Tentative translation

Discussion paper

# JFSA's supervisory approaches to Lending business

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金融庁
Financial Services Agency

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# I. Introduction

This document aims to present how the Financial Services Agency (JFSA), Japan's integrated financial regulator, intends to transform its supervisory approaches to lending business.

The business environment for financial institutions is becoming increasingly challenging due to aging and declining population, persistent global low interest rates, and diverging customer needs. Under this unprecedented situation, financial institutions are seeking to revisit and redevelop their own business principles to better fit their changing business conditions.

On the other hand, the supervisory approaches had been designed to the rigid standards of the Inspection Manuals with little regard to the diversity of business models of financial institutions. For example, such standardized approaches to loan loss provisioning contributed to the resolution of the non-performing loan problems in the past, but its mechanical repetition to this date carries a risk of imposing a one-size-fits-all solution across the industry and also of stifling their initiatives to better estimate expected credit losses based on the characteristics of their own portfolios and surrounding business environments.

Meanwhile, global practices of credit loss reserve are now developing to make better estimation of future credit losses. New accounting standards which require financial institutions to reflect reasonable and supportable forecasts in the provisioning has started to be applied.

In line with these rapidly changing situations, the Agency has been reforming its supervisory approaches. A panel of experts commissioned by the Agency, the Advisory Group on Supervisory Approaches, submitted a report "Transforming the JFSA's supervisory approaches" to the Agency in March 2017, and recommended the Agency to recast its existing supervisory approaches. The Agency published, as a response to the panel's report, "JFSA's supervisory approaches - Replacing checklists with engagement" in June 2018 and declared its intentions to enhance its communications with financial institutions and other stakeholders on underlying concepts, approaches and principles, by both repealing the Inspection Manuals and issuing Discussion Papers on specific areas of supervision.

In July 2018, the Agency organized a study group comprised of financial institutions, external auditors and other experts, which has discussed the better practices of lending business and the supervisory approaches to these activities.

This Discussion Paper, owing to the debate at the study group, describes how the Agency intends to transform its supervisory approaches to lending business. Given the rapid evolution of financial businesses, the new supervisory approaches will be commensurate with the changing business models of financial institutions to help ensure that the firms find their lending policies and loan review policies consistent and fitted to their own conditions and circumstances. Alongside, the Agency will try to acquire in-depth knowledge on a wider range of relevant factors, including each financial institution's business environments, credit and investment policies, and reasonable and supportable forecasts, so that the Agency strike the right balance between ensuring financial stability and securing effective financial intermediation.

To note, while this document mainly focuses on depository institutions, it is also used as a material for dialogue in inspections and supervision of other types of financial institutions.

The Agency received various comments through the public consultation and nationwide dialogue with financial institutions and their external auditors, and an outline of the comments as well as response of the JFSA are published on its website.

(https://www.fsa.go.jp/news/r1/yuushidp/20191218.html)

The Agency intends to continuously engage in dialogue with consumers, financial institutions, market participants and other stakeholders and to continuously update this document and enhance its supervisory approaches.

This document intends to be a springboard for dialogue on better practices and not formally applied or used as a checklist in supervisions. The dialogue with financial institutions will take full account of the individuality and characteristics of each financial institution.

## II. Reexamining the Current Supervisory Approaches

### 1. Addressing the Post-bubble non-performing loan problems

In Japan, the asset price bubble, which expanded in the late 1980s, burst in the early 1990s. During the period of boom and bubbles, financial institutions provided many loans under the expectations of a rise in land and stock prices. Thus, when Japan experienced the bubble burst and a plummet in asset prices, many financial institutions ended up accumulating non-performing loans due to the significant deterioration of non-financial borrowers' credit quality.

In the early years since the establishment of the Financial Supervisory Agency in 1998, one of the top priorities of the FSA' missions was to rebuild domestic and international credibility by accurately grasping the non-performing loans that had occurred and reflecting the decline in asset prices up to then in the allowance.

The Financial Supervisory Agency therefore established uniform standards with little room for financial institutions' discretion (the Table of the Inspection Manual), and examined the results of loan classification with an emphasis on whether liabilities of borrowers exceeded assets when they are assessed at fair value and whether loans were secured by collateral and guarantees. Inspections conducted in accordance with uniform standards also led financial institutions to establish their business practices of estimating allowance for loan losses using a certain formula, based mainly on historical performance of loans, for each borrower category.

Such inspection and supervisory methods played a role in resolving non-performing loan problems, which was the prior concern for the FSA at that time. During the period of booms and bubbles, many borrowers borrowed funds for asset purchases with a prospect of obtaining the funds for repayment by selling real estate and stocks after the prices had risen, and thus, deterioration in borrowers' balance sheet due to the decline in asset prices directly affected their credit quality. Under such circumstances, it was considered to be effective to assess borrowers' credit quality by examining the level of deterioration in their actual balance sheet.

However, as the internal control systems of financial institutions such as risk management and provisioning was examined uniformly without sufficient regard to the business strategies and lending policies of each financial institution, the business models encompassed in the Inspection Manuals have become quite limited, and following effects, as examples, were considered to have occurred,.

① It had affected financial institutions' lending practices by causing an excessive reliance on collateral and guarantees and a decline in their ability to understand and assess borrowers' businesses. (In contrast, before the bubble period, lending businesses focused on the use of funds, such as working capital and capital expenditures, as well as source of repayment, with an emphasis on future cash flows.)

② As the practice of estimating allowances based solely on historical loss experience and increasing or decreasing the amount of allowances due to changes in the borrower classification of individual borrowers established, it has become difficult for financial institutions to appropriately reflect the risks of future loan losses recognized by the management.

## 2. Supervisory Approaches appropriate for the changing business models and practices of financial institutions

### (1) Responding to the diversification of business model

In the past, there was a high need for funds due to a domestic shortage of funds, and financial institutions were able to choose borrowers. However, recently, borrowers are able to choose financial institution to borrow funds from due to the continuing bank competition on interest rate under drastic changes in the financial environment, such as the declining population, the aging of society, and the prolonged low interest rate.

Also, the needs for financial services have diversified. For example, regional enterprises have needs for not only business loans but also business succession, M & A, market development, human resources staffing, and business owners' asset management.

In order to meet such various needs of customers, an increasing number of financial institutions are offering unique services that draw on their own strength and in-depth knowledge attained through establishing relationships with customers, such as providing necessary funds through effective consulting. More financial institutions are expected to take such initiatives in the future.

For example, some financial institutions are not merely lending funds but also contributing to the increase in customers' corporate value. Some financial institutions also assess borrowers' credit ability by analyzing their business feasibility and future cash flow rather than by putting excessive emphasis on financial data, collateral and guarantees like they have done in the past. Furthermore, in order to support startups for which banks are unable to lend funds on their own risk but have high business potentials, some banks offer services other than lending such as introducing venture capitals and investment funds or offering advice on market development.

### (2) Increasing needs toward adequate preparation for future loan losses and crises

As financial institutions' business strategies and lending policies as well as borrowers' businesses have become more diversified and complex, and as borrowers' business environments have changed, the factors of credit risk in financial institutions' loan portfolios have also become divergent.

Not to notice, it will remain important for financial institutions to be able to respond appropriately to borrowers undergoing serious problems in their business conditions.

In addition, it is becoming more important for financial institutions to prepare for the future loan losses and to effectively initiate supporting borrowers' businesses that are not in serious business conditions at present, but have potential credit risks in the future before such risks become imminent.

### (3) Supervisory approaches fitted to the diversity of financial institutions

As described above, business environment of financial institutions has changed significantly and credit risk factors in the financial institutions' loan portfolio has diversified. In order to achieve better financial stability" and financial intermediation in a well-balanced manner, the Agency should also continuously review their supervisory methods in accordance with the diversity of financial institutions' business models, so as to make it easier for and encourage financial institutions to take their own initiatives.

# III. Basic concepts of supervisory approaches to lending business

## 1. Relationship between financial stability and effective intermediation

As mentioned at the beginning, it is expected that financial institutions' management should design and implement appropriate strategies based on its management principles and the Board of Directors should exercise governance in order to contribute to the sustainable growth of companies and the economy by attaining secure profitability and future soundness through continuous and effective financial intermediation in accordance with their respective business environments.[1]

[1] "Japan's Corporate Governance Code" (Principle 4.1 Roles and Responsibilities of the Board (1)) states that "The board should view the establishment of corporate goals (business principles, etc.) and the setting of strategic direction as one major aspect of its roles and responsibilities. It should engage in constructive

Therefore, when assessing the soundness of individual financial institutions, the Agency will identify and assess the risks arising from financial intermediation and engage in dialogue with financial institutions on priority issues regarding the soundness, based on an accurate understanding of each financial institution's unique characteristics, conditions, and initiatives in terms of financial intermediation.

As described above, the soundness policy and the effective financial intermediation are highly related and should be discussed as a whole.

## 2. Supervisory approaches in accordance with the unique characteristics of financial institutions

As mentioned at the beginning, it is desirable for the management of a financial institution to decide, with its own will, responsibility and resources (people, goods and capital), on the types, sizes and balance of risks to accept as business strategies based on its management principles. Also, the management should establish an internal control system that is consistent with such business strategies on risk monitoring and control.

Therefore, the Agency will take supervisory approaches fitted to each financial institution's unique characteristics based on the understanding on the diversity of the financial institutions' business principles, strategies and internal control systems.

In this document, the "unique characteristics of financial institutions" includes the management principles of each financial institution under its business environment (characteristics of customers, regional economies, and competitive environment), its corporate governance and culture, its practices as management strategies and plans, lending policies, risk and compliance management, loan classification, loan write-offs and loan loss provisioning, its loan and investment portfolios, its types of businesses (including various services for customers and securities investment) and its financial condition.

In developing each financial institution's internal control system, the underlying concepts of the Inspection Manuals, such as the development and dissemination of policies and rules, appropriate allocation of human resources and authorization, independence and checks and balances role of the risk management and internal audit divisions, and the importance of PDCA, should continue to be essential. However, the

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discussion with respect to specific business strategies and business plans, and ensure that major operational decisions are based on the company's strategic direction."

Agency will evaluate each financial institution on whether its internal control system is effective in light of its unique characteristics, whether the business principles and strategies are thoroughly shared within the organization, and whether sales promotion and risk management are carried out in accordance with these principles and strategies, instead of imposing establishment of standardized internal control system to financial institutions.

Each financial institution should decide on risk assessment methods and levels based essentially on its business strategies and aims, the diversity of businesses, and the complexity of risks it takes. The Agency should not require establishment of complex risk assessment and management system to financial institutions with simple business models and risk profile. When changes occur in a financial institution's established business practices, the Agency will engage in dialogue with the financial institution where appropriate regarding the risks that may arise from the changes without preventing the financial institution's initiatives for the better practices in accordance with characteristics of its business model and customers.

## 3. The Importance of Identifying and Assessing Credit Risks for the Future

It is necessary to identify and assess the credit risk of loan portfolios in order to promote a dialogue on not only the appropriateness of write-offs and loan loss provisioning, but also risk-taking and internal control in business strategies, adequacy of equity capital, profitability, and the sustainability of business models.[2]

It is important to appropriately identify and assess the present and emerging credit risk in the loan portfolio , based on the unique characteristics of each financial institution, from a wide range of information, including future forecast information and not limited to historical performance nor quantitative and qualitative information on individual companies.

Although the credit risk in the loan portfolio is partially covered by loan write-offs and loan loss provisioning in financial accounting, the credit risk not reflected in loan

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[2] Such dialogue is also familiar with the idea of the risk appetite framework (refer to pages 40 and 41 of the "JFSA's Approaches toPrudential Supervision"). Rather than promoting all financial institutions to adopt this framework uniformly, the main focus is to raise the consent of financial institutions regarding the sustainability of their business models, in accordance with the unique characteristics of each financial institution.

write-offs and loan loss provisioning is covered by capital base to ensure the soundness of the financial institution.

Previous supervisory approaches have focused on the appropriateness of the levels of write-offs and provisioning, especially on the accuracy of loan classification as a prerequisite. The changing supervisory approaches will promote discussions with financial institutions on the effective capital adequacy, and not limited to the accuracy of loan classification , when recognizing the credit risk not captured through provisioning or capital adequacy regulations.

The basic concept of JFSA's supervisory approaches regarding the soundness such as sustainability of business models is summarized in "JFSA's Approaches to Prudential Supervision.".

## IV. Supervisory approaches to lending business

### 1. Dialogue with financial institutions based on understandings of their unique characteristic

Regarding dialogue with financial institutions, the Agency will put the highest priority on facts rather than imposing its beliefs and hypotheses, and refer to the facts from time to time throughout the supervisory process.

Specifically, the Agency will conduct accurate profiling of the financial institutions on a risk basis, identifying and focusing on the issues appropriate for unique characteristics of each financial institution from the perspectives of their business environment, management principles, lending policies and actual lending practices as well as actual earnings, and credit risk that may arise from such lending businesses.

The Agency may engage in dialogue and examination on a loan-by-loan basis if necessary in order to understand in-depth the financial institution's financial intermediation function and to effectively assess each system regarding lending such as loan screening, management during the term, management of credit risk, loan classification, write-off and provisioning, in addition to accurate profiling of regional economic conditions, features of its loan portfolio, capital allocation and profit management.

The Agency will furthermore engage in dialogue on the sustainability of financial institutions' business models, taking into account not only the appropriateness of their levels of the allowance, but also their risk-taking and internal control system within management strategies, capital adequacy and earnings, based on the credit risk in their loan portfolio

## 2. Future supervisory approaches to lending business

The followings are the possible images at the present on specific dialogue in terms of promoting disclosure of supervisory process for lending business. Not to mention, the following cases are merely images, and supervisory approaches may certainly differ accordingly to each situation and changes in the future situation..

<Examples of sharing an understanding of the unique characteristic of a financial institution>

For example, a regional financial institution invests in securities, controlling risks and reducing costs, with its capital adequacy ratio in mind. Although its loans are based on long-term transactions relationships with customers , the regional financial institution has adopted a policy of expanding lending to local SMEs by improving branch offices' ability to understand and assess borrowers' businesses and actively supporting the business turnaround of local core borrowers whose business performance has deteriorated, while restraining lending to industries with high volatility, rather than increasing the loan volume of already-existing borrowers (core borrowers). In spite of population decline in local areas, lending to real estate leasing industry accounts for high portion of the loan portfolio. On the other hand, cross-border lending to metropolitan areas has been expanding in order to manage surplus funds.

<Issues to focus for accurate profiling >

Given the unique characteristics of a financial institution described above, for example, the authorities and the financial institution could conduct accurate profiling of the financial institution by focusing on the following points. The

Agency could also keep track of regional economy, the competitive environment, and the initiatives of an individual financial institution through dialogue with local stakeholders such as customers.

① Management's Discussion on Future Management Policies

- For example, it should focus on the consistency with the bank's business principles, the current conditions of borrowers as well as profits and costs, and the specificity of lending measures.

② Consistency between the management plans or policies and actual lending practices

- Relationship with Core Customers
  - ✓ For example, when the number of local core borrowers has declined, although the outstanding loan amount to local core borrowers has remained unchanged, the Agency should focus on the causes of the decline and the effectiveness of countermeasures.
- Curbing lending to high-volatility industries
  - ✓ For example, the Agency may examine the effects of actual economic fluctuations by focusing on the historical loss experience and the relationship between the transition of internal ratings and changes in the external environment of each industry.
- Lending to SMEs
  - ✓ The Agency may pay attention to financial institution’s profiling of customers, such as customer’s businesses, working capital, uses of loans, and future cash flow taking into account source of repayment, based on their relationships with the customers, as well as to the improvements in business conditions of borrowers to whom the financial institution provided support for business turnaround.
  - ✓ Relationship between the policy of focusing on lending to SMEs and the actual loan portfolio (for example, different from its lending policy, there may be cases where large loans to large enterprises are increasing or lending to local SMEs is not growing as expected in

spite of the financial institution's efforts due to the severe business conditions).

- Borrowers of large loan

  - ✓ In cases where large-sized loans are increasing, the Agency may heed attention to which large-sized loan borrowers the financial institution considers to have a large impact on its management, or to what management strategies and policies (including support for business turnaround) such large-scale sized loans are based on.

③ Implementation of capital allocation and profit management

- For example, in a situation where the allocable capital is relatively limited, the Agency may heed attention to the profits expected by the management by risk-taking and the consistency with the management policies.

<Examples of dialogue based on accurate profiling>

The authority should identify and assess financial institutions' risks based on an understanding of their unique characteristics, and engage in dialogue with financial institutions from the perspective of sustainability of their business models, including risk-taking and profitability.

① Identification, assessment and response to important credit risks

- When it is confirmed that the impact of economic fluctuations on loans to SMEs is small (with low volatility), credit risk is estimated based on historical performance unless customer characteristics and the internal environment of financial institutions have changed.

- If a financial institution has cultivated a new customer with a different risk characteristic from that of existing customers, such as engaging in cross-border lending to metropolitan area, the Agency may hold a dialogue on capital adequacy and the level of the allowance the financial institution considers as adequate, estimating its credit risk that can be assumed from the new customer's risk characteristics (refer to the examples of adjustment in V.2.(3) regarding the allowance for loan losses). If it is not possible to make a decision immediately, the Agency may continue monitoring.

- When it is confirmed that credit loss regarding loans for real estate leasing business has the tendency to increase or decrease due to changes in the past vacancy rate and rent level in the region, the Agency may discuss on how the financial institution perceives its capital adequacy and the appropriate level of the allowance, estimating credit risk by taking into account changes in the external environment in addition to historical performance.

- Regarding credit management of large borrowers, as indicated by the Guidelines for Supervision, dialogue may be conducted from the following viewpoints.

  - ✓ Credit, financial, and monitoring status of large borrowers that may have a significant impact on management, such as uses of funds for loans, future prospects for the borrower's business, and future cash flows.

  - ✓ Policies to be taken in case of increased credit risks (such as provisioning and capital adequacy requirements, support for borrowers' business improvement, and verification of appropriateness and effectiveness of borrower’s business improvement plans formulated).

  - ✓ The extent of effect on capital adequacy in the event that risks materialize from the perspective of whether financial institutions have the capacity and strength to provide effective support for business turnaround.

② Effective financial intermediation

- For example, a possible approach would be to understand how financial institutions' policies of "increasing loans to local SMEs by improving the discernment of branch offices and actively supporting the business turnaround of local core borrowers whose performance has deteriorated" have been realized at sales sites, providing added value to customers, and to discuss on governance of financial institutions.

- The authorities and financial institutions should clarify the factors that contribute to or hinder the realization of the above mentioned policy and share the future issues.

  For example, even if the actual lending practice differs from the lending policy, the authority and financial institutions could discuss the future policy of the management team based on such factors and the current situation, rather than considering the difference itself as an issue.

③ Sustainability of Business Models

- Based on the above mentioned substantial levels of capital, capital allocations, and profit management policies, the sustainability of the business model could be discussed from the standpoint of whether framework for ensuring that management strategies and policies are implemented throughout the financial institution is established, such as

  - whether the relationship with existing customers can be maintained,
  - whether management intentions are understood,
  - whether management strategies are considered within the scope of management resources such as capital,
  - whether management resources are appropriately allocated in accordance with management strategies and profits and costs are appropriately managed, including the recruitment and training of capable human resources as well as performance evaluation system.

<BOX1> The relationship between Credit Risk and Compliance Risk

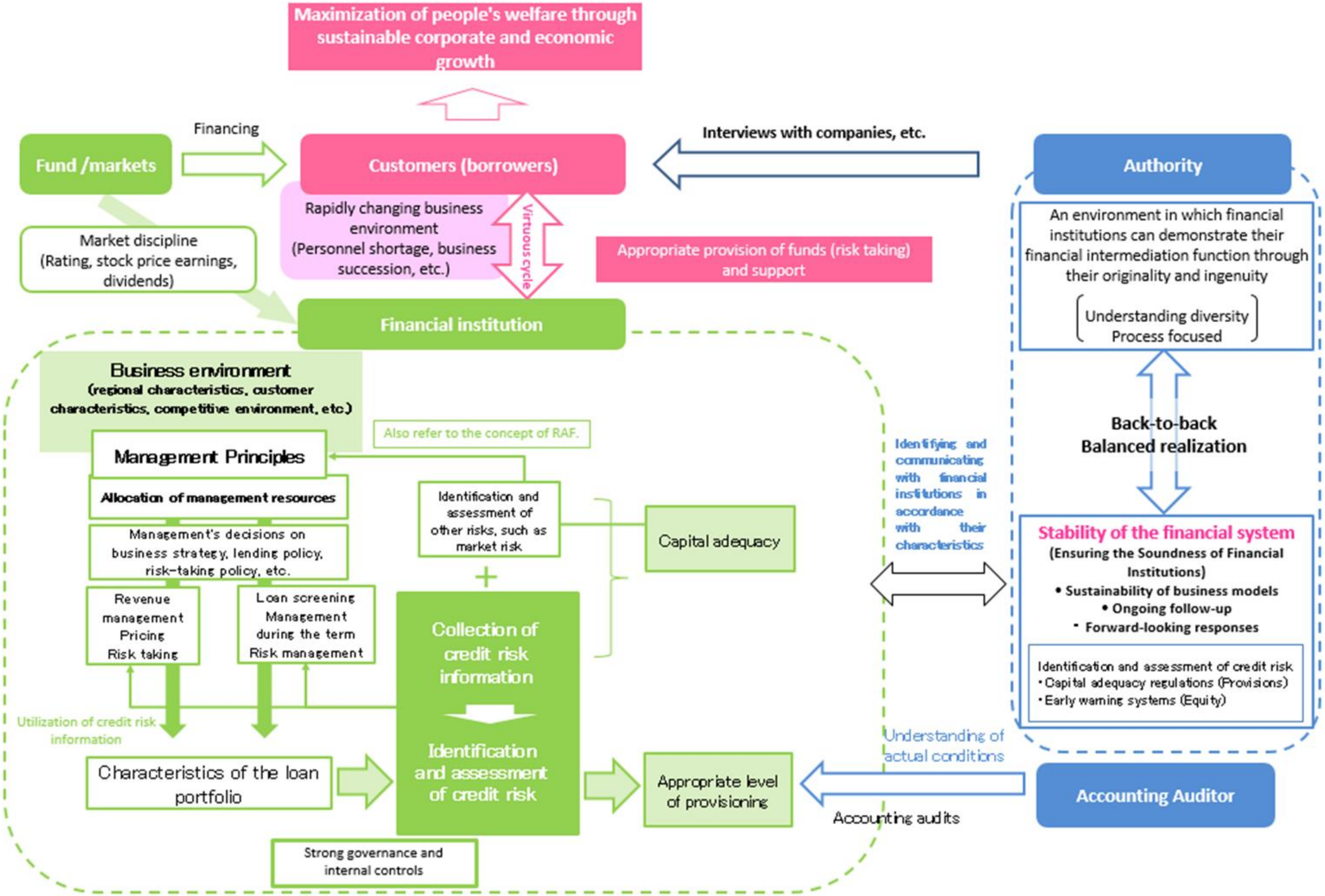
The idea of identifying and assessing risks from the supervisory process of examining how financial institutions adopt lending policies under their business philosophy, and what risks arise from lending operations conducted based on these policies is common to not only credit risks but also compliance risks.

When conducting an accurate profiling of financial institutions, the authority should conduct multidimensional examinations, taking into account not only credit risks but also the possibility that other risks may be identified as problematic events.

For example, in the case where illicit business activities, such as unreasonable sales activities, poor credit examinations, and falsification of examination-related documents conducted under a corporate culture that has a tendency to be profit first, credit risks and compliance risks may considered to be problems as two sides of the same coin.

Considering the possibility of a relationship between credit risk and compliance risk as described above, portfolio of financial institutions should be analyzed taking into account possible compliance risks based on their unique characteristics. In cases where there are loan products, regions, or industries with unnaturally expanding loan balances and profits, or where compliance and risk management problems are suspected based on information inside and outside the financial institution, individual loans should be examined as necessary from the viewpoint of the effectiveness of the compliance risk management system.

## 〔Overview of Inspection and Supervision of Lending Business〕



# V. Reflection of credit risk information in allowances

## 1. Basic Perspectives

In the past inspections and supervision, the JFSA have examined the appropriateness of write-offs and provisioning of financial institutions based on the framework of the Table of the Inspection Manuals (see the Appendix).

The framework of the Table of the Inspection Manuals is based on the framework of the accounting standards for financial instruments. It further subdivides borrowers into normal borrowers, borrowers who need attention (including borrowers who need special attention), borrowers who are in danger of bankruptcy, and effectively bankrupt borrowers, and bankrupt borrowers. As a general rule, for normal borrowers and borrowers who need attention (including borrowers who need special attention), an allowance is recorded in an amount equivalent to the expected loss, which is determined by multiplying the expected loss rate by the amount of receivables for each borrower classification (general allowance for doubtful accounts). For borrowers who are in danger of bankruptcy, effectively bankrupt, and bankrupt, an allowance is recorded in the expected uncollectible amount for each individual borrower (specific allowance for doubtful accounts).

Under this framework, for normal borrowers and borrowers who need attention (including borrowers who need special attention), future loss is basically estimated collectively, using expected loss rates reflecting future prospects based on historical performance. For borrowers who are in danger of bankruptcy, effectively bankrupt borrowers, and bankrupt borrowers, appropriate write-offs and provisioning are basically made for individual credit by estimating the expected uncollectible amount.

Nevertheless, with the Inspection Manuals being in place for many years, the practice of estimating general loan loss reserves by quantitative, uniform, and objective methods based on historical loan loss experience has become established among financial institutions. It has been pointed out that together with the inspection and supervisory methods of the authority, this practice has restricted efforts to estimate allowance for loan loss from a forward-looking perspective using wide range of information, not limited to historical performance. In addition, there was a tendency among financial institutions to classify borrowers with more emphasis on form than on substance of borrowers. As a result, there were cases in which it was difficult to appropriately reflect the credit risks recognized by financial institutions in allowances, and cases in which a roundabout method that was to maintain an overall appropriate level of the allowance by using borrower classifications, which deviated from the actual conditions of borrowers, was taken

The authority’s supervisory process also placed emphasis on requiring financial institutions to record additional allowance by pointing out differences in individual borrower classifications. In some cases, the authorities' inspections denied additional loans to borrowers that had liabilities in excess of assets with concern about bankruptcy although financial institutions were actively supporting business turnaround based on the judgment that business is viable. It has been pointed out that such practices had led to constrain financial institutions' smooth lending behavior.

In order to improve the problems that have occurred over the years, the following basic perspectives are considered to be important in supervisory process regarding financial institutions’ efforts to reflect the credit risk of their loan portfolios in allowance.

① The JFSA will encourage financial institutions to identify, assess, and reflect future credit risk in loan classification, write-offs, and provisioning based on their business strategies and policies consistent with their management principles.

② The JFSA will not hinder financial institutions' efforts to perform their financial intermediation function by paying attention not only to the collectability of loans from collateral and guarantees, but also to the repayment prospects based on future cash flows.

On the other hand, it is assumed that many financial institutions that are considering approaches to better estimates may start from the framework of borrower classification described in the Table of the Inspection Manuals.

Based on such understanding, this document does not deny the current practices that have been established based on the Table of the Inspection Manual. Rather, with the current borrower classification as the starting point, it presents estimation methodologies for more accurately reflecting credit risks recognized by financial institutions based on their own lending policies and the actual conditions of borrowers in their allowance for loan losses, in accordance with the current accounting standards.[3]

[3]In the past, there were cases in which borrowers' credit standing was intentionally disguised due to problems regarding soundness (for example, additional interest loans to show repayment capacity, indirect financing, fictitious sales using circular transactions, guarantees by uncreditable group companies), cases in

The basic concepts behind such estimates are described below, separately for general allowance for doubtful accounts and specific allowances for doubtful accounts.

### (1) Basic Concepts for Estimating General Allowance for Doubtful Accounts

Among borrower classifications, for normal borrowers and borrowers who need attention (including borrowers who need special attention), which are subject to general allowance for doubtful accounts, there is uncertainty about the future business conditions of individual borrowers. Therefore, statistical credit risks analysis will improve the accuracy of future loss estimates for the entire loan portfolio. Thus, it is possible to identify and analyze the characteristics of each financial institution's portfolio based on the appropriate judgment of each financial institution's management, then classify the groups of credits with unique risk characteristics that differ from those of other credits as separate groups, and reflect current and future information, such as changes in the external and internal environments, in addition to historical performance, in the allowance collectively.

In doing so, the judgment of the financial institution’s management should be made based on the facts collected to the extent reasonably possible. However, given that it is a future prospects, the estimates may vary from institution to institution.

The authority will assess whether the decisions of the financial institution's management are consistent with the management principles and strategies of each financial institution, and whether the management's decision-making process regarding the future prospects (in addition to historical performance) is appropriate and reasonable. However, in cases where circumstances specific to the borrower that are not captured in the collective assessment could have a significant impact on the financial institution’s business management, such as large-sized borrowers that need

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which financial institutions did not recognized the deterioration in their borrowers’ credit standing or leave their credit standing deteriorating although they recognize the deterioration (for example, classifying borrowers whose credit standing is deteriorating as normal borrowers without sufficient review until they become delinquent or bankruptcy), and cases in which the estimation of allowances had been arbitrarily underestimated (for example, focusing only on a part of historical performances with low loan losses).There were cases of problems with self-assessment, write-offs, and reserves.

Of course, the authority will conduct in-depth reviews for financial institutions that have issues with systems as minimum standards and will request to rectify their governance and internal control systems.

In addition, the authority will request them to re-estimate appropriate write-offs and loan loss provisioning when it is deemed necessary to appropriately assess the soundness of the financial institution.

These measures are taken based on the fact that credibility regarding matters that serve as a basis for financial intermediation and an appropriate assessment of financial institutions’ soundness lack to a certain degree and that systems as minimum standards not being established.

special attention, the accuracy of the estimation will improve by estimating the allowance individually, such as using the DCF method.

### (2) Basic Concepts for Estimating Specific Allowance for Doubtful Accounts

Regarding borrowers in danger of bankruptcy, effectively bankrupt, or bankrupt borrowers that are subject to specific allowance for doubtful accounts, there are serious problems in their business conditions, and characteristics of their risk vary. Therefore, it is appropriate to individually estimate the uncollectible amounts, accurately evaluating the repayment prospects of individual loans, and to record write-offs and provisioning in a timely manner.

[Reference 1]Relationship with Accounting Standard for Financial Instruments

Under the current Accounting Standard for Financial Instruments in Japan, loan receivables are classified into 1) general loans, 2) doubtful loans, and 3) bankruptcy or reorganization loans, depending on the financial condition and business performance of the borrower, and allowance for doubtful account is estimated for each category. (The "Practical Guidelines on Accounting Standards for Financial Instruments" and "Q&A on Accounting for Financial Instruments" define and provide details on definitions and estimation methods.)

The framework of the Accounting Standard for Financial Instruments formed the basis for the concepts of borrower classifications and allowance for loan losses from the perspective that concepts of evaluating loans largely differs, depending on whether or not it is highly probable that a serious problem will arise in the repayment of debts. Specifically, general loans are evaluated collectively, and doubtful loans and bankruptcy or reorganization loans are evaluated individually.

[Reference 2] Practices in the U.S.

Under the current accounting standard in the United States, loans are classified into Impaired Loans and Non-Impaired Loans. Impaired Loans should be charge-off at an early stage, taking into account individually the collectability from collateral. While for Non-Impaired Loans, the allowance is determined based on management's judgment, taking into account not only historical performance but also current qualitative factors.

The basic perspective of this document is similar to the U.S. charge-off and provisioning framework in that loans are broadly classified into two categories and for impaired loans, credit risk recognized from a wide range of information not limited to the historical performance is reflected in the allowance based on management's judgment.

## 2. Perspectives on Estimation of General Allowance for Doubtful Accounts

### (1) Basic Perspectives

As mentioned above, in order to address the risk of bad debts in the future, it is appropriate to promote each financial institution to assess the borrower's condition and business environment in light of its business philosophy and strategy, assess risks hidden based on management's judgment, and reflect such risks in allowances.

Therefore, the authority will assess the appropriateness and reasonableness of estimates of the allowance from the following perspectives.

1) Credit risk information

As mentioned in III.3. The Importance of Identifying and Assessing Credit Risks for the Future, the authority will assess how financial institutions identify credit risks from a wide range of information, including current information and future forecast, and not limited to historical credit loss experience and quantitative and qualitative information attributed to individual companies.[4][5]

There are various types of credit risk information as shown in the figure below. However, the type of information and the extent to which the information should

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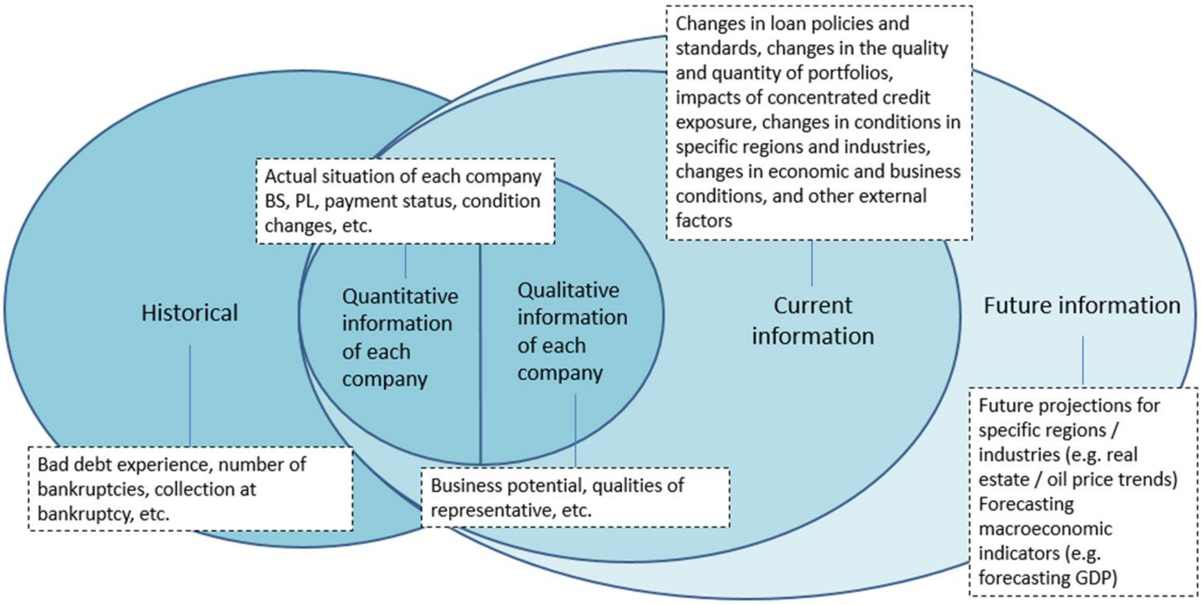
4 Regarding past information, the so-called one-and-three-year rule (see Appendix) concerning the expected loss period has been established in practice, and the authority does not deny the current practice. Each financial institution may adopt an average remaining maturity for a particular group of borrowers, based on its own lending policy and risk characteristics of its loan portfolio. If different expected loss periods from so-called one-and-three-year rule are adopted in the loan portfolio, the reasons for the adoption should be explained.

5 There are cases that the current and future information related to the individual company is taken into consideration in the process of determining the internal rating and borrower classification of an individual company.

be considered differs depending on the lending policy of each financial institution and the characteristics of its loan portfolio.

The authority will discuss with financial institutions how they use credit risks recognized from a wide range of information to examine the adequacy of equity capital and consider lending policies. Furthermore, if the credit risks are reflected in the allowance for loan losses based on management's judgment, the authority will review the appropriateness of the judgment process, as described later. Credit risk information to be reflected in the allowance needs to be reasonable and supportable, and as long as it can be used without incurring excessive costs and labor, information that leads to an increase in credit risk and information that leads to a decrease in credit risk need to be taken into consideration without bias.

〔 **Examples of information on credit risk** 〕



<BOX2> Unique characteristics of Each Financial Institutions and Information Important to Management

The range of credit risk information obtained through lending business and the key information used in evaluating the credit risk of loan portfolios differs depending on the unique characteristics of each financial institution.

For example, financial institutions that focus on qualitative information on individual companies obtained through relationships with customers in loan screening, management during the term, and support for business turnaround and engage in lending business rooted in specific regions often need to consider the same information when identifying and assessing credit risks and estimating the allowance. In addition, when considering the current and future information not attributable to a specific customer, credit risks can be assessed in detail by taking into account information that may affect borrowers in specific regions and industries, such as changes in the industrial structure in specific regions and changes in the occupancy rates and rent levels of rental real estate in specific regions.

On the other hand, financial institutions that conduct loan screening with an emphasis on quantitative information, such as financial information and account information, while reducing the costs necessary to establish relationship with customers and providing loans in a wide area both within the country and abroad, may be able to obtain only limited qualitative information on individual companies and may evaluate credit risks and estimate the allowance based mainly on quantitative information. In addition, when taking into account current and future information not attributable to a specific customer, the access to information on specific industries and regions is more limited compared to that of financial institutions that engage in lending business rooted in specific regions, and tend to lend to customers who form corporate groups spanning multiple industries. Therefore, macro-economic information such as the GDP growth rate, interest rates, foreign exchange rates, and unemployment rate may be more familiar to the assessment of credit risk.

2) Fairness of the estimation process and governance

Estimation of the allowance taking into account current information and future forecast involve uncertainty in estimates and management's judgment. Therefore, the fairness of the estimation process should be ensured through appropriate governance and internal control.

The purpose of the reflection of credit risk information as described in 1) above is to more accurately estimate future credit losses, and arbitrary adjustments to the allowance are not permitted. For example, the management of a financial institution may make an arbitrary estimate that reduces the allowance or increase reversal of allowance, contrary to the actual state of credit risk, during a recession when the level of profits declines. However, such estimation is not acceptable from the viewpoint of proper financial reporting, nor is it acceptable in JFSA’s supervisory approaches.

For this purpose, the authority will focus on examining whether financial institutions have established an appropriate governance system that serves as check function against the management, mainly regarding the Board of Directors, Audit & Supervisory Committee, Audit & Supervisory Committee, and Audit Committee (the Board of Directors, and Auditors in the case of cooperative structured financial institutions). The authority will also examine whether financial institutions have sufficiently discussed for accurate estimation not in an arbitrary way.

Reference

> In the United States, in order to ensure the fairness of estimates of the allowance, a framework was introduced under which a risk committee, the majority of whose members are outside directors with expertise in the relevant field, was established for the approval of the process and results regarding estimates of the allowance.

The authority will also examine issues necessary for an appropriate management’s judgment, including whether a framework to ensure that appropriate information is provided to management without bias is established. For example, in cases where appropriate information is not provided to the management such as important credit risk information is not collected, only some information is not collected arbitrarily, or only one-way analysis is conducted, it lacks information necessary for the management to make an appropriate judgment.

- A policy should be established for estimating the allowance from the viewpoint of what risks are assumed in light of the lending policy and what credit risk information should be collected.
- Customer information and external environment-related information should be collected and assessed without bias or deficiency in the business divisions (including other divisions that collect and possess credit risk information such as the research division and the management planning division), which are the source of risk, and shared with the risk management division.
- The risk management division should collect and evaluate credit risk information in accordance with the above policies and internal rules, discuss on estimates of the allowance from various perspectives, and report the results of the discussion to the management.
- The Internal Audit Division should conduct risk assessment based on the business model of the financial institution, evaluate and review whether the business philosophy and strategy are permeated to throughout the organization and whether an effective internal control system is established through monitoring the business division's information collection and assessment process and the risk management division's allowance estimation process, and propose improvements when problems are found.

3) Internal and External Verifiability

➢ Factual management decisions

The appropriateness and reasonableness of the management's judgment regarding the future prospects need to be examined by the internal audit division, outside officers, accounting auditors, and the authority.

Accordingly, the authority will examine the appropriateness and reasonableness of the management's judgment by verifying the facts upon which management's judgments are based and the views on results of allowance estimation derived from the facts.

In principle, financial institutions may use facts that they own. However, information from external common databases such as CRITS (Credit Risk Information Total Service) and SDB (Shinkin Central Bank's SME Risk

Database) may also be used if necessary.[6][7]

Although a model may be developed and used when estimating the allowance from credit risk information, the development of the model itself is not important. It is merely one means of securing the verifiability of the decision-making process of the management.

In the future, IT technologies, including AI, may be used for estimating the allowance. When utilizing such technologies, it is necessary to ensure the verifiability of the estimation process, such as the visualization of the introduction process.

Moreover, regarding the accuracy of data and models, it is sufficient if the accuracy is at the level necessary for the above relevant parties to make judgments. It becomes contrary to the original intent if the work itself becomes self-purpose and more refined than necessary.

➢ Appropriate documentation (visualization of management's decision-making process)

In estimating the allowance, the appropriate estimation methods may differ depending on each financial institution’s loan policy and the characteristics of its loan portfolio. Accordingly, the authorities will review whether the financial institution has appropriately documented its management's decision-making process for estimating the allowance to ensure verifiability, including the following documents:

(Example of Documentation)

- Policies and methods of estimating the allowances adopted by the financial institution
- Internal control framework related to lending
- The process of estimating the allowance (including the process for collecting facts underlying the estimates, the process for considering appropriate estimating methods, the process for assessing the

[6] Integrated credit risk information services for the regional banking industry (consisting of financial and credit information database, scoring model, and portfolio analysis functions)
[7] Credit risk database for small and medium enterprises for the Shinkin Bank Industry

reasonableness of management’s assumptions, the process for considering alternative assumptions or results, and the content of discussions by management).

4) Comparability for users of financial statements

Since the purpose of the provisioning is to estimate future losses more accurately, the direction of this document, which aims to more accurately represent credit risks in the loan portfolio, is useful not only for the authority to assess the soundness of financial institutions, but also for the decision-making of financial statement users, and in this sense, will improve the comparability of financial statements.

On the other hand, in light of the direction of this document, it is expected that allowance estimation methods vary by each financial institution. In order to enable users of financial statements compare amounts of the allowance in financial statements based on the understanding of the estimation methods, it is important to enhance the disclosure of provisioning policies and estimation methods by, enhancing the description of the notes to the accounting standards for recording provisions, while taking into account the possibility of causing speculation about individual debtors.

### (2) Approach to Loans that are Appropriate to Estimate Collectively

The overall accuracy of the estimation is expected to be improved by using statistical methods, since the number of financial institution’s individual loans is huge and there is uncertainty such as that business conditions may always deteriorate, even among borrowers who are performing well. Therefore, with respect to estimates of the allowance it is reasonable to make collective estimates in principle. In addition, as described in (3) below, when reflecting the current and future information in the allowance, it is more appropriate to estimate the amount of the allowance collectively in a separate group for a group of loans with unique risk characteristics different from other loans, rather than by estimating individually.

The purpose of grouping is to facilitate the reflection of important credit risk information of each financial institution's loan portfolios in the allowance. Therefore, the methods are not uniform and each financial institution should adopt an appropriate method in the light of this purpose. Excessive group segmentation to reflect unimportant credit risk information in the allowance is not appropriate.

If the number of loans included in the group becomes small and the amount of data for statistical estimation is insufficient for individual financial institutions, the use of external data may be considered among relevant parties.

<Example of grouping based on current practice>

Rather than creating a new group of borrowers that completely differs from existing borrower classifications, it is likely that financial institutions group borrowers based on their current practices. In such case, for example, the following can be considered.

- Grouping within borrower classification (industry, region, use of funds, loan products, main and non-main borrowers, amount of credit, and internal ratings)
- Grouping across borrower classifications (borrowers whose borrower classifications tend to fluctuate due to the economic fluctuations are segmented and assessed in a separate group)

**(3) Examples of reflecting the current and future information that is not attributable to an individual company in allowance for loan losses**

As described in (1) 1) above, the credit risk information includes current information and future forecast that is not reflected in the financial statements of an individual company, but is expected to affect the individual company in the future. When the situation is significantly changing or is reasonably expected to change in the future compared to the period covered by the historical loan loss experience, financial institutions may be able to reflect credit risk of the loan portfolio in the allowance more accurately by reflecting current and future information in the allowance on the basis of the historical loan loss experience.

On the other hand, if there is no significant difference in the future prospect even after taking into consideration the current information and future forecast information, financial institutions may estimate the allowance based on the historical loss rate.

The followings are examples of how to reflect the information in the allowance depending on the type of information that may be currently considered. It should be noted that the followings are merely examples. Financial institutions are expected to estimate credit risk in voluntary initiatives in accordance with their unique characteristics, not limited to the following examples, and they should not establish the allowance based on the formal or superficial adjustments to the examples.

1) Changes in the Internal Environment

Recently, in order to adapt to the rapidly changing business environment, some financial institutions have reviewed their lending policy, credit screening system, system for management during the term, and system for supporting business turnaround. When such changes in the internal environment occur, financial institutions may not be able to appropriately reflect the credit risk of a specific group in the allowance based only on the historical information.

In such cases, by making necessary adjustments based on the probabilities estimated from historical information, financial institutions may reflect the changes in risks due to changes in the current internal environment in the allowance.

Such estimates are made based on the appropriate and reasonable judgment of the management of each financial institution from the above basic perspectives, and are not limited to a specific method. However, for example, the following adjustments can be made for financial institutions that adopt the calculating method based on historical loss rate, which is calculated in accordance with the status of loans for total loans or similar type of loans.

Examples of Adjustments

- In cases where financial institutions newly adopted policies to promote loans to middle-risk borrowers, or in cases where financial institutions expedited loan screening by expanding the authority of branch managers, they may segment such borrowers as a group and consider the necessity of adjustment.

  In such cases, provisioning coverage ratio in line with the actual condition of such group of loans may be adopted, for example, by multiplying the outstanding loan amount by the historical loss rate of the lower-rated normal borrowers rather than that of the whole normal borrowers.

  Loans to middle-risk borrowers may also be provided using other types of loan products. For example, in cases where loan products with relatively high risks, such as loans on deeds with extremely long scheduled repayment periods compared to existing loans and long-term loans with lump-sum repayment dates for which specific source of repayment is not scheduled, are segmented in a group, provisioning coverage ratio for borrowers with similar risk characteristics may be adopted (For example, there were cases that provisioning coverage ratio for borrowers who need special attention was applied due to the similar risk characteristics. In addition, financial institutions may obtain similar cases' data for reference, using external common databases such as CRITS, and SDB).

Examples of Initiatives in Current Practice (**start-up financing, financing of medium-risk borrowers**)

In the case of new loans to borrowers newly provided with start-up finance or borrowers receiving support for improvement (middle risk borrowers), the same provisioning coverage ratio as that applied to borrowers who need special attention shall be applied for the time being, after separating such loans from other loans. When data such as the actual number of bankruptcies has accumulated, the provisioning coverage ratio based on such data shall be substituted for the new loans (shinkin banks).

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| Possible lending behaviour and risk analysis methods | ✓ New start-up financing to meet local start-up support needs<br>✓ Provide equity-like long-term loans bundled with core business support to companies whose credit conditions have deteriorated somewhat on their financial statements but whose business conditions are expected to improve<br>✓ Appropriate identification of risks that are different from those of conventional loan products and customer segments |
| Reflection in provisioning | ✓ Since this is a new loan, there is no past credit loss experience. However, in order to tackle relatively high-risk areas, provisions are booked for these risks in groups. |

- In cases where financial institutions adopted a new policy to promote lending in areas distant from the local area, they may segment such borrowers into a group and consider the necessity of adjustment.

  In some cases, such changes in the lending policy lead to a shortage of credit risk information, compared with borrowers with deeper local relationship, and thus to an increase in loan losses due to sudden bankruptcies even for borrowers with similar internal ratings. In other cases, such changes in the lending policy do not lead to a significant increase in loan losses. Therefore, it is necessary to consider whether or not adjustment based on grouping is appropriate and in the cases where such adjustment is appropriate, to consider which adjustment is appropriate in light of the actual credit risk.

- When making adjustments, various methods can be considered depending on the information held by the financial institution. For example, financial institutions may refer to the historical loan loss experience of which expanding business in other region, or to the results of a comparison of the most recent number of bankruptcies between a non-local group and a local group. In addition, financial institutions may obtain similar cases' data for reference, using external common databases such as CRITS, and SDB. When the financial institution newly strengthens its system for supporting business turnaround, targeting a certain group of borrowers who need attention for providing support, and their business improvement became smoother than other borrowers, the financial institution may segment such borrowers into a group and consider the necessity of adjustment.

In doing so, for example, the financial institution may assess the effectiveness of its support system by comparing the upward transition rate and the downward transition rate of the group's loans and other loans over a certain period of time, and adjust the provisioning coverage ratios according to the degree of its effectiveness.

In cases where the credit risk of the group is reasonably assessed separately from other loans due to the sufficient accumulation of information on the group's historical loan loss experience, it is reasonable to use the historical loss rate of the group.

2) Changes in the External Environment

During the past economic cycle, it was sometimes difficult to appropriately estimate future losses by merely assessing credit risk based on historical loan loss experience, especially when the economy was already deteriorating or was expected to deteriorate.

In such cases, financial institutions may make necessary adjustments based on the probabilities estimated from past information to assess the impact of changes in the current external environment and in the future external environment over the expected loss period and reflect the results in the allowance.

Indicators of changes in the external environment can be relatively micro-level (for example, vacancy rates and rent levels of rental real estate in specific regions, ship chartering fees by type of ship, and amount of fish caught by types of fish) and macro-level (for example, GDP growth rate, interest rates, exchange rates, unemployment rate, and house price index). It is important to consider the adoption and combination of indicators, taking into account the loan policy of each financial institution and the characteristics of its loan portfolio, in light of the objective of accurately estimating future losses.

Regarding the timing of the information, it is first important to appropriately reflect the current information already known in the allowance for loan losses, but moreover, financial institutions may estimate future changes in the indicator and reflect the change in the allowance. However, when reflecting future forecast information in the allowance, the forecast need to be supported by the reasonable basis, since unlike current information, future information involves forecasts (even in such cases, it is necessary to take into account the available information unbiasedly without excessive costs and effort).

Examples of Adjustments

- In cases where financial institutions that has a policy to maintain a long-term relationship with customer to which they provide support for business improvement including to change terms, continuously support the management of certain fisheries business, which is an important local industry, and when a poor catch of that certain type of fish is reasonably expected during the expected loss period based on current signs and historical statistics, financial institutions may segment such borrowers of certain fisheries business as a group and calculate the provisioning coverage ratio by estimating the effect on profit and loss due to the poor catch.

  Specifically, financial institutions may adopt historical loss rate based on the period, which includes the period when the similar type of poor catch had an impact on loan loss in the past, instead of historical loss ratio based on the average for the most recent period.

- When a financial institution that has a policy of focusing on the real estate leasing business in a specific region and that loan segment is susceptible to the economic fluctuations, the financial institution may segment the relevant loans into a group and adjust the provisioning coverage ratio by estimating the effects of changes in the current and future external environment with the basis of historical loss rate.

There are various methods of adjustment. For example, one method is to identify indicators that are highly correlated with the trend of loan loss in the segment (for example, changes in the vacancy rate of the similar type of real estate in that region, and rent levels), and then adjust the provisioning coverage rate based on the current trend of the indicators.

Examples of Initiatives in Current Practice(**Ocean Ship Leasing Business**)

In the ocean ship leasing business, if it is determined that the amount of decrease in earnings expected over the next few years cannot be covered by the cash and deposits currently held and that there is a high possibility that the bank will change the terms of the loan, the bank will record a provision equivalent to that for loans requiring special attention (bank).

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| Possible lending behaviour and risk analysis methods | ✓ Although the bank is promoting loans to specific industries, it plans to recover mainly cash flows rather than disposing of collateral because there is a risk of a shortage of collateral due to large fluctuations in the value of collateral in these industries.<br>✓ For this purpose, the bank identifies changes in the future cash flows of customers' businesses due to changes in ship charter fees, etc., at an early stage, and appropriately manages risks. |
| Reflection in provisioning | ✓ For industries that account for a relatively large share of financial institutions' loan portfolios and where economic fluctuations have a large impact on future cash flows, the financial institution analyzes the risks associated with future cash flow fluctuations from a forward-looking perspective, and reflect this in provisions. |

3) Events that could significantly affect the borrowers' credit standing

It is important in lending business to identify and respond to sudden events that could have a significant impact on borrowers' credit standing in a timely manner.

There are various possible events, and typical examples include the occurrence of large-scale disasters, structural changes in specific industries due to technological innovation, the introduction of regulations that have a significant impact on the management of specific industries, and the entry of competitors that have a significant impact on the sales of businesses in specific regions.

In relation to the allowance, when the impact of events on the credit standing of individual borrowers is clear, financial institutions may reflect such credit risk in the allowance through internal ratings and borrower classifications. On the other hand, there are cases that it takes certain period of time for the impact of events to appear in the financial statements of individual borrowers, so the impact may not be obvious at the reporting date.

In such cases, financial institutions may reflect the impact of current events in the allowance by making necessary adjustments to the probabilities estimated based on past information.

Such estimates are made through the appropriate and reasonable judgment of the management of each financial institution based on the above basic perspectives. Estimations methods are not limited to a specific method, but the following adjustments are the examples for financial institutions that for example, adopt the calculating method based on historical loss rate.

It is important to continuously follow up on the impact of these events on individual borrowers, since the impact of these events are merely estimated at a certain point in time and is not a determined impact.

Examples of Adjustments

- In the event of a large-scale disaster in a specific region, financial institutions may group borrowers in the area expected to be affected by the disaster, collect information on historical loan losses in the event of a similar type and sized disaster, and record an additional provision in the amount exceeding the amount set aside for the group by calculating method based on historical loss rate. Financial institutions may also calculate the historical loss rate in the event of a similar disaster in the past and replace with the ordinary historical loss rate.

  Since some financial institution may not have sufficient data on disasters, they may accumulate data in external databases such as CRITS for the utilization by each financial institution in the future.

- If the orders to manufacturers of specific parts for existing products are expected to decline significantly in the future due to the recent spread of new products, financial institutions may estimate how much the number of orders will decline for such group of borrowers that may be affected, and in that case, how much it will affect business, and reflect the estimation in the allowance.

Examples of Initiatives in Current Practice (**Auto Parts Manufacturing Industry**)

When extending loans to car manufacturers' partner companies, swiftly set aside loan loss provisions by, for example, changing borrower classifications in response to expected increases or decreases in order volumes resulting from changes in economic conditions and industrial structure (shinkin banks)

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| Possible lending behaviour and risk analysis methods | ✓ A high proportion of its loans are to the automobile industry, and many of its customers are heavily affected by sudden economic changes. Therefore, the bank's policy is to detect the impact of sudden economic changes at an early stage and provide appropriate support to minimize the impact on business operators.<br>✓ In the automobile industry, the business flow of components is clear, and fluctuations in order volume are easy to estimate. Therefore, loans are provided based on the risks of each component manufacturer<br>✓ Early recognition of risks in order to provide support quickly |
| Reflection in provisioning | ✓ Even at a stage when the impact of changes in economic conditions or industrial structures is not reflected in the profits and losses of individual borrowers, for a group of component manufacturers that are particularly affected, risks are recognized by estimating increases and decreases in order volumes and reflected in provisions. |

※This is a case where borrower classification was changed in anticipation of the impact on individual borrowers of changes in economic conditions and industrial structures, and is not a case where allowance ratios and amounts were adjusted as a whole

### (4) Approach to Loans of Large Borrowers

As described in (2) above, since the allowance should be estimated collectively in principle, in the cases where the trends in individual industry may affect multiple companies, financial institutions may group borrowers with similar risk characteristics and estimate the allowance collectively.

On the other hand, in the cases where borrowers who need special attention or whose borrower classification is likely to fluctuate due to economic fluctuations, and when such borrowers are large borrowers who may have a significant impact on the management, the risk characteristics of such borrowers may differ from those of other borrowers. In such cases, some financial institutions actually take such measures.[8]

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8 As mentioned above, when the risk characteristics of large borrowers differ from those of other loans and the risk characteristics of large borrowers moved downward below the level of borrowers in danger of bankruptcy, it is not necessary to immediately raise the expected loss rate in a similar way for all other loans. Rather, the management of financial institutions should make judgments in light of the characteristics of the portfolios of individual financial institutions.

There are several methods for estimating individually on the large borrowers. Followings are some examples of the methods. Financial institutions should adopt appropriate methods, taking into account the credit exposure, importance of large borrowers' lending in the management considering volatility, the risk characteristics of individual borrowers, and their lending policies.

1) The Discounted Cash Flow method (DCF method) (however, since some point out that the current DCF method requires an excessively complex estimation process, it is expected that further discussions and research on suitable methods to make individual estimates for more than certain numbers should be conducted by the Japanese Institute of Certified Public Accountants).[9]

2) PD method (Even for financial institutions adopting calculating method based on historical loss rate for collective estimation, for large borrowers, as described in (1)1) above, financial institutions may calculate the amount of expected loan losses individually, using probability of default) and loss given default that take account of historical, present, and future credit risk information (such as industry characteristics, economic sensitivity).

3) Method of deducting the expected available for sale amount in the market from the amount of loans

In addition, even when estimating future cash flows individually, it is appropriate to consider past, present and future credit risk information to the reasonable extent, not limited to financial and qualitative information of the borrowers.

In doing so regarding large borrowers, it is important to distinguish between for example the cases assessing large local company with a long relationship to which financial institution is intending to support as much as possible even when the business condition deteriorates and cases assessing borrowers for investment purposes without established relationship due to their credit risk characteristics differ.

[9] Regarding the current DCF method, see "Notes on Audits When the Cash Flow Estimation Method (DCF Method) is Adopted for Recording of the Allowance for Loan Losses at Banks and Other Financial Institutions" (February 24, 2003, Japanese Institute of Certified Public Accountants).

Therefore, it is important to make estimates taking into account the risk characteristics of each borrower. Specifically, the level and period of future cash flows that can be estimated may differ depending on the information available and differences in lending policies of financial institutions (see also BOX3).

In particular, even within normal borrowers, for those with different risk characteristics from other borrowers, they may include borrowers who are susceptible to the economic cycle and have a high volatility of future cash flows, although they do not have current problems on financial conditions and business performance. Therefore, in such cases, financial institutions may estimate considering the volatility of the future cash flow.

## 3. Perspective of estimating the Specific Allowance for Doubtful Account

### 1) Accurate Understanding of Loans subject to Specific Allowance for Doubtful Accounts

In order to prevent delaying the recognition of credit losses in the loan portfolio, the authority should examine whether each financial institution accurately identifies the loans subject to the specific allowance for doubtful accounts and has developed a system to record write-offs and provisioning for the estimated uncollectible amount in a timely manner. Thus, it remains important to examine whether financial institutions are appropriately evaluating individual loans.

In doing so, for example, the authority should pay attention to the following points.

- Whether an additional lending without economic reasonableness is not provided
- Whether the conditions of borrowers are appropriately understood
- Whether sudden bankruptcies of normal borrowers and borrowers who need attention are not increasing unnaturally[10]

[10] Under current practice, there are some cases where normal borrowers and borrowers who need attention suddenly go bankrupt due to financial institutions' failure to appropriately manage during the term. In such cases, it is important for financial

In past inspections, the authority repeatedly pointed out that borrowers should be classified as borrowers in danger of bankruptcy, focusing on the fact that liabilities of borrowers actually exceed assets when they are assessed at fair value. Such attitude of the authority had a certain impact on the lending behavior of financial institutions.

When assessing the credit standing of borrowers, it is certainly important to determine whether liabilities of borrowers actually exceed assets, taking into account the collectability of receivables and unrealized losses on assets. However, it is ultimately important to examine whether there are serious concerns about the collectability of principal and interest, and whether there is a high likelihood of default for all or part of loans.

Therefore, in assessing whether a borrower is in danger of bankruptcy, the authority should evaluate whether there is a high likelihood of default with a focus on the repayment prospects (future cash flows), taking into account not only the borrower's historical business performance and business improvement plans, but also the business growth potential and the support for business turnaround provided by financial institutions.[11]

Under current practice, some financial institutions have adopted a policy of conservatively classifying borrowers with fair value liabilities in excess of assets as borrowers in danger of bankruptcy, even when their businesses are viable, and actively providing support for business turnaround. However, when the authority examine loans to borrowers in danger of bankruptcy but whose businesses are viable, it is essential to facilitate financial institutions' efforts to support such borrowers' business turnaround. For example, rather than pointing out that there is a problem in the loan screening system only because additional loans have been provided to borrowers in danger of bankruptcy, the authority should examine whether there is a

institutions to develop a system that enables them to recognize the deterioration in borrowers' credit standing in a timely and accurate manner.

[11] In considering financial institutions' support for business turnaround, it is necessary to pay attention to the effectiveness of financial institutions' support from the perspective of the support's sustainability, such as the financial institution's policy for risk-taking to support borrowers and a policy for capital allocation to support such risk-taking, in addition to the system for supporting business turnaround and the borrowers' business improvement performance.

problem in the screening of individual loans from the viewpoint of consistency with the management philosophy and lending policy of the financial institution and whether the loans are ultimately collectable.[12]

**(2) Estimation Method for Specific Allowance for Doubtful Accounts**

For loans to borrowers in danger of bankruptcy, effectively bankrupt, and bankrupt borrowers, it is appropriate to estimate the allowance individually since the risk characteristics of each loan differ from those of other loan.

With regard to the method for estimating the allowance for loans to borrowers in danger of bankruptcy, several methods, including the followings, have been established in practice, and financial institutions should adopt methods suited to the risk characteristics of individual loans and the policies of each financial institution. For example, when estimating the allowance for large borrowers that are deemed to have a large impact on the soundness and profits of financial institutions in the event of bankruptcy, it may be easier to reflect the actual condition of credit risk in the allowance by estimating future cash flows on an individual basis.

1) Estimated loss rate method (a method that uses the probability of historical loan losses, taking into account the amount expected to be collected from collateral and guarantees for each individual loan)

   Under current practice, in calculating the expected loss rate, it is sufficient to estimate losses for the next three years. However, if losses are expected to occur over a longer period of time, financial institutions may expect losses for that relevant period.

2) DCF method

3) Cash flow deduction method (a method in which the amount remaining

[12] When estimating the amount of specific allowance for doubtful accounts using the expected loss ratio method (a method that uses the probability of historical loan losses, taking into account the amount expected to be collected from collateral and guarantees for each individual loan) for borrowers in danger of bankruptcy but whose businesses are viable, financial institutions may group borrowers into those with business viability and those with not, and consider an appropriate expected loss ratio for each group's credit risk.

after excluding the amount that are collectable from reasonably estimated future cash flow is deemed to be the expected loss amount, taking into account the amount expected to be collected from collateral and guarantees for each individual loan)

4) A method of deducting the estimated amount of available-for-sale in the market from the amount of loans

**Examples of initiatives in current practice (long-term support for firms in danger of bankruptcy and lengthening of expected loss periods)**

In calculating the allowance for credit losses on loans classified as Category III for borrowers in danger of default, a long-term loss expectation period is set, and the allowance for credit losses is calculated based on the credit loss experience during that period (multiple companies)

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| Possible lending behaviour and risk analysis methods | ✓ The lending policy is to maintain a long-term relationship with customers, and even if customers are classified as borrowers in danger of default, the policy is to maintain a continuous relationship as much as possible.<br>✓ On the other hand, there is a risk that the customer's risk over a long period of time may be underestimated if losses over only three years are assumed, although the customer's risk over a long period of time should be understood. |
| Reflection in provisioning | ✓ If the provisioning coverage ratio is calculated based on the assumption of losses only for three years, the amount of loan-loss provision may be excessively small. Therefore, the historical loan-loss experience is calculated by aggregating the loan loss experience for the remaining period, taking into account the actual remaining period of loans. |

<BOX3> Relationships between policies and actions of financial institutions and the allowance

When multiple financial institutions providing loans to a specific customer, estimated amount of the allowance may differ depending on the policies and actions of each financial institution. For example, the following cases can be considered.

- Impact of business turnaround support on borrowers' future repayment capacity

When the borrower's business is expected to be viable, even if a borrower's credit standing is deteriorating, financial institutions' policies on lending and business turnaround support as well as actions taken based on those policies may affect the borrower's business viability and repayment capacity, and the total amount of repayment may increase. (On the other hand, in cases where it is difficult for a borrower to continue the business and the borrower is expected to go bankrupt, it is unlikely that there will be a significant difference in the total amount collected from the borrower depending on the policies and actions of the financial institution. However, there may be a difference in the amount collected depending on the individual financial institution's behavior for collecting loans.)

For example, a financial institution that has developed an effective system for supporting business turnaround and has a policy of maintaining relationships with and providing support to borrowers even for those whose credit standing has deteriorated may estimate the allowance by taking into account the borrowers' business viability expected through such support (Note). In addition, financial institutions that have a policy to sell loans to third parties that provide business turnaround support for borrowers whose credit standing has deteriorated to reduce the number of personnel to allocate to providing support for business turnaround may estimate the amount of allowance by taking into account the losses on the sale of such loans.

(NOTE) While respecting such measures taken by financial institutions, in cases where financial institutions' support for business turnaround is not effective and the business viability of borrowers is disguised by providing unreasonable additional loans to delay the occurrence of losses, the authority should appropriately recognize financial institutions' situation, including the increased amount of credit, and encourage financial institutions to reconsider their estimates of write-offs and provisioning in accordance with the actual conditions of such borrowers.

- Differences in estimated amount of the allowance due to differences in the degree of influence on borrowers

When estimating the allowance for specific customers whose credit standing has deteriorated, the prospects for the business viability of the borrower may differ between the main bank that provides effective support for business turnaround and the non-main bank that maintains transactions but success or failure of business turnaround depends on the main bank.

Specifically, in cases where the business viability of a borrower depends on the continuity of support by a main bank, the main bank, which has a lot of information on the borrower and has a significant impact on the borrower's business viability, may estimate the allowance on the assumption that there is little concern about the business viability of the borrower since the main bank adopts the policy of continuing its support. On the other hand, non-main banks, which has a little information on the borrower and does not have much impact on the borrower, may estimate the allowance on the assumption that there is concern about business viability.

<BOX4> Normal Working Capital and Estimates of the Allowance

From the perspective of reflecting the collectability of loans, when estimating borrowers in danger of bankruptcy, the financial institutions may estimate the allowance by taking into account not only the estimated amount of repayment from collateral and guarantees, but also the amount of loans that are deemed to be normal working capital and have reasonable and supportable certainty of collectability, based on the continuous monitoring of cash flow.

In cases where adopting a method for estimating future cash flows based on such concept (for example, 2) and 3) above), it would be sufficient to incorporate the above-mentioned amount of normal working capital into future cash flows for evaluation.

In addition, in cases where adopting a method using the expected loss rate (for example, in 1) above), there are methods such as estimating the allowance by incorporating the above mentioned amount of normal working capital in the estimated amount of repayment from collateral and guarantees, and estimating the allowance by grouping borrowers with prospects of future cash flows other than the estimated amount of repayment from collateral and guarantees and incorporating the expected collectability of normal working capital.

<BOX5> Examples of Relationships between Supervisory Approaches to Lending Business and Financial Institutions' Initiatives

Even if financial institutions try to improve their initiatives regarding lending business and the process of identifying and assessing credit risks including the estimation method for the allowance in accordance with their management philosophy and strategies, their efforts may be constrained if the authority conducts uniform inspections and supervision based on specific business models. Therefore, the authority will take supervisory approaches in accordance with the unique characteristics of each financial institution so as not to constrain their voluntary initiatives.

Specifically, the following cases can be considered.

**Example ①**

**Past**

✓ Even if a financial institution explains the business potential of a borrower that is subject to revitalization support when the FSA assesses an individual loan, if the FSA does not understand the explanation and points out that the borrower is at risk of bankruptcy because its real liabilities exceed assets, the financial institution may be reluctant to provide business improvement support or additional loans to the borrower.

**From now on**

✓ Instead of focusing on examining whether or not individual borrower classifications are incorrect, we will identify how the financial institution is providing support for customers' revitalization in line with its management principles, and examine the business conditions of customers and the rationality of support for their revitalization. Then, we will discuss issues for further provision of support.

**Example ②**

**Past**

✓ If supervisors are excessively concerned about financial institutions' arbitrary loan-loss provision estimates and uniformly force them to rely on historical loan-loss experience ratios, some financial institutions may not be able to estimate appropriate loan-loss provisions for credit risk, which in turn may make it difficult to appropriately assess the soundness of the institutions.

**From now on**

✓ Based on discussions with related parties, we will accumulate and publish methods for estimating loan loss provisions that suit the characteristics of various loan portfolios. This will make it easier for each financial institution to move forward with their initiatives.

✓ For individual financial institutions, we will emphasize the verification of the estimation process for loan loss provisions. For example, we will respect initiatives by the management of the financial institution to estimate loan loss provisions based on the risk characteristics of a group of companies targeted for support.

**Example ③**

**Past**

✓ When the loan balance of local small and medium-sized enterprises (SMEs) does not increase as much as expected and their profits temporarily deteriorate, the FSA simply point out that their core business is in the red without showing an understanding of their management principles and raise questions about the sustainability of their business model.

**From now on**

✓ Based on the financial institution's management principles and policies, the FSA shall understand over what time frame the return commensurate with the risk is expected, and monitor the financial institution taking into account its soundness with an eye to the time frame.

Engaging in dialogue on priority issues in line with the unique characteristics of each financial institution enables financial institutions to make initiatives for improving their business in line with their management philosophy easier without constraint, and contributes to an appropriate assessment of their soundness.

<Box6> Relationships with Disclosure of Risk-managed Loans

In Japan, disclosure of risk-managed loans is required under the Banking Act and disclosure of non-performing loans is required under the Act on Emergency Measures for the Revitalization of the Financial Functions (hereinafter referred to as the "Emergency Revitalization Act"). In May 2019, the amendments of the Ordnance for Enforcement of the Banking Act were put to public consultation, to unify the classification and disclosure of risk-managed loans under the Banking Act and non-performing loans under the Emergency Revitalization Act.

- Risk-managed loans: Loans are classified into "Bankrupt loans," "Past due loans," "Three months or more past due loans," and "Restructured loans" and disclosed.

- Non-performing loans under the Emergency Revitalization Act: Loans, loan securities, customers’ liabilities for acceptances and guarantees, foreign exchange, privately placed bonds with financial institution guarantee, and other interest receivable and suspense payments in assets are classified into " bankruptcy or reorganization loans and similar loans," "doubtful loans," "loans in need of special attention," and "normal loans" and disclosed.

The disclosure of these loans is a legal requirement, and the accuracy and comparability of these classifications remain important.

However, it is pointed out that the management of the non-performing loan classification affects the lending behavior of financial institutions. Therefore, it is necessary to review the following points, for example, in order to continue accurate disclosure.

- "Doubtful loans" in non-performing loans under the Emergency Revitalization Act are defined as "claims for which the debtor's financial condition and business performance is deteriorating, although not yet gone bankrupt, and is highly likely that it is unable to collect principal and interest in accordance with the contract" (Article 4(3) of the Ordinance for Enforcement of the Emergency Revitalization Act).

  Under such definition, when classifying loans, it is important to focus on the repayment prospects. In the past, however, there were cases in which borrowers with future cash flow prospects were classified as doubtful loans, focusing merely on the borrowers' financial position, and as result, hindered economically reasonable lending behavior. As mentioned in "3. (1) Accurate Understanding of Loans subject to Specific Allowance for Doubtful Accounts" above, it is advisable to improve the classification of loans based on the degree of repayment prospects, which should be considered as an important factor.

- "Restructured loans" in risk-managed loans are loans on which an agreement has been made in favor of the borrower, such as reduction or exemption of interest rates, deferral of interest payment, deferral of repayment of principal, and wavier of debt, for the purpose of restructuring or supporting the borrower's business (Article 19-2(1)(v)(b)4. of the Ordinance for Enforcement of the Banking Act).

  Under the current framework, even when interest rates are reduced or exempted, if a yield that is substantially equivalent to the yield when the base rate is applied is secured, it does not fall under "an agreement favorable to the borrower" and thus, such loans are not classified as restructured loans (Comprehensive Guidelines for Supervision of Major Banks, etc. III-3-2-4-3 Disclosure of Risk Management Loans).

However, while the interpretation of the base rate itself has become increasingly complex, there are views that, under the current low interest rate environment, it is not meaningful to apply the complicated criteria to determine whether a loan qualifies as the restructured loan.

Based on such opinion, the approach to the basic interest rate for restructured loans will be discussed in the future, including revisions.

In doing so, not only the current interest rate environment, but also the current practice of financial institutions, the purpose of the Act, which requires disclosure of restructured loans, and the impact of conflict of base rate on collectability should be taken into consideration.

# Ⅵ. Development of Framework for Supervisory Approaches for Lending Business

## 1. Improving the Assessment Ability of the Authority

Since the new supervisory approaches to lending business are tailored to the unique characteristics of each financial institution, a wide range of knowledge and sophisticated assessment ability are required particularly in the following areas. Therefore, it is increasingly important for the authority to develop a quality management system as an organization to ensure the quality and depth of monitoring and appropriate supervisory responses.

1) Appropriately understanding the unique and characteristics of each financial institution (including management philosophy and strategies)

2) Identifying and assessing significant credit risks in loan portfolios through accurate understanding of the unique characteristics of the financial institution

3) Reviewing governance and decision-making process to ensure the appropriateness and reasonableness of management's decisions

Specifically, the authority will take following measures based on the “JFSA’s supervisory approaches - Replacing checklists with engagement” as well as concepts and approaches for specific issues and areas.

The authority has already started to conduct off-site monitoring to understand the unique characteristics of each financial institution and to develop monitoring plans fitted to such efforts under the current inspection and supervision. The authority will continue to improve the quality of inspection and supervision through the PDCA cycle.

[Enhancement of risk profile and off-site monitoring]

- Understanding and analyzing the unique characteristics of each financial institution on a daily and organizational basis, and sharing awareness with financial institutions
    - ✓ Analysis of regional economy and competitive environment, and understanding and analysis of materials for the board of directors and executive meetings (including revision of loan screening standards and discretionary power of branch managers, and internal audit results) in cooperation with Local Finance Bureau staff
- Analysis of the occurrence of misconducts, complaints, whistle-blowing, and news reports
- Dialogues with top management and staff of financial institutions, as well as with various level of parties inside and outside of financial institutions such as outside directors, audit firms, customers (including questionnaires on business companies), chambers of commerce and industry, guarantee associations

[Development and Securing of Human Resources]

- Development and securing of human resources regarding lending at the JFSA and the Local Financial Bureau (improvement of the ability to assess repayment prospects based on the understanding of industries, use of funds, and source of repayment, and accumulation of organizational know-how)

[Development of Information Infrastructure]

- Review of data and methods for collecting data regarding loans
- Sophistication of information infrastructure and analysis methods

Quality management

- Improving the quality of ongoing monitoring through the introduction of a mechanism for internal verification of individual monitoring and evaluation by external experts

## 2. Respecting the judgments of the financial institutions' Management based on the examination of the estimation process

As mentioned above, the authority will focus on the unique characteristics of each financial institution and take supervisory approaches fitted to such characteristics in order to appropriately assess the soundness of financial institutions, while developing environment that enables financial institutions to take their own initiatives to meet their customers' diverse needs. In doing so, it is important, in principle, to respect the judgments of the financial institutions' management, not to hinder their initiatives.

Therefore, in order to ensure the appropriate level of the allowance, the authority will examine the process leading to management's judgment, such as the fairness and verifiability of estimates including the governance of financial institutions, while taking into account the possibility of arbitrariness in financial institutions' estimates during recessions when profit levels decline.

As a result, assuming that the process leading to management's judgment is appropriate, in cases where, for example, when estimates are made at a level lower than the simple historical loss rate as a result of taking into account current and future information, the authority will conduct ongoing monitoring, including examining any changes in the situation and ex-post examination such as back-testing , while respecting the judgment of the management of the financial institution in principal.

On the other hand, in cases where there are concerns about the process leading to management's judgment (including the problems in the effectiveness of the internal control system), the authority will conduct more in-depth understanding of the financial institution request the financial institution to rectify the governance and internal control system, and consider encouraging the financial institutions to reconsider their estimates of write-offs and provisioning.

As mentions above, the authority will assess the soundness of financial institutions from the perspective of whether their business models are sustainable overall, taking into account not only the appropriateness of the levels of write-offs and provisioning, but also the adequacy of equity capital, risk-taking, and profitability.

## VII. Relationship with Accounting Auditors

As mentioned above, regarding the credit risk of each financial institution's loan portfolio, the estimation made by the management of the financial institution is primarily important. Among these, it is considered appropriate to provide for losses that can be reasonably estimated based on accounting standards by write-offs and provisioning, and for risks that cannot be recognized in accounting by equity capital.

In inspections and supervision of loans, the authority will identify and assess credit risks with forward-looking perspective, including credit risks not reflected in the write-offs and provisioning in financial accounting. The JFSA will utilize such identification and assessment in discussions on the sustainability of the business model, taking into account factors such as profitability, risk-taking, adequacy of equity capital, and the overall appropriateness of the level of the allowance.

On the other hand, accounting audits provide accurate representation of expected losses in the financial statements, and accurate financial reports to stakeholders such as investors (shareholders) and depositors, which are aimed to serve as useful decision-making materials. As a premise, undergoing the process of identifying and assessing the credit risks of the loan portfolio starting from the management philosophy, is considered to contribute to this objective.

In addition, although the credit risks should be reflected in the write-offs and provisioning in the financial accounting primarily though the management's judgment, accounting auditor should be responsible for auditing whether or not such judgment and reflection are made in an appropriate manner in accounting. It is considered appropriate for the authority to respect the management's judgment and accounting auditor's professional opinions as long as the judgment and the opinions have been properly made in the process of identification and assessment of credit risk (if there is concern about the process of identification and assessment of credit risk, as in VI.2 above, the authority should conduct more in-depth understanding of the financial institution and request the financial institution to rectify the governance and internal control system, and examine measures in accordance with the extent of the problem, such as encouraging the financial institution to reconsider the estimation of the write-offs and provisioning).[13]

## VIII. Future Issues Regarding Supervisory Approaches to Lending Business

This document sets out the authority's concepts and approaches to overall loan inspection and supervision practices, and provides basic perspectives and examples to encourage financial institutions to improve their estimates of the allowance based on more accurate future prospects.

Nevertheless, there are various approaches to specific improvement based on the basic perspectives other than those described in this document, depending on changes in the external environment and the unique characteristics of each financial institution.

Therefore, in the future, if new issues and examples are identified in the process of inspections and supervision regarding loans, the authority will consider publishing them in some form after discussions with relevant parties.

[13] The authority in this chapter refer to the authority responsible for the supervision of financial institutions.

Appendix

Framework for Loan Classification, Write-offs, and Provisioning under Current Practice

## 1. Loan Classification

In assessing assets, financial institutions in principle perform credit ratings and classify borrowers accordingly to these credit rating. Then, they consider individually the use of funds regarding credits, and classify credits according to the degree of risk of collectability or risk of impairment of value, taking into account the status of the collateral and guarantees.

Credits refer to loans and credits similar to loans (loan securities, foreign exchange, interest receivable, accounts receivable, suspense payments similar to loans, and customers' liabilities for acceptances and guarantees).

[Borrower Classification]

<table>
<tr><td colspan="2">Normal borrowers</td><td>Borrowers whose business conditions are favorable and whose financial conditions are deemed to have no particular problems</td></tr>
<tr><td colspan="2">Borrowers who need attention</td><td>Borrowers who have problems with loan terms, such as waivers, reductions, or deferrals of interests, borrowers who have problems in performance, such as de facto arrears on principal or interest payments, borrowers whose business conditions are poor or unstable, and borrowers who have problems with financial conditions, and other borrowers who require attention in the future management</td></tr>
<tr><td></td><td>Borrowers who need special attention</td><td>Among the borrowers who need attention, the borrowers whose credits wholly or partially require special attention (a "Three months or more past due loans" or a "Restructured loans ")</td></tr>
<tr><td colspan="2">Borrowers in danger of bankruptcy</td><td>Borrowers who are currently not in bankruptcy but are in business difficulty and have poor progress in business improvement plans, and are deemed have high possibility of falling into bankruptcy in the future (including borrowers receiving support from financial institutions)</td></tr>
</table>

| | |
|---|---|
| Effectively bankrupt borrowers | Borrowers who are not yet legally or formally in bankruptcy, but are in serious business difficulties with no prospect of restructuring, and who are effectively in bankruptcy |
| Bankrupt borrowers | Borrowers who are legally and formally bankrupt due to, for example, bankruptcy, liquidation, civil rehabilitation, corporate reorganization, and suspension of transactions by the clearinghouse. |

[Upgrading of borrower classifications through highly feasible and fundamental business restructuring plans and reasonable and feasible management improvement plans, etc.]

| Type of plan | Reasonable and feasible management improvement plans | Highly feasible and fundamental business restructuring plans |
|---|---|---|
| Upgrading | From borrowers in danger of bankruptcy to borrowers who need attention | From borrowers who need special attention to borrowers who need attention other than those who need special attention |
| Contents | See the Supervisory Guidelines | See the Supervisory Guidelines and the interpretation of restructured loans in the Q & A on restructured loans. |

[Loans with sufficient capital characteristics]

- For the purpose of understanding the "actual condition of borrowers," loans with sufficient capital characteristics, whether they are new loans or conversions of existing loans, may be treated as equity rather than liabilities.

[Loans to SMEs]

- The borrower classification of SMEs and micro-enterprises will be determined based on the comprehensive understanding of the company's business condition, taking into account not only the financial status of the company, but also the company's technological capabilities, sales capabilities and growth potential, remuneration to the representative director and other directors, income and assets of directors, the guarantees status and ability.

Credit categories

<table>
<tr><th>Borrower classifications</th><th>Estimated disposal value of superior collateral and recoverable amount by superior guarantees</th><th>Recoverable amount by ordinary guarantee</th><th>Estimated disposal value of general collateral</th><th>Difference between the estimated fair value and the estimated disposal value of superior collateral and ordinary collateral</th><th>Unsecured by collateral or guarantees</th></tr>
<tr><td>Normal</td><td colspan="5">Category I (Non-Categorized)</td></tr>
<tr><td>Needs attention</td><td>Category I</td><td colspan="4">Category II</td></tr>
<tr><td>Needs special attention</td><td>Category I</td><td colspan="4">Category II</td></tr>
<tr><td>In danger of bankruptcy</td><td>Category I</td><td colspan="2">Category II</td><td colspan="2">Category III</td></tr>
<tr><td>Effectively bankrupt</td><td>Category I</td><td colspan="2">Category II</td><td>Category III</td><td>Category IV</td></tr>
<tr><td>Bankrupt</td><td>Category I</td><td colspan="2">Category II</td><td>Category III</td><td>Category IV</td></tr>
</table>

Category I (non-categorized) includes discount bills of certain settlement and credits that are deemed certain of collection within a short period of time from specific repayment resources.

In the case of borrowers who need attention, in principle, claims that are deemed to be normal working capital are classified as Category I (non-classified).

Category II of borrowers in danger of bankruptcy, effectively bankrupt and bankrupt borrowers include those that are deemed recoverable through liquidation dividends in the event of bankruptcy.

"Ordinary collateral" refers to collateral other than superior collateral that is disposal from objective perspective. For example, it includes real estate collateral, industrial factory foundation collateral, chattel collateral, finance receivable as collateral, etc. may be included in general collateral.

With regard to chattel collateral and finance receivable as collateral, the authority pay attention to whether the substantial recoverable amount has been calculated by comprehensively taking into account the state of collateral management, the method of disposing of the collateral, the existence of legal defects in collateral, and the credit standing of third party debtor. For example, regarding finance receivable as collateral under the current Civil Code, the provision of a special non-assignment could be a legal defect, but after the enforcement of the revised Civil Code, the substantive recoverable amount should be calculated taking into account the purpose of the revision, and is not uniformly recognized as non-ordinary collateral.

## 2. Write-offs and provisioning

General allowance for doubtful accounts (normal borrowers, borrowers who need attention other than those who need special attention, borrowers who need special attention)

- Calculation methods
    - Calculate for each borrower classification by calculating method based on historical loss rate or calculation method based on probability of default
    - Adoption of the DCF method to large borrowers who need special attention
    - It is desirable to calculate the general allowance for doubtful accounts by group according to the composition of the portfolio (by industry, region, size, amount of loans, individuals or corporations, product characteristics, and secured status of loans).

- Expected loss period (calculation period)
  - Principle: Average remaining maturity corresponding to the actual loan period
  - Simplified method: If development and accumulation of data such as historical loan losses and losses in the average remaining period cannot be expected, it is sufficient to expect losses for the next year for normal borrowers and borrowers who need attention other than those who need special attention, and for the next three years for borrowers who need attention
- Calculation of the amount of the expected loan losses
  - For each of the normal borrowers, borrowers who need attention, and who need special attention, the amount of expected loan losses is calculated by calculating the average historical loss rate or probability of default for at least the past three calculation periods, calculating expected loss rate after making necessary adjustments regarding future expected losses to the average historical loss rate or probability of default, and multiplying each loan amount by the expected loss rate.
  - The expected loss rate is determined by taking into account changes in the economic conditions, changes in the lending policy, changes in the composition of the portfolio (changes in the composition of the credit rating, the industry of the borrower, the region of the borrower, the amount of the loans, the size of the borrower, whether the borrower is an individual or a corporation, and the secured status of loans), and other factors, and by making necessary adjustments to the historical loss rate or the probability of default based on future forecast.
  - In particular, in cases where the economic situation is rapidly deteriorating, when adopting the calculation period for the historical loss rate or the probability of default, it shall be determined by methods such as increasing the weight of the most recent calculation period and adjusting the expected loss rate in consideration of the increase rate of historical loss rate or probability of default in the most recent period.

Specific allowance for doubtful account

<<In danger of bankruptcy>

- Establish necessary allowance for the remaining amount (Category III amount) after deducting the estimated amount to be collected from collateral and guarantees (Category I and II) for each borrower.

(Calculation methods of the allowance for the Category III amount)

- Expected loss rate method
- Cash flow deduction method
- Method of deducting the estimated amount of available-for-sale in the market from the amount of the loans

- Adoption of the DCF method to large borrowers

<<Effectively bankrupt or bankrupt >>

- Provision for the Category III amount
- Provision or write-offs (partial direct write-offs) for Category IV

<<Non-recording of interest receivable>>

In principle, interest receivable on borrowers in danger of bankruptcy, effectively bankrupt, and bankrupt borrowers shall not be recorded as assets.