of risk management and related areas have deep understandings and awareness of these issues?	
	(7) Establishment of risk management guidelines	(7) Does the board of directors articulate clear risk management policies in light of the institution's strategic goals? Does the board of directors take appropriate steps to communicate its risk management policies throughout the organization? Does the board of directors regularly (at least once per year) review risk management policies? Does it review risk management policies at other times as required (for example, because of changes in strategic goals)?	

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	(8) Establishment of organizations for risk management	(8) Has the board of directors established a risk management division to manage various risks? Does the risk management division have a system that enables it to provide integrated management of risks? Doe this system provide for full functioning of mutual-checking and similar controls, for example, by segregating the profit divisions from the risk management division? Are organizations and systems reviewed as necessary? Are improvements made to keep pace with changes in strategic goals and advances in risk management techniques?	
	(9) Reporting on risk status to board of directors and use of risk information in decision-making for the organization as a whole	(9) Does the board of directors etc. receive regular reports on the status of risk and make such decisions as are necessary? Does the board of directors etc. make use of measured risk information in business execution and in enhancements etc. to management systems?	
	(10) Establishment of guidelines regarding the training and assignment of personnel for appropriate risk management	(10) Does the board of directors etc. articulate clear guidelines regarding personnel management designed to achieve appropriate risk management? This would include, but not be limited to the training of personnel versed in risk management operations, the assignment of full-time risk managers, and personnel management policies regarding the organization of risk managers and measures to prevent incidents.	
	(11) Functioning of the board of auditors	(11) Are the auditors and the board of auditors assured of their independence and do they perform effective operational audits of the directors and audits of accounts? (In inspections of cooperative financial institutions, inspectors should be aware that cooperative financial institutions are only required to select external auditors in limited cases.) 1) Does at least one auditor attend meetings of the board of directors when risk management issues are on the agenda? It is desirable that a full-time auditor attend for financial institutions that fall under Article 18 Paragraph 2 of the Law Concerning Special Exceptions to the Commercial Code or the mutatis mutandis application thereof.	

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		2) Is the board of auditors assured of its independence as intended by the law? 3) Does the board of auditors appropriately exercise the wide-ranging authority granted to it to perform operational audits in addition to accounting audits? Does the board of auditors have necessary and appropriate adjunct staff? 4) Are external auditors used to complement the functions of the board of auditors etc? Does the institution use the services of law offices etc. when necessary? 5) Do auditors understand that they are still independent agents even when there is a board of auditors, and do they actively perform audits on their own personal responsibility? 6) Are there systems in place to enable the board of auditors to check that the findings of external audits by external auditors etc. are themselves appropriate and, if necessary, to take measures such as replacing external auditors etc?	
2. Awareness and roles of senior management (Principle 2)	(1) Senior management's understanding and awareness of risk management	(1) Does senior management understand the locus and type of risks to which the institution is exposed? Does it understand the techniques that are used to measure, monitor, and manage various risks, and is it aware of the importance of risk management? Does it take appropriate measures to cause relevant personnel within their divisions to understand and be aware of these issues? Does it take appropriate measures to improve risk management policies and risk management rules?	Note: "Senior Management" refers to branch office managers and persons in senior managerial positions (including directors) with equivalent levels of responsibility, and so throughout.
	(2) Establishment of rules for risk management	(2) Does senior management establish techniques for measurement, monitoring, and management etc. in accordance with the type of risk and the institution's risk management policies? Does it establish rules for appropriate risk management with the approval of the board of directors etc?	

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	(3) Establishment of organizations for risk management	(3) Does senior management establish organizations for appropriate risk management in line with risk management policies and risk management rules?	
	(4) Appropriate risk management practice	(4) Is senior management responsible for appropriately measuring monitoring, and managing etc. risks in line with risk management policies and risk management rules? Does it verify the effectiveness of risk management techniques and organizations at appropriate times and in appropriate manners? Does it review risk management techniques and organizations as warranted by changes in markets, increases in risk exposure, and improvements in techniques etc?	
	(5) Appropriate assignment of risk management staff	(5) Does senior management assign expert risk management personnel based on policies articulated by the board of directors etc. or otherwise make appropriate personnel assignments so that organizations are able to function effectively in risk management? In assigning personnel, does senior management select personnel with practical experience or other expertise?	
	(6) Establishment of training systems for personnel development	(6) Does senior management provide personnel training based on the policies articulated by the board of directors etc? Does it establish training systems to improve the risk management skills of risk management personnel in individual divisions? Is it otherwise involved in the training of expert personnel?	
	(7) Personnel management designed to prevent incidents	(7) Does senior management, in accordance with the policies articulated by the board of directors etc., have programs in place to require employees (including senior management) to stay away from their jobs for a minimum of one week a year for the purpose of preventing incidents? This might include continuous leave, training, internal reassignment, or any combination thereof. It is desirable that this period be at least two weeks. Does senior management manage the status of these programs and ensure that they are carried out effectively?	

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		Does senior management engage in appropriate personnel rotation so that specific employees are not engaged in the same jobs in the same departments for prolonged periods of time? If specific employees must be engaged in the same jobs in the same departments for prolonged periods of time, does senior management have other appropriate measures to prevent incidents from occurring?	
3. Control culture (Principle 3)	Cultivation of a control culture emphasizing the importance of risk management	Are the representative directors and board of directors fully aware that neglect of the risk management division will have serious consequences to corporate profitability, and do they emphasize the risk management division as well as profit divisions? In particular, do they avoid providing undue emphasis on short-term, profit-oriented goals that ignore appropriate risk management or long-term risks, and do they avoid establishing compensation schemes that overly depend on the achievement of these short-term goals? Does senior management emphasize risk management and take appropriate steps to inculcate this attitude in individual divisions?	
II. Establishment of appropriate risk management systems 1. Risk recognition and assessment (Principle 4)	Identification of locus and types of risks to be managed	Does the institution identify on an on-going, consolidated basis what types of business individual divisions are engaged in to meet their strategic goals, what kinds of financial instruments they are handling, and what kinds of risk management must be practiced in these circumstances? In particular, when engaging in new businesses or handling new instruments, are risks identified, necessary infrastructure put in place, and full preparations made for appropriate risk management? Should the risk identified be uncontrollable, does the institution decide whether or not to withdraw from or reduce the level of business activity? Does it follow through on that decision?	
2. Control activities (Principle 5)	(1) Appropriate risk management techniques and rules	(1) Are risk management techniques and rules appropriate in light of the strategic goals of individual profit divisions of the institution, or in light of the nature of the businesses and financial instruments handled? Does risk management form an integral part of the daily activities of the financial institution?	

Item	Risk Management System Check Point	Explanation of Risk Management Check Points	Remarks
	(2) Establishment and review of rules in individual business divisions	(2) Do risk management rules specify the procedures, authority, required documentation, contingency planning, and other aspects of business execution for individual types of business? Does senior management verify that employees follow the rules and comply with procedures? Does senior management regularly review these rules?	Note: "Business division" includes the risk management divisions for individual businesses.
	(3) Comprehensive risk management	(3) Does the risk management system manage the various risks to which branch offices (including foreign offices) and consolidated subsidiaries are exposed to the extent permitted under applicable laws and ordinances? Does the risk management division manage risks in a comprehensive manner? Is there integrated management of the risks managed by individual risk management divisions?	
3. Segregation of duties (Principle 6)	Erection of a system of mutual checking	Are managers and employees in the risk management division involved in other work that would constitute a conflict of interest (i.e., are they involved in the work of profit centers)? Do internal inspectors and external audits continually verify that there are no conflicts of interest?	
4. Information and communication (Principle 7) (Principle 8) (Principle 9)	(1) Reports to the board of directors etc. from the risk management division	(1) Is the risk management division able to design and execute risk management systems for the organization as a whole without being influenced by profit centers? Is it able to report directly to the board of directors etc. whenever necessary?	
	(2) Content of reports to the board of directors etc.	(2) Does the risk management division report in an accurate and easily understood manner to the board of directors etc. so as to provide the board of directors etc. with comprehensive information on risk that would have a significant impact on the management of the institution?	
	(3) Availability of information systems etc.	(3) Does the institution maintain and operate management information systems that cover all major businesses? Does it build and operate highly-reliable electronic information systems? Has it formulated effective contingency plans to prepare for failures of these information systems?	

Item	Risk Management System Check Point	Explanation of Risk Management Check Points	Remarks
III. Monitoring activities and correcting deficiencies 1. Internal audits (Principle 10) (Principle 11)	(1) Awareness of the importance of the inspections division	(1) Is the board of directors aware that neglect of the inspections division will have serious consequences to corporate profitability? Does it emphasize the inspections division?	Note: "Internal inspections" refer to inspections of the head office by the inspections division and self-inspections by individual business divisions and branch offices etc.
	(2) Assurance of the independence of the inspections division	(2) Is the inspections division organized so that it is able to play a sufficient checking function? For example, is it independent of other business divisions?	
	(3) Establishment of systems within the inspections division	(3) Does the inspection have appropriate numbers of personnel who are versed in its operations and is it able to perform dynamic, effective inspections? Do financial institutions calculating their capital adequacy ratios according to the Basle standards assign, as a rule of thumb, one internal auditor who is independent of the branch manager and reports directly to the inspections division etc. to each overseas branch office with 40 employees or more?	
	(4) Internal inspections	(4) Are internal inspections performed for each business division (including the risk management division) and branch office etc. (including overseas offices)?	
	(5) Content and techniques of inspections by the inspections division	(5) Are effective inspections performed (for example, surprise inspections)? Do financial institutions calculating their capital adequacy ratios according to the Basle standards avoid having the same inspector inspect the same areas for the same branch twice in a row? (It would also be desirable for financial institutions calculating their capital adequacy ratios according to domestic standards to avoid this.) Do inspections check risk management status, improprieties, and compliance with rules etc. for all aspects of business? Are there checks to ensure that internal auditors assigned to overseas offices perform their audits appropriately?	

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	(6) Frequency of inspections by the inspections division	(6) Does the inspections division perform inspections of each business division and branch office etc. in principle at least once per year?	
	(7) Reports on inspection findings	(7) Does the inspections division report directly and regularly (as needed) on inspection findings to the representative directors and board of directors?	
	(8) Reviews of inspection findings	(8) Does the inspections division manage the improvement plans and improvement schedules of business divisions and branch offices etc. as warranted by inspection findings?	
2. External audits	Use of external auditors	Do external auditors etc. perform external audits of the effectiveness etc. of internal control systems (including risk management systems) at least once per year? (In inspections of cooperative financial institutions, inspectors should be aware that cooperative financial institutions are only required to select external auditors in limited cases.) Do financial institutions calculating their capital adequacy ratios according to the Basle standards conduct external audits as warranted by local circumstances in the host country? Are the findings from these audits reported directly and accurately to the board of auditors? Do they contribute to the effectiveness of audits performed by the institution's auditors?	
3. Correction of deficiencies (Principle 12)	(1) Reporting and correction of deficiencies	(1) Are deficiencies identified by internal inspections, external audits, or regulatory audits etc. corrected by business divisions and branch offices etc. within a set period of time as warranted by the degree of seriousness of the problem? Are deficiencies with internal control and/or inadequacies in risk controls discovered in the course of internal inspections or daily checks reported quickly to the persons responsible for the division in which the deficiencies are located and to the inspections division regardless of the division to which the person detecting the deficiencies belong? Are reports quickly furnished to senior management, the representative directors, and the board of directors for problems considered to have a serious impact on the management of the institution?	

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		Are such problems corrected within a set period of time as warranted by their degree of seriousness etc? Does the internal inspections division etc. follow up on the status of improvements?	
	(2) Reporting on deficiencies to representative directors, board of directors and senior management	(2) Even when individual problems would not have a serious impact on the management of the institution, it is possible that all problems put together would have a serious impact because of the way in which they interact with each other. Do the representative directors, board of directors, and senior management receive regular reports summarizing all management problems and do they take appropriate responses for these problems?	

Attachment

Framework for Internal Control Systems in Banking Organizations (Basle Committee on Banking Supervision)

Item	Principle	Description
A. Management oversight and the control culture	Principle 1	The board of directors should have responsibility for: (1) Approving and periodically reviewing the overall business strategies and significant policies of the bank; (2) Understanding the major risks run by the bank, setting acceptable levels for these risks and ensuring that senior management takes the steps necessary to identify, measure, monitor and control these risks; (3) Approving the organizational structure; and (4) Ensuring that senior management is monitoring the effectiveness of the internal control system. The board of directors is ultimately responsible for ensuring that an adequate and effective system of internal controls is established and maintained.
	Principle 2	Senior management should have responsibility for: (1) Implementing strategies and policies approved by the board; developing processes that identify, measure, (2) Monitor and control risks incurred by the bank; (3) Maintaining an organizational structure that clearly assigns responsibility, authority and reporting relationships; (4) Ensuring that delegated responsibilities are effectively carried out; (5) Setting appropriate internal control policies; and (6) Monitoring the adequacy and effectiveness of the internal control system.
	Principle 3	The board of directors and senior management are responsible for promoting high ethical and integrity standards, and for establishing a culture within the organization that emphasizes and demonstrates to all levels of personnel the importance of internal controls. All personnel at a banking organization need to understand their role in the internal controls process and be fully engaged in the process.
B. Risk Recognition and Assessment	Principle 4	An effective internal control system requires that the material risks that could adversely affect the achievement of the bank's goals are being recognized and continually assessed. This assessment should cover all risks facing the bank and the consolidated banking organization (that is, credit risk, country and transfer risk, market risk, interest rate risk, liquidity risk, operational risk, legal risk and reputational risk). Internal controls may need to be revised to appropriately address any new or previously uncontrolled risks.

Item	Principle	Description
C. Control Activities and Segregation of Duties	Principle 5	Control activities should be an integral part of the daily activities of a bank. An effective internal control system requires that an appropriate control structure is set up, with control activities defined at every business level. These should include: top level reviews; appropriate activity controls for different departments or divisions; physical controls; checking for compliance with exposure limits and follow-up on non-compliance; a system of approvals and authorizations; and, a system of verification and reconciliation.
	Principle 6	An effective internal control system requires that there is appropriate segregation of duties and that personnel are not assigned conflicting responsibilities. Areas of potential conflicts of interest should be identified, minimized, and subject to careful, independent monitoring.
D. Information and communication	Principle 7	An effective internal control system requires that there are adequate and comprehensive internal financial, operational and compliance data, as well as external market information about events and conditions that are relevant to decision making. Information should be reliable, timely, accessible, and provided in a consistent format.
	Principle 8	An effective internal control system requires that there are reliable information systems in place that cover all significant activities of the bank. These systems, including those that hold and use data in an electronic form, must be secure, monitored independently and supported by adequate contingency arrangements.
	Principle 9	An effective internal control system requires effective channels of communication to ensure that all staff fully understand and adhere to policies and procedures affecting their duties and responsibilities and that other relevant information is reaching the appropriate personnel.
E. Monitoring Activities and Correcting Deficiencies	Principle 10	The overall effectiveness of the bank's internal controls should be monitored on an ongoing basis. Monitoring of key risks should be part of the daily activities of the bank as well as periodic evaluations by the business lines and internal audit.
	Principle 11	There should be an effective and comprehensive internal audit of the internal control system carried out by operationally independent, appropriately trained and competent staff. The internal audit function, as part of the monitoring of the system of internal controls, should report directly to the board of directors or its audit committee, and to senior management.
	Principle 12	Internal control deficiencies, whether identified by business line, internal audit, or other control personnel, should be reported in a timely manner to the appropriate management level and addressed promptly. Material internal control deficiencies should be reported to senior management and the board of directors.
F. Evaluation of Internal Control Systems by Supervisory Authorities	Principle 13	Supervisors should require that all banks, regardless of size, have an effective system of internal controls that is consistent with the nature, complexity, and risk inherent in their on- and off-balance-sheet activities and that responds to changes in the bank's environment and conditions. In those instances where supervisors determine that a bank's internal control system is not adequate or effective for that bank's specific risk profile (for example, does not cover all of the principles contained in this document), they should take appropriate action.