

(Provisional translation)

* This translation is provisionally prepared and subject to change without notice.

**Inspection Manual
for Deposit-Taking Institutions**

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Financial Services Agency

Inspection Manual for Deposit-Taking Institutions

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【Introduction】

1. Interpretations and applications of this manual should be in accordance with “The Financial Inspection Basic Guidelines,” issued on July 1, 2005, which specifies the basic concepts of financial inspections.
2. In order to conduct appropriate inspections based on the basic concepts of financial inspections shown in the Basic Guidelines, when inspectors conduct inspections of deposit-taking financial institutions¹ (hereinafter referred to as “financial institutions”), they must pay particular attention to the following points.

- (1) Inspection focusing on major risks (“a risk-focused, forward-looking” approach)

Based on information and the examination details obtained before and through on-site inspections, the inspector must analyze the locations of risks in each financial institution, and endeavor to conduct a prioritized examination focused on major risks².

- (2) In-depth analysis and clarification of causes, which lead to the fundamental improvement of problems

Regarding problems which have a major effect on the soundness etc. of the business, the inspector must have dialogues between the inspector and the financial institution and carry out especially in-depth analysis and clarification of the causes, which will lead to a shared understanding with the financial institution regarding the direction of actions needed for fundamental improvement of the problems (direction of improvement).

- (3) Identification of problems, evaluation of appropriate improvement efforts, and examination of static and dynamic aspects

The inspector must accurately understand the actual circumstances, considering two points: (i) accurate identification of problems and evaluation of appropriate initiatives that lead to improvements and enhancements, (ii) in addition to the static aspect at the inspection, also full examination of the dynamic aspect, such as progress in system development.³

- (4) Explanation of the basis for issues pointed out and ratings, and clarification of items to be considered for improvement

In advancing dialogues and discussions on findings and assessments, the inspector must show

¹ Refer to *Points of Attention for Inspections with Use of This Manual* 1.

² Here, it covers all risks which could have a major effect on the ensuring of the soundness and appropriateness of the financial institution’s operations, not limited to the risks of each risk management system mentioned in this manual. Major risks include not only cases where problems have actually occurred, but also cases where problems have not actually occurred. In making such judgments, the investigation must consider the possibility of a problem actually occurring as well as the extent to which problem occurrence would affect the business.

³ One must fully investigate vectors toward improvements and enhancements. (Is it heading towards improvement and enhancement? Do the initiatives cover a broad scope? Are the initiatives carried out with a sense of urgency?)

specific and logical grounds, and in order to build a more advanced internal control system, clarify the points which should be considered for improvement, and show them specifically.

(5) Accurate understanding (“feeling of agreement”) of examination findings

The inspector must use accurate examinations, dialogue and discussions with the management, etc., to obtain accurate understanding (“feeling of agreement”) of the examination findings, in order to bring about the financial institution’s proactive and dynamic efforts for business improvement.

3. This manual is intended as guidance for inspections of financial institutions. Financial institutions, for their part, should endeavor to ensure the soundness and appropriateness of their business under the leadership of the management, based on the principle of self-responsibility and by exploiting resourcefulness and creativity, develop policies and internal rules suited to their own scales and natures.

This concept is shared by financial institutions and the authorities, in “Principles in the Financial Services Industry.”⁴

Meanwhile, financial institutions are not necessarily required to meet all of the criteria set forth in the check items of this manual. When using this manual, inspectors should take care not to apply the criteria in a mechanical and undistinguishing manner.

Therefore, even a case where a financial institution does not literally meet the requirement of a check item should not be regarded as inappropriate if the arrangements and procedures put in place by the institution are reasonable from the viewpoint of securing the soundness and appropriateness of its business, and are thus deemed as effectively meeting the requirement or as sufficient in light of the institution’s scale and nature. For example, if a financial institution does not have a division described in the checklists of each system, the inspector should review, with due consideration of the institution’s scale and nature, whether its organization is structured in a way to enable the execution of necessary functions and a check-and-balance system.

⁴ Published in April 18, 2008, as major norms and principles of conduct for how a financial institution conducts its business, and for administration by authorities. These principles present the concepts that financial service providers are, for example, expected to “1. pursue greater customer benefits and fulfill their expected roles through voluntary efforts with creativity” and “12. conduct appropriate risk management in accordance with the size and features of the business operation and inherent risk profile.”

【Points of Attention for Inspections with Use of This Manual】

1. This manual shall apply to all deposit-taking financial institutions. “Deposit-taking financial institutions” refer to the institutions listed below and other institutions that take deposits. This does not include insurance companies, etc.
 - Banks
 - Shinkin Banks and Federations of Credit Associations
 - Credit Cooperatives and Federations of Credit Cooperatives
 - Labor Credit Associations and Federations of Labor Credit Associations
 - Agricultural Cooperatives and Federations of Agricultural Cooperatives
 - Fishery Cooperatives and Federations of Fishery Cooperatives
 - Marine Product Processing Cooperatives and Federations of Marine Product Cooperatives
 - Norinchukin Bank
 - Overseas branches of the above financial institutions (including overseas offices, subsidiaries and representative offices. However, whether they are subject to inspections under this manual shall be decided on a case-by-case basis in light of the applicable laws and regulations, including local laws, and the like)
 - Japanese branches of foreign banks

It should be noted that when inspecting financial institutions that have obtained approval under Paragraph 1, Article 1 of the Law concerning Financial Institutions’ Concurrent Undertaking of Banking and Trust Business (hereinafter referred to as “Concurrent Business Law”), inspectors should conduct examination of banking business in accordance with this manual and examination of trust business and issues specific to banking-trust institutions in accordance with the Inspection Manual for Trust and Banking Companies (Supplement of the Financial Inspection Manual for Trust Business), while considering the purpose of the approval of concurrent undertaking of banking and trust business by financial institutions under the Concurrent Business Law and clearly bearing in mind the separation of the banking and trust business.

Also, when inspecting parties conducting transactions with financial institutions or inspecting the holding companies that are the parents of financial institutions, inspectors should make a necessary examination in light of the relevant parts of this manual.

However, the “Checklist for Finance Facilitation Section” in this manual covers the financial institutions listed above, excluding Japanese branches of foreign banks.

2. When inspecting financial institutions, the FSA will take the following approach in view of the

reduction of administrative workload, size, and characteristics of these financial institutions.

- (1) In conducting the on-site inspection of financial institutions, the FSA will avoid setting the hearing on the date of a general shareholders meeting (or general meeting) or the fiscal year end to ensure that the department in charge of the general shareholders meeting or account settlement is able to operate related tasks smoothly.
- (2) When making requests to financial institutions for documents, etc., for reference purposes, the FSA will endeavor to utilize the already existing documents, etc., at the financial institution or those obtained by the Supervisory Bureau. In requesting financial institutions to submit additional documents other than those already existing and available, the FSA will clarify the necessity of such documentation and endeavor to require those that are truly necessary.
- (3) The FSA will make efforts to avoid interfering in the smooth operation of small-sized sales branches of financial institutions or bank agency service providers (e.g., small-sized post offices, etc.), considering their capability of dealing with an inspection.

3.

The “Checklist for Finance Facilitation Section” was developed to arrange the items which should be especially considered in inspections to ensure effectiveness of finance facilitation and to clarify the focus of inspections. Therefore, this checklist overlaps with some parts of check items written in the “Checklist for Credit Risk Management” and the “Checklist for Customer Protection Management” for aspects of financial facilitation.

Same as for other checklists, achievement of the level of each check item in this checklist is not an obligation immediately imposed on financial institutions. In applying this checklist, inspectors must fully consider the financial institution’s size and characteristics, and take care to avoid its mechanical and uniform application. Inspectors must also take care not to intervene in individual credit decisions which should be decided by business judgment of the financial institution.

Therefore, even if the financial institution does not literally comply with what is written in this checklist’s items, it does not necessarily mean that it is inappropriate. From the perspective of sound and appropriate operations, if the financial institution’s responses are found to be rational or to have similar effects as the contents of the check items, or are found to be sufficiently corresponding to the financial institution’s scales and natures, then it is not inappropriate.

Also, for this checklist, the “Financial Facilitation Management Policy,” “Financial Facilitation Management Rules” and “Financial Facilitation Manual” do not necessarily have to be developed as a unified policy which covers all items that should be clearly written. Inspectors must keep in mind that it is sufficient if items are prescribed in multiple policies in multiple departments.

Moreover, inspectors must keep in mind that in some cases, the Financial Facilitation Manager in this checklist has an additional post as a staff (or manager) in another division such as the Credit Risk Management Division.

4. The descriptions in this manual are in principle based on the assumption that the manual shall be applied to banks that appoint corporate auditors (establish a board of auditors) under the Company Law. Inspectors should bear it in mind that with regard to some of the check items, certain types of financial institutions may not be legally obligated to conform with the criteria and requirements specified therein.
 - (1) In the case of a financial institution that has established nominating, audit and compensation committees under the Company Law, inspectors should review with due consideration for the following points, whether the Board of Directors, the committees and executive officers are exercising their authority appropriately.
 - 1) The authority over business execution rests with executive officers, but not with directors in principle.
 - 2) The Board of Directors may delegate the decision-making authority concerning business operations to executive officers by adopting a relevant determination.
 - 3) The Board of Directors is responsible for supervising the execution of duties by directors and executive officers.
 - 4) The ultimate auditing authority rests with the auditing committee, not with individual auditing committee members. (Auditing committee members appointed by the auditing committee execute the auditing authority on behalf of the committee.)
 - (2) The cooperative type of financial institution is required to appoint accounting auditors only in limited cases.
 - (3) In the case where an executive director (non-director) assumes the roles and responsibilities that would normally be assumed by a director in charge of a specific business operation, it is necessary to conduct a comprehensive review as to whether the Board of Directors has assigned authority to the officer that is similar in effect to what would be granted to a director in charge, whether the focus of the responsibility is made clear and whether the Board of Directors sufficiently monitors the execution of the relevant business operation. Based on the findings thereof, the inspector should determine whether the executive officer is performing the roles and responsibilities required for a director in charge as specified in the checklists of this manual.
5. Unless specified otherwise, items expressed in the question form such as “does the institution...” or “is the institution...” refer to requirements that must be met by financial institutions. Meanwhile, items expressed in the sentence “It is desirable...” refer to what would be expected as part of best practices recommended for financial institutions unless specified otherwise. For items following the conjunction “for example,” financial institutions are not required to fully accomplish letter-by-letter the criteria and requirements specified therein. They are merely examples of items that may be useful for checking whether financial institutions are meeting certain criteria and requirements in a manner that fits the scale and nature of their

business.

6. Following are the definitions and use of some of the key terms in this manual
 - (1) Decisions concerning items specified as the prerogatives of the “Board of Directors” must be made based on substantive debate by the Board of Directors itself. However, this shall not preclude other deliberative bodies, division or department from discussing draft proposals for decision.
 - (2) The “Board of Directors or organization equivalent to the Board of Directors” includes, in addition to the Board of Directors, other entities that decide matters concerning corporate management with the participation of senior managers such as a council of managing directors and a corporate management council (hereinafter referred to as the “Council of Managing Directors, etc.”) It is desirable that decisions concerning items specified as the prerogatives of the Board of Directors or organization equivalent to the Board of Directors be made by the Board of Directors itself. In the case where the decision-making authority is delegated to the Council of Managing Directors, etc., it is necessary to make sure that the delegation has been made in a clear manner, that a follow-up review is provided through the compilation of the minutes of meetings of the Council of Managing Directors, etc. and that a sufficient check-and-balance system is ensured through arrangements such as requiring reports to be made to the Board of Directors and allowing corporate auditors to attend meetings of the Council of Managing Directors, etc.
 - (3) The “manager” of a division is the senior management officer (including a director) in charge of that division. The “manager” of a sales branch, etc. is the head of that branch or a senior management officer (including a director) who assumes the same level of work responsibilities as or higher responsibilities than those of the branch head.
 - (4) “Internal rules” are rules that specify arrangements on a financial institution’s business in accordance with its corporate management policy, etc. that are applicable within the institution. It should be noted that internal rules do not necessarily have to specify detailed procedures.
 - (5) The “marketing and sales division” refers to a division, department, or sales office engaged in sales business. For example, a division involved directly or indirectly in sales or engaged in sales promotion planning is a marketing and sales division.
 - (6) The “office (trading, banking) division” is a division or a department engaged in market transactions.
 - (7) The “legal checks, etc.,” which includes a compliance check, means, for example, a validation of the consistency and compatibility of internal rules and the legality of transactions and business operations. The “legal checks, etc.” will be verified by personnel in charge of legal affairs, a division in charge thereof, lawyers within and outside the financial institutions, and other experts.
 - (8) “Monitoring” refers not only to surveillance but also implementation of specific pre-emptive

measures such as issuing warnings.

- (9) The “risk profile” of a financial institution refers to all the features of various risks to which the institution is exposed.

Business Management (Governance)

Checklist for Business Management (Governance) (for Basic Elements)

Checkpoints

- For a financial institution to ensure the soundness and appropriateness of its business, maintain its credibility, protect depositors and facilitate finance, the institution must perform financial intermediary functions including business consultation and guidance, and ensure full legal compliance and customer protection, as well as precise management of various risks under an appropriate business management (governance) system.

- In order to enable a financial institution to conduct business management (governance) effectively, officers and employees, as well as organizations within the institution must perform their respective roles and responsibilities. To be more specific, directors and other executives are responsible for nurturing work ethics and cultivating an institution-wide culture that attaches importance to internal control. The representative directors, non-representative directors and corporate auditors must understand their own roles in the various processes of internal control and fully involve themselves in the processes. Also, it is important that the Board of Directors and the Board of Auditors function effectively and that the functions of a check-and-balance system among divisions and departments, and the functions of internal audits by the Internal Audit Division are executed appropriately.

- The inspector should determine whether the financial institution's business management (governance) system is functioning effectively throughout the institution and whether the management is performing its roles and responsibilities appropriately by way of reviewing, with the use of the check items listed in this checklist, the effectiveness of the functions of four basic elements, namely (1) a system of business management (governance) by the representative directors, non-representative directors and the Board of Directors, (2) a system of internal audits, (3) a system of audits by corporate auditors and (4) a system of external audits.

- If the institution's management fails to recognize weaknesses or problems recognized by the inspector, it is also necessary to explore, in particular, the possibility that the Internal Control System is not functioning effectively, and review the findings thereof through dialogue.

- The inspector should review the status of improvements with regard to the major issues pointed out on the occasion of the last inspection and determine whether or not effective improvement measures have been developed and implemented.

I. Development and Establishment of Business Management (Governance) System by Representative Directors, Non-Representative Directors and Board of Directors

1. Development of Corporate Management Policies

(1) Establishment and Development of Corporate Ethics

Do directors and the Board of Directors regard the establishment of corporate ethics with emphasis on the social responsibilities and the public duties of financial institutions as an important task and provide a system to develop the establishment?

(2) Development and Dissemination of Corporate Management Policy and Corporate Management Plan

Does the Board of Directors clearly establish a corporate management policy for achieving the objectives set by the financial institution? Does it clearly formulate a corporate management plan in accordance with the corporate management policy and disseminate it throughout the institution?

(3) Management Policy, Management Plan, etc., and Roles Expected of Financial Institutions

Does the Board of Directors develop management policies and plans, etc. that are based on the roles of financial institutions, namely, working to maintain confidence, ensure the protection of depositors, etc. and facilitate financing?

(4) Development and Dissemination of Internal Control Basic Policy

Does the Board of Directors establish a basic policy concerning the development of a system to secure the soundness and appropriateness of the financial institution's business (hereinafter referred to as the "Internal Control Basic Policy,") in accordance with the corporate management policy and without delegating the task to the representative directors, etc. and disseminate it throughout the institution? Is ¹the Internal Control Basic Policy an appropriate one befitting the scales and natures of the institution's business?

(5) Development and Dissemination of Strategic Objectives

Does the Board of Directors clearly develop strategic objectives for the financial institution as a whole that include institution-wide profit objectives and strategies for risk-taking and allocation of human and physical resources intended to help achieve the profit objectives, in accordance with the corporate management policy and without delegating the task to the representative directors, etc.? Does the Board of Directors clearly develop strategic objectives for each operational area based on the strategic objectives for the institution as a whole and disseminate

¹ The inspectors should review the document that includes the financial institution's basic policy for developing a system for securing the soundness and appropriateness of its business regardless of the title of the document such as "Internal Control Basic Policy," "Internal Control Policy," and "Internal Management Policy," etc.

both the business-by-business and institution-wide strategic objectives throughout the institution?

(6) Ensuring Compatibility and Consistency with Finance Facilitation Management Policy

Does the Board of Directors develop Finance Facilitation Management Policy, in consideration of compatibility and consistency with the overall strategic objectives of the financial institution?

(7) Verification of Compatibility and Consistency of Risk Management Policies, etc.

With regard to institution-wide risk management, does the Board of Directors establish a Comprehensive Risk Management Policy and a management policy for various risks based on the strategic objectives for the institution as a whole after verifying their compatibility and consistency?

2. Roles and Responsibilities of Directors and Board of Directors

(1) Roles and Responsibilities of Representative Directors and Non-Representative Directors

- (i) Do the directors regard finance facilitation, legal compliance, customer protection and risk management as important corporate management tasks based on an understanding of the major points of Laws (including, but not limited to laws and regulations, etc. hereinafter referred to as the “Laws”) applicable to the financial institution, the nature of the various risks to which the institution is exposed and the importance of promoting business consultation and guidance and other finance facilitation, customer protection, improvement in customer convenience and risk management? Do they understand the importance of audits by corporate auditors, internal audits² and external audits in ensuring finance facilitation, legal compliance, customer protection and risk management?
- (ii) Do the representative directors appropriately allocate human and physical resources in accordance with the corporate management policy, the corporate management plan, the Internal Control Basic Policy, the strategic objectives and the Comprehensive Risk Management Policy and appropriately exercise his/her authority so as to ensure flexible management thereof?
- (iii) Do the representative directors take specific measures to have officers and employees get acquainted with his/her approach to finance facilitation, legal compliance, customer protection and risk management? For example, do the representative directors express his/her approach to business consultation and guidance and other finance facilitation, legal compliance, customer

² “Internal audits” refer to the process of review of the appropriateness and effectiveness of the internal control system of divisions (including risk management divisions. The same shall apply hereinafter.) and sales branches, etc. (including sales branches and overseas offices. The same shall apply hereinafter.) (hereinafter referred to as the audited divisions, etc.) by a division in charge of internal audits (inspection division, operational audit division, etc.) that is independent from the audited divisions, etc. This process includes not only detecting and pointing out problems with the audited divisions’ administrative processes, etc. but also evaluating the internal control system and proposing improvement measures. In principle, it does not include inspections conducted by the audited divisions, etc. themselves as part of the internal control. The same shall apply hereafter.

protection and risk management to officers and employees when delivering a New Year's speech and speaking at branch Managers' meetings?

(2) Check and Balance against Representative Directors

Do non-representative directors engage in substantive debate at meetings of the Board of Directors and perform their duties of making decisions concerning business execution and supervising business execution in order to ensure appropriate business execution by exercising a check-and-balance system against the representative directors and preventing autocratic management? With regard to decision-making concerning the provision of loans, for example, do non-representative directors seek to ensure a check-and-balance system to prevent arbitrary decision-making by the representative directors by taking specific measures such as requiring that important loans whose terms exceed prescribed limitations be subject to a decision by the Board of Directors or organization equivalent to the Board of Directors rather than by the representative directors alone?

Also, is it ensured, for example, that under the rules governing the Board of Directors, decisions on matters concerning business consultation and guidance and other finance facilitation, legal compliance, customer protection and risk management that would seriously affect the financial institution's corporate management are treated as the exclusive prerogatives of the Board of Directors and judgment as to whether or not specific cases meet the criteria of "seriously affect" is not left to the representative directors?

(3) Roles and Responsibilities of Outside Directors (in the case where outside directors have been appointed)

Are outside directors aware of the significance of their roles and actively involved in meetings of the Board of Directors in order to ensure the objectivity of corporate management decision-making? Does the Board of Directors ensure that information concerning the conditions of the financial institution is provided to outside directors on an ongoing basis so as to enable them to make appropriate judgment at meetings of the Board of Directors?

(4) Directors' Duty of Care and Duty of Loyalty

Do directors fully perform their duty of care and duty of loyalty in their execution of office, for example by engaging in substantive debate at meetings of the Board of Directors in order to ensure the soundness and appropriateness of the financial institution's business?

3. Development of Organizational Frameworks

(1) Development of Institution-wide Organizational Framework

Has the Board of Directors developed an organizational framework that enables the financial institution as a whole to conduct business and risk management appropriately and effectively, for

example by establishing divisions between which conflicts of interest may arise and assigning them authority in a way to allow them to exercise a mutual check-and-balance system even as they maintain coordination?

(2) Disclosure

Does the Board of Directors provide a system to disclose information about financial conditions and other matters concerning the financial institution in an appropriate and timely manner?

(3) Collection, Analysis and Examination of Information Concerning Financial Institution as A Whole

- (i) Does the Board of Directors or organization equivalent to the Board of Directors provide a system to obtain, from within and outside the financial institution and in a timely manner, information concerning business consultation and guidance and other finance facilitation, legal compliance, customer protection and risk management that is necessary for corporate governance?

For example, does the Board of Directors or organization equivalent to the Board of Directors make sure to have access to necessary information, for example by having the Manager of each division report matters specified by it in a regular and timely manner or on an as needed basis or by installing a computer system function that enables directors and corporate auditors to survey information managed by each division?

- (ii) Does the Board of Directors or organization equivalent to the Board of Directors have in place procedures for the storage and management of information concerning the execution of business operations by directors, etc. in accordance with the Internal Control Basic Policy?

For example, does it make sure to compile, store and manage the minutes of meetings of the Board of Directors or organizations equivalent to the Board of Directors? Does it also record instructions issued by the Board of Directors or organizations equivalent to the Board of Directors and documents related to its decisions and store and manage the records as necessary?

- (iii) Are the contents of the minutes of the meetings, when combined with the raw data used there, sufficient to confirm the agenda and substance of the meetings, such as matters reported to the Board of Directors or organizations equivalent to the Board of Directors (including business consultation and guidance and other finance facilitation, the actual status of risk management, problems related to legal compliance and customer protection, inappropriate acts and other problems) and details of the approval given and decisions made by the Board of Directors or organization equivalent to the Board of Directors (including the process and substance of debate)? Is it ensured that the raw data used at these meetings is stored and managed for the same period of time as the minutes?

- (iv) Is it ensured that corporate auditors have easy access to the minutes of the meetings of the Board of Directors or organization equivalent to the Board of Directors or other information concerning directors' execution of business operations?

(4) Handling of Screening of New Products

- (i) With regard to handling of new products, start of new business and other matters specified in the Comprehensive Risk Management Policy, etc. as requiring prior screening and approval (hereinafter referred to as “New Products, etc.”), does the Board of Directors or organization equivalent to the Board of Directors provide a system to have such matters subject to prior screening and approval (hereinafter referred to as “New Products Approval”) by a division in charge of screening New Products or a committee in charge thereof (hereinafter referred to as the “New Product Committee, etc.”)?³
- (ii) Has the Board of Directors or organization equivalent to the Board of Directors clearly specified the criteria for judgment as to whether specific matters are subject to the New Products Screening and the focus of the judgment authority and disseminated them to all of the officers and employees?
- (iii) On the occasion of the New Products Screening, do the Board of Directors or organization equivalent to the Board of Directors provide a system to ensure that information concerning the validity and legality of New Products, etc. is collected and sufficient examination is conducted?

For example, is a system in place to ensure that:

- The Comprehensive Risk Management Division and divisions in charge of managing various risks identify the risks inherent in New Products, etc. and report them to the New Product Committee, etc. in a timely manner?
- The Managers in charge of various customer protection management examine issues related to customer protection management and report their findings to the Board of Directors or organization equivalent to the Board of Directors in a timely manner?
- Legal issues related to New Products, etc. are subjected to legal checks, etc. beforehand?

(5) Management System of Subsidiaries, etc.

Does the Board of Directors or organization equivalent to the Board of Directors appropriately manage the business of subsidiaries, etc.⁴ in a manner befitting the scales and natures of their business and provide for measures to ensure that their business is appropriate from the viewpoint of business consultation and guidance and other finance facilitation, legal compliance, customer protection and risk management? Does the Board of Directors or organization equivalent to the Board of Directors provide for measures to ensure that transactions between the financial institution and its subsidiaries, etc. are in compliance with the rules concerning the prevention of inappropriate practices and the “arms’ length rules”?

³ This shall not preclude the Comprehensive Risk Management Division or other entities from conducting the New Products Screening.

⁴ See Paragraph 2, Article 13, the Banking Law.

(6) Emphasis on Finance Facilitation, Legal Compliance, Customer Protection and Risk Management

Does the Board of Directors or organization equivalent to the Board of Directors, instead of placing too much emphasis on the Marketing and Sales Division, etc., implement specific measures that attach importance to business consultation and guidance and other finance facilitation, legal compliance, customer protection, comprehensive risk management, management of various risks and internal audits? For example, does the Board of Directors or organization equivalent to the Board of Directors provide a system to ensure that staff members engaged in operations related to legal compliance, customer protection, comprehensive risk management, management of various risks and internal audits are fairly treated in performance assessment and personnel evaluation and receive appropriate evaluation in light of the strategic importance of those operations?

(7) Crisis Management System

Does the Board of Directors or organization equivalent to the Board of Directors appropriately understand what constitutes a crisis for the financial institution and provide a system even in normal times to have an appropriate crisis management system in place so as to enable the management to respond immediately in the event of a crisis and take risk mitigation measures?

For example, does the Board of Directors or organization equivalent to the Board of Directors provide a system to ensure that a crisis management manual and a business continuity plan (BCP) are formulated and that procedures for collecting information and responding to unfounded rumors in the event of a crisis are established?

4. Monitoring and Revision

Does the Board of Directors receive a report with regard to the status of business operations and the risks faced by the financial institution in a regular and timely manner or on an as needed basis and order an investigation as necessary to review the effectiveness and validity of the corporate management policy, the corporate management plan, the Internal Control Basic Policy, the strategic objectives, the Finance Facilitation Management Policy, the Comprehensive Risk Management Policy, the policies concerning management of various risks, the Legal Compliance Policy, the Customer Protection Management Policy and other policies as well as the effectiveness of the financial institution's governance system based on these policies and revise them as necessary?

II. Development and Establishment of Internal Audit System

1. Development and Establishment of Internal Audit System by Board of Directors or organization equivalent to Board of Directors

1) Policy Development

(1) Roles and Responsibilities of Directors

Do directors fully understand that the development of an effective internal audit system suited to the scales and natures of the financial institution's business and its risk profile as well as the Laws applicable to the business are vital for business consultation and guidance and other finance facilitation, appropriate legal compliance, customer protection and risk management? In particular, does the director in charge of internal audits examine a policy and specific measures necessary for the development and establishment of an appropriate internal audit system based on an accurate understanding of the status of the institution's internal audits?

(2) Development and Dissemination of Internal Audit Policy

Has the Board of Directors established a policy for securing the effectiveness of internal audits (hereinafter referred to as the "Internal Audit Policy") in accordance with the corporate management policy and the Internal Control Basic Policy and disseminated it throughout the institution?

2) Development of Rules and Organizational Framework

(1) Development of Internal Audit Rules

Does the Board of Directors or organization equivalent to the Board of Directors have the Internal Audit Division or the chief of the division establish rules concerning internal audits (hereinafter referred to as the "Internal Audit Rules") and approve them after confirming their consistency with the Internal Audit Policy?

Do the Internal Audit Rules specify the following items in particular?

- Purpose of internal audits
- Organizational independence of the Internal Audit Division
- Scope of the Internal Audit Division's operations, authority and responsibilities
- Arrangements for the Internal Audit Division to obtain information
- Arrangements for implementation of internal audits
- Arrangements for reporting by the Internal Audit Division

(2) Development of Internal Audit Implementation Guidelines

Does the Board of Directors or organization equivalent to the Board of Directors have the Internal Audit Division or the chief of the division establish a guideline that specifies the items subject to internal audits and the procedures for the implementation thereof (hereinafter referred to as the Internal Audit Implementation Guidelines) and approve it? Does the Internal Audit

Implementation Guidelines reflect the actual status of operations at the divisions audited and enable the implementation of effective audits suited to the divisions' operations? Does the Board of Directors or organization equivalent to the Board of Directors have the Internal Audit Division establish operational procedures that specify details of the items subject to internal audits and the audit procedures where necessary?

(3) Development of Internal Audit Plan

- (i) Does the Board of Directors or organization equivalent to the Board of Directors have the Internal Audit Division or the chief of the division grasp the status of business consultation and guidance and other finance facilitation, legal compliance, customer protection and risk management at the divisions audited and formulate a plan for implementing internal audits in an efficient and effective manner with due consideration for the frequency and depth of necessary audits (hereinafter referred to as the "Internal Audit Plan") and approve basic matters concerning the plan, including its key priority items? Does the Board of Directors or organization equivalent to the Board of Directors approve it after making sure that the Internal Audit Plan provides for additional audits as and when necessary?
- (ii) Does the Internal Audit Plan subject the operations of subsidiaries, etc. to internal audits within the limitations allowed under law? With regard to the operations of subsidiaries and operations commissioned to outsourcing contractors not subject to internal audits, does the plan subject the status of the management of those operations by divisions with the supervisory responsibilities thereof to internal audits?

(4) Establishment of System of Internal Audit Division

- (i) Has the Board of Directors established an Internal Audit Division in charge of reviewing the appropriateness and effectiveness of the internal control system in accordance with the Internal Audit Policy and the Internal Audit Rules and does the Board provide a system to enable the division to perform its functions fully?
- (ii) Has the Board of Directors allocated in the Internal Audit Division a division chief with the necessary knowledge and experience to supervise the division and enabled the division chief to implement his/her operation by assigning him/her the necessary authority therefor? In the case where the chief of the Internal Audit Division concurrently takes charge of an operation subject to audits, is there an arrangement to secure the independence of the Internal Audit Division?
- (iii) Has the Board of Directors or organization equivalent to the Board of Directors allocated in the Internal Audit Division an adequate number of staff members with the necessary knowledge and experience as well as the expertise to sufficiently review the operations and assigned such staff the authority necessary for implementing the operations? Does the Board of Directors or organization equivalent to the Board of Directors make sure to provide in-house and outside training to enhance the expertise of staff members that conduct internal audits? It is desirable that there be a system to provide such training on an ongoing basis and that the

relevant staff members regularly utilize it.

- (iv) Does the Board of Directors keep the Internal Audit Division independent from divisions subject to audits and secure the function of a check-and-balance system? Does the Board of Directors provide a system to enable the Internal Audit Division to implement audits without being unduly restricted by divisions audited, etc.? Does the Board of Directors provide a system to prevent the Internal Audit Division from engaging in business activities or operations that should be conducted by divisions subject to audits, such as compilation of information concerning financial conditions and other matters?
- (v) Does the Board of Directors provide a system to implement extraordinary audits aside from ordinary ones with regard to operations and computer systems susceptible to violation of Laws and practices? In the case where outside experts are employed to complement the audits of operations for which internal audits alone would not be sufficient, does the Board of Directors also assume responsibility for the audit process and results?
- (vi) Does the Board of Directors, in accordance with the Internal Audit Rules, assign staff members engaged in internal audits the authority to obtain any documents necessary for their execution of operations and interview or question any officer or employee when necessary for their execution of operations?
- (vii) Does the Board of Directors provide a system to disseminate the scope of the Internal Audit Division's operations, authority and responsibilities to all of the officers and employees?
- (viii) Does the Board of Directors or organization equivalent to the Board of Directors allocate to overseas offices determined as being exposed to higher risk than a certain level internal auditors who are independent from the Managers of the offices and directly linked with the Internal Audit Division?
- (ix) Does the Board of Directors provide a system to have the results of internal audits reported in a timely and appropriate manner?

3) Systems for Follow-up

(1) Improvement Steps by Board of Directors

With regard to problems included in internal audit reports that are determined as likely to seriously affect the corporate management or impossible for an audited division alone to handle, does the Board of Directors promptly take appropriate measures? Does it provide arrangements to have the Internal Audit Division conduct necessary follow-up audits on such cases, check the status of improvement and ensure that cases in which improvement is insufficient are reported to it?

2. Roles and Responsibilities of Internal Audit Division

(1) Development of Internal Audit Implementation Guidelines

Does the Internal Audit Division appropriately identify the items subject to audits, formulate an

Internal Audit Implementation Guidelines that specifies the items subject to audits and the procedures for audit implementation and seek approval thereof from the Board of Directors or organization equivalent to the Board of Directors? Does the Internal Audit Implementation Guidelines exhaustively cover the items included in this checklist so as to enable effective audits? Where necessary, does the Internal Audit Division establish operational procedures that specify details concerning the items subject to internal audits and the audit procedures?

(2) Development of Internal Audit Plan

Does the Internal Audit Division formulate a plan for implementing internal audits in an efficient and effective manner with due consideration for the frequency and depth of necessary audits based on its understanding of the status of business consultation and guidance and other finance facilitation, legal compliance, customer protection and risk management at the divisions audited and obtain approval by the Board of Directors or organization equivalent to the Board of Directors of basic matters concerning the plan, including its key priority items? Does the division subject the operations of subsidiaries, etc. to internal audits within the legal limitations? With regard to the operations of subsidiaries not subject to internal audits and operations commissioned to outsourcing contractors, does the division subject the status of the management of those operations by divisions with the supervisory responsibilities thereof to internal audits?

(3) Implementation of Internal Audits

- (i) Does the Internal Audit Division implement internal audits of divisions subject to audits in an efficient and effective manner (by implementing an unannounced audit, for example) in accordance with the Internal Audit Implementation Guidelines and the Internal Audit Plan?
- (ii) Does the Internal Audit Division, in accordance with the Internal Audit Rules, etc. seek to ensure fair audits, for example by preventing the same auditing staff member from continuing to audit the same division or preventing an auditing staff member from auditing the division in which he worked immediately before moving to the Internal Audit Division?
- (iii) Do auditing staff members accurately record the procedures followed in internal audits and problems detected therein? Do they compile, in accordance with the Internal Audit Implementation Guidelines and the Internal Audit Plan and without delay, internal audit reports that accurately reflect problems detected in internal audits?
- (iv) Does the chief of the Internal Audit Division check the contents of internal audit reports, analyze the frequency and the degree of importance, etc. of problems pointed out therein and report his/her findings to the Board of Directors without delay? In particular, does the chief of the Internal Audit Division report problems deemed likely to seriously affect the corporate management or significantly undermine customer interests to the Board of Directors without delay? Does the chief attend meetings concerning internal control (e.g. a meeting of a legal compliance committee) as necessary in order to report the status of internal audits and collect information?

- (v) In the case where the Internal Audit Division detects an obvious or suspected illegal act during the process of internal audits, does the division immediately report it to the Compliance Control Division?⁵ Does the Internal Audit Division accurately identify problems based on the analysis of internal audits and disseminate its findings to the Compliance Control Division, operational divisions and sales branches, etc. in a regular and timely manner or on an as needed basis?

(4) Systems for Follow-Up

Do divisions subject to internal audits take improvement measures without delay with regard to problems pointed out in internal audit reports with due consideration for the degree of their importance and formulate plans for improvement as necessary? Does the Internal Audit Division appropriately check the status of improvement at divisions subject to internal audits and reflect its findings in subsequent Internal Audit Plans?

3. Assessment and Improvement Activities

1) Analysis and Assessment

(1) Analysis and Assessment of Effectiveness of Internal Audits

Does the Board of Directors appropriately determine whether there are any weaknesses or problems in the internal audit system and the particulars thereof, and appropriately examine their causes by precisely grasping the status of internal audits and analyzing and assessing the effectiveness of internal audits, based on all information available regarding the status of internal audits (including the status of compliance with the Internal Audit Implementation Guidelines and the Internal Audit Plan), such as the results of audits by corporate auditors, internal audits and external audits, findings of various investigations and reports from various divisions?

In addition, if necessary, does it take all possible measures to find the causes by way of, for example, establishing fact findings committees, etc. consisting of non-interested persons?

Does the chief of the Internal Audit Division analyze and assess the effectiveness of the Internal Audit Implementation Guidelines and the Internal Audit Plan in a regular and timely manner or on an as needed basis and report his/her findings to the Board of Directors?

(2) Revision of Analysis and Assessment Processes

Does the Board of Directors revise the analysis and assessment processes in a timely manner by reviewing their effectiveness based on reports and findings on the status of internal audits in a regular and timely manner or on an as needed basis?

2) Improvement Activities

⁵ See Checklist for Legal Compliance.

(1) Improvement Activities Concerning Internal Audit System

Does the Board of Directors provide a system to implement improvements in the areas of the problems and weaknesses in the internal audit system identified through the analysis, assessment and examination referred to in 3. 1) above in a timely and appropriate manner based on the results obtained by developing and implementing an improvement plan as required or by other appropriate methods?

(2) Progress Status of Improvement Activities

Does the Board of Directors provide a system to follow up on the efforts for improvement in a timely and appropriate manner by reviewing the progress status in a regular and timely manner or on an as needed basis?

(3) Revision of Improvement Process

Does the Board of Directors revise the improvement process in a timely manner by reviewing its effectiveness based on reports and findings on the status of internal audits in a regular and timely manner or on an as needed basis?

III. Development and Establishment of Auditing System by Corporate Auditors and Board of Auditors

1. Development of Environment for Auditing by Corporate Auditors

(1) Development of Auditing Environment

Do auditors endeavor to develop a favorable environment for collecting information and conducting audits in order to execute their operations appropriately, for example by maintaining close coordination with directors, accounting auditors, the Internal Audit Division, the Manager of the Compliance Control Division and directors of subsidiaries, etc. and seeking reports from them regularly?

(2) Functions of Board of Auditors

In the case where there is a board of auditors, does it hold consultations and make decisions based on reports obtained from individual auditors and other relevant parties within limitations that would not prevent the individual auditors' execution of authority?

(3) Systems for Supporting Auditing Operation

Do corporate auditors secure an adequate number of staff members suited to support auditors and the board of auditors? Is it ensured that staff members supporting auditors and the board of auditors are kept outside the line of command from directors and the Board of Directors in their execution of auditor support operations?

(4) Securing of Independence

Is it ensured that the independence of corporate auditors and the board of auditors is secured in terms of execution of operations and organizational framework? In particular, moves to obstruct the investigative and reporting authority of auditors and restrict audit-related expenses in an unreasonable manner must be excluded in order to secure the independence of auditors.

2. Implementation of Audits

(1) Development of Audit Policy and Audit Plan

Do corporate auditors identify the items subject to audits and develop an audit policy and an audit plan from the viewpoint of reviewing whether directors have developed an appropriate internal control system and are operating it appropriately?

(2) Effective Implementation of Audits

Do corporate auditors and the board of auditors audit operations in addition to conducting accounting audits by appropriately executing the wide-ranging authority assigned to them? Even when there is a board of auditors, does each individual auditor actively conduct audits on their

own responsibility as an independent agent?

(3) Investigations of Subsidiaries

Do corporate auditors pay attention to whether there is an appropriate internal control system within the corporate group of the financial institution and check the status of corporate governance and internal control at subsidiaries as necessary from the viewpoint of examining the status of directors' execution of business operations for the purpose of securing the soundness of the business operations of the corporate group?

(4) Attendance at Board of Directors' Meetings

Do corporate auditors appropriately examine the status of directors' execution of business operations, for example, by attending meetings of the Board of Directors and expressing opinions as necessary? Do they also attend meetings of the Board of Directors or organization equivalent to the Board of Directors other than meetings of the Board of Directors and express their opinions, thus appropriately executing their auditing authority?

(5) Employment of Outside Experts

Do corporate auditors and the board of auditors employ lawyers, certified public accountants and other outside experts as necessary in order to supplement their functions?

(6) Review of Audit Results

Do corporate auditors and the board of auditors check whether the process of accounting audits by accounting auditors and the results thereof are reasonable and, if necessary, take measures such as making an appropriate proposal with regard to the replacement of an accounting auditor, for example?

(7) Prevention of Illegal Acts

When detecting an obvious or possible inappropriate act by a director, or when detecting a fact that violates laws or the articles of incorporation or a markedly unreasonable fact, do corporate auditors report it to the Board of Directors without delay? When they determine that a director's act that violates laws or the articles of incorporation may significantly damage the financial institution, do corporate auditors take appropriate measures to halt the act?

(8) Outside Auditors

Do outside auditors fully perform their auditing functions by taking advantage of their positions? When an outside auditor serves on a non-permanent basis in particular, does he/she make sufficient efforts to maintain communications and coordination with permanent auditors so as to perform his/her functions?

IV. Development and Establishment of External Audit System

(1) External Audit of Internal Control System by Accounting Auditors, Lawyers, etc.

Does the institution undergo an external audit⁶ by an outside expert such as an accounting auditor and a lawyer at least once a year in order to review the effectiveness of the internal control system?⁷ In the case of a financial institution subject to international standards, Does the institution check whether the institution subjects each of its overseas offices to an external audit suited to the circumstances of the relevant country.

Does the Board of Directors or the board of auditors receive the audit results in a timely manner?

(2) Cooperation to Effective Audits

Does the Board of Directors provide for measures to have operational divisions and departments cooperate with external auditors to enable effective audits?

(3) Analysis and Assessment of Effectiveness of External Audits

Do the Board of Directors and the board of auditors regularly check whether external audits are functioning effectively?

Do the Board of Directors and the board of auditors also make sure that external audits of subsidiaries are functioning effectively, for example by receiving reports concerning the results of external audits of subsidiaries, etc. so as to grasp any problem thereof?

(4) Improvements and Follow-up

Does the Board of Directors provide a system to implement improvements within a certain period of time with regard to problems pointed out by external auditors? Do divisions subject to audits implement improvements according to the level of the importance of the problems pointed out and formulate plans for improvements as necessary? Does the Internal Audit Division check the progress status of improvements appropriately?

⁶ External audits as mentioned here shall not be limited to audits of financial statements by accounting auditors, but the inspector should bear it in mind that audits other than the audit of financial statements required under the rules and the verification of the internal control system conducted as part of the procedures of this audit are not obligatory. In the case where the institution inspected undergoes an external audit other than the audit of financial statements in order to secure the effectiveness of the internal control system, the inspector should review the effectiveness of the internal control system by examining the audit results in a comprehensive manner.

⁷ It should be noted that the co-operative type of financial institutions are required to appoint accounting auditors only in limited cases.

Finance Facilitation Section

Checklist for Finance Facilitation Section

I. Development and Establishment of System by Management

Checkpoints

- Smoothly supplying funds needed by customers in order to manage sound businesses is one of the most important roles of a financial institution. Financial institutions are strongly expected to appropriately and actively take risks, and actively play their role as financial intermediary function, under an appropriate risk management system.
- Financial institutions should also capture in detail the status of each borrower such as small and medium sized enterprises (SMEs), small business owners, and borrowers of housing loans. Financial institutions should also cooperate sufficiently with related financial institutions and other financial business operators, aiming to facilitate financing activities (including the provision of new credit limits) and the modification of lending conditions, etc.¹
- In particular, financial institutions should keep in mind that they are expected to take an appropriate and active part in the vitalization of the regional economy and the facilitation of regional finance, sufficiently considering the purpose of Article 64 under the Act on Regional Economy Vitalization Corporation of Japan (the “REVIC Act”, Act No.63 of 2009).²
- Based on the perspectives discussed above, financial institutions should not only act as a fund provider but also maximize their support for the efforts of borrowers such as SMEs, small business owners and borrowers of housing loans through the provision of management consultation/instruction, etc., for business improvement..
- Furthermore, in line with the purpose of the Guidelines for Personal Guarantee Provided by Business Owners (the “Personal Guarantee Guidelines”) (Study Group on Personal Guarantee Guidelines, December 5, 2013), financial institutions should further promote the provision of financing that does not rely on personal guarantees by the business owners and work to achieve financing based on a reasonable guarantee agreement as specified in the Personal Guarantee Guidelines.
- In this checklist, “Finance Facilitation” signifies items (1) to (5) below. “Finance Facilitation Management” signifies that the financial institution performs the management required to achieve items (1) to (5) below, from the viewpoint of appropriately and actively taking risks under appropriate risk management, and actively playing its financial intermediary function.

(1) Ensuring financial institutions appropriately provide new finance or change the loan conditions, etc. while

¹ “Modification of lending conditions, etc.” refers to changes to loan conditions, debt refinancing DESs (debt-equity swaps) and other measures taken to reduce the borrower’s burden for debt repayment.

² Article 64 of the REVIC Act stipulates that “when supporting business owners in revitalizing their businesses or business activities expected to contribute to the vitalization of the regional economy, REVIC and financial institutions should cooperate with each other and aim to vitalize the economy in the region and facilitate regional finance by strengthening the overall economy.

- considering the customer's business condition, etc.
- (2) Ensuring financial institutions provide business consultation, guidance and support to improve its business while considering the customer's business condition, etc.
 - (3) Ensuring provision of appropriate and sufficient explanation to the customer in credit transactions (loan contracts and accompanying collateral-guarantee contracts)
 - (4) Ensuring provision of appropriate responses for inquiries, consultations, requests and complaints from customers regarding credit transactions
 - (5) Ensuring appropriate implementation of other items the financial institution deems to be necessary in order to perform financial intermediary functions actively.
- The development and establishment of a Finance Facilitation Management system is very important for a financial institution from the perspective of the soundness and appropriateness of its business. Therefore, the institution's management is in charge of and responsible for taking the initiative to develop and establish the Finance Facilitation Management system.
 - The inspector should determine whether the Finance Facilitation Management system is functioning effectively and whether the roles and responsibilities of the institution's Board of Directors are being appropriately performed by way of reviewing, with the use of check items listed in Chapter I, whether the management is appropriately implementing (1) policy development, (2) development of internal rules and organizational frameworks and (3) assessment and improvement activities.
 - If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II onwards, it is necessary to exhaustively examine which of the elements listed in Chapter I are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.
 - If the institution's management fails to recognize weaknesses or problems recognized by the inspector, it is also necessary to explore in particular the possibility that the Internal Control System is not functioning effectively and review findings thereof through dialogue.
 - The inspector should review the status of improvements with regard to the finance facilitation related issues pointed out on the occasion of the last inspection that are not minor, and determine whether or not effective improvement measures have been developed and implemented.

1. Policy Development

(1) Roles and Responsibilities of Directors

Do directors attach importance to finance facilitation, including business consultation and guidance for obligors and support to improve the businesses of obligors, based on a full recognition that finance facilitation is vital for maintaining public confidence in the institution and securing the soundness and appropriateness of the institution's business? In particular, are directors aware of finance facilitation problems concerning the business operations they are in

charge of, that need special attention, and do they make absolutely sure to conduct business operations properly?

Does the director in charge of Finance Facilitation Management fully understand the importance of Finance Facilitation Management? Based on such understanding, does the director appropriately grasp the status of finance facilitation at the institution and consider a policy and specific measures necessary for developing and establishing an appropriate Finance Facilitation Management system?

In particular, does the director in charge of Finance Facilitation Management recognize that when a financial institution actively provides business consultation and guidance to a client enterprise and supports initiatives to improve its business, this contributes to reducing its own credit risk by improving that enterprise's business? Does the director consider policies and specific measures to actively provide business consultation and guidance to client enterprises and to support initiatives to improve their businesses?

(2) Development and Dissemination of Finance Facilitation Management Policy

Has the Board of Directors established a policy regarding Finance Facilitation Management (hereinafter referred to as the "Finance Facilitation Management Policy"), and disseminated it throughout the institution? In particular, is the appropriateness of the Finance Facilitation Management Policy being secured by way of clear statements on the following matters, etc.³ Also, does the Board of Directors pay attention to ensuring consistency between Credit Risk Management Policy, Customer Protection Management Policy, etc. and Finance Facilitation Management Policy?

- 1) Roles and responsibilities of the Board of Directors, director in charge of Finance Facilitation Management, etc.
- 2) Ensure that appropriate examinations are performed in response to requests for new finance or loan condition changes, etc. (including appropriate examination of funds to be supplied after loan conditions are changed, etc.)
- 3) Ensure suitability of business consultations and guidance for debtors, and support for initiatives to improve their businesses
- 4) Policy to enhance abilities to appropriately assess the business value of customers
- 5) Ensure appropriateness and sufficiency of customer explanations in response to consultations and requests for new finance or loan condition changes, etc. (including ensuring appropriateness and sufficiency of responses when loans are denied)
- 6) Ensure appropriateness and sufficiency of responses to inquiries, consultations, requests

³ It is not necessary to develop a unified finance facilitation management policy that exhaustively covers all items that must be clearly specified, but it should suffice that all such items are covered by multiple policies etc. established by divisions etc. engaged in finance facilitation management.

and complaints from customers regarding consultations and requests, such as for new finance or change in loan conditions

- 7) Ensure that appropriate actions are taken in relation to the personal guarantee provided by the business owner based on the Personal Guarantee Guidelines.
- 8) Ensure close cooperation with other related financial institutions and financial business operators, if any (including governmental financial institutions, etc.,⁴ credit guarantee associations, etc.,⁵ and the SME Business Rehabilitation Support Co-operative), in relation to the borrower's request for the modification of lending terms, confirmation of a request for execution of business reconstruction through the Alternative Dispute Resolution (ADR) procedure (ADR procedure stipulated in Paragraph 25, Article 2 of the Law on Special Measures for Industrial Revitalization; hereinafter referred to as "Business Reconstruction ADR Procedure"), or a request from REVIC or the Organization for Supporting the Turnaround of Businesses Damaged by the Great East Japan Earthquake to purchase loan receivables.
- 9) Ensure close cooperation with REVIC in supporting business activities that will contribute to revitalizing the borrower's business or vitalizing the regional economy.
- 10) When requested to confirm whether to request an initiation of the Business Reconstruction ADR procedure by an ADR business operator ("Business Reconstruction ADR Business Operator" as defined in Paragraph 24, Article 2 of the Law on Special Measures for Industrial Revitalization) which received a request from a borrower for such procedure, ensure that appropriate actions are taken and the request is made for quick dispute resolution.
- 11) Ensure an appropriate response to a credit purchase request from REVIC or the Organization for Supporting the Turnaround of Businesses Damaged by the Great East Japan Earthquake, or to a request for agreement to credit management or disposal under a business reconstruction plan
- 12) For a business reconstruction plan concerning the above agreement, ensure cooperation for change in loan conditions, etc.
- 13) Ensure that measures agreed by the Board of Directors as necessary for achieving an active financial intermediary function are implemented appropriately

⁴ Japan Finance Corporation, Shoko Chukin Bank, Ltd., Development Bank of Japan, Inc., Japan Bank for International Cooperation, The Okinawa Development Finance Corporation (Incorporated Administrative Agency or IAA), Fund for the Promotion and Development of the Amami Islands (IAA), Organization for Small & Medium Enterprises and Regional Innovation, JAPAN (IAA), Welfare and Medical Service Agency (IAA), Japan Housing Finance Agency (IAA). (Same shall apply in this checklist.)

⁵ Credit Guarantee Association, Agricultural Credit Fund Association, Fishery Credit Fund Association, Fund for the Promotion and Development of the Amami Islands (IAA), and Agriculture, Forestry and Fisheries Credit Foundations (IAA). (Same shall apply in this checklist.)

(3) Revision of Policy Development Process

Does the Board of Directors revise the policy development process in a timely manner by reviewing its effectiveness based on reports and findings on the status of Finance Facilitation Management periodically or on an as needed basis?

2. Development of Internal Rules and Organizational Frameworks

(1) Development and Dissemination of Internal Rules

Has the Board of Directors or organization equivalent to the Board of Directors had the manager in charge of supervising overall Finance Facilitation Management for developing and establishing the Finance Facilitation Management system (hereinafter referred to as the “Finance Facilitation Manager”) develop internal rules that clearly specify the arrangements on the management of finance facilitation (hereinafter referred to as the “Finance Facilitation Management Rules”) in accordance with the Finance Facilitation Management Policy?⁶ Has the Board of Directors or organization equivalent to the Board of Directors approved the Finance Facilitation Management Rules and disseminated them throughout the institution, after determining whether they comply with the Finance Facilitation Management Policy after legal checks, etc.?

(2) Assignment of Finance Facilitation Manager and Assigning of Authority

Does the Board of Directors or organization equivalent to the Board of Directors provide a system to have the Finance Facilitation Manager appointed, stipulate the responsibilities and authority of the Manager and allocate appropriate roles to the Manager in accordance with the Finance Facilitation Management Policy and the Finance Facilitation Management Rules? Does the Manager have sufficient knowledge and experience for that operation?⁷

⁶ The Finance Facilitation Management Rules may not be available as a single set of rules in some cases, and they may be integrated with the Credit Risk Management Rules, etc. in other cases. The inspector should empirically review, regardless of the form of rules, whether or not the rules exhaustively stipulate necessary matters and are fully disseminated throughout the organization, upon approval by the Board of Directors, thus ensuring an effective management system of Financial Support.

⁷ When the Finance Facilitation Manager holds an additional post (including the Manager post) at a division such as credit risk management, the inspector should pay attention to whether such a system is reasonable in light of the scales and natures of the business operations concerned, and whether an equivalent level of Finance Facilitation functions is secured compared with the case where a dedicated Manager is appointed. For example, multiple Finance Facilitation Managers may be appointed. In such a case, the inspector should review whether the areas of responsibility are clearly defined, with methods such as having the Managers jointly bear the responsibility for the overall Finance Facilitation business operation or having one of the Managers bear this responsibility.

(3) Development of Finance Facilitation Management System for Credit Risk Management Division and Customer Explanation Manager, etc.

- 1) Does the Board of Directors or organization equivalent to the Board of Directors provide a system to disseminate internal rules and operational procedures to the divisions, departments and employees whose operations require Finance Facilitation Management, including the Credit Risk Management Division, Customer Explanation Manager, Marketing and Sales Division, etc., and have them comply with the rules and procedures? For example, does the Board of Directors or organization equivalent to the Board of Directors instruct the Finance Facilitation Manager to take concrete measures such as specifying the internal rules and operational procedures that must be observed by the Credit Risk Management Division, Customer Explanation Manager, Marketing and Sales Division, etc., and conducting effective training on a regular basis?
- 2) Does the Board of Directors or organization equivalent to the Board of Directors provide a system to ensure, through the Finance Facilitation Manager, effective Finance Facilitation Management for the Credit Risk Management Division, Customer Explanation Manager, Marketing and Sales Division, etc.? For example, are there in place such useful measures as assigning people in charge of finance facilitation, such as the Customer Explanation Manager, in the Credit Risk Management Division, or in the Marketing and Sales Division, etc. for coordination with the Finance Facilitation Manager?⁸

(4) Ensuring Finance Facilitation at Outsourcing Contractors

Has the Board of Directors or organization equivalent to the Board of Directors, through the Finance Facilitation Manager, developed a system to ensure the effectiveness of Finance Facilitation Management at outsourcing contractors where there is a need for Finance Facilitation Management (hereinafter referred to simply as “outsourcing contractors”)?⁹

(5) Development of System of Reporting to Board of Directors and Approval

Has the Board of Directors or organization equivalent to the Board of Directors appropriately specified matters to be reported and approved, and does it have the Finance Facilitation Manager report the current status to the Board of Directors or organization equivalent to the Board of Directors, or have the Manager seek the approval of the Board of Directors or organization equivalent to the Board of Directors on the relevant matters in a regular and timely manner or on an as needed basis? In particular, does it ensure that the Manager reports

⁸ When a department or a post other than the Board of Directors or organization equivalent to the Board of Directors is empowered to allocate staff and assign them authority, in light of the nature of such a department or a post, is this arrangement reasonable in terms of a check-and-balance system and other aspects?

⁹ For example, call centers, banking agencies, etc., to which loan related operations are outsourced.

without delay to the Board of Directors or organization equivalent to the Board of Directors, regarding any matters that would seriously affect corporate management or significantly undermine customer interests?

(6) Development of System of Reporting to Corporate Auditor

In the case where the Board of Directors has specified matters to be directly reported to a corporate auditor, has it specified such matters appropriately and do they provide a system to ensure that the Finance Facilitation Manager reports directly to the auditor?¹⁰

(7) Development of Internal Audit Guidelines and an Internal Audit Plan

Does the Board of Directors or organization equivalent to the Board of Directors have the Internal Audit Division appropriately identify the matters to be audited with regard to Finance Facilitation, develop guidelines that specify the matters subject to internal audit procedures (hereinafter referred to as the “Internal Audit Guidelines”) and internal audit plan, and approve them?¹¹

(8) Revision of Development Process of Internal Rules and Organizational Frameworks

Does the Board of Directors or organization equivalent to the Board of Directors revise the development process of internal rules and organizational frameworks in a timely manner, by reviewing their effectiveness based on reports and findings on the status of Finance Facilitation Management in a regular and timely or on an as needed basis?

3. Assessment and Improvement Activities

(1) Analysis and Assessment

1) Analysis and Assessment of Finance Facilitation Management

Does the Board of Directors or organization equivalent to the Board of Directors appropriately determine whether there are any weaknesses or problems in the Finance Facilitation Management system and the particulars thereof, and appropriately examine their causes by precisely analyzing the status of Finance Facilitation Management and assessing the effectiveness of Finance Facilitation Management, including business consultation and guidance for debtors and support to improve the businesses of debtors, based on all of the information available regarding the status of Finance Facilitation Management, such as the

¹⁰ It should be noted that this shall not preclude a corporate auditor from voluntarily seeking a report, and shall not restrict the authority and activities of the auditor in any way.

¹¹ The Board of Directors or organization equivalent to the Board of Directors only needs to have approved the basic matters with regard to an internal audit plan.

results of audits by corporate auditors, internal audits and external audits, findings of various investigations and reports from various divisions? In addition, if necessary, does it take all possible measures to find the causes by, for example, establishing fact findings committees, etc. consisting of non-interested persons?

2) Revision of the Analysis and Assessment Processes

Does the Board of Directors or organization equivalent to the Board of Directors revise the analysis and assessment processes in a timely manner by reviewing their effectiveness based on reports and findings on the status of Finance Facilitation Management in a regular and timely or on an as needed basis?

(2) Improvement Activities

1) Implementation of Improvements

Does the Board of Directors or organization equivalent to the Board of Directors provide a system to implement improvements in the areas of the problems and weaknesses in the Finance Facilitation Management system, identified through the analysis, assessment and examination referred to in 3. (1) above in a timely and appropriate manner, based on the results obtained by developing and implementing an improvement plan as required or by other appropriate methods?

2) Progress Status of Improvement Activities

Does the Board of Directors or organization equivalent to the Board of Directors provide a system to follow up on the efforts for improvement in a timely and appropriate manner, by reviewing the progress status in a regular and timely or on an as needed basis?

3) Revision of the Improvement Process

Does the Board of Directors or organization equivalent to the Board of Directors revise the improvement process in a timely manner, by reviewing its effectiveness based on reports and findings on the status of Finance Facilitation Management in a regular and timely or on an as needed basis?

II. Development and Establishment of System by Manager

Checkpoints

- This chapter lists the check items to be used when the inspector examines the roles and responsibilities that must be performed by the Finance Facilitation Manager.
- The descriptions in this checklist are based on the assumption that the role that must be performed by the Finance Facilitation Manager is extensive, and therefore a dedicated division or department in charge of Finance Facilitation Management may be established, or persons in charge of Finance Facilitation Management may be assigned to the Credit Risk Management Division or Marketing and Sales Division, etc. and coordinate with Manager, in the case where the Board of Directors determines that the Manager alone would not be sufficient to secure effective finance facilitation. In such a case, it is necessary to review whether the Finance Facilitation Management system is functioning effectively, based on the empirical review and analysis as to whether an adequate number of persons with the knowledge and experience necessary for implementing the business are allocated and whether they are assigned the authority necessary for implementing the business.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II., it is necessary to exhaustively examine which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review the findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter I. are not functioning appropriately, and review the findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the finance facilitation related issues pointed out on the occasion of the last inspection that are not minor, and determine whether or not effective improvement measures have been developed and implemented.

1. Roles and Responsibilities of Manager

(1) Development of Internal Rules

1) Development and Dissemination of Finance Facilitation Management Rules and Finance Facilitation Manual

- (i) Does the Finance Facilitation Manager fully understand the scope, types and management methods of operations necessary to ensure the appropriateness of finance facilitation, including business consultation and guidance for obligors and support to improve the businesses of obligors? Does this Manager, in accordance with Finance Facilitation Management Policy, identify the operations necessary to ensure the appropriateness of finance facilitation, decide on finance facilitation related monitoring methods, and create Finance Facilitation Management Rules which clearly determine arrangements to manage those

operations based on these? Or does the Manager have other divisions create such Rules and check appropriateness of their content? Have the Finance Facilitation Management Rules been disseminated throughout the institution upon approval by the Board of Directors or organization equivalent to the Board of Directors?

- (ii) Regarding procedures etc. for finance facilitation, including business consultation and guidance for obligors and support to improve the businesses of obligors, has the Finance Facilitation Manager developed detailed operation rules which clearly determine the relevant customers and transactions, product scope and their management methods, items which should be checked, procedures and decision criteria, etc. (hereinafter referred to as the “Finance Facilitation Manual”), in accordance with Finance Facilitation Management Policy and Finance Facilitation Management Rules, or had another division develop it and then checked that it has proper content?¹²

2) Finance Facilitation Management Rules

Do the Finance Facilitation Management Rules exhaustively cover the necessary arrangements for managing the businesses which require appropriate Finance Facilitation in a manner befitting the nature of the businesses and appropriately specify those arrangements, for example by clearly defining the organizational framework for the management as well as the allocation of the relevant authority and roles and the management method? Do the rules clearly specify the following items in particular?

- (i) Arrangements concerning the organizational system for finance facilitation (including authority and responsibilities etc., in cases where a Finance Facilitation Management Division is established or a Finance Facilitation Manager is appointed)
- (ii) Arrangements concerning items which the Credit Risk Management Division must comply with
- (iii) Arrangements concerning business consultations and guidance for debtors, and support for initiatives to improve their businesses
- (iv) Arrangements to enhance abilities to appropriately assess the business value of customers
- (v) Arrangements for items which must be complied with by people who provide customer explanations in response to consultations and requests for new finance or loan condition changes, etc.

¹² It should be noted that the Finance Facilitation Management Rules and the Finance Facilitation Manual should not necessarily be compiled separately. At some financial institutions, such rules and manuals are integrated into the customer explanation manual. At other institutions, several Finance Facilitation rules and Finance Facilitation manuals are available according to the types of products and business. The inspector should review, regardless of the form of rules, whether or not the rules exhaustively stipulate necessary matters and are disseminated throughout the Marketing and Sales Division, etc. upon approval from the Board of Directors, thus ensuring appropriate execution of finance facilitation.

- (vi) Arrangements for items which must be complied with by people who respond to inquiries, consultations, requests and complaints from customers regarding consultations and requests for new finance or loan condition changes, etc.
- (vii) Arrangements for monitoring of the finance facilitation conducted by financial institution itself
- (viii) Arrangements for sharing of information needed in finance facilitation
- (ix) Arrangements for cooperation and information communication among divisions concerning finance facilitation
- (x) Arrangements for reporting to the Board of Directors
- (xi) Arrangements for taking appropriate actions based on the Personal Guarantee Guidelines
- (xii) Arrangements to work in close cooperation with other related financial institutions including other financial business operators (including governmental financial institutions, etc., credit guarantee associations, etc., and the SME Business Rehabilitation Support Co-operative), if any, in relation to the borrower's requests for loan condition changes, etc., and confirmation requests as to the implementation of the Business Reconstruction ADR Procedure; or requests from REVIC or the Organization for Supporting the Turnaround of Businesses Damaged by the Great East Japan Earthquake for the purchase of loan receivables
- (xiii) Arrangement for working in close cooperation with REVIC in supporting the reconstruction of the borrower's business, or business activities expected to contribute to the vitalization of the regional economy
- (xiv) Arrangements for taking appropriate actions and making requests for quick dispute resolution in cases where there was confirmation as to whether to request execution of the Business Reconstruction ADR Procedure, by the ADR business operator which received from a borrower a request for execution of the Business Reconstruction ADR Procedure
- (xv) Arrangements to appropriately respond to a credit purchase request from REVIC or the Organization for Supporting the Turnaround of Businesses Damaged by the Great East Japan Earthquake, or to a request for agreement to credit management or disposal under a business reconstruction plan
- (xvi) For a business reconstruction plan concerning the above agreement, arrangements for cooperation in loan condition changes, etc.

3) Finance Facilitation Manual

Does the Finance Facilitation Manual exhaustively cover specific procedures for finance facilitation related loan examinations, customer explanations, etc., in accordance with the

contents and method of the financial institution's business? Are those procedures stipulated in detail in an easy-to-understand manner? In particular, are the following items clearly stipulated?

- (i) Procedures for credit screening concerning new finance or loan condition changes, etc. (including appropriate examination of funds to be supplied after loan conditions are changed, etc.)
- (ii) Procedures to grasp the actual situations of customers who requested new finance or loan condition changes, etc.
- (iii) Procedures concerning business consultations and guidance for debtors, and support for initiatives to improve their businesses
- (iv) Procedures for response to consultations and requests for new finance or loan condition changes, etc. (reception of consultations and requests, procedures to confirm the content of consultations and requests, managing the progress of consultations and requests, handling to gain customer understanding concerning consultations and requests, procedures to prevent the occurrence of long term unresolved cases and for consultations or requests which turned into disputes, etc.)
- (v) Procedures to create and store records when there are consultations and requests for new finance and loan condition changes, etc. (including procedures for recording and storing specifically as possible the reasons for denial, in cases where a request for a loan condition change, etc. was denied)
- (vi) Procedures for communicating to related divisions the information on consultations and requests regarding new finance and loan condition changes, etc.
- (vii) Procedures for taking actions appropriately based on Personal Guarantee Guidelines
- (viii) Procedures to work in close cooperation with other related financial institutions including other financial business operators (including governmental financial institutions, etc., credit guarantee associations, etc., and the SME Business Rehabilitation Support Co-operative), if any, in relation to responses to the borrower's requests for the modification of loan conditions, etc., and confirmation requests as to the implementation of the Business Reconstruction ADR Procedure; or requests from REVIC or the Organization for Supporting the Turnaround of Businesses Damaged by the Great East Japan Earthquake for the purchase of loan receivables
- (ix) Procedures for working in close cooperation with REVIC in supporting the reconstruction of the borrower's business or business activities expected to contribute to the vitalization of the regional economy
- (x) In case of receiving a confirmation request as to implementation of the Business Reconstruction ADR Procedure from the Business Reconstruction ADR Business

Operator which received a request from the borrower, procedures to take actions appropriately and confirm the request for quick dispute resolution

- (xi) Procedures for responding to a request from REVIC or the Organization for Supporting the Turnaround of Businesses Damaged by the Great East Japan Earthquake Enterprise Turnaround Initiative Corporation of Japan to consent to a credit purchase, or credit management/ disposal based on the business reconstruction plan
- (xii) For a business reconstruction plan concerning the above agreement, procedures for cooperation in loan conditions changes, etc.

(2) Implementation of Finance Facilitation Management

1) Development of Finance Facilitation Management System

- (i) Does the Finance Facilitation Manager have staff serving in operations concerning finance facilitation, such as in the Credit Risk Management Division and Marketing and Sales Division ,etc. , comply with the Finance Facilitation Management Rules, Finance Facilitation Manual and other rules and arrangements concerning Finance Facilitation? Does this Manager develop systems for appropriate finance facilitation and implement specific measures for securing its effectiveness? In particular, are the following items implemented appropriately?
 - Development of a system that enables an appropriate credit screening of applications for new loans and changes in loan conditions, etc. (including appropriate credit screening in relation to the provision of funds after the modification of loan conditions)
 - Development of a system to ensure the appropriateness of management consulting/instruction provided to the borrower and of support for improving the borrower's management
 - Development of a system to improve the ability to assess the customer's enterprise value appropriately
 - Development of a system to ensure that customers are given appropriate and sufficient explanation when consulting/applying for new loans, changes in lending conditions, etc. (including the assurance of appropriate and sufficient handling when the lending request is declined)
 - Development of a system to ensure appropriateness and sufficiency in responding to inquiries, consultations, requests, and complaints from customers regarding consultations and requests for a new loan or changes in loan conditions.
 - Development of a system to achieve close cooperation, if any, with other related financial institutions and other financial business operators (including governmental financial institutions, etc. , credit guarantee associations, etc. , and the SME Business Rehabilitation

- Support Co-operative), in relation to the borrower's requests for the modification of loan conditions and confirmation requests for entering the Business Reconstruction ADR Procedure, and requests from REVIC or the Organization for Supporting the Turnaround of Businesses Damaged by the Great East Japan Earthquake to purchase loan receivables
- Development of a system to work in close cooperation with REVIC in supporting the reconstruction of the borrower's business or businesses expected to contribute to vitalizing the regional economy
 - Development of a system to take appropriate actions and make requests for the Business Reconstructing ADR Procedure in response to a request from the Business Reconstruction ADR Business Operator, which received a request from the borrower to enter the ADR procedure, for a confirmation of whether to request the implementation of such procedure in order to achieve a quick dispute resolution
 - Development of a system to appropriately take actions based on the Personal Guarantee Guidelines
 - Development of a system to respond appropriately to the consultation from a primary borrower or a guarantor concerning business owner's personal guarantee
 - Development of a system to respond appropriately to the application by REVIC or Organization for Supporting the Turnaround of Businesses Damaged by the Great East Japan Earthquake for a purchase of loan receivables or request for consent for the management/ disposal of loan receivables in accordance with the business reconstruction plan
 - Development of a system to cooperate with respect to the business reconstruction plan noted above in relation to the consent, including the agreement to changes in loan conditions
 - Assurance of consistency between the performance evaluation standard for sales branches and the policies for finance facilitation management
- (ii) Does the Finance Facilitation Manager issue instructions to divisions engaged in relevant business and sales branches, etc. with regard to specific measures for securing appropriate execution of finance facilitation, and manage them in ways to ensure that finance facilitation is done appropriately at each division?

2) Collection, Management, Analysis and Examination of Finance Facilitation Related Information

Does the Finance Facilitation Manager collect in an efficient and timely manner finance facilitation related information scattered across the institution's divisions and departments,

according to the natures of the institution's business? Does the Manager provide a system to appropriately manage the finance facilitation related information collected, analyze it, and for it to serve in improving the finance facilitation system?

3) Monitoring System

In order to ensure appropriate finance facilitation in each business division and sales office etc., does the Finance Facilitation Manager monitor the situation of finance facilitation in each business division and sales office etc. on an ongoing basis, by seeking reports on the situation of finance facilitation in each business division and sales office etc., or by conducting field surveys in a regular and timely manner or on an as needed basis? Also, does the Manager monitor the situation of finance facilitation in Outsourcing Contractors?

4) Cooperation with the Credit Risk Management Division, etc.

Does the Finance Facilitation Manager appropriately cooperate with the Credit Risk Management Division and Customer Explanation Manager, etc., and obtain information timely and appropriately on inappropriate or possibly inappropriate handling of consultations and requests for new finance and loan condition changes, etc., considering the intention of finance facilitation?

5) Guidance and Supervision

Does the Finance Facilitation Manager appropriately manage by guidance and supervision etc. for people serving in operations concerning finance facilitation of the Credit Risk Management Division and Marketing and Sales Division etc., in order to enable appropriate execution of Finance Facilitation Management? Does the Manager also provide appropriate guidance for business consultation and guidance and initiatives to support business improvement, and for enhancing abilities to appropriately assess the business value of customers?

6) Dissemination of Finance Facilitation Manual via Training

Does the Finance Facilitation Manager endeavor to fully disseminate the Finance Facilitation Manual to employees by conducting training on a regular basis, etc.? When the Finance Facilitation Manual is revised, does the Finance Facilitation Manager disseminate the revision in a timely manner?

7) System for Reporting to Board of Directors

Does the Finance Facilitation Manager report the report items established by the Board of

Directors, to the Board of Directors or organization equivalent to the Board of Directors in a regular and timely or on an as needed basis? In particular, does the Manager report to the Board of Directors or organization equivalent to the Board of Directors without delay any matter that would seriously affect corporate management or significantly undermine customer interests?

8) Development of System of Reporting to Corporate Auditor

Does the SME Finance Facilitation Manager report matters specified by the Board of Directors directly to a corporate auditor?

(3) Assessment and Improvement Activities

Does the Finance Facilitation Manager review the effectiveness of the Finance Facilitation Management system in a regular and timely manner or on an as needed basis based on reports and findings on the status of Finance Facilitation Management, including business consultation and guidance for debtors and support to improve the businesses of debtors, and the status of compliance with the Finance Facilitation Management Rules and the Finance Facilitation Manual, as well as based on the results of monitoring? Does the Manager present the Board of Directors or organization equivalent to the Board of Directors with proposals for improvement as necessary by revising in a timely manner the contents of the Finance Facilitation Management Rules and the Finance Facilitation Manual, the organizational framework, the implementation of training and guidance and the method of monitoring?

III. Specific Issues

Checkpoints

- This chapter lists the check items to be used when the inspector reviews specific issues particular to the actual status of Finance Facilitation Management. Reviews of these items must be done based on the intention of these items, while considering the product characteristics. It should be noted that these are merely examples of items, and if there are items required from the viewpoint of finance facilitation, they should be reviewed.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter III., it is necessary to exhaustively examine which of the elements listed in Chapters I. and II. are absent or insufficient, thus causing the said problem, with the use of the checklists in those chapters, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter 1. are not functioning appropriately, and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the finance facilitation related issues pointed out on the occasion of the last inspection that are not minor, and determine whether or not effective improvement measures have been developed and implemented.

1. Common

(1) Credit Examinations and Credit Management

- 1) Are the customer's consultation requests and application for new loans and modification of loan conditions handled appropriately based on the Finance Facilitation Management Policy, etc.?
- 2) For the Finance Facilitation Management Rules and Finance Facilitation Manual, are the following items especially considered?
 - Is the financial institution actively working to provide business consultation and guidance for obligors, and support for drafting the business improvement plans of obligors? Is it actively using these efforts to work for the obligor's business reconstruction?
 - Are not there inappropriate cases, such as restricting finance or work on early collection without rational reasons and only due to formal judgment, such as a specific industry, superficial numbers of financial statements such as excessive debt, history of changed loan conditions, etc.?
- 3) Is the financial institution actively providing business consultation and guidance for debtors, and support for initiatives to improve their businesses?
- 4) Does the financial institution respond to consultations or requests from customers for new

finance or loan condition changes, etc. by grasping of the customer's conditions carefully, instead of, for example, mechanical and uniform decisions based only on the specific industry or superficial numbers of financial statements, etc.?

- 5) Instead of emphasizing customer's technical abilities and growth potential, etc. and profitability and future potential of the business itself, is not there excessive reliance on collateral and personal guarantees? For example, instead of appropriately studying the customer's business value and cash flow forecasts, is not finance denied or reduced for only reasons such as the financing amount exceeds the expected disposable amount of real estate collateral? Also, is not finance denied or reduced based only on excessively harsh valuations of disposable real estate collateral? Moreover, due to reduced security value, does not the financial institution demand additional security or guarantees which do not suit the customer's conditions, without setting a suitable time period?
- 6) In response to consultations or requests from customers for new finance or loan condition changes, etc., does not the financial institution demand collateral or guarantees which do not suit the customer's conditions, present the loan conditions, raise interest rate, etc.?
- 7) In response to consultations or requests from customers for loan condition changes, etc., does not the financial institution respond inappropriately, for example by selling the debt immediately without any consideration?
- 8) For obligors who had their loan conditions changed, etc., does the financial institution fully grasp the debtor's actual circumstances and provide appropriate funds? Only because of a history of changed loan conditions, does not the financial institution deny consultations or requests for new finance or loan condition changes, etc.?
- 9) In cases where the consultation or request from the customer for new finance or loan condition changes, etc. is denied (including the case it is cancelled by the customer itself), and in cases where finance is provided under different conditions than the customer's requested, are the reasons specifically recorded and stored?
- 10) For delinquent obligors, does the financial institution work to prevent delinquency for long term, by grasping and analyzing the reasons for the delinquency, and consulting and advising in a timely manner?
- 11) In relation to requesting the guarantor (including a primary borrower who is the business owner) to perform guarantee obligation (including the primary borrower's obligation), is any system in place to ensure careful handling by taking a rational approach aligned with the guarantor's credit capability determined based on their life condition considering the repayment status of the guaranteed debt and the degree of the guarantor's responsibility such as the background to the provision of guarantee? Given the possibility that the Personal Guarantee Guidelines will be applied to third-party joint and several guarantees,

has the financial institution considered utilizing the Personal Guarantee Guidelines and set out a procedure for a fulfillment of third-party joint and several guarantees obligations in accordance with the Personal Guarantee Guidelines as necessary?

- 12) For sales or securitizations of problem loans, does the financial institution consider protection of the original obligor, and has it developed a system for not selling loan to parties who apply pressure or would harm the steady operations of the obligors, etc.?
- 13) For syndicated loans, etc., does not the financial institution mechanically and formally handle the covenants? For example, when covenants are violated, does the financial institution refrain from immediately demanding debt repayment, etc., instead of fully considering the borrowing enterprise's business conditions and reconstruction possibilities? Also, does it respond appropriately to consultations from enterprises regarding change or deferment of covenants? In particular, for syndicated loans, does it cooperate with related financial institutions to work on a unified response?
- 14) Is there inappropriate handling, such as using the Financial Inspection Manual specified by the authorities or financial inspections by the authorities as reasons for denying new finance or collecting loans, etc.?
- 15) When receiving a request for loans by a borrower of other financial institutions, etc. (including governmental financial institutions, etc.), does the financial institution, based on the borrower's consent, appropriately work in close cooperation with other relevant lending institutions (including the credit guarantee association, etc., if a guarantee is involved) and mutually confirm the information regarding changes in loan conditions, etc., while taking into considering the duty of confidentiality? Especially, does a financial institution with a large loan balance work in close cooperation with other financial institutions, actively accepting confirmation requests as to information on the modification of loan conditions?
- 16) Does the financial institution, based on the borrower's consent, appropriately handle requests to disclose information on changes in loan conditions, etc., from other financial institutions, etc. (including governmental financial institutions and credit guarantee associations, etc.) while considering the duty of confidentiality? Especially, does a financial institution with a large loan balance work in close cooperation with other financial institutions, actively accepting such requests for information as to the changes in loan conditions?
- 17) When the financial institution received a borrower's request for changes in loan conditions and was able to confirm that other financial institutions including governmental financial institutions accepted the request for changes in loan conditions, does the financial institution appropriately handle and endeavor to accept such request based on its financial

- facilitation management policy, considering the improvement of the borrower's business and capability for business reconstruction, and the fact that other institutions allowed the modification of loan conditions?
- 18) Does the financial institution deal with the above (xv) through (xvii) carefully in order to avoid violating the Antitrust Act, keeping in mind the following points in particular?
- Necessary information should be confirmed among financial institutions, etc. (including governmental financial institutions, etc., and credit guarantee association, etc.) for each request by the borrower.
 - Information shared among financial institutions (including governmental financial institutions, etc., and credit guarantee associations, etc.) should be limited only to information which is relevant to each request.
 - The responsibility to make the final decision on whether to accept or decline the request for changes in loan conditions, etc., should rest with each financial institution.
- 19) Is the financial institution making efforts to expand its lending technique such as a guarantee agreement with a suspension or termination clause and ABL (Asset Based Lending) to replace the function of the personal credit guarantee provided by business owners, and to disseminate the availability of such lending methods to the customer?
- 20) When receiving a funding request from an SME, etc., who is the primary borrower, does the financial institution analyze the business condition and review whether the borrower is making efforts towards the separation of corporate and individual identities? As a result of review, if a satisfactory level of efforts for separation is confirmed, is there a procedure to review the possibility of not requiring the business owner's personal credit guarantee while incorporating the borrower's consent?
- 21) In sorting out guaranteed debt, does the financial institution adequately work to restructure the guaranteed debt in cooperation/coordination with the related financial institutions, outside experts (certified public accountants, tax lawyers and attorneys, etc.) and external institutions (SME Revitalization Support Councils) in accordance with the Personal Guarantee Guidelines?
- 22) Does the financial institution try to work in close cooperation with the REVIC in support of the reconstruction of the borrower's business or business activities expected to vitalize the regional economy?
- 23) Does the financial institution appropriately handle the request from REVIC or the Organization for Supporting the Turnaround of Businesses Damaged by the Great East Japan Earthquake for consenting to a purchase of loan receivables or management/disposal of loan receivables in line with the business reconstruction plan, based on the financial facilitation management policy, etc.? Further, in relation to the aforementioned business

reconstruction plan, is the financial institution willing to cooperate with and modify loan conditions, etc. based on the financial facilitation management policy, etc.?

(2) Customer Explanation, etc.

- 1) When a consultation or request is received from a customer regarding new finance or loan condition changes, etc., does the financial institution work to quickly consider and reply to it? Also, in cases of denial or loan collection, does the financial institution try as much as possible to show the grounds and provide explanation to obtain the customer's understanding and acceptance? For example, does not the financial institution respond by denying only because of denial by the credit guarantee association, etc.? Moreover, in providing these explanations, does the financial institution grasp the customer's information carefully and act quickly, corresponding to business relations until then and the customer's knowledge and experience and asset situation?
- 2) When a consultation is received from an obligor regarding loan condition changes, etc., does the financial institution respond appropriately? Does not the financial institution prevent the request for loan condition changes, etc. which are related to that consultation? Also, when a request for loan condition changes, etc. is received from an obligor, is not the obligor pushed to cancel his request against its will?
- 3) When there is a consultation or request from a customer regarding new finance or loan condition changes, etc., if that financial institution demands new collateral or guarantees or presentation of new loan conditions (including raising the interest rate, etc.), does it promptly present its details? Also, does it fully explain with the aim of obtaining the customer's understanding and acceptance, considering the business relations until then and the customer's knowledge, experience and asset situation? In particular, upon succession of the borrower's business, does the financial institution follow the Personal Guarantee Guidelines, and consider anew the necessity of the guarantee agreement based on the disclosure of necessary information, instead of requesting the successor of the business to succeed to the guaranteed debt outright? If, as a result, the execution of the guarantee agreement is deemed necessary, does the financial institution provide adequate explanation as to the need for the guarantee agreement, etc. to the primary borrower and the successor of the business? Further, if the termination of the guarantee agreement is requested by the former business owner, does the financial institution make an appropriate decision on the cancellation, considering the involvement of the former business owner (i.e., whether the former business owner substantially retains rights to manage and control), securities other than the guarantee agreement available to the existing debt, the ability of repayment

- through corporate assets and its earnings ability, etc.?
- 4) When there is a consultation or request from a customer regarding new finance or loan condition changes, etc., are specific records of the actual response created and stored to enable later review?
 - 5) When there was confirmation as to whether to request implementation of the Business Reconstruction ADR Procedure by the ADR business operator which received from the borrower a request for implementation of the Business Reconstruction ADR, is that request made appropriately for quick dispute resolution, based on the financial facilitation policy, etc.?
 - 6) When there is an oral request from an obligor for loan condition changes, etc., is that request's content recorded?

2. Finance for Micro, Small and Medium-sized Enterprises

(1) Handling of Finance Facilitation

- 1) Regarding credit for micro, small and medium-sized enterprises, etc., does the financial institution perform credit management such as credit rating, while considering comprehensively the borrower's business circumstances, based on the business and financial aspect characteristics of micro, small and medium-sized enterprises, etc., which are generally easily affected by the economy, and easily end up with excessive debt due to temporary causes?
- 2) When the value of the collateral falls below the loan value, does not the financial institution immediately collect on the loan or raise the interest rate, without rational reasons?
- 3) When there are delinquent business loans, etc. for which a scoring model is used, is not the loans mechanically collected or sold, without discussing actions to improve the business? Also, when ending provision of business loans, etc., does the financial institution consider the situation in which this places the obligor, and study a substitute means of providing funds as necessary?
- 4) When requested for financing by the primary borrower that is working towards separation of identity between the corporate entity and the individual (i.e., business owner), does the financial institution, through the course of making an overall judgment as to the primary borrower's business condition, use of funds and repayment possibility based on the Personal Guarantee Guidelines, make efforts and consider the possibility of not using the business owner's personal guarantee but alternative methods of lending (guarantee agreement with a suspension/termination clause, ABL, upward adjustment to the level of interest rate, etc.)?

(2) Business Consultation, Guidance, Support in Drafting a Business Improvement Plan, etc. for Client Micro, Small and Medium-sized Enterprises, etc.

- 1) For an obligor which is a micro, small or medium-sized enterprise, is there detailed credit management, etc. based on its natures? For example, is there handling as described below?
- Does the financial institution endeavor to manage credit by fully grasping the business situation through continual enterprise visits, including qualitative information such as the enterprise's technical and sales abilities and managers' qualities?
 - Are there active efforts for the enterprise and its business reconstruction, through detailed business consultation and guidance, and support in drafting a business improvement plan, etc.?¹³
 - Are there efforts to use that financial institution's information functions and network for providing support, such as information on business matching and M&A?
 - Is detailed support provided corresponding to each stage of the lifecycle (support for founding and new business, business improvement support, business reconstruction, business succession)?
 - Are there efforts to thoroughly use loan techniques which assess business value, and other funding techniques which suit small and medium-sized enterprises?

In reviewing the detailed support provided corresponding to each lifecycle stage, and thorough use of funding techniques which suit small and medium-sized enterprises, considering the financial institution's size and characteristics, the following examples are referred to in reviews.

(Reference 1) Specific techniques of detailed support at each lifecycle stage – Examples

- Special arbitration procedure using an alternative dispute resolution procedure by a Business Reconstruction ADR Business Operator
- Use of REVIC, the Organization for Supporting the Turnaround of Businesses Damaged by the Great East Japan Earthquake, or a Small and Medium Size Business Rehabilitation Support Co-operative
- Use of enterprise reconstruction scheme of The Resolution and Collection Corporation
- Use of various funds such as of the Organization for Small & Medium Enterprises and Regional Innovation, JAPAN
- Use of DES and DDS
- Use of new share subscription rights finance and redeemable DES, etc., which have upside potential

¹³ When providing advice to facilitate the borrower in understanding its management goals/issues accurately and adequately, it is effective to encourage the use of the Guidelines on Accounting of Small and Medium-sized Enterprises and the Basic Guidelines for SME Accounting.

- Use of DIP finance, including appropriate use of the credit guarantee system
- Cooperation with authorized organizations supporting business innovation
- Cooperation with human resource introduction operations, etc., implemented by the chamber of commerce and industry
- Use of baby boom retirees among financial institutions
- Industry/academia/government cooperation
- Initiatives in cooperation with technology evaluations, etc. promoted by the Ministry of Economy, Trade and Industry
- Use of the credit guarantee system when an enterprise which failed once endeavors to succeed again, even if there is remaining debt
- Use of guarantee agreement aligned with the conditions of micro and small & medium enterprises, etc.
- Use of stronger consultant abilities and organization and business matching, for support through its own information functions and network (local public governments, chamber of commerce and industry, commerce and industry association, other financial institutions, etc.)
- Use of small and medium-sized enterprise policies in cooperation with national and local public governments
- Initiatives in cooperation with external experts such as for legal affairs, finance and tax, while using the community's information network
- In addition to consulting on succession of the business, etc., support for share purchase funding including MBO and EBO, etc., and M&A matching support

(Reference 2) Thorough use of funding techniques which suit small and medium-sized enterprises – Specific examples

- Use of intellectual property business reports, with systematic nonfinancial qualitative information evaluation of patents, brands, organizational abilities, network of customers and suppliers, etc.
- Use of the accounting counselor system, and wider use of *Guidelines on Accounting of Small and Medium-sized Enterprises* and *the Basic Guidelines on Accounting of Small and Medium Enterprises*.
- Initiatives in cooperation with technology evaluations, etc. promoted by the Ministry of Economy, Trade and Industry
- Finance using movable property and receivable backed financing (i.e. use of accounts receivables and trade receivables), ABL, etc.
- Use of various covenants (obligor enterprise imposed to report items determined in

contract, joint guarantee subject to condition precedent (attach a covenant which imposes an obligation to report on the business or management situation, and seeks joint guarantee by the representative as a condition precedent violations of that covenant), etc.)

- Use of various public and private funds such as of the Organization for Small & Medium Enterprises and Regional Innovation, JAPAN, and investment finance techniques which benefit from the upside (mezzanine investment and loans, loans with new share subscription rights, etc.)
 - Use of so-called local investment trusts which work on investing in local enterprises
 - Use of CLO
 - Use of syndicated loans
- 2) When giving support for the business improvement/reconstruction, etc., of each borrower, does the financial institution work closely with the borrower, propose the best suitable solution for the borrower's management issue and provide support for implementation from the borrower's point of view? When there is any involvement of other related financial institutions (including governmental financial institutions, etc., credit guarantee associations, SME Revitalization Support Councils etc.), does the financial institution work to cooperate and coordinate adequately with such institutions such as by holding a conference to cooperate with other related financial institutions?
- 3) Is the financial institution working to develop a framework at its sales branches as well as its head office, for cooperating as necessary, appropriately and in a timely manner with outside expertise (tax lawyers, attorneys, certified public accountants, SME management consultants, business advisors, etc.), external institutions (local public entities, Bureaus of Economy, Trade and Industry, The Japan Chamber of Commerce and Industry, commercial and industrial associations, the Federation of Small Business Associations, JETRO, JBIC, REVIC, the Organization for Supporting the Turnaround of Businesses Damaged by the Great East Japan Earthquake, SME Revitalization Support Councils, the Organization for Small & Medium Enterprises and Regional Innovation Japan, authorized organizations supporting business innovation, business reconstruction funds, regional revitalization funds, etc.), other financial institutions, etc., considering the need for complementing the lack of internal expertise and knowhow, medium to long term human resource development and the accumulation of knowhow? Particularly when the borrower needs support for business reconstruction, change in industry, succession/closure of business, does the financial institution actively seek third-party opinion, outside expertise and functions of outside experts, outside institutions, etc., instead of delaying the decision-making? Is the financial institution voluntarily and continuously involved in providing

support for the borrower's business reconstruction as a main financial institution, using the function of REVIC or the Organization for Supporting the Turnaround of Businesses Damaged by the Great East Japan Earthquake? Additionally, does the main financial institution consider third party views of outside experts, external institutions, etc., to make final decisions as to the difficulty of the business reconstruction of the borrower? Further, when other financial institutions are also involved in the borrower's business reconstruction using outside experts, external institutions, etc., does the financial institution take appropriate actions for active coordination and cooperation with other institutions?¹⁴

- 4) For an enterprise receiving business improvement support, does the financial institution appropriately grasp the progress status of the business improvement plan, and work on business improvements as needed, such as with business consultation and guidance?
- 5) For loans (including loans on bills) which are roll over of short term loans, if further refinancing corresponds to a *Kashidashi Joken Kanwa Saiken* (hereinafter referred to as the "Rescheduled Loan"), instead of easily denying the customer's request, does it appropriately provide support for drafting a business improvement plan, etc.?
- 6) Are requests for loan condition changes, etc. not denied because the debtor did not draft a large and very detailed business improvement plan, etc.?

(3) Handling of Credit Guarantee System

- 1) Is this handled appropriately, such as timely and accurate recognition of the credit guarantee system, and are easily understood explanations provided to customers?
- 2) Does not a financial institution instruct its sales offices to promote the enhancement of its credit protection by using guarantee system? Also, in response to a request for a loan to a customer who's request can be met sufficiently based on the customer's credit situation, does not the financial institution refuse to handle it if the credit system cannot be used, without a rational reason and against the customer's will?
- 3) Is not the guarantee system used to collect existing loans? For example, is such handling suggested to sales offices via instruction notices, etc.? Even in exceptional cases where existing loan collection is approved¹⁵, are not procedures taken without the recognition of

¹⁴ Each financial institution should decide on the specific entity for coordination through independent business judgment considering the institution's size, characteristics, and expectations/needs of the users. It should be noted that this paragraph is not intended to require coordination with all entities listed in the parentheses or to exclude coordination with other non-listed entities. It is also important to note that the borrower's consent is the prerequisite for sharing information regarding the borrower's business obtained by the financial institution with the entity in cooperation.

¹⁵ Case in which the existing loan collection becomes the customer's profit as business funds, such as extending the loan period by refinancing the existing guaranteed loan as a new guaranteed one, where this is approved in advance by the Credit Guarantee Association, etc.

- customer?
- 4) For a transaction approved by a Credit Guarantee Association, etc., is not the request for a guaranteed loan denied, or the loan decision pointlessly drawn out for a long time, without rational reason or explanation to gain the customer's understanding?
 - 5) For a guaranteed loan with an approved deferred repayment period, is not it approved with conditions shorter than the deferred repayment period presented by the customer, without a rational reason?
 - 6) For cases in which it is difficult for that financial institution alone to change loan conditions, etc., instead of immediate denial, does that financial institution study whether it is possible to attach a guarantee of a Credit Guarantee Association, etc., and change the loan conditions, etc.? Also, if there is a request from the customer, does the financial institution discuss it with the Credit Guarantee Association, etc.?
 - 7) In studying loan conditions, for credit risk reduction by credit guarantee, is this fully considered when setting the interest rate, etc.?

3. Housing Loans

(1) Credit Screening and Customer Explanations

- 1) For housing loans, are not there inappropriate uniform denials, for example, of customers working in specific industries or in micro, small or medium-sized enterprises?
- 2) Regarding product content and risks, are drawings and examples used to provide simple explanations which match the customer's knowledge and experience, and are documents given?
- 3) For variable interest rate housing loan or fixed interest rate housing loans for a certain period of time, are interest rate movement risks sufficiently explained?

(2) Credit Management

- 1) Is a system developed to enable appropriate responses to consultations for refinancing and loan condition changes, etc.? Also, in response to consultations and requests for loan condition changes, etc., does the financial institution fully consider the customer's actual situation to respond quickly and appropriately? For example, for the obligor to make repayments over the future without excessive difficulty, does the response comprehensively consider the family revenues and future revenues?
- 2) In cases where self-assessment standard are used which could result in a rescheduled loan if the loan conditions are changed, etc., is not there inappropriate handling such as not changing loan conditions for only that reason?

- 3) In cases where loan conditions are not changed, etc., is explanation provided with the aim of obtaining the customer's understanding and acceptance as much as possible?
- 4) In cases where delinquency happens, is there consideration of possible responses including loan condition changes, etc., as needed, instead of easy collection by collateral disposal, etc. without fully studying the obligor's actual circumstances?

(3) Guarantee Company

- 1) In cases where a guarantee company guarantees a housing loan, are the following points handled appropriately?
 - Are there guidance, discussions and requests, etc. so that the guarantee company performs appropriate screening?
 - In response to consultations and requests from customers regarding new finance and loan condition changes, etc., does the financial institution closely cooperate with that guarantee company, etc. and work to quickly respond?
 - In cases of denial of the customer's request for a new finance or loan condition changes, etc., does the financial institution closely cooperate with that guarantee company, and provide appropriate explanations corresponding to the customer's knowledge, experience and asset situation?
- 2) In cases in which the guarantee company acquires the housing loan claim by subrogation, are there guidance, discussions and requests, etc. so that the guarantee company collects appropriately?

Risk Management Section

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Checklist for Legal Compliance

I. Development and Establishment of Legal Compliance System by Management

Checkpoints

- The development and establishment of a legal compliance system is one of the most important tasks for a financial institution in order to secure the soundness and appropriateness of its business. Therefore, the institution's management is charged with and responsible for taking the initiative in developing and establishing the legal compliance system that covers the institution's entire business by deciding a basic policy on legal compliance and developing an organizational framework, etc..
- The inspector should determine whether the legal compliance system is functioning effectively and whether the roles and responsibilities of the institution's Board of Directors are being appropriately performed by way of reviewing, with the use of check items listed in Chapter I., whether the management is appropriately implementing (1) policy development, (2) development of internal rules and organizational frameworks and (3) assessment and improvement activities.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II. and later in this checklist, it is necessary to exhaustively review which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize weaknesses or problems recognized by the inspector, it is also necessary to explore in particular the possibility that the Internal Control System is not functioning effectively and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Policy Development

(1) Roles and Responsibilities of Directors

Do directors attach importance to legal compliance based on a full recognition that full legal compliance throughout the financial institution is vital for maintaining public confidence in the institution and securing the soundness and appropriateness of the institution's business? In particular, are directors aware of legal problems concerning the business operations they are in

charge of that need special attention and do they make absolutely sure to conduct business operations legally?

Does the director in charge of legal compliance understand not only all of the Laws (including but not limited to laws and regulations, etc.; hereinafter referred to as the “Laws”) applicable to the financial institution’s business but also how to monitor the status of legal compliance and fully enforce compliance throughout the institution? Based on such understanding, does the director appropriately grasp the status of legal compliance at the institution and consider a policy and specific measures necessary for developing and establishing an appropriate legal compliance system?

(2) Development and Dissemination of Legal Compliance Policy

Has the Board of Directors established a basic policy regarding legal compliance (hereinafter referred to as the “Legal Compliance Policy” in accordance with the institution’s corporate management policy and disseminated it throughout the institution?

(3) Revision of the Policy Development Process

Does the Board of Directors revise the policy development process in a timely manner by reviewing its effectiveness based on reports and findings on the status of legal compliance in a regular and timely manner or on an as needed basis?

2. Development of Internal Rules and Organizational Frameworks

(1) Development and Dissemination of Internal Rules

Does the Board of Directors or organization equivalent to the Board of Directors have the Manager (hereinafter simply referred to as the “Manager” in this checklist) of the division in charge of overseeing matters related to legal compliance in an integrated manner (hereinafter referred to as the “Compliance Control Division”) develop internal rules that clearly specify the arrangements on legal compliance (hereinafter referred to as the “Legal Compliance Rules”) and disseminate them throughout the institution in accordance with the Legal Compliance Policy?¹ Has the Board of Directors or organization equivalent to the Board of Directors approved the Legal Compliance Rules after determining if they comply with the Legal Compliance Policy and after legal checks, etc.?

(2) Establishment of System of the Compliance Control Division

- 1) In order to fully enforce legal compliance throughout the institution, it is essential to collect, manage, analyze and review in an integrated manner information concerning legal compliance (hereinafter referred to as the “Compliance-related Information”) scattered across the

institution's divisions and departments and, based on the results of the analysis and review, take appropriate steps and measures. From such a point of view, does the Board of Directors or organization equivalent to the Board of Directors have the Compliance Control Division, established in accordance with the Legal Compliance Policy and the Legal Compliance Rules, clarify its areas of responsibilities and assign it the necessary authority so as to enable the division to perform its roles and functions appropriately?¹

- 2) Has the Board of Directors allocated to the Compliance Control Division a Manager with the necessary knowledge and experience to supervise the division and enabled the Manager to implement management operations by assigning him/her the necessary authority therefor?
- 3) Has the Board of Directors or organization equivalent to the Board of Directors allocated to the Compliance Control Division an adequate number of staff members with the necessary knowledge and experience to execute the relevant operations and assigned such staff the authority necessary for implementing the operations?²
- 4) Does the Board of Directors or organization equivalent to the Board of Directors provide a system to keep the Compliance Control Division independent from the Marketing and Sales Division and secure a check-and-balance system of the Compliance Control Division? In the case where the Compliance Control Division also takes charge of another business, the inspector should give consideration in particular to whether there is a system to prevent interference from the Marketing and Sales Division, etc.

(3) Development of Legal Compliance System in Operation Divisions and Sales Branches

- 1) Does the Board of Directors or organization equivalent to the Board of Directors provide a system to fully disseminate the relevant internal rules and operational procedures³ to operation divisions and sales branches, etc.? For example, does the Board of Directors or organization equivalent to the Board of Directors instruct the Manager or the Compliance Control Division to identify the Laws, internal rules and operational procedures to be observed by the operation divisions and to regularly carry out specific measures for ensuring observance such as providing effective training suited to the nature and responsibilities of the operations?
- 2) Does the Board of Directors or organization equivalent to the Board of Directors provide a

¹ When the Compliance Control Division is not established as an independent division (e.g., when the division is consolidated with another risk management division to form a single division or when a division in charge of other business also takes charge of compliance control or when a Manager or Managers take charge of compliance control instead of a division or a department), the inspector shall review whether or not such a system is sufficiently reasonable and provides the same functions as in the case of establishing an independent division commensurate with the scales and natures of the institution and its risk profile.

² When a department or a post other than the Board of Directors or organization equivalent to the Board of Directors is empowered to allocate staff and assign them authority, the inspector shall review, in light of the nature of such a department or post, whether or not the structure of the Compliance Control Division is reasonable in terms of a check-and-balance system and other aspects.

³ Operational procedures are rules established, revised and abolished by a person or a division empowered by the Board of Directors or organization equivalent to the Board of Directors to do so and are subsidiary to internal rules.

system to ensure the effectiveness of the compliance control system in operation divisions and sales branches, etc. through the Manager or the Compliance Control Division?

- 3) Does the Board of Directors or organization equivalent to the Board of Directors allocate a person in charge of compliance to each operation division and sales branch for coordination with the Compliance Control Division? With regard to operation divisions and sales branches for which it is especially necessary to secure the effectiveness of the legal compliance system, for example because it is difficult to monitor their operations (e.g. overseas branches), does the Board of Directors allocate a compliance officer responsible for securing legal compliance at such divisions and branches and ensure that coordination with the Compliance Control Division is maintained through the coordination between the compliance officer and the Manager while keeping independence from the Marketing and Sales Division?
- 4) Does the Board of Directors provide a system to establish firewalls and take other measures to block the flow of information when necessary from the viewpoint of legal compliance according to the scales and natures of the institution's business? Cases that require such measures include when the prevention of insider trading or management of conflicts of interest, etc. is necessary, for example.

(4) Development and Dissemination of Compliance Manual

Does the Board of Directors have the Manager establish, in accordance with the Legal Compliance Policy and the Legal Compliance Rules, a manual that explains the Laws that officers and employees must comply with (hereinafter referred to as the Compliance Manual) and provides specific instructions as to what measures should be taken when illegal acts are detected and disseminate the manual throughout the institution upon approval by the Board of Directors or organization equivalent to the Board of Directors? Is an important revision of the Compliance Manual subject to approval by the Board of Directors?

(5) Development and Dissemination of Compliance Program

Does the Board of Directors have the Manager formulate, in accordance with the Legal Compliance Policy and the Legal Compliance Rules, a program for implementing specific measures to ensure compliance (Including the development of internal rules and planning of employee training. Hereinafter referred to as the "Compliance Program") at least once a year and disseminate it throughout the institution upon approval by the Board of Directors?

Do the representative directors and the Board of Directors regularly and accurately grasp the progress and achievement status of the Compliance Program? Do they provide a system to reflect the implementation status of the Compliance Program in the performance assessment and personnel evaluation?

(6) Arrangement for the System of Reporting to Board of Directors or organization equivalent to Board of Directors and Approval

Has the Board of Directors or organization equivalent to the Board of Directors appropriately specified matters that require reporting and those that require approval and does it have the Manager report the current status of legal compliance to the Board of Directors or organization equivalent to the Board of Directors in a regular and timely manner or on an as needed basis or have the Manager seek the approval of the Board of Directors or organization equivalent to the Board of Directors on the relevant matters? In particular, does it ensure that the Manager reports to the Board of Directors or organization equivalent to the Board of Directors without delay any matters that would seriously affect corporate management or significantly undermine customer interests?

(7) Arrangement for System of Reporting to Corporate Auditor

In the case where the Board of Directors has specified matters to be directly reported to a corporate auditor, has it specified such matters appropriately and does it provide a system to have the Manager directly report such matters to the auditor?⁴

(8) Development of Internal Audit Guidelines and Internal Audit Plan

Does the Board of Directors or organization equivalent to the Board of Directors have the Internal Audit Division appropriately identify the matters to be audited with regard to legal compliance, develop guidelines that specify the matters subject to internal audit and the audit procedure (hereinafter referred to as “Internal Audit Guidelines”) and an internal audit plan, and approve such guidelines and plan?⁵

(9) Revision of Development Process of Internal Rules and Organizational Frameworks

Does the Board of Directors or organization equivalent to the Board of Directors revise the development process of internal rules and organizational frameworks in a timely manner by reviewing its effectiveness based on reports and findings on the status of legal compliance in a regular and timely manner or on an as needed basis?

3. Assessment and Improvement Activities

(1) Analysis and Assessment

1) Analysis and Assessment of Legal Compliance System

Does the Board of Directors or organization equivalent to the Board of Directors appropriately

⁴ It should be noted that this shall not preclude a corporate auditor from voluntarily seeking a report and shall not restrict the authority and activities of the auditor in any way.

⁵ The Board of Directors or organization equivalent to the Board of Directors only needs to have approved the basic matters with regard to an internal audit plan.

determine whether there are any weaknesses or problems in the legal compliance system and the particulars thereof, and appropriately review their causes by precisely analyzing the status of legal compliance and assessing the effectiveness of the legal compliance system, based on all information available regarding the status of legal compliance, such as the results of audits by corporate auditors, internal audits and external audits, findings of various investigations and reports from various divisions? In addition, if necessary, does it take all possible measures to find the causes by way of, for example, establishing fact findings committees, etc. consisting of non-interested persons?

2) Revision of Analysis and Assessment Processes

Does the Board of Directors or organization equivalent to the Board of Directors revise the analysis and assessment processes in a timely manner by reviewing their effectiveness based on reports and findings on the status of legal compliance in a regular and timely manner or on an as needed basis?

(2) Improvement Activities

1) Implementation of Improvements

Does the Board of Directors or organization equivalent to the Board of Directors provide a system to implement improvements in the areas of the problems and weaknesses in the Customer Protection Management system that are identified through the analysis, assessment and review referred to in 3. 1) above in a timely and appropriate manner based on the results obtained by developing and implementing an improvement plan as required or by other appropriate methods?

2) Progress Status of Improvement Activities

Does the Board of Directors or organization equivalent to the Board of Directors provide a system to follow up on the efforts for improvement in a timely and appropriate manner by reviewing the progress status in a regular and timely manner or on an as needed basis?

3) Revision of the Improvement Process

Does the Board of Directors or organization equivalent to the Board of Directors revise the improvement process in a timely manner by reviewing its effectiveness based on reports and findings on the status of legal compliance in a regular and timely manner or on an as needed basis?

II. Development and Establishment of Legal Compliance System by Manager

Checkpoints

- This chapter lists the check items to be used when the inspector reviews the roles and responsibilities to be performed by the Manager and the Compliance Control Division.

- If any problem is recognized as a result of a review conducted with the use of the check items listed in Chapter II., it is necessary to exhaustively review which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.

- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter I. are not functioning appropriately and review findings thereof through dialogue.

- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Roles and Responsibilities of Manager

(1) Development of Internal Rules

1) Development and Dissemination of Legal Compliance Rules

Has the Manager, in accordance with the Legal Compliance Policy, developed the Legal Compliance Rules based on a full understanding of the Laws that officers and employees must comply with according to the nature of their operations? Have the Legal Compliance Rules been disseminated throughout the institution upon approval by the Board of Directors or organization equivalent to the Board of Directors?

2) Legal Compliance Rules

Do the Legal Compliance Rules exhaustively cover the arrangements with regard to compliance with the Laws that officers and employees must observe according to the nature of their operations and specify the arrangements appropriately? Do the rules specify the following items, for example?

- Arrangements on the roles, responsibilities and organizational framework of the Compliance Control Division
- Arrangements on the collection, management, analysis and review of Compliance-related

Information

- Arrangements on monitoring of legal compliance
- Arrangements on legal checks, etc. (For example, which of the internal rules, contract documents and advertising documents compiled by each division and transactions and operations in which it is involved are subject to legal checks, etc.?)
- Arrangements on implementation of training and guidance
- Arrangements on the storage and management of records on investigations conducted by the Compliance Control Division
- Arrangements on approval and screening of New Products
- Arrangements on reporting to the Board of Directors and corporate auditor, etc.

3) Development and Dissemination of Compliance Manual

Has the Manager, in accordance with the Legal Compliance Policy and the Legal Compliance Rules, developed the Compliance Manual based on a full understanding of the importance of legal compliance in the business of financial institutions? After developing the Compliance Manual or conducting an important revision of the manual, does the Manager disseminate it throughout the institution upon approval by the Board of Directors?

4) Compliance Manual

Does the Compliance Manual, in light of the social responsibilities and public duties of financial institutions, explain the Laws that officers and employees must comply with according to the nature of the relevant institution's business and exhaustively cover and specify in an easy-to-understand way measures to be taken when illegal acts are detected? Does the manual clearly specify the following items, for example?

- Explanation of Laws that officers and employees must comply with
- Specific and detailed notes with regard to Laws that must be complied with in relation to each operation
- Divisions and departments to be contacted when officers and employees detect suspected violation of Laws (Compliance Division, "help line," "compliance hot line," etc.)

5) Development of Compliance Program

Does the Manager formulate a reasonable Compliance Program at least once a year in accordance with the Legal Compliance Policy and the Legal Compliance Rules and based on a full understanding of the importance of legal compliance in the business of financial institutions? After developing a new Compliance Program or conducting an important revision of the existing one, does the Manager disseminate the new program or revised one throughout the institution upon approval by the Board of Directors?

(2) Development of Framework

1) Development of System of the Compliance Control Division by Manager

- (i) Does the Manager, in accordance with the Legal Compliance Policy and the Legal Compliance Rules, provide a system to have the Legal Compliance Division prepared to exercise a check-and balance in order to make absolutely sure to pre-empt violation of Laws and prevent the recurrence of past violation of Laws ?
- (ii) Does the Manager ensure the system of training and education to enhance the ability and knowledge of employees with regard to legal compliance, thus developing human resources with relevant expertise?

2) Collection, Management, Analysis and review of Compliance-Related Information

Does the Manager provide for measures to collect in an efficient and timely manner Compliance-related Information scattered across the institution's divisions and departments according to the nature of the institution's business? Does the Manager provide a system to appropriately manage the Compliance-related Information collected and analyze it so as to use it to pre-empt violation of Laws and prevent the recurrence of the past violation of Laws? For example, does the Manager provide for a means of reporting by establishing a "help line," a "compliance hot line," etc.?

3) Communication and Coordination System

- (i) Does the Manager, in person or through the Compliance Control Division, maintain close communication and coordination with divisions which hold Compliance-related Information?
- (ii) Does the Manager maintain coordination with a person in charge of compliance allocated to each operation division and sales branch, etc.?

4) Monitoring System

Does the Manager, in order to ensure appropriate legal compliance at each division, make sure to monitor the status of compliance on an ongoing basis by requiring each division in a regular and timely manner or on an as needed basis to report the status of its compliance, to collect information from persons in charge of enforcing compliance on an ongoing basis or to conduct a field survey, for example?

5) System for Handling Violation of Laws

Does the Manager provide a system to ensure that an investigation is promptly conducted in response to a report about a suspected violation of Laws if the suspicion is determined as justified as a result of analysis of Compliance-related Information and review whether or not the institution is required under law to report the case to the authorities and report it when

necessary? (The Manager may have a suitable division or department other than the Compliance Control Division investigate, review and report such a case.)

Does the Manager provide a system to make an appropriate disclosure under the Financial Instruments and Exchange Law?⁶

6) Coordination with Customer Support Manager

- (i) Does the Manager, in coordination with the Customer Support Management⁷, provide a system to collect information in a prompt and wide-ranging manner with regard to Consultation Requests, Complaints, etc.⁸ from customers that should be recognized as legitimate complaints and that may develop into legitimate complaints?
- (ii) With regard to complaints that involve information related to violation of Laws, including suspected ones, does the Manager provide a system to require and obtain reports from divisions, departments and individuals that hold the relevant information and analyze and review it so as to provide feedback to the division in charge of processing complaints?
- (iii) Does the Manager provide a system to have a non-interested party conduct appropriate and sufficient investigations to identify the cause with regard to complaints determined as requiring such action?

7) System for Training and Guidance

Has the Manager fully disseminated the details of the Compliance Manual to all of the officers and employees? Does the Manager make sure to provide sufficient training and guidance with regard to the Laws that must be complied with in each operation? Do all of the employees get fully acquainted with the need to prevent violation of Laws through training sessions and workplace morning assemblies, etc.?

8) System for Reporting to Board of Directors or organization equivalent to Board of Directors and Approval

Does the Manager provide a system to report matters determined as necessary by the Board of Directors or organization equivalent to the Board of Directors in a regular and timely manner or on an as needed basis? In particular, does the Manager report to the Board of Directors or organization equivalent to the Board of Directors without delay any matter that would seriously affect corporate management or significantly undermine customer interests?

9) System for Reporting to Corporate Auditor

⁶ This shall apply only to financial institutions subject to timely disclosure rules under the Financial Instruments and Exchange Law.

⁷ See Checklist for Customer Protection Management.

⁸ See Checklist for Customer Protection Management.

Does the Manager report matters specified by the Board of Directors directly to a corporate auditor?

(3) Assessment and Improvement Activities

Does the Manager review the effectiveness of the Compliance Control Division's enforcement of legal compliance in a regular and timely manner or on an as needed basis based on the reports and the results of investigations concerning the status of legal compliance, including the status of compliance with the Compliance Manual and various rules, as well as based on the results of monitoring? Does the Manager present the Board of Directors or organization equivalent to the Board of Directors with proposals for improvement as necessary by revising in a timely manner the various rules (including the Compliance Manual), the organizational framework, the implementation of training and guidance and the method of monitoring?

2. Roles and Responsibilities of the Compliance Control Division

(1) Implementation of Compliance Program

Does the Compliance Control Division implement specific measures of the Compliance Program in a timely and appropriate manner, conduct follow-up review of the status of progress and achievement and report it to the Board of Directors or organization equivalent to the Board of Directors?

(2) Communication and Collection of Information

From the viewpoint of ensuring the full enforcement of legal compliance throughout the institution, does the Compliance Control Division collect, manage, analyze and review in an integrated manner Compliance-related Information scattered across the institution's divisions and departments and, based on the results of the analysis and review, take appropriate steps and measures? In particular, does the division collect information in close coordination with persons in charge of compliance allocated to operation divisions and sales branches, etc?

(3) Monitoring of Legal Compliance

Does the Compliance Control Division monitor the status of legal compliance at operation divisions and sales branches, etc. on an ongoing basis in order to ensure full legal compliance throughout the institution?

For example, does the division conduct monitoring by requiring reports in a regular and timely manner or on an as needed basis from persons in charge of compliance with regard to the status of legal compliance at operation divisions and sales branches, etc., or by collecting information on an ongoing basis and conducting a field survey in a timely manner?

(4) Handling of Violation of Laws

- 1) When the Compliance Control Division detects a suspected case of violation of Laws as a result of the review of Compliance-related Information or receives a report about such a case, does the division immediately conduct a fact-finding investigation or have a non-interested division or department conduct such an investigation and determine whether or not the case constitutes a violation of Laws and review whether or not there is any weakness in the legal compliance system?
- 2) Does the Compliance Control Division immediately report to the Manager an incident determined as a result of the fact-investigation mentioned in (i) above as constituting a violation of Laws or as having a high probability of constituting an illegal act and take appropriate measures in coordination with the relevant divisions and departments? Does the division at this stage consider whether or not it is necessary to report the incident as an illegal act to the authorities as required under law, whether or not to report it as a suspicious transaction and whether or not to disclose it publicly?
- 3) Does the Compliance Control Division investigate the background and cause of a violation of Laws act and the extent of its impact or have a non-interested division or department conduct such an investigation and then analyze the case and report the results of the analysis to the Manager?
- 4) Does the Compliance Control Division feed back the results of the analysis mentioned above to the Managers of the relevant divisions and sales branches in order to prevent the recurrence of the case and promptly take prevention measures or have another division do so?

(5) Coordination with Customer Support Manager

- 1) Does the Compliance Control Division appropriately maintain coordination with the Customer Support Manager as required under the Customer Protection Management System and provide advice to help facilitate customer support?
- 2) Does the Compliance Control Division collect information in a prompt and wide-ranging manner with regard to requests for consultations and complaints from customers⁹ that should be recognized as legitimate complaints or that are likely to develop into legitimate complaints?
- 3) With regard to requests for consultations and complaints that involve information concerning violation of Laws, does the Compliance Control Division require and obtain reports from divisions, departments and individuals that hold the relevant information in an appropriate manner, analyze and review the information and provide feedback to the division in charge of processing complaints?
- 4) Does the Compliance Control Division have non-interested parties conduct appropriate and sufficient investigations to identify the cause with regard to requests for consultations and

⁹ See Checklist for Customer Protection Management.

complaints determined as requiring such action?

(6) Roles of Persons in Charge of Compliance

Do persons in charge of compliance keep under unified control Compliance-related Information at the divisions and departments to which they are allocated, communicate the information to the Compliance Control Division in a regular and timely manner or on an as needed basis and appropriately engage in efforts to ensure compliance at the divisions and departments? Do they perform their functions fully based on the legal knowledge accumulated with regard to their operations?

III. Specific Issues

Checkpoints

- This chapter lists the check items to be used when the inspector reviews specific issues particular to the actual status of legal compliance. It should be noted that although this chapter lists points of attention concerning representative Laws, it is also necessary to review whether the financial institution inspected has in place an appropriate system to prevent violation of other Laws applicable to it and whether there is not actually any violation of Laws.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter III., it is necessary to exhaustively review which of the elements listed in Chapters I. and II. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter I. are not functioning appropriately and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Measures against Organized Crime

(1) Verification at the Time of Transaction^{10 11}

1) Development of Internal Rules/Operational Procedures Concerning Customer Identity

Does the Board of Directors or organization equivalent to the Board of Directors have internal rules or operational procedures concerning the verification at the time of transaction (hereinafter referred to as the "Rules for Verification at the Time of Transaction") established? Are the Rules for Verification at the Time of Transaction subject to legal checks, etc. and approval by the Board of Directors or organization equivalent to the Board of Directors? Do the Rules for Verification at the Time of Transaction specify the arrangements on the opening of customer accounts (e.g. criteria for rejecting customer requests for account opening), for example?¹²

¹⁰ "Verification at the Time of Transaction" means the act of verification at the time of executing a transaction as specified under Paragraph 6, Article 4 of the Act on Prevention of Transfer of Criminal Proceeds.

¹¹ Please refer to "Points to be Considered in Relation to the Act on Prevention of Transfer of Criminal Proceeds" (FSA, October 2012).

¹² The Rules for Verification at the Time of Transaction may not be available as a single set of rules in some cases, and they may be integrated with the Compliance Manual, etc. in other cases. The inspector should empirically review,

2)Development of System for Verification at the Time of Transaction

- (i) Does the Board of Directors or organization equivalent to the Board of Directors have a person in charge of verification at the time of transaction appointed or a department in charge thereof established?
- (ii) Does the Board of Directors or organization equivalent to the Board of Directors provide a system to ensure that matters concerning verification at the time of transaction that would seriously affect corporate management are reported to the Compliance Control Division, the Internal Audit Division and the Board of Directors or organization equivalent to the Board of Directors without delay?
- (iii) Does the Board of Directors or organization equivalent to the Board of Directors provide a system to ensure that records of review and transactions are compiled and stored appropriately?

3)Guidance and Training Concerning Verification at the Time of Transaction

Does the person or department in charge of verification at the time of transaction disseminate the Rules for Verification at the Time of Transaction and related operational procedures to all of the relevant employees by providing guidance and training regularly or through other means in order to ensure that verification at the time of transaction is conducted in a timely and appropriate manner?

4)Points of Attention Concerning the Methods of Verification at the Time of Transaction

- (i) For transactions with a corporate customer, does the institution review the the customer identification data of the person in charge of the transaction, in addition to the review of the corporate customer?
- (ii) With regard to a transaction conducted through an agent, does the institution review the customer identification data of the agent, in addition to the review of the customer?
- (iii)When strict customer management such as (a) through (c) below is considered highly necessary, has the financial institution established a framework to verify (and re-verify) at the time of transaction appropriately with a stricter approach such as requiring additional review documents or supplemental documents, etc., in addition to the customer review data normally used for verification? Has the financial institution developed a framework to appropriately handle the situation in a case that requires the review of status of assets and income?
 - (a) A transaction in which it is highly suspected that the counterparty of the

regardless of the form of rules, whether or not the rules exhaustively stipulate necessary matters and are fully disseminated to the personnel who should be acquainted with them, upon approval by the Board of Directors or organization equivalent to the Board of Directors, thus ensuring effective verification at the time of transaction.

transaction is pretending to be a customer or a representative who is subject to the verification at the time of transaction

- (b) A transaction with a customer who is highly likely to have presented false information at the time of such transaction
- (c) A transaction with a customer who is a resident of, or is located in a country or a region where an adequate system does not exist for preventing the transfer of criminal proceeds specified in Paragraph 2, Article 12 of the Order for Enforcement of the Act on Prevention of Transfer of Criminal Proceeds, etc.

- (iv) With regard to a case in which a verification at the time of transaction has been done at an overseas head office, branch office, subsidiary or affiliate, does the institution conduct review again when such customer opens an account in Japan as required by laws and ordinances?

(2) Suspicious Transactions ¹¹

1) Development of Internal Rules and Operational Procedures Concerning Suspicious Transactions

Does the institution have in place internal rules concerning money laundering and other suspicious transactions (hereinafter referred to as the Suspicious Transaction Rules) or operational procedures concerning such transactions? Are the Suspicious Transaction Rules subject to legal checks, etc. and approval by the Board of Directors or organization equivalent to the Board of Directors? Do the rules specify the following items, for example?

- Arrangements on judgment with regard to suspicious transactions (e.g. judgment criteria, specific examples and the focus of the judgment authority)
- Arrangements on measures to be taken with regard to suspicious transactions (e.g. reporting to the authorities and suspension of the use of accounts for transactions and contract cancellation)
- Arrangements on communication of information when suspicious transactions are detected
- Arrangements on the storage and management of records on suspicious transactions

2) System for Handling Suspicious Transactions

- (i) Does the Board of Directors have a person in charge of handling suspicious transactions appointed or a department in charge thereof established? Does the Board of Directors or organization equivalent to the Board of Directors provide a system to ensure that officers and employees disseminate in a timely manner to the person or the department in charge

information concerning cases that may constitute suspicious transactions?

- (ii) Does the person or department in charge of handling suspicious transactions report such transactions without delay to the authorities in accordance with the Suspicious Transaction Rules? Does the person or department in charge, when a transaction is determined as a suspicious transaction, take appropriate measures as necessary in a timely manner with regard to the transaction and the relevant customer account in accordance with the Suspicious Transaction Rules or related operational procedures?
- (iii) Does the Board of Directors or organization equivalent to the Board of Directors provide a system to report a suspicious transaction to the authorities in an appropriate manner based on information concerning the attributes of the party concerned, the situation at the time of the transaction and other details related to the transaction that the institution holds?
- (iv) Does the Board of Directors or organization equivalent to the Board of Directors provide a system to have the person or department in charge of handling suspicious transactions regularly report to the Board of Directors or organization equivalent to the Board of Directors the key points of reports from sales branches, etc. with regard to suspicious transactions?
- (v) Does the Board of Directors or organization equivalent to the Board of Directors provide a system to ensure that matters concerning suspicious transactions that would seriously affect corporate management are reported to the Compliance Control Division and the Internal Audit Division as well as the Board of Directors or organization equivalent to the Board of Directors without delay?
- (vi) Does the Board of Directors or organization equivalent to the Board of Directors provide a system to ensure that all suspicious transactions are reported to the authorities?

3) Guidance and Training Concerning Suspicious Transactions

Does the person or department in charge of handling suspicious transactions seek to ensure that suspicious transactions are reported and other appropriate measures are taken with regard to such transactions in a timely manner by regularly providing guidance and training to the relevant employees?

4) Points of Attention in Examining Suspicious Transactions

- (i) Does the institution build a database of cases of suspicious transactions and disseminate the obtained results throughout the relevant divisions by compiling reference casebook depicting examples of suspicious transactions, for example?
- (ii) Does the institution fully collect and accumulate information concerning the attributes of the parties the transactions with whom should be treated as suspicious transactions and the nature of suspicious transactions?
- (iii) It should be noted that in the case where the number of suspicious transactions reported by the

institution is markedly small relative to the scales and natures of its business, it is necessary to carefully review whether the institution's judgment criteria for suspicious transactions are effective.

(3) Development of System for Execution/Continuation of Correspondent Bank Agreement

In terms of the correspondent bank agreement, does the financial institution have a system in relation to the correspondent bank agreement developed based on Article 10 of the Act on Prevention of Transfer of Criminal Proceeds and Article 25 of the Ordinance for Enforcement of the Act on Prevention of Transfer of Criminal Proceeds¹³ as described in the following?

- 1) Does the financial institution appropriately conduct screening and make decisions on whether to execute/renew the correspondent bank agreement via the decision-making process involving the senior management after appropriately evaluating the counterparty of the agreement through efforts to collect information on the counterparty's customer base and businesses and the status of development of the system to prevent terrorism financing/money laundering; and the status of supervision by the authority in the relevant jurisdiction?
- 2) Is the financial institution making efforts to clarify the allocation of responsibility by documenting in relation to the prevention of terrorism financing/money laundering when transacting with the counterparty of the correspondent bank agreement by means of documenting such responsibility, etc.?
- 3) Does the financial institution require review to ensure that the counterparty of the correspondent bank agreement is not a bank that does not operate any business (a so-called shell bank), and that the counterparty will not permit a shell bank to use a bank account owned by the counterparty?

Additionally, if, as a result of review, it is found that the counterparty is a shell bank, or it has been permitting a shell bank to use the counterparty's bank account, does the financial institution systematically stop executing or discontinue the correspondent bank agreement?

(4) Development of a System Concerning Measures against Terrorism Financing/Money Laundering at Overseas Offices

Does the financial institution maintain a system to ensure that measures to prevent terrorism financing and money laundering are implemented appropriately at its overseas offices?

- 1) Does the financial institution endeavor to appropriately implement measures against terrorism financing/money laundering with an equivalent level of quality as those

¹³ "Foreign exchange transactions under a consignment agreement or trust agreement with a forex transaction service provider located in the foreign country" in Article 25 of the Ordinance for Enforcement of the Act on Prevention of Transfer of Criminal Proceeds refers to the forex transactions for international settlement through the consignment/trust agreement (Correspondent Bank Agreement) with the forex transaction service provider (Correspondent Bank Agreement Counterparty) as to forex business including electric money transfer, collection of bills, and arrangement for letter of credit; and banking business such as fund management.

implemented in Japan within the scope of the laws and regulations in the relevant jurisdiction?¹⁴

- 2) When the level of requirement for measures against terrorism financing/money laundering overseas is higher than that in Japan, does the financial institution work to comply with the higher standard overseas?
- 3) When implementing measures against terrorism financing/money laundering equivalent to those in Japan is not possible, due to legal/regulatory restrictions applied overseas, does the financial institution endeavor to report the information such as that listed below to the FSA or the local finance bureau supervising the area where the financial institution's head office is located?
 - (i) Relevant country/region
 - (ii) Specific reasons why measures against terrorism financing/money laundering cannot be implemented
 - (iii) Details of alternative measures against terrorism financing/money laundry if any.

2. Handling of Anti-Social Forces

(1) Development and Dissemination of Policy on Handling of Anti-Social Forces, Compliance Manual, etc.

- 1) Do directors fully understand that prohibiting association with anti-social forces and excluding such forces firmly is vital for maintaining public confidence in the financial institution and securing the appropriateness and soundness of the institution's business? Taking into account the necessity and the importance of prohibiting association with anti-social forces as the entire organization, does the Board of Directors or organization equivalent to the Board of Directors take measures themselves, instead of leaving it completely to the person or department in charge of it?
- 2) Has the Board of Directors made clear the policy of prohibiting association with anti-social forces and excluding such forces firmly? Has the Board of Directors disseminated the policy to all of the institution's officers and employees?
- 3) Does the Compliance Manual explain how to handle anti-social forces in an easy-to-understand way and clearly indicate the contact information concerning the section and person in charge of such handling? Is a similar arrangement in place at subsidiaries etc. as necessary?

(2) Development of System for Handling of Anti-Social Forces

Does the Board of Directors have such a system as mentioned below in place to handle anti-

¹⁴ Particularly, it is noted that the development of a system equivalent to that of Japan is required for overseas bases located in countries/regions where FATF Recommendations are not applied or the application of recommendations is not considered satisfactory.

social forces systematically, taking into account the individual situation of transactions?¹⁵¹⁶

- 1) Does the institution have a department that utilizes information obtained through industry associations or information sharing within the group, etc., in charge of collecting, analyzing, and updating (adding, eliminating, and changing information) internal and external information concerning anti-social forces and managing such information in an integrated manner?
- 2) Is there a system to prevent transactions with anti-social forces by conducting prior screening utilizing the information, etc. about anti-social forces and by enforcing the implementation of a clause to exclude organized crime groups (i.e. Boryokudan) in contracts and terms of transactions?¹⁷
- 3) Is there an arrangement of a system for collaboration as well as quick and appropriate communications including a report on Board of Directors, etc. across the relevant divisions?
- 4) Is there a system for conducting post screening of existing credit and contracts?
- 5) Is there a system to support the department in charge and ensure the security of the person in charge of actually handling anti-social forces, as well as ensuring the termination of the contract without providing funds or having inappropriate/extraordinary transactions and taking care not to give profits, when it is clear that it is anti-social forces?

(3) Roles of Department in Charge of Handling of Anti-Social Forces

- 1) When contacted by an officer or employee with regard to how to handle anti-social forces, does the department in charge provide guidance to ensure appropriate handling while maintaining coordination with the police, administration, lawyers and bar association as necessary, as well as consider the utilization of Deposit Insurance Corporation of Japan's purchasing system for specified difficult recovery claims and utilize the resolution and collection corporation's service function for the companies within the group that is not covered by the former Deposit Insurance Corporation's system?
- 2) Has the department in charge disseminated the portions of the internal rules and the Compliance Manual concerning transactions with anti-social forces to all of the officers and employees through training, guidance, etc.?

¹⁵ Refer as necessary to "Manual for Implementing Charter of Corporate Code" by *Ippan Shadan Hojin Nippon Keizai Dantai Rengokai* (Nippon Keidanren or Japan Business Federation), etc.

¹⁶ The system mentioned here includes a system to exclude anti-social forces not only as an individual financial institution, but also as the entire group and a system to exclude anti-social forces when having transactions like providing financial services with cooperation of other companies outside the group (credit companies, etc.).

¹⁷ For affiliated loans (where a credit company that received application from the customer through the affiliated store reviews/approves and a financial institution lends to the customer, quadrilateral type), this includes a system that reviews the development of a database about anti-social forces and the implementation of clauses to exclude anti-social forces at the cooperating credit company. This also includes conduction of prior screening by the financial institution itself, as well as the implementation of a clause to exclude organized crime groups (i.e. Boryokudan).

3. Handling of Violation of Laws

(1) Clarification of Responsibility Concerning Violation of Laws

- 1) Does the institution provide a system to have an entity independent from the department where a violation of Laws occurred investigate the case, seek to hold the person or persons involved to account and clarify the supervisory responsibility?
- 2) Does the institution appropriately clarify the responsibility of the person or persons who conducted a violation of Laws and the Manager in charge of supervision thereof and holds them to account?

(2) Reward and Punishment and Personnel Evaluation

In rewarding and punishing employees and evaluating their work performance, does the institution fully take their status of legal compliance into consideration? For example, does the institution exclude employees whose legal compliance is questionable from its in-company awards system as a way to attach importance to legal compliance?

4. Legal Checks System

(1) Development of Legal Checks System Concerning Transactions and Businesses

Does the institution provide a system to ensure appropriate legal checks, etc. from the viewpoint of legal compliance in accordance with the Legal Compliance Rules? With regard to the legality of matters determined as subject to legal checks, etc. does the institution conduct careful prior review from the legal and compliance perspective? For example, does the institution provide a system to conduct especially careful review with regard to the legality of the following matters? Are the range of documents, transactions and businesses subject to legal checks, etc. and the focus of responsibility for the checks specified and disseminated throughout the institution?

- Legality of a new business
- Arrangements on the opening of customer accounts and other transactions at overseas head and branch offices, overseas subsidiaries, etc.
- Transactions in which abuse of a dominant position may arise
- Compliance on the occasion of a capital increase
- Legality of transactions with a complex scheme (e.g. liquidation of assets including off-balance sheet assets, non-performing loan disposals, transactions conducted for the purpose of realizing unrecognized profits, transactions that involve issuance of a special type of classified shares and corporate bonds)
- Cases that require review of possible conflicts of interest
- Non-standardized transactions in the so-called private banking business, etc.

- Legality of intra-group transactions subject to the “arms’ length rules”
- Disclosure as required by laws and ordinances
- Other documents, transactions, businesses, etc. that are reasonably and objectively determined as involving high legal risk

(2) Points of Attention Concerning Legal Checks, etc.

- 1) When conducting legal checks, etc., does the institution ensure that background information and the underlying facts necessary for judgment on legality are provided with regard to documents such as the internal rules, contracts, and advertisements written by the relevant division as well as transactions and businesses in which the division is involved?
- 2) In the case where the legal checks, etc. is conducted by an outside lawyer, does the institution fully review the details of the legal opinions provided before implementing transactions, etc.?

Checklist for Customer Protection Management

I. Development and Establishment of Customer Management System by the Management

Checkpoints

- “Customer Protection” as referred to in this checklist covers (1) to (6) below, and “Customer Protection Management” refers to management necessary for achieving (1) to (6) from the viewpoint of protecting customers of financial institutions and enhancing customer convenience.

(1) Securing the provision of appropriate and sufficient explanations to customers with regard to credit transactions (loan contracts and related collateral and guarantee contracts), deposit-taking as well as sales, brokerage and offer of products (hereinafter referred to as the “Transaction”) (including ensuring appropriate and sufficient customer explanations, from the viewpoint of business consultation and guidance and other finance facilitation)

(2) Securing appropriate processing of inquiries, consultation, requests in general, complaints from customers and disputes (hereinafter referred to as the “Consultation, Complaints, etc.”) (including ensuring appropriate handling of Consultation Requests, Complaints, etc. from customers, from the viewpoint of business consultation and guidance and other finance facilitation)

(3) Securing appropriate management of customer information in order to prevent information leakage

(4) In the case where financial institution’s business outsourced, securing the accuracy of the implementation of the outsourced operations and securing appropriate management of customer information and appropriate handling of customers

(5) Securing appropriate management of conflicts of interest so that customer interests are not unfairly harmed due to Transactions by the financial institution or a group company¹

(6) Securing appropriate management of other operations determined by a financial institution as necessary for protecting customers and enhancing customer convenience

- The development and establishment of a Customer Protection Management System at a financial institution is not only important from the viewpoint of protecting users of the institution including depositors (hereinafter referred to as the “Customer”) and enhancing their convenience but it is also extremely important from the viewpoint of ensuring the soundness and appropriateness of the institution’s business. Therefore, the institution’s management is charged with and responsible for taking the initiative in developing and establishing such a system.

- With regard to the Customer Protection Management, it is important for a financial institution’s management as well as the other officers and employees to review their own business operations from the Customer’s standpoint

¹ As stipulated in the Banking Act, Article 13-3-2, that Bank, a Bank Agent for which that Bank serves as a Principal Bank, a parent financial institution or subsidiary institution, etc. of that bank, as well as a company for which that financial institution deems it necessary to manage conflicts of interest in order to protect customers.

and to constantly review and improve the business operations. It is also important that they fully understand that public confidence in financial institutions is based on such constant review efforts.

- The descriptions in this checklist are based on the assumption that the roles of and responsibilities for developing a system for each business concerning Customer Protection and ensuring the effectiveness thereof rests with the Manager in charge of the relevant business. There are other various organizational frameworks for Customer Protection Management. For example, a financial institution may establish a dedicated division or department in charge of Customer Protection Management, or assign persons in charge of such management to divisions and departments which require Customer Protection, including the Marketing and Sales Division. In such cases, it is necessary to review whether the system of Customer Protection is effectively functioning based on the empirical review and analysis as to whether an adequate number of persons with the knowledge and experience necessary for implementing the relevant operation are allocated and whether they are assigned the authority necessary for implementing the operation.
- In examinations, in addition to this checklist, the inspector also considers Customer Protection Management related items written in the Checklist for Finance Facilitation Section.
- The inspector should determine whether the Customer Protection Management System is functioning effectively and whether the roles and responsibilities of the institution's management are being appropriately performed by way of reviewing, with the use of check items listed in Chapter I., whether or not the management is appropriately implementing (1) policy development, (2) development of internal rules and organizational frameworks and (3) development of a system for assessment and improvement activities.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II. and later, it is necessary to exhaustively examine which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize weaknesses or problems recognized by the inspector, it is also necessary to explore in particular the possibility that the Internal Control System is not functioning effectively and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Policy Development

(1) Roles and Responsibilities of Directors

Do directors attach importance to Customer Protection, based on full recognition of the importance of Customer Protection and enhancement of customer convenience? Do the directors also fully recognize the importance of Customer Protection from the viewpoint of business consultation and guidance and other finance facilitation?

In particular, does the director in charge of Customer Protection Management accurately grasp the current status of the financial institution's Customer Protection based on full understanding of the importance of Customer Protection Management and is the director considering a policy and specific measures for developing and establishing an appropriate system for Customer Protection Management?

(2) Development and Dissemination of Customer Protection Management Policy

Has the Board of Directors developed a management policy regarding Customer Protection and enhancement of customer convenience (Hereinafter referred to as the "Customer Protection Management Policy." When there are two or more policies, they are also collectively referred to as the "Customer Protection Policy.") in accordance with the institution's corporate management policy and disseminated it throughout the institution?

Is the Customer Protection Management Policy sufficient and appropriate for Customer Protection, with the inclusion of clear statements with regard to the following matters in particular? Does the Board of Directors also ensure consistency with Finance Facilitation Management Policy?

1) Management Policy concerning Following Matters Necessary for Customer Protection

- Securing appropriate and sufficient explanations and information provision for the Customer with regard to Transactions and products (hereinafter referred to as the "Customer Explanation")
- Securing appropriate and sufficient handling of Consultation Requests, Complaints, etc. (hereinafter referred to as the "Customer Support")
- Securing appropriate management of information concerning the Customer (hereinafter referred to as the "Customer Information Management")
- Securing appropriate management of customer information and appropriate handling of the Customer in the case where the institution's business are outsourced (hereinafter referred to as the "Outsourcing Management")
- Securing appropriate management of conflicts of interest so that customer interests are not unfairly harmed due to Transactions by the financial institution or a group company (hereinafter referred to as the "Conflict of Interest Management")

- Securing appropriateness of other business operations determined by the Board of Directors as necessary for Customer Protection and enhancement of customer convenience.
- 2) Scope of the Customers (e.g. the Customers “include people who are users of the financial institution’s business and people who are ready to become users.”)
- 3) The Scope of Business Operations Requiring Customer Protection

(3) Revision of the Policy Development Process

Does the Board of Directors revise the policy development process in a timely manner by reviewing its effectiveness based on reports and findings on the status of Customer Protection Management in a regular and timely manner or on an as needed basis?

2. Development of Internal Rules and Organizational Frameworks

(1) Development and Dissemination of Internal Rules

Has the Board of Directors or organization equivalent to the Board of Directors had the Managers in charge of operations concerning Customer Protection Management develop internal rules that clearly specify the arrangements on the management of Customer Explanation and Customer Support, as well as Customer Information Management, Outsourcing Management and Conflict of Interest Management (hereinafter referred to as the “Customer Protection Management Rules”) in accordance with the Customer Protection Management Policy?² Has the Board of Directors or organization equivalent to the Board of Directors approved the Customer Protection Management Rules and disseminated them throughout the institution after determining if they comply with the Customer Protection Management Policy after legal checks, etc.?

(2) Assignment of Managers and Assigning of Authority

Does the Board of Directors or organization equivalent to the Board of Directors provide a system to have the Managers specified below appointed, stipulated the responsibilities and authority of the Managers and allocated appropriate roles to them in accordance with the Customer Protection Management Policy and the Customer Protection Management Rules? Do the Managers have sufficient knowledge and experience for the business they are in charge?³

² The Customer Protection Management Rules may not be available as a single set of rules in some cases, and they may be integrated with the compliance manual, etc. in other cases. The inspector should empirically review, regardless of the form of rules, whether or not the rules exhaustively stipulate necessary matters and are fully disseminated to personnel who should be acquainted with them, upon approval by the Board of Directors, thus ensuring an effective system of Customer Protection.

³ When the Manager in charge of one of the operations concerning Customer Protection concurrently serves as the Manager in charge of another such business or in a post (including the Manager post) at a division not related to Customer Protection, the inspector should pay attention to whether such a system is reasonable in light of the scales and natures of the business operations concerned and whether an equivalent level of Customer Protection functions is secured compared with the case where a dedicated Manager is appointed. With regard to Customer Explanation, for example, two or more Customer Explanation Managers may be appointed. In such a case, the inspector should review

- The Manager in charge of supervising overall management of explanations to the Customer in order to develop and establish a system for securing appropriate explanations to the Customer (hereinafter referred to as the “Customer Explanation Manager”)
- The Manager in charge of overseeing the status of progress in the processing of Consultation Requests, Complaints, etc. and the issuance of relevant instructions in an integrated manner by putting together information concerning Customer Support under unified control (hereinafter referred to as the “Customer Support Manager”)
- The Manager in charge of overall supervision of Customer Information for the development and establishment of an appropriate system for Customer Information Management (hereinafter referred to as the “Customer Information Supervisory Manager”).
- The Manager in charge of supervising the management of customer information and the handling of the Customer in the case where the institution’s operations are outsourced. (hereinafter referred to as the “Outsourcing Manager”)
- The Manager in charge of overall supervision of Conflict of Interest Management, for the development and establishment of an appropriate system for Conflict of Interest Management (hereinafter referred to as the “Conflict of Interest Manager”)

(3) Securing of Check-and-Balance System

Does the Board of Directors or organization equivalent to the Board of Directors provide a system to ensure an effective check and balance against the Managers specified above? In particular, in the case where a Manager responsible for one operation also takes charge of another operation, it is necessary to conduct a review by paying attention to whether or not there is a system to prevent interference from the Marketing and Sales Division, etc.

(4) Development of Customer Protection Management System at Marketing and Sales Division, Etc.

- 1) Does the Board of Directors or organization equivalent to the Board of Directors provide a system to disseminate internal rules and operational procedures to the divisions, departments and employees whose operations require Customer Protection Management, including the Marketing and Sales Division, etc., and have them observe the rules and procedures? For example, does the Board of Directors or organization equivalent to the Board of Directors instruct the Managers to take concrete measures such as specifying the internal rules and operational procedures that must be observed by the Marketing and Sales Division, etc. and

whether the areas of responsibility are clearly defined with methods such as having the Managers jointly bear the responsibility for the overall Customer Management business operation or having one of the Managers bear this responsibility.

conducting effective training on a regular basis?

- 2) Does the Board of Directors or organization equivalent to the Board of Directors provide a system to ensure, through the Managers, appropriately and sufficiently effective Customer Protection Management at the Marketing and Sales Division, etc.? With regard to Customer Explanation, for example, are there in place such useful measures as assigning a person in charge of the explanation to the Marketing and Sales Division, etc. for coordination with the Customer Explanation Manager?⁴
- 3) Does the Board of Directors or organization equivalent to the Board of Directors assign a person in charge of managing customer information at each division and department and specify the responsibilities and authority thereof? Does the person have sufficient knowledge and experience for the relevant business?

(5) Ensuring Customer Information Protection at Outsourcing Contractors

- 1) Has the Board of Directors or organization equivalent to the Board of Directors clearly specified the rules concerning the handling of customer information by outsourcing contractors operating under outsourcing contracts (hereinafter referred to as the “Outsourcing Contractors”) in a manner suited to the nature and quantity of the customer information handled?
- 2) Has the Board of Directors or organization equivalent to the Board of Directors specified the department that is responsible for supervising the Outsourcing Contractor and assigned a person in charge of managing customer information to the department?
- 3) Does the Board of Directors or organization equivalent to the Board of Directors provide a system to ensure verification of Customer Information Management at the Outsourcing Contractor on a regular basis?
- 4) Does the Board of Directors or organization equivalent to the Board of Directors provide a system to ensure that measures for protecting customer information are appropriately disseminated to the Outsourcing Contractor and that accidents, etc. at the contractor are reported to the department in charge promptly and accurately?

(6) Arrangement for System of Reporting to Board of Directors and Approval

Has the Board of Directors or organization equivalent to the Board of Directors appropriately specified matters to be reported and approved and does it have the relevant Manager report the current status to the Board of Directors or organization equivalent to the Board of Directors or

⁴ When a department or a post other than the Board of Directors or organization equivalent to the Board of Directors is empowered to allocate staff and assign them authority, the inspector shall review, in light of the nature of such a department or a post, whether or not this arrangement is reasonable in terms of a check-and-balance system and other aspects.

have the Manager seek the approval of the Board of Directors or organization equivalent to the Board of Directors on the relevant matters in a regular and timely manner or on an as needed basis? In particular, does it ensure that the Manager reports to the Board of Directors or organization equivalent to the Board of Directors any matters that would seriously affect corporate management or significantly undermine customer interests without delay?

(7) Arrangement for System of Reporting to Corporate Auditor

In the case where the Board of Directors has specified matters to be directly reported to a corporate auditor, has it specified such matters appropriately and do they provide a system to ensure that the Managers in charge of operations concerning Customer Protection Management reports directly to the auditor? ⁵

(8) Development of Internal Audit Guidelines and an Internal Audit Plan

Does the Board of Directors or organization equivalent to the Board of Directors have the Internal Audit Division appropriately identify the matters to be audited with regard to Customer Protection, develop guidelines that specify the matters subject to internal audit procedures (hereinafter referred to as the “Internal Audit Guidelines”) and internal audit plan, and approve them?⁶

(9) Revision of Development Process of Internal Rules and Organizational Frameworks

Does the Board of Directors or organization equivalent to the Board of Directors revise the development process of internal rules and organizational frameworks in a timely manner by reviewing their effectiveness based on reports and findings on the status of Customer Protection Management in a regular and timely manner or on an as needed basis?

3. Assessment and Improvement Activities

(1) Analysis and Assessment

1) Analysis and Assessment of Customer Protection Management

Does the Board of Directors or organization equivalent to the Board of Directors appropriately determine whether there are any weaknesses or problems in the Customer Protection Management system and the particulars thereof, and appropriately examine their causes by precisely analyzing the status of Customer Protection Management and assessing the

⁵ It should be noted that this shall not preclude a corporate auditor from voluntarily seeking a report and shall not restrict the authority and activities of the auditor in any way.

⁶ The Board of Directors or organization equivalent to the Board of Directors only needs to have approved the basic matters with regard to an internal audit plan.

effectiveness of Customer Protection Management, based on all of the information available regarding the status of Customer Protection Management, such as the results of audits by corporate auditors, internal audits and external audits, findings of various investigations and reports from various divisions? In addition, if necessary, does it take all possible measures to find the causes by, for example, establishing fact findings committees, etc. consisting of non-interested persons?

2) Revision of the Analysis and Assessment Processes

Does the Board of Directors or organization equivalent to the Board of Directors revise the analysis and assessment processes in a timely manner by reviewing their effectiveness based on reports and findings on the status of Customer Protection Management in a regular and timely manner or on an as needed basis?

(2) Improvement Activities

1) Implementation of Improvements

Does the Board of Directors or organization equivalent to the Board of Directors provide a system to implement improvements in the areas of the problems and weaknesses in the Customer Protection Management system identified through the analysis, assessment and examination referred to in 3. 1) above in a timely and appropriate manner based on the results obtained by developing and implementing an improvement plan as required or by other appropriate methods?

2) Progress Status of Improvement Activities

Does the Board of Directors or organization equivalent to the Board of Directors provide a system to follow up on the efforts for improvement in a timely and appropriate manner by reviewing the progress status in a regular and timely manner or on an as needed basis?

3) Revision of the Improvement Process

Does the Board of Directors or organization equivalent to the Board of Directors revise the improvement process in a timely manner by reviewing its effectiveness based on reports and findings on the status of Customer Protection Management in a regular and timely manner or on an as needed basis?

II. Development and Establishment of Customer Protection Management System by Managers

Checkpoints

- This chapter lists the check items to be used when the inspector examines the roles and responsibilities that must be performed by the Managers in charge of business operations concerning Customer Protection Management.
- The descriptions in this checklist are based on the assumption that the roles of and responsibilities for developing a system for each business operation concerning Customer Protection and ensuring the effectiveness thereof rests with the Manager in charge of the relevant business. Given that the role that must be performed by each Manager is extensive, a dedicated division or department in charge of Customer Protection Management may be established or persons in charge of Customer Protection Management may be assigned to divisions and departments that require Customer Protection Management, including the Marketing and Sales Division, and coordinate with Manager, in the case where the Board of Directors determines that the Manager alone would not be sufficient to secure effective Customer Protection. In such a case, it is necessary to confirm whether the Customer Protection system is functioning effectively based on the empirical review and analysis as to whether an adequate number of persons with the knowledge and experience necessary for implementing the business are allocated and whether they are assigned the authority necessary for implementing the business.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II., it is necessary to exhaustively examine which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter I. are not functioning appropriately and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Customer Explanation Management System

(1) Development of Internal Rules

1) Development and Dissemination of Customer Explanation Management Rules and Customer Explanation Manual

- (i) Does the Customer Explanation Manager fully understand the areas and types of business which require appropriate and sufficient Customer Explanation and the management method thereof?
- (ii) Has the Customer Explanation Manager, in accordance with the Customer Protection Management Policy, specified the business which require appropriate and sufficient Customer Explanation, decided the method of monitoring with regard to Customer Explanation and developed internal rules that clearly define the arrangements for managing those business (hereinafter referred to as the “Customer Explanation Management Rules”)?
- (iii) With regard to the procedures that must be followed by persons who provide explanations to customers, has the Customer Explanation Manager, in accordance with the Customer Protection Management Policy and the Customer Explanation Management Rules, developed operational procedures (hereinafter referred to as the “Customer Explanation Manual”) that clearly define the scope of Customers to whom explanations must be provided as well as Transactions and products which must be explained, the management method thereof, the matters and procedures that must be reviewed and the judgment criteria, or has the Manager had another division developed such operational procedures, and then reviewed the appropriateness thereof?⁷
- (iv) Have the Customer Explanation Management Rules been approved by the Board of Directors and disseminated throughout the institution after they have been verified through legal checks, etc. as sufficiently taking account of the Laws (including but not limited to laws and regulations, etc.; hereinafter referred to as the “Laws”) that concern Customer Explanation and exhaustively covering the applicable Laws?
- (v) In the Customer Explanation Management Rules and Customer Explanation Manual, is consistency with the Finance Facilitation Rules and Finance Facilitation Manual ensured?

2) Customer Explanation Management Rules

Do the Customer Explanation Management Rules exhaustively cover the necessary arrangements for managing the business which require appropriate and sufficient Customer

⁷ It should be noted that the Customer Explanation Management Rules and the Customer Explanation Manual should not necessarily be compiled separately. At some financial institutions, such rules and manuals are integrated into the compliance manual. At other institutions, several rules and manuals are available according to the types of products and business. The inspector should review, regardless of the form of rules, whether or not the rules exhaustively stipulate necessary matters and are disseminated throughout persons in charge of Customer Explanation upon approval from the Board of Directors, thus ensuring effective Customer Explanation.

Explanation in a manner befitting the nature of the business and appropriately specify those arrangements, for example by clearly defining the organizational framework for the management as well as the allocation of the relevant authority and roles and the management method. Do the rules clearly specify the following items in particular?

- Arrangements on the organizational framework for Customer Explanation (including the authority and roles of a division or a person in charge of managing Customer Explanation in the case where there is such a division or person).
- Arrangements on the matters that must be observed by persons who provide Customer Explanation (e.g. the arrangements on the necessary capabilities such as the knowledge level required for persons in charge of Customer Explanation, the confirmation of the Customer's attributes, the explanation of important matters to be provided after the confirmation of the Customer's attributes and before the conclusion of the contract, the follow-up after the conclusion of the contract, etc.)
- Arrangements on the representation of risks inherent in the Transactions and products handled by the financial institution
- Arrangements on the representation of important matters other than the risks mentioned above that must be explained in a manner suited to the attributes of the Customer
- Arrangements on the screening and approval of new products
- Arrangements on the sharing and use of information necessary for Customer Protection
- Arrangements on the reporting to the Board of Directors or organization equivalent to the Board of Directors
- Arrangements on coordination and communication with the Compliance Control Division
- Arrangements on the reporting from persons in charge of sales or management of Customer Explanation to the Customer Explanation Manager

3) Customer Explanation Manuals

Does the Customer Explanation Manual exhaustively cover the procedures for Customer Explanation, including the detailed procedures concerning the explanation of important matters suited to the knowledge and experience as well as the status of assets of the Customer, in accordance with the contents and method of the financial institution's business? Are those procedures stipulated in detail in an easy-to-understand manner? For example, does the Customer Explanation Manual enable persons in charge of Customer Explanation to provide explanations to and deal with the Customer in an appropriate and sufficient manner by stipulating the following matters according to the characteristics of the relevant Transaction and product?⁸

⁸ When the Customer Explanation Manual fails to stipulate necessary matters sufficiently, the inspector should review whether appropriate and sufficient explanations to the Customer are ensured by verifying the contents of the manual and training, etc. from a comprehensive perspective.

(i) Specification of Risks

- The types of Transactions and products that are handled by the financial institution and that require explanations to the Customer.
- The types and quantities of risks involved in Transactions and products (e.g. principal loss risk, interest rate risk and maximum loss amount)

(ii) Confirmation of Customer Attributes

- Procedures for the confirmation of customer attributes (which refer to the knowledge and experience as well as the status of assets, etc. of the Customer. More specifically, the attributes include the Customer's age, presence or lack of investment experience, length of the investment experience, the level of understanding concerning risks, the composition of the current financial assets and the amount of each type of asset, risk tolerance, the degree of the guarantor's involvement in the customer's business management if there is a joint and several personal guarantee agreement,⁹ and information concerning other necessary attributes)
- Procedures for the confirmation of the compatibility between the risks involved in the Transactions and products and the Customer's attributes (including compilation of records on how the relevant judgment was made).

(iii) Procedures to be taken between Confirmation of Customer Attributes and Contract Conclusion

- Code of conduct concerning the solicitation of customers (e.g. code of conduct concerning abuse of a superior position, misleading explanation and prevention of Transactions with tie-in provisions)
- Explanation of important matters that must be explained to the Customer to seek the understanding thereof (e.g. explanation of details of Transactions and products, principal loss and other risks, procedures and fees necessary for the contract termination, the likelihood of guarantee to be executed in the case where a joint and several personal guarantee agreement is attached to the debt,¹⁰ and in the case of a guarantee by business owners,¹¹ the necessity of a guarantee agreement,¹² etc.)

⁹ In executing a joint and several personal guarantee agreement with a third-party other than the business owner, the FSA will verify, as necessary, if the financial institution keeps in mind the statement released as of March 31, 2006, by the Small and Medium Enterprise Agency, titled "Prohibition of Requesting Third-party Guarantee as a General Rule under the Guarantee System of the Credit Guarantee Association" (available on the agency's website) in view of establishing a lending practice without requiring third-party guarantee other than the business owner as a General Rule.

¹⁰ If the guarantor, despite the fact that there is no substantial involvement in the borrower's business management, voluntarily offered to provide joint and several guarantee, the FSA will verify whether the financial institution developed a framework to verify that the guarantee is not based on a request of the financial institution by, for example, obtaining a statement signed by the guarantor that the guarantee is provided voluntarily based on an explicit explanation by the financial institution, etc.

¹¹ For a personal guarantee provided by the business owner, the FSA will check whether the financial institution takes into account the Personal Guarantee Guidelines Provided by Business Owners.

- Compilation and storage of records on the negotiations, etc. concerning Transactions
 - Cases that require the provision of a document to the Customer and procedures for the document provision.
 - Contents of the document to be provided to the Customer
 - Procedures for confirming the Customer's understanding and contents of the confirmation document to be obtained from the Customer.
 - Destination of submission of records on Customer Explanation and procedures for checking the contents of the records
 - Procedures for rejecting an application from the Customer
- (iv) Procedures after Contract Conclusion
- Procedures for follow-up confirmation of the conclusion and implementation of the contract
 - Procedures for follow-up reviews of the appropriateness and sufficiency of the Customer Explanation.
 - Policy concerning coordination with persons at other divisions with regard to Consultation Requests, Complaints, etc.
 - Procedures for communicating information to the Compliance Control Division
 - Procedures for providing information concerning Customer Support

(2) Implementation of Customer Explanation Management

1) Development of Customer Explanation Management System

Does the Customer Explanation Manager ensure appropriate and sufficient Customer Explanation by having persons who provide Customer Explanation observe the Customer Explanation Management Rules, the Customer Explanation Manual and other rules and arrangements concerning Customer Explanation and implement specific measures for securing the effectiveness of the explanation?

Does the Customer Explanation Manager issue instructions to divisions engaged in relevant business and sales branches with regard to specific measures for securing appropriate and sufficient Customer Explanation and manage them in ways to ensure that Customer Explanation is made appropriately and sufficiently at each division?

¹² The FSA will review whether for a primary borrower and a guarantor the financial institution considers the necessity of the guarantee agreement, as well as setting the scope of the execution considering the guarantor's status of assets, etc., at the execution of such guarantee obligation as a general rule when requesting the execution of guarantee obligation, instead of uniformly requesting the payment of the entire amount guaranteed. Additionally, the FSA will review whether the financial institution has a procedure to explain the possibility of reviewing for modification or termination of the guarantee agreement if the personal guarantee by the business owner is deemed no longer necessary.

2) Guidance and Supervision

Does the Customer Explanation Manager appropriately manage persons in charge of Customer Explanation as well as divisions engaged in relevant business and sales branches by providing guidance and supervision to them so as to secure appropriate and sufficient Customer Explanation?

3) Dissemination of Customer Explanation Manual via Training

Does the Customer Explanation Manager endeavor to fully disseminate the Customer Explanation Manual to employees by conducting training on a regular basis? When the Customer Explanation Manual is revised, does the Customer Explanation Manager take measures accordingly, such as disseminating the revision in a timely manner?

4) Management Concerning Advertising

Does the Customer Explanation Manager, in accordance with internal rules concerning the representations used in materials for advertisement and solicitation (hereinafter referred to as the “Advertisements, etc.”), etc., subject the Advertisements etc. of Transactions and products to legal checks, etc. in advance and verify that there is no violation of the Banking Law¹³, the Financial Instruments and Exchange Law, the Act Against Unjustifiable Premiums and Misleading Representations and the notification thereof, the Act concerning Prohibition of Private Monopolization and Maintenance of Fair Trade and other relevant Laws as well as rules established by voluntary regulatory organizations and that the Advertisements etc. provide appropriate and sufficient explanations to customers, or does the Customer Explanation Manager have a person in charge of screening of Advertisements, etc. conduct such checks?

5) Implementation of Monitoring of Customer Explanation

(i) Monitoring of Customer Explanation

Does the Customer Explanation Manager review, on an ongoing basis, whether appropriate and sufficient Customer Explanation is secured by monitoring the status of compliance with the Customer Explanation Manual at the Marketing and Sales Division, etc. and take deterrent action as necessary?

(ii) Monitoring of Compilation and Storage of Records on Customer Explanation

Does the Customer Explanation Manager enable follow-up reviews of Customer Explanation as necessary by conducting monitoring to check whether persons in charge of Customer Explanation appropriately compile and keep records on the status of explanation in a timely manner in accordance with the Customer Explanation Manual?

¹³ Including cases where the Banking Law shall be applied mutatis mutandis

(iii) Monitoring of Status of Compliance with Laws in Customer Explanation

Does the Customer Explanation Manager conduct monitoring on an ongoing basis with regard to Customer Explanation so as to prevent violations of Laws?

6) Cooperation with Finance Facilitation Manager

Does the Customer Explanation Manager appropriately cooperate with the Finance Facilitation Manager, and considering the intention of finance facilitation, does the Manager appropriately collect information in a timely manner on inappropriate or possibly inappropriate cases in its handling of consultations and requests for new finance and loan condition changes, and report this to the Finance Facilitation Manager?

7) System for Reporting to Board of Directors

Does the Customer Explanation Manager report necessary matters to the Board of Directors or organization equivalent to the Board of Directors in a regular and timely manner or on an as needed basis? In particular, does the Manager report to the Board of Directors or organization equivalent to the Board of Directors without delay any matter that would seriously affect corporate management or significantly undermine customer interests?

8) System for Reporting to Corporate Auditor

Does the Customer Explanation Manager report matters specified by the Board of Directors directly to a corporate auditor?

(3) Assessment and Improvement Activities

Does the Customer Explanation Manager review the effectiveness of the Customer Explanation system in a regular and timely manner or on an as needed basis based on reports and findings on the status of management of Customer Explanation, including the status of compliance with the Customer Explanation Management Rules and the Customer Explanation Manual, as well as based on the results of monitoring? Does the Manager present the Board of Directors or organization equivalent to the Board of Directors with proposals for improvement as necessary by revising in a timely manner the contents of the Customer Explanation Management Rules and the Customer Explanation Manual, the organizational framework, the implementation of training and guidance and the method of monitoring?

2. Customer Support Management System

(1) Development of Internal Rules

1) Development and Dissemination of Customer Support Management Rules and Customer Support Manual¹⁴

- (i) Does the Customer Support Manager fully understand the need and importance of securing appropriate and sufficient Customer Support?
- (ii) Has the Customer Support Manager decided on the arrangements for securing appropriate and sufficient Customer Support and developed internal rules that clearly define the arrangements for managing the related business (hereinafter referred to as the “Customer Support Management Rules”) in accordance with the Customer Protection Management Policy?
- (iii) Has the Customer Support Manager developed operational procedures that specify the method of Customer Support and the procedures to be observed (hereinafter referred to as the “Customer Support Manual”) in accordance with the Customer Protection Management Policy and the Customer Support Management Rules?
- (iv) Have the Customer Support Management Rules been disseminated throughout the organization upon approval by the Board of Directors or organization equivalent to the Board of Directors after legal checks, etc.?
- (v) In the Customer Support Management Rules and Customer Support Manual, is consistency with the Finance Facilitation Rules and Finance Facilitation Manual obtained?

2) Customer Support Management Rules

Do the Customer Support Management Rules exhaustively cover the necessary arrangements for securing appropriate and sufficient Customer Support in a manner suited to the scales and natures of the business? Do the Customer Support Management Rules appropriately stipulate such arrangements, for example, by clearly defining the organizational framework for conducting customer support management as well as the allocation of authority and roles? More specifically, do they clearly prescribe the following points?

- Arrangements on the organizational framework for Customer Support (including whether or not to establish a division or a person in charge of Customer Support as well as the authority and roles of such a division or a person)
- Arrangements on the procedures to be observed by persons engaged in Customer Support
- Arrangements to provide services to handicapped persons,¹⁵ etc., of an equivalent quality

¹⁴ It should be noted that the Customer Support Management Rules and the Customer Support Manual should not necessarily be compiled separately. At some financial institutions, such rules and manuals are integrated into the compliance manual. The inspector shall verify, regardless of the form of rules, whether or not the rules exhaustively stipulate necessary matters and are disseminated throughout all persons who should be acquainted with them, thus ensuring effective management.

¹⁵ Defined as individuals who are able to express their own intentions and are outside the scope of the application of the Adult Guardianship System, but are unable to carry out administrative processes, etc., in banking transactions by themselves due to disability related to eyesight, hearing or bodily functions.

as those for the non-handicapped

- Arrangements for handling complaints and resolving disputes by the alternative dispute resolution system (hereinafter referred to as the “Financial ADR System”) for the financial sector
- Arrangements on the monitoring of the status of Customer Support
- Arrangements for dealing with pressures from anti-social forces under the guise of Consultation Requests, Complaints, etc.
- Arrangements on information sharing necessary for Customer Support
- Arrangements on the reporting to the Board of Directors or organization equivalent to the Board of Directors
- Arrangements on coordination and communication with the Compliance Control Division

3) Customer Support Manual

Does the Customer Support Manual exhaustively cover the detailed procedures of Customer Support? Are they stipulated in detail in an easy-to-understand manner? For example, does the Customer Support Manual enable the persons engaged in Customer Support to carry out Customer Support appropriately and sufficiently and enable them to aptly disseminate information concerning Consultation Requests, Complaints, etc. to the Board of Directors or organization equivalent to the Board of Directors by stipulating the following matters?

- Procedures for compiling and keeping records of Consultation Requests, Complaints, etc.
- Procedures for confirming the details of Consultation Requests, Complaints, etc. (procedures for receipt of Consultation Requests, Complaints, etc. and procedures for confirming the details of Consultation Requests, Complaints, etc.)
- Procedures for dealing with Consultation Requests, Complaints, etc. (responses for satisfying customers with regard to Consultation Requests, Complaints, etc., progress management for resolving Consultation Requests, Complaints, etc., procedures for prevention of long-pending cases and procedures for cases where Consultation Requests, Complaints, etc. develop into disputes)
- Procedures for handling complaints and resolving disputes by the Financial ADR System
- Procedures for conveying information concerning Consultation Requests, Complaints, etc. to relevant divisions
- Contact information and procedures for dealing with pressures from anti-social forces under the guise of Consultation Requests, Complaints, etc.
- Typical examples of cases suspected to be violation of Laws and the contact information of the division in charge (the Compliance Control Division, etc.) for dealing with a case suspected to be a violation of Laws.

- Procedures for dealing with Consultation Requests, Complaints, etc. suspected to involve damage from billing fraud and other crimes or misuse of an account.

(2) Implementation of Customer Support

1) Development of Management System for Customer Support

- (i) Does the Customer Support Management Manager have the people who provide customer support comply with the Customer Support Management Rules, Customer Support Manual and other customer support related arrangements? Does the Manager develop a system in order to provide appropriate and sufficient customer support, and implement specific measures in order to ensure its effectiveness?
- (ii) In response to Consultation Requests, Complaints, etc. and customer desires, has the Customer Support Manager developed a system for introducing customers to appropriate external institutions (including external institutions the financial institution uses for the Financial ADR System. Same hereinafter.), and providing information with outlines of procedures for those external institutions? Has the Manager developed a system for appropriate cooperation with external institutions, to enable prompt complaint handling and dispute resolution?
- (iii) For when Consultation Requests, Complaints, etc. are received from customers, has the Customer Support Manager developed a system to provide a sufficient response, and to appropriately examine the necessity of a petition for dispute resolution procedures, instead of easily submitting a petition to an external institution, etc.?
- (iv) Has the Customer Support Manager developed a system for the Financial ADR System, especially regarding the following points?¹⁶
 - a. If there is a designated dispute resolution institution (hereinafter referred to as the “Designated ADR Institution”)
 - (a) Is a basic contract for the execution of procedures promptly signed with the Designated ADR Institution? Also, if there was a change in the Designated ADR Institution, is the optimum policy chosen from the viewpoint of customer protection and enhancing convenience, and are necessary measures promptly taken? Moreover, is a system developed to appropriately perform the procedures execution basic contract which was signed with the Designated ADR Institution?
 - (b) Is there appropriate publication of the trade name or name and the contact information of the Designated ADR Institution with which the procedures execution basic contract was signed? Is the public disclosure of such information

¹⁶ When examining specific cases regarding these items, keep in mind that the examination must be based on related Laws and supervisory guidelines.

easy for the customer to understand? (For example, for a public disclosure on a website, the customers should be able to access the page related to the Financial ADR System easily.)

Also, is the trade name or name and the contact information of the Designated ADR Institution written on documents in which it is legally obligated to write about handling under the Financial ADR System, such as documents providing information to depositors and documents provided before contract signing?

- (c) In the case where the financial institution sells financial or insurance products structured by the financial instrument business operator or the insurance company, does such financial institution carefully handle the sale by understanding the customer's concerns and introducing the suitable Designated ADR Institution in view of the cause of problems, given the fact that multiple business operators from different financial sectors are involved in the transaction (i.e., the financial instrument business operator or the insurance company as the structurer of the financial instrument; and the financial institution as the seller of the financial instrument)?¹⁷

b. If there is no Designated ADR Institution

- (a) Considering the size and characteristics of the business, is one or several of the following items appropriately selected as a complaint handling measure and dispute resolution measure? Is a system developed for the selected measures to function appropriately? In doing so, the financial institution should endeavor to contribute to the improvement of customer convenience, for example, by improving geographic access so that the customer can place complaints and requests for a dispute resolution easily.

a) Complaint Handling Measures

- Use of advice and guidance from consumer consultants, etc. to people engaged in complaint handling
- That financial institution's business operation system and internal rules, etc. are developed and published, etc.
- Use of a financial instruments firms association or certified investor protection organization

¹⁷ It should be noted that in the case of the sale of insurance products, the customer, in principle, has the right to petition through the Designated ADR institutions under the Basic Agreement to Implement Procedures with the insurance company, as well as through the financial institution, based on Article 283, Section 1 of the Insurance Business Act (excluding the exceptions stipulated in Article 283, Section 2 of the Insurance Business Act) stipulating that insurance companies are responsible to indemnify insurance policyholders for damages caused by the associated insurance solicitor even though the related problem is caused in the process of selling insurance products such as when providing an explanation to the customer.

- Use of a National Consumer Affairs Center or consumer affairs centers
- Use of another business form of Designated ADR Institution
- Use of a corporation which can fairly and accurately perform complaint handling operations

b) Dispute Resolution Measures

- Use of certified dispute resolution procedures stipulated in the Act on Promotion of Use of Alternative Dispute Resolution Procedures
- Use of a financial instruments firms association or certified investor protection organization
- Use of a bar association
- Use of a National Consumer Affairs Center or consumer affairs centers
- Use of another business form of Designated ADR Institution
- Use of a corporation which can fairly and accurately perform complaint handling operations

(b) Regarding documents in which it is legally obligated to write about handling under the Financial ADR System, such as documents providing information to depositors and documents provided before contract signing, for example if the financial institution uses an external institution, are appropriate items according to the situation written on those documents, such as the trade name or name and the contact information of that institution? If an external institution is used by the financial institution, from the viewpoint of customer protection, for example the financial institution should disseminate and publish, in an easy to understand format, information such as the availability of the external institution for placing complaints and requesting a dispute resolution; and the trade name or name, and contact information of the external institution and the procedure to utilize the external institution, etc.

(c) Please refer to Section II .2. (2) 1) (iv) a. (c) of this checklist for the case where the financial institution sells financial instruments or insurance products structured by the financial instrument business operator and the insurance company.

2) Enhancement of Consultation Counter Functions

(i) Does the Customer Support Manager provide for measures to enhance and strengthen the handling of Consultation Requests, Complaints, etc. at counters responsible for the consultation requests, complaints (relevant counters in the case where Consultation Requests, Complaints, etc. are handled as a part of ordinary counter services)? Does the Manager endeavor to receive Consultation Requests, Complaints, etc. from a wide base, for example

by setting up receiving channels such as an Internet-based counter and opinion boxes through which opinions can be expressed anonymously? Does the Manager also widely disclose these initiatives, and publicize them in an easily understood manner?

- (ii) If a call center is established to act as a consultation counter, is sufficient care taken to ensure the allocation of persons with appropriate knowledge and experience and to fully disseminate the Customer Support Manual to the persons via training?

3) Appropriateness of Customer Support

- (i) Do officers who receive Consultation Requests, Complaints, etc. appropriately respond in a timely manner in accordance with the Customer Support Manual and in coordination with relevant divisions? Do the officers ensure that the occurrence of long-pending cases is prevented and any pending case is resolved promptly by managing progress toward solutions concerning Consultation Requests, Complaints, etc. in an appropriate and timely manner?
- (ii) Are pressures from anti-social forces under the guise of Consultation Requests, Complaints, etc. distinguished from ordinary Consultation Requests, Complaints, etc. and promptly reported to the Compliance Control Division, etc., so as to take resolute action? If necessary, is an appropriate response made in coordination with the police and other relevant organizations?

4) Recording, Storage and Reporting

- (i) Does the Customer Support Manager record the details of Consultation Requests, Complaints, etc., including the results of responses to them, for storage in register books, etc. and keep the records under integrated control?
- (ii) Does the Customer Support Manager report the details of Consultation Requests, Complaints and the results of the handling thereof in a timely manner to the Compliance Control and Internal Audit Divisions, etc.? In particular, does the Manager report to the Compliance Control and Internal Audit Divisions, etc., as well as the Board of Directors, without delay any matter that would seriously affect corporate management or significantly undermine customer interests?

5) Analysis of Causes of Consultation Requests, Complaints, etc. and Implementation of Improvement

Does the Customer Support Manager analyze the details and the results of the handling of Consultation Requests, Complaints, etc., using the information provided by the Designated ADR Institution, conduct necessary investigations to grasp their causes, and, based on the results of the analysis, present the Board of Directors with proposals for improvements and

ask the relevant departments to submit reports and make improvements as necessary, thus ensuring that constant efforts are made for improvements? With regard to the Consultation Requests, Complaints, etc. that are conveyed repeatedly in particular, does the Manager review them thoroughly with the possibility in mind that some kind of problem exists and take specific measures to handle such requests and complaints appropriately?

6) Monitoring of Customer Support

Does the Customer Support Manager check, on an ongoing basis, whether appropriate and sufficient Customer Support is secured by monitoring the status of compliance with the Customer Support Manual and take deterrent action as necessary? When a call center is established to act as a consultation counter, does the Manager monitor the degree of congestion of calls and review whether appropriate Customer Support is provided promptly?

7) Coordination with Finance Facilitation Manager

Does the Customer Support Manager appropriately coordinate with the Finance Facilitation Manager, and considering the intention of finance facilitation, appropriately collect information in a timely manner on inappropriate or possibly inappropriate cases in its handling of consultations and requests for new finance and loan condition changes, and report this to the Finance Facilitation Manager?

8) System for Reporting to Board of Directors

Does the Customer Support Manager report necessary matters to the Board of Directors or organization equivalent to the Board of Directors in a regular and timely manner or on an as needed basis? In particular, does the Manager report to the Board of Directors or organization equivalent to the Board of Directors without delay any matter that would seriously affect corporate management or significantly undermine customer interests?

9) System for Reporting to Corporate Auditor

Does the Customer Support Manager report matters specified by the Board of Directors directly to a corporate auditor?

(3) Assessment and Improvement Activities

Does the Customer Support Manager review the effectiveness of the Customer Support Management system in a regular and timely manner or on an as needed basis based on reports and findings on the status of management of Customer Support, including the status of compliance with the Customer Support Management Rules and the Customer Support Manual as

well as based on the results of monitoring? Does the Manager present the Board of Directors or organization equivalent to the Board of Directors with proposals for improvement as necessary by revising in a timely manner the contents of the Customer Support Management Rules and the Customer Support Manual, the organizational framework, the implementation of training and guidance and the method of monitoring?

3. Customer Information Management System

(1) Development of Internal Rules

1) Development of Customer Information Management Rules and Customer Information Management Manual

- (i) Does the Customer Information Supervisory Manager fully understand the need and importance of securing appropriate and sufficient Customer Information Management?
- (ii) Has the Customer Information Supervisory Manager decided the method of monitoring and the organizational framework for securing appropriate Customer Information Management and developed internal rules that clearly define the arrangements for managing the relevant business (hereinafter referred to as the “Customer Information Management Rules”) in accordance with the Customer Protection Management Policy? Have the Customer Information Management Rules been disseminated throughout the institution upon approval by the Board of Directors or organization equivalent to the Board of Directors after undergoing legal checks, etc.?
- (iii) Has the Customer Information Supervisory Manager developed operational procedures that specify the method of Customer Information Management and the procedures to be followed (hereinafter referred to as the “Customer Information Management Manual”) in accordance with the Customer Protection Management Policy and the Customer Information Management Rules and disseminated them throughout the institution?

2) Customer Information Management Rules

Do the Customer Information Management Rules exhaustively cover the necessary arrangements for securing appropriate Customer Information Management in a manner suited to the scales and natures of the business? Do the Customer Information Management Rules appropriately stipulate such arrangements, for example, by clearly defining the organizational framework for the management as well as the allocation of the relevant authority and roles and the management method?

3) Customer Information Management Manual

Does the Customer Information Management Manual exhaustively cover the detailed procedures concerning Customer Information Management and is it stipulated in detail and in an easy-to-understand manner? Does the manual specify the following points in particular?

- Written records and electronic media to be managed
- The method of appropriately managing written records and electronic media to be managed, for example, where to store them and how to dispose of them.
- The scope of officers who have access to customer information and the method of controlling access rights
- The method of handling customer information in ways to prevent information leakage when the information is taken outside.
- The method of responding to information leakage (e.g. reporting to the Customer Information Supervisory Manager, the person in charge of managing customer information and the public authorities and implementing measures to prevent secondary damage from information leakage, including limiting information access and providing explanations to the Customer as necessary)

(2) Implementation of Customer Information Management

1) Arrangement for Customer Information Management System

Does the Customer Information Supervisory Manager ensure appropriate handling of customer information at divisions engaged in the relevant business as well as at sales branches and proper functioning of a check-and-balance system against them by securing, through the person in charge of managing customer information, compliance with the Customer Information Management Rules and the Customer Information Management Manual, etc.? Does the Manager implement specific measures for securing the effectiveness of the arrangement?

2) Guidance and Supervision

Does the Customer Information Supervisory Manager provide appropriate guidance and supervision to the divisions engaged in the relevant business as well as sales branches so as to enable them to implement administrative work related to customer information management in an appropriate and timely manner?

3) Handling of Computer System

Does the Customer Information Supervisory Manager take the following steps through the division or the person in charge of the computer system?

- (i) When customer information is printed out or downloaded, does the Manager impose limitations in an appropriate manner on the nature and quantity of the data that may be

printed out or downloaded according to the purpose of the use?

- (ii) Does the Manager limit the scope of customer information which may be accessed to a necessary minimum according to the accessing person's corporate post and qualifications?
- (iii) Are customer information data stored in personal computer terminals or the host computer, etc. protected through measures such as the use of a password system for access to the customer information database, the establishment of an identification system and encoding of the data?
- (iv) Are necessary protection measures taken in terms of system operations with regard to exchanges of customer information data between the financial institution and the Outsourcing Contractor?

4) Status of Management of Response to Customer Information Leakage

- (i) Does the Customer Information Supervisory Manager provide a system to ensure that the person in charge of customer information management immediately reports to the Customer Information Supervisory Manager in the event of an information leak?
- (ii) Does the Customer Information Supervisory Manager provide a system to ensure that the person in charge of customer information management reports to the Compliance Control Division or the Board of Directors or organization equivalent to the Board of Directors without delay in the event of an information leak in accordance with the Customer Information Management Rules?
- (iii) Does the Customer Information Supervisory Manager ensure the implementation of measures to prevent secondary damage from an information leak, such as reporting to the public authorities, limiting information access and providing explanations to the Customer as necessary? Does the Manager analyze the cause of a customer information leak so as to prevent its recurrence?

5) Monitoring of Status of Customer Information Management at Each Division

Does the Customer Information Supervisory Manager, through the person in charge of customer information management, monitor on an ongoing basis the status of compliance with the internal rules and the Customer Information Management Manual as well as the status of customer information management at each division?

6) Monitoring of Status of Customer Information Management at Outsourcing Contractor

Does the Customer Information Supervisory Manager or the person in charge of customer information management keep track on whether bank agents and Outsourcing Contractors appropriately manage customer information and whether they take prescribed measures in the

event of accidents?

7) System for Reporting to Board of Directors and Approval

Does the Customer Information Supervisory Manager report necessary matters to the Board of Directors or organization equivalent to the Board of Directors in a regular and timely manner or on an as needed basis? In particular, does the Manager report to the Board of Directors or organization equivalent to the Board of Directors without delay any matter that would seriously affect corporate management or significantly undermine customer interests?

8) System for Reporting to Corporate Auditor

Does the Customer Information Supervisory Manager report matters specified by the Board of Directors directly to a corporate auditor?

(3) Assessment and Improvement Activities

Does the Customer Information Supervisory Manager review the effectiveness of the Customer Information Management system in a regular and timely manner or on an as needed basis based on reports and findings on the status of Customer Information Management, including the status of compliance with the Customer Information Management Rules and Customer Information Management Manual as well as based on the results of monitoring? Does the Manager present the Board of Directors or organization equivalent to the Board of Directors with proposals for improvement as necessary by revising in a timely manner the contents of the Customer Information Management Rules and the Customer Information Management Manual, the organizational framework, the implementation of training and guidance and the method of monitoring?

4. Outsourcing Management System

(1) Development of Internal Rules

1) Development of Outsourcing Rules

- (i) With regard to outsourcing management, has the Outsourcing Manager developed internal rules that specify the management method, the rules and arrangements on matters and procedures that must be checked and the judgment criteria (hereinafter referred to as the “Outsourcing Rules”)?
- (ii) Have the Outsourcing Rules been disseminated throughout the institution upon approval from the Board of Directors after legal checks, etc.?

2) Outsourcing Rules

Do the Outsourcing Rules exhaustively cover the necessary arrangements for securing appropriate Outsourcing Management in a manner suited to the scales and natures of the business? Do the Outsourcing Rules appropriately stipulate such arrangements, for example, by clearly defining the organizational framework for conducting Outsourcing Management as well as the allocation of the relevant authority and roles and the management method? Do they stipulate the following matters in particular?

- Arrangements on the selection of Outsourcing Contractors
- Arrangements on the monitoring of Outsourcing Contractors
- Arrangements on the supervision of bank agents as the employing bank when employing such agents as contractors
- Arrangements on the handling of customer information in the event of the termination of contracts with bank agents and Outsourcing Contractors

(2) Implementation of Outsourcing Management

1) Measures for Securing Apt Implementation of Outsourcing Operations

In the case where the financial institution's operations are outsourced to third parties (including the institution's parent, subsidiaries and affiliates), does the Outsourcing Manager provide for measures to secure apt implementation of those operations in a manner suited to the scales and natures of the operations (including requiring the outsourcing contractor to establish a necessary system under the outsourced contract)?

2) Selection of Outsourcing Contractors

Does the Outsourcing Manager provide for measures to ensure that the outsourced operation is consigned to a party capable of implementing the operation aptly, fairly and efficiently after specifying the operational risks inherent in the operation in coordination with the Integrated Operational Risk Management Division and recognizing possible risk management problems related to the quality of service and the reliability of service continuity?

3) Contract Conclusion

Does the Outsourcing Manager provide a system to subject the outsourcing contract to legal checks, etc. in advance and confirm whether the provisions of the contract allow appropriate measures to be taken in a manner suited to the scales and natures of the outsourced operation?

4) Monitoring of Outsourcing Contractors

Does the Outsourcing Manager ensure the exercise of necessary and appropriate supervision

over the Outsourcing Contractor by reviewing whether the contractor is implementing the business operation aptly in accordance with the outsourcing contract based on checks conducted on the status of the implementation of the consigned operation in a regular and timely manner or on an as needed basis and having the contractor make improvements as necessary? Does the Manager ensure that appropriate measures can be taken in a timely manner under the outsourced contract, for example by appropriately stipulating the contract provisions that concern the supervision, monitoring and reporting?

5) System for Processing of Consultation Requests, Complaints, etc. Concerning Outsourced Operations

Does the Outsourcing Manager provide for measures necessary for appropriately and promptly processing the Customer's Consultation Requests, Complaints, etc. concerning consigned operations undertaken by Outsourcing Contractors? Is there an appropriate system for the processing of Consultation Requests, Complaints, etc., such as the establishment of a direct communication channel between the Customer and the institution with regard to customer claims?

6) Backup System for Outsourced Operations

When the Outsourcing Contractor fails to appropriately implement the consigned operation, does the Outsourcing Manager take measures to prevent the disruption of the operation from the viewpoint of Customer Protection, such as selecting another appropriate Outsourcing Contractor and promptly transfer the operation to the alternative contractor?

7) Coordination with Finance Facilitation Manager

Does the Outsourcing Manager appropriately coordinate with the Finance Facilitation Manager, and considering the intention of finance facilitation, appropriately collect information in a timely manner on inappropriate or possibly inappropriate cases in its handling of consultations and requests for new finance and loan condition changes, and report this to the Finance Facilitation Manager?

8) Contract Modification and Termination

Does the Outsourcing Manager provide for measures to enable prompt modification or termination of the outsourcing contract if necessary in order to secure sound and appropriate business of the financial institution and protect the Customer related to the outsourced operation?

9) Measures for Customer Information Protection

Does the Outsourcing Manager provide for measures to ensure customer information management at the Outsourcing Contractor? Does the outsourcing contract have provisions that prohibit the use of customer information for purposes other than the prescribed ones and obligate confidentiality, for example? Does the Manager provide for measures to ensure the exercise of appropriate supervision over the Outsourcing Contractor so as to ensure appropriate handling of customer information when the handling of information concerning customers who are individuals is outsourced?

10) System for Reporting to Board of Directors and Approval

Does the Outsourcing Manager report necessary matters to the Board of Directors or organization equivalent to the Board of Directors in a regular and timely manner or on an as needed basis? In particular, does the Manager report to the Board of Directors or organization equivalent to the Board of Directors without delay any matter that would seriously affect corporate management or significantly undermine customer interests?

11) System for Reporting to Corporate Auditor

Does the Outsourcing Manager report matters specified by the Board of Directors directly to a corporate auditor?

(3) Assessment and Improvement Activities

Does the Outsourcing Manager review the effectiveness of the Outsourcing Management system in a regular and timely manner or on an as needed basis based on reports and findings on the status of Outsourcing Management, including the status of compliance with the Outsourcing Rules as well as based on the results of monitoring? Does the Manager present the Board of Directors or organization equivalent to the Board of Directors with proposals for improvement as necessary by revising in a timely manner the contents of the Outsourcing Rules, the organizational framework, the implementation of training and guidance and the method of monitoring?

5. Conflict of Interest Management System

(1) Development of Internal Rules

1) Development of Conflict of Interest Management Rules

- (i) Does the Conflict of Interest Manager fully understand the need and importance of securing appropriate Conflict of Interest Management?
- (ii) Has the Conflict of Interest Manager developed internal rules that clearly define the arrangements for appropriate Conflict of Interest Management (hereinafter referred to as the “Conflict of Interest Management Rules”) in accordance with the Customer Protection Management Policy?
- (iii) Have the Conflict of Interest Management Rules been disseminated throughout the institution upon approval from the Board of Directors or organization equivalent to the Board of Directors after legal checks, etc.?

2) Conflict of Interest Management Rules

Do the Conflict of Interest Management Rules exhaustively cover the necessary arrangements for securing appropriate Conflict of Interest Management in a manner suited to the scales and natures of the business of the financial institution or a group company, including items stipulated in implementation policies of Conflict of Interest Management based on Laws¹⁸? Do the Conflict of Interest Management Rules appropriately stipulate such arrangements, for example, by clearly defining the organizational framework and methods for conducting Conflict of Interest Management, as well as the allocation of authority and roles? More specifically, do they prescribe the following points?

- Arrangements for the organizational framework for Conflict of Interest Management (including whether or not to establish a division or a person in charge of Conflict of Interest Management as well as the authority and roles of such a division or a person)
- Arrangements on the procedures to be observed by persons engaged in Conflict of Interest Management
- Arrangements on the monitoring of the status of Conflict of Interest Management
- Arrangements on identification of transactions with possible conflicts of interest
- Arrangements on methods of Conflict of Interest Management
- Arrangements on saving records of Conflict of Interest Management
- Arrangements on gathering information necessary for Conflict of Interest Management
- Arrangements on reporting to the Board of Directors or organization equivalent to the Board of Directors
- Arrangements on coordination and communication with the Compliance Control Division,

¹⁸ Banking Act Ordinance for Enforcement, Article 14-11-3-3, Paragraph 1, Item 3.

Customer Explanation Manager, Customer Information Manager, etc.

(2) Implementation of Conflict of Interest Management

1) Development of Conflict of Interest Management

- (i) Does the Conflict of Interest Manager develop a system for appropriate and sufficient Conflict of Interest Management, such as compliance with Conflict of Interest Management Rules? Does the Manager implement specific measures to ensure its effectiveness? In particular, regarding conflicts of interest management, does the Manager develop a system to ensure independence of the Marketing and Sales Division, and to demonstrate a check-and-balance function?
- (ii) For the conduct of Conflict of Interest Management, does the Conflict of Interest Manager develop a system for appropriate coordination with the Compliance Control Division, Customer Explanation Manager, Customer Information Manager, etc.?

2) Guidance and Supervision

Does the Conflict of Interest Manager provide appropriate guidance and supervision to the divisions engaged in the relevant business as well as sales branches so as to enable them to implement Conflict of Interest Management in an appropriate and timely manner?

3) Identification of Transactions with Possible Conflicts of Interest

Does the Conflict of Interest Manager develop a system to appropriately identify transactions with possible conflicts of interest?

4) Methods of Conflict of Interest Management

Does the Conflict of Interest Manager develop a system for ensuring appropriate and sufficient Conflict of Interest Management, for example by the following kinds of methods, or by combining the following kinds of methods?

- Separate the divisions where conflicts of interest could occur
- Change for one or both parties the conditions or methods of transactions which could involve conflicts of interest
- Suspend the transactions of one party which could involve conflicts of interest
- Disclose possible conflicts of interest to customers

5) Recording & Storage

Does the Conflict of Interest Manager appropriately create and save records, such as those on methods of Conflict of Interest Management implemented to identify transactions with possible

conflicts of interest, and to protect customer interests?

6) Implementation of Monitoring of Conflict of Interest Management

Does the Conflict of Interest Manager monitor the situation of compliance with Conflict of Interest Management Rules, in order to continually check whether appropriate and sufficient Conflict of Interest Management is ensured? Does the Manager take deterrent actions as necessary?

7) System for Reporting to Board of Directors

Does the Conflict of Interest Manager report necessary matters to the Board of Directors or organization equivalent to the Board of Directors, in a regular and timely manner or on an as needed basis? In particular, does the Manager report to the Board of Directors or organization equivalent to the Board of Directors without delay any matter that would seriously affect corporate management or significantly undermine customer interests?

8) System for Reporting to Corporate Auditor

Does the Conflict of Interest Manager report matters specified by the Board of Directors directly to a corporate auditor?

(3) Assessment and Improvement Activities

Does the Conflict of Interest Manager review the effectiveness of the Conflict of Interest Management system in a regular and timely manner or on an as needed basis, based on reports and findings on the status of Conflict of Interest Management, including the status of compliance with the Conflict of Interest Management Rules as well as based on the results of monitoring? Does the Manager present the Board of Directors or organization equivalent to the Board of Directors with proposals for improvement as necessary, by revising in a timely manner the contents of the Conflict of Interest Management Rules, the organizational framework, the implementation of training and guidance, and the method of monitoring, etc.?

III. Specific Issues

Checkpoints

- This chapter lists the check items to be used when the inspector reviews specific issues particular to the actual status of Customer Protection Management.
- The descriptions in this checklist are based on the assumption that the roles of and responsibilities for developing a system for each business operation concerning Customer Protection and ensuring the effectiveness thereof rests with the Manager in charge of the relevant business. There are other various organizational frameworks for Customer Protection Management. For example, the financial institution may establish a dedicated division or department in charge of Customer Protection Management, or assign persons in charge of such management to divisions and departments that require Customer Protection, including the Marketing and Sales Division. In such cases, it is necessary to review whether the Customer Protection system is effectively functioning based on the review and analysis as to whether an adequate number of persons with the knowledge and experience necessary for implementing the relevant business are allocated and whether they are assigned the authority necessary for implementing the business.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter III., it is necessary to exhaustively examine which of the elements listed in Chapters I. and II. are absent or insufficient, thus causing the said problem with the use of the checklists in those chapters, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter I. are not functioning appropriately and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Customer Protection in General

(1) Handling of New Products

Does the Manager in charge of Customer Protection Management conduct prior investigations with regard to the public and internal rules that concern new products specified in the Comprehensive Risk Management Policy when requested by the Comprehensive Risk Management Division and report to the division in a timely manner after identifying issues that may arise from the viewpoint of Customer Protection?

2. Customer Explanation System

(1) Viewpoints Concerning Customer Explanation System in General

1) Policy Concerning Customer Explanation

Is a policy concerning solicitation activities related to sales of financial products (hereinafter referred to as the “Solicitation Policy”) developed appropriately in accordance with laws and ordinances and publicly disclosed promptly? When the Solicitation Policy is modified, is the disclosure thereof made promptly? Is the Solicitation Policy compatible with the Customer Explanation Manual?

2) Viewpoint Concerning Prevention of Violation of Laws with Regard to Customer Explanation

Are appropriate measures provided for to prevent violation of Laws with regard to Customer Explanation? For example, is there an effective system to prevent violation of Laws as part of the daily operational process through measures such as using multi-person monitoring system and obtaining written confirmation as necessary according to the nature of the operations concerned, in addition to developing the Customer Explanation Manual and conducting training?

3) Viewpoints Concerning Implementation of Legally-Required Customer Explanation

Are measures provided for to appropriately implement the provision of information and the prevention of mistaken recognition as required by laws and ordinances with regard to Customer Explanation? Is there a system to ensure full compliance with Laws with regard to the following Transactions and products in particular through the provision of appropriate and sufficient explanations to the Customer?

- Agency and intermediary service for the conclusion of trust contracts that do not involve compensation for principal losses
- Exchange-traded financial futures transactions

- Fiduciary service for financial futures transactions
- Financial derivatives transactions and intermediary, brokerage and agency services thereof
- Products that combine derivatives, deposits, etc. without the guarantee of the full principal repayment at maturity

4) Prevention of Disputes

Is there a system to prevent disputes with the Customer? Are the following matters thoroughly established or implemented?

- A legal check system
- Specification of matters that require explanations and compilation of explanation documents
- Compilation of documents concerning the confirmation of the intent of the Customer with regard to the contract
- Compilation and storage of records on the status of explanations to the Customer
- Appropriate disclosure to customers that there are possible conflicts of interest
- A system to prevent the abuse of a superior position and unfair transactions such as tie-in transactions
- A system to provide information related to the syndicated loan arranger business.

(2) Viewpoints Concerning Specific Transactions and Products¹⁹

1) Customer Explanation Concerning Deposits

Is there a system to provide appropriate and sufficient Customer Explanation in accordance with the Customer Explanation Manual when the institution accepts deposits? Are the representation of the interest rates and the explanations concerning the fees and procedures necessary for contract termination made in an easy-to-understand manner, for example? When deposit transactions involve derivatives transactions such as options and swaps (including the case where only derivatives transactions are done) in particular, the inspector should pay attention to the following points.

- Are explanations made in an easy-to-understand manner suited to the knowledge and experience of the Customer with the use of diagrams and examples, and are the explanations provided in the written form?
- Are explanations provided with regard to the method of calculating the fee necessary for premature contract termination and the fee amount calculated?
- Is there a system to provide detailed explanations with regard to deposit products which

¹⁹ Refer as necessary to “Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.” and “Comprehensive Guidelines for Supervision of Insurance Companies,” etc.

involve derivatives transactions and which may cause principal losses due to derivatives-related losses, including the explanation about the absence of the principal guarantee?

2) Customer Explanation Concerning “Risk Products”

Is there a system to provide appropriate and sufficient Customer Explanation in accordance with the Customer Explanation Manual when the institution sells so-called risk products? For example, is the representation of the risk of principal losses appropriate and sufficient and are explanations suited for the Customer’s attributes provided in a sufficient and appropriate manner? Is there a system to secure the compliance of Customer Explanation with the Banking Act, the Financial Instruments and Exchange Act, the Insurance Business Law, the Antimonopoly Act and other Laws when the institution sells risk products?

3) Customer Explanation Concerning Credit Transactions

(i) Is there a system to provide appropriate and sufficient Customer Explanation with regard to credit transactions (loan contracts and related collateral and guarantee contracts) in accordance with the Customer Explanation Manual? With regard to the following cases of credit transactions in particular, the inspector should pay attention to the points listed below each case.

a. In the case where loan transactions involve derivatives transactions such as options and swaps (including the case where only derivatives transactions are done)

- Are explanations made in an easy-to-understand manner suited to the knowledge and experience of the Customer with the use of diagrams and examples, and are the explanations provided in the written form?
- Are explanations provided with regard to the method of calculating the fee necessary for premature contract termination and the fee amount calculated?

b. Housing Loan Contracts

- Are explanations made in an easy-to-understand manner suited to the knowledge and experience of the Customer with the use of diagrams and examples, and are the explanations provided in the written form?
- Are full explanations made with regard to the interest rate risk when the institution extends a housing loan which carries a variable interest rate or which carries a fixed interest rate for a prescribed limited period of time?

(ii) When a consultation or request is received from a customer regarding new finance or loan condition changes, etc., does the financial institution work to quickly study and reply to it? Also, in cases of denial or debt collection, does the financial institution try as much as possible to show the grounds and provide explanation to obtain the customer’s

understanding and acceptance? For example, does the financial institution respond by denying only because of denial by the credit guarantee association, etc.? Moreover, in providing these explanations, does the financial institution gain a detailed understanding of the customer's information and act quickly, corresponding to business relations until then and the customer's knowledge and experience and asset situation?

- (iii) When a consultation is received from a debtor regarding loan condition changes, etc., does the financial institution respond appropriately? Does the financial institution prevent the request for loan condition changes, etc. which are related to that consultation? Also, when a request for loan condition changes, etc. is received from a debtor, is the debtor pushed to cancel his request against his will?
- (iv) When there is a consultation or request from a customer regarding new finance or loan condition changes, etc., if that financial institution demands new collateral or guarantees or presents loan conditions (including raising the interest rate), does it promptly present its details? Also, does it fully explain with the aim of obtaining the customer's understanding and acceptance, considering the business relations until then and the customer's knowledge, experience and asset situation? Especially at the time of business succession of the borrower company, does the financial institution, in light of the Personal Guarantee Guidelines Provided by Business Owner, review anew issues such as whether the guarantee agreement is necessary based on the disclosure of necessary information, instead of automatically transferring the existing guarantee obligation from the former business owner to the successor of the borrower company? If the financial institution, as a result of such review, decides to execute a guarantee agreement with the successor, does the financial institution provide to the primary borrower and the business successor adequate explanation such as the reason why the guarantee agreement is necessary? Further, in the event that a termination of the guarantee agreement is requested by the former business owner, does the financial institution make the decision on the termination request appropriately, considering the information such as whether the former business owner retains his or her right to manage and control the company, the status of alternative securities available other than the relevant guarantee agreement to secure the existing credit, the company's debt repayment ability through its assets and earnings ability, etc.?

4) Customer Explanations about Insurance Solicitation

For insurance solicitation, is a system developed for appropriate and sufficient customer explanations in accordance with the Customer Explanation Manual? Is the sales system, etc. built for self-responsibility? For example, in coordination with the insurance company which outsourced the work, does the Customer Explanation Manual have stipulations needed to ensure

accurate explanations for insurance products and contracts, and explanations in accordance with Laws such as the Insurance Business Law (including the Insurance Solicitation Guidelines)? Are staffs thoroughly informed of its content, such as by providing periodic training? Also, does the system ensure provision of documents with contract outlines and warning information, and explanations which take into account the customer's needs, knowledge, experience and asset situation?

(3) Viewpoints Concerning Prevention of Inappropriate Practices

Is there a system to take measures, such as the establishment of the "firewall" between the operational divisions, to prevent inappropriate practices on the occasion of Customer Explanation from the viewpoint of avoiding inappropriate incidents in Transactions with the Customer, such as tie-in transactions and abuse of a superior position?

For example are opt-out²⁰ opportunities provided to corporate clients, for appropriate handling among Financial Instruments Business Operators in cases where private information is provided, and in cases where private information is received or provided to conduct operations, etc. related to internal management and conduct? Also, are measures to prevent inappropriate practices in insurance solicitations functioning appropriately, such as prevention of abuse of a superior position and other unfair transactions, and prevention of use of private financial information and private insurance information without obtaining the customer's agreement?

3. Customer Support Management System

(1) Processing of Consultation Requests, Complaints, etc. as Dispute-Settlement Mechanism

In handling Consultation Requests, Complaints, etc., does the financial institution regard them as a nascent form of dispute-settlement issue, rather than merely as a matter to be processed, and aim as much as possible to provide solutions by obtaining the understanding and satisfaction of the Customer in a manner suited to the details of the requests and complaints?

(2) Customer Support concerning Insurance Solicitation

- 1) Does handling of Consultation Requests, Complaints, etc. from customers regarding insurance contracts aim as much as possible to resolve issues while obtaining the customer's understanding and acceptance, in close coordination with the insurance company?
- 2) Among the operations which must be performed after the insurance contract is signed, is a system developed in order to appropriately perform the operations which the financial

²⁰ Gives advance notice of the intention to share private information, and if the customer does not want it shared, then it seeks to halt the provision of private information to the parent company and subsidiaries, etc.

institution is assigned in the outsourcing contract with the insurance company? Also, even for operations which are only assigned to the insurance company, when inquiries are received from customers, is care taken to avoid the customers being “turning away at the door” or “shuffled around”? For example, does the financial institution introduce the customer to the insurance company contact point which corresponds to that inquiry?

4. Customer Information Management System

(1) Development of Organization for Customer Information Management

With regard to information concerning customers who are individuals, is there an arrangement for the Customer Information Supervisory Manager to take the following measures as necessary and appropriate in order to prevent leakage, loss or destruction of the information as the supervisor of the information safety management as well as of employees and the Outsourcing Contractor (in the case where handling of the information concerned is outsourced)?

- 1) Measures based on the provisions of Clauses 10, 11 and 12 of the Guidelines on Personal Information Protection in the Financial Industry
- 2) Measures based on the provisions of the operational instructions of security management measures I, II and III as well as Attachment 2 of the Guidelines on Personal Information Protection in the Financial Industry

(2) Viewpoint Concerning Information Sharing

When customer information is shared between the financial institution and third parties, is there a system to obtain in an appropriate manner the prior consent of the Customer, in the written form in principle, with regard to the sharing? Notwithstanding the above, this checkpoint shall not apply to cases to which Paragraph 6, Article 13 of the Guidelines on Personal Information Protection in the Financial Industry is applicable.

5. Outsourcing Management System

(1) Outsourcing of Business Concerning Deposit-Taking and Withdrawal

When the operation of ATM (automated teller machine) system is outsourced, does the Outsourcing Manager appropriately conduct monitoring and supervision over the status of management at the Outsourcing Contractor so as to ensure that necessary security measures are taken?

6. Outsourcing Management System Concerning Bank Agents

When an operation is outsourced to a bank agent, the following points should be examined in addition to the viewpoints concerning outsourcing listed in Chapter II. 4. 2).

(1) Arrangement for the System to Supervise Bank Agents

Is there a system to supervise bank agents, auditing their operations, providing training to them and monitoring their operations by establishing a division or department in charge of the relevant supervision or by appointing a person in charge thereof?²¹

(2) Selection of Bank Agents

With regard to the selection of a bank agent, is there a system to conduct full deliberations as to whether the agent concerned meets the criteria for legal approval? When the bank agent entrusts the agent operations to another party, is there a system to conduct full deliberations as to the suitability of the said party?

(3) Entrustment Contract with Bank Agent

Is there a system to check whether the legally required measures listed below can be implemented appropriately under the entrustment contract with the bank agent?

- 1) Measures for conducting training for legal compliance
- 2) Measures for appropriately supervising the bank agent by reviewing the status of the implemented operations, inspecting the status of ongoing implementation and having the agent make improvements as necessary
- 3) Measures for modifying or terminating the entrustment contract when necessary in order to secure the sound and appropriate implementation of the operation entrusted to the bank agent
- 4) Measures for allowing the financial institution to conduct screening as necessary with regard to agent or intermediary services for the conclusion of a contract concerning the provision of a loan or bill discounting
- 5) Measures for securing appropriate management of customer information
- 6) Measures concerning appropriate name representation
- 7) Measures for preventing crime with regard to the operations concerning the bank agent business
- 8) Measures for preventing significant effects on the Customer when the bank agent abolishes sales branches and offices, by ensuring that the operations concerned are transferred elsewhere appropriately and through other means

²¹ This does not preclude the Outsourcing Manager from concurrently taking charge of the supervision.

9) Measures for promptly processing Consultation Requests, Complaints, etc. with regard to the bank agent operation of the agent employed

7. Conflict of Interest Management System

(1) Development of System for Conflict of Interest Management for Customers of Bank Agents and Related Financial Institutions, etc.

Even for customers of bank agents and related financial institutions²² which pertain to that financial institution, is a system developed to conduct Conflict of Interest Management so that customers' interests are not unfairly harmed?

8. Other Matters

With regard to operations²³ determined by the financial institution as necessary for Customer Protection and enhancement of customer convenience, is there an appropriate management system that meets the level prescribed by the financial institution in the Customer Protection Management Policy and the Customer Protection Management Rules, etc.?

²² Refer to the Banking Act, Article 13-3-2, Paragraph 3.

²³ Refer to (5) "Securing appropriate management of other operations determined by the financial institution as necessary for protecting customers and enhancing customer convenience" listed as the first checkpoint in Chapter I of this checklist.

Checklist for Comprehensive Risk Management

I. Development and Establishment of Comprehensive Risk Management System by Management

【Checkpoints】

- Comprehensive risk management refers to a self-control type of risk management based on a comparison of a financial institution's financial strength (capital) and all risks faced by the institution, including risks not counted in the calculation of the capital adequacy ratios (credit concentration risk, interest rate risk in the banking book, etc.) and assessed on a category-by-category basis (credit risk, market risk, operational risk, etc.). The "integrated risk management" is a type of comprehensive risk management based on a comparison of a financial institution's financial strength (capital) and the aggregate of various risks measured with uniform yardsticks such as VaR (value at risk). On the other hand, a comprehensive risk management method not using this universal-yardstick approach may conduct risk management by, for example, comparing a financial institution's financial strength (capital) and the overall risk level evaluated as a result of qualitative and quantitative assessments of the risks conducted with various methods according to the risk type.
 - The development and establishment of the risk management system for a financial institution in its entirety is one of the key elements for ensuring the soundness and appropriateness of the institution's business. The institution's management is charged with and responsible for taking the initiative in the development and establishment of this system by deciding basic corporate management policies (business policies), determining strategic objectives based on these policies and developing an organizational framework for securing the effectiveness of the function of managing risks for the whole of the institution in a comprehensive manner.
 - A financial institution should, with a view to ensuring the soundness and appropriateness of its business, make voluntary efforts to develop a comprehensive risk management system based on self-recognition of the need thereof, by taking account of the strategic objectives, the scales and natures of its business and its risk profile.
 - When reviewing a financial institution's comprehensive risk management system, the inspector should, while paying as much respect as possible to the institution's voluntary efforts to develop and establish the system, check whether the system being developed and established is an appropriate one commensurate with the institution's strategic objectives, the scales and natures of its business and its risk profile as well as the levels of complexity and sophistication of the risk assessment method used by the institution.
- It should be noted that the type and level of the risk assessment method to be used by a financial institution should be determined according to the institution's strategic objectives, the diversity of its business and the risks faced by it and therefore a complex or sophisticated risk management system is not necessarily suited to all financial

institutions.

- The inspector should determine whether the comprehensive risk management system is functioning effectively and whether the roles and responsibilities of the institution's management are being appropriately performed by way of reviewing, with the use of check items listed in Chapter I., whether the management is appropriately implementing (1) policy development, (2) development of internal rules and organizational frameworks and (3) development of a system for assessment and improvement activities.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II. and later of each of the checklists for the various risk management systems including this checklist, it is necessary to exhaustively examine which of the elements listed in Chapter I. of each checklist, including the elements listed in this checklist as necessary, are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize weaknesses or problems recognized by the inspector, it is also necessary to explore in particular the possibility that the Internal Control System is not functioning effectively and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Policy Development

(1) Roles and Responsibilities of Directors

Do directors attach importance to comprehensive risk management, fully recognizing that a lack of such an approach could seriously hinder attainment of strategic objectives? In particular, does the director in charge of comprehensive risk management review the policy and specific measures for developing and establishing an adequate comprehensive risk management system with a full understanding of the scope, types and nature of risks, and the risk identification, assessment, monitoring and control technique as well as the importance of comprehensive risk management, and with precise recognition of the current status of comprehensive risk management within the financial institution based on such understanding? For example, does the director in charge understand the limitations and weaknesses of the method of assessing various risks in a comprehensive manner (including the assessment and measuring techniques and the

assumptions thereof; hereinafter referred to as the “Comprehensive Risk Assessment Method”) and consider countermeasures to supplement such shortcomings?

(2) Development and Dissemination of Strategic Objectives

Has the Board of Directors developed strategic objectives covering institution-wide profit objectives, risk-taking strategy (the asset and liability management strategy and the risk-return strategy, etc.) in accordance with the institution’s corporate management policy, and disseminated them throughout the institution? When developing such strategic objectives, does the Board of Directors give due consideration to the asset and liability structure (including off-balance sheet items) and various risks and take into account the status of the institution’s capital? For example, does it pay attention to the following matters?

- Does it make clear whether to aim at minimizing the risk or to aim at making a profit by aggressively taking and managing a certain amount of risk in deciding the levels of risk-taking and profit objectives?
- Does it avoid setting institution-wide and division-specific strategic objectives that sacrifice risk management for profit? In particular, does it avoid setting objectives that pursue short-term profit by disregarding long-term risk or avoid setting a performance appraisal system that reflects such inappropriate objectives?

(3) Development and Dissemination of Comprehensive Risk Management Policy

Has the Board of Directors established a policy regarding comprehensive risk management (hereinafter referred to as the “Comprehensive Risk Management Policy”) and disseminated it throughout the institution? Is the appropriateness of the Comprehensive Risk Management Policy being secured by way of, for example, clear statements on the following matters?

- The roles and responsibilities of the director in charge and the Board of Directors or equivalent organization to the Board of Directors with regard to comprehensive risk management
- The policy on organizational framework, such as establishment of a division concerning comprehensive risk management (hereinafter referred to as the “Comprehensive Risk Management Division”) and the authority assigned thereto
- The policy on organizational framework, such as establishment of an organization that comprehensively manages assets and liabilities and participates in the development and implementation of the strategy regarding Assets, Liabilities and Liquidity, etc. (hereinafter referred to as the “Asset and Liability Management [ALM] Committee”) and the authority assigned thereto
- The policy regarding the setting of risk limits

- The policy regarding identification of risks to be managed
- The policy regarding comprehensive assessment of risks and the monitoring, control and mitigation of the assessed risks
- The policy regarding New Products, etc.¹

(4) Revision of Policy Development Process

Does the Board of Directors revise the policy development process in a timely manner by reviewing its effectiveness based on reports and findings of various investigations on the status of comprehensive risk management in a regular and timely manner or on an as needed basis?

2. Development of Internal Rules and Organizational Frameworks

(1) Development and Dissemination of Internal Rules

Does the Board of Directors or equivalent organization to the Board of Directors have the Manager of the Comprehensive Risk Management Division (hereinafter simply referred to as the “Manager” in this checklist) develop internal rules that clearly specify the arrangements concerning comprehensive risk management (hereinafter referred to as the “Comprehensive Risk Management Rules”) and disseminate them throughout the institution in accordance with the Comprehensive Risk Management Policy? Has the Board of Directors or equivalent organization to the Board of Directors approved the Comprehensive Risk Management Rules after determining if they comply with the Comprehensive Risk Management Policy and after legal checks, etc.?

(2) Establishment of Comprehensive Risk Management Division

- (i) Does the Board of Directors or equivalent organization to the Board of Directors have a Comprehensive Risk Management Division established and have the division prepared to undertake appropriate roles in accordance with the Comprehensive Risk Management Policy and the Comprehensive Risk Management Rules?²
- (ii) Has the Board of Directors allocated to the Comprehensive Risk Management Division a Manager with the necessary knowledge and experience to supervise the division and enabled the Manager to implement management operations by assigning him/her the necessary

¹ See “Checklist for Business Management (Governance) (for Basic Elements),” I. 3. (4).

² When the Comprehensive Risk Management Division is not established as an independent division (e.g., when the division is consolidated with another risk management division to form a single division or when a division in charge of other business also takes charge of comprehensive risk management or when a Manager or Managers take charge of comprehensive risk management instead of a division or a department), the inspector shall review whether or not such a system is sufficiently reasonable and provides the same functions as in the case of establishing an independent division commensurate with the scales and natures of the institution and its risk profile.

authority therefor?

- (iii) Has the Board of Directors or equivalent organization to the Board of Directors allocated to the Comprehensive Risk Management Division an adequate number of staff members who have the necessary knowledge and experience to execute the relevant operations and assigned such staff the authority necessary for conducting the aforementioned operations?³
- (iv) Does the Board of Directors or equivalent organization to the Board of Directors keep the Comprehensive Risk Management Division independent from the Office (Trading, Banking) Divisions, Marketing and Sales Divisions, etc. and secure a check-and-balance system of the Comprehensive Risk Management Division?

(3) Development of Comprehensive Risk Management Systems in Office (Trading, Banking) Divisions, Marketing and Sales Divisions, etc.

- (i) Does the Board of Directors or equivalent organization to the Board of Directors provide a system to fully disseminate the relevant internal rules and operational procedures to the divisions involving risks to be managed (e.g. the Office (Trading, Banking) Divisions, Marketing and Sales Divisions, etc.) and ensure that such divisions observe them? For example, does the Board of Directors or equivalent organization to the Board of Directors instruct the Manager to identify the internal rules and operational procedures that should be observed by the Office (Trading, Banking) Divisions, Marketing and Sales Divisions, etc. and to carry out specific measures for ensuring observance such as providing effective training on a regular basis?
- (ii) Does the Board of Directors or equivalent organization to the Board of Directors provide a system to ensure the effectiveness of comprehensive risk management in the Office (Trading, Banking) Divisions, Marketing and Sales Divisions, etc. through the Manager or the Comprehensive Risk Management Division?

(4) Establishment of ALM Committee, etc.

Does the Board of Directors or equivalent organization to the Board of Directors have an ALM Committee established that comprehensively manages assets and liabilities and participates in the development and implementation of the strategy regarding Assets, Liabilities and Liquidity, etc. or an organization that provides an equivalent function (hereinafter collectively referred to as an “ALM Committee, etc.”) based on the Comprehensive Risk Management Policy? If not, does it have in place an alternative risk management process?

³ When a department or a post other than the Board of Directors or equivalent organization to the Board of Directors is empowered to allocate staff and assign them authority, the inspector shall review, in light of the nature of such a department or post, whether or not the structure of the Comprehensive Risk Management Division is reasonable in terms of a check-and-balance system and other aspects.

(5) System for Reporting to Board of Directors or equivalent organization to Board of Directors and Approval

Has the Board of Directors or equivalent organization to the Board of Directors appropriately specified matters that require reporting and those that require approval and does it have the Manager report the current status to the Board of Directors or equivalent organization to the Board of Directors in a regular and timely manner or on an as needed basis or have the Manager seek the approval of the Board of Directors or equivalent organization to the Board of Directors on the relevant matters? In particular, does it ensure that the Manager reports to the Board of Directors or equivalent organization to the Board of Directors without delay any matters that would seriously affect corporate management?

(6) System for Reporting to Corporate Auditor

In the case that the Board of Directors has specified matters to be directly reported to a corporate auditor, has it specified such matters appropriately and do they provide a system to have the Manager directly report such matters to the auditor?⁴

(7) Development of Internal Audit Guidelines and an Internal Audit Plan

Does the Board of Directors or equivalent organization to the Board of Directors have the Internal Audit Division appropriately identify the matters to be audited with regard to comprehensive risk management, develop guidelines that specify the matters subject to internal audit and the audit procedure (hereinafter referred to as “Internal Audit Guidelines”) and an internal audit plan, and approve such guidelines and plan?⁵ For example, does it have the following matters clearly specified in the Internal Audit Guidelines or the internal audit plan and provide a system to have these matters appropriately audited?

- Status of development of the comprehensive risk management system
- Status of observance of the Comprehensive Risk Management Policy, Comprehensive Risk Management Rules, etc.
- Appropriateness of the comprehensive risk management processes commensurate with the scales and natures of the business and risk profile
- Appropriateness of the use of the comprehensive risk assessment method based on the limitations and the weaknesses thereof
- Appropriateness of the Comprehensive Risk Assessment Method

⁴ It should be noted that this shall not preclude a corporate auditor from voluntarily seeking a report and shall not restrict the authority and activities of the auditor in any way.

⁵ The Board of Directors or equivalent organization to the Board of Directors only needs to have approved the basic matters with regard to an internal audit plan.

- Accuracy and completeness of the data used in comprehensive assessment of risks
- Appropriateness of stress test scenarios, etc.
- Status of improvement of matters pointed out in an internal audit or in the last inspection

(8) Revision of Development Process of Internal Rules and Organizational Frameworks

Does the Board of Directors or equivalent organization to the Board of Directors revise the development process of internal rules and organizational frameworks in a timely manner by reviewing their effectiveness based on reports and findings on the status of comprehensive risk management in a regular and timely manner or on an as needed basis?

3. Assessment and Improvement Activities

1) Analysis and Assessment

(1) Analysis and Assessment of Comprehensive Risk Management

Does the Board of Directors or equivalent organization to the Board of Directors appropriately determine whether there are any weaknesses or problems in the comprehensive risk management system and the particulars thereof, and appropriately examine their causes by precisely analyzing the status of comprehensive risk management and assessing the effectiveness of comprehensive risk management, based on all information available regarding the status of comprehensive risk management, such as the results of audits by corporate auditors, internal audits and external audits, findings of various investigations and reports from various divisions? In addition, if necessary, does it take all possible measures to find the causes by, for example, establishing fact findings committees, etc. consisting of non-interested persons?

(2) Revision of Analysis and Assessment Processes

Does the Board of Directors or equivalent organization to the Board of Directors revise the analysis and assessment processes in a timely manner by reviewing their effectiveness based on reports and findings on the status of comprehensive risk management in a regular and timely manner or on an as needed basis?

2) Improvement Activities

(1) Implementation of Improvements

Does the Board of Directors or equivalent organization to the Board of Directors provide a system to implement improvements in the areas of the problems and weaknesses in the comprehensive risk management system identified through the analysis, assessment and examination referred to in 3. 1) above in a timely and appropriate manner based on the results

obtained by developing and implementing an improvement plan as required or by other appropriate methods?

(2) Progress Status of Improvement Activities

Does the Board of Directors or equivalent organization to the Board of Directors provide a system to follow up on the efforts for improvement in a timely and appropriate manner by reviewing the progress status in a regular and timely manner or on an as needed basis?

(3) Revision of Improvement Process

Does the Board of Directors or equivalent organization to the Board of Directors revise the improvement process in a timely manner by reviewing its effectiveness based on reports and findings on the status of comprehensive risk management in a regular and timely manner or on an as needed basis?

II. Development and Establishment of Comprehensive Risk Management System By Manager

【Checkpoints】

- This chapter lists the check items to be used when the inspector reviews the roles and responsibilities to be performed by the Manager and the Comprehensive Risk Management Division.

- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II., it is necessary to exhaustively examine which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.

- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter 1. are not functioning appropriately and review findings thereof through dialogue.

- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Roles and Responsibilities of Manager

(1) Development and Dissemination of Comprehensive Risk Management Rules

Has the Manager, in accordance with the Comprehensive Risk Management Policy, identified the risks, decided the methods of assessment and monitoring thereof and developed the Comprehensive Risk Management Rules that clearly define the arrangements on risk control and mitigation, based on a full understanding of the scope, types and nature of the risk and the relevant comprehensive risk management technique?

Have the Comprehensive Risk Management Rules been disseminated throughout the institution upon approval by the Board of Directors or equivalent organization to the Board of Directors?

(2) Comprehensive Risk Management Rules

Do the Comprehensive Risk Management Rules exhaustively cover the arrangements necessary for comprehensive risk management and specify the arrangements appropriately in a manner befitting the scales and natures of the financial institution's business and its risk profile? Do the rules specify the following items, for example:

- Arrangements on the roles, responsibilities, and organizational framework of the Comprehensive Risk Management Division
- Arrangements on the risk limits
- Arrangements on the identification of risks to be subjected to comprehensive risk management
- Arrangements on the comprehensive risk assessment method and assessment methods used for the each risk areas
- Arrangements on the comprehensive risk monitoring method
- Arrangements on periodic reviews of the comprehensive risk assessment method
- Arrangements on approval process for New Products, etc.
- Arrangements on reporting to the Board of Directors or equivalent organization to the Board of Directors

(3) Development of Organizational Frameworks by Manager

- (i) Does the Manager, in accordance with the Comprehensive Risk Management Policy and the Comprehensive Risk Management Rules, provide for measures to have the Comprehensive Risk Management Division exercise a check-and-balance system in order to conduct comprehensive risk management appropriately?
- (ii) Does the Manager provide a system to prevent any lapse in the risk management for the financial institution as a whole so as to ensure an appropriate comprehensive risk management? Does the Manager ensure that the Manager of each risk management division promptly reports to the Comprehensive Risk Management Division when detecting any weakness or problem that may affect comprehensive risk management?
- (iii) Does the Manager ensure that on a risk category-by-category basis, each risk management division identifies risks inherent in New Products as specified in the Comprehensive Risk Management Policy and the Comprehensive Risk Management Rules and reports them for the purpose of the screening of New Products?⁶
- (iv) Does the Manager understand the limitations and weaknesses of the comprehensive risk assessment method and provide a system to make risk management more sophisticated in a manner commensurate with the scales and natures of the financial institution's business and its risk profile?⁷
- (v) Does the Manager have in place a comprehensive risk management computer system⁸ with

⁶ See "Checklist for Business Management (Governance) (for Basic Elements)," Chapter I. 3. (4)

⁷ It should be noted that sophistication of risk management includes not only expansion of scope of risk measurement and improvement in precision and other aspects of risk management but also enhancement of measures to complement the limits and weaknesses of the management and the technique of utilizing measurement results.

⁸ It should be noted that the computer system may be a centralized dataprocessing environment system, distribution processing system, or EUC (end user computing) type. The same shall apply hereafter.

the high reliability suited to the scales and natures of the financial institution's business and its risk profile?

- (vi) Does the Manager ensure the provision of training and education systems to enhance the ability of employees to conduct comprehensive risk management in an effective manner, thus developing human resources with relevant expertise?
- (vii) Does the Manager provide a system to ensure that matters specified by the Board of Directors or equivalent organization to the Board of Directors are reported in a regular and timely manner or on an as needed basis? In particular, does the Manager provide a system to ensure that matters that would seriously affect corporate management are reported to the Board of Directors or equivalent organization to the Board of Directors without delay?

(4) Revision of Comprehensive Risk Management Rules and Organizational Frameworks

Does the Manager conduct monitoring on an ongoing basis with regard to the status of the execution of operations at the Comprehensive Risk Management Division?

Does the Manager review the effectiveness of the comprehensive risk management system in a regular and timely manner or on an as needed basis, and, as necessary, revise the Comprehensive Risk Management Rules and the relevant organizational framework, or present the Board of Directors or equivalent organization to the Board of Directors with proposals for improvement?

2. Roles and Responsibilities of Comprehensive Risk Management Division

1) Risk Identification and Assessment

(1) Identification of Risks to Be Managed

- (i) Does the Comprehensive Risk Management Division have each Risk Management Division exhaustively identify all risks faced by the bank on a category-by-category basis and identify the risks to be subjected to comprehensive risk management commensurate with the size and nature of the identified risks? Does the Manager ensure that the identification process covers the full scope of business including those of overseas offices, consolidated subsidiaries and consignees, in addition to exhaustively covering the risk categories such as credit risk, market risk and operational risk?
- (ii) Does the Comprehensive Risk Management Division apply comprehensive risk management to the credit concentration risk and the interest rate risk in the banking book and is it considering whether to apply comprehensive risk management to the risks not included in the calculation of the capital adequacy ratio? When there are risks not covered by comprehensive risk management, has the Comprehensive Risk Management Division determined whether their effects are negligible?

- (iii) With regard to New Products as specified by the Comprehensive Risk Management Policy and the Comprehensive Risk Management Rules, does the Comprehensive Risk Management Division identify their inherent risks in advance through each risk management division and report to the new product committee, etc. in a timely manner?⁹

(2) Assessment of Various Risks

- (i) When some risks to be controlled through comprehensive risk management cannot be quantified, does the Comprehensive Risk Management Division appropriately assess them by conducting graded assessment of their effects and self-assessment of the levels of management and control to the scope achievable? Or does the Comprehensive Risk Management Division have each risk management division provide necessary information concerning the specific risk areas to be managed in an appropriate and timely manner in such a case?
- (ii) Does the Comprehensive Risk Management Division determine the validity of the risk assessment and measurement techniques used by the Risk Management Divisions and the assumptions thereof? Or does it make sure that each risk management division examines the validity of the techniques and assumptions? Does it determine the following items, for example?:
- Are the treatment of core deposits and the technique of measuring the optionality inherent in assets and liabilities (nonlinear risks such as the risks of early termination and early redemption) appropriate when measuring the interest rate risk in the banking book?
 - When the scenario approach is employed in measuring risk, are the scenarios used appropriate?
 - When VaR, a uniform yardstick for measuring risk, is employed, are the measuring techniques, the holding periods and the confidence levels applied in a manner befitting the financial institution's strategic objectives and risk profile?
 - When the integrated risk measurement technique is employed, is consistency between the employed measurement techniques ensured?

(3) Comprehensive Assessment of Risks

- (i) Does the Comprehensive Risk Management Division comprehensively assess and measure risks including those existing at sales branches, etc.¹⁰ consolidated subsidiaries and subcontractors with important operations?
- (ii) Does the Comprehensive Risk Management Division comprehensively assess and measure the various risks to be controlled through comprehensive risk management? When the various

⁹ See "Checklist for Business Management (Governance) (for Basic Elements)," I. 3. (4).

¹⁰ Sales branches and overseas offices

risks to be thus managed are integrated, is the integration method appropriate? When the integrated risk measurement technique is used, are the various risks integrated in light of the check items listed in Chapter III. 1. 3) (1) of this checklist?

- (iii) Does the Comprehensive Risk Management Division comprehensively assess and measure risks based on stress scenarios that cover incidents capable of having serious effects on the financial institution?

2) Monitoring

(1) Comprehensive Monitoring of Overall Risks

Does the Comprehensive Risk Management Division, in accordance with the Comprehensive Risk Management Policy and the Comprehensive Risk Management Rules, conduct monitoring with regard to the status of overall risks comprehensively and with an appropriate frequency in light of the financial institution's internal environment (risk profile, the status of the use of risk limits, etc.) and external environment (economic cycles, markets, etc.)? Does the division conduct monitoring with regard to the status of internal and external environments and the appropriateness of the assumptions?

(2) Monitoring of Compliance with Risk Limits

Does the Comprehensive Risk Management Division regularly monitor the status of compliance with the risk limits and the risk capital limits (in the case where capital allocation management is employed) and the status of the use thereof?

(3) Reporting to Board of Directors or equivalent organization to Board of Directors

Does the Comprehensive Risk Management Division, in accordance with the Comprehensive Risk Management Policy and the Comprehensive Risk Management Rules, provide in a regular and timely manner or on an as needed basis information necessary for the Board of Directors or equivalent organization to the Board of Directors to make an appropriate assessment and judgment with regard to the status of the comprehensive risk management and the status of the risks assessed comprehensively? Does the division report the following items, for example?

- The risk profile and the trend thereof
- The status of compliance with the risk limits and the risk capital limits (in the case where capital allocation management is employed) and the status of the usage thereof
- The status of external environment such as economic cycles
- The validity of the comprehensive risk assessment methods and the limitations and weaknesses thereof

(4) Coordination with the Capital Management Division

Does the Comprehensive Risk Management Division communicate, in a timely and appropriate manner, information determined as necessary by the Capital Management Divisions such as data on the status of risks, the status of compliance with the risk limits and the risk capital limits (in the case where capital allocation management is employed) and the status of the use thereof as well as the validity of the risk assessment and measurement techniques and the assumptions thereof?

(5) Feedback to Risk Management Divisions

Does the Comprehensive Risk Management Division feed back the results of its assessment, analysis and review with regard to the status of risks to each risk management division as necessary?

3) Control and Mitigation

(1) Response to Case Where Unmanageable Risks Exist

In the case where risks not covered by comprehensive risk management have non-negligible effects or where risks to be controlled through comprehensive risk management cannot be managed appropriately, does the Comprehensive Risk Management Division provide information necessary for the Board of Directors or equivalent organization to the Board of Directors to make decisions as to whether the financial institution should withdraw from or downsize the business affected by those risks?

(2) Handling with the Case Where Risk Limits are Exceeded

In the case where the financial institution has exceeded the risk limits or the risk capital limits (in the case where capital allocation management is employed), does the Comprehensive Risk Management Division provide information necessary for the Board of Directors or equivalent organization to the Board of Directors without delay to make decisions as to whether to take steps to mitigate risks or alter the limits?

4) Review and Revision

(1) Sophistication of Risk Management

Does the Comprehensive Risk Management Division conduct a review to grasp the limitations and weaknesses of the comprehensive risk assessment method and devise countermeasures to complement the method? Does it conduct investigations, analysis and consideration commensurate with those limitations and weaknesses with a view to making risk management more sophisticated commensurate with the risk profile?

(2) Review and Revision of Comprehensive Risk Management Method

Does the Comprehensive Risk Management Division grasp the limitations and weaknesses of the comprehensive risk assessment method as well as changes in the internal and external environments, and regularly review whether the method suits the institution-wide strategic objectives, the scales and natures of the business in question and the risk profile of the financial institution in its entirety, and revise the method? Does the division review and revise the following items, for example:

- Validity of the identification of risks to be subjected to comprehensive risk management
- Validity of the comprehensive risk assessment method
- Appropriateness of the operation of the comprehensive risk assessment method commensurate with its limitations and weaknesses

III. Specific Issues

【Checkpoints】

- This chapter lists the check items to be used in the inspection of financial institutions that employ the “integrated risk measurement technique” which measures various risks with uniform yardsticks such as VaR and measures the aggregated risks.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter III., it is necessary to exhaustively examine which of the elements listed in Chapters I. and II. are absent or insufficient, thus causing the said problem, with the use of the checklists in those chapters, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution’s management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter 1. are not functioning appropriately and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Check Items to Be Used When Integrated Risk Measurement Technique Is Employed

1) Establishment of Integrated Risk Measurement System

- (i) Is the integrated risk measurement system conceptually sound and has it been properly implemented?
- (ii) Is the role of the integrated risk measurement technique (model) clearly positioned under the Comprehensive Risk Management Policy and operated based on the understanding of the items listed below? Does it determine if there is no problem with the application of the technique to consolidated subsidiaries?
 - (a) The financial institution’s strategic objectives, the scales and natures of its business and its risk profile
 - (b) The fundamental design concept of the integrated risk measurement technique based on (a)
 - (c) Identification and measurement of risks based on (b) (scope, technique, assumptions, etc.)
 - (d) Nature (limitations and weaknesses) of the integrated risk measurement technique that derive from (c) and the validity of the technique
 - (e) Details of the method of validating with respect to (d)

- (iii) In the case where capital allocation management¹¹ is employed, has the policy of capital allocation management been developed based on the results calculated by way of the integrated risk measurement technique? When there are risks which are not measured with this technique are there any reasonable grounds for excluding them from the measurement? Is the risk capital allocated with due consideration for the risks excluded from the measurement?

2) Appropriate Involvement of Directors and Corporate Auditors

(1) Understanding of Integrated Risk Measurement Technique

- (i) Do directors understand that decisions concerning the integrated risk measurement technique as well as the risk limits and the risk capital limits (in the case where capital allocation management is employed) have serious implications for the financial institution's corporate management and financial conditions?
- (ii) Does the director in charge of integrated risk management understand the integrated risk management technique required for the business of the financial institution and have a grasp on the nature (limitations and weaknesses) thereof?
- (iii) Do directors and corporate auditors seek to enhance their understanding of the integrated risk management technique by participating in training courses or through other means?

(2) Approach to Integrated Risk Management

Do directors involve themselves actively in integrated risk management based on the integrated risk measurement technique?

3) Integrated Risks Measurement

(1) Appropriateness of Measurement Technique

- (i) With regard to the various risk measurement techniques used by the Comprehensive Risk Management Division, is the validity of each of them ensured, and is consistency among those techniques secured with a view to measuring risks appropriately in an integrated manner?
- (ii) Are the assumptions that underlie the risk measurement conducted by the Comprehensive Risk Management Division reasonable in light of the strategic objectives and the risk profile?
- (iii) Is the technique used by the Comprehensive Risk Management Division to aggregate various risks with different risk nature and loss distributions appropriate? When correlations among various risks (distribution effect) are taken into consideration, does the division regularly validate the correlations?

(2) Ongoing Validation and Stress Test

¹¹ See "Checklist for Capital Management."

- (i) Does the Comprehensive Risk Management Division regularly analyze the appropriateness of the measuring techniques through ongoing validation (back testing, etc.)? Are revisions of the measuring techniques conducted in accordance with the internal rules?
- (ii) Does the Comprehensive Risk Management Division grasp the stress status of various risks individually and the risks as a whole through stress tests based on a comprehensive and appropriate stress scenarios and make appropriate use of the test results?

(3) Systems for Validating and Managing the Integrated Risk Measurement Technique

Were the integrated risk measurement technique and the assumptions thereof validated during the development of the technique and thereafter on a regular basis by a person or persons with no involvement in the development and with sufficient capabilities? If any deficiency is recognized in the integrated risk measurement technique or the assumptions thereof, is a corrective action taken appropriately?

Are there frameworks and internal rules to prevent the integrated risk measurement technique and the assumptions thereof from being altered on unreasonable grounds, and is the integrated risk measurement technique managed appropriately in accordance with the internal rules?

4) Records on Integrated Risk Measurement Technique

Are systems developed for the purpose of keeping records for future reference on the review process with regard to the selection of the integrated risk measurement technique and the assumptions thereof and the grounds for the selection process in order to enable follow-up verification and utilize the records to make the measurement more sophisticated and elaborated?

5) Audits

(1) Development of Auditing Program

Is an auditing program that exhaustively covers the auditing of the integrated risk measurement technique in place?

(2) Scope of Internal Audits

Is auditing conducted to check the following items?

- Consistency of the integrated risk measurement technique with the strategic objectives, the scales and natures of business and the risk profile
- Appropriateness of the business in light of the nature (limitations and weaknesses) of the integrated risk measurement technique
- Records on the integrated risk measurement technique are appropriately documented and updated in a timely manner

- Appropriate incorporation of alterations to the process of integrated risk management into the risk measurement technique
- Appropriateness of the scope of the risks measured by the integrated measurement technique
- Absence of any deficiency in the information system for the management
- Validity of the integrated risk measurement technique and the assumptions thereof
- Validity of the method of aggregating various risks
- Accuracy and completeness of the data used in integrated risk measurement
- Adequacy of the process and results of ongoing verification (backtesting, etc.)

(3) Utilization of Auditing Results

Does the Comprehensive Risk Management Division appropriately revise the integrated risk measurement technique based on the results of auditing?

6) Utilization of Management Indicators with Due Consideration for Risks

Does the Comprehensive Risk Management Division utilize management indicators such as return on equity not only for the purpose of grasping performance but also for that of enhancing risk management? ¹²When management indicators are utilized, are they used to review the reasonableness of the risk-return strategy, etc. and help formulate strategies?

¹² It should be noted that the level of utilization of return on equity and other management indicators varies according to the corporate management policy, strategic objectives, etc.

Checklist for Capital Management

I. Development and Establishment of Capital Management System by Management

【Checkpoints】

- Capital management refers to implementing measures to maintain sufficient capital, assessing its internal capital adequacy and calculating the capital adequacy ratio.

- It is extremely important for a financial institution to calculate the capital adequacy ratio and secure sufficient capital to cover risks it faces by developing and establishing a capital management system, from the viewpoint of ensuring the soundness and appropriateness of the institution's business. Therefore, the institution's management is charged with and responsible for taking the initiative in developing and establishing such a system.

- There are various capital management methods according to corporate management policies and other factors. In some cases, there may be two or more sets of policies and internal rules with regard to capital management, and the necessary tasks may be divided between two or more divisions because of the diversity of the tasks, including development and implementation of capital plans, assessment of capital adequacy, calculation of the capital adequacy ratio and capital allocation processes. In other cases, the Comprehensive Risk Management Division may concurrently undertake the task of capital management. The purpose of this manual is not to require the establishment of an independent division in charge of capital management, or to seek to bar a financial institution from having two or more divisions conduct capital management operations in accordance with their respective policies and internal rules as mentioned above.

In the case where two or more divisions engage in capital management in coordination with each other, the inspector should review whether the policies and internal rules adopted by the divisions and the tasks undertaken by them are compatible with one another and whether their respective capital management processes are functioning effectively. In the case where the Comprehensive Risk Management Division undertakes the task of internal capital adequacy assessment, review should be conducted by using both the check items concerning internal capital adequacy assessment as part of the capital management system and those concerning the comprehensive risk management system, and any problem with regard to capital adequacy should be examined as the issue of capital management system.

- It is important for the inspector to review whether a financial institution has a capital management system suited to the levels of complexity and sophistication of the internal capital adequacy assessment processes used by the institution. It should be noted that the type and level of the process of internal capital adequacy assessment to be used by a financial institution should be determined according to the institution's corporate management policy, the diversity of its business and the level of complexity of the risks faced by it, and therefore a complex or sophisticated

process of internal capital adequacy assessment is not necessarily suited to all financial institutions.

- The inspector should determine whether the capital management system is functioning effectively and whether the roles and responsibilities of the institution's management are being appropriately performed by way of reviewing with the use of check items listed in Chapter I., whether or not the management is appropriately implementing (1) policy development, (2) development of internal rules and organizational frameworks and (3) development of a system for assessment and improvement activities.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II. and later, it is necessary to exhaustively examine which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize weaknesses or problems recognized by the inspector, it is also necessary to explore in particular the possibility that the Internal Control System is not functioning effectively and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Policy Development

(1) Roles and Responsibilities of Directors

Do directors attach importance to capital management, fully recognizing that the lack of such an approach could seriously hinder attainment of strategic objectives? In particular, does the director in charge of capital management review the policy and specific measures for developing and establishing an adequate capital management system with a full understanding of the assessment, monitoring and control techniques of internal capital adequacy as well as the importance of capital management, and with precise recognition of the current status of capital management based on such understanding? For example, do directors in charge understand the limitations and weaknesses of methods of the internal capital adequacy assessment and consider ways to supplement such shortcomings?

(2) Development and Dissemination of Capital Management Policy

Has the Board of Directors established a policy regarding capital management (hereinafter referred to as the “Capital management Policy”) and disseminated it throughout the institution? Is the appropriateness of the Capital Management Policy being secured by way of, for example, including clear statements on the following matters?¹

- The roles and responsibilities of the director in charge and the Board of Directors or equivalent organization to the Board of Directors with regard to capital management
- The basic policy for maintaining sufficient capital
- The policy on organizational frameworks, such as establishment of a division concerning capital management (hereinafter referred to as the “Capital Management Division”) and the authority assigned thereto
- The policy on the risk limits in relation to the capital
- The definition of capital and risk as used in the internal capital adequacy assessment
- The policy on the assessment, monitoring and control of internal capital adequacy
- The policy on the calculation of the capital adequacy ratio
- The policy on capital allocation process (in the case where capital allocation process is conducted)

(3) Development and Dissemination of Corporate Management Plans

Has the Board of Directors developed corporate management plans in accordance with the corporate management policy and disseminated them throughout the institution? When developing corporate management plans, does the Board of Directors analyze how much capital the institution needs presently and will need in the future in light of the institution’s strategic objectives and take into consideration the desirable level of capital thus determined, the amount of capital that must be raised to achieve that level and suitable capital-raising methods? With regard to the capital level objectives, does the Board of Directors ensure its consistency with the institution’s risk profile and the situation surrounding its business?

(4) Development of Capital Plans, etc.

Has the Board of Directors, in accordance with the financial institution’s corporate management plans, its strategic objectives, the strategic objectives of various divisions and the Capital Management Policy, developed capital plans, etc. designed to achieve an appropriate level of capital targeted by the institution? In the case where capital allocation process is conducted, do the capital plans, etc. clearly specify the basis for the calculation of capital to be allocated to risk (hereinafter referred to as the “Risk Capital”) and the limits on capital to be allocated to each of

¹ It is not necessary to develop a unified capital management policy that exhaustively covers all items that must be clearly specified, but it should suffice that all such items are covered by two or more policies established by divisions engaged in capital management and corporate management plans.

the risk categories?

(5) Revision of Policy Development Process

Does the Board of Directors revise the policy development process in a timely manner by reviewing its effectiveness based on reports and findings on the status of capital management in a regular and timely manner or on an as needed basis?

2. Development of Internal Rules and Organizational Frameworks

(1) Development and Dissemination of Internal Rules

Does the Board of Directors or equivalent organization to the Board of Directors have the Managers of the Capital Management Division (hereinafter simply referred to as the “Manager” in this checklist) develop internal rules that clearly specify the arrangements concerning capital management (hereinafter referred to as the Capital Management Rules) , and disseminate them to the employees concerned in accordance with the Capital Management Policy? Has the Board of Directors or equivalent organization to the Board of Directors approved the Capital Management Rules after determining if they comply with the Capital Management Policy after legal checks, etc.?

(2) Definition of Capital as Used in Internal Capital Adequacy Assessment

Does the Board of Directors or equivalent organization to the Board of Directors clearly define capital as used in the internal capital adequacy assessment? Does it ensure the consistency of the definition of capital used in the internal capital adequacy assessment and the financial institution’s corporate management policy and plans, its strategic objectives, etc. in light of the fact that building up capital means preparing for potential losses? Does the Board of Directors or equivalent organization to the Board of Directors make clear the basis for determining the definition of capital as used in the internal capital adequacy assessment in reference to its relation to capital, etc. as defined under regulations concerning capital adequacy ratios.?

(3) Establishment of Capital Management Division

1) Does the Board of Directors or equivalent organization to the Board of Directors have the Capital Management Division established and have the division prepared to undertake appropriate roles in accordance with the Capital Management Policy and the Capital Management Rules?²

² When the Capital Management Division is not established as an independent division (e.g., when the division is consolidated with other risk management division to form a single division or when a division in charge of other business also takes charge of capital management or when a Manager or Managers take charge of capital

- 2) Has the Board of Directors allocated to the Capital Management Division a Manager with the necessary knowledge and experience to supervise the division and enabled the Manager to implement management business by assigning him/her the necessary authority therefor?
- 3) Has the Board of Directors or equivalent organization to the Board of Directors allocated to the Capital Management Division an adequate number of staff members with the necessary knowledge and experience to execute the relevant business and assigned such staff the authority necessary for implementing the business?³
- 4) Does the Board of Directors or equivalent organization to the Board of Directors keep the Capital Management Division in charge of the internal capital adequacy assessment and the calculation of the capital adequacy ratio independent from the Office (Trading, Banking) Divisions and the Marketing and Sales Division and secure a check-and-balance system?

(4) Disclosure

Does the Board of Directors or equivalent organization to the Board of Directors provide a system to disclose the information concerning capital adequacy as specified by Laws (including but not limited to laws and regulations, etc.; hereinafter referred to “Laws.”) in a timely and appropriate manner based on a full understanding of the purpose thereof?

(5) The System for Reporting to Board of Directors and equivalent organizations to Board of Directors and Approval

Has the Board of Directors appropriately specified matters that require reporting and those that require approval and does it have the Manager report the current status to the Board of Directors and the Board of Directors or equivalent organization to the Board of Directors in a regular and timely manner or on an as needed basis or have the Manager seek the approval of the Board of Directors and equivalent organization to the Board of Directors on the relevant matters? For example, do the matters to enable the appropriate assessment and judgment of the matters listed below? In particular, does the Board of Directors ensure that the Manager, without delay, reports to the Board of Directors any matters that would seriously affect corporate management?

- The levels and trends of major risks and their impact on the capital
- Validity of the internal capital adequacy assessment process (including the definition of capital and the methods of determining the range of risks to be covered by capital

management instead of a division or a department), the inspector shall review whether or not such a system is sufficiently reasonable and provides the same functions as in the case of establishing an independent division commensurate with the scales and natures of the institution and its risk profile.

³ When a department or a post other than the Board of Directors or equivalent organization to the Board of Directors is empowered to allocate staff and assign them authority, the inspector shall review, in light of the nature of such a department or post, whether or not the structure of the Capital Management Division is reasonable in terms of a check-and-balance system and other aspects.

- management and evaluating such risks)
- Status of internal capital adequacy in light of the scales and natures of the financial institution's business and its risk profile
 - Consistency among the capital level objective and the institution's risk profile and the situation surrounding its business
 - Necessity for revising capital plans, etc.

(6) The System for Reporting to Corporate Auditor

In the case where the Board of Directors has specified matters to be directly reported to a corporate auditor, has it specified such matters appropriately and do they provide a system to have the Manager directly report such matters to the auditor? ⁴

(7) Development of Internal Audit Guidelines and an Internal Audit Plan

Does the Board of Directors or equivalent organization to the Board of Directors have the Internal Audit Division appropriately identify the matters to be audited with regard to capital management, develop guidelines that specify the matters subject to internal audit and the audit procedure (hereinafter referred to as "Internal Audit Guidelines") and an internal audit plan, and approve such guidelines and plan?⁵ For example, does it have the following matters clearly specified in the Internal Audit Guidelines or the internal audit plan and provide a system to have these matters appropriately audited?

- Status of development of the capital management system
- Eligibility of the institution's capital under regulations on capital requirements in light of the purposes of "Criteria for Judging Whether A Financial Institution's Own Capital Is Sufficient in Light of the Assets Held, etc. under the Provision of Article 14-2 of the Banking Law" (Notification No. 19 of 2006, the Financial Services Agency; hereinafter referred to as the "Notification") and the Basel Accord
- Status of compliance with the Capital Management Policy and the Capital Management Rules, etc.
- Appropriateness of the internal capital adequacy assessment process commensurate with the scales and natures of business and the risk profile
- Appropriateness of the use of the internal capital adequacy assessment method taken in consideration of the limitations and the weaknesses thereof
- Validity of the internal capital adequacy assessment method (technique, assumptions), etc.

⁴ It should be noted that this shall not preclude a corporate auditor from voluntarily seeking a report and shall not restrict the authority and activities of the auditor in any way.

⁵ The Board of Directors or equivalent organization to the Board of Directors only needs to have approved the basic matters with regard to an internal audit plan.

- Accuracy and completeness of the data used in the internal capital adequacy assessment
- Validity of scenarios, etc. used in stress tests
- Appropriateness of the process of calculating the capital adequacy ratio
- Status of improvement of matters pointed out in an internal audit or on the occasion of the last inspection

(8) Revision of the Development Process of Internal Rules and Organizational Frameworks

Does the Board of Directors or equivalent organization to the Board of Directors revise the development process of internal rules and organizational frameworks in a timely manner by reviewing their effectiveness based on reports and findings on the status of capital management in a regular and timely manner or on an as needed basis?

3. Assessment and Improvement Activities

(1) Analysis and Assessment

1) Analysis and Assessment of Capital Management

Does the Board of Directors or equivalent organization to the Board of Directors appropriately determine whether there are any weaknesses or problems in the capital management system and the particulars thereof, and appropriately review their causes by precisely analyzing the status of capital management and assessing the effectiveness of capital management, based on all the information available regarding the status of capital management, such as the results of audits by corporate auditors, internal audits and external audits, findings of various investigations and reports from various divisions? In addition, if necessary, does it take all possible measures to find the causes by, for example, establishing fact findings committees, etc. consisting of non-interested persons?

2) Revision of Analysis and Assessment Processes

Does the Board of Directors or equivalent organization to the Board of Directors revise the analysis and assessment processes in a timely manner by reviewing their effectiveness based on reports and findings on the status of capital management in a regular and timely manner or on an as needed basis?

(2) Improvement Activities

1) Implementation of Improvements

Does the Board of Directors or equivalent organization to the Board of Directors provide a system to implement improvements in the areas of the problems and weaknesses in the capital

management system identified through the analysis, assessment and review referred to in 3. (1) above in a timely and appropriate manner based on the results obtained by developing and implementing an improvement plan as required or by other appropriate methods?

2) Progress Status of Improvement Activities

Does the Board of Directors or equivalent organization to the Board of Directors provide a system to follow up on the efforts for improvement in a timely and appropriate manner by reviewing the progress status in a regular and timely manner or on an as needed basis?

3) Revision of the Improvement Process

Does the Board of Directors or equivalent organization to the Board of Directors revise the improvement process in a timely manner by reviewing its effectiveness based on reports and findings on the status of capital management in a regular and timely manner or on an as needed basis?

II. Development and Establishment of Capital Management System by Manager

【Checkpoints】

- This chapter lists the check items to be used when the inspector reviews the roles and responsibilities that must be performed by the Manager and the Capital Management Division.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II., it is necessary to exhaustively examine which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter I. are not functioning appropriately and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Roles and Responsibilities of Manager

(1) Development and Dissemination of Capital Management Rules

Has the Manager, in accordance with the corporate management plans, capital plans, etc. and the Capital Management Policy, decided the internal capital adequacy assessment process and the method of monitoring thereof and developed the Capital Management Rules, based on a full understanding of the scales and natures of the financial institution's business and its risk profile as well as the capital management technique? Have the Capital Management Rules been disseminated to all of the relevant employees upon approval by the Board of Directors or equivalent organization to the Board of Directors?

(2) Capital Management Rules

Do the Capital Management Rules exhaustively cover the arrangements necessary for the internal capital adequacy assessment and the calculation of the capital adequacy ratio and specify the arrangements appropriately in a manner befitting the scales and natures of the financial

institution's business and its risk profile? Do the rules specify the following items, for example?⁶

- Arrangements on the roles, responsibilities and organizational framework of the Capital Management Division
- Arrangements on the establishment of Risk Capital limits (in the case where capital allocation process is conducted)
- Arrangements on the identification of risks subject to capital management in the internal capital adequacy assessment and the method of risk assessment
- Arrangements on the internal capital adequacy assessment method
- Arrangements on the monitoring method of capital adequacy
- Arrangements on periodic reviews of the internal capital adequacy assessment method
- Arrangements on the process of calculating the capital adequacy ratio
- Arrangements on the allocation of capital with regard to New Products⁷ (in the case where capital allocation process is conducted)
- Arrangements on reporting to the Board of Directors or equivalent organization to the Board of Directors

(3) Development of Organizational Frameworks by Manager

- 1) Does the Manager, in accordance with corporate management plans, capital plans, the Capital Management Policy and the Capital Management Rules, provide for measures to have the Capital Management Division exercise a check-and-balance system in order to conduct the system of capital management appropriately?
- 2) Has the Manager specified the information necessary for conducting an appropriate capital management befitting the financial institution's risk profile, and does he or she make sure to receive reports from divisions which hold the necessary information in a regular and timely manner or on an as needed basis? Does the Manager receive reports with regard to the following items, for example, in a timely and appropriately manner?
 - Status of risks
 - Status of compliance with the risk limits and use thereof
 - Status of compliance with the Risk Capital limits and use thereof (in the case where capital allocation is conducted)
 - Status of profits
 - Validity of the risk assessment method (assessment and measurement technique, assumptions, etc.)

⁶ It is not necessary to develop a unified set of capital management rules that exhaustively covers all items that must be clearly specified, but it should suffice that all such items are covered by two or more sets of internal rules established by divisions engaged in capital management.

⁷ See "Checklist for Business Management (Governance) (for Basic Elements)," I. 3. (4).

- 3) Has the Manager, for the purpose of calculating the capital adequacy ratio accurately, established a manual, etc. that specifies the calculation process, and does he or she provide a system to obtain accurate raw data for calculation?
- 4) Does the Manager have in place computer systems⁸ for the internal capital adequacy assessment and the calculation of the capital adequacy ratio with the high reliability suited to the scales and natures of the financial institution's business and its risk profile?
- 5) Does the Manager ensure the provision of training and education to enhance the ability of employees to conduct capital management in an effective manner, thus developing human resources with relevant expertise?
- 6) Does the Manager provide a system to ensure that matters specified by the Board of Directors are reported in a regular and timely manner or on an as needed basis? In particular, does the Manager provide a system to ensure that matters that would seriously affect corporate management are reported to the Board of Directors without delay?

(4) Revision of Capital Management Rules and Organizational Frameworks

Does the Manager conduct monitoring on an ongoing basis with regard to the status of the execution of operations at the Capital Management Division? Does the Manager review the effectiveness of the capital management system in a regular and timely manner or on an as needed basis, and, as necessary, revise the Capital Management Rules and the relevant organizational framework, or present the Board of Directors or equivalent organization to the Board of Directors with proposals for improvement?

2. Roles and Responsibilities of Capital Management Division

(1) Implementation of Measures for Capital Adequacy

1) Implementation of Measures and Monitoring for Capital Adequacy

- (i) Does the Capital Management Division smoothly implement measures for capital adequacy in accordance with corporate management plans and capital plans, etc.?
- (ii) Does the Capital Management Division monitor changes in external environment, including the economic cycle from the viewpoint of smoothly implementing measures for capital adequacy?

2) Maintenance of Capital Level

- (i) Does the Capital Management Division conduct sufficient analysis and deliberations in order to

⁸ It should be noted that the computer system may be a centralized data processing environment system, distribution processing system, or EUC (end user computing) type.

maintain a sufficient level of capital based on the results of monitoring of the status of internal environment (risk profile, status of use of the risk limits, etc.) and external environment (economic cycle, market, etc.) as well as the validity of the assumptions?

- (ii) Does the Capital Management Division assume the possibility of the institution failing to make a sufficient capital adequacy and examine feasible countermeasures to build up the capital base? Does the division conduct such an examination by taking into consideration the possibility in particular that a reputational risk will make it more difficult for the institution to raise capital than under normal conditions?

(2) Internal Capital Adequacy Assessment

1) Identification of Risks Subject to Capital Management in the Internal Capital Adequacy Assessment

- (i) In the case where the Capital Management Division is in charge of risk identification, does the division identify risks faced by the institution exhaustively on a category-by-category basis and specify the risks to be subjected to capital management in the internal capital adequacy assessment in light of the size and nature of the identified risks? Does the Manager ensure that the identification process covers the full extent of business including those of overseas offices, consolidated subsidiaries and consignees, in addition to exhaustively covering the risk categories such as the credit risk, market risk and operational risk?
- (ii) Does the Capital Management Division apply capital management to the credit concentration risk and the interest rate risk in the banking book in the internal capital adequacy assessment and is it considering whether to apply capital management to the risks not included in the calculation of the capital adequacy ratio? When there are risks not covered by capital management in the internal capital adequacy assessment, has the Capital Management Division made sure that their impact is negligible?

2) Risk Assessment Method in Internal Capital Adequacy Assessment

In the case where the Capital Management Division is in charge of risk assessment, does the division assess risks appropriately in internal capital adequacy assessment with a risk assessment method befitting the scales and natures of the financial institution's business and its risk profile? Does the division review the validity of the risk assessment and measurement techniques and the assumptions thereof, etc.? Does it review the following items, for example?

- Are the treatment of core deposits and the technique of measuring optional risks involved in assets and liabilities (nonlinear risks such as the risks of early termination and early redemption) appropriate when measuring the interest rate risk related to the banking book?

- When the scenario method is used to measure the risk quantity, is the scenario used appropriate?
- When VaR, a uniform yardstick to measure the risk quantity is employed, are the measuring technique, the holding period and the confidence level applied suited to the financial institution's strategic objectives and risk profile?
- When the comprehensive risk measurement technique is employed, is consistency among various measurement techniques used ensured and is the method of adding up various risks reasonable?

3) Internal Capital Adequacy Assessment

Does the Capital Management Division assess capital adequacy in a manner befitting the scales and natures of the financial institution's business and its risk profile? Does it take into consideration the following items, for example?

- Is the quality of capital suited to the internal capital adequacy assessment?
- Are the method of internal capital adequacy assessment and risk assessment valid?
- Are limitations and weaknesses of the risk assessment method taken into consideration?
- Is the internal capital adequacy assessment conducted in light of two or more stress scenarios and based on the analysis of the level of the impact thereof on the capital? Do the stress scenarios give due consideration to all material risks that would seriously affect capital adequacy?
- Is the internal capital adequacy assessment conducted from medium- and long-term perspectives?
- Is a lack or excess of loan loss provisions against expected losses taken into consideration?
- In the case where losses are realized, are they taken into consideration in the internal capital adequacy assessment?
- In the case where a decline in earnings is expected to lead to losses, is the risk of changes in earnings taken into account?

(3) Monitoring

1) Monitoring of Capital Adequacy

Does the Capital Management Division, in accordance with the Capital Management Policy and the Capital Management Rules, conduct monitoring with regard to the status of capital adequacy with an appropriate frequency in light of the financial institution's internal environment (risk profile, the status of the use of risk limits, etc.) and external environment (economic cycle, markets, etc.)? Does the division also conduct monitoring with regard to the

status of internal and external environments and the validity of the assumptions?

2) Reporting to Board of Directors or equivalent organization to Board of Directors

Does the Capital Management Division, in accordance with the Capital Management Policy and the Capital Management Rules, provide in a regular and timely manner or on an as needed basis information necessary for the Board of Directors or equivalent organization to the Board of Directors to make appropriate assessment and judgment with regard to the status of capital management and capital adequacy?

3) Feedback to Relevant Divisions

Does the Capital Management Division feedback the results of its assessment, analysis and consideration with regard to the status of capital adequacy to relevant divisions as necessary?

(4) Control

1) Countermeasures to Case Where Unmanageable Risks Exist

In the case where risks not covered by capital management have non-negligible impact from the viewpoint of capital adequacy or where risks subject to capital management cannot be managed appropriately, does the Capital Management Division provide information necessary for the Board of Directors or equivalent organization to the Board of Directors to make decisions as to whether the financial institution should withdraw from or downsize the operations affected by those risks?

2) Countermeasures to the Case Where Capital Adequacy is Insufficient

In the case where capital adequacy is insufficient, does the Capital Management Division promptly consider feasible countermeasures to build up the capital base and provide information necessary for the Board of Directors or equivalent organization to the Board of Directors to make decisions as to what specific countermeasures should be taken in the future?

(5) Review and Revision

1) Review and Revision of the Internal Capital Adequacy Assessment Method

Does the Capital Management Division grasp the limitations and weaknesses of the internal capital adequacy assessment method as well as changes in the internal and external environments, and regularly review whether the method suits the financial institution's strategic objectives, the scales and natures of its business, and its risk profile and revise the method, or provide information necessary for the Board of Directors to make appropriate assessment and judgments? Does the division review and revise the following items, for example?

- Consistency of the definition of capital as used in the internal capital adequacy assessment with the corporate management policy, corporate management plans and strategic objectives, etc. and validity of the grounds for determining the definition
- Validity of identification of risks subject to capital adequacy in the internal capital adequacy assessment
- Validity of the risk assessment method used in the internal capital adequacy assessment (assessment and measurement techniques, assumptions, etc.)
- Validity of the internal capital adequacy assessment method
- Appropriateness of the use of the internal capital adequacy assessment method taken in consideration of its limitations and weaknesses

III. Specific Issues

【Checkpoints】

- Criteria for judging whether or not the status of a financial institution's capital adequacy is appropriate are specified in Article 14-2 of the Banking Law to enable judgments with regard to the soundness of the institution's corporate management. The Banking Law also specifies criteria for issuing an order for corrective measures in a prompt and appropriate manner with a view to encouraging financial institutions as necessary to take corrective action quickly.
- This chapter lists the check items to be used when the inspector reviews whether the capital adequacy ratio is calculated accurately in accordance with the Notification and other rules and procedures. It should be noted that relevant Laws should be taken into consideration when specific cases are examined with the use of the check items listed in this checklist.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter III., it is necessary to exhaustively examine which of the elements listed in Chapters I. and II. are absent or insufficient, thus causing the said problem, with the use of the checklists in those chapters, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter 1. are not functioning and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Accuracy of Calculation of Capital Adequacy Ratio

(1) Calculation Formula for Capital Adequacy Ratio

Is the capital adequacy ratio calculated in accordance with the stipulation of Article 2 or Article 14 of the Notification in the case of financial institutions subject to international standards, and Article 25 or Article 37 of the Notification in the case of financial institutions subject to domestic standards? (It should be noted that financial institutions subject to domestic standards can exclude from the calculation the amount equivalent to market risk in accordance with the stipulation of Article 27 or 39 of the Notification.)

(2) Range of Consolidation

Is the range of consolidation in accordance with the stipulation of Article 3 of the Notification in the case of financial institutions subject to international standards, and Article 26 of the Notification in the case of financial institutions subject to domestic standards?

(3) Capital Amount

1) Financial Institutions subject to International Standards

- (i) Is the amount of basic and adjustment items related to Tier 1 capital such as common equity, etc., calculated in accordance with the stipulation of Article 5 or Article 17 of the Notification?
- (ii) Is the amount of basic and adjustment items related to other Tier 1 capital calculated in accordance with the stipulation of Article 6 or 18 of the Notification?
- (iii) Is the amount of basic and adjustment items related to Tier 2 capital calculated in accordance with the stipulation of Article 7 or Article 19 of the Notification?
- (iv) Is the amount of the adjusted minority interests, etc. and the adjustment items calculated in accordance with the stipulation of Article 8 or Article 20 of the Notification?
- (v) Does the institution pay attention to the following matters when considering the eligibility of its capital amounts?
 - Does the common equity, etc., fully satisfy the eligibility specified under Paragraph 3, Article 5 or Paragraph 3, Article 17 of the Notification?
 - Do the “Instruments Issued by the Special Purpose company, etc. to Raise Other Tier 1 Capital” fully satisfy the eligibility specified under Paragraph 3, Article 6 or Paragraph 3, Article 18 of the Notification?
 - Do the “Instruments Issued to Raise Other Tier 1 Capital” fully satisfy the eligibility specified under Paragraph 4, Article 6 or Paragraph 4, Article 18 of the Notification?
 - Do the “Instruments Issued by the Special Purpose Company, etc. to Raise Tier 2 Capital” fully satisfy the eligibility specified under Paragraph 3, Article 7, or Paragraph 3, Article 19 of the Notification?
 - Do the “Instruments Issued to Raise Tier 2 Capital” fully satisfy the eligibility specified under Paragraph 4, Article 7 or Paragraph 4, Article 19?
 - Is the amount of the tax effect equivalent (amount commensurate with deferred tax assets) included in the capital account posted appropriately in light of the purposes of “Audit Treatment of Judgments with Regard to Recoverability of Deferred Tax Assets” (Report No. 66, the audit committee of the Japanese Institute of Certified Public Accountants) and other standards and Guidances concerning the tax effect accounting?

- Is the amount of liabilities related to retirement benefits or reserves for retirement allowances posted appropriately in the liabilities side (in the asset side of the balance sheet if categorized as assets associated with retirement benefits or as prepaid pension expenses) in accordance with “Accounting Standard for Retirement benefits” (Standard No. 26 of the Business Accounting Standard) and “Guidance on Accounting Standard for Retirement Benefits” (Guidance No. 25 of the Guidance for Application of Corporate Accounting Standard)?
- Is the amount of intentionally-owned common equity of other financial institutions, etc., and Instruments Issued to Raise Capital appropriately posted as adjustment items?

2) Financial Institutions subject to Domestic Standards

- (i) Is the amount of basic and adjustment items related to core capital calculated in accordance with the stipulation of Article 28 or 40 of the Notification?
- (ii) Is the amount of the adjusted minority interests and the adjustment items calculated in accordance with Article 29 or 41 of the Notification?
- (iii) Does the institution pay attention to the following matters when considering the eligibility of its capital amounts?
 - Does Common Equity fully satisfy the eligibility specified under Paragraph 3, Article 28 or, Paragraph 3, Article 40 of the Notification?
 - Does Mandatory Convertible Preferred Share fully satisfy the eligibility specified under Paragraph 4, Article 28 or Paragraph 4, Article 40 of the Notification?
 - Is the amount of the tax effect equivalent (amount commensurate with deferred tax assets) included in the capital account posted appropriately in light of the purposes of “Audit Treatment of Judgments with Regard to Recoverability of Deferred Tax Assets” (Report No. 66, the audit committee of the Japanese Institute of Certified Public Accountants) and other standards and guidance concerning the tax effect accounting?
 - Is the amount of liabilities related to retirement benefits or reserves for retirement allowances posted appropriately in the liabilities side (in the asset side of the balance sheet if categorized as assets associated with retirement benefits or as prepaid pension expenses) in accordance with “Accounting Standard for Retirement benefits” (Standard No. 26 of the Business Accounting Standard) and “Guidance on Accounting Standard for Retirement Benefits” (Guidance No. 25 of the Guidance for Application of Corporate Accounting Standard)?
 - Is the amount of the “intentionally-owned Instruments Issued to Raise Capital of other financial institutions, etc.” appropriately posted as an adjustment item?

(4) Amounts of Credit Risks and Assets

- 1) Is the amount of credit risks and assets calculated in accordance with the stipulation of Article 10 or Article 21 of the Notification in the case of financial institutions subject to international standards, and Article 33 or Article 44 of the Notification in the case of financial institutions subject to domestic standards?
- 2) In the case where the institution inspected falls under the category of institutions that adopt The Standardized Approach under Item 10, Article 1 of the Notification, the inspector should pay attention to the items included in a checklist for The Standardized Approach attached to the “Checklist for Credit Risk Management.”
- 3) In the case where the institution inspected falls under the category of institutions that adopt The Internal Ratings-Based Approach under Item 3, Article 1 of the Notification, the inspector should pay attention to the items included in a checklist for The Internal Ratings-Based Approach attached to the “Checklist for Credit Risk Management.”
- 4) Does the financial institution practice regulatory arbitrage within the framework for reducing credit risk? For example, while the financial institution handles a desirable treatment for a short term in calculating the required capital by the credit guarantee transaction with an unusually high level of premium, fees, and other direct and indirect expenses as compared with the amount of credit risk to be transferred, does the financial institution postpone the realization of losses for a long time without substantial risk transfer?

(5) Total Sum of Market Risk Equivalent Amounts

- 1) Is the total sum of market risk equivalent amounts calculated in accordance with the stipulation of Article 11 or Article 22 of the Notification in the case of financial institutions subject to international standards, and Article 34 or Article 45 of the Notification in the case of financial institutions subject to domestic standards?
- 2) In the case of the financial institution using the Internal Model Approach defined under Item 12-2, Article 1 of the Notification, the inspector should pay attention to the items included in Chapter III. 4. “Market Risk Measurement Technique” of the “Checklist for Market Risk Management.”

(6) Total Sum of Operational Risk Equivalent Amounts

- 1) Is the total sum of operational risk equivalent amounts calculated in accordance with the stipulation of Article 12 or Article 23 of the Notification in the case of financial institutions subject to international standards, and Article 35 or Article 46 of the Notification in the case of financial institutions subject to domestic standards?
- 2) In the case where the institution uses The Standardized Approach under Article 305 of the

Notification, does it meet the criteria specified in Article 308 of the Notification on a continuous basis?

- 3) In the case where the institution falls under the category of institutions that adopt the Advanced Measurement Approaches as defined in Item 13, Article 1 of the Notification, does it calculate the risk equivalent amount as specified in Article 311 of the Notification? Does it also meet the criteria specified in Article 315 of the Notification on a continuous basis?

(7) Minimum Required Capital

With regard to institutions that adopt the Internal Ratings-Based Approach as defined in Item 3, Article 1 of the Notification or those that adopt the Advanced Measurement Approaches as defined in Item 13, Article 1 of the Notification, does the institution calculate the minimum capital in accordance with the stipulation of Article 13 or Article 24 of the Notification in the case of financial institutions subject to international standards, and Article 36 or Article 47 of the Notification in the case of financial institutions subject to domestic standards?

Checklist for Credit Risk Management

I. Development and Establishment of Credit Risk Management System by Management

Checkpoints

- Credit risk is the risk that a financial institution will incur losses from the decline or elimination of the value of assets (including off-balance sheet assets) due to deterioration in the financial condition of an entity to which credit is provided. In particular, the risk that a financial institution will incur losses with regard to credit provided to an overseas customer due to changes in the foreign currency situation or the political and economic conditions of the country to which the customer belongs is called country risk.

- The development and establishment of a system for credit risk management is extremely important from the viewpoint of ensuring the soundness and appropriateness of a financial institution's business. Therefore, the institution's management is charged with and responsible for taking the initiative in developing and establishing such a system. Also, understanding the status of debtors and providing business consultation and guidance for debtors and support to improve their businesses is important from the viewpoint of credit risk reduction.

- It is important for the inspector to review whether the credit risk management system developed is an appropriate one suited to the financial institution's strategic objectives, the scales and natures of its business and its risk profile.

It should be noted that the type and level of the credit risk assessment method to be used by a financial institution should be determined according to the institution's strategic objectives, the diversity of its business and the level of complexity of the risks faced by it, and therefore a complex or sophisticated credit risk assessment method is not necessarily suited to all financial institutions.

- In examinations, in addition to this checklist, the inspector also considers credit risk related items written in the Checklist for Finance Facilitation Section, as necessary.

- The inspector should determine whether the credit risk management system is functioning effectively and whether the roles and responsibilities of the institution's management are being appropriately performed by way of reviewing, with the use of check items listed in Chapter I., whether or not the management is appropriately implementing (1) policy development, (2) development of internal rules and organizational frameworks and (3) development of a system for assessment and improvement activities.

- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II. and later, it is necessary to exhaustively examine which of the elements listed in Chapter I are absent or

insufficient, thus causing the said problem, and to review findings thereof through dialogue between the inspector and the financial institution.

- If the institution's management fails to recognize weaknesses or problems recognized by the inspector, it is also necessary to explore in particular the possibility that the Internal Control System is not functioning effectively and review findings thereof through dialogue.

- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Policy Development

(1) Roles and Responsibilities of Directors

Do directors attach importance to credit risk management, fully recognizing that the lack of such an approach could seriously hinder attainment of strategic objectives? In particular, does the director in charge of credit risk management review the policy and specific measures for developing and establishing an adequate credit risk management system with a full understanding of the scope, types and nature of risks, and the techniques of identification, assessment, monitoring and control regarding credit risk as well as the importance of credit risk management, and with precise recognition of the current status of credit risk management within the financial institution based on such an understanding? For example, does the director in charge understand the limitations and weaknesses of the credit risk measurement and analysis methods (including the techniques and the assumptions, etc.) and consider countermeasures to supplement such shortcomings? Also, does the director in charge grasp the debtor's and study specific measures to provide the debtor with business consultation, guidance and support for initiatives to improve its business, as necessary?

(2) Development and Dissemination of Loan Divisions' Strategic Objectives

Has the Board of Directors developed strategic objectives for the Loan Division that are consistent with the institution-wide strategic objectives and disseminated them throughout the institution? When developing the strategic objectives for the Loan Division, does the Board of Directors give due consideration to the following point, for example, in light of the institution's capital status?

- Does the Board of Directors avoid setting institution-wide and division-specific strategic

objectives that sacrifice credit risk management for profit? In particular, does it avoid setting objectives that pursue short-term profit by disregarding long-term risk or avoid setting a performance appraisal system that reflects such inappropriate objectives?

(3) Development and Dissemination of Credit Risk Management Policy

Has the Board of Directors developed a policy regarding credit risk management (hereinafter referred to as the “Credit Risk Management Policy”) and disseminated it throughout the institution? Is appropriateness of the Credit Risk Management Policy secured by, for example, including clear statements on the following matters? Also, is consistency with Finance Facilitation Management Policy obtained?

- The roles and responsibilities of the director in charge and the Board of Directors or organization equivalent to the Board of Directors with regard to credit risk management
- The policy on organizational framework, such as establishment of a division concerning credit risk management (hereinafter referred to as the “Credit Risk Management Division”) and the authority assigned thereto
- The policy on identification, assessment, monitoring, control and mitigation of credit risks

(4) Revision of Policy Development Process

Does the Board of Directors revise the policy development process in a timely manner by reviewing its effectiveness based on reports and findings on the status of credit risk management in a regular and timely manner or on an as needed basis?

2. Development of Internal Rules and Organizational Frameworks

(1) Development and Dissemination of Internal Rules

Has the Board of Directors or organization equivalent to the Board of Directors had the Manager of the Credit Risk Management Division (hereinafter simply referred to as the “Manager” in this checklist) develop internal rules that clearly specify the arrangements concerning credit risk management (hereinafter referred to as the “Credit Risk Management Rules”) and disseminate them throughout the institution in accordance with the Credit Risk Management Policy? Has the Board of Directors or organization equivalent to the Board of Directors approved the Credit Risk Management Rules after determining if they comply with the Credit Risk Management Policy after legal checks, etc.?

(2) Establishment of Credit Risk Management Division

- 1) Does the Board of Directors or organization equivalent to the Board of Directors have a

Credit Risk Management Division established and have the division prepared to undertake appropriate roles in accordance with the Credit Risk Management Policy and the Credit Risk Management Rules?¹

- 2) Has the Board of Directors allocated to the Credit Risk Management Division a Manager with the necessary knowledge and experience to supervise the division and enabled the Manager to implement management business by assigning him/her the necessary authority therefor?
- 3) Has the Board of Directors or organization equivalent to the Board of Directors allocated to the Credit Risk Management Division an adequate number of staff members with the necessary knowledge and experience to execute the relevant business and assigned such staff the authority necessary for implementing the business?²
- 4) Does the Board of Directors or organization equivalent to the Board of Directors keep the Credit Risk Management Division independent from the Marketing and Sales Division, etc. and secure a check-and-balance system of the Credit Risk Management Division?

(3) Development of Credit Risk Management Systems in the Marketing and Sales Division, etc.

- 1) Does the Board of Directors or organization equivalent to the Board of Directors provide a system to fully disseminate the relevant internal rules and operational procedures to the divisions involving credit risks to be managed (e.g., the Marketing and Sales Division, etc.) and ensure that such divisions observe them? For example, does the Board of Directors or organization equivalent to the Board of Directors instruct the Manager to identify the internal rules and operational procedures that should be observed by the Marketing and Sales Division, etc. and to carry out specific measures for ensuring observance such as providing effective training on a regular basis?
- 2) Does the Board of Directors or organization equivalent to the Board of Directors provide a system to ensure the effectiveness of credit risk management in the Marketing and Sales Division, etc. through the Manager or the Credit Risk Management Division?

(4) The System for Reporting to Board of Directors or organization equivalent to Board of Directors and Approval

Has the Board of Directors or organization equivalent to the Board of Directors appropriately

¹ When the Credit Risk Management Division is not established as an independent division (e.g., when the division is consolidated with another risk management division to form a single division or when a division in charge of other business also takes charge of credit risk management or when a Manager or Managers take charge of credit risk management instead of a division or a department), the inspector shall review whether or not such a system is sufficiently reasonable and provides the same functions as in the case of establishing an independent division commensurate with the scale and nature of the institution and its risk profile.

² When a department or a post other than the Board of Directors or equivalent organization to the Board of Directors is empowered to allocate staff and assign them authority, the inspector shall review, in light of the nature of such a department or post, whether or not the structure of the Credit Risk Management Division is reasonable in terms of a check-and-balance system and other aspects.

specified matters that require reporting and those that require approval and does it have the Manager report the current status to the Board of Directors or organization equivalent to the Board of Directors in a regular and timely manner or on an as needed basis or have the Manager seek the approval of the Board of Directors or organization equivalent to the Board of Directors on the relevant matters? In particular, does it ensure that the Manager reports to the Board of Directors or organization equivalent to the Board of Directors without delay any matters that would seriously affect corporate management?

(5) The System for Reporting to Corporate Auditor

In the case where the Board of Directors has specified matters to be directly reported to a corporate auditor, has it specified such matters appropriately and do they provide a system to have the Manager directly report such matters to the auditor?³

(6) Development of Internal Audit Guidelines and an Internal Audit Plan

Does the Board of Directors or organization equivalent to the Board of Directors have the Internal Audit Division appropriately identify the matters to be audited with regard to credit risk management, develop guidelines that specify the matters subject to internal audit and the audit procedure (hereinafter referred to as “Internal Audit Guidelines”) and an internal audit plan, and approve such guidelines and plan?⁴ For example, does it have the following matters clearly specified in the Internal Audit Guidelines or the internal audit plan and provide a system to have these matters appropriately audited?

- Status of development of the credit risk management system
- Status of compliance with the Credit Risk Management Policy, Credit Risk Management Rules, etc.
- Appropriateness of the credit risk management processes commensurate with the scales and natures of the business and risk profile
- Appropriateness of the use of the credit risk assessment method taken into account the limitations and the weaknesses thereof
- Validity of the Credit Risk Assessment Method (including techniques and assumptions), etc.
- Accuracy and completeness of the data used in credit risk assessment
- Appropriateness of stress test scenarios, etc.
- Status of improvement of matters pointed out in an internal audit or on the occasion of the last inspection

³ It should be noted that this shall not preclude a corporate auditor from voluntarily seeking a report and shall not restrict the authority and activities of the auditor in any way.

⁴ The Board of Directors or equivalent organization to the Board of Directors only needs to have approved the basic matters with regard to an internal audit plan.

(7) Revision of Development Process of Internal Rules and Organizational Frameworks

Does the Board of Directors or organization equivalent to the Board of Directors revise the development process of internal rules and organizational frameworks in a timely manner by reviewing their effectiveness based on reports and findings on the status of credit risk management in a regular and timely manner or on an as needed basis?

3. Assessment and Improvement Activities

(1) Analysis and Assessment

1) Analysis and Assessment of Credit Risk Management

Does the Board of Directors or organization equivalent to the Board of Directors appropriately determine whether there are any weaknesses or problems in the credit risk management system and the particulars thereof, and appropriately examine their causes by precisely analyzing the status of credit risk management and assessing the effectiveness of credit risk management, based on all of the information available regarding the status of credit risk management, such as the results of audits by corporate auditors, internal audits and external audits, findings of various investigations and reports from various divisions? In addition, if necessary, does it take all possible measures to find the causes by, for example, establishing fact findings committees, etc. consisting of non-interested persons?

2) Revision of Analysis and Assessment Processes

Does the Board of Directors or organization equivalent to the Board of Directors revise the analysis and assessment processes in a timely manner by reviewing their effectiveness based on reports and findings on the status of credit risk management in a regular and timely manner or on an as needed basis?

(2) Improvement Activities

1) Implementation of Improvements

Does the Board of Directors or organization equivalent to the Board of Directors provide a system to implement improvements in the areas of the problems and weaknesses in the credit risk management system identified through the analysis, assessment and review referred to in 3. (1) above in a timely and appropriate manner based on the results obtained by developing and implementing an improvement plan as required or by other appropriate methods?

2) Progress Status of Improvement Activities

Does the Board of Directors or organization equivalent to the Board of Directors provide a system to follow up on the efforts for improvement in a timely and appropriate manner by reviewing the progress status in a regular and timely manner or on an as needed basis?

3) Revision of Improvement Process

Does the Board of Directors or organization equivalent to the Board of Directors revise the improvement process in a timely manner by reviewing its effectiveness based on reports and findings on the status of credit risk management in a regular and timely manner or on an as needed basis?

II. Development and Establishment of Credit Risk Management System By Manager

Checkpoints

- This chapter lists the check items to be used when the inspector reviews the roles and responsibilities that must be performed by the Manager and the Credit Risk Management Division.

- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II., it is necessary to exhaustively examine which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.

- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter 1. are not functioning appropriately and review findings thereof through dialogue.

- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Roles and Responsibilities of Manager

(1) Development and Dissemination of Credit Risk Management Rules

Has the Manager, in accordance with the Credit Risk Management Policy, identified risks, decided the methods of assessment and monitoring thereof and developed the Credit Risk Management Rules that clearly define the arrangements on risk control and mitigation, based on a full understanding of the scope, types and nature of risk and the credit risk management technique? Has the Manager also developed the Credit Risk Management Rules based on the importance of understanding the status of debtors and supporting their business improvement by providing business consultation and guidance, etc.? Have the Credit Risk Management Rules been disseminated throughout the institution upon approval by the Board of Directors or organization equivalent to the Board of Directors? Moreover, is consistency of Credit Risk Management Rules with the Finance Facilitation Management Rules obtained?

(2) Credit Risk Management Rules

Do the Credit Risk Management Rules exhaustively cover the arrangements necessary for credit

risk management and specify the arrangements appropriately in a manner befitting the scales and natures of the financial institution's business and its risk profile? Do the rules specify the following items, for example?

- Arrangements on the roles, responsibilities (including the scope of loans that need to be managed as problem loans, and measures for handling problem borrowers), and organizational framework of the Credit Risk Management Division
- Arrangements on the identification of risks to be subjected to credit risk management
- Arrangements on the credit risk assessment method
- Arrangements on the credit risk monitoring method
- Arrangements on the system of reporting to the Board of Directors or organization equivalent to the Board of Directors

(3) Development of Organizational Frameworks by Manager

- 1) Does the Manager, in accordance with the Credit Risk Management Policy and the Credit Risk Management Rules, provide for measures to have the Credit Risk Management Division exercise a check-and-balance system in order to conduct the system of credit risk management appropriately?
- 2) Does the Manager ensure that they report to the Comprehensive Risk Management Division without delay when detecting any weaknesses or problems of the credit risk management system that may affect comprehensive risk management?
- 3) With regard to New Products as specified by the Comprehensive Risk Management Policy, etc., does the Manager provide a system to identify the inherent risks in advance and report them to the Comprehensive Management Division when requested by the division to do so?⁵
- 4) Does the Manager have in place a credit risk management computer system⁶ with the high reliability befitting the scales and natures of the financial institution's business and its risk profile?
- 5) Does the Manager develop a system to appropriately coordinate with the Finance Facilitation Manager, and obtain timely and appropriately information on inappropriate or possibly inappropriate handling of consultations and requests for new finance and loan condition changes, etc., considering the intention of finance facilitation, and report this to the Finance Facilitation Manager?
- 6) Does the Manager ensure the system of training and education to enhance the ability of employees to conduct credit risk management in an effective manner, thus developing human resources with relevant expertise?

⁵ See "Checklist for Business Management (Governance) (for Basic Elements)," I. 3. (4).

⁶ It should be noted that the computer system may be a centralized data processing environment system, distribution processing system, or EUC (end user computing) type.

- 7) Does the Manager provide a system to ensure that matters specified by the Board of Directors or organization equivalent to the Board of Directors are reported in a regular and timely manner or on an as needed basis? In particular, does the Manager provide a system to ensure that matters that would seriously affect corporate management are reported to the Board of Directors or organization equivalent to the Board of Directors without delay?

(4) Revision of Credit Risk Management Rules and Organizational Frameworks

Does the Manager conduct monitoring on an ongoing basis with regard to the status of the execution of operations at the Credit Risk Management Division? Does the Manager review the effectiveness of the credit risk management system in a regular and timely manner or on an as needed basis, and, as necessary, revise the Credit Risk Management Rules and the relevant organizational framework, or present the Board of Directors or organization equivalent to the Board of Directors with proposals for improvement?

2. Roles and Responsibilities of Credit Risk Management Division⁷

(1) Roles and Responsibilities of Screening Division

- 1) Is the Screening Division established independently from the Marketing and Sales Division, etc. and is the situation avoided where the director in charge of the division concurrently takes charge of the Marketing and Sales Division, etc., for example, in order to prevent interference from the Marketing and Sales Division? In the case where the Screening Division is not independent from the Marketing and Sales Division, etc. or where the director in charge of the Screening Division concurrently takes charge of the Marketing and Sales Division, etc., it is especially necessary to check whether a check-and-balance system is secured to ensure appropriate screening.
- 2) Does the Screening Division accurately comprehend the status of the borrower's financial condition, the purpose of the use of funds, financial sources for loan repayments, etc. and conduct appropriate screening and management in light of the risk nature of the loan application? When participating in a syndicated loan, for example, does the Screening Division decide whether or not to provide the loan after appropriately grasping the actual status of the borrower? When participating in a syndicated loan or project finance, does the division appropriately set and control a covenant when necessary?⁸
- 3) Does the Screening Division review whether the Marketing and Sales Division is appropriately following its instructions?

⁷ It should be noted that the purpose of this inspection item is not to review whether or not divisions such as the Screening Division, the Credit Management Division and the Problem Loan Management Division have been established as organizations but to review whether or not the functions required for such divisions are being performed.

⁸ It should be noted that covenants may be controlled by another division.

- 4) Does the Screening Division keep the Marketing and Sales Division, etc. fully aware that it is necessary to attach importance to the soundness of borrowers' business operations such as their strength in technology and sales and their growth potential as well as the profitability and the future potential of the businesses they are engaged in and to avoid relying too much on the collateral and personal guarantees, and does it review whether the Marketing and Sales Division is acting appropriately?
- 5) Does the Screening Division appropriately coordinate with the Finance Facilitation Manager, and obtain timely and appropriately information on inappropriate or possibly inappropriate handling of consultations and requests for new finance and loan condition changes, etc., considering the intention of finance facilitation, and report this to the Finance Facilitation Manager?

(2) Roles and Responsibilities of Credit Management Division

- 1) Does the Credit Management Division have the function and authority to exert integrated control over the financial institution, its consolidated subsidiaries and affiliates to which the equity method is applicable within legal limits in the monitoring of the status of the trend of borrowers' business conditions? Does the division exert such an integrated control system with regard to assets containing credit risks and off-balance sheet items (including credit risks related to market transactions) in addition to loans?
- 2) Does the Credit Management Division identify credit risks to which the institution is exposed and specify the risks subject to credit risk management in light of the risks identified? Does the division conduct assessment and measurement of credit risk with the use of credit ratings in a manner suited to the scales and natures of the institution's business and its risk profile? (With regard to details concerning credit ratings, see Chapter III. (1) "Credit Ratings," and for details concerning credit risk measurement techniques, see Chapter III. (7) "Check Items for Credit Risk Measurement Technique.")
- 3) Does the Credit Management Division appropriately control credit risks through the establishing of credit limits and the management of credit concentration risk? (See Chapter III. (2) "Credit Limits" with regard to details concerning credit limits and Chapter III (3) "Management of Credit Concentration Risk" with regard to details concerning credit concentration risk.)
- 4) Does the Credit Management Division appropriately grasp and manage the status of the credit portfolio (e.g. status of credit concentration in a specific business sector or a specific group) and report it regularly to the Board of Directors or organization equivalent to the Board of Directors?
- 5) Does the Credit Management Division identify credit risks when the institution introduces

New Products and starts business at new overseas offices and subsidiaries?

- 6) Does the Credit Management Division appropriately coordinate with the Finance Facilitation Manager, and obtain timely and appropriately information on inappropriate or possibly inappropriate handling of consultations and requests for new finance and loan condition changes, etc., considering the intention of finance facilitation, and report this to the Finance Facilitation Manager?
- 7) Does the Credit Management Division review the appropriateness of the credit management operations such as accuracy of credit ratings and management of borrowers and report the results to the Board of Directors or organization equivalent to the Board of Directors in a regular and timely manner or on an as needed basis?

(3) Roles and Responsibilities of Problem Loan Management Division

- 1) Does the problem Loan Management Division provide a system to detect at an early date loans that need to be managed as problem loans in accordance with the Credit Risk Management Rules, based on recognition of the impact of problem loans on the soundness of the financial institution's corporate management?

In the case of a financial institution subject to international standards, the inspector should make sure that the division in charge of managing and recovering problem loans is dedicated to these tasks. In the case of a financial institution subject to domestic standards, too, it is desirable that such a division is a dedicated one.⁹

- 2) Does the problem Loan Management Division, in accordance with the Credit Risk Management Rules, appropriately grasp and manage the status of corporate management at problem borrowers and provide guidance on the formulation of business rehabilitation plans or collect loans as necessary?
- 3) Does the problem Loan Management Division appropriately coordinate with the Finance Facilitation Manager, and obtain timely and appropriately information on inappropriate or possibly inappropriate handling of consultations and requests for new finance and loan condition changes, etc., considering the intention of finance facilitation, and report this to the Finance Facilitation Manager?
- 4) Does the problem Loan Management Division provide a system to report matters determined as necessary by the Board of Directors or organization equivalent to the Board of Directors with regard to the status of problem loans?

⁹ "Financial institutions subject to international standards" are ones that calculate their capital adequacy ratios according to international standards, and "financial institutions subject to domestic standards" are ones that calculate their capital adequacy ratios according to domestic standards.

III. Specific Issues

Checkpoints

- This chapter lists the check items to be used when the inspector reviews specific issues particular to the actual status of credit risk management. Examinations of these items must be done based on the intentions of these items, while considering the product characteristics.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter III., it is necessary to exhaustively examine which of the elements listed in Chapters I. and II. are absent or insufficient, thus causing the said problem, with the use of the checklists in those chapters, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter 1. are not functioning appropriately and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

(1) Risk Management by Business Consultation and Guidance, etc. for Micro, Small and Medium-Sized Enterprises

- 1) For a borrower which is a micro, small or medium-sized enterprise, is there detailed credit management, etc. based on its characteristics? For example, is there handling as described below?
 - Does the financial institution endeavor to manage the debts by fully understanding the business situation through continual enterprise visits, etc., including qualitative information such as the enterprise's technical and sales abilities and managers' qualities?
 - Are there active efforts for the enterprise and its business reconstruction, through detailed business consultation and guidance, and support in drafting a business improvement plan?
 - Are there efforts to use that financial institution's information functions and network for providing support, such as information on business matching and M&A?
 - Is detailed support provided corresponding to each stage of the lifecycle (support for founding and new business, business improvement support, business reconstruction,

business succession)?

- Are there efforts to thoroughly use loan techniques which assess business value, and other funding techniques which suit small and medium-sized enterprises?
- 2) Regarding credit for micro, small and medium-sized enterprises, etc., does the financial institution comprehensively consider the borrower's business status and credit rating when performing credit management such as credit ratings, by considering the business and financial aspect characteristics of micro, small and medium-sized enterprises, etc., which are generally easily affected by the economy, and easily end up with excessive debt due to temporary causes?
 - 3) When there are delinquent on business loans, etc. for which scoring or a model is used, is the debt mechanically collected or sold, without discussing actions to improve the business? Also, when ending provision of business loans, etc., does the financial institution consider the situation in which this places the obligor, and study a substitute means of providing funds as necessary?
 - 4) When the value of the collateral falls below the loan value, does the financial institution immediately collect on the loan or raise the interest rate, without rational reasons?
 - 5) For an enterprise receiving business improvement support, does the financial institution appropriately understand the progress status of the business improvement plan, and work on business improvements as needed, such as with business consultation and guidance?
 - 6) Regarding loans (including loans on bills) which are roll over of short term loans, if further refinancing corresponds to a restructured loan, instead of easily denying the customer's request, does it appropriately provide support for drafting a business improvement plan, etc.?
 - 7) Are requests for loan condition changes, etc. denied because the obligor did not draft a large and very detailed business improvement plan, etc.?

(2) Risk Management Based on Understanding the Obligor's Status

- 1) Is a sound screening system developed to facilitate funding for customers which manage sound businesses, especially micro, small and medium-sized enterprises, etc.?
- 2) Is a sound screening system developed to prohibit speculative real estate loans and loans for speculative financial management, and to deny financing for anti-social forces?
- 3) Does the financial institution respond to consultations or requests from customers for new finance or loan condition changes, etc. by grasping the customer's conditions carefully, instead of, for example, mechanical and uniform decisions based only on the specific industry or superficial numbers of financial statements, etc.?
- 4) Instead of emphasizing customer's technical abilities and growth potential and profitability and future potential of the business itself, is there excessive reliance on collateral and personal

guarantees? For example, instead of appropriately studying the customer's business value and cash flow forecasts, is finance denied or reduced for only reasons such as the financing amount exceeds the expected disposable amount of real estate collateral? Also, is finance denied or reduced based only on excessively harsh valuations of disposable real estate collateral? Moreover, due to reduced collateral value, does the financial institution demand additional collateral or guarantees which do not suit the customer's conditions, without setting a suitable time period?

- 5) Is there inappropriate handling, such as using the Financial Inspection Manual specified by the authorities or financial inspections by the authorities as reasons for denying new finance or collecting debts, etc.?
- 6) Regarding debtors who had their loan conditions changed etc., does the financial institution fully understand the debtor's actual situation and provide appropriate funds? Only because of a history of changed loan conditions, does the financial institution deny consultations or requests for new finance or loan condition changes, etc.?

(3) Management of Problem Loans

- 1) In managing a problem loan, does the financial institution appropriately assess the debtor's reconstruction possibilities, and for a debtor which could be reconstructed, make the utmost efforts towards its reconstruction? In that case, does the financial institution strive to create a reconstruction plan which is respected by the market, using company split, debt-equity swap (DES), debt-debt swap (DDS), corporate restructuring fund, etc. as necessary? Does it have a system to execute quick handling, by rehabilitation according to the Private Rehabilitation Guidelines and by legal procedures?
- 2) For debtors with delinquent, does the financial institution work to prevent long term late payments, by understanding and analyzing the reasons for the delinquent, and consulting and advising in a timely manner
- 3) In a case where sale or securitization of a problem loan is used to move it off balance sheet, is there a system to enable confirmation and verification that its credit risks are clearly separated, instead of using credit enhancement, etc. to continue substantially bearing the credit risks of that loan? Also, for sales and securitizations of problem debts, does the financial institution consider protection of the original debtor, and has it developed a system for not selling debts to parties who apply pressure or would harm the steady life and operations of the debtors, etc.?

(4) Credit Ratings

Does the institution have in place an appropriate credit rating system befitting the scales and natures of its business and its risk profile in order to assess and measure credit risks accurately?

Are its rating categories meaningful and consistent from the viewpoint of credit risk management?

- 1) Does the institution assign a credit rating according to the level of credit risk involved in the obligator based on ratings assigned by credit rating agencies, information provided by credit investigation companies and the like? Are its rating categories consistent with the obligator categories?
- 2) Does the institution assign credit ratings accurately and in a manner that allows verification of the objectivity of the ratings? Does it provide a system to revise the ratings in a timely manner, for example by setting a validity period? Does it also provide a system to have the credit ratings reflect in a timely and appropriate manner information concerning matters such as loan arrears, deterioration in the borrower's funding and business conditions, a change in the parent company's support and bankruptcy of a large-lot customer?

(5) Credit Limits

- 1) In the case where the institution provides credit on a large scale or on a continuous basis, does it establish credit limits (the maximum value of credit allowed to be provided, the maximum allowable ratio relative to the overall credit provided, the trigger level for a review of the credit provision policy, etc.) in advance? In practice, are credit limits established and revised by the Credit Management Division independent from the Marketing and Sales Division, etc. in accordance with standards established upon approval by the Board of Directors or organization equivalent to the Board of Directors?
- 2) Does the Credit Management Division have in place internal rules and operational procedures concerning credit limits that specify the arrangements, authority, and procedures with regard to reporting of a breach of credit limits to the division (to the Board of Directors or organization equivalent to the Board of Directors as necessary)? Does the division appropriately manage credit limits in accordance with the relevant rules and procedures?

(6) Management of Credit Concentration Risk

- 1) Does the institution provide a system to select, based on reasonable criteria, large-lot borrowers whose conditions could have a major impact on the institution and monitor the status of their credit and financial conditions individually and on an ongoing basis and manage them individually? Does the selection cover each borrower's group, including its affiliated companies, as a whole?
- 2) Does the Board of Directors or organization equivalent to the Board of Directors itself have an accurate grasp on large-lot borrowers and actively involve itself in credit risk management thereof?

- 3) When providing credit to borrowers with similar risk nature in terms of business sector, region, and product range, does the institution make sure to conduct appropriate management, for example by establishing credit limits suited to each portfolio or by dispersing credit risks through means such as asset-backed securitization?

(7) Risk management associated with acquiring and holding stocks

In the case where the institution holds large stocks and non-listed stocks, it is necessary to consider not only impairment risk with holding stocks and loss risk with selling stocks but also the risk of having difficulty in sales. And does the institution establish the system to prevent the negative consequences of the conflict of interest between stockholders and creditors?¹⁰

Especially, in the case where the institution acquires and holds voting rights that exceeds the Voting Right Holding Threshold, it is necessary to note the following points based on implementation of a review of the voting right possession regulation by Banking Act revision of 2013.

- 1) In the case where the institution acquires and holds stocks of a company specified by a Cabinet Office Ordinance, as a company performing new business activity that contributes considerably to the improvement of the governance management, (so-called company that implements the business reconstruction) as stipulated in the Banking Act, Article 16-2(1)12 or 52-23(1)11-2, does the institution establish a system to examine the business reconstruction plan appropriately, and to analyze/evaluate the progress, etc. accurately?

Does the institution accordingly establish a system to provide support and advice, etc. with regard to the governance for improvement of the corporate value subject to a company?

- 2) In the case where the institution acquires and holds stocks of companies through a specialized investment subsidiary as follows, does the institution establish a system to capture, analyze and manage, etc. the situation of risk management?
- (i) A Company specified by a Cabinet Office Ordinance as a company exploring new business fields (so-called venture business company) as stipulated in the Banking Act, Article 16-2(1)12 or 52-23(1)11.
 - (ii) Company specified by a Cabinet Office Ordinance as a company performing activity that contributes to vitalization of a region (so-called company that implements the business to vitalize regional economics (re-vitalization)) as stipulated in the Banking Act, Article 16-3(8) or 52-24(8).

(8) Risk Management of ABCP Program, etc.

Does the financial institution appropriately manage the sponsored business, etc. in relation to the ABCP program, etc., considering the possibility of receiving requests for liquidity enhancement due

¹⁰ See checklist for market risk management.

to the reputational risk regardless of the contract details?

(9) Risk Management of Derivative Transactions, etc.

Does the financial institution appropriately manage the credit risk of major counterparties to derivative transactions, etc., including the following?

- 1) Exposure management for each counterparty and based on the types of counterparty
- 2) Understanding of potential risks arising from the increased exposure due to the changes in market value of the reference assets under the derivative transactions
- 3) Confirmation of the effectiveness of collateral and other credit enhancement
- 4) Appropriate stress-testing incorporating the scenario assuming the tightening market liquidity

(10) Management of Risk related to Transactions with Central Counterparty Clearing House (CCP)

Does the financial institution appropriately manage risks arising from transacting with CCPs in relation to centrally cleared derivative transactions, etc., including the following?

- 1) Risks specific to the transactions with CCPs
- 2) Risks arising from material flaws in the eligible CCPs or in the framework to regulate and supervise the eligible CCPs in the country where they operate
- 3) With regard to CCPs other than the eligible CCPs, risks that the unpaid portion of the clearing fund to be paid upon request will be applied to cover such CCP's loss

(11) Check Items for Credit Risk Measurement Technique

- 1) Establishment of Credit Risk Measurement System
 - (i) Is there not any conceptual problem with the credit risk measurement system, and is the system operated without any lapse?
 - (ii) Is the role of the credit risk measurement technique (model) clearly positioned under the Credit risk Management Policy and operated based on an understanding of the items listed below? Is it ensured that there is no problem with the application of the technique to consolidated subsidiaries?
 - a. The financial institution's strategic objectives, the scales and natures of its business and its risk profile
 - b. The basic design concept of the credit risk measurement technique based on a.
 - c. Identification and measurement of credit risk based on b. (coverage, technique, assumptions, etc.)
 - d. Nature (limitations and weaknesses) of the credit risk measurement technique that derive from c. and the validity of the technique

- e. Details of the method of verifying d.
 - (iii) In the case where capital allocation management¹¹ is conducted, has the capital allocation management policy been developed based on the calculation results obtained through the use of the credit risk measurement technique? When there are risks excluded from measurement, is there any reasonable ground for the exclusion? Is risk capital allocated with due consideration for the risks excluded from measurement?
- 2) Appropriate Involvement of Directors and Corporate Auditors
- (i) Understanding of Credit risk Measurement Technique
 - a. Do directors understand that decisions concerning the credit risk measurement technique as well as the risk limits and the risk capital limits (in the case where capital allocation management is employed) have serious implications for the financial institution's corporate management and financial conditions?
 - b. Does the director in charge of credit risk management understand the credit risk measurement technique required for the business of the financial institution and comprehend the nature (limitations and weaknesses) thereof?
 - c. Do directors and corporate auditors seek to enhance their understanding of the credit risk measurement technique by receiving training or through other means?
 - (ii) Approach to Credit risk Management

Do directors involve themselves actively in credit risk management that uses the credit risk measurement technique?
- 3) Credit risk Measurement
- (i) Measurement of Credit Risk Quantity with Universal Yardstick

Does the institution grasp the credit risk quantity with the use of a uniform yardstick? It is desirable that the uniform yardstick is used to grasp and measure all necessary credit risk elements. If there are credit risks that are not sufficiently grasped and measured with the uniform yardstick, does the institution ensure that all necessary elements are taken into consideration in corporate management decisions by utilizing supplementary information?

Is the measurement of the credit risk quantity conducted with a rational, objective and precise statistical technique such as a VaR method, for example?
 - (ii) Ongoing Verification and Stress Testing
 - a. Does the Credit Management Division regularly analyze the validity of the measurement technique through ongoing verification (backtesting, etc.)? Is a revision of the measurement technique conducted in accordance with the internal rules?
 - b. Does the Credit Management Division grasp the stress status of credit risks through stress testing based on comprehensive stress scenarios and make use thereof appropriately?

¹¹ See Checklist for Capital Management.

(iii) System to Verify and Manage Measurement Technique

Are the validity of the credit risk measurement technique and the assumptions thereof, etc. verified during the development of the technique and thereafter on a regular basis by a person or persons with no involvement in the development and with sufficient competency? If any deficiency is recognized in the credit risk measurement technique or the assumptions thereof, is a corrective action taken appropriately?

Are there a framework and internal rules in place to prevent the credit risk measurement technique and the assumptions thereof from being altered on unreasonable grounds, and is the credit risk measurement technique managed appropriately in accordance with the internal rules?

4) Records on Credit risk Measurement Technique

Is there a system to keep records, for future reference, on the process of verification with regard to the selection of the credit risk measurement technique and the assumptions and on the basis for the selection decision, in order to enable follow-up verification and utilize the records to make the measurement more sophisticated and elaborated?

5) Audit

(i) Development of Auditing Program

Has the institution developed an audit program that exhaustively covers audits of the credit risk measurement technique?

(ii) Scope of Internal Audit

Is auditing conducted to check the following items?

- Consistency of the credit risk measurement technique with the strategic objectives, the scales and natures of the business and the risk profile
- Appropriateness of employing the credit risk measurement technique in light of the nature (limitations and weaknesses) thereof
- Appropriate documentation of records on the credit risk measurement technique and timely updating thereof
- Appropriate reflection of any modification of the process of credit risk management in the measurement technique
- Validity of the scope of measurement conducted with the credit risk measurement technique
- Absence of any deficiency in the information system for the management
- Validity of the credit risk measurement technique and the assumptions
- Accuracy and completeness of data used in credit risk measurement
- Appropriateness of the process and results of ongoing verification (backtesting, etc.)

(iii) Utilization of the Results of Audits

Does the Credit Management Division appropriately revise the credit risk measurement technique based on the results of audits?

6) Credit Risk Measurement Model Developed by Outsourcing Contractor¹²

(i) Appropriateness of Credit Risk Measurement System

- a. Does the person in charge of credit risk measurement at the financial institution have sufficient knowledge with regard to the measurement technique and understand the modeling process of credit risk measurement?
- b. Do the institution's Credit Management Division and the Internal Audit Division conduct a theoretical and empirical verification of the validity of the measurement technique?

(ii) Appropriateness of Credit Risk Measurement Model

- a. Is there not any "black box" with regard to the measurement model? If there is one, has the validity of the measurement model been verified?
- b. Are the consistency and the accuracy of data used in measurement secured?
- c. Is the measurement model selected suited to the scales and natures of the institution's business and its risk profile?

(iii) Management of Developer of Credit Risk Measurement Model

- a. Is the developer consigned with the development of the credit risk measurement model capable of ensuring continuous management of the model and promoting sophistication and elaboration of the model? Does the institution regularly evaluate the developer?
- b. Does the support system (training, consulting and maintenance) for users of credit risk measurement select a sufficient developer?
- c. Is it ensured that the developer reports to the institution on the status of its verification of the validity of the measurement model in a regular and timely manner or on an as needed basis?

(12) Credit Risk Management System under the Capital Adequacy Requirements

Does the institution provide a system to conduct credit risk management under the capital adequacy requirements in a manner suited to the risk management approach adopted? With regard to detailed inspection items, see Attachments "Checklist for The Standardized Approach" and "Checklist for The Internal Ratings-Based Approach"

1) In the case of institutions adopting The Standardized Approach

(i) Treatment of External Ratings

Does the institution have in place standards for the use of ratings and country risk scores assigned by eligible rating agencies for the purpose of determining risk weightings?

(ii) Risk Weightings Application

Does the institution categorize exposures appropriately and apply an appropriate risk weighting

¹² When the credit risk measurement is outsourced, the verification should be conducted by using the check items listed in this paragraph.

suitable to each category? Does it appropriately calculate the credit equivalent amount of off-balance sheet transactions, derivatives and transactions with long settlement periods?

(iii) Use of Credit Risk Mitigation Technique

When using a credit risk mitigation technique, does it utilize eligible financial asset collateral?

When using guarantee and credit derivatives as credit risk mitigation techniques in offsetting loans provided against deposits taken, does the institution use the techniques appropriately?

(iv) Treatment of Securitization Exposure

Does the institution apply the risk weight of 1250% to the following (excluding the amount equivalent to the increase in capital along with the securitization transaction)?

a. Securitization exposure to which the 1250% risk weight is applied as stipulated under Chapter 8 of the Notification

b. Interest only (I/O) strips with a credit enhancement function

2) In the case of institutions adopting The Internal Ratings-Based Approach

(i) Internal Control

Do the Board of Directors or organization equivalent to the Board of Directors and departments in charge of credit risk management and audits appropriately perform the roles and responsibilities necessary for the calculation of the capital adequacy ratio with the use of the Internal Ratings-Based Approach?

(ii) Calculation of Credit Risk Asset Amount

Is the amount of credit risk assets calculated appropriately in line with each risk asset class?

(iii) Designing of Internal Ratings System

With regard to corporate exposures, does the institution have in place an internal ratings system that assigns ratings on both obligator-by-obligator basis and facility-by-facility basis? It should be noted that when the institution applies slotting criteria to designated loans, it is allowed to adopt an internal ratings system that assigns ratings according to expected loss rates.

With regard to retail exposures, does the institution's internal ratings system give due consideration to the nature of risks involved in obligators and retail exposure-related transactions? In order to enable itself to consistently assign identical ratings to obligators and exposures that contain similar risks or allocate such obligators and exposures to identical pools, does the institution specify in sufficient detail the definition of "identical ratings" and "identical pools" and the criteria for the identical rating assignment and pool allocation?

In the case where different rating and pool allocation criteria or different rating and pool allocation procedures are applied according to the type of obligators and exposures, does the Credit Management Division conduct monitoring so as to detect any inconsistency and adjust rating criteria in a timely manner so as to improve consistency?

(iv) Operation of Internal Rating System

With regard to corporate exposures, does the institution revise obligator and facility ratings at least once a year? With regard to retail exposures, does it revise the loss nature and the status of arrears of each pool at least once a year? Does it appropriately store data concerning corporate and retail exposures?

Does the institution regularly conduct stress testing for the purpose of evaluating the level of its capital buildup and useful and adequately conservative credit risk stress testing that takes account of a scenario of at least a moderate economic recession?

(v) Use of Credit Ratings

Do ratings, PD and LDG play important roles in the institution's credit screening, risk management, internal capital allocation and internal control?

In the case where there are differences between the PD and LGD used in the calculation of the capital adequacy ratio and the estimated figures used in credit screening, risk management, internal capital allocation and internal control, does the institution mention the differences in the Credit Risk Management Policy and explain the reasons therefor?

(vi) Risk Quantification

When estimating PD, LGD and EAD (the estimation of LGD and EAD concerning corporate exposures is limited to institutions adopting an Advanced Internal Ratings-Based Approach), does the institution use all available important data, information and techniques related to the estimate? It should be noted that the use of internal and external data are allowed only in the case where estimates based on the data reflect long-term results.

Does the institution revise the estimated PD, LGD and EAD at least once a year? Does it conservatively revise the estimated PD, LGD and EAD given the possibility of errors in the estimate?

(vii) Verification of Internal Rating System and Estimated Figures

Does the institution compare the estimates of parameters and the actual figures at least once a year and make sure that the deviation of the estimate of each parameter from the actual figure is within an expected range? Does it conduct such verification for each category of obligator rating with regard to corporate exposures and for each pool with regard to retail exposures? Does the institution conservatively revise a parameter estimate in the case where the actual figure continuously exceeds the estimate?

(viii) Treatment of Securitization Exposure

a. Does the institution apply the risk weight of 1250% to the following (excluding the amount equivalent to the increase in capital along with the securitization transaction)?

- Securitization exposure to which the risk weight of 1250% is applied as stipulated under Chapter 8 of the Notification
- I/O strips with credit enhancement function

- b. In the case where the method of calculating credit risk assets to be applied to the underlying assets of a securitization exposure is not specified, does the institution use The Standardized Approach for the calculation of the amount of credit risk assets if it is the originator and does it use an external ratings-based approach for the calculation if it is not?
- c. In the case where it is impossible to calculate, either with the use of an external ratings-based approach, a specified-function approach, or an internal assessment approach, the amount of credit risk assets with regard to securitization exposures subject to the internal ratings-based approach, does the institution apply the risk weight of 1250% to securitization exposure?

Review List of Standardized Method Components

Banks adopting a standardized method (including banks that partially use a standardized method, while adopting an internal rating based method) are required to calculate their capital adequacy ratios accurately by applying appropriate risk weights to their exposures.

In order to specifically review the credit risk management status of a bank that adopts the standardized method (hereinafter an "SA bank"), this "Review List of Standardized Method Components" is created based on the "Standards for Determining the Adequacy of a Bank's Capital Adequacy Ratio Based on Its Assets under Article 14.2 of the Banking Act" (Financial Services Agency Notification No. 19, 2006, hereinafter the "Notification").

The inspector shall hold sufficient discussions with a financial institution, while referring to this Review List, the Notification, Q&A on the Notification and other reference materials.

(Note) Explanation about components to be reviewed

Unless otherwise specified, components to be reviewed are minimum standards required of SA banks.

The review of the following components needs special attention because transitional measures are specified for these components:

1. As for trust contracts with compensation of principal loss executed on and before March 31, 2010, the credit risk assets may be calculated by using the former standard.
2. As for the upper limit of credit risk assets of securitization exposures held by a bank as of March 31, 2006, the bank may choose the higher one between (1) the credit risk assets of such securitization exposures over the period until June 30, 2014 calculated in accordance with the Notification, and (2) the credit risk calculated in accordance with the provisions in "Setting the capital adequacy ratio" in accordance with Article 14-2 of the Banking Act (Notification No.55, 1993, Ministry of Finance).

(Note) Definition of terms

The terms used in this Review List shall have the meaning specified in the Notification.

I. Treatment of External Ratings

1. Standards for using the ratings

To determine risk weights, does a bank set standards for using the ratings of a qualified rating agency or country risk scores provided by the Organization for Economic Co-operation and Development (OECD) or an export credit agency (hereinafter such standards shall be referred to as "standards for use of ratings")?

Are such standards for use of ratings designed to intentionally reduce the credit risk amounts of exposures?

When a bank uses the ratings of a qualified rating agency or the country risk scores of the OECD or an export credit agency in its internal control processes, are the standards for use of ratings consistent with the method used in such internal control process?

2. Unsolicited ratings

Are the determination of risk weights based on unsolicited ratings (unless such ratings are given by the national government)? Does a bank treat an exposure as unrated without confirming the rating status of such exposure (solicited or unsolicited) with the borrower or rating agencies?

3. Ratings in different currencies

When a facility rating (referring to a rating assigned to a specific obligation) or borrower rating (referring to a rating of the general repayment ability of a borrower) is related to an exposure in a currency which is different from the currency of the exposures held by an SA bank, does the SA bank not use such facility rating or borrower rating, unless an exposure held by the bank in the local currency relates to a syndicated loan with a multilateral development bank (limited to loans for which a risk weight of 0% is permitted).

4. Different ratings

If an exposure held by a bank has different ratings or country risk scores assigned by two or more of qualified rating agencies, the OECD or export credit agencies, and different risk weights are used for those ratings or scores, does the bank use the second lowest risk weight? If the lowest risk weight is associated with more than one rating or country risk score, however, is the lowest risk weight used?

5. Rating based on assessment of a different subject category

Does an SA bank use a rating which is based on assessment of a category different from the category of its exposure if the adoption of such rating may result in the underestimation of the risk

asset?

II. Application of Risk Weights

1. Exposure types

- (1) Is exposure satisfying the following requirements and having a risk weight of 75% or higher adequately classified under "small and medium business exposures" or "personal exposures"?
 - 1) The amount determined by subtracting the amount guaranteed by a credit guarantee association from the total exposures to a single borrower (limited to a small business or individual person) does not exceed 100 million yen.¹
 - 2) The amount determined by subtracting the amount guaranteed by a credit guarantee association from the total exposures to a single borrower does not exceed 0.2% of the total of exposures satisfying the requirement in 1) above (excluding those delinquent for three months or longer).
- (2) Are exposures satisfying all of the following requirements and intended only for the construction, acquisition or reconstruction/enlargement of housing adequately classified as housing mortgage loans:
 - 1) Does such mortgage satisfy the following conditions?
 - (i) The mortgaged housing is intended for the borrower's residence or for rent (excluding second housings for vacations or any housings similar); and
 - (ii) The mortgage is a first mortgage. However, if the mortgage is a second mortgage following a mortgage of the Japan Housing Finance Agency or any other public agency and there is some mortgage capacity left, the requirement in this paragraph does not apply;
 - 2) Is such exposure fully protected by the mortgage?
 - 3) Does such exposure fall under any of the following conditions?
 - (i) Exposures to business operators who are mainly engaged in housing construction or housing land development;
 - (ii) Exposures intended for the construction, acquisition or reconstruction/enlargement of company housing; or
 - (iii) Exposures related to mortgaged housing which is not leased currently and for which repayment relies solely on rents and other revenues from the leasing of such housing.
- (3) Are corporate exposures, small and medium business exposures or personal exposures intended

¹ The term "credit guarantee association" refers to a credit guarantee association, agriculture credit guarantee fund association or fisheries credit guarantee fund association in Japan.

for acquisition or investment in real estate adequately classified as real estate business exposures if the repayment of such exposures relies solely on rents and other revenues from such real estate?

- (4) Are exposures that are delinquent for three months or longer (refers to exposures for which the payment of principal or interest is overdue by three months or longer from the day after its agreed due date) adequately classified?

Is the percentage of individual allowance for doubtful accounts (including allowance for doubtful accounts, allowance for specified overseas receivables and partial direct write-offs) to the sum of such exposures and partial direct write-offs adequately calculated? Are risk weights adequately calculated according to such percentage?

- (5) Are uncollected bills/capital subscription exposures adequately classified? Out of such exposures, are exposures related to material capital subscriptions adequately classified?

- (6) Are exposures guaranteed by credit guarantee cooperation, the Regional Economy Vitalization Corporation of Japan or the incorporated Organization for Supporting the Turnaround of Businesses Damaged by the Great East Japan Earthquake adequately classified?

- (7) Does a bank using Japanese standards² adequately classify exposures to capital instruments issued by other financial institutions, excluding common share exposures?

- (8) Does a bank using uniform international standards² adequately classify exposures to portions of designated items which are not included in the adjustments to common stocks and other Tier 1 capitals? Does a bank using Japanese standards adequately classify exposures to portions of designated items which are not included in the adjustments to core capital?

2. Off-balance sheet transactions

Does a bank calculate credit exposure equivalents of off-balance-sheet transactions by multiplying their notional principals by the following credit conversion factors?

- (1) Commitments cancellable any time unconditionally (excluding those stipulated in (5), (8) and (4) below) or commitments automatically cancellable when the creditworthiness of the borrower is deteriorated: 0%
- (2) Commitments with an original maturity of up to one year (excluding those stipulated in (1)

² The Review List of Standardized Method Components is a summary of the Notification for the convenience of reference. The terms "banks using the Japanese Standards" and "banks using uniform international standards" must be replaced with appropriate bank types.

above): 20%

- (3) Short-term and highly liquid trade-related contingent obligations: 20%
- (4) Certain transaction-related contingent obligations (excluding those listed in (3) above): 50%
- (5) NIF or RUF: 50%
- (6) Commitments with an original maturity exceeding one year (excluding those stipulated in (1) above): 50%
- (7) Contingent obligations that directly substitute credits: 100%
- (8) Asset sales with buy-back conditions and right to obtain reimbursement: 100%
- (9) Forward asset purchases, forward deposits, and purchase of partly paid shares and securities: 100%
- (10) Lending of securities, provision of cash or securities as collateral, or sale/purchase of securities with buy-back/resale right: 100%

If a bank has an agreement to execute off-balance-sheet transactions in the future, and if different credit conversion factors are applicable, is the lowest factor applied?

3. Derivative transactions and long-term settlement transactions

Are the credit exposure equivalents of forward, swap, option and other derivative transactions and long-term settlement transactions adequately calculated by using the current exposure approach, the standard approach or the expected exposure approach?

III. Use of a credit risk mitigation method

1. Common review items

- (1) If the rating assigned to an exposure by a qualified rating agency is already reflective of the effects of a credit risk mitigation (hereinafter "CRM") method, does the calculation of the credit risk asset of such exposure use a CRM method redundantly?

When a CRM method is used, does the method use a rating that assesses only the probability of the redemption of the principal?

- (2) When a bank uses a CRM method for the calculation of risk assets, do the documents related to an agreement on the use of such CRM method bind all parties involved in the transaction and are the documents valid in all aspects of the laws applicable to such transaction?

Do the bank constantly confirm the legal validity of the CRM method?

2. Review of transactions secured with eligible financial collaterals

- (1) When a bank applies a CRM method for credit exposure equivalents of off-balance-sheet transactions or derivative transactions involving assets subject to the calculation of market risk equivalents, does the bank use a comprehensive method?

When a bank applies a CRM method for transactions secured with eligible financial collaterals that are not subject to the calculation of market risk equivalences, does the bank choose a simplified method or a comprehensive method and apply the chosen method consistently to all those transactions?

- (2) When a bank uses eligible financial collaterals as a CRM method, does the bank satisfy the following requirements?

- 1) Does the bank take all necessary measures to maintain and exercise the claims over the eligible financial collaterals?
- 2) Does the bank have the rights to dispose of or collect the eligible financial collaterals in a timely manner, from the counterparty of the transaction or an entrusted manager of such collaterals when an event that triggers the exercise of the collateral claim occurs?
- 3) Does the bank have adequate internal procedures in place that ensure timely disposal or collection of the eligible financial collaterals?
- 4) If the management of the eligible financial collaterals is entrusted to a third party manager, does the bank confirm that the entrusted manager controls such collaterals by separating them from its own assets?

- (3) When the credit risk of the counterparty of a transaction secured with eligible financial collateral has a significantly positive correlation with the credit risk of such collateral, does a bank use such collateral as a CRM method?

- (4) When a bank uses a simplified method, are eligible financial collaterals any of the following assets?

- 1) Cash or deposit accounts at the bank (including credit link bonds issued by the bank for the exposure unless the bank issues such credit link bonds for assets that are included in the calculation of market risk equivalents);
- 2) Gold;
- 3) Yen-denominated bonds issued by the national government or a local government in Japan, bonds issued by the Bank for International Settlements, the International Monetary Fund, the European Central Bank, or the European Community, or bonds issued by an international development bank for which a risk weight of 0% is applied in the standardized method;
- 4) Bonds which are rated by a qualified rating agency and which satisfy the following

- requirements, excluding those specified in (3) above:
- (i) Bonds issued by the national government, the central bank, a local government or a local public financial organization in Japan, or a national governmental organization in Japan, to which a qualified rating agency has assigned a rating equivalent to a credit risk category of 1-4 or a higher grade;
 - (ii) Bonds which are not bonds stipulated in a. above and to which a qualified rating agency has assigned a rating equivalent to a credit risk category of 2-2, 4-3, or 6-3 (excluding those falling under the definition of resecuritization exposures) or a higher grade;
 - (iii) Short-term bonds to which a qualified rating agency has assigned a rating equivalent to a credit risk category of 5-3 or 7-3 (excluding those falling under the definition of resecuritization exposures) or a higher grade;
- 5) Bonds which are not rated by a qualified rating agency and which satisfy all of the following conditions:
- (i) Is the issuer of such bonds as follows?
 - a. a financial institution, foreign bank, bank-holding company or a foreign corporation equivalent to a bank-holding company; and
 - b. Financial instruments business operator engaged in type I financial instruments business or management company that is subject to the capital adequacy ratio standards established by the Basel Committee on Banking Supervision or similar standards.
 - (ii) Are such bonds traded on a financial instrument exchange market, an over-the-counter securities market or a foreign financial instrument market?
 - (iii) Are such bonds subordinated claims?
 - (iv) Are pari passu obligations owed by the issuer rated by a qualified rating agency to grades which are lower than the credit risk category of 4-3 or 5-3?
 - (v) The SA bank does not have information based on which it believes that such bond has creditworthiness lower than the credit risk category of 4-3 or 5-3; and
 - (vi) Does the bond have sufficient liquidity?
- 6) Equities issued by corporations which comprise the major stock index of the designated country; or
- 7) Investment trusts or other similar instruments (hereinafter "investment trusts, etc.") that satisfy all of the following conditions:
- (i) Investments are limited to assets eligible as collateral in the simplified method. However, a bank may use derivative transactions to hedge against the risk of assets in which such investment trusts, etc. invest; and
 - (ii) The market trade prices of such investment trusts, etc. are published every trade day.

- (5) When a bank uses a comprehensive method, do eligible financial collaterals satisfy the conditions in (4) above and are they any of the assets specified below? However, for repo-style transactions involving assets that are included in the calculation of market risk equivalents (excluding those falling under the definition of resecuritization exposures), the range of eligible financial collateral is not limited.
- 1) Listed equities issued by corporations which do not comprise the major stock index of the designated country; or
 - 2) Investment trusts, etc. that satisfy all of the following conditions:
 - (i) Investments are limited to assets specified in (4) above and equities specified in (1) above. However, a bank may use derivative transactions to hedge against the risk of assets in which such investment trusts, etc. invest;
 - (ii) The market trade prices of such investment trusts, etc. are published every trade day.

3. Comprehensive method

- (1) When a bank uses a comprehensive method, does it calculate the exposure amount after making adjustment with a CRM method (hereinafter, "CRM-adjusted credit risk exposure") by the following calculation method using a haircut rate (volatility adjustment rate):

$$E^* = E \times (1 + He) - C \times (1 - Hc - Hfx)$$

where E^* is the CRM-adjusted credit risk exposure (not less than "0");

E is the amount of the exposure;

He is the haircut rate applied to collateral assets provided to the counterparty where the exposure is the lending of securities, the provision of cash or securities as collateral, or a credit exposure equivalent to a securities sale or purchase with repurchase rights;

C is the value of the eligible financial collateral;

Hc is the haircut rate applied to such eligible financial collateral; and

Hfx is the haircut rate applied in the case where the currency of the exposure is different from the currency of the eligible financial collateral.

- (2) When a bank uses a standard haircut rate, does the bank use an appropriate haircut rate? For example, does the bank adjust the haircut rate and the collateral amount depending on the minimum holding period, or adjust the haircut rate depending on the frequency of the mark to market?
- (3) When a bank uses its own-estimate haircuts, does the bank confirm that it satisfies the criteria

(qualitative and quantitative) for approving such haircut rates?

- (4) When a transaction is not a repo-style transaction and the counterparty is a core market participant, does the bank not exclude such transaction from the application of haircuts?
- (5) When a bank considers the effect of bilateral netting contracts for two or more repo-style transactions under a legally effective bilateral netting contract, does the bank calculate the CRM-adjusted credit risk exposure by the following calculation method?

$$E^* = (\Sigma E - \Sigma C) + \Sigma (E_s \times H_s) + \Sigma (E_{fx} \times H_{fx})$$

where E^* is the CRM-adjusted credit risk exposure (not less than "0") of such two or more repo-style transactions;

ΣE is the total of the exposures to such two or more repo-style transactions;

ΣC is the total value of collaterals for such two or more repo-style transactions;

E_s is the absolute value of the net position in the given security;

H_s is the haircut rate applicable to such security;

E_{fx} is the absolute value of the net position in a currency different from the settlement currency, and

H_{fx} is the haircut rate applied in the case where the currency of the exposure is different from the currency of the collateral.

- (6) When a bank uses an exposure variation estimation model to calculate a CRM-adjusted credit risk exposure for two or more repo-style transactions under a legally effective bilateral netting contract, does the bank confirm that it satisfies the criteria (qualitative and quantitative) for approving the use of such estimation model?

4. Simplified method

- (1) When a bank uses a simplified method, does it satisfy the following conditions?
 - 1) Is the maturity of the exposure not longer than the maturity of the eligible financial collateral; and
 - 2) Is the eligible financial collateral reevaluated at least once in six months?
- (2) In a simplified method, is the risk weight on the portion of an exposure to which a CRM method is applied the same as the risk weight of the collateral asset, instead of the risk weight of the counterparty?

Is such risk weight not lower than 20%, excluding in the following cases?

- 1) Repo-style transactions which satisfy the requirements for exclusion from the haircuts and which are made with core market participants: 0%
- 2) Repo-style transactions which satisfy the requirements for exclusion from the haircuts and which are made with counterparties who are not core market participants: 10%
- 3) Cases where the exposures to derivative transactions (limited to those using the current exposure method) and the collaterals are in the same currency and such collaterals are cash or borrowers' deposit accounts at the bank and are marked to market every trade day: 0%
- 4) In the cases stipulated in (iii) above, the collaterals are bonds issued by the national government or a local government in Japan and the risk weight of such bonds in the standardized method is 0%: 10%
- 5) Exposures and collaterals are in the same currency and the conditions in a. or b. below are satisfied (excluding repo-style transactions and derivative transactions): 0%
 - (i) The collateral is cash or borrower's deposit accounts at the bank; or
 - (ii) The collateral is bonds issued by the national government or a local government in Japan and the risk weight of such bonds in the standardized method is 0%, and the collateral is evaluated at 80% of the market price or lower.

5. Netting of the loan balance with the borrower's deposit account at the bank

- (1) If a bank calculates a CRM-adjusted credit risk exposure by netting the loan balance with the borrower's deposit account at the bank in accordance with a netting agreement with such borrower, does the bank satisfy all of the conditions specified below? If the loan and the borrower's deposit account are in different currencies, does the bank apply to such exposure the haircut rate applicable to cases where the collaterals and the exposures are in different currencies?
 - 1) Does the bank have sufficient proof that netting of the loan balance with the borrower's deposit account for a transaction is legally enforceable in the event of insolvency of the borrower, a decision to commence proceedings for bankruptcy, rehabilitation or reorganization, an order for commencement of reorganization or special liquidation, or any other similar event that occurs to the borrower?;
 - 2) Is the bank at any time be able to identify the loan balance and the borrower's deposit balance under a netting agreement executed with the borrower?
 - 3) Does the bank monitor and control the risk that the borrower's deposit account may be cancelled?
 - 4) For the relevant exposure, does the bank monitor and manage the balance after netting of the loan with the deposit?

For the calculation of the haircut rate above, are the requirements stipulated for the comprehensive method applied? The minimum holding days, however, are 10 business days.

6. Guarantees and credit derivatives

- (1) When a bank uses guarantees or credit derivatives as a CRM method, does the bank satisfy all of the following conditions?
 - 1) Does the guarantee or credit derivative represent a direct claim on the guarantor or protection provider?
 - 2) Is the range of guaranteed or underlying claims, or claims that may be covered by guarantees or credit derivatives, clearly identified?
 - 3) Is the provision of such CRM method not be able to be cancelled unless payment necessary to receive the provision of a CRM effect by a guarantee or credit derivative is not made, or the guarantor or protection provider has a right to terminate the credit risk mitigation effect?;
 - 4) Does the guarantee or credit derivative contract not include a clause that substantially requires additional payment in the event of deterioration of the credit quality of the borrower of the guaranteed or underlying claim?;
 - 5) The guarantee or credit derivatives contract is executed in writing; and
 - 6) Does the guarantee or credit derivatives contract not include a clause that prevents timely payment by the guarantor or protection provider in the event of a default of the guaranteed obligation or the occurrence of an event that triggers the exercise of the protection.

- (2) In addition to the conditions in (1) above, does the guarantee contract satisfy all of the following conditions?
 - 1) Upon a default event of the guaranteed obligation, the bank may directly demand that the guarantor pay such guaranteed obligation without going through a demand against the borrower of the guaranteed obligation via lawsuit;
 - 2) Are commission fees, interests and other charges also covered by the guarantee, in addition to the principal amount?

- (3) In addition to the conditions in (1) above, does the credit derivatives contract satisfy all of the following conditions?
 - 1) Does such credit derivatives contract stipulate that the bank will receive payment if any of the following events occurs?
 - (i) Default of the payment obligation related to the underlying claim (a deductible amount may be set in the contract);
 - (ii) A decision to commence proceedings for bankruptcy, rehabilitation or reorganization, order

for commencement of reorganization or special liquidation, or insolvency of the borrower of the underlying claim, or the presentation of a document that recognizes high probability of default of the obligation on the due date of the underlying claim, or any other similar event;

or

- (iii) Reduction, exemption or postponement of the payment of the principal or any interest of the underlying claim or any related charge, implemented for the purpose of reconstructing or supporting the business of the borrower of the underlying claim.
- 2) If the credit derivative allows the protection provider to calculate the amount to be paid for any event described in (i) above based on the appraisal value of a specific obligation of the borrower of the underlying claim and to pay such calculated amount in cash to settle the obligation, are the procedures for such appraisal (including the days used for the appraisal) established?;
 - 3) If the credit derivative requires that the underlying claim be transferred to the protection provider in any event stipulated in (i) above for settlement of the obligation, and if such transfer has to obtain consent from the borrower of the underlying claim, is it stipulated in the contract for such underlying claim that such consent is not to be withheld without due cause?;
 - 4) The bank has the right to notify the occurrence of any event stipulated in (i) above to the protection provider. Is the person responsible for determining whether such event occurred clearly decided? Is such person, however, responsible for determination not limited to the protection provider?
 - 5) Where the underlying claim is not included in the reference obligations for settlement, is the reference obligation for settlement rank *pari passu* with the underlying obligation, and does the underlying obligation and the reference obligation share the same obligor, and does the credit derivative contract include a legally effective cross default clause for the reference obligation (if an event stipulated in (i) above occurs for the underlying claim, the bank may demand acceleration of the payment of the reference obligation)?
 - 6) Where the underlying claim is not included in the reference obligations for determining whether a credit event has occurred, does the reference obligation for settlement rank *pari passu* with or be subordinate to the underlying obligation for the determination, and does the underlying obligation and the reference obligation share the same obligor, and does the credit derivative contract include a legally effective cross default clause for the reference obligation?
 - 7) Is such credit derivative a credit default swap or a total return swap that provides a CRM method equivalent to a guarantee? However, if the net proceedings received from such total return swap are recognized as revenues, is the reduction in the underlying claim value recognized by reducing the book value or by using an allowance.

- (4) When a guarantee or credit derivative is used as a CRM method, is the guarantor or the protection provider as follows?
- 1) Any of the following entities to which a risk weight lower than that for the borrower of the guaranteed or underlying claim is applied:
 - (i) the national government, a local government or a local public financial organization in Japan, a national governmental organization in Japan, a public sector entity of a foreign country (excluding a national government), or an international development bank;
 - (ii) a financial institution, a foreign bank, a bank-holding company or a foreign corporation equivalent to a bank-holding company; or
 - (iii) Financial instruments business operator engaged in type I financial instruments business or management company that is subject to the capital adequacy ratio standards established by the Basel Committee on Banking Supervision or similar standards.
 - 2) Any other entity not specified above (i), to which a qualified rating agency has assigned a rating (including a parent company, subsidiary or affiliate of the borrower of the guaranteed or underlying claim).
- (5) If a guarantee or credit derivative contract, which is used as a CRM method, stipulates a threshold value for a loss or default of payment related to a guaranteed or underlying claim below which no payment is required of the guarantor or the protection provider, is a risk weight stipulated in Chapter 8 of the Notification applied to the amount equal to such threshold value?
- (6) Where the amount guaranteed or protected by a guarantee or credit derivative as a part of the CRM method is smaller than the amount of the exposure, if the guarantor or protection provider bears the loss related to the guaranteed or underlying claim in proportion to the percentage of their guarantee or protection to the exposure amount, does the bank apply the CRM effect only to the portion of the exposure covered by such guarantee or protection?
- (7) Where a portion of the credit risks of an exposure is divided into one or more tranches and transferred to one or more guarantors or protection providers and the bank retains the remaining credit risk, if the transferred risk and the retained risk have different seniorities, does the bank apply the rules for securitization exposures to such retained credit risk?
- (8) Where the currency of the guarantee or credit derivative is different from the currency of the exposure, is the notional principal of the guarantee or credit derivative determined by the following calculation method;

$$Ga = G \times (1 - Hfx)$$

where Ga is the notional principal of the guarantee or credit derivative after adjustment;

G is the notional principal of the guarantee or credit derivative; and

Hfx is the haircut rate (volatility adjustment rate) applied in the case where the currency of the guarantee or credit derivative is different from the currency of the exposure.

Does the bank adjust the haircut rate or the collateral amount depending on the minimum holding period, or adjust the haircut rate depending on the frequency of mark to market?

7. Treatment of cases where the maturity of the CRM method is less than the maturity of the exposure

- (1) When a bank uses a CRM method, does it define both the maturity of the exposure and the maturity of the CRM method in a conservative manner, in accordance with the following rules?
 - 1) Is the maturity of an exposure determined based on the latest possible due date for fulfillment of the obligation, taking into account any grace period (the days given to the obligor before its obligation is accelerated)?
 - 2) Does a bank determine the maturity of a CRM method in accordance with a. and b. below, in principle, and does it choose the shortest period, taking into account the possibility that the option incorporated in the CRM method may reduce the maturity?
 - (i) If the guarantor or protection provider has the right to terminate the CRM method, is the maturity until the first day when such termination right becomes exercisable?
 - (ii) Where an SA bank has the right to terminate the CRM method, if the bank has a due reason to terminate the CRM method earlier than the originally agreed date, is the maturity of the CRM method until the first day when such termination right becomes exercisable?
- (2) If the maturity of a CRM method is less than the maturity of the exposure and if any of the following conditions is satisfied, does the bank not use a CRM method?
 - 1) The maturity of a CRM method is less than a year the first time the bank considers such CRM method, or
 - 2) The maturity of a CRM method has become three months.
- (3) If the maturity of a CRM method is less than the maturity of the exposure, is the effect of the CRM method adjusted by the following calculation method?

$$Pa = P \times \{(t - 0.25)/(T - 0.25)\}$$

where Pa is the adjusted amount of the CRM method after adjustment of the maturity;
 P is the amount of the CRM method (adjusted by the haircut rate, if a haircut rate is applied);
 t is the maturity of the CRM method, expressed in years; provided, however, that if t is larger than T , then T is used; and
 T is the maturity of the exposure, expressed in years, with the upper limit being five years.

8. Other matters related to CRM method

- (1) When a bank considers the effect of more than one CRM method applied to a single exposure, does the bank separate the exposure into portions to which each CRM methods are individually used and is one CRM method corresponding to each portion used?
- (2) Where a single entity provides more than one guarantee or credit derivative to a single exposure, and if those protections are in different currencies or have different residual maturities, does the bank separate the exposure into portions corresponding to the respective guarantees or credit derivatives.

9. First-to-default credit derivatives

- (1) When a bank uses a first-to-default credit derivative as a CRM method, does the bank use the CRM method only to the exposure which has the smallest reduction of a credit risk asset when the risk weight of the protection provider is applied (up to the notional principal of such credit derivative), out of the exposures that may be protected by such credit derivative?
- (2) Where a protection is provided by a first-to-default credit derivative, if a qualified rating agency has assigned a rating to such credit derivative, does the bank determine the risk weight applied to the exposure covered by such protection, by applying the rules applicable to securitization exposures?

If a rating is not assigned by a qualified rating agency, are the risk weights of all exposures that may be covered by such protection added, up to a maximum of 1250%, and multiplied by the credit equivalent of such credit derivative to obtain the risk-weighted credit risk asset amount?

10. Second-to-default credit derivatives

- (1) When a bank uses a second-to-default credit derivative as a CRM method, does the bank satisfy the following requirements?
 - 1) In a case where a protection is provided not only by such second-to-default credit derivative but also by a first-to-default credit derivative covering the same exposure

Does the bank use the CRM method only to the exposure which has the second smallest reduction of a credit risk asset when the risk weight of the protection provider is applied (up to the notional principal of the second-to-default credit derivative), out of the exposures that may be protected by such credit derivative?

- 2) In a case where a credit event has occurred to any of the exposures that may be subject to the protection

Does the bank use the CRM method only to the exposure which has the smallest reduction of a credit risk asset when the risk weight of the protection provider is applied (up to the notional principal of the second-to-default credit derivative), out of the exposures that may be protected by such credit derivative and for which no credit event has occurred?

- (2) If a protection is provided by a second-to-default credit derivative, does a bank apply the rules for the first-to-default credit derivatives with appropriate adjustments?
- (3) For order-reference credit derivatives (excluding first-to-default and second-to-default credit derivatives), are the requirements stipulated in (1) and (2) above applied with appropriate adjustments?

IV. Securitization exposures

1. Common treatment

- (1) Is the risk weight of 1250% applied to the exposures stipulated in a. and b. below, after excluding the amount corresponding to the increased capital as a result of the securitization transaction? An amount equal to the individual allowance for doubtful accounts may also be deducted.
- 1) Securitization exposures to which the 1250% risk weight is applied in accordance with Chapter 8 of the Notification; and
- 2) Credit-enhancing I/O strips.
- (2) If a bank is the originator of an asset-transfer-type securitization transaction, and it does not fall under any of the following conditions, does the bank calculate the credit risk asset of the underlying asset?
- 1) Major credit risks of the underlying assets have been transferred to a third party; or
- 2) The bank does not have effective control over the underlying asset, and the underlying asset is legally isolated from the bank with documents by lawyers regarding such conditions, put

beyond the reach of the bank and its creditors, even in the event of the bank's bankruptcy or any other similar proceedings. For the purpose of this paragraph, a bank is deemed to have effective control over the asset if it falls under either of the following conditions:

- (i) The bank has the right to buy back the underlying asset from the assignee, unless the exercise of such buy-back right is a clean-up call stipulated in (vi) below; or
 - (ii) The bank bears the credit risk related to such underlying asset. However, the bank is not precluded from possessing the subordinated portion as long as the condition in (i) above is satisfied.
- 3) In securitization transactions, the rights of investors in such securitization exposures do not include claims against the bank (the transferor of the underlying assets).
- 4) The assignee of the underlying asset is a sponsor for the securitization, and the equity holders of such sponsor have free rights to set pledge on or transfer such equities.
- 5) The transfer agreement for the underlying asset does not include any or all of the following provisions:
- (i) A provision requiring the bank to exchange assets that comprise backing assets for the securitization exposures, aiming to improve the average creditworthiness of the underlying asset. However, the bank is not precluded from selling the underlying asset to an independent third party at the market price;
 - (ii) A provision that permits the bank's additional underwriting of the lowest subordinate portion or credit enhancement after the transfer date; or
 - (iii) A provision that stipulates increases in payment of profits to investors, third party providers of credit enhancement or other parties, excluding the originating bank, in response to the deterioration of the creditworthiness of the backing assets for the securitization exposures.
- 6) If such securitization transaction includes a clean-up call, does such clean-up call satisfy all of the following requirements?
- (i) The clean-up call may be exercised by the bank's sole discretion;
 - (ii) The clean-up call is not intended to prevent the transfer of loss to investors or to provide credit enhancement to the securitization exposures held by such investors; and
 - (iii) The exercise of the clean-up call is allowed only when the balance of the underlying asset or the unredeemed securitization exposures held by a party who is not the originator becomes 10% or less of the original balance.
- 7) The bank has not provided any other credit enhancement than those agreed under a contract.

2. Standardized method

- (1) Does a bank calculate the credit risk assets of a securitization exposure, by multiplying the

value of such securitization exposure by the appropriate risk weight for the credit risk categories corresponding to the rating assigned by a qualified rating agency?

- (2) Does the rating for a securitization transaction satisfy the following criteria for adequacy of the ratings?
 - 1) Does the rating assigned by a qualified rating agency reflective of the credit risk of the exposure take into account the principal, interests and other factors?
 - 2) Is such rating assigned by a qualified rating agency that has experience in the rating of securitization exposures?
 - 3) Has such rating been published and included in the rating migration matrix?
 - 4) Are the ratings assigned to the bank's securitization exposures not based on liquidity facilities, credit enhancement or any other credit arrangement provided by the bank without payment?

- (3) Does the bank satisfy the following requirements for the use of ratings for securitization transactions?
 - 1) Does the bank designate one or more qualified rating agencies that it uses for the same type of securitization exposures?
 - 2) Does the bank constantly use the ratings assigned by such qualified rating agencies?
 - 3) Does the bank not apply different ratings obtained from different qualified rating agencies to individual securitization exposures that comprise the same securitization transaction?
 - 4) Does the bank have a system in place that is necessary to continually collect information about the comprehensive risk characteristics of its securitization exposures?
 - 5) Does the bank have a system in place that is necessary to collect in a timely manner information about the comprehensive risk characteristics and performance of the backing assets for its securitization exposures?
 - 6) Does the bank have a system in place that is necessary to collect information about the structural characteristics of the securitization transactions related to its securitization exposures?
 - 7) Where a bank has exposures related to securitization transactions which are excluded from resecuritization transactions in accordance with Article 1.2 (2) a. or b. of the Notification, does the bank have a system in place that is necessary to collect in a timely manner information on the comprehensive risk characteristics and performance of the backing assets for the securitization exposures that comprise part or all of the backing assets for such securitization transactions?
 - 8) Does the bank have management rules in place to ensure that the requirements stipulated in (iv) to (vii) above are met?

(4) In a case listed in 1) to 3) below, or if the securitization exposures are unrated, does the bank apply a risk weight of 1250% to such securitization exposures?

- 1) The rating assigned by a qualified rating agency does not satisfy any of the requirements related to the rating adequacy stipulated in (2);
- 2) Any of the requirements stipulated in (3) related to the use of ratings for securitization transactions are not satisfied;
- 3) The rating assigned by a qualified rating agency to a securitization exposure is reflective of the guarantee or credit derivative directly provided to the sponsor of the securitization, and the guarantor or protection provider is not an eligible guarantor or protection provider.

If an unrated securitization exposure (including those stipulated in (i) to (iii) above, the same definition shall apply in this paragraph) satisfies all of the requirements stipulated in (i) and (ii) below, a bank may apply to such unrated securitization exposure the weighted average of risk weights that can be applied to individual exposures of backing assets comprising such securitization exposures:

- (i) Such securitization exposure is the top priority;
- (ii) The bank always knows the composition of the backing assets for such securitization exposures.

When all of the requirements stipulated in (i) and (ii) below are satisfied, a bank may apply to an unrated commitment line contract, credit enhancement or any other similar securitization exposure the highest of the risk weights that can be applied to individual assets comprising the underlying assets of such securitization exposures (if such highest value is less than 100%, 100% may be applied), instead of a risk weight of 1250%:

- (i) Such securitization exposure is not financially in the first-loss position, and the first-loss portion in a securitization transaction comprised by such securitization exposure is deemed to assume sufficient credit risks for such securitization exposure; and
- (ii) The bank does not possess the first-loss portion of the securitization transaction related to such securitization exposure.

For an unrated and eligible liquidity facility, the highest of the risk weights that can be applied to individual backing assets covered by the contract for such eligible liquidity facility may be used as its risk weight.

V. CVA risks

(1) By using a standardized risk measurement method, does a bank calculate the CVA risk equivalent amount related to derivative transactions with parties that are not any of the entities listed below?

1) Central counterparty;

2) Direct clearing members that satisfy all of the following conditions, if the bank is an indirect clearing member of a qualified central counterparty (hereinafter "CCP"):

(i) As for indirect clearing member trade exposures, the qualified CCP or the direct clearing member takes proper measures to prevent the loss in the following cases:

a. Default or insolvency of direct clearing members; or

b. Default or insolvency of other indirect clearing members.

(ii) When an indirect-clearing member entrusts to a direct-clearing member intermediation of the clearing of qualified CCP trade exposures, if such direct-clearing member loses its qualification to participate in the clearing at the qualified CCP as a result of its default or insolvency, there is a system that enables, without additional burden on the indirect-clearing member, continuance or succession of the contract related to such trade exposure with another direct-clearing participant or the qualified CCP.

(iii) Fund clearing houses

A bank that uses Japanese standards and does not fall under any of (i) to (iv) below may use a simplified risk measurement method to calculate the CVA risk equivalent of a derivative transaction with a counterparty who is not an entity listed in (i) to (iii) above:

(i) Banks adopting the IRB method;

(ii) Banks adopting an internal model approach;

(iii) Banks adopting an advanced measurement method; or

(iv) Banks that have obtained approval for the use of an expected exposure approach.

(2) If a bank has obtained the approval of the Commissioner of the Financial Services Agency for its use of an internal model method for the calculation of individual risks related to bonds, and if it has obtained the approval of the Commissioner of the Financial Services Agency for the use of the expected exposure approach for the calculation of a credit equivalent amount, does the bank use an advanced risk measurement method, regardless of the requirement in (1) above, to calculate the CVA risk equivalent amount related to a transaction with parties that do not fall under the entities listed below?

1) Central counterparty;

- 2) If the bank is a direct clearing member of a CCP, direct clearing members that satisfy all of the conditions stipulated in (1) 2) above; or
- 3) Fund clearing houses

VI. CCP exposures

Does a bank adequately calculate the credit risk asset of the following exposures, in accordance with the provisions in Chapter 8-3 of the Notification?

- (i) CCP trade exposures;
- (ii) Clearing funds related to central counterparties; and
- (iii) Direct clearing member trade exposures.

Review List of IRB Approach Components

A bank that adopts an internal rating based (IRB) approach needs to secure the accuracy and objectivity of its capital adequacy ratio by a robust internal control system. Accordingly, it needs to have a credit risk control unit which is independent from the credit examination department, and internal auditing is very important.

In order to specifically review the credit risk management status of a bank that adopts the IRB approach (hereinafter, "IRB bank"), this "Review List of IRB Approach Components" is created based on the "Standards for Determining the Adequacy of a Bank's Capital Adequacy Ratio Based on Its Assets under Article 14.2 of the Banking Act" (Financial Services Agency Notification No. 19, 2006, hereinafter, the "Notification").

The inspector shall hold sufficient discussions with a financial institution, while referring to this Review List, the Notification, Q&A on the Notification and other reference materials.

(Note) Explanation about components to be reviewed

Unless otherwise specified, components to be reviewed are those minimum standards required of banks adopting the IRB approach (banks adopting a foundation IRB approach and banks adopting an advanced IRB approach).

The review of the following components needs special attention because Transitional measures are specified for these components:

1. As for the trust contracts with compensation of principal loss executed on and before March 31, 2010, the credit risk assets may be calculated by using the former standard.
2. As for the long-run average loss-given-default (LGD) of residential real estate exposures, the lower limit ("floor") will be set to 10% for the time being.
3. As for an exposure that falls under any of the following conditions on any date chosen from the period from June 28, 2004 to September 30, 2004, the risk asset of such exposure may be set, until June 30, 2004, to an amount determined by multiplying the amount of the exposure by a risk weight of 100%, as long as such exposure is possessed by the bank.
 - (1) Equity exposures, excluding exposures to be deducted from the calculation of the capital adequacy ratio.
 - (2) Trust beneficial rights or equities in corporations or similar entities formed for the business of investment, all of whose assets satisfy the condition stipulated in a. above, and of such assets, the names and values of the continuously held assets can be identified. In

identifying such assets, if an asset held by a bank is invested based on a major stock index (referring to an index of listed stocks commonly used in the market) in advance in its articles of incorporation or a contract, the asset may be treated as an identifiable asset.

(Note) Definition of terms

The terms used in this Examination List shall have the meaning specified in the Notification.

I. Internal Control

1. Board of Directors

Does the internal control of the bank satisfy the following conditions?

- (1) Are all material aspects of the rating and estimation processes (collectively referring to the rating of corporate exposures, assignment of retail exposures to pools, and a series of processes for estimating the PDs, LGDs and EADs of exposures) approved by the bank's board of directors or a designated committee thereof, and senior management?
- (2) Do directors and executive officers have a general understanding of the bank's risk rating system and detailed comprehension of its associated management reports?
- (3) Does senior management provide notice to the board of directors or a designated committee thereof of significant changes or exceptions from established policies that will significantly impact the operations of the bank's rating system?
- (4) Does senior management also have a good understanding of the rating system's design and operation, at the same time approving material differences between the established procedure and actual practice?
- (5) Does senior management also ensure, on an ongoing basis, that the internal rating system is operating properly?
- (6) Do senior management and staff in the credit risk control unit meet regularly to discuss the performance of the rating process, areas needing improvement, and the status of efforts to improve previously identified deficiencies?
- (7) Does rating play an important role in the reports submitted to the board of directors or executive officers? Are risk profile by grade, changes in the ratings, estimation of variables for each rating, comparison of the estimated PD and the actual PD (PD, LGD and EAD for banks adopting advanced IRB approach), and other important matters reported to the board of directors, its designated committee or senior management?

2. Credit risk control unit

- (1) Does a bank have an independent unit that is responsible for the design or selection, implementation and performance of its internal rating system (hereinafter, "credit risk control unit")?
- (2) The credit risk control unit is independent functionally from the credit examination department and personnel responsible for credit examination.
- (3) Does the credit risk control unit take responsibility for the following duties?

- 1) Review the internal rating system and monitor its operation;
 - 2) Create and analyze summary reports about the internal rating system (including dates of defaults, ratings assigned during the one year prior to defaults, default data by pool, analysis of changes in rating, and monitoring of trends in key criteria of ratings and pools);
 - 3) Follow the process to review that the definition of each pool and rating are consistently applied across each department and geographic area (a bank may use different rating standards and procedures for individual borrowers or exposures);
 - 4) Review any change in the rating process and create a document relating to the change (including the reason for the change);
 - 5) Review the rating and pool standards to assess whether they are predicting risks accurately; and
 - 6) Create and maintain documents regarding the rating process, rating and pooling standards, and changes in the rating or variables related to pools.
- (4) Is a credit risk control unit actively participate in the development, selection, implementation and review of rating models used in the rating process?
- (5) Is the credit risk control unit responsible for managing and supervising the model in (4) above as well as continuously reviewing and revising such models?

3. Audit

Does an internal audit department which is functionally independent from other departments review at least annually the bank's rating system and its operations, including the status of operations of the credit examination department and the estimation of PDs, LGDs and EADs? Areas of review include adherence to all applicable minimum requirements as well. Does the internal audit unit create an audit report documenting its findings?

II. Use of the IRB approach

1. Reporting of changes in the approved matters

Is a report submitted to the Commissioner of the Financial Services Agency without delay when the following cases occur?

- (1) Any change in information contained in the approval application;
- (2) Significant change in information contained in documents attached to the approval application;
- (3) Any situation where the minimum requirement for the IRB approach is not satisfied.

2. Review of adequacy of exclusion from the IRB approach

- (1) Is a business unit or asset class excluded from the IRB approach reviewed periodically to confirm their satisfaction of the following quantitative criteria?
 - 1) Is the total value of the credit risk assets of business units or asset classes for which the standard approach is adopted not more than 10% of the total value of the credit risk assets of the IRB bank (an amount determined by deducting the values of the CVA risks and credit risk assets related to the central counterparty (CCP) exposures from the total value of the credit risk assets of the IRB bank)?
 - 2) Is the total value of the credit risk assets of a single business unit or asset class for which the standard approach is adopted not more than 2% of the total value of the credit risk assets of the IRB bank (an amount determined by deducting the values of the CVA risks and credit risk assets related to the CCP exposures from the total value of the credit risk assets of the IRB bank)?; provided, however, that if such IRB bank is a subsidiary of another bank or bank-holding company that adopts the IRB approach, are the credit risk assets of a business unit or asset class for which the standard approach is adopted not more than 2% of the total value of the credit risk assets of such another bank or bank-holding company that uses the IRB approach (which is not a subsidiary of another bank or bank holding company that adopts the IRB approach)?
- (2) Are such excluded units or assets reviewed periodically to confirm that they satisfy the qualitative conditions specified in the IRB approach implementation plan or the advanced IRB approach transition plan of the bank, to be classified as "insignificant" for the calculation of the credit risk asset value?

III. Calculation of credit risk assets

1. Corporate exposures

- (1) Is the PD used for the calculation of the credit risk asset not 0.03% or lower, for corporate/financial institutions exposures?

Is a PD of 100% used for a corporate exposure which is assigned a rating equivalent to default?
- (2) Does a bank that adopts a foundation IRB approach use an LGD of 45% for calculating the credit risk assets of corporate exposures? However, for subordinated claims, is the LGD set at 75%?

In setting the LGD, the effect of a credit risk mitigation technique may be taken into account, by using the following calculation method:

$$\text{LGD} = 45\% \times (\text{Corporate exposure adjusted by the effect of the credit risk mitigation technique based on a comprehensive approach}) / (\text{The value of corporate exposure})$$

If the investment requirements, the goal of eligible collateral receivables, eligible collateral real estate or any other assets eligible as collateral (hereinafter, "eligible collateral") are satisfied and if the percentage of the value of such eligible collateral to the value of such exposure equals or exceeds the minimum collateral coverage rate specified in the table below, a bank that adopts the foundation IRB (hereinafter, "foundation IRB bank") may apply the LGD specified in the table below to the amount determined by dividing the value of such eligible collateral by the following excess coverage rate:

	Minimum collateral coverage rate	Excess collateral coverage rate	LGD
Eligible collateral receivables	0%	125%	35%
Eligible collateral real estate	30%	140%	35%
Other eligible collateral	30%	140%	40%

(3) Do the eligible collateral receivables satisfy all of the following requirements and are they provided as collateral?

- 1) Such receivable is a claim of the borrower of a collateral loan to receive a payment from a third party for a transaction with such third party, with its original maturity within one year;
- 2) The receivable is not securitized, nor related to a loan participation or credit derivative; and
- 3) The receivable is not a claim to a "subsidiary corporation" of the borrower (as defined in Article 4-2.2 of the Order for Enforcement of the Banking Act) or an affiliated corporation (as defined in Article 4-2.3 of the same Order), or any other person who has a strong default correlation with the borrower.

(4) Is the eligible collateral real estate intended for business operation or residence, having all of the following characteristics?

- 1) The risk related to the borrower of a collateral loan is subject to the solvency of the borrower who has a resource for the repayment which is not such real estate or a project related to such real estate;
 - 2) The value of the real estate provided as collateral does not vary significantly depending on the business performance of the borrower; and
 - 3) The collateral loan is not a loan for business-purpose real estate.
- (5) Are all the other eligible collateral in the form of ships, airplanes or golf association memberships that are eligible as collateral?
- (6) When calculating the credit risk asset for a corporate exposure, does the EAD of the balance sheet items used for the calculation exceed the sum of the own capital that would decrease in the event of full write-off of such exposure, the individual allowance for doubtful accounts, the partial direct write-off and the discount that would be applied for purchasing discounted defaulted receivables (limited to those not requiring repayment)?

Notwithstanding the above, the effect of the following credit risk mitigation techniques may be taken into account by EAD:

- 1) Legally effective netting agreements (limited to repo-style transactions); and
 - 2) Offsetting of the loan balance with the borrower's deposit account at the bank.
- (7) Does the calculation of the credit risk asset for a corporate exposure use an effective maturity properly determined by the following calculation method. If such maturity is less than one year, however, it will be counted as one year, and if such maturity is longer than five years, it will be counted as five years.

$$\text{Effective maturity (M)} = \frac{\sum_t t \times \text{CF}_t}{\sum_t \text{CF}_t}$$

where CF_t is a cash flow contractually payable by the borrower in period t.

If a bank is not in a position to calculate the effective maturity of the contracted payment obligation, is an alternate conservative value, such as the remaining exposure period specified in the contract, used in place of the formula above?

Regardless of the proviso above, the lower limit of one year maturity does not apply to a short-term exposure whose original maturity specified in the contract is less than one year and which falls under any of the conditions stipulated below. For such exposure, is the effective maturity a number of days less than one year and at least one day?

- 1) Exposures of repo-style transactions (limited to those conducted under the commonly-used form of contract for repo-style transactions), call transactions and other short-term transactions in the financial market;
- 2) Exposures of other transactions in the capital market that satisfy all of the following conditions:
 - a. Sufficiently and continuously secured with collateral;
 - b. Marked to market every business day and subject to remarkining; and
 - c. In the event of forfeiture of the benefit of time of the counter party, or failure of the obligation of remarkining, the collateral asset can be promptly disposed of or used for offsetting.
- (3) Short-term and high liquidity trade-related contingent obligations; or
- (4) Exposures of securities, commodities or transactions for settling foreign currencies or funds (excluding derivative instruments).

2. Retail exposures

- (1) Is the PD used for credit risk asset calculation not 0.03% or lower?
- (2) Is the LGD an estimation of the ratio of the economic loss that may be caused in the event of a default to EAD, expressed in a percentage?
- (3) Does the EAD of the balance sheet assets used for the calculation exceed the sum of the company's own capital that would decrease in the event of full write-off of such retail exposure, the individual allowance for doubtful accounts, the partial direct write-off and the discount that would be applied for purchasing discounted defaulted receivables (limited to those not requiring repayment)? However, if the EAD calculation takes into account the effect of the offsetting of the loan balance with the borrower's deposit account at the bank, the rules of the standard technique applied to the offsetting of the loan balance with the borrower's deposit account at the bank and the rules of the credit risk mitigating technique for a case where its maturity is less than the maturity of the exposure may be applied.
- (4) Is the EAD for off-balance-sheet assets an amount determined by multiplying the unused portion of the credit line by a ratio estimated by the bank, or an amount from which an additional amount estimated by the bank can be withdrawn?
- (5) As for off-balance-sheet assets related to eligible revolving retail exposures, is the EAD estimated by taking into account the possibility that if only the executed portion of the credit line is assigned as an underlying asset for securitization transaction, an additional amount may be

withdrawn from the unused portion held by the assignor? Further, is the credit risk asset calculated by using such EAD.

Is the EAD for off-balance-sheet assets estimated above determined by multiplying the EAD for the entire unused portion of the credit line whose executed portion was assigned as the underlying assets for the securitization transaction by the percentage of the portion possessed in such securitization transaction to the total value of the underlying asset?

3. Equity exposures

(1) Is the credit risk asset of equity exposures calculated by either of the following approaches?

- 1) Market based approach (simplified method, internal model method); or
- 2) PD/LGD approach

(2) Is the same approach and method consistently used for calculating credit risk assets of equity exposures included in the same portfolio?

(3) When a bank uses a simplified method to calculate the credit risk assets, are credit risk assets determined by multiplying the equity exposure by the risk weight of 300% for a listed equity, or by 400% for an unlisted equity?

(4) When a bank uses an internal model method, is the credit risk asset calculated by using an internal value-at-risk model, assuming a one-sided 99% confidence interval for the difference between the appropriate risk-free rate and the quarterly earning rate calculated for a long sample period?

Is the credit risk asset of each equity exposure not less than the amount determined by multiplying the value of such equity exposure by 200% for a listed equity, or by 300% for an unlisted equity?

(5) When the PD/LGD approach is used for calculating the credit risk asset of an equity exposure, is such equity exposure treated as a corporate exposure?

For the calculation, are the LGD of 90% and the maturity of five years used as well?

(6) When a bank uses the PD/LGD approach for a corporation, if the bank does not possess any other exposure to such corporation than equity exposure and if the bank does not have sufficient default information about the corporation, is the credit risk asset calculated by multiplying the amount determined based on the PD estimated by the bank by 1.5?

(7) When a bank uses the PD/LGD approach, is the sum value of the credit risk asset and the amount determined by dividing the expected loss of such equity exposure by 8% not less than the amount determined by multiplying the amount of such equity exposure by the risk weight of 200% for a listed equity, or by 300% for an unlisted equity, and not more than the amount determined by multiplying the amount of such equity exposure by 1,250%?

(8) Notwithstanding the requirement in (7) above, for the following equity exposures, the sum value of the credit risk asset and the amount determined by dividing the expected loss of such equity exposure by 8% are not to be less than the amount determined by multiplying the EAD of such equity exposure by the risk weight of 100%:

- 1) A listed equity and the investment in such listed equity has become a part of long-term customer transactions, and no capital gain is expected from short-term trading and no capital gain higher than the market trend is expected for a long term; or
- 2) An unlisted equity and the investment in such equity are collected regularly from the cash flow, not from capital gain, and no capital gain or profit higher than the market trend is expected in the future.

(9) Are the parties to whom the transitional arrangements for equity exposures apply properly identified and managed?

4. Deemed calculation of credit risk assets

(1) Is the calculation method for credit risk assets chosen properly based on the order of precedence specified in the deemed calculation of credit risk assets?

(2) If the credit risk asset of a possessed exposure cannot be directly calculated and if the individual underlying assets for the exposure are identifiable, is the total value of the credit risk assets of such underlying assets used as the credit risk asset of such exposure?

(3) However, in the case of (2) above, if equity exposure is included in the underlying assets for the exposure and if the majority of such underlying assets for the exposure is comprised of equity exposures in terms of value, the credit risk asset of such exposure may be determined by multiplying the value of such exposure by the risk weight corresponding to such equity exposures which comprise the majority of the underlying assets. In this case, however, such majority status should be properly reviewed.

(4) If the credit risk asset of a possessed exposure cannot be directly calculated, and cannot be

calculated by the methods in (2) and (3), and if the investment standards for the underlying assets of the exposure are identifiable, is the credit risk asset of such exposure determined based on the credit risk asset which is assumed for an asset portfolio with the greatest risk assets under such asset investment standards?

When each of the following method is used, are the corresponding requirements satisfied?

- 1) If a risk weight calculated for each underlying exposure is used as a risk weight for the maximum possible investment amount, is such asset assigned an internal rating?
- 2) If a rating assigned by an external credit assessment institution or any other similar agency (hereinafter such agency is referred to as "external credit rating agency," and such rating is referred to as "external rating"), is such external rating associated with the internal rating of the bank?

- (5) If the credit risk asset of a possessed exposure cannot be directly calculated, and cannot be calculated by the methods in (2) and (3), and if the investment standards for the underlying assets of the exposure are not identifiable, is the credit risk asset properly calculated by a standard established by the bank for determining risk weights?

Does a bank have proper standards to determine the probability that the weighted average risk weight of the individual underlying assets of such exposure is lower than 400%?

5. Purchased receivables

- (1) Is the credit risk asset of purchased receivables the sum of the credit risk asset of the portion corresponding to the default risk and the credit risk asset of the portion corresponding to the dilution risk? If the portion corresponding to the dilution risk is insignificant, the credit risk asset of purchased receivables may be determined only based on the credit risk asset of the portion corresponding to the default risk.

Does a bank have proper standards to determine that the value of the portion corresponding to the dilution risk is insignificant?

- (2) Is the EAD for the default risk of a purchased corporate exposure determined by subtracting (i) the sum of (a) the amount equal to 8% of the credit risk asset of the portion corresponding to the dilution risk and (b) the amount of the EAD_{dilution} for the purchased corporate exposure multiplied by EL_{dilution} from (ii) the EAD_{dilution} for the purchased corporate exposure?
- (3) Is the EAD for the unused credit line for revolving-type purchased receivables determined by subtracting the capital requirement for the dilution risk from the amount equal to 75% of the unused credit line? If this calculation results in a negative value, the EAD should be set to "0."

- (4) If a top-down approach is used for the calculation of the credit risk asset of an eligible purchased corporate exposure, is the effective maturity (M^*) for such exposure equal to the effective maturity (M) calculated for individual eligible purchased exposures within the eligible purchased corporate exposure pool to which such exposure belongs, weight averaged with the outstanding balance of such exposure.
- (5) Is the effective maturity of an undrawn credit line for revolving-type purchased receivables the sum of (i) the maturity of a receivable that has the longest maturity assignable out of the receivables that could be drawn in the future under the sales contract for revolving-type purchased receivables during the remaining period of the commitment line contract and (ii) the maturity of the credit line for the purchased receivables?
- (6) Is the EAD for the default risk of a purchased retail exposure determined by subtracting (i) the sum of (a) the amount equal to 8% of the credit risk asset of the portion corresponding to the dilution risk and (b) the amount of the EAD_{dilution} for the purchased retail exposure multiplied by the EL_{dilution} from (ii) the EAD_{dilution} for the purchased retail exposure?
- (7) If a purchased retail exposure pool includes an asset which falls under more than one asset class, is such pool deemed to be comprised of only asset classes with which the credit risk asset value of the portion corresponding to the default risk become the greatest (limited to those included in such pool)?

6. Lease transactions

- (1) Is the credit risk asset for lease charges calculated by using (a) an EAD determined by subtracting an interest amount which is reasonably estimated by the lessor on the start date of the lease from the lease charges, (b) the maturity (M) which is the lease period, and (c) the lessee's PD, LGD and sales revenues (S) (or the total asset value if it is not appropriate to use the sales revenue to determine the business size of a corporation, such as a wholesaler)? However, the maturity (M) may be calculated based on the effective maturity of the lease charge amount after deducting the interest-equivalent amount, instead of the lease period.
- (2) In a lease transaction in which the residual risk is "0," if the leased asset is treated as being provided as collateral for the lessee exposure, are the following requirements satisfied?
- 1) Does the lessor conduct strict risk management of the leased asset, particularly its location, purpose of use, elapsed years and measures against obsolescence?

- 2) Is there a robust legal framework establishing the lessor's legal ownership of the asset and enforcing its ability to exercise its rights as owner in a timely fashion?
 - 3) Is the difference between the depreciation rate of the leased asset and the amortization rate of the lease payments not so large as to overstate the credit risk mitigation method attributed to the leased assets?
 - 4) Are the investment requirements for the eligible other collateral assets satisfied?
- (3) In a lease transaction, is the credit risk asset for the residual value determined by multiplying the residual value by 100%?

IV. Designing of an internal rating system

1. Internal rating system for corporate exposures

- (1) Does a bank have the methods, procedures, controls, data collection and IT systems (hereinafter collectively referred to as an "internal rating system") necessary for credit risk assessment, the assignment of internal ratings to exposures, and the estimation of PDs, LGDs and EADs? (For the estimation of LGDs and EADs of corporate exposures, does the bank adopt an advanced internal rating based approach?)
- (2) If a bank uses more than one internal rating system, does the bank develop and document standards for choosing the best internal rating system for each borrower to determine the risk of such borrower?

In such a case, does the bank not choose an internal rating system arbitrarily for a specific borrower in order to increase its capital adequacy ratio?
- (3) Does the bank have an internal rating system for corporate exposures that controls the borrower rating and the facility rating? However, if a bank applies slotting criteria to designated loans, it is allowed to adopt an internal ratings system that assigns ratings according to expected loss rates, for such designated loans.
- (4) Do borrower ratings have all of the following characteristics?
 - 1) Do they correspond to the borrower's PD?
 - 2) Are multiple corporate exposures to the same borrower assigned the same borrower rating, except in the following two cases?
 - (i) Taking into account country transfer risk, a bank may assign different borrower ratings depending on whether the facility is denominated in local or foreign currency; or

(ii) In the case where the guarantees associated with such exposure are reflected in a borrower rating.

(5) Does the bank's practice of borrower rating assignment for corporate exposures stipulated in its credit risk management policy not deviate from the actual conditions, in the following aspects?

1) Is the relationship between borrower ratings clarified in terms of the risk levels implied by individual borrower ratings?

2) Does the risk level increase as the credit rating declines from one grade to the next?

3) Is the risk level of each borrower rating stipulated in the standards designed to determine the probability of default risk and the credit risk typical for borrowers assigned to such borrower rating?

(6) Does the bank set facility ratings for corporate exposures corresponding to their LGDs?

However, a foundation IRB bank may take into account factors specific to individual borrowers and transactions when establishing facility ratings for corporate exposures.

2. Internal Rating System for Designated Loans

When a bank applies slotting criteria to designated loans, are the bank's internal standards, rating structure and procedures consistent with the minimum requirements and are they used to assign ratings to such designated loans? Are such ratings associated (mapped) to the risk weight classes specified in the Notification?

Is the mapping process clearly documented and reviewed from time to time to review its adequacy?

3. Internal rating system for retail exposures

(1) Does the bank have an internal rating system for retail exposures that is based on and reflects the characteristics of the borrowers and transaction risks related to the exposures?

(2) Are retail exposures assigned to appropriate pools so that the following requirements are satisfied?

1) Risks are properly classified by such assignments;

2) Each pool is comprised of exposures all having sufficient similarity; and

3) Such assignments enable accurate and ongoing estimation of the loss characteristics of each pool.

(3) In assigning exposures to pools, are the following factors and other risk characteristics

considered?

- 1) Risk characteristics of borrowers;
 - 2) Risk characteristics of transactions (For a contract with a joint mortgage clause, is the clause always taken into account?); and
 - 3) Delinquency of exposure
- (4) Are the PDs, LGDs and EADs for retail exposures estimated for each pool? It does not mean, however, that the estimation of PDs, LGDs, or EADs cannot be the same for different pools as a result.

4. Rating structure for corporate exposures

- (1) Are corporate exposures properly distributed across each borrower rating and facility ratings with no excessive concentration on certain ratings, unless the adequacy of the concentration is supported by fully-proven data?
- (2) For corporate exposures, does a bank have a minimum of seven (7) borrower ratings for non-defaulted exposures and minimum of one (1) for those that have defaulted?
- (3) Are the borrower ratings defined by using the standards designed to determine the credit risk typical for borrowers assigned to such borrower rating and the credit risk corresponding to such rating?
- (4) Does a bank adopting the advanced IRB approach (hereinafter, "advanced IRB bank") have a sufficient number of facility ratings to avoid grouping facilities with widely varying LGDs into a single rating?
- (5) Does an advanced IRB bank define its facility ratings in accordance with the standards established based on proven data?
- (6) When a bank applies slotting criteria to designated loans, does it have a minimum of four (4) borrower ratings for non-defaulted borrowers and minimum of one (1) for those that have defaulted?

5. Rating structure for retail exposures

When retail exposures are assigned to pools, are all of the following requirements satisfied?

- (1) The PDs, LGDs and EADs of individual pools are quantified;

- (2) The number of exposures included in each pool are sufficient to enable the quantification and review of PDs, LGDs and EADs by pool;
- (3) When pools are compared, the borrowers and exposures assigned to each pool are appropriate;
- (4) Exposures are not excessively concentrated in one single pool.

6. Rating criteria

- (1) Does a bank have a clear definition, clear processes, and clear criteria for the ratings and pools in order to enable proper assignment of each rating of the rating structure to an exposure or assignment of an exposure to a pool?
- (2) Does a bank have a sufficiently detailed definition and sufficiently detailed criteria for the ratings and pools to ensure that borrowers and exposures having similar risks are assigned to the same rating or the same pool consistently, irrespective of business unit, department or geographic location?
- (3) When a bank applies different criteria and processes for the rating and pool assignment depending on the types of borrowers and exposures, does it monitor the criteria and processes to find any inconsistency and revise the rating criteria in a timely manner to improve its consistency?
- (4) Does a bank have a sufficiently detailed clear definition and sufficiently detailed clear criteria for the rating and pools so that an independent internal audit unit or a third party can assess the adequacy of the rating and pool assignments?
- (5) Is the criteria for the rating and pool assignment consistent with the bank's credit line criteria and policy for handling troubled borrowers and exposures?
- (6) When a bank assigns a borrower rating and a facility rating to an exposure or assigns an exposure to a pool, is all available and recent significant, relevant information taken into account?
- (7) If the bank has less information, is it more conservative in assigning exposures to borrower ratings and facility ratings or pools?
- (8) If a bank uses an external rating as a primary ground for assigning a rating to an exposure or assigning an exposure to a pool, does the bank ensure that it also considers other relevant information?

- (9) Does a bank review periodically the criteria and processes for the rating and pool assignments to determine whether they are adequate, considering the current structure of its overall assets and the external environments?

7. Assessment period of rating and pool assignment

- (1) When assigning an exposure to a borrower rating and a pool, does the bank use the following method or any other proper method to assess the ability and willingness of the borrower to fulfill its obligations under the contract?

- 1) In assigning a corporate exposure to a borrower rating or a retail exposure to a pool, are the PD and LGD estimated based on specific, appropriate stress scenarios?;
- 2) Does the bank take into account adequately the borrower's characteristics that are reflective of its vulnerability to adverse economic conditions or unexpected events?
- 3) Depending on the characteristics of the borrower, does the bank take into account the borrower's vulnerability to the fluctuation of its asset values in stress scenarios?

- (2) In making the assessment in (1) above, does the bank take into account the economic situations that could occur during the assessment period or in the economic cycle of the respective industry or region?

Given the difficulties in forecasting future events and the influence they will have on a particular borrower's financial condition, does a bank take a conservative assessment of the expected information?

Furthermore, where limited forecast data are available, does a bank analyze more conservatively?

8. Use of models

- (1) When statistical models and other mechanical methods (hereinafter referred to as "models") are used to assign borrower or facility ratings or in estimation of PDs, LGDs, or EADs, do the models satisfy all of the following requirements?

- 1) The model and entered values have all of the following characteristics:
 - (i) The model has good predictive ability, and regulatory capital requirements are not distorted to be lightened as a result of its use;
 - (ii) The variables that are input to the model form a reasonable set of predictors of the results;
and
 - (iii) The model is accurate from the perspective of the range of borrowers or exposures and there are no significant biases
- 2) The bank has in place a process for assessing the accuracy, completeness, appropriateness, etc.

of the data inputs into a statistical default or loss prediction model.

- 3) The data used to build the model are representative of the population of the bank's actual borrowers or exposures.
- 4) When the model is combined with human judgment, all of the following requirements are satisfied.
 - (i) The human judgment takes into account all relevant and material information not considered in the model; and
 - (ii) The bank has written guidance describing how human judgment and model results are to be combined.
- 5) The bank has procedures for human reviews of model-based rating assignments and such procedures focus on finding and preventing errors associated with known weaknesses of the model and also enhance the sustainable improvement the model's performance.
- 6) The bank has a regular assessment of the performance and stability of the model; the review of relationships between the model and the situations assumed in the model; comparison between the actual value and the expected value from the model; and other examinations of the model.

9. Documentation of internal rating system design and operation

- (1) In its credit risk management policy, does a bank describe the design and operation of its internal rating system?
- (2) Does the actual practice of the system not deviate from the processes stipulated in its credit risk management policy in the following aspects?
 - 1) Portfolio classification;
 - 2) Rating and pool criteria, as well as the rationale for its choice of rating and pool criteria (with analysis demonstrating that the chosen rating and pool assignment criteria and procedures for the assignment are likely to result in assignment to proper ratings and pools in accordance with the respective risks);
 - 3) The department responsible for the rating and pool assignment, the department authorized to define and approve exceptions to ratings and pool assignments, and other organization involved in the rating and pool assignment (including descriptions of the processes of the rating and pool assignments and the structure of the internal control system);
 - 4) The frequency of the review of the rating and pool assignment; the assignment process of the rating and pool; and supervision of assignment process of the rating and pool by the board of directors or its subordinate committee (hereinafter referred to collectively as "the board") and the senior management (the executive officer who is empowered to perform the supervision of the credit risk management);

- 5) The history of major changes in the rating and pool assignment process; and
 - 6) The specific definitions of default and loss used internally and consistency with the definitions in the Notification.
- (3) If a bank employs a model in the rating and pool assignment process, does the bank have the following descriptions in its credit risk management policy?
- 1) Outline of the model (detailed outline of the theory, assumptions and/or mathematical and empirical basis of the assignment of estimated values to ratings, individual borrowers, exposures, or pools; and detailed outline of the data source(s) used to create the model);
 - 2) Performance tests using data which are not sample data and over a period which is not an assessment period used in the model, and other rigorous statistical processes to review the model; and
 - 3) Any circumstances under which the model is not expected to work effectively.

V. Operations of an internal rating system

1. Rating assignment to corporate exposures

- (1) For corporate exposures, are each borrower and guarantors or parties that provided protections assigned a borrower rating (only when the credit risk mitigation effect by guarantees or credit derivatives of guarantors or protection providers is taken into account) and is each exposure associated with a facility rating in the course of the loan approval process according to its characteristics?
- (2) For corporate exposures, is each separate legal entity to which the bank is exposed separately rated, provided, however, that a bank may establish and follow a policy to assign the same rating to the parent company, etc. of such entity, or all or some of the subsidiaries and affiliates in the same corporate group?

2. Pool assignment of retail exposures

When a bank takes into account the credit risk mitigating effects of guarantees/credit derivatives of corporate exposures, does it assign the exposures to pools assuming that no such guarantees or credit derivatives are provided, and estimate PDs, LGDs and EADs based on such assignments?

3. Soundness of the process to assign ratings to corporate exposures

- (1) Are borrower ratings and facility ratings reviewed at least once a year for corporate exposures,

and more often for exposures with higher risks or problems?

- (2) Does a bank promptly review borrower ratings and facility ratings if it finds any significant risk information on corporate exposures or their borrowers?
- (3) Is the final assignment of a rating and revision of a rating in accordance with (1) or (2) made by or approved by a person who has no direct conflict of interest with such credit rating?
- (4) Does a bank have an effective process to obtain relevant and significant information on a borrower's characteristics that affect PDs and a facility's characteristics that affect LGDs and EADs?

4. Soundness of the process to assign retail exposures to pools

- (1) Does a bank review the loss characteristics and delinquency status of each pool of retail exposures at least once a year?
- (2) To ensure that each retail exposure continues to be assigned to an appropriate pool, does the bank also review the status of individual borrowers within each pool at least once a year, by reviewing representative samples of retail exposures in the pool or by any other appropriate method?

5. Overrides of ratings

- (1) When a bank uses an internal rating system that is based on human judgment, does the bank clearly articulate the following matters and other matters relating to the change of ratings and estimated values?:
 - 1) How the change is made;
 - 2) The extent of change possible; and
 - 3) The person in charge of the change.
- (2) When a bank uses an internal rating system that is based on models, does the bank have guidelines and processes to monitor the following matters?
 - 1) Change of estimated values or change in assignment of ratings, based on models by human judgment;
 - 2) Exclusion of variables from the model; and
 - 3) Change in input values.
- (3) Do the guidelines in (2) above specify the person in charge of change in assignment of ratings or

change of estimated values?

- (4) If ratings and estimates are overridden, does the bank separately track their performance after the change, according to the change?

6. Maintenance and management of data on corporate exposures

- (1) Does a bank collect and store the following data on corporate exposures?

- 1) The dates when the borrower ratings were revised since the original borrower ratings were assigned to borrowers and guarantors, the method used to assign such borrower ratings and major supporting data, the person in charge of rating assignments, the models used for estimation, and other history of data related to the borrower ratings of borrowers and guarantors;
- 2) The identity of the defaulted borrowers and exposures, and the dates and circumstances of such defaults;
- 3) Data on PDs corresponding to the ratings and actual PDs, and changes in ratings.

- (2) Does an advanced IRB bank collect and store the following data on corporate exposures?

- 1) A complete history of data on the LGD and EAD estimates associated with each exposure, the key data used to derive the estimates, and information of the person in charge and the model used for the estimation;
- 2) The estimated and actual LGDs and EADs associated with each defaulted exposure;
- 3) Do banks that take into account the credit risk mitigating effects of guarantees/credit derivatives through LGD retain data on the LGD of the exposure before and after evaluation of the effects of the guarantee/credit derivative (only if the credit risk mitigation effect of the guarantees or credit derivatives is reflected in the LGD estimation)?; and
- 4) Data on loss or recovery for each defaulted exposure, including the amount recovered, the source of recovery (e.g. collateral, liquidation proceeds and guarantees), the time period and recovery costs.

7. Maintenance of data on retail exposures

Does a bank collect and store the following data on retail exposures?

- (1) Data used in the process of allocating exposures to pools, including data on borrowers and exposure characteristics;
- (2) Delinquency data;
- (3) Data on the estimated PDs, LGDs and EADs, associated with pools of exposures; and
- (4) For defaulted exposures, does the bank retain data on the pools to which the exposures were

assigned over the year prior to default and the actual LGDs and EADs?

8. Stress test

(1) Does an IRB bank have in place sound stress testing processes used for the assessment of capital adequacy?

(2) Is the stress test in (1) above designed to identify possible events or future changes in economic conditions that could have unfavorable effects on a bank's credit exposures, including deterioration in economic conditions, market environments and liquidity, and assess the bank's ability to withstand such unfavorable changes?

(3) To assess the effect of certain specific conditions on its capital requirements against credit risks, does the bank perform a meaningful and reasonably conservative credit risk stress test that takes into account at least the effect of mild recession scenarios for the portfolio that comprises the majority of the bank's exposures?

(4) Does the stress test in (3) above satisfy the following requirements?

- 1) The bank's internal data allow estimation of the changes in ratings of at least some of its exposures;
- 2) The bank considers the impact of a smaller degree of deterioration in the credit environment on its ratings, gathering information on the possible impact by the deterioration of the credit environment; and
- 3) The bank considers the actual changes in external ratings by roughly matching its internal ratings with external ratings or by any other appropriate method.

(5) If a bank considers the effect of double defaults when performing the stress test in (3) above, are the following requirements, in addition to the requirements stipulated in (4) above, satisfied?

- 1) The bank considers what impact would be expected if the credit risk mitigation effect of guarantees or credit derivatives is lost as a result of a change in the rating of the guarantor or protection provider; and
- 2) The bank considers what impact would be expected in the event of a default by the guarantor, the protection provider or the borrower of the guaranteed or protected loan.

VI. Use of ratings

1. Use of ratings

Internal ratings, PDs and LGDs should play a significant role in managing the credit risk, actually used as essential tools by banks for the credit approval, risk management, internal capital allocations, and internal control functions.

If the PDs or LGD used by the bank for the capital adequacy ratio calculation are different from the estimates used for the internal capital allocations and internal control, are the differences and the reasons for the differences described in the credit risk management policy of the bank?

VII. Risk quantification

1. Definition of default

(1) Is a default defined as an occurrence of any of the following events (hereinafter, a "default event") to a borrower?

- 1) The occurrence of an event as a result of which the exposure to a borrower is assessed as a "claim under bankruptcy/rehabilitation or similar proceedings," "risky claim" or "claim requiring monitoring" as defined in the Ordinance for Enforcement of The Law concerning Emergency Measures for the Revitalization of the Financial Functions, which shall not include a delinquency of any repayment or payment of the principal/interest of a retail exposure that is "overdue for more than three months" from the next day of the due date, but not exceeding the delinquent days stipulated in the bank's credit risk management policy (not exceeding 180 days);
- 2) A sale related to the exposure to the borrower, which results in significant economic loss; or
- 3) Overdrafts of the checking account of the borrower longer than or equal to three months from the next day of the date when the overdraft amount exceeded the contracted upper limit (or "0" if no limit is set) or the date a limit lower than the current limit was notified to the borrower.

(2) If any default event has occurred to any single exposure to a borrower, does a bank regard that such default event has also occurred to all other exposures of such borrower? This requirement does not apply to retail exposures.

(3) When a default event for an exposure is eliminated, does the bank reassign an adequate rating to the exposure? Does an advance IRB bank estimate LGDs and EADs?

After reassignment to a rating, if the exposure defaults again, is the default treated as a new default event?

(4) Does a bank have clearly articulated and documented policies in respect of the counting of days past due, in particular in respect of the revisions to existing accounts and the granting of

extensions, deferrals, renewals and rewrites to existing accounts (hereinafter collectively referred to as "revision") including the following?

- 1) reporting requirements and authorities for revision approval;
- 2) the minimum dates for the credit granting before it becomes eligible for revision;
- 3) the delinquency levels of exposures that are eligible for revision;
- 4) the maximum number of revisions allowed for each exposure; and
- 5) reassessment of the borrower's capacity to repay.

Are these policies applied consistently over time?

If a bank treats a re-aged exposure in a similar fashion to defaulted exposures in its internal risk management process, is such re-aged exposure treated as a defaulted exposure for the IRB purposes?

- (5) Does a bank have strict standards to assess the creditworthiness of customers to whom it offers overdraft accounts?

2. Common requirements for estimation

- (1) Do internal estimates of PDs, LGDs, and EADs incorporate all relevant, significant and available data, information and methods? A bank may utilize internal data and data from external sources (including pooled data) only if the estimates based on such data are representative of long run experience.

If the following requirements are satisfied, internal and external data based on a definition which is different from the definition of a default event may be utilized:

- 1) Are the requirements described in "3. PD estimation" below satisfied?
- 2) Are internal and external data properly adjusted to arrive at a result which is almost equivalent to a result which might be derived for a default event?

- (2) Does a bank take into account changes made to the processes of the credit granting practice and recoveries during the rating assignment and pool assessment period?

- (3) Do estimates promptly reflect the implications of technical advances and new data and other information, as it becomes available?

- (4) Are PDs, LGDs and EADs estimated based on history of data and empirical evidence?

- (5) Are estimated PDs, LGDs and EADs reviewed at least once a year?

- (6) The population of exposures represented in the data used for estimation, and credit granting standards in use when the data were generated, and other relevant characteristics should be closely matched to or at least comparable with those of the entire bank's exposures and standards.
- (7) Are economic conditions or a market environment that is assumed by the data relevant to current and foreseeable economic conditions or market environment?
- (8) Is the number of exposures in the sample and the data period used for quantification sufficient to provide the bank with confidence in the accuracy and robustness of its estimates?
- (9) Does the estimation methods perform well in out-of-sample data tests?
- (10) Does a bank adjust its estimates in a conservative way taking into account the likely range of errors?

3. PD estimation

- (1) Does a bank use information and methods that take appropriate account of the long-run experience when estimating PDs for corporate exposure? Such methods include:
 - 1) A method to estimate a long-run average PD of the borrower ratings assigned to corporate exposures, based on internal data on default experiences;
 - 2) A method to estimate a PD by associating (hereinafter "mapping") internal ratings to external ratings and assigning a PD corresponding to an external rating to the associated internal rating; and
 - 3) A method to calculate a PD as a simple average of default-probability estimates for individual borrowers in a given borrower grade based on the model.
- (2) If a bank uses the method to estimate PDs of the borrower ratings assigned to corporate exposures based on internal data on default experience, are the following requirements satisfied?
 - 1) Are the estimates reflective of the credit granting standards and of any differences between the internal rating system used for generating the data and the current rating system? Does the credit risk management policy include an analysis of the method of reflection?
 - 2) Where only limited data are available, or where the credit granting standards or the internal rating system have changed, does the bank adjust its estimate of PD in a conservative way?
 - 3) If pooled data are used by more than one bank, do the internal rating systems and the criteria of the IRB bank not significantly differ from those of other banks in the pool?

(3) If a bank uses the mapping method to estimate PDs of the borrower ratings assigned to corporate exposures, are the following requirements satisfied?

- 1) Is the mapping based on a comparison of internal rating criteria and the external rating criteria and on a comparison of the internal and external ratings of any common borrowers?
- 2) Are any biases or inconsistencies in the mapping method or data used for quantification avoided?
- 3) Are the external credit rating agency's criteria underlying the data used for quantification oriented to the risk of the borrower, not the exposure's characteristics?
- 4) Does the credit risk management policy of the bank include analysis and comparison of the definition of default events used in the internal and external rating criteria? Does it also include the mapping standard?

(4) When estimating PDs of corporate exposures, does a bank use data over a five-year or longer observation period, from one or more external data sources, internal data sources or data pools used by more than one bank?

When using those data, are data over the longest observation period included? Data with less relevance or insignificant data for the PD estimation may be excluded.

(5) Do estimates of PDs, LGDs, and EADs use internal data as a primary data source? However, considering all relevant and significant data sources, if there is a strong link between the bank's criteria for assigning exposures to a pool and the criteria used by the external data source, and between the bank's internal data composition and the external data composition, external data or an external model may be used for the estimation.

(6) When estimating a long-run average PD of retail exposures, does a bank use data over a five-year or longer observation period, from one or more external data sources, internal data sources or data pools used by more than one bank?

When using those data, are relevant data over the longest observation period included? When estimating a PD, data in an observation period with less relevance need not be given equal importance to data in another observation period with stronger relevance.

(7) If a PD of a retail exposure relies on the timing of credit granting or the lapse of time and if it is improper to use a short-term PD estimate, does a bank consider making adjustment to increase the PD estimate?

4. LGD estimation

- (1) When estimating LGDs, are the following requirements satisfied?
 - 1) The definition of loss used in estimating an LGD is economic loss;
 - 2) When measuring economic loss, all relevant factors should be taken into account, including significant discount effects (excluding insignificant discounts) until the collection, and significant direct as well as indirect costs associated with collecting on the exposure; and
 - 3) Is the bank's ability to collect debts taken into account? If the bank does not have sufficient empirical evidence of the impact of its ability on the collection, is the adjustment to the LGD estimate based on such collection ability conservative?

- (2) Is the LGD for each exposure estimated to satisfy all of the following characteristics, reflecting the economic recession?
 - 1) Is this LGD not less than the long-run average loss rate given default (hereinafter, a "long-run average LGD") calculated based on the average economic loss of all defaulted claims within the data source for that type of exposure?
 - 2) Does a bank take into account the possibility that the LGD of the exposure may be higher than the long-run average LGD during a period when credit losses are substantially higher than the long-run average loss?

- (3) When estimating an LGD, does the bank consider the extent of any dependence between the risk of the borrower and that of the collateral or collateral provider? Are cases where there is a significant degree of dependence addressed in a conservative manner?

- (4) Are any currency mismatch between the underlying obligation and the collateral also considered and treated conservatively in the estimation of LGDs?

- (5) Are LGD estimates not solely based on the collateral's estimated market value but also grounded in historical recovery rates?

- (6) When LGD estimates take into account the credit risk mitigation effect of collaterals, does a bank establish internal requirements for collateral management, operational procedures, legal certainty and risk management processes that are generally consistent with those required for the standardized approach?

- (7) For each defaulted exposure, does the bank also construct its best estimate of the expected loss (EL_{default}) on that exposure based on current economic circumstances and the exposures' status?

(8) When an advanced IRB bank estimates LGDs of corporate exposures, does it use data over a seven-year or longer observation period, from one or more external data sources, internal data sources or data pools used by more than one bank?

If there are multiples of data within the observation period stipulated above, are the data during the longest period used? Data with less relevance or immaterial data for the LGD estimation may be excluded.

(9) When estimating LGDs of retail exposures, does a bank use data over a five-year or longer observation period, from one or more external data sources, internal data sources or data pools used by more than one bank?

5. Minimum requirements for guarantees and credit derivatives

(1) When an advanced IRB bank uses guarantees to mitigate credit risks of corporate exposures, does it adjust either the PDs or the LGDs of such corporate exposures accordingly?

Excluding cases where the effect of double defaults is considered, are such adjusted risk weights not lower than the risk weights applied to the direct exposures to the guarantors?

(2) When a bank use guarantees to mitigate credit risks of retail exposures, does it adjust either the PDs or the LGDs of such retail exposures accordingly?

Excluding cases where the effect of double defaults is considered, are such adjusted risk weights not lower than the risk weights applied to direct exposures to the guarantors?

(3) In making the adjustment stipulated in (1) and (2), does the bank choose which of the PDs or the LGDs it will adjust, and is it consistent?

(4) Excluding cases where the effect of double defaults is considered, does a bank not consider the potential credit mitigation effect of imperfect expected correlation between the default events for the borrower and guarantor for the purposes of calculating regulatory minimum capital requirements?

(5) When an advanced IRB bank uses guarantees to mitigate credit risks of corporate exposures, does it satisfy the following requirements?

1) From the following day of the adoption of guarantees to mitigate the credit risk, are the guarantors assigned borrower ratings on an ongoing basis?

2) Does a bank follow all minimum requirements for assigning borrower ratings, including regular monitoring of the guarantor's condition and ability and willingness to honor its obligations?

- 3) Does a bank retain all relevant information on the guarantor and all information on the borrower that is required if the guarantee is not provided?
- (6) When a bank uses guarantees to mitigate credit risks of retail exposures, does it satisfy the following requirements?
- 1) Is such guarantee used as a credit risk mitigation technique in relation to the assignment to a pool on an ongoing basis from the first day when the credit risk mitigation effect by guarantee is considered?
 - 2) Does a bank follow all minimum requirements for the PD estimation and the assignment of borrower ratings or pools, including regular monitoring of the guarantor's condition and ability and willingness to honor its obligations?
 - 3) Does a bank retain all relevant information on the guarantor and all information on the borrower that is required if the guarantee is not provided?
- (7) When a bank uses guarantees to mitigate credit risks of exposures, does the bank have clearly specified criteria for the types of guarantors used for the calculation of the credit risk asset in accordance with such mitigation technique?
- (8) When a bank uses guarantees to mitigate credit risks of exposures, do such guarantees have all of the following characteristics?
- 1) A written contract regarding the guarantee is created and concluded;
 - 2) The guarantor is not able to cancel the contract unilaterally;
 - 3) Such contract remains effective until the obligation of the guarantor is completely fulfilled (to the extent of the amount and purpose of the guarantee); and
 - 4) The enforcement of the guarantee against the guarantor is possible at the location where the guarantor has assets.

6. EAD estimation

- (1) Is the estimated EAD of balance-sheet items not lower than the current outstanding credit?
This requirement shall not apply to cases where a bank considers the credit risk mitigation effect of legally effective netting agreements (limited to repo-style transactions) and the netting of a loan with the borrower's deposit account at the bank.
- (2) When estimating EADs of off-balance-sheet items, does a bank have procedures for each exposure type to ensure the satisfaction of the following requirements?
 - 1) The EAD estimation should reflect the possibility of additional drawings by the borrower

before and after a default event. However, when a bank estimates the LGDs of retail exposures which have the possibility of drawing by a credit card or any other future uncommitted drawing, as for the possibility of additional drawings by the borrower after a default event, the requirement above shall not apply if the bank considers the borrower's historical additional drawings before a default event or expected additional drawings; and

- 2) If different methods are used for different exposure types in estimating EADs of off-balance-sheet items, are the types of exposures clearly defined?

- (3) Does the estimation of an EAD for each exposure satisfy all of the following characteristics?
 - 1) The EAD estimate is a long-run default-weighted average of similar exposures and borrowers;
 - 2) The EAD estimate is adjusted conservatively taking into account the range of errors that are likely;
 - 3) If a positive correlation can reasonably be expected between the default frequency and the magnitude of the EAD, the EAD estimate is adjusted more conservatively; and
 - 4) For exposures for which EAD estimates are volatile over the economic cycle, the bank uses EAD estimates that are appropriate for an economic downturn, if these are more conservative than the long-run average.

- (4) Does a bank have criteria for estimating EADs, which satisfy all of the following requirements?
 - 1) The criteria are credible and intuitive;
 - 2) The criteria are supported by credible internal analysis by the bank and consider all factors that may have significant effects on the EAD; and
 - 3) The bank is able to analyze the effects in (ii) on the EAD estimate.

- (5) Across all exposure types, does the bank review its estimates of EADs whenever significant new information is received and at least on an annual basis?

- (6) When an advanced IRB bank estimates the EADs of corporate exposures, does it use data over a seven-year or longer observation period, from one or more external data sources, internal data sources or data pools used by more than one bank?

When using those data, is data over the longest observation period included? Data with less relevance or immaterial data for the EAD estimation may be excluded.

Does the advanced IRB bank use the weighted average of the number of defaults for the EAD estimation?

- (7) When estimating EADs of retail exposures, does a bank use data over a five-year or longer

observation period, from one or more external data sources, internal data sources or data pools used by more than one bank?

7. Estimation of PDs, LGDs and EL_{dilution} of purchased receivables

- (1) Does a bank estimate an EL_{dilution} , unless the assignor of the purchased receivables guarantees all of the dilution risks of the purchased receivables?

- (2) When a bank uses a top-down approach to estimate a PD and an LGD (including an estimation using EL) or EL_{dilution} , or to estimate a PD, LGD or EL_{dilution} of a purchased retail exposure, does it consider all available data on the quality of the purchased receivables, including the bank's data on a pool similar to the pool of the eligible purchased corporate exposures or retail exposures, and data provided by the assignor of the purchased receivables or external sources?

- (3) Does the purchasing bank determine whether the data provided by the assignor of the purchased receivables are consistent with the conditions agreed upon by both parties concerning, for example, the type, amount and quality of purchased receivables during the term of the assignment agreement? If such data are not consistent with the agreed conditions, does the bank obtain and rely on additional and more relevant information on the purchased receivables?

- (4) Are purchased retail exposures and eligible purchased corporate exposures for which a top-down approach is adopted assigned to homogeneous pools so that accurate and consistent estimates of PD, LGD and EL_{dilution} for the portion corresponding to the default risk of those exposures can be determined? However, for eligible purchased corporate exposures for which a top-down approach is adopted, only advanced IRB banks need to estimate PDs and LGDs.

- (5) When a bank quantifies the risks of eligible purchased corporate exposures, do the estimate of PDs and LGDs not reflect guarantees or protections provided by the assignors or third parties?

- (6) When a top-down approach is used to estimate PDs, LGDs and EADs of eligible purchased corporate exposures, estimate EL_{dilution} , or estimate PDs, LGDs and EADs of purchased retail exposures, are all of the following requirements satisfied?:
 - 1) The structure of the exposures satisfies the legal requirements;
 - 2) The bank monitors the quality of the purchased receivables, the financial condition of the assignor of the purchased receivables and servicers (those who provide services of the management of, demanding payments of, and collecting of purchased receivables under contract or subcontract with the bank) and satisfies the criteria for the monitoring;

- 3) The bank has systems and processes that enable monitoring of the terms of the purchase contract for the purchased receivables, early detection of the poor performance of the assignor of the purchased receivables and the deterioration of the quality of the purchased receivables, and takes preventive measures against potential problems, and also satisfies the criteria for work-out systems;
- 4) The bank has clear and effective criteria for collateral, the upper limit of the credit line granted by the obligee of the purchased receivables to the borrower, and the management of the collected money; and
- 5) The bank satisfies all major internal guidelines and standards for compliance with the process.

VIII. Review of internal rating system and estimates

1. Review

Does a bank have a robust system in place to review the accuracy and consistency of its internal rating system, operation of the system, and the estimation of PDs, LGDs and EADs?

2. Backtesting

- (1) Does the bank regularly (at least once a year) compare actual default rates with estimated PDs for each borrower rating of corporate exposures to review that the differences between the estimates and actual default rates are within the expected range for that rating?
- (2) Does an advanced IRB bank regularly (at least once a year) compare actual loss with estimated LGDs for corporate exposures to review that the differences between the estimates and actual losses are within the expected range for the exposure or the facility rating assigned to such exposure?
- (3) Does the advanced IRB bank regularly (at least once a year) compare actual EADs with estimated EADs for each corporate exposure to review that the differences between the estimates and the actual EADs are within the expected range for the exposure?
- (4) Does a bank regularly (at least once a year) compare actual values with estimated PDs, LGDs and EADs for each pool of retail exposures to review that the differences between the estimates and actual values are within the expected range for that pool?
- (5) Do the comparisons and reviews stipulated in (1) to (4) above satisfy all of the following requirements?

- 1) Comparisons and reviews make use of historical data that are over the possible longest period;
and
- 2) The methods and data used in such comparisons are clearly documented by the bank.

3. Review of internal rating system using external data

- (1) Does a bank also use other quantitative review tools and comparisons with relevant external data sources, in addition to the backtesting stipulated in 2. above?
- (2) Does the review method referred to in (1) above have all of the following characteristics?
 - 1) The analysis is based on data that are appropriate to the portfolio, are updated regularly, and cover a relevant observation period;
 - 2) The analysis is based on long-term data;
 - 3) The result is not affected systematically by the economic cycle; and
 - 4) Changes in methods, data sources and periods covered are clearly and thoroughly documented.

4. Correction of estimates

- (1) Does a bank have clear internal standards to determine if deviations in actual PDs, LGDs and EADs from expectations are significant enough to question the validity of the estimates?
- (2) When setting the standards mentioned in (1) above, does a bank take into account the business cycles and other similar systematic variable factors in default experiences?
- (3) If actual PDs, LGDs or EADs continue to be higher than the expected values, does the bank revise the estimation method and the estimated values to reflect the actual values?

IX. Minimum requirements for internal models approach for equity exposures

1. Compliance with the approval standards for internal models approach regarding equity exposures

When an internal models approach is used to calculate credit risk assets of equity exposures, are the following requirements satisfied?

- (1) The bank has a framework in place to satisfy the risk qualification standards;
- (2) The a bank has a framework in place to satisfy the internal control standards; and
- (3) The bank has a framework in place to satisfy the review standards.

2. Documentation

Does a bank using an approved internal model approach document all major information regarding such internal model and the modeling process?

Do such documents detail the design of the internal model and its operation and also demonstrate that the internal model complies with the risk quantification standards, internal control standards and review standards?

X. Securitization exposures

1. Common treatment

(1) Is the risk weight of 1250% applied to the exposures stipulated in a. and b. below, after excluding the amount corresponding to the increase capital as a result of the securitization transaction? An amount equal to the individual allowance for doubtful accounts may also be deducted.

- 1) Securitization exposures to which the 1250% risk weight is to be applied in accordance with Chapter 8 of the Notification; and
- 2) Credit-enhancing I/O strips

(2) If a bank is an originator of an asset-transfer-type securitization transaction, and it does not fall under any of the following conditions, does the bank calculate the credit risk asset of the underlying asset?

- 1) Major credit risks of the underlying assets have been transferred to a third party; or
- 2) The bank does not have effective control over the underlying asset, and the underlying asset is legally isolated from the bank in such a way that it is put beyond the reach of the bank and its creditors, even in the event of the bank's bankruptcy or any other similar proceedings. For the purpose of this paragraph, a bank is deemed to have effective control over the asset if it falls under either of the following conditions:
 - (i) The bank has a right to buy back the underlying asset from the assignee, unless the exercise of such buy-back right is a clean-up call stipulated in (vi) below; or
 - (ii) The bank bears the credit risk related to such underlying asset. However, the bank is not precluded from possessing the subordinated portion as long as the condition in (i) above is satisfied.
- 3) In securitization transactions, the rights of investors in such securitization exposures do not include claims against the bank (the transferor of the underlying assets).
- 4) The assignee of the underlying asset is a sponsor for the securitization, and equity holders of such sponsor have free rights to set pledge on or transfer such equities.
- 5) The transfer agreement for the underlying asset does not include any or all of the following provisions:

- (i) A provision requiring the bank to exchange assets that comprise the backing assets for the securitization exposures, aiming to improve the average creditworthiness of the underlying asset. However, the bank is not precluded from selling the underlying asset to an independent third party at the market price;
 - (ii) A provision that permits the bank's additional underwriting of the lowest subordinate portion or credit enhancement after the transfer date; or
 - (iii) A provision that stipulates increases in payment of profits to investors, third party providers of credit enhancement or other parties, excluding the originating bank, in response to the deterioration of the creditworthiness of the backing assets for the securitization exposures.
- 6) If such securitization transaction includes a clean-up call, does such clean-up call satisfy all of the following requirements?
- (i) The clean-up call may be exercised by the bank's sole discretion;
 - (ii) The clean-up call is not intended to prevent transfer of loss to investors or to provide credit enhancement to the securitization exposures possessed by such investors; and
 - (iii) The exercise of the clean-up call is allowed only when the balance of the underlying asset or the unredeemed securitization exposures held by a party who is not the originator becomes 10% or less of the original balance.
- 7) The bank has not provided any other credit enhancement than those agreed under contract.

2. Treatment of the IRB approach

- (1) If a majority of the credit risk assets of the underlying assets of the securitization exposures are subject to the standardized approach, is the credit risk asset of such securitization exposures calculated by the standardized approach?
- (2) If a credit risk asset calculation method to be applied to the underlying asset of the securitization exposures is not specified, does the originating bank use the standardized approach and does the bank which is not an originator use an external rating-based approach, for the credit risk asset calculation?
- (3) For securitization exposures assigned to ratings or inferred ratings, is an external rating-based approach used for the credit risk asset calculation?

For unrated securitization exposures, a supervisory formula may be used for the credit risk asset calculation. For unrated securitization exposures to ABCP programs (limited to those with a maturity within one year), including unrated liquidity facilities and unrated credit enhancements, an internal assessment approach may be used for the credit risk asset calculation.

(4) If an external rating-based approach, supervisory formula or internal assessment approach cannot be used for the calculation of credit risk assets of securitization exposures for which an IRB approach should be applied, is a risk weight of 1250% used for such securitization exposures?

(5) When an external rating-based approach is used, is the credit risk asset of a securitization exposure determined by multiplying the value of such securitization exposures by the risk weight for the credit risk class corresponding to the rating assigned by a qualified rating agency?

(6) If an internal assessment approach is used for the calculation of the credit risk assets of securitization exposures, does a bank obtain the approval of the Commissioner of the Financial Services Agency?

In such a case, a bank may calculate a credit risk asset by multiplying the value of the securitization exposure by the risk weight of the credit risk class of the internal rating corresponding to the rating assigned by a qualified rating agency.

(7) If an internal assessment approach is used for the calculation of credit risk assets of securitization exposures, does a bank satisfy the following operational requirements?

1) The ABCPs are rated by a qualified rating agency and such ratings satisfy all criteria for the rating adequacy of the securitization transaction;

2) The internal assessment of credit risk of securitization exposures to ABCP programs is performed in accordance with the assessment standards used by a qualified rating agency for assessing the underlying assets purchased by the ABCP program, and the first assessment of such exposures result in a rating equivalent to the investment grade;

3) The internal assessment is incorporated in the bank's internal risk control process, including management information and capital allocation systems, and satisfies the minimum requirements for the IRB approach;

4) The bank clearly indicates that the internal assessment process is designed to identify the risk level and which of its internal assessments correspond to the rating used by a qualified rating agency;

5) The internal assessment process (including stress factors to determine the level of credit enhancement) is more conservative than the assessment standards published by major qualified rating agencies. Such qualified rating agencies give ratings to ABCPs backed by assets similar to the underlying assets purchased by the ABCP program and assessed by the bank by its internal assessment process?;

6) If two or more qualified rating agencies have given ratings to an ABCP, and if these agencies set different credit enhancement levels to the same rating, the bank uses the stress factors of the

qualified rating agency requiring the most conservative credit enhancement level;

- 7) When selecting qualified ABCP rating agencies, a bank chooses only agencies that generally have relatively less restrictive rating methodologies. If any chosen qualified rating agency changes its rating method (including stress factors), the bank considers whether its internal assessments need revisions accordingly;
- 8) The rating method of qualified rating agencies for the asset or exposure to be assessed is published. However, a bank may use its internal assessment approach, subject to the approval of the Commissioner of the Financial Services Agency, for ABCPs based on new or special transactions not covered by the ratings of qualified ABCP rating agencies;
- 9) An internal or external auditor, qualified rating agency, or an internal credit assessment department or risk control department makes regular review to confirm the internal assessment process and its validity;
- 10) The auditing person referred to in (ix) above is independent of the customer relations department and the sales department that handles ABCPs;
- 11) The bank continuously tracks the operation of its internal assessment approach to assess its performance, and make necessary adjustments to its assessment process when the performance of the exposures constantly diverges from the assigned internal assessments on those exposures;
- 12) The bank establishes underwriting guidelines for ABCP programs and defines the structural outline of transactions to purchase underlying assets;
- 13) The bank performs a credit analysis of the risk profile of the assignor of the underlying asset in a securitization transaction;
- 14) The bank has standards for the following matters and other matters related to the eligibility of the underlying asset:
 - (i) No purchases of long-delinquent claims and defaulted claims;
 - (ii) No excess concentration to a specific obligor or geographic area; and
 - (iii) An upper limit for the maturity period of the purchasable claims.
- 15) When a bank plans to purchase an asset in an ABCP program and estimates a loss on an asset pool of such asset, it considers all potential risk factors, such as credit and dilution risks; and
- 16) The ABCP program includes structural features for asset purchases, including the suspension of purchases for each exposure pool, in order to mitigate potential credit deterioration of the underlying portfolio.

- (8) When a bank uses an external rating-based approach or an internal assessment approach to calculate credit risk assets of securitization exposures to off-balance-sheet assets, does the bank determine the credit equivalent amount of such securitization exposure by multiplying the unused portion of the notable principal of the credit risk by 100%?

- (9) When a bank uses a supervisory formula to calculate the credit risk asset of the securitization exposures to off-balance-sheet assets, and if the capital ratio requirement cannot be calculated, does the bank apply the risk weight of 1250% to the unused portion of such off-balance-sheet assets?

However, the credit risk assets of securitization exposures to eligible liquidity facilities may be calculated by multiplying the unused portion of the notional principal (set as a credit equivalent) by the highest risk weight, out of the risk weights applied in the standardized approach to individual backing assets.

XI. CVA risks

1. By using a standardized risk measurement method, does a bank calculate a CVA risk equivalent amount related to derivative transactions with parties that are not the entities listed below?

(1) Central counterparty;

(2) If the bank is an indirect clearing member of a qualified central counterparty (hereinafter, "CCP"), direct clearing members that satisfy all of the following conditions:

1) As for indirect clearing member trade exposures, the qualified CCP or the direct clearing member takes proper measures to prevent their suffering of loss in the following cases:

(i) Default or insolvency of direct clearing members; or

(ii) Default or insolvency of other indirect clearing members.

2) When an indirect-clearing member entrusts to a direct-clearing member intermediation of the clearing of qualified CCP trade exposures, if such direct-clearing member loses its qualification to participate in the clearing at the qualified CCP as a result of its default or insolvency, there is a system that enables, without additional burden on the indirect-clearing member, continuance or succession of the contract related to such trade exposure with another direct-clearing participant or the qualified CCP.

(3) Fund clearing organizations

2. If a bank has obtained the approval of the Commissioner of the Financial Services Agency for its use of an internal model approach for the calculation of individual risks related to bonds, and if it has obtained the approval of the Commissioner of the Financial Services Agency for the use of the expected exposure approach for the calculation of a credit equivalent amount, does the bank use an advanced risk measurement method, regardless of the requirement in 1. above, to calculate a CVA risk equivalent amount related to a transaction with parties that do not fall under the entities listed below?

- (1) Central counterparty;
- (2) If the bank is a direct clearing member of a CCP, direct clearing members that satisfy all of the conditions stipulated in 1. (2) above; or
- (3) Fund clearing organizations

XII. CCP exposures

Does a bank properly calculate the credit risk assets of the following exposures, in accordance with the provisions in Chapter 8-3 of the Notification?

1. CCP trade exposures;
2. Clearing funds related to central counterparties; and
3. Direct clearing member trade exposures.

Checklist for Asset Assessment Management

I. Development and Establishment of Asset Assessment Management System by Management

【Checkpoints】

- Asset assessment refers to examining individual loan assets held by a financial institution and categorizing them according to the degree of risk of default and impairment of the asset value. Asset assessment enables judgment with regard to the degree of safety secured by the quality of assets for funds deposited by customers and, in other words, with regard to the degree of risk to which the institution is exposed due to possible deterioration of the quality of its assets. Self-assessment, conducted by financial institutions themselves, is not only a means for the institutions to manage credit risk and but also a preparation for implementing write-offs and loan loss provisions in an appropriate manner. Implementing write-offs and loan loss provisions is equivalent to calculating the amount of estimated future credit losses in a timely and appropriate manner based on the self-assessment and in light of the actual status of defaults and other factors.
- The development and establishment of a system for asset assessment management is extremely important from the viewpoint of ensuring the soundness and appropriateness of a financial institution's business. Therefore, the institution's management is charged with and responsible for taking the initiative in developing and establishing such a system.
- The inspector should determine whether the asset assessment management system is functioning effectively and whether the roles and responsibilities of the institution's management are being appropriately performed by way of reviewing , with the use of check items listed in Chapter I., whether the management is appropriately implementing (1) development of internal rules and organizational frameworks and (2) development of a system for assessment and improvement activities.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II. and later, it is necessary to exhaustively examine which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize weaknesses or problems recognized by the inspector, it is also necessary to explore in particular the possibility that the Internal Control System is not functioning effectively and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of

the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Development of Internal Rules and Organizational Frameworks

(1) Development and Dissemination of Standards

- (i) Does the Board of Directors have the Managers of the Asset Assessment Management Divisions¹ (hereinafter simply referred to as the “Managers” or “Manager” in this checklist) develop standards that clearly specify the arrangements for conducting self-assessment in an appropriate and accurate manner (hereinafter referred to as the “Self-Assessment Standards”) and standards that clearly specify the arrangements for implementing write-offs and loan loss provisions in an appropriate and accurate manner (hereinafter referred to as the “Write-Off/Loan Loss Provision Standards”) and disseminate them throughout the institution?
- (ii) Has the Board of Directors approved the Self-Assessment Standards and the Write-Off/Loan Loss Provision Standards based on the opinions of the Compliance Control Division and the Internal Audit Division, etc.?

(2) Development of Asset Assessment Management System

Does the Board of Directors or equivalent organization to the Board of Directors have Asset Assessment Management Divisions established and have the divisions prepared to undertake appropriate roles in accordance with the Self-Assessment Standards and the Write-off/Loan-loss Provision Standards?²

(i) Self-Assessment Management System

a. Does the Board of Directors or equivalent organization to the Board of Directors provide a system to ensure that self-assessment is conducted appropriately by securing a sufficient check-and-balance system against Sales-Related Divisions³ through the following arrangements, for example?

- Sales branches and the Sales Division of the headquarters conduct a first-stage assessment,

¹ The Asset Assessment Management Divisions are those in charge of controlling self assessment and write-off and loan loss provision.

² When an Asset Assessment Management Division is not established as an independent division (e.g., when the division is consolidated with another risk management division to form a single division or when a division in charge of other business also takes charge of asset assessment management or when a Manager or Managers take charge of asset assessment management instead of a division or a department), the inspector shall review whether or not such a system is sufficiently reasonable and provides the same functions as in the case of establishing an independent division commensurate with the scales and natures of the institution and its risk profile.

³ Sales-Related Divisions are sales branches and the sales and Loan Approval Divisions of the headquarters.

to be followed by a second-stage assessment conducted by the Loan Approval Division of the headquarters, and then a division independent from the Sales-Related Divisions verifies the appropriateness of the assessment.

- A division independent from Sales-Related Divisions conducts a self-assessment in cooperation with such divisions.
- b. Has the Board of Directors allocated to the Self Assessment Management Division a Manager with the necessary knowledge and experience to supervise the division and enabled the Manager to implement management operations by assigning him/her the necessary authority therefor?
- c. Has the Board of Directors or equivalent organization to the Board of Directors allocated to the Self-Assessment Management Division, etc.⁴ an adequate number of staff members with the necessary knowledge and experience to execute the relevant business and assigned such staff the authority necessary for implementing the business?⁵
- d. Does the Board of Directors or equivalent organization to the Board of Directors have each division store sufficient documents and other records to enable follow-up reviews on the status of implementation of self-assessment in audits by accounting auditors, etc.?

(ii) Systems for Write-Offs and Loan Loss Provisions

- a. Does the Board of Directors or equivalent organization to the Board of Directors ensure that the amounts of write-offs and loan-loss provisions are calculated appropriately by securing a sufficient check-and-balance system against divisions in charge of conducting self-assessment and Account Settlement-Related Divisions through the following arrangements, for example?
 - A division in charge of implementing self-assessment calculates the amount of specific loan loss provisions while Account Settlement-Related Divisions calculate the amount of general loan loss provisions, and then a division independent from Sales-Related Divisions and Account-Settlement Divisions verifies the appropriateness of the calculation.
 - A division independent from Sales-Related Divisions and Account-Settlement Divisions calculates the amount of specific loan loss provisions and general loan loss provisions in cooperation with Sales-Related Divisions.
- b. Has the Board of Directors allocated to the Write-Off/Loan Loss Provision Division a Manager with the necessary knowledge and experience to supervise the division and enabled the

⁴ The "Self-Assessment Management Division, etc." refers to divisions equipped with functions necessary for conducting self-assessment appropriately and established as necessary according to the scales and natures of the financial institution, including the Self Assessment Management Division and divisions in charge of conducting self-assessment and verifying the self-assessment that are independent from Sales-Related Divisions.

⁵ When a department or a post other than the Board of Directors or equivalent organization to the Board of Directors is empowered to allocate staff and assign them authority, the inspector shall review, in light of the nature of such a department or post, whether or not the structure of the Self-Assessment Management Division is reasonable in terms of a check-and-balance system and other aspects.

Manager to implement management operations by assigning him/her the necessary authority therefor?

- c. Has the Board of Directors or equivalent organization to the Board of Directors allocated to the Write-Off /Loan Loss Provision Division, etc.⁶ an adequate number of staff members with the necessary knowledge and experience to execute the relevant business and assign such staff the authority necessary for implementing the business?⁷
- d. Does the Board of Directors or equivalent organization to the Board of Directors have each division store sufficient documents and other records to enable follow-up reviews on the status of implementation of write-offs and loan loss provisions in audits by accounting auditors, etc.?

(3) Development of Asset Assessment Management System in First- and Second-Stage Assessment Divisions

Does the Board of Directors or equivalent organization to the Board of Directors provide a system to fully disseminate the relevant internal rules and operational procedures to the divisions in charge of first- and second-stage assessments and have such divisions observe them? For example, does the Board of Directors or equivalent organization to the Board of Directors instruct the Managers to identify the internal rules and operational procedures that should be observed by the divisions in charge of first- and second-stage assessments and to carry out specific measures for ensuring observance such as providing effective training on a regular basis?

(4) Arrangement for System of Reporting to Board of Directors or equivalent organization to Board of Directors and Approval

Has the Board of Directors or equivalent organization to the Board of Directors appropriately specified matters that require reporting and those that require approval and do they make sure to obtain a report with regard to the current status in a regular and timely manner or on an as needed basis or require application for approval on the relevant matters? In particular, do they make sure to obtain a report without delay with regard to any matters that would seriously affect corporate management?

⁶ The “Write-Off/Loan Loss Provision Management Division, etc.” refers to divisions equipped with functions necessary for implementing write-offs and loan loss provisions appropriately and established as necessary according to the scales and natures of the financial institution, including the Write-Off/Loan Loss Provision Management Division and divisions in charge of calculating the write-off and loan loss provision amounts and verifying the write-offs and loan loss provisions that are independent from Sales- and Account Settlement-Related Divisions.

⁷ When a department or a post other than the Board of Directors or equivalent organization to the Board of Directors is empowered to allocate staff and assign them authority, the inspector shall review, in light of the nature of such a department or post, whether or not the structure of the Write-Off/Loan Loss Provision Division is reasonable in terms of the absence of problems such as conflicts of interest.

(5) Arrangement for System of Reporting to Corporate Auditor

In the case where the Board of Directors has specified matters to be directly reported to a corporate auditor, has it specified such matters appropriately and does it provide a system to have the Managers directly report such matters to the auditor?⁸

(6) Development of Internal Audit Guidelines and an Internal Audit Plan

Does the Board of Directors or equivalent organization to the Board of Directors have the Internal Audit Division appropriately identify the matters to be audited with regard to asset assessment management, develop guidelines that specify the matters subject to internal audit and the audit procedure (hereinafter referred to as “Internal Audit Guidelines”) and an internal audit plan, and approve such guidelines and plan?⁹ For example, does it have the following matters clearly specified in the Internal Audit Guidelines or the internal audit plan and provide a system to have these matters appropriately audited?

(i) Internal Audit Guidelines concerning self-assessment

- Status of development of the self-assessment management system
- Appropriateness of the self-assessment management process
- Accuracy of self-assessment results
- Status of improvement of matters pointed out in an internal audit or in the last inspection

(ii) Internal Audit Guidelines concerning write-offs and loan loss provisions

- Status of development of the write-off and loan loss provision system based on self-assessment
- Appropriateness of the process of posting write-offs and loan loss provisions based on self-assessment results
- Appropriateness of results of write-offs and loan loss provisions (It is desirable to verify the appropriateness of the loan loss provision ratio, the total amount of loan loss provisions, etc. and the amount of loan loss provisions in the past fiscal years)
- Status of improvement of matters pointed out in an internal audit or in the last inspection

(7) Revision of Development Process of Internal Rules and Organizational Frameworks

Does the Board of Directors or equivalent organization to the Board of Directors revise the development process of the Self-Assessment Standards, the Write-off/Loan Loss Provision Standards and organizational frameworks in a timely manner by reviewing their effectiveness based on reports and findings on the status of asset assessment management in a regular and

⁸ It should be noted that this shall not preclude a corporate auditor from voluntarily seeking a report and shall not restrict the authority and activities of the auditor in any way.

⁹ The Board of Directors or equivalent organization to the Board of Directors only needs to have approved the basic matters with regard to an internal audit plan.

timely manner or on an as needed basis?

2. Assessment and Improvement Activities

1) Analysis and Assessment

(1) Analysis and Assessment of Asset Assessment Management

Does the Board of Directors or equivalent organization to the Board of Directors appropriately determine whether there are any weaknesses or problems in the asset assessment management system and the particulars thereof, and appropriately examine their causes by precisely analyzing the status of asset assessment management and assessing the effectiveness of asset assessment management, based on all the information available regarding the status of asset assessment management, such as the results of audits by corporate auditors, internal audits and external audits, findings and reports from various divisions? In addition, if necessary, does it take all possible measures to find the causes by, for example, establishing fact findings committees, etc. consisting of non-interested persons?

(2) Revision of Analysis and Assessment Processes

Does the Board of Directors or equivalent organization to the Board of Directors revise the analysis and assessment processes in a timely manner by reviewing their effectiveness based on reports and findings on the status of asset assessment management in a regular and timely manner or on an as needed basis?

2) Improvement Activities

(1) Implementation of Improvements

Does the Board of Directors and the Board of Directors or equivalent organization to the Board of Directors provide a system to implement improvements in the areas of the problems and weaknesses in the asset assessment management system identified through the analysis, assessment and examination referred to in 2. 1) above in a timely and appropriate manner based on the results obtained by developing and implementing an improvement plan as required or by other appropriate methods?

(2) Progress Status of Improvement Activities

Does the Board of Directors or equivalent organization to the Board of Directors provide a system to follow up on the efforts for improvement in a timely and appropriate manner by reviewing the progress status in a regular and timely manner or on an as needed basis?

(3) Revision of Improvement Process

Does the Board of Directors or equivalent organization to the Board of Directors revise the improvement process in a timely manner by reviewing its effectiveness based on reports and findings on the status of asset assessment management in a regular and timely manner or on an as needed basis?

II. Development and Establishment of Asset Assessment Management System by Managers

【Checkpoints】

- This chapter lists the check items to be used when the inspector examines the roles and responsibilities to be performed by the Managers in charge of operations concerning asset assessment management and Asset Assessment Management Divisions.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II., it is necessary to exhaustively examine which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter I. are not functioning appropriately and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Roles and Responsibilities of Managers and Asset Assessment Management Divisions

(1) Development and Dissemination of Self-Assessment Standards and Write-Off/Loan Loss Provision Standards

Have the Managers developed the Self-Assessment Standards and the Write-off/Loan Loss Provision Standards based on a full understanding of the importance of asset assessment management? Have the Self-Assessment Standards and the Write-off/Loan Loss Provision Standards been disseminated throughout the institution upon approval by the Board of Directors?

(2) Details of Self-Assessment Standards and Write-off/Loan Loss Provision Standards

(i) Validation of Self-Assessment Standards

- a. Are the Self-Assessment Standards in accordance with the relevant laws and the frameworks specified in this checklist (including Attachment 1), and are they clear and valid? Do they include clear statements with regard to the following matters in particular, exhaustively cover necessary procedures and specify them appropriately?

- Scope of assets to be covered by self-assessment
- Self-assessment management system
- Implementation standards for self-assessment
- Allocation of responsibilities with regard to the conduct of self-assessment

When there are specific rules established by the institution within the Self-Assessment Standards (e.g. rules concerning collateral evaluation and simplified assessment of securities), are they reasonable and compatible with the standards, and are there sufficient reasons for any difference with the relevant frameworks?

- b. Does the institution have a consistent basic policy with regard to the Self-Assessment Standards and operate based on it on a continuous basis? When the institution changes its basic policy concerning Self-Assessment Standards, is there a rational and legitimate reason?

(ii) Validation of Write-off/Loan Loss Provision Standards

- a. Are the Write-off/Loan Loss Provision Standards in accordance with the relevant laws, corporate accounting standards generally accepted as fair and valid and the frameworks specified in this checklist (including Attachment 2), and are they clear and valid? Do they include clear statements with regard to the following matters in particular, exhaustively cover necessary procedures and specify them appropriately?

- Scope of assets to be covered by write-offs and loan loss provisions
- Write-off/loan loss provision management system
- Standards for calculating the write-off and loan loss provision amounts
- Allocation of responsibilities with regard to the implementation of write-offs and loan loss provisions

When there are specific rules established by the institution with regard to write-offs and loan loss provisions (e.g. rules concerning the calculation of the loan loss provision ratios based on credit ratings and those concerning the calculation of the loan loss provision ratios according to the industrial sector, the region, etc.), are they reasonable and compatible with the Write-off/Loan Loss Provision Standards, and are there sufficient reasons for any difference with the relevant frameworks? For example, are specific costs and losses that are highly likely to arise in the future estimated appropriately?

- b. Does the institution have a consistent basic policy with regard to the Write-off/Loan Loss Provision Standards and operate based on it on a continuous basis? When the institution changes its basic policy concerning the Write-off/Loan Loss Provision Standards, is there a rational and legitimate reason?

(3) Development of Organizational Frameworks by Managers

- (i) Does the Manager, in accordance with the Self-Assessment Standards and the Write-off/Loan

Loss Provision Standards, provide for measures to have the self-assessment and Write-Off/Loan Loss Provision Management Divisions exercise a check-and-balance system in order to ensure that the institution implements write-offs and loan loss provisions appropriately?

- (ii) Have the Managers developed detailed and rational operational procedures (a self-assessment manual and a write-off/loan loss provision manual) in accordance with the Self-Assessment Standards and the Write-off/Loan Loss Provision Standards, in order to ensure an appropriate implementation of self-assessment, write-offs and loan loss provisions?
- (iii) Have the Managers in place computer systems¹⁰ with the high reliability suitable for conducting self-assessment and implementing write-offs and loan loss provisions in an appropriate and accurate manner?
- (iv) Do the Managers ensure the system of training and education to enhance the ability of employees to conduct self-assessment and implement write-offs and loan loss provisions in an appropriate and accurate manner, thus developing human resources with relevant expertise?
- (v) Do the Managers provide a system to ensure that matters specified by the Board of Directors and the Board of Directors or equivalent organization to the Board of Directors are reported in a regular and timely manner or on an as needed basis? In particular, do the Managers provide a system to ensure that matters that would seriously affect corporate management are reported to the Board of Directors and the Board of Directors or equivalent organization to the Board of Directors without delay?

(4) Revision of Asset Assessment Management Standards and Organizational Frameworks

Do the Managers conduct monitoring on an ongoing basis with regard to the status of execution of operations at the Self-Assessment Management Division and Write-Off/Loan Loss Provision Management Division? Do the Managers review the effectiveness of the self-assessment management system and write-off/loan loss provisions management system in a regular and timely manner or on an as needed basis, and, as necessary, revise the Self-Assessment Standards and Write-off/Loan Loss Provisions Standards as well as the relevant organizational framework, or present the Board of Directors or equivalent organization to the Board of Directors with proposals for improvement?

¹⁰ It should be noted that the computer system may be a centralized dataprocessing environment system, distribution processing system, or EUC (end user computing) type.

III. Accuracy of Self Assessment Results and Appropriateness of Write-Offs/Loan Loss Provisions

【Checkpoints】

- This chapter lists the check items to be used when the inspector reviews the accuracy of the results of self-assessment and the appropriateness of the results of write-offs and loan loss provisions.
- In the process of examining the accuracy of the results of self-assessment, the inspector should precisely grasp the actual status of development of the self-assessment system, the actual status of reporting of the results of self-assessment to the Board of Directors and the actual status of internal audits and audits by corporate auditors and accounting auditors of the status of the development of the self-assessment system.
- In the process of examining the appropriateness of the results of write-offs and loan loss provisions, the inspector should precisely grasp the actual status of the development of the write-off/loan-loss provision system, the actual status of reporting of the results of write-off/loan-loss provisions to the Board of Directors and the actual status of internal audits and audits by corporate auditors and accounting auditors of the status of the development of the write-off/loan-loss provisions system.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter III., it is necessary to exhaustively examine which of the elements listed in Chapters I. and II. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter I. are not functioning properly, and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

Accuracy of Self-Assessment Results and Appropriateness of Write-Off/Loan Loss Provision Results

(1) Accuracy of Self-Assessment Results

- (i) Does the institution actually conduct self-assessment accurately in accordance with the

Self-Assessment Standards with a method listed in Attachment 1?

- (ii) When the results of self-assessment are deemed as inappropriate or inaccurate, does the institution grasp and analyze the cause thereof (e.g. a problem with the Self-Assessment Standards or a problem with the conduct of self-assessment) and consider and implement necessary improvement measures in a timely and appropriate manner?
- (iii) Does the institution provide necessary education and guidance to divisions in charge of conducting first- and second-stage self-assessments?

(2) Appropriateness of Write-Off/Loan Loss Provision Results

- (i) Does the institution actually implement write-offs and loan loss provisions appropriately in accordance with the Write-off/Loan Loss Provision Standards with a method listed in Attachment 2?
- (ii) When the results of write-offs and loan loss provisions are deemed as inappropriate or inaccurate, does the institution grasp and analyze the cause thereof (e.g. a problem with the Write-off/Loan Loss Provision Standards or a problem with the calculation of loan loss provisions) and consider and implement necessary improvement measures in a timely and appropriate manner?
- (iii) Does the institution provide necessary education and guidance to divisions in charge of calculating the write-off and loan loss provision amounts?

Notes to the Attachment

- I. "Borrower classifications" are categorizations of borrowers as determined from the borrower's financial condition, cash flow, earnings ability and other considerations. The classifications are: "normal," "needs attention," "in danger of bankruptcy," "De facto bankrupt" and "bankrupt."
- II. In self-assessment, "classification" refers to the assignment of assets to Categories II, III or IV, and assets that have been assigned to Categories II, III or IV are referred to as "classified assets." Furthermore, assets not assigned to Categories II, III or IV are referred to as "non-classified," and all assets other than classified assets (i.e., all Category I assets) are referred to as "non-classified assets."
- III. "Credit categories" are as defined in the asset assessment standards set forth in Article 6:2 of the "Act on Emergency Measures for the Revitalization of the Financial Functions" (Act No. 132 of 1998; hereinafter, "Emergency Revitalization Act") and Article 4 of the "Ordinance for Enforcement of the Act on Emergency Measures for the Revitalization of Financial Functions" (Financial Reconstruction Commission's Ordinance No. 2 of 1998; hereinafter, "Emergency Revitalization Act Ordinances"). Credit categories are based on the financial position and the business results of the borrower, and consist of "Non-classified," "Needs special attention," "Doubtful," "Bankrupt and De facto bankrupt".
- IV. Categories used in self-assessment
- Self-assessment shall classify assets into four groups according to the unrecovery risk and the loss of value risk: I, II, III, and IV.
1. Category I consists of assets not assigned to Categories II, III or IV. These are assets with no problem in terms of unrecovery risk or loss of value risk.
 2. Category II consists of "assets deemed to include a higher than normal repayment risk because conditions for ensuring the integrity of the credit have not been fully met or because there are questions regarding the creditworthiness of the borrower." Category II may include both assets secured with collateral and guarantees, and unsecured assets.
 3. Category III consists of "assets for which there are serious doubts about final collection or value and therefore a high risk of losses, but for which the amount of loss is difficult to rationally estimate." However, it is not entirely impossible for financial institutions to estimate loss amounts and it is appropriate that institutions do estimate losses according to their own rules and a detailed consideration of the status of the individual asset.
 4. Category IV consists of "assets that are deemed uncollectable or no value." Category IV assets are not, however, assets that are absolutely uncollectable or no value. Partial collection may indeed be possible at some point in the future, but the asset is uncollectable or without value on the assessment base date.
- V. Base date used in self-assessment

The base date must be the last day of the accounting period. If, in practice, a provisional base date is used during self-assessment, it shall be verified whether the provisional base date falls within three months from the last day of the accounting period in principle. If credit ratings, borrower classifications, classifications, and other matters are being reviewed on a timely basis according to changes in the borrower's conditions, it shall be verified whether the review of such matters is carried out according to an appropriate timing and method.

Self-assessment (Attachment 1)

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
<p>1. Credit classification method</p> <p>(1) Basic concepts</p>	<p>“Credit” refers to loans and credits similar to loans (loan securities, foreign exchange, interest receivable, accounts receivable, suspense payments similar to loans, and per contras for acceptances and guarantees). Credits are classified according to the following method.</p> <p>In managing credit risk, institutions are also expected in principle to perform self-assessments for assets other than those listed above when there are credit risks associated therewith, and also for off-balance sheet assets. In these cases, the institution must clearly articulate the scope of assets, etc., subject to self-assessments.</p> <p>Financial institutions calculating their capital adequacy ratios according to international standards shall perform self-assessments for off-balance-sheet assets. Institutions calculating their capital adequacy ratios according to domestic standards are not required to perform self-assessments for off-balance-sheet assets, but it is desirable that they do so.</p> <p>In assessing assets, institutions shall in principle perform credit ratings and classify borrowers according to these credit ratings. Having done this, they shall consider individually the uses to which the funds for the credit are employed and the status of the credit’s collateral, guarantees or other security provisions. This shall form the basis for categorizing credits according to their repayment risk and loss of value risk.</p> <p>However, credits to government, local public entity and to financial institutions under government control are treated as not having repayment risk or loss of value risk and therefore borrower</p>	<p>In verifying credit classification methods, check that credit ratings are rational and consistent with borrower classifications (when credit ratings are employed), that borrower classifications are accurate, that the use of funds, etc., is considered individually, and that accurate adjustments are made for collateral, guarantees, and other security provisions. Verify also that classifications are accurate in light of self-assessment results.</p>	<p>Note: “Loan securities” refer to “securities used in loans of securities that are to be noted in the margin (only those for loans for use or by a lease contract),” as stipulated in Article 4:1 of the Emergency Revitalization Act Ordinances.</p> <p>Note: “Institutions calculating their capital adequacy ratios according to international standards” refers to financial institutions calculating their capital adequacy ratios according to international standards; “institutions calculating their capital adequacy ratios according to domestic standards” refers to financial institutions calculating their capital adequacy ratios according to domestic standards, and so throughout.</p> <p>Note: “Financial institutions under government control” refers to financial institutions that</p>

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
(2) Credit ratings	<p>classifications are not required. They are treated as normal credits.</p> <p>Note that financial institutions calculating their capital adequacy ratios according to international standards are required to perform credit ratings. Institutions calculating their capital adequacy ratios according to domestic standards may classify borrowers without performing credit ratings but it is desirable that credit ratings be introduced into their systems.</p> <p>Credit ratings are a measure of the degree of credit risk associated with the borrower, and shall be performed based on the financial position of the borrower, ratings issued by ratings agencies, information from credit research bureaus, and other relevant data. Credit ratings must be consistent with the borrower classifications described below.</p>	<p>For institutions performing credit ratings, verify that the credit rating is rational in light of the borrower’s financial position, the ratings issued by ratings agencies, information from credit research bureaus, and other relevant data, and that the institution maintains consistency between the concepts underlying its credit ratings and borrower classifications.</p> <p>When credit ratings are performed based on internal data in the possession of the financial institution under inspection, verify the reliability of the data and the sufficiency of the sample. Verify that the institution supplements this data with data from outside credit research bureaus and the like in the event that the internal data is inadequate.</p> <p>Verify that the institution reviews the credit rating regularly and whenever there is need as indicated by business conditions and forecasts relating to the borrower, reviews of the ratings issued by ratings agencies, and the evaluation given the borrower by the markets, etc. Verify also that the internal audit division checks the accuracy of the credit rating</p>	<p>have been certified under Article 16:2 of the Supplementary Provisions of the Deposit Insurance Act, and so throughout.</p> <p>Note: “Ratings agency” refers to an institution performing credit ratings as stipulated in Article 2:36 of the Financial Instruments and Exchange Act, and so throughout.</p>
(3) Borrower classifications	<p>Borrowers are to be classified as follows in light of conditions, etc., at the borrower as evidenced in principle by credit ratings.</p>	<p>In verifying borrower classifications, check that classifications are accurate in light of conditions, etc., at the borrower as evidenced in principle by credit ratings. Note that project finance credits may be classified according to the degree of repayment</p>	<p>Note: “Project finance” refers, for example, to a non-recourse loan that is used to finance a specific project (business),</p>

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
		<p>risk.</p> <p>Borrower classifications would require comprehensive judgment. Begin by considering repayment ability as evidenced by the borrower’s financial position, cash flow, and earnings ability, etc., confirm lending terms and the borrower’s fulfillment of the terms, factor in the nature of the industry, etc., and the forecast for business continuity and profitability, and then evaluate the borrower’s ability to pay the debt at maturity from cash flow, the appropriateness of its business improvement plans, etc., and the support provided by financial institutions etc.</p> <p>Particularly for medium, small, and micro companies, consider the company’s technology skills, sales capacity and growth potential, remuneration to the representative director and other directors, income and assets of directors, etc., guarantee status, and guarantee ability, etc., to arrive at a comprehensive judgment of the company’s business status.</p> <p>When factoring in the conditions of the parent company etc., of the borrower, it is not sufficient to determine the borrower classification merely on the basis of the parent company having a strong financial position. When factoring in support from the parent company, inspectors must fully check the parent company’s track record in supporting subsidiaries and the potential for support in the future.</p> <p>If the borrower is using official financing (hereinafter, “government funding”), for example, central or local public entity subsidies for the interest payments on loans from private financial institutions, consider the borrower classification in terms of the nature of the government funding utilized in addition to the financial position of the borrower itself.</p>	<p>with the funding for payments of interest and principal on the loan limited to the cash flow (profits) generated by the project. In this type of financing, the loan is secured only by the assets of the project. This definition applies throughout this document.</p> <p>Note: In understanding the “borrower’s actual financial position,” borrowings with a sufficient capital nature may be considered capital instead of liabilities, regardless of whether they are new loans or switched over from existing borrowings.</p> <p>Note: “Cash flow” refers to current profits adjusted for depreciation charges and other non-asset items, and so throughout.</p> <p>Note: Refer to the “Supplement to the Financial Inspection Manual [Treatment of Classifications Regarding Credit to Small and Medium sized Enterprises]” for the application of matters</p>

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
<p>1) "Normal"</p> <p>2) "Needs attention"</p>	<p>A "normal" borrower has strong results and no particular problems with its financial position.</p> <p>A "needs attention" borrower has problems with lending conditions (i.e., waivers, reductions, or deferrals of interest), has problems with fulfillment (i.e., de facto arrears on principal or interest payments), has poor results or is unstable, has problems with its financial position, or otherwise requires special attention in future management.</p> <p>It is desirable that "needs attention" borrowers be divided into "needs special attention" borrowers and other borrowers.</p>	<p>Verify if these borrowers are classified as "normal" borrowers.</p> <p>Verify if these borrowers are classified as "needs attention" borrowers.</p> <p>If the institution divides "needs attention" borrowers into "needs special attention" borrowers and others borrowers, verify that the classifications are appropriate.</p> <p>Check that "needs attention" borrowers do not include borrowers that would ordinarily be classified as "in danger of bankruptcy" in light of their financial position, etc., but have been classified as "needs attention" borrowers merely because their parent company, etc., has a strong financial position.</p> <p>If borrowers meet criteria 1.-3. below, check whether they are "needs attention" in light of the considerations to the left. Do not immediately classify them as "needs attention."</p> <p>1. Borrowers that are in the red because of start-up costs but have not departed much from their initial business plans may be considered "normal."</p> <p>"Borrowers that are in the red because of start-up costs but have not departed much from their initial business plans" refers to borrowers with rational initial business plans that are proceeding roughly according to plan when results and plans are compared, and that evince a high potential to achieve their plans</p> <p>Specifically, these borrowers will in principle target profitability within about five years and will have at least 70% of the sales and profits targeted in their initial business plans.</p>	<p>mentioned to the left.</p> <p>Note: "Borrowers needing special attention" are "needs attention" borrowers for which all or part of the credits require special attention. However, borrowers for which "needs special attention" credits consist only of rescheduled credits, all of which are credits that may be considered as capital under this Attachment 1.(3) "Note" or the "Supplement to the Financial Inspection Manual [Treatment of Classifications Regarding Credit to Small and Medium sized Enterprises] 7. Capital subordinated loans" are not considered "borrowers needing special attention," and so throughout.</p>

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
		<p>These standards are merely yardsticks for determining the rationality and achievability of business plans. They should not be applied mechanically or uniformly when reviewing the borrower classification of companies that are in the red because of start-up costs</p> <p>Reviews of borrower classification entail a comprehensive judgment that takes into account the nature of the industry; the nature of the business; the size of the business; the ability to repay the loan in full from cash flow; the borrower's technology skills, sales capacity, and growth potential; and other relevant factors. Inspectors should not immediately classify a borrower as "needs attention" merely because it does not formally meet these standards.</p> <p>2. The following kinds of borrowers may be classified as "normal" even if they are in the red.</p> <p>These standards are merely yardsticks for determining the rationality and achievability of business plans. They should not be applied mechanically or uniformly when reviewing the borrower classification of companies that are in the red.</p> <p>Reviews of borrower classification entail a comprehensive judgment that takes into account the nature of the industry, the business condition of the borrower, the reasons for the losses, the internal reserves of the company, and the forecast for the future. Inspectors should not immediately classify a borrower as "needs attention" merely because it does not formally meet these standards.</p> <p>(1) Borrowers whose losses are caused by transient factors such as losses on the sale of fixed assets, and which are certain to return to profitability in a short period of time.</p> <p>(2) Borrowers, as medium, small, and tiny companies that are in the red, but for which there are deemed to be no</p>	

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
<p>3) “In danger of bankruptcy”</p>	<p>An “in danger of bankruptcy” borrower is not bankrupt now but is facing business difficulties and has failed to make adequate progress on its business improvement plan, etc., such that there is a large possibility of it falling into bankruptcy in the future (this includes borrowers that are receiving support from financial institutions, etc.).</p> <p>Specifically, an “in danger of bankruptcy” borrower is continuing in business now but is already in de facto insolvency, with its business results markedly depressed and its debt service in arrears so that there are serious concerns about its final repayment of principal and interest. In other words, these are borrowers with a high likelihood of generating losses for the institution and a large potential to go bankrupt in the future.</p>	<p>particular problems with the recoverability of the credit.</p> <p>3. A borrower that has dishonored bills, accommodation bills, discount bills for which there are doubts regarding payment at maturity, or electronically recorded monetary claims that are similar to such bills may be classified as “normal” if a general evaluation of the borrower’s profits and financial position indicates that it has the ability to bear the cost of the dishonored bills, etc.</p> <p>Inspectors should consider whether borrowers that do not fall under criteria 1. through 3. above correspond to “needs attention” in light of matters described to the left and should not immediately classify them as “needs attention.”</p> <p>Verify that these borrowers are classified as “in danger of bankruptcy” borrowers.</p> <p>However, when a borrower has formulated a business improvement plan, etc., predicated on support from financial institutions, etc., and all of the conditions below are met, the business improvement plan may be deemed rational and possessed of a high potential for achievement, and therefore the borrower may be classified as a “needs attention borrower.”</p> <p>These standards are merely yardsticks for determining the rationality and achievability of business plans. They should not be applied mechanically or uniformly when reviewing the borrower classification of companies that have formulated business improvement plans, etc.</p> <p>Reviews of borrower classification entail a comprehensive judgment that takes into account the nature of the industry, the forecast for business continuity and profitability, the ability to repay the loan in full from cash flow, the appropriateness of the business improvement plan, etc., and the availability of support</p>	<p>Note: Refer to the “Supplement to the Financial Inspection Manual [Treatment of Classifications Regarding Credit to Small and Medium sized Enterprises]” for the application of matters mentioned at left.</p>

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
		<p>from financial institutions, etc. Inspectors should not immediately classify a borrower as “in danger of bankruptcy” merely because it does not formally meet these standards.</p> <p>In particular, medium, small, and tiny companies may not always formulate business improvement plans, etc., and in these cases, inspectors should consider not only the company’s financial condition but also its technology skills, sales capacity and growth potential, payment of remuneration to representative director and directors, income and assets of directors, etc., guarantee status, and guarantee ability, etc., to arrive at a comprehensive judgment of the company’s business status. Do not immediately classify a borrower as “in danger of bankruptcy” merely because it has not formulated a business improvement plan, etc.</p> <p>Additionally, when a borrower is using government funding to formulate a business improvement plan, etc., and the business improvement plan, etc., has been reviewed by the central or prefectural government, inspectors should take account of the involvement of the central or prefectural government and its appropriateness in light of conditions at the borrower.</p> <p>1. The period for the business improvement plan, etc., should in principle be no more than about five years and the plan should have a high potential for achievement.</p> <p>However, this may include business improvement plans, etc., with periods of between five and 10 years if, after the plan is formulated, progress in its achievement has been generally according to plan (at least 80% of the sales and current profit targets), and the borrower is deemed likely to continue to achieve the plan in the future.</p> <p>2. The plan will in principle enable the borrower to be classified as “normal” when it is completed. However, it is acceptable for the borrower to be classified as “needs attention” after the</p>	<p>Note: Refer to the “Supplement to the Financial Inspection Manual [Treatment of Classifications Regarding Credit to Small and Medium sized Enterprises]” for the application of matters mentioned at left.</p>

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
		<p>completion of the plan, provided that after completion of the plan it will not require rebuilding support from financial institutions and will be able to continue in business on its own.</p> <p>3. There are documents or other confirmations attesting that all financial institutions, etc., with which the borrower does business (including the financial institution under inspection) have completed formal internal procedures for providing support as called for in the business improvement plan, etc., and that an agreement on support has been reached.</p> <p>However, in cases in which it is possible to rebuild the company with support only from the financial institution under inspection, or in cases in which it is possible to rebuild the company with support from only some of the financial institutions, etc., with which the borrower does business (including the financial institution under inspection), it is sufficient for there to be documentary or other confirmations that the financial institutions, etc., involved have completed formal internal procedures and reached an agreement on support as called for in the business improvement plan, etc.</p> <p>4. Support from financial institutions, etc., must be limited to waivers and reductions of interest, maintenance of lending balances and the like, and may not include the debt forgiveness, cash gifting, or other provisions of funds to the borrower.</p> <p>However, this shall include cases in which the institution has already provided funds to the borrower (debt forgiveness, cash gifting) but is not expected to do so after the initiation of the business improvement plan, etc., and cases in which plans require the provision of cash to the borrower (relinquishment of credits, cash gifts) but full reserves have already been allocated for the losses forecast from this support and there are no forecasts for further losses in the future.</p>	

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
4) “De facto bankrupt”	<p>An “De facto bankrupt” borrower is not yet legally and formally bankrupt, but is in serious business difficulties from which it is considered impossible to rebuild. In other words, the borrower is just about bankrupt.</p> <p>Specifically, this refers to borrowers who are still formally in business but whose financial position includes large amounts of non-performing assets or excessive borrowings compared to the borrower’s ability to repay. The borrower has effectively been in serious insolvency for a considerable period of time and has no hope of business improving; or, the borrower has taken large losses from a natural disaster, accident, rapid change in business conditions or the like (or similar events have occurred), has no hope of rebuilding, and has in effect been in arrears for a prolonged period of time in its payments of principal and interest.</p>	<p>Note that when the borrower is making use of government funding, interest subsidies and the like made by prefectural governments with subsidies from the central government as provided for in government funding programs are not included in the debt forgiveness, etc.</p> <p>Verify that these borrowers are classified as “De facto bankrupt” borrowers.</p> <p>If the borrower is not legally or formally bankrupt but has voluntarily gone out of business or has otherwise effectively ceased operations, verify that it has been classified as “De facto bankrupt.”</p> <ol style="list-style-type: none"> 1. Among “borrowers who have formulated a business improvement plans, etc., predicated on support from financial institutions etc.,” those who are far behind in the achievement of their business improvement plans, etc., and have no hope of a rapid recovery in their results in the future and no review has been made for their business improvement plan, etc., or those for which some correspondent financial institutions have not agreed to provide support based on the business improvement plan, etc., should, if there is a certain likelihood of bankruptcy in the future, be deemed “in serious business difficulties with no hopes of rebuilding,” and therefore may be classified as “De facto bankrupt.” 2. “In effect been in arrears for a prolonged period of time” shall be interpreted in principle as having effective arrears of six months or longer that are not deemed transient arrears. 	
5) “Bankrupt”	<p>A “bankrupt” borrower is legally and formally bankrupt. This would include bankruptcy, liquidation, corporate reorganization, civil-rehabilitation, composition, and deposition by suspension of</p>	<p>Verify that these borrowers have been classified as “bankrupt”. However, a borrower for whom a rehabilitation plan, etc., as provided in the Corporate Reorganization Law and the Civil</p>	

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
	<p>business in the clearing house.</p>	<p>Rehabilitation Law, etc., has been confirmed may be classified as “in danger of bankruptcy.” Furthermore, if such borrower has fulfilled all of the conditions below, the rehabilitation plan may be deemed rational and possessing high potential for achievement, and therefore the borrower may be classified as a “needs attention borrower.”</p> <p>The borrower in question is likely to be classified as “normal” within approximately five years in principle after the rehabilitation plan, etc., has been confirmed (it is acceptable for the borrower to be classified as “needs attention” if the borrower in question does not require rebuilding support from financial institutions, etc., and will be able to continue in business on its own), and progress in the achievement of the rehabilitation plan is generally according to plan.</p> <p>However, this includes cases in which the plan enables the borrower in question to be classified as a “normal” borrower in a period of over five to roughly 10 years (it is acceptable for the borrower to be classified as “needs attention” if the borrower in question does not require rebuilding support from financial institutions, etc., and will be able to continue in business on its own), a certain amount of time has passed since the rehabilitation plan, etc., has been confirmed, and progress in its achievement is expected to be generally according to plan.</p> <p>Borrowers for whom a petition for special conciliation in accordance with the provisions of the Act on Special Conciliation Proceedings for Expediting Arrangement of Specified Debts, etc. has been filed, shall not be classified as “bankrupt” due to the petition, but their classification shall be determined according to the management condition of the borrower in question.</p>	

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
<p>(4) Adjustment for collateral</p> <p>1) Superior collateral</p>	<p>Categorize assets secured with collateral as follows. If the asset is secured with superior collateral, the estimated disposal value of which covers the value of the asset, it is “non-classified”; if it is secured with ordinary collateral, the estimated disposal value of which covers the value of the asset, it is in Category II.</p> <p>Use the following to calculate appraised collateral value and estimated disposal value.</p> <p>Deposits, etc. (deposits, savings, premiums, money trusts with guaranteed principal, insurance and mutual-aid policies with returns at maturity, and so throughout), government bonds and other securities of high creditworthiness, commercial bills of certain settlement, and similar instruments such as electronically recorded monetary claims.</p>	<p>Verify that assets secured with collateral have been categorized, and that the appraised value and estimated disposal value are rational, as described at left.</p> <p>Verify that the instruments listed left are categorized as “superior collateral.”</p> <ol style="list-style-type: none"> 1. Note that for “insurance and mutual-aid policies with returns at maturity,” the estimated disposal value is the amount received if the policy were cancelled on the base date. 2. “Government bonds and other securities of high creditworthiness” refers to the following bonds, equities and foreign securities when these instruments are deemed to be safe and have no particular problems. <ul style="list-style-type: none"> (Bonds) (1) Government bonds, local government bonds. (2) Government-guaranteed bonds (public corporation bonds, etc.). (3) Special bonds (bonds issued by special public corporations such as public corporations or companies with government funding, excluding government-guaranteed bonds). (4) Bonds of financial institution. (5) All bonds issued by companies that issue bonds whose latest ratings by a rating agency are BBB or better. (6) All corporate bonds issued by companies that issue corporate bonds listed in financial instruments exchanges, and corporate bonds selected as quotation of 	<p>Note: “Commercial bills of certain settlement” and “similar instruments such as electronically recorded monetary claims” includes cases in which separate deposits are retained for provisional payments against bills.</p> <p>Note: “Deposits etc.,” “government</p>

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
		<p>over-the-counter.</p> <p>(Equities)</p> <p>(1) Equities listed in financial instruments exchanges, over-the-counter shares, non-listed shares issued by companies listed on a financial instruments exchange.</p> <p>(2) Equities issued by companies with government investment (excludes liquidated companies).</p> <p>(3) Equities of companies that issue bonds whose latest ratings by a rating agency are BBB or better.</p> <p>(Foreign securities)</p> <p>(1) All equities issued by companies listed on a foreign financial instruments exchange or a domestic financial instruments exchange, and all bonds issued by bond issuers listed on such exchanges.</p> <p>(2) Bonds covered by over-the-counter standard bond quotations in Japan or abroad.</p> <p>(3) Bonds issued by international institutions established under treaties to which Japan is a signatory, and bonds issued by governments or similar institutions (state governments, etc.) or municipalities of countries with which Japan has relations.</p> <p>(4) Equities and bonds issued by financial institutions licensed, etc., by governments of countries with which Japan has relations.</p> <p>(5) All bonds from issuing companies that have been rated BBB (triple B) or better in their most recent ratings by a ratings agency, and all equities issued by companies issuing said bonds.</p> <p>If the collateral consists of securities other than securities with high creditworthiness such as government bonds, etc.,</p>	<p>bonds and other securities of high creditworthiness,” and “commercial bills of certain settlement” shall not be deemed superior collateral if there are any impediments to collection by disposal of collateral.</p>

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2) Ordinary collateral	<p>Collateral other than “superior collateral” that is disposable from an objective perspective.</p> <p>For example, real estate collateral, industrial factory foundation collateral, etc.</p> <p>Chattels collateral is collateral for which appropriate management and objectivity/rationality of appraisal is secured to ensure conversion.</p> <p>Finance receivable as collateral is collateral for which appropriate credit management is secured to ensure collection.</p>	<p>it must fulfill liquidity and negotiability requirements such as ease of disposal and cashability.</p> <p>3. “Commercial bills of certain settlement” refers to bills from issues with no problems in their financial position or cash flow, when those bills are certain to be settled on the date of maturation. However, accommodation bills issued to provide financial support (i.e., cash flow, etc.) with no basis in actual commercial transactions are excluded.</p> <p>4. “Similar instruments such as electronically recorded monetary claims” refers to electronically recorded monetary claims from debtors with no problems in their financial position or cash flow, when claims are certain to be paid on the payment date. However, electronically recorded monetary claims recorded to provide financial support (i.e., cash flow, etc.) with no basis in actual commercial transactions are excluded.</p> <p>Verify if the instruments listed to the left are categorized as “ordinary collateral.” Real estate collateral, etc., shall in principle not be handled as ordinary collateral if mortgage right registration has been reserved. However, it may be handled as ordinary collateral if there are rational reasons for reserving registration, if all of the required documents for registration have been collected, and if immediate registration is possible.</p> <p>Even in these cases it is appropriate to register without fail in order to counter the claims of third parties, and it is necessary that the setting of mortgage rights for the real estate collateral be appropriately managed.</p> <p>When chattels are collateral, verify that appropriate management as well as objective and rational appraisal are secured and conversion is objectively/rationally expected to be certain, according to the nature of the chattels, such as through appropriate</p>	<p>Note: “International institutions established under treaties to which Japan is a signatory” refers to the International Bank for Reconstruction and Development (IBRD), the International Finance Corporation (IFC), the Inter-American Development Bank (IDB), the European Bank for Reconstruction and Development (EBRD), the African Development Bank (AfDB), and the Asian Development Bank (ADB).</p>

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3) Appraised collateral value	An appraised value (market value) calculated objectively and rationally.	<p>fulfillment of perfection requirements, continuous monitoring of the volume and quality, etc., feasible objective/rational appraisal, which should already have been obtained, appropriate conversion methods secured for the chattels in question, and the establishment of procedures to appropriately secure the chattels in question upon exercising security rights.</p> <p>In addition, when finance receivable is collateral, verify that appropriate credit management such as appropriate fulfillment of perfection requirements, timely acquisition of information required to determine the credibility of the third party debtor in question (the borrower of the target credit), continuous monitoring of the financial condition of the third party debtor, and rational calculation of the percentage of loan losses, etc., is secured and collection (includes conversion through assignment to a third party) can be objectively and rationally expected as certain.</p> <p>Verify that appraised collateral values are calculated objectively and rationally.</p> <p>The appraised collateral value must be verified from a multilateral perspective including comparative analysis of the trend of appraised value, consistency with charge-offs and allowances, as well as disposal prices of collateral real estate by type, borrower classification and disposal method, and the actual trend of selling/buying prices of the collateral in verifying disposal prices.</p> <p>Collateral appraisal is based on current conditions in principle. It is necessary to conduct appropriate appraisal after confirming the location by foot as well as examining the situation of rights and legal restrictions (e.g., the Building Standards Act, the Agricultural Land Act, etc.). Environmental conditions such as land contamination and asbestos must also be taken into</p>	Note: Note that forest preserves, roads and swamps, etc. cannot be considered as ordinary collateral in principle even if the mortgage right is registered.

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
		<p>consideration.</p> <ol style="list-style-type: none"> <li data-bbox="1122 225 1771 608">1. For borrowers categorized as “in danger of bankruptcy,” “De facto bankrupt,” or “bankrupt”, reviews of the appraised value of real estate securing assets (re-appraisal, or adjustments to market, and so throughout) must be made at least once per year and desirably made once per half-year, because the allocation to individual reserves must be calculated each accounting term. Reviews of appraised values should be based on the most recent official land prices, standard land prices, inheritance tax appraisal values, or the like available on the base date of the last day of the accounting period or the provisional base date. <ul style="list-style-type: none"> <li data-bbox="1155 624 1771 727">For borrowers categorized as “needs attention,” it would also be desirable that the appraised value of real estate securing assets be reviewed once per year. <li data-bbox="1155 743 1771 847">It is desirable that appraisals of real estate value be performed by qualified real estate appraisers for properties above a certain threshold value. <li data-bbox="1155 863 1771 1206">Verify that appraisals of rental office buildings and other income property utilize the “returns method” in principle in addition to the “cost method” and the “recent sales method” as needed. If there are large differences between the appraisal methods in such cases, the adequacy must be carefully examined from the standpoint of the characteristics of the property in question as well as credit security. In particular, verify that appraisals of special real estate (golf courses, etc.) have taken marketability sufficiently into account. <li data-bbox="1122 1222 1771 1366">2. If there are changes in the method by which collateral is appraised (for example, a change in the standard from official land prices to inheritance tax appraisal values), verify that there are rational reasons for the change. <li data-bbox="1122 1382 1771 1406">3. Verify that appraisal of chattels and finance receivable as 	

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4) Estimated disposal value	<p>A value based on the appraised value in 3) above considered certain to be recovered if the collateral were disposed of. This must take full account of the nature of the property as a credit security. If the appraised value is of sufficiently high precision, the appraised value and estimated disposal value may be equal.</p>	<p>collateral is objective and rational in light of the actual management method, etc.</p> <p>Verify that the estimated disposal value is calculated in an objective and rational manner based on the appraised value of the collateral.</p> <ol style="list-style-type: none"> 1. If the appraised value is used as the estimated disposal value, verify that there is rational justification for considering the appraised value to be of high precision. For example, if a considerable number of collateral have actually been disposed, and comparisons of disposal prices and estimated disposal value document that disposal prices are higher than the estimated disposal value, and this assertion can be confirmed, it may be deemed a “rational justification.” 2. If there is a recent appraised value from a real estate appraiser (including assistant real estate appraisers) or if there is a minimum sale price set by a court, the appraised value may be deemed to be of sufficient precision that this price can be used as the estimated disposal value. However, verify that necessary corrections have been made to said appraised value as needed by considering the preconditions of the appraisal and examples of selling and buying, from the perspective of taking into full account the nature of the credit security. <p>Note that for prices other than appraised values from real estate appraisers (including assistant real estate appraisers) and minimum sale prices set by courts, the appraised value may be used as the estimated disposal value as long as there is rational justification for considering the appraised value to be of high precision. The request method and relationship with the requestee should also be noted with regard to appraisal.</p> <ol style="list-style-type: none"> 3. Verify that the multipliers used to calculate the estimated 	

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<p>(5) Adjustment for guarantees, etc.</p>	<p>Categorize assets secured with guarantees, etc., as follows. Asset secured with “superior guarantees” shall be deemed “non-classified.” Asset secured with ordinary guarantees, etc., shall</p>	<p>disposal value are rational.</p> <p>(1) If the rationality of the multipliers used to calculate the estimated disposal value of real estate, chattels and accounts receivable cannot be secured for reasons such as insufficient disposal records, verify that the multipliers are below the values shown below.</p> <p>Note whether the calculations do not easily depend on multipliers that are less than the following values.</p> <p>(Real estate collateral)</p> <table border="0"> <tr> <td>Land</td> <td>70% of appraised value</td> </tr> <tr> <td>Building</td> <td>70% of appraised value</td> </tr> </table> <p>(Chattels collateral)</p> <table border="0"> <tr> <td>Inventories</td> <td>70% of appraised value</td> </tr> <tr> <td>Machinery</td> <td>70% of appraised value</td> </tr> </table> <p>(Accounts receivable collateral)</p> <table border="0"> <tr> <td>Accounts receivable</td> <td>80% of appraised value</td> </tr> </table> <p>(2) It may be deemed appropriate if the estimated disposal value of securities is less than the value gained by multiplying the appraised value with the following multiplier.</p> <p>(Securities collateral)</p> <table border="0"> <tr> <td>Government bonds</td> <td>95% of appraised value</td> </tr> <tr> <td>Government-guaranteed bonds</td> <td>90% of appraised value</td> </tr> <tr> <td>Listed equities</td> <td>70% of appraised value</td> </tr> <tr> <td>Other bonds</td> <td>85% of appraised value</td> </tr> </table> <p>Guarantees from non-financial institutions shall not be deemed guarantees if there are procedural inadequacies, for example, if the board of directors of the company has not completed approval</p>	Land	70% of appraised value	Building	70% of appraised value	Inventories	70% of appraised value	Machinery	70% of appraised value	Accounts receivable	80% of appraised value	Government bonds	95% of appraised value	Government-guaranteed bonds	90% of appraised value	Listed equities	70% of appraised value	Other bonds	85% of appraised value	<p>Note: It is desirable that “comparisons” are categorized by the type of collateral property.</p> <p>Note: “Appraised value” refers to an appraisal based on real estate appraisal standards (notification from the Administrative Vice-Minister of Land, Infrastructure, Transport and Tourism), and does not include appraisals carried out by a simplified method.</p>
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1) Superior guarantees, etc.	<p>be deemed Category II.</p> <p>1. Guarantees of extremely high certainty of fulfillment, for example, guarantees from public credit guarantee institutions, guarantees from financial institutions, guarantees from guarantee institutions established jointly by a number of financial institutions, guarantees from guarantee institutions established jointly by a number of local governments and financial institutions, loss reimbursement guarantees from local governments. However, even these guarantees shall not be deemed “superior guarantees” if conditions at the guarantee institutions, etc., procedural inadequacies, and similar factors raise doubts about subrogated repayment, or if the bank (cooperative, union) does not intend to seek fulfillment of the guarantee.</p>	<p>procedures for the guarantee.</p> <p>Guarantees, etc., made with the intention of reducing risk assets for capital adequacy ratio purposes, guarantees, etc., made with the intention of reducing non-performing assets on the fiscal year end, and the like shall not be deemed to secure the asset unless the term of the guarantee, etc., exceeds the period from the base date to the fiscal year end of the next accounting term.</p> <p>Verify that the guarantees described at left have been categorized as superior guarantees.</p> <p>1. “Public credit guarantee institutions” refer to institutions that are established by law and allowed to provide guarantee services. Examples include the Credit Guarantee Association, the Agriculture, Forestry and Fisheries Credit Foundations, and the Agriculture, Forestry and Fisheries Credit Foundations Association.</p> <p>Note that there are some types of guarantees from public credit guarantee institutions that do not guarantee the full value of the asset.</p> <p>In the case as below the guarantee is not to be deemed a “superior guarantee” as the case that conditions at the guarantee institutions, etc., procedural inadequacies, and similar factors raise doubts about subrogated repayment, or if the bank (cooperative, union) does not intend to seek fulfillment of the guarantee.</p> <p>(1) The financial institution has not claimed subrogated repayment from the guarantee institutions, etc., because of poor business conditions, etc., at the guarantee institution, or the financial institution has claimed subrogated repayment but has not received it for these reasons. (This excludes the public credit</p>	<p>Note: “Other bonds” refer to municipal bonds (both publicly and privately placed), public corporation bonds without government guarantees, bank debentures, exchange-listed industrial bonds from corporate issuers, and securities investment trust beneficiary certificates.</p>

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2) Ordinary guarantees	<p>2. Guarantees from non-financial institutions will be deemed superior guarantees in principle if the guarantor is a dividend-paying exchange-listed or over-the-counter-traded company, has sufficient resources to provide guarantees, and has signed a formal guarantee contract.</p> <p>3. “Home loan guarantee insurance” and the like from Japan Housing Finance Agency and other public insurance companies, and “home loan guarantee insurance” and similar policies from private insurance companies.</p> <p>Guarantees other than superior guarantees. For example, guarantees from non-financial institutions (other than those in 1) 2. above) and individuals that have sufficient guarantee resources.</p>	<p>guarantee institutions in 1. above.)</p> <p>(2) The financial institution receiving the guarantee has refused to accept subrogated repayment from the guarantee institutions, etc., because it has forgotten or delayed subrogated repayment procedures or had other inadequacies in guarantee fulfillment procedures.</p> <p>(3) The financial institution receiving the guarantee has no intention of seeking fulfillment of the guarantee for other reasons.</p> <p>2. Guarantees from non-financial institutions that are non-dividend-paying exchange-listed or over-the-counter-traded companies may be deemed superior guarantees if the lack of dividend payment is for transient reasons and the business conditions and financial position, etc., of the company indicate that it is certain to restore dividends the next accounting period, and the company has sufficient resources to provide guarantees and has signed a formal guarantee contract.</p> <p>3. Examples of public insurance other than that from Japan Housing Finance Agency would include “export bill insurance” and “overseas investment insurance” provided under the trade insurance system.</p> <p>Verify that the guarantees described at left are categorized as ordinary guarantees.</p> <p>Verification of the guarantee resources of a guarantee company shall be based on sufficient understanding of the actual state with reference to the guarantee company’s financial condition, the characteristics of the debt guarantee, self-assessment, charge-offs and allowances, guarantee rates, etc. If the guarantee is by a</p>	

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3) Guarantee reservation and management supervision pledges		<p>subsidiary of the financial institution and the subsidiary is receiving support, etc., from the parent financial institution, etc., it should be noted that the adequacy of the management improvement plans and the situation in which such support etc., is deducted should also be taken into consideration.</p> <p>When a non-financial institution in a guarantee reservation and/or management supervision pledge notes guarantee reserves, etc., for the borrower in the financial statements of the guaranteeing company as a debt guarantee or a guarantee-like action, or when it is clear that the nature of the action would legally be deemed of equivalent effect to a guarantee, it may be treated as a formal guarantee provided that documents and other materials attest that formal internal procedures have been followed at the company in question and that the company in question has sufficient resources to provide guarantees.</p>	
(6) Credits not subject to classification	<p>The following credits are not subject to classification.</p> <ol style="list-style-type: none"> Discount bills of certain settlement and similar instruments such as electronically recorded monetary claims, credits that are deemed certain of collection within a short period of time from specific repayment sources, and credits deemed to be normal operating capital. 	<p>Verify that the credits described to the left have been treated as “credits not subject to classification.”</p> <ol style="list-style-type: none"> Bills issued by borrowers the classifications of which have been categorized as “in danger of bankruptcy,” “De facto bankrupt,” or “bankrupt” and electronically recorded monetary claims of which the debtors are such borrowers shall not be treated as discount bills of certain settlement for self-assessment purposes. <p>“Credits that are deemed certain of collection within a short period of time from specific repayment sources” refers to cases in which it is verifiable from relevant documents that loaned funds will be collected within about one month.</p>	<p>Note: “Specific repayment sources” refers to the monies from capital increases, bond issues, sales of real estate, agency commission contracts and the like when deposit is certain within a short period of time, or to borrowings, etc. from other financial institutions that are certain to be allocated to repayment, provided that the certainty of</p>

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	<p>2. Credits secured with deposits, etc. or with “government bonds and other securities of high creditworthiness” or with other superior collateral, or credits for which emergency binding measures have been taken for deposits, etc., up to the amount of the estimated disposal value.</p> <p>3. Credits with superior guarantees and insurance and mutual-aid credits of certain payment.</p>	<p>2. Operating capital for borrower classifications “in danger of bankruptcy,” “De facto bankrupt,” and “bankrupt” shall not be treated as normal operating capital for self-assessment purposes. Note that operating capital for “needs attention” borrowers may not be treated as normal operating capital for all “needs attention” borrowers in self-assessments. Treatment will depend on individual judgments of conditions at the borrower.</p> <p>Operating capital for “in danger of bankruptcy” borrowers shall be treated according to the degree of collection risk when repayment funds from specific repayment sources are deposited to deposit accounts with the bank (cooperative, union) and collection is considered possible.</p> <p>Generally, the following formula should be used for calculating normal operating capital for companies in wholesaling, retailing, and manufacturing, but calculations do not recognize the uncollectable amount of accounts receivable and/or bills receivable or loans against non-performing inventories as normal operating capital, so an amount equivalent to this will need to be deducted prior to calculation.</p> <p style="text-align: center;">Normal operating capital</p> <p style="text-align: center;">= Sales credit [accounts receivable + bills receivable (excluding discount bills)]</p> <p style="text-align: center;">+ Inventory assets (ordinary inventory goods excluding non-performing inventories)</p> <p style="text-align: center;">- Purchasing liabilities [accounts payable + bills payable (excluding bills payable for facilities)]</p> <p style="text-align: center;">If more than one financial institution is lending operating capital, multiply by the lending share of the financial institution under inspection.</p> <p>3. When the use of funds from credits with superior guarantees is designated as “operating capital,” and the total of this</p>	<p>deposit can be verified from the capital increase or bond issue prospectus, the sales contract, the agency commission, fund transfer requests, or other documents.</p> <p>Note: “Normal operating capital” refers to operating capital deemed to be continuously necessary in order to conduct normal business.</p>

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(7) Credit categorization standards	<p>4. Credits held against companies in which the government is a shareholder.</p> <p>5. For cooperative financial institutions expecting to recover credits from the return of investments because of the withdrawal or expulsion of an investor, credits equivalent to the amount of the investment.</p> <p>Categorize credits according to the borrower classification. Project finance credits shall be categorized under deemed borrower classification according to the degree of risk of collection without regard to borrower classification. Such categorization shall be performed following rational methods such as a comprehensive evaluation of collection risk by adding scoring ratings and indicators such as the LTV (Lone to Value) and the DSCR (Debt</p>	<p>operating capital and other operating capital exceeds the normal operating capital, the amount of the credit not subject to categorization shall not exceed the amount of the normal operating capital.</p> <p>4. Do not treat credits against borrowers to which a company with government investment has provided investments or loans or against borrowers in which a local government has provided investments or loans as “not subject to classification.” Verify that they have in principle been categorized in the same manner as credits against ordinary industrial companies.</p> <p>Specifically, when there is rational justification that support from the government-invested company or support from the local government is certain, study the borrower category with reference to the nature of the support. Verify that the institution does not merely deem a credit “not classified” because a government-invested company or local government is providing investment or loans.</p> <p>Verify that credits are categorized accurately according to borrower classification as adjusted for collateral and guarantees, and whether there are any non-classified credits. For project finance credits, verify that categorization has been performed according to the degree of risk of collection under the deemed borrower classification.</p>	

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<p>1) "Normal" credits</p> <p>2) "Needs attention" credits</p>	<p>Service Coverage Ratio).</p> <p>Credits related to liquidation of assets, etc., shall be categorized according to the degree of risk of collection with appropriate reference to risks inherent to the scheme.</p> <p>It is also acceptable to categorize home loans and other standardized loans to individuals as well as small-lot standardized loans for small and mid-sized companies, etc., according to simplified criteria, for example, arrears status.</p> <p>Credits to normal borrowers are non-classified.</p> <p>Credits to "needs attention" borrowers are in principle assigned to Category II when they meet the requirements listed in 1. through 5. below for the portion that is not secured by the estimated disposal value for superior collateral or the guarantee for superior guarantees, etc.</p> <p>1. Dishonored bills, accommodation bills and discount bills doubtful to be settled at maturity, as well as similar instruments such as electronically recorded monetary claims.</p> <p>2. Funds to compensate for losses or defaulted credits, funds to support or undertake the obligations of poorly-performing affiliates, etc.</p> <p>Note: Credits to borrowers with losses carried over and non-performing assets, etc., shall in principle be categorized in this category when they are deemed to have been used to cover losses carried over, etc., regardless of different purposes under which they were loaned. In calculating the categorized amount, if it is unclear which credits will be used to cover losses carried over, etc., it is permissible, as exceptional treatment, to calculate a credit amount commensurate with the coverage of losses carried over, etc.,</p>	<p>When categorization is according to simplified standards, verify the rationality of the standards and the application of the standards.</p> <p>Verify that credits to normal borrowers are non-classified.</p> <p>Verify that the credits described at left have been categorized as "needs attention" credits.</p> <p>Below are the interpretations to be used for the categorized credits described at left.</p> <p>2. Calculate the bank's (cooperative, union's) lending commensurate to carried over losses, etc., and the bank's (cooperative, union's) share of lending as follows:</p> <p>The bank's (cooperative, union's) lending commensurate to carried over losses, etc.</p> <p>= Amount of carried over losses, etc. x the bank's (cooperative, union's) share of lending</p> <p>The bank's (cooperative, union's) share of lending</p> <p>= The Bank's (cooperative, union's) total lending (excluding discount bills) / Total borrowings of the borrower (excluding discount bills)</p>	

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	<p>taking account of the amount of the borrower's losses carried over and non-performing assets, etc., and the bank's (cooperative, union's) share of lending to the borrower.</p> <p>3. Credits for which there have been substantial mitigations of lending terms (reductions, waivers or deferrals of interest, grace periods on repayment of principal, etc.), credits with extremely long repayment contracts, or credits with other lending condition problems.</p> <p>4. Credits with problems in fulfillment (principal repayment or</p>	<p>3. "Credits for which there have been substantial mitigations of lending terms" refers to credits for which the borrower's business conditions, etc., have deteriorated to the point that it is difficult to make repayment according to contract, and for which the institutions have provided reductions, waivers or deferrals of interest or grace periods for principal repayment as a support measure for the borrower; or credits for equipment funds that should be repaid from revenues but for which repayment is allowed in full on the date of maturity without a rational reason therefor.</p> <p>"Credits with extremely long repayment contracts" refers to loans of equipment funds that have repayment periods longer than the useful life of the equipment in question, or loans that, judging from the use to which funds are put, etc., should be repaid within a certain period but have a repayment period in excess of the normal repayment period because of problems with the borrower's earnings ability, financial position or the like.</p> <p>Additionally, when a borrower is using government funding, inspectors should make a comprehensive judgment taking account of the nature of the government funding and the factors leading to the loan of government funding to determine whether there has been a substantial mitigation of lending conditions or whether there is an extremely long repayment contract. They should not immediately judge government funding to be credits for which there have been substantial mitigations of lending terms or credits with extremely long repayment contracts.</p>	

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<p>3) “In danger of bankruptcy” credits</p>	<p>interest payment effectively in arrears) or credits deemed to have a high potential for repayment problems in the future.</p> <p>5. Credits for which the financial position, etc., of the borrower indicates a greater than normal collection risk.</p> <p>All credits to “in danger of bankruptcy” borrowers in excess of the estimated disposal value of superior collateral and the amount protected with superior guarantees, etc., shall be categorized. The estimated disposal value from ordinary collateral, the amount deemed collectable from ordinary guarantees, and the amount deemed collectable from liquidation dividends in the event of bankruptcy shall be assigned to Category II. The remainder shall be assigned to Category III.</p> <p>If the appraised value of ordinary collateral is of sufficiently high precision, an amount equivalent to the appraised value of the collateral may be assigned to Category II.</p>	<p>Verify that credits to “in danger of bankruptcy” borrowers have been categorized as described at left.</p> <p>Refer to the following for interpretations of “collectable amounts.”</p> <ol style="list-style-type: none"> 1. “Amount deemed collectable from guarantees” refers to an amount deemed to be certain of collection in light of the assets and guarantee resources of the guarantor. If the assets and guarantee resources of the guarantor have not been confirmed or if collection under the guarantee is uncertain, the credit shall be considered not to be protected by the guarantee and this portion shall be assigned to Category III. Verify that this has been done. 2. “Amount deemed collectable from liquidation dividends” refers to an amount deemed to be certain of collection when it is possible to accurately measure the assets of the borrower (for example, the financial institution under inspection has a clear grasp of the collateral provided by the borrower to other lenders) and to create a liquidation balance sheet for the borrower, assuming the estimated liquidation dividend, etc., is rational. <p>If an “amount deemed collectable from liquidation dividends” is categorized as Category II, verify that the estimated liquidation dividend, etc., is rational.</p>	
<p>4) “De facto bankrupt” and</p>	<p>All credits to “De facto bankrupt” and “bankrupt” borrowers in</p>	<p>Verify that credits to “De facto bankrupt” and “bankrupt”</p>	

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<p>“bankrupt” credits</p>	<p>excess of the estimated disposal value of superior collateral and the amount protected with superior guarantees, etc., shall be categorized. The estimated disposal value from ordinary collateral, the amount deemed collectable from ordinary guarantees, and the amount deemed collectable from liquidation dividends in the event of bankruptcy shall be assigned to Category II. The difference between the appraised values and estimated disposal values of superior collateral and ordinary collateral shall be assigned to Category III. The remainder shall be assigned to Category IV, for which there is no hope of collection.</p> <p>If the appraised value of ordinary collateral is of sufficiently high precision, an amount equivalent to the appraised value of the collateral may be assigned to Category II. The amount of any uncertainty of collection from guarantees shall be assigned to Category IV, though it may be reassigned to Category II at the point at which collection under the guarantee is deemed possible.</p>	<p>borrowers have been categorized as described at left.</p> <p>Credits to “De facto bankrupt” and “bankrupt” borrowers should, to the extent possible, be categorized as Category II for the portion deemed collectable from collateral, etc., with the amount deemed uncollectable assigned to Category IV. Note that nothing should be assigned to Category III except “the difference between the appraised values and the estimated disposal values of superior collateral and ordinary collateral.”</p> <p>Refer to the following for interpretations of “collectable amounts.”</p> <ol style="list-style-type: none"> 1. “Amount deemed collectable from guarantees” refers to an amount deemed to be certain of collection in light of the assets and guarantee resources of the guarantor. If the assets and guarantee resources of the guarantor have not been confirmed and collection under the guarantee is uncertain, the credit shall be considered not to be protected by the guarantee and this portion shall be assigned to Category IV. Verify that this has been done. 2. For “De facto bankrupt” credits, the amount deemed collectable from liquidation dividends” refers to an amount deemed to be certain of collection when it is possible to accurately measure the assets of the borrower (for example, the financial institution under inspection has a clear grasp of the collateral provided by the borrower to other lenders) and to create a liquidation balance sheet for the borrower, assuming the estimated liquidation dividend, etc., is rational. <p>For “bankrupt” credits, the “amount deemed collectable from liquidation dividends” refers to 1) the expected amount of repayment within five years from the date a notification of liquidation dividend, etc., is received from a liquidator, etc., should such notice be received; 2) an amount deemed to be</p>	

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		<p>certain of collection when it is possible to accurately measure the assets of the borrower (for example, the financial institution under inspection has a clear grasp of the collateral provided by the borrower to other lenders) and to create a liquidation balance sheet for the borrower, assuming the estimated liquidation dividend, etc., is rational.</p> <p>If the amount deemed collectable from liquidation dividends, etc., is assigned to Category II, verify that the estimate of the liquidation dividend, etc., is rational.</p> <p>3. Verify that categorization has in principle been performed as follows for borrowers that have been the subject of a filing for rehabilitation under the Corporate Reorganization and Civil Rehabilitation Law, etc., a filing for composition under the Composition Law, etc., a filing for bankruptcy under the Bankruptcy Law, a filing for initiation of liquidation or initiation of special liquidation under the Commercial Code, or other similar action.</p> <p>(1) Are the rehabilitation collateral rights in principle assigned to Category II?</p> <p>(2) Among ordinary rehabilitation credits, is the amount deemed collectable within five years of the approval of the rehabilitation plan assigned to Category II, and any amount deemed to require in excess of five years assigned to Category IV?</p> <p>(3) Are relinquished credits assigned to Category IV?</p> <p>If the borrower classification and category are reviewed after a certain period of time has elapsed from the approval of the rehabilitation plan, etc., verify that the categorization and classification are according to the degree of collection risk.</p> <p>4. For common benefit claims to borrowers that have been the subject of a filing for rehabilitation under the Corporate</p>	

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(8) Credits to foreign governments, etc.	<p>In light of the special nature of credits to foreign governments, central banks, government-affiliated institutions and state enterprises, these credits are to be categorized according to objective facts and not according to the criteria in (7) above. For example, in cases like the following, consideration should be given to categorizing credits according to the degree of collection risk in light of the political or economic conditions in the country in question.</p> <ol style="list-style-type: none"> 1) Payment of principal and interest is one month or more in arrears. 2) Contracts have been signed within five years of the scheduled maturity to defer loan repayments, provide flat-rate relending from major creditor banks, or take other similar measures (hereinafter, “deferral of debt repayment, etc.”). 3) A request has been received for deferral of debt repayment, etc. and a month or more has elapsed without a contract being signed. 4) The facts described in 1) – 3) above are considered likely to occur in the near future. 	<p>Reorganization and Rehabilitation Law, etc. or a filing for composition under the Composition Law, etc. verify that they are non-classified or assigned to Category II in principle, according to the degree of collection risk.</p> <p>Inspectors should verify that credits to foreign governments, etc., are categorized according to collection risk as indicated by the country’s financial conditions, economic conditions, and foreign exchange balances. At the very least, they should verify that the credits described at left have been categorized.</p>	
(9) Credits to foreign private companies and Japanese companies abroad	<p>Categorize credits to foreign private companies and Japanese companies abroad according to the criteria found in (7) above.</p> <p>However, when arrears, etc., are clearly the result of the country’s foreign exchange balance, categorize the credits according to the criteria in (8) above.</p> <p>Note that self-assessments should take account of the nature of</p>	<p>Verify that credits to private companies and Japanese companies in countries the government of which has been categorized according to (8) above are categorized according to (7) above, and categorization according to (8) above has been considered.</p> <p>Verify how the institution understands the nature of business dealings in the country, its markets, and the status of collateral,</p>	

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(10) Interest receivable similar to loans	<p>business dealings in the country, its markets, and the status of collateral.</p>	<p>etc.</p> <p>For uncollected interest that is similar to loans, verify that the institution is in principle not posting those for “in danger of bankruptcy,” “De facto bankrupt,” and “bankrupt” borrowers as assets. Verify in particular that it is not posting uncollected interest from “De facto bankrupt” and “bankrupt” borrowers as assets.</p> <p>However, when the institution posts uncollected interest as assets in light of the potential to collect this interest from “in danger of bankruptcy” borrowers because of protection measures, etc., verify that this uncollected interest is categorized according to the degree of collection risk.</p> <p>For credits to “needs attention” borrowers, verify the rationality if interest that is uncollected after more than six months from the contracted interest payment day is posted as assets.</p> <p>When uncollected interest from “in danger of bankruptcy” borrowers is posted as assets, verify that the credit to the borrower is subject to reporting and publication as described in (11) below. Check that the institution is not posting uncollected interest as assets when it should not be in order to exclude the loan for which there is uncollected interest from disclosure as a managed credit.</p>	
(11) Relationship with credit categories under the “Emergency Revitalization Act”	<p>Below is the relationship between the credit categories set forth in Article 4 of the “Emergency Revitalization Act Ordinances” and the borrower classifications, etc., in this inspection manual.</p> <p>Note that under the provisions of Article 3:2:1 of the Act on Emergency Measures for Early Strengthening of Financial Functions (Law No. 143 of 1998), the institutions required to assess assets according to the criteria described in Article 6:2 of the “Emergency Revitalization Act” are: banks, trust banks, long-term</p>	<p>Verify that classification is performed according to the borrower classification, etc., as determined based on the financial position and business performance, etc., of the borrower pursuant to the criteria set forth in Article 4 of the “Emergency Revitalization Act Ordinances”</p> <p>It is required that the results of asset assessments according to Article 6 of the “Emergency Revitalization Act” be reported to the Prime Minister. Article 7 requires that they be published. Article</p>	

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1) “Non-classified” credits	<p>credit banks, shinkin banks, credit cooperatives, labor credit associations, the National Association of Shinkin Banks, the National Central Society of Credit Cooperatives, the National Federation of Labor Credit Associations, the Central Cooperative Bank for Agriculture and Forestry, the Credit Federation of Agricultural Cooperatives, the Credit Federation of Fishery Cooperatives, and bank holding companies, etc.</p> <p>“Non-classified” credits are “credits with no problems in terms of the financial position or business performance of the borrower,” i.e., all credits not classified as “Needs special attention,” “Doubtful,” or “Bankrupt or De facto bankrupt” credits. “Non-classified” credits are credits to the state, local government and financial institutions under management, credits to “normal” borrowers and credits to “needs attention” borrowers that do not fall into the category “needs special attention.”</p>	<p>78 and Article 86 of the law provide for penal measures should the reports to the Prime Minister be falsified.</p> <p>Therefore, if the results of self-assessment under Article 6 of the law are found to be inaccurate, endeavor to fully and accurately determine the cause (caused by the appropriateness of self-assessment standards or by the way in which self-assessments are performed, or by other factors) and the future improvements to be made by the financial institution under inspection.</p> <p>Verify that the credits described at left have been categorized as “Non-classified” credits.</p>	
2) “Needs special attention” credits	<p>“Needs special attention” credits are credits to “needs attention” borrowers that are “three months or more in arrears” (payments of principal or interest are three months or more in arrears from the day after the contracted payment date) or have been given relaxed lending conditions (credits for which there have been modifications to contractual conditions in order to give advantageous concessions to borrowers that have fallen on economic difficulties for the purpose of aiding their rebuilding and support and thereby promoting collection of the credit). (Article 4 of the “Emergency Revitalization Act Ordinances”).</p> <p>Manage “needs special attention” credits separately from other “needs attention” credits.</p>	<p>Verify that the credits described at left have been categorized as “needs special attention” credits. In doing this, verify the definition of “credits with relaxed lending conditions” for risk-managed credits as set forth in Article 19-2:1:5:c(4) of the Concomitant Orders to the Banking Law and the comments on credits with relaxed lending conditions in the “Disclosure of Risk-Managed Credit Amounts” item of the supervision guidelines of the authorities as reference.</p> <p>Verify that the institution categories credits that are not formally in arrears but are in fact three or more months behind are classified as “needs special attention” credits.</p> <p>Note: To verify whether credits are not actually in arrears, check internal sign-off documents and trace funds provided to the</p>	<p>Note: “Supervision guidelines of the authorities” mentioned to the left refers to “Comprehensive Guideline for Supervision of Major Banks, etc.” and “Comprehensive Guidelines for Supervision of Regional Financial Institutions.”</p> <p>Comments include “Q&A related to credits with relaxed lending conditions.”</p> <p>Note: Refer also to examples (18 –26) “Supplement to the</p>

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3) "Doubtful" credits	<p>"Doubtful" credits are "credits with a high likelihood that the principal will not be collected and interest not received according to the contract because the financial position and business performance of the borrower have worsened, although the borrower is not yet bankrupt." In other words, these are credits to "in danger of bankruptcy" borrowers.</p>	<p>borrower, looking for loans disbursed near the repayment date used as funds to repay principal and interest.</p> <p>Verify that the credits described at left have been categorized as "Doubtful" credits.</p>	<p>Financial Inspection Manual [Treatment of Classifications Regarding Credit-to Small- and Medium-Sized Enterprises]" upon application of the left.</p>
4) "Bankrupt or De facto bankrupt" credits	<p>"Bankrupt or De facto bankrupt " credits are "credits to borrowers that have fallen into bankruptcy, corporate rehabilitation, composition or the like, or similar credits." These are credits to "De facto bankrupt" borrowers and "bankrupt" borrowers.</p>	<p>Verify that the credits described at left have been categorized as "Bankrupt or De facto bankrupt "</p>	
(12) Credits to consolidated subsidiaries		<p>Verify that credits to consolidated subsidiaries (including affiliated "non-banks") have in principle been categorized as follows.</p> <p>1) Credits to consolidated subsidiaries of the financial institution under inspection</p> <p>Credits to consolidated subsidiaries should in principle be assessed according to the self-assessment methods of the financial institution under inspection and assigned a borrower classification and credit categorization according to an accurate measurement of the financial position, etc., of the consolidated subsidiary.</p> <p>However, in cases in which it is difficult to assess the assets</p>	

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<p>2. Securities categorization methods</p> <p>(1) Basic concepts</p> <p>(2) Securities subject to mark-to-market valuation (trading securities and other securities the market value of</p>	<p>When assessing securities, categorize them in terms of their marketability and safety, based on appropriate evaluation according to their ownership purpose segment (trading securities, bonds held to maturity, shares of subsidiaries and affiliates, and other securities).</p> <p>Judgments of the safety of securities, the market value of which is deemed extremely difficult to measure or the fair value of which cannot be grasped, are in principle made with the same concepts as those used for credits and will depend on the financial position, etc., of the issuer of the security.</p> <p>The book value is non-classified.</p>	<p>of the consolidated subsidiaries according to the self-assessment methods of the financial institution under inspection because of the industry of the subsidiary or the laws of the country in which it is located, borrower classification and credit categorization shall be made according to asset assessment results made with methods similar to the self-assessment methods of the financial institution under inspection.</p> <p>2) Credits to consolidated subsidiaries of other financial institutions</p> <p>Categorize according to the same methods as credits for non-financial institutions.</p> <p>Verify that the ownership purpose segment and evaluation of securities are performed accurately according to the “Accounting Standards concerning Financial Products” (Accounting Standards Board of Japan) etc.</p> <p>Verify that the book value is evaluated at appropriate market value.</p>	<p>“Accounting Standards concerning Financial Products,” etc., include “Practical Guideline Regarding Accounting for Financial Instruments” and “Q&A related to Accounting for Financial Instruments.”</p> <p>Note: “Fair value” refers to fair value as stipulated in Paragraph 92 (Impairment accounting of shares the market value of which is deemed extremely difficult to measure) of the “Practical</p>

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<p>which can be measured)</p> <p>(3) Securities not subject to mark-to-market valuation (bonds held to maturity, shares of subsidiaries and affiliates, and other securities the market value of which is deemed extremely difficult to measure)</p> <p>1) Bonds</p>	<p>Categorize bonds in principle according to classifications A through C below.</p> <p>1. Non-classified bonds</p> <p>The book value of the following bonds is non-classified in principle.</p> <p>(1) Government bonds, local government bonds</p> <p>(2) Government-guaranteed bonds (public corporation, etc.)</p> <p>(3) Special bonds (bonds issued by special public corporations such as public corporations or companies with government funding, excluding government-guaranteed bonds</p> <p>(4) bonds of financial institution</p> <p>(5) All bonds issued by companies that issue bonds whose latest ratings by a rating agency are BBB or better.</p> <p>2. Bonds held to maturity (excluding bonds that correspond to 1. above.)</p> <p>(1) When market value can be measured</p> <p>1) If the market value exceeds the book value, the book value is non-classified.</p> <p>2) If the market value is below the book value, the amount equivalent to market value shall be non-classified, and the</p>	<p>Verify that bonds are categorized as described at left.</p> <p>Verify that the appropriate market value of the bonds has been grasped and whether any of the bonds are subject to impairment accounting according to (4) below.</p> <p>Verify that the appropriate market value is measured.</p>	<p>Guideline Regarding Accounting for Financial Instruments,” and so throughout.</p>

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2) Equities	<p>difference between the book value and the market value shall be assigned to Category II in principle.</p> <p>(2) When the market value is deemed extremely difficult to measure</p> <p>In principle, the book value is categorized according to the degree of loss of value risk with the same methods as used for credits.</p> <p>3. Bonds of other securities (excluding bonds that correspond to 1. above.)</p> <p>In principle, the book value is categorized according to the degree of loss of value risk with the same methods as for credits.</p> <p>Categorize equities in principle according to classifications 1. through 3. below.</p> <p>1. Non-classified equities</p> <p>The book value of the following equities is non-classified in principle.</p> <p>(1) Equities issued by companies in which the government has invested (excluding liquidation companies)</p> <p>(2) Equities of companies that issue bonds whose latest ratings by a rating agency are BBB or better.</p> <p>2. Shares of subsidiaries and affiliates (excluding shares that correspond to A above.)</p> <p>(1) If the market value or fair value exceeds the book value, the book value shall be non-classified.</p> <p>(2) If the market value or fair value is below book value, the market value or the amount equivalent to fair value shall be non-classified. The difference between the book value and the market value or the amount equivalent to fair value shall be assigned to Category II in principle.</p>	<p>Verify that categorization is performed with the same methods as used for credits.</p> <p>Verify that categorization is performed with the same methods as for credits.</p> <p>Verify that equities are categorized as described at left.</p> <p>Verify that the appropriate market value or fair value has been grasped and whether any of the equities are subject to impairment accounting according to (4) below.</p> <p>Verify that in principle, the evaluation difference based on the mark-to-market valuation of assets, etc., of the issuer of the equity has been added upon the calculation of fair value.</p> <p>Verify that the book value of equities acquired through debt equity swaps (DES) is appropriately calculated based on “Practical Solution on Accounting of Creditors for the Execution of Debt Equity Swaps” (Accounting Standards Board of Japan, October 9, 2002). Note in particular the verification items, etc., regarding whether the DES is authentic.</p> <p>Verify that the term-end valuation of class shares including equities acquired through a DES is performed appropriately based on “Practical Solution on Measurement of Class Shares at the</p>	<p>Note: Refer to “Notes for Audits” (Japanese Institute of Certified Public Accountants, March 11, 2005) regarding the handling of virtual DESs and DESs.</p>

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
3) Foreign securities	<p>However, in this case, the amount equivalent to the fair value may be non-classified and the difference between the book value and the market value or the amount equivalent to the fair value may be assigned to Category III according to the period during which the market value of the said equity dropped or the situation of the drop in fair value, etc.</p> <p>3. Equities of other securities (excluding equities that correspond to 1. above.)</p> <p>(1) If the fair value exceeds the book value, the book value is non-classified.</p> <p>(2) If the fair value is below the book value, the amount equivalent to the fair value shall be non-classified and the amount equivalent to the difference between the book value and the amount equivalent to the fair value shall be assigned to Category II.</p> <p>However, in this case, the amount equivalent to the fair value may be non-classified, and the amount equivalent to the difference between the book value and the amount equivalent to the fair value may be assigned to Category III according to the situation of the drop in fair value of the said equity, etc.</p> <p>Categorize foreign securities in principle according to classifications A and B below.</p> <p>1. Non-classified foreign securities</p> <p>The book value of the following foreign securities is non-classified in principle.</p> <p>(1) Bonds issued by international institutions established under treaties to which Japan is a signatory, bonds issued by governments or similar institutions (state governments, etc.) or municipalities of countries with which Japan has relations.</p>	<p>Balance Sheet Date” (Accounting Standards Board of Japan, March 13, 2003). Note in particular the appropriateness of assumptions of the valuation model.</p> <p>Verify that foreign securities are categorized as described at left.</p> <p>Verify that the appropriate market value or fair value of the foreign securities has been grasped, as well as whether any of them are subject to impairment accounting according to (4) below.</p>	<p>Note: Refer to “Audit Treatments of Allowance for Investment Loss in Shares of Subsidiaries, etc.” (Japanese Institute of Certified Public Accountants, April 17, 2001) when assigning the difference between the book value and the market value or the amount equivalent to the fair value to Category III.</p> <p>Note: “International institutions established under treaties to which Japan is a signatory”</p>

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
<p>4) Other securities</p> <p>(4) Impairment accounting</p> <p>1) When market value can be measured</p> <p>2) Equities for which the market</p>	<p>(2) Equities and bonds issued by financial institutions licensed, etc., by governments of countries with which Japan has relations.</p> <p>(3) All bonds from issuing companies that have been rated BBB (triple B) or better in their most recent rating by a ratings agency, and all equities issued by companies issuing said bonds.</p> <p>2. Foreign securities other than 1. above</p> <p>Categorization shall be performed according to the categorization methods of 2. and 3. of (1) Bonds and 2. and 3. of (2) Equities above in principle.</p> <p>Categorize other securities in a manner similar to (1) to (3) above and (4) below. Beneficiary certificates for loan trusts and securities investment trusts, etc., that are similar to deposits in nature are non-classified.</p> <p>When the market value of securities other than trading securities the market value of which can be measured has dropped significantly, the difference between the said market value and the acquisition cost or amortized cost shall be assigned to Category IV except for when recovery is deemed likely.</p> <p>When the fair value of equities the market value of which is</p>	<p>With regard to funds, obtain detailed information from the seller as needed with reference to characteristics such as the type, contents and risk profiles of the fund, and verify whether the financial institution has considered the fund's asset nature and evaluation appropriately on its own.</p> <p>1. Verify whether the institution has considered the possibility of recovery for securities the market value of which has dropped significantly.</p> <p>2. Verify that, as a result of consideration of the possibility of recovery, only those that are deemed unlikely to recover have been made subject to impairment accounting.</p> <p>3. Verify that the difference between the market value and the acquisition cost or amortization cost is assigned to Category IV when impairment accounting is required in light of A and B above.</p> <p>If the fair value of equities at term-end has dropped by a</p>	<p>refers to the International Bank for Reconstruction and Development (IBRD), the International Finance Corporation (IFC), the Inter-American Development Bank (IDB), the European Bank for Reconstruction and Development (EBRD), the African Development Bank (AfDB), and the Asian Development Bank (ADB).</p> <p>Note: Refer to Paragraphs 91, 92, 283-2, 284 and 285 of "Practical Guideline Regarding Accounting for Financial Instruments" for specific methods of impairment accounting.</p>

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
<p>value is deemed extremely difficult to grasp</p> <p>3. Derivative transaction categorization method</p> <p>4. Method of categorization of other assets (i.e., assets other than credits, securities and derivative transactions)</p>	<p>deemed extremely difficult to grasp has dropped significantly due to deterioration of the financial condition of the issuer of the said equities, the difference between the said fair value and its acquisition cost shall be assigned to Category IV.</p> <p>However, the said difference may be assigned to a category other than Category IV if the possibility of recovery is backed by sufficient evidence.</p> <p>When assessing derivative transactions, categorize them according to classifications 1. and 2. below.</p> <p>1. When mark-to-market valuation is performed The book value is non-classified.</p> <p>2. When mark-to-market valuation is not performed In principle, categorization shall be performed according to the degree of loss of value risk with the same methods as for credits.</p> <p>Categorize other assets as follows based on proper evaluation. Use the same methods as for credits when performing categorization for self-assessments of assets and off-balance-sheet instruments with credit risks. Pay particular attention to credit liquidation instruments that move credits off the balance sheet but do not fully transfer credit risks to third parties so that the financial institution under inspection still holds all or a part of the credit risk. Categorize these assets with the same methods as used for the underlying assets in the credit liquidation instruments and categorize them according to the degree of risk of loss of value for the credit risk portion held by the financial institution under inspection.</p>	<p>reasonable amount compared to the fair value at the time of acquisition due to deterioration of the financial condition of the issuer of the equities, and the said fair value is below the acquisition cost by approximately more than 50%, verify that the said difference has been assigned to Category IV.</p> <p>Verify that the possibility of recovery is backed by sufficient evidence if not assigned to Category IV..</p> <p>Verify that the book value is evaluated at the appropriate market value.</p> <p>Verify that financial instruments of other assets are categorized appropriately according to the “Accounting Standards concerning Financial Products” (Accounting Standards Board of Japan), etc. In addition, verify that other assets are categorized as described at left. Verify that assets and off-balance-sheet instruments with credit risks are categorized using the same methods as credits. In particular, when the financial institution under inspection holds all or a part of the credit risks for credit liquidation instruments that take credits off the balance sheet, verify that the risk portion held by the institution has been categorized according to the degree of risk of loss of value.</p>	<p>“Accounting Standards concerning Financial Products” etc. include the “Practical Guideline Regarding Accounting for Financial Instruments” and “Q&A related to Accounting for Financial Instruments.”</p> <p>Note: Refer to the “Accounting Standards Regarding</p>

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
(1) Suspense payments	<p>Categorize all suspense payments other than those that are similar to loans (suspense payments related to claims of reimbursement or loans resulting from subrogated repayment based on acceptances and guarantees) according to the collection risk or the degree of risk of loss of value.</p>	<p>Verify that all suspense payments other than those that are similar to loans are categorized according to the collection risk and the degree of risk of loss of value.</p>	<p>Impairment of Fixed Assets” (Business Accounting Council, August 9, 2002) for impairment of fixed assets within chattels and real estate.</p>
(2) Chattels and real estate	<p>Assign the book value of owned chattels and real estate not used for business purposes (offices, branch offices, etc.) to Category II in principle.</p> <p>Furthermore, the book value amount deemed necessary to be reduced when impairment accounting has been applied shall be assigned to Category IV regardless of whether it is for business purposes or not.</p>	<p>Verify that chattels and real estate have been categorized as described at left.</p> <p>Verify that chattels and real estate are categorized as owned chattels and real estate if 1) they are for the purpose of employee welfare but seldom used, or 2) they are not in actuality used for business purposes and it is not certain that they will be used for business purposes in the future.</p>	<p>Note: Refer to Paragraphs 135 and 311 of the “Practical Guideline Regarding Accounting for Financial Instruments” for specific methods of impairment accounting, etc., of golf club memberships.</p>
(3) Golf club memberships	<ol style="list-style-type: none"> 1. Categorize golf club memberships according to impairment accounting of the securities. 2. Assign them in principle to Category II except for those held for welfare purposes. <p>However, when there are deemed to be problems in the financial position of the issuer of the membership, assign a borrower classification using the same concepts as for credits regardless of the purpose for which the membership is held. Assign those classified as “needs attention” or “in danger of bankruptcy” to Category II; those classified as “De facto bankrupt” or “bankrupt” for which the facilities can still be used as Category II; and those for which the facilities cannot be used as Category IV.</p> <p>When golf club memberships are held not as “other assets” but</p>	<p>Verify that golf club memberships are categorized as described at left.</p> <p>When memberships are held on securities accounts, verify that</p>	

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
(4) Other assets	<p>on securities accounts, use appropriate securities methods for their categorization.</p> <p>If the institution does not have credits against the issuer of the membership, it may use simplified criteria in categorization.</p> <p>Categorize assets other than those above according to their collection risk and degree of risk of loss of value in light of the nature of the asset.</p> <p>Evaluate and verify other assets that fall into securities under the Financial Instruments and Exchange Act and those treated as securities in accounting according to categorization methods for securities.</p>	<p>they are categorized as described at left.</p> <p>Verify that other assets are categorized as described at left.</p> <p>1. For purchasing credits issued by a non-financial institution that are deemed to be long-term credits because of continuing purchases at set amounts, verify that the purchasing credit is categorized using the same methods as for credits.</p> <p>Note that banks that have segregated trading books and use those books to purchase on a continual basis purchasing credits issued by non-financial institutions so as to be deemed to be providing long-term credits, have inaccurately categorized the credit and also inaccurately calculated their capital adequacy ratio, and are furthermore in violation of Article 13-6-3, Paragraphs 3 and 4 (ban on inter-book transfers) of the Concomitant Orders to the Banking Law (Finance Ministry Ordinance No. 10 of 1982). Verify that this has not taken place.</p> <p>2. When the financial institution under inspection uses trust schemes to liquidate credits, and the financial institution under inspection holds beneficiary certificates in the loan credit trust scheme, verify that these loan credit trust beneficiary certificates are categorized using the same methods as credits.</p>	

Write-offs, allowances (Attachment 2)

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
<p>1. Allowance for doubtful accounts</p>	<p>An allowance for doubtful accounts shall be provided at least for credits (loans and credits similar to loans) using rational estimates of losses highly likely to be incurred in the future.</p> <p>However, credits to the national government, local public entities and managed financial institutions are not subject to allowances since they are considered to be without collection risk or value impairment risk.</p> <p>The basic principle of calculating the amount of allowance for doubtful accounts is to determine write-offs and allowances in conjunction with self-assessments that are performed based on credit ratings in a coherent manner. In other words, the financial institution first performs self-assessments based on credit ratings in consideration of the degree of credit risk of borrowers, etc., and then calculates the amounts of write-offs and allowances based on the self-assessment results.</p> <p>For project finance credits, the expected loss amount is estimated and appropriated rationally according to the degree of collection risk of the said credit.</p> <p>For credits related to securitization of assets, the loss amount is estimated and appropriated rationally upon appropriate consideration of risks inherent in the said scheme.</p>	<p>Review calculations of allowance for doubtful debt in principle by reviewing that write-offs and allowances are determined in conjunction with self-assessments in a coherent manner in principle based on credit ratings and by fulfilling that write-offs and allowances are in line with write-off and allowance criteria.</p> <p>Next, review if the total amount of allowance for doubtful accounts is at a sufficient level for the credit risks to which the financial institution under inspection is exposed. If the financial institution employs a rational and appropriate internal model to quantify credit risks, review whether the financial institution has confirmed the sufficiency of its total allowance for doubtful account levels based on the nature of the comparison between the total allowance for doubtful accounts and the expected default losses for the entire portfolio deduced from the quantification of credit risks.</p> <p>In the calculation of write-off and allowance for project finance in particular, review if a lack of allowance records is not the reason for not setting aside allowances.</p>	<p>Note: “Managed financial institutions” mentioned in the criteria refers to financial institutions that have been certified based on Article 16 Paragraph 2 of the Supplementary Provisions of the Deposit Insurance Law.</p> <p>Note: Refer to “Audit treatment of the calculation of estimated defaults of capital subordinated loans, etc., and the accounting of transfers of finance receivables owned by banks and other financial</p>

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
			<p>institutions to capital subordinated loans, etc.,” (Japanese Institute of Certified Public Accountants, November 2, 2004) for the calculation methods of allowance for doubtful accounts for borrowings deemed to possess sufficient capital nature in the Note for 1.(3) of Attached List 1 of “Self-Assessment” (including capital subordinated loans (quasi-capital type) in 7.(3) of the “Supplementary to the Financial Inspection Manual [Finances for Small and Medium-Sized Companies]”) and capital subordinated loans (special early business improvement type) in 7.(1) of the “Supplementary to the Financial Inspection Manual [Finances for Small and Medium-Sized Companies]”).</p>

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
(1) General allowance for doubtful accounts	<p>In calculating general allowance for credits against “normal” borrowers and credits against “needs attention” borrowers, calculate the loss ratio to be incurred in the future (the expected loss rate) based on past default rates and bankruptcy probabilities calculated using the methods shown below for each credit rating, or at least for each borrower classification in principle. Calculate the expected loss amount by multiplying the credit value in principle for each credit rating and at least for each borrower classification by the expected loss rate. Record the amount of allowance for doubtful accounts at values commensurate to the expected loss amount.</p> <p>The basic principle for calculating general allowance for doubtful accounts is to calculate expected loss amounts using a migration analysis of individual credit ratings and/or borrower classifications.</p> <p>In addition, it is desirable that general allowance for doubtful accounts be calculated in light of the nature of the credit risks associated with the credits held by the financial institution under inspection. For example, a method could be used in which expected loss amounts are calculated by specific groups as warranted by the nature of the financial institution’s portfolio (type of business of borrower, location of borrower, credit amount, scale of borrower, individual/company, nature of the product, credit security situation, etc.).</p> <p>The expected loss rate is determined after making needed adjustments considering changes in economic conditions, changes in credit policies, changes in</p>	<p>Review if calculations of general allowance for doubtful accounts to “normal” borrowers and “needs attention” borrowers rationally estimate expected loss amounts based on the write-off and allowance criteria for each credit rating classification or for each borrower classification.</p> <p>Specifically review the following items.</p> <p>1. Review of the appropriateness of the amount of allowance for doubtful accounts appropriated based on default rates or bankruptcy probabilities</p> <p>(1) Review of average time to maturity, etc.</p> <p>If the financial institution calculates expected loss amounts over a set period in the future by the average time to maturity, review if the average time to maturity is rational.</p> <p>Specifically, review how the financial institution reflects credits associated with current account overdrafts in the average time to maturity; how it reflects credits that have in fact become long-term fixed credits, even though contractual periods are short-term, in average time to maturity; and other issues that would impinge upon the rationality of the average time to maturity.</p> <p>If the financial institution categorizes credits to “needs attention” borrowers by degree of credit risk to calculate the expected loss amounts for specific categories over a set period in the future, review if the future periods used for individual credit risk categories are rational.</p> <p>(2) Review of default rates and bankruptcy probabilities</p> <p>If the financial institution employs a method based on default rates, review if the expected loss amount reflects</p>	

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
	<p>portfolio structures (credit ratings, type of business of borrower, location of borrower, credit amount, scale of borrower, individual/company, changes in credit security situation, etc.), as well as past default rates and/or bankruptcy probability forecasts.</p> <p>Should there be a rapid worsening of economic conditions in particular, the weight of the most recent calculation periods should be increased in the determination of past default rates and bankruptcy probabilities, or the expected loss rate should be adjusted to reflect recent increases in default rates and bankruptcy probabilities, or some other similar method should be employed.</p> <p>(Calculation method of general allowance for doubtful accounts)</p> <p>Calculation method of expected loss amount:</p> <p>Expected loss amount = Credit amount × Expected loss rate</p> <p>Examples of specific methods for calculating expected loss rate:</p> <ol style="list-style-type: none"> 1. Using Default rates: Amount of impaired loans, such as doubtful accounts write-off / Credit amount 2. Using bankruptcy probability (based on the number of bankruptcy cases): Bankruptcy probability × (1- forecast collection rate) 	<p>the amount of all losses, including direct write-offs, indirect write-offs, relinquished credits, and losses on credits sold.</p> <p>If the financial institution employs a method based on bankruptcy probabilities, review if the number of bankruptcies at the very least reflects all loans to “effectively bankrupt” and “bankrupt” borrowers.</p> <p>It is appropriate to include the number of “in danger of bankruptcy” borrowers in the number of cases of bankruptcy in some manner. Review if the method for doing so is rational, for example, adding to the number of bankruptcies the number calculated by multiplying the number of “in danger of bankruptcy” loans by the bankruptcy probability. If the financial institution does not reflect the number of “in danger of bankruptcy” loans in the number of bankruptcies, fully review that the total amount of general allowance for doubtful accounts are at a level commensurate with the credit risk exposure of the financial institution under inspection, calculations of expected loss amounts in earlier periods were at sufficient levels, and the financial institution compares expected loss amounts based on default rates.</p> <p>If the financial institution employs migration analysis by credit rating or borrower classification for the calculation of bankruptcy probabilities, review if there is rational justification for this analysis.</p> <p>If the financial institution employs a method that uses bankruptcy probabilities and there is a likelihood that large losses will be incurred so that the expected loss</p>	

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
	<p>(Note: There is also a method that substitutes percentage of unsecured loans, or average percentage of impaired loans for “1-forecast collection rate.”</p> <p>In addition, for credits to “needs attention” borrowers, particularly the cash flow which can be rationally estimated, related to the collection of credit principal and receivable interests, a method that applies the difference between the said cash flow discounted by the initially agreed interest rate and the book value of the credit can be used (hereinafter, “DCF method”).</p>	<p>amount as calculated from default rates is higher than the expected loss amount as calculated from bankruptcy probabilities, it is desirable that the financial institution record the expected loss amount calculated using the default rate-based method as allowance for doubtful accounts.</p> <p>(3) Review of exclusion of abnormal values</p> <p>If the financial institution excludes losses or bankruptcies associated with specific borrowers from calculations of default rates and/or bankruptcy probabilities because these values are “abnormal,” review if there is rational justification for the exclusion.</p> <p>Specifically, if the financial institution excludes losses or bankruptcies associated with specific borrowers from calculations of default rates and/or bankruptcy probabilities as “abnormal” values by claiming that the borrower should have been classified as “in danger of bankruptcy” but was instead classified as “normal” or “needs attention,” review if the amount of loss or the number of cases of bankruptcy is reflected in calculations of allowance for doubtful accounts in some manner, for example, by including them in calculations of expected loss amounts for credits to “in danger of bankruptcy” borrowers.</p> <p>Review whether the financial institution excludes as “abnormal” values the amount of loss and/or the number of cases of bankruptcy associated with specific industries and/or locations by claiming that the amount of loss and the number of cases of bankruptcy in these industries</p>	

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
		<p>and/or locations are significantly different from those in other industries and/or locations. In these cases it is not appropriate to exclude losses and/or bankruptcies associated with specific industries and/or locations as “abnormal.” Rather, it is desirable that the financial institution groups credits by industry and/or location, calculates default rates and/or bankruptcy probabilities for each group, finds the expected loss rates for each, and calculates the expected loss amounts as the credits to each group multiplied by the expected loss rate for the group.</p> <p>(4) Review of calculation period for default rates and bankruptcy probabilities</p> <p>Review if calculations of expected loss amounts are based at the very least on default rates and bankruptcy probabilities for the preceding three calculation periods.</p> <p>If the calculation period is not the three most recent calculation periods, review if there is a rational reason why to do so (for example, if there is an insufficient accumulation of data, etc.). In such cases, identify the time at which sufficient data will have been accumulated to enable the use of default rates and bankruptcy probabilities for three calculation periods, and review if the methods used to calculate expected loss amounts during the interim are rational.</p> <p>(5) Review of expected loss rates</p> <p>Review how well the financial institution under inspection captures changes in economic conditions that could affect the borrower’s business, changes in credit</p>	

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
		<p>policies, changes in portfolio factors, and other relevant information in the determination of expected loss rates. If the financial institution corrects the rates for changes in economic conditions, etc., review if there is rational justification for the corrections in light of the way in which the financial institution captures changes in economic conditions, etc.</p> <p>If the financial institution under inspection has identified large changes in economic conditions, etc., but has not made necessary corrections, review if there is rational justification for not making corrections.</p> <p>(6) Review of expected loss amounts from previous periods</p> <p>Compare the expected loss amounts from previous periods and the subsequent actual defaults and/or bankruptcies to review if the levels were adequate. If this review indicates that the expected loss levels were inadequate, review the reasons why (for example, in calculating the amount of estimated loss in the previous periods, whether corrections in the previous periods based on future projections were appropriate), and review if a correction of the expected loss rates as of the reference date is appropriate.</p> <p>2. Review of the appropriateness of the amount of allowance for doubtful accounts recorded based on the DCF method</p> <p>Review if allowance for doubtful accounts is calculated according to the “Audit notes to cases where the cash flow estimation method (DCF method) has been</p>	

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
1) Allowance for doubtful accounts for credits to “normal” borrowers	<p>Allowance for doubtful accounts for credits to “normal” borrowers should estimate an expected loss amount for a set period in the future that corresponds to the average time to maturity of the credits. It is acceptable for expected loss amounts to be estimated for the next one year.</p> <p>In calculating expected loss amounts, use average default rates and/or bankruptcy probabilities for at least the last three calculation periods (three year average of cumulative default rates and/or bankruptcy probabilities for a set period in the past corresponding to a set period in the future) to calculate past default rates, correct for expected future losses to find an expected loss rate, and multiply the amount of credits to “normal” borrowers by the expected loss rate (if calculating the expected loss amount for the next one year, calculate the average one-year default rate and/or bankruptcy probability for the past three calculation periods).</p>	<p>adopted as the method for recording allowance for doubtful accounts at banks and other financial institutions” (Japanese Institute of Certified Public Accountants, February 24, 2003) for credits whose cash flow related to the collection of credit principal and receivable interests can be rationally estimated.</p> <p>With regard to allowance for doubtful accounts for credits to “normal” borrowers, review if the expected loss amount for a set period in the future or for the next one year that corresponds to the average time to maturity of credits to “normal” borrowers is rationally estimated based on write-off and allowance criteria.</p> <p>When the financial institution estimates the expected loss amount for the next one year, review the rationality of the “set period in the future” vis-à-vis the average time to maturity may be omitted.</p>	
2) Allowance for doubtful accounts for credits to “needs attention” borrowers	<p>1. Method based on default rates or bankruptcy probabilities</p> <p>The basic principle for allowance for doubtful accounts for credits to “needs attention” borrowers is</p>	<p>1. Review of the appropriateness of allowance for doubtful accounts recorded based on default rates or bankruptcy probabilities</p>	<p>Note: To be reviewed in the event of a change in the public notice on the standards for “needs</p>

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
	<p>to estimate the expected loss amount for a set period in the future that corresponds to the average time to maturity of the credits when using the method based on default rates or bankruptcy probabilities. However, it is acceptable to classify “needs attention” borrowers according to their degree of credit risk and to estimate expected loss amounts for set periods in the future deemed rational for each classification.</p> <p>For example, it would be acceptable to estimate expected loss amounts for the average time to maturity or the next three years for credits to “needs special attention” borrowers and estimate the expected loss amounts for the average time to maturity or the next one year for other borrowers (hereinafter, “other needs attention”) (refer to 2. and 3. below).</p> <p>In calculating expected loss amounts, use period-average default rates and/or bankruptcy probabilities for at least the last three calculation periods (three year average of cumulative default rates and/or bankruptcy probabilities for a set period in the past corresponding to a set period in the future) to calculate past default rates, make necessary corrections for expected future losses to find the expected loss rate, and multiply the amount of credits to “needs attention” borrowers by the expected loss rate.</p> <p>2. Calculation method of allowance for doubtful accounts for large “needs special attention” borrowers</p>	<p>With regard to allowance for doubtful accounts for credits to “needs attention” borrowers, review if the expected loss amount for a set period in the future that corresponds to the average time to maturity of credits to “needs attention” borrowers, or for a set period in the future deemed rational for each category when credits to “needs attention” are categorized by the degree of credit risk is rationally estimated based on write-off and allowance criteria.</p> <p>If the financial institution calculates the expected loss amount for a set period in the future based on credit risk categories, review if the calculation of the expected loss amount is rational.</p> <p>If the financial institution calculates a three-year expected loss amount for “needs special attention” borrowers and a one-year expected loss amount for other borrowers, review of the rationality of the “set period in the future” vis-à-vis the average time to maturity may be omitted.</p> <p>2. Review of the calculation method of allowance for</p>	<p>attention” borrowers.</p> <p>Note: “Credits to ‘needs special attention’ borrowers” refer to all credits to “needs special attention” borrowers (including credits that are not “needs special attention” credits), and so throughout.</p> <p>Note: “Large borrowers” refer</p>

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
	<p>(1) It is desirable to apply the DCF method for large “needs special attention” borrowers.</p> <p>While the DCF method should be applied on a per-credit basis in principle, it would be acceptable to apply the method on a per-borrower basis if it is deemed rational.</p> <p>In addition, for credits to borrowers to whom the DCF method could not be applied because a rational estimate of future cash flow was difficult, it is desirable to individually calculate the average time to maturity and estimate the expected loss amount for a set period in the future corresponding to the average time to maturity.</p> <p>(2) Estimation of future cash flow</p> <p>Estimation of future cash flow should be the best forecast of the bank. It should be determined carefully by appropriately reflecting uncertainties based on objective evidence such as collection records and should be reviewed each term.</p>	<p>doubtful accounts for large “needs special attention” borrowers</p> <p>(1) When the DCF method is adopted, review if allowance for doubtful accounts is recorded based on the difference between the amount of cash flow related to the collection of credit principal and receivable interest discounted by the initially agreed interest rate and the book value of the credit. If the method is applied on a per-borrower basis, review if it is rational.</p> <p>In addition, when the DCF method could not be applied, review if the adjustment from the contractual lending period to the actual lending period is rationally determined upon calculating the individual time to maturity.</p> <p>(2) Review of the estimation of future cash flow</p> <p>Review if the estimation of future cash flow is the best forecast by banks and other financial institutions based on an assumption, hypothesis and scenario deemed rational and sufficiently feasible.</p> <p>Review if the estimation of future cash flow and the assumption, hypothesis and scenario that were the basis of the estimation have been determined carefully according to rational and objective evidence such as past collection records, in light of various matters that influence the borrower.</p> <p>In addition, review if the estimation of future cash flow and the assumption, hypothesis and scenario that were the basis of the estimation have been reviewed at</p>	<p>to borrowers whose credit amount for the time being is 10 billion yen or more, and so throughout.</p> <p>Note: Refer to “Considerations of a set period of time in recording allowance for doubtful accounts based on default rates or bankruptcy probabilities of credits to “normal” borrowers and credits to “needs attention” borrowers by banks and other financial institutions” (Japanese Institute of Certified Public Accountants, February 24, 2003) for the concept of the calculation method of the time to maturity.</p>

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
	<p>(3) Discount rate The discount rate shall be the agreed interest rate at the time of the generation of credit or the effective interest rate at the time of acquisition of credit.</p> <p>(4) Appropriateness, etc., of the total amount The amount of allowance for doubtful accounts</p>	<p>each fiscal year end. If there is a gap between the best forecast and future results in the back test of the amount of allowance for doubtful accounts recorded, review if the recording method of allowance for doubtful accounts has been reviewed, including the estimation of future cash flow and the assumption, hypothesis and scenario that were the basis of the estimation.</p> <p>Furthermore, review if necessary adjustments for reflecting uncertainties have been performed based on rational and objective evidence with regard to the estimation of future cash flow. “Necessary adjustments” in these cases include, for example, adjustments using information accumulated internally such as default rates, bankruptcy probabilities and rating migration analysis by credit rating.</p> <p>(3) Review of the discount rate Review if future cash flow is discounted by the agreed interest rate that was applied to the loan before the lending conditions of the loan were relaxed or by the effective interest rate at the time of acquisition.</p> <p>If the initially agreed interest rate is decided based on interest rates that fluctuate ex-post facto, review if the discount rate has been applied continuously regardless of whether the discount rate has been fixed at the agreed interest rate prior to the relaxation of lending conditions or has been decided for each accounting date based on the margin prior to the relaxation of lending conditions and said variable interest rate.</p> <p>(4) Review of the appropriateness of the total amount</p>	

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
(2) Specific allowances for doubtful accounts and direct write-offs	<p>recorded based on the DCF method must sufficiently cover the degree of credit risk of the large “needs special attention” borrower.</p> <p>Furthermore, the application of the DCF method and the decision of allowance for doubtful accounts at financial institutions under inspection must be backed by rational and objective evidence.</p> <p>3. Calculation method of allowance for doubtful accounts for large borrowers that migrated upward from “needs special attention” or “in danger of bankruptcy” to “other needs attention”</p> <p>If a large “needs special attention” or “in danger of bankruptcy” borrower for which the allowance for doubtful accounts from the previous period was calculated by the DCF method or by estimating individual time to maturity moved upward to “other needs attention,” it is desirable to apply the DCF method or the calculation method of allowance for doubtful accounts against credits to “needs special attention” borrowers mentioned in 1. above (estimating the expected loss amount for a set period of time in the future that corresponds to the average time to maturity, or the expected loss amount for the next three years) during the period of the business improvement plan, etc., in principle.</p> <p>For specific allowances for doubtful accounts and direct write-offs, calculate in principle the expected loss amount for each individual “in danger of bankruptcy,”</p>	<p>Review the sufficiency and rationality of the allowance for doubtful accounts level through methods such as comparing the amount of allowance for doubtful accounts recorded based on the DCF method and the amount calculated by estimating the expected loss amount for a set period in the future based on past default rates and bankruptcy probabilities.</p> <p>Review if individual write-off amounts and direct write-offs are calculated based on the write-off and</p>	

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
<p>1) Specific allowances for doubtful accounts for credits to “in danger of bankruptcy” borrowers</p>	<p>“effectively bankrupt,” and “bankrupt” borrower and either record as allowance for doubtful accounts or directly write off an amount equivalent to the expected loss amount.</p> <p>The required amounts for individual allowance for doubtful accounts shall be calculated each period.</p> <p>The DCF method is also a method for recording allowance for doubtful accounts against credits to “in danger of bankruptcy” borrowers whose cash flow related to the collection of credit principal and receivable interest can be rationally estimated.</p> <p>For allowances for credits to “in danger of bankruptcy” borrowers, estimate in principle the expected loss amount for a set period in the future deemed rational for credits to each individual “in danger of bankruptcy” borrower and record the amount equivalent thereto as allowance for doubtful accounts. It is acceptable to estimate the expected loss amount for the next three years.</p> <p>It is desirable to apply the DCF method to large borrowers.</p> <p>Sample calculations of expected loss amount for credits to “in danger of bankruptcy” borrowers:</p> <p>1. Methods under which Category III credit amount multiplied by the expected loss rate is regarded as the expected loss amount (including a method under</p>	<p>allowance criteria in principle by estimating the expected loss amount for each individual “in danger of bankruptcy,” “effectively bankrupt,” and “bankrupt” borrower, and that the amount equivalent to the expected loss amount is either recorded as allowance for doubtful accounts or directly written off.</p> <p>Review if the rational estimation of cash flow is performed according to credits to “needs attention” borrowers.</p> <p>For individual allowances for credits to “in danger of bankruptcy” borrowers, review if the estimated loss value has been rationally estimated for a set period in the future.</p> <p>Specifically, review the items below and review if estimates cover the full value of Category III loans, including the difference between the appraised value and the estimated disposal value of general collateral.</p> <p>1. Using Category III credit amounts multiplied by the expected loss rate as the expected loss amount</p>	

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
	<p>which the expected loss amount is a remainder after the amount collectible from rationally estimated cash flow is deducted.)</p> <p>When using Method 1. above, in principle find a loss rate expected for the future (expected loss rate) based on past default rates and/or bankruptcy probabilities for each credit rating or at least for each borrower classification of “in danger of bankruptcy” borrowers, and in principle multiply the amount of Category III credits to the individual borrower by the expected loss rate to calculate the expected loss amount. Record the amount equivalent to the expected loss amount to allowance for doubtful accounts.</p> <p>The expected loss rate should in principle be determined for each individual borrower based on past default rates and/or bankruptcy probabilities with necessary corrections made for future forecasts in light of changes in economic conditions, forecasts for business conditions in the industry, etc., of the borrower, forecasts for local economic conditions in the business territory of the borrower, and other relevant information.</p> <p>In calculating expected loss amounts, use average default rates and/or bankruptcy probabilities for at least the last three calculation periods (three year average of cumulative default rates and/or bankruptcy probabilities for a set period in the past corresponding to a set period in the future) to calculate past default rates, make corrections for expected future losses to</p>	<p>(1) Review of the “set period in the future”</p> <p>Review that the “set period in the future” used to estimate expected loss amounts is rational. However, this review may be omitted if the financial institution estimates expected loss amounts for a three-year period.</p> <p>(2) Review of default rates and bankruptcy probabilities</p> <p>If the financial institution employs a method based on default rates, review that the expected loss amount reflects the amount of all losses, including direct write-offs, indirect write-offs, relinquished credits, and losses on credits sold (excluding losses on credits to “in danger of bankruptcy” borrowers).</p> <p>If the financial institution employs a method based on bankruptcy probabilities, review if the number of bankruptcies reflects all loans to “effectively bankrupt” and “bankrupt” borrowers.</p> <p>(3) Review of exclusion of abnormal values</p> <p>If the financial institution excludes losses or bankruptcies associated with specific borrowers from its default rates and/or bankruptcy probabilities because these values are “abnormal,” review if there is rational justification for the exclusion.</p> <p>(4) Review of the calculation period for default rates and bankruptcy probabilities</p> <p>Review if calculations of expected loss amounts are based at the very least on default rates and bankruptcy probabilities for the preceding three calculation periods.</p> <p>If the calculation period is not the past three periods, review if there is a rational reason why (for example,</p>	

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
	<p>find the expected loss rate, and multiply the amount of Category III credits by the expected loss rate.</p> <p>If the financial institution has a considerable number of borrowers classified as “in danger of bankruptcy” borrowers and it is difficult to calculate write-off and allowance amounts in light of the collateral and other security status for individual borrowers, it is acceptable to use a single expected loss rate for each group of credits to “in danger of bankruptcy” borrowers below a set threshold level, and to record the amount equivalent to the expected loss amount as allowance for doubtful accounts. In such a case, the scope of credits to “in danger of bankruptcy” borrowers under a certain amount for which the same expected loss rates may be applied to each group shall be within a range deemed rational in light of the size and nature of the assets of the financial institution under inspection, and calculations of expected loss rates must be rigorous and clear.</p>	<p>data has not been accumulated). In such cases, identify the time at which sufficient data will have been accumulated to enable the use of default rates and bankruptcy probabilities for three calculation periods and review if the methods used to calculate the expected loss amounts during the interim are rational.</p> <p>(5) Review of expected loss rates</p> <p>Review how the financial institution under inspection captures changes in economic conditions, forecasts for the industry, etc., of the borrower, and local economic conditions in the business territory of the borrower.</p> <p>If the financial institution under inspection has identified large changes in economic conditions, etc., but has not made necessary corrections for individual borrowers, review if there is rational justification for not making corrections.</p> <p>(6) Review of expected loss amounts from previous periods</p> <p>Compare expected loss amounts for individual borrowers from previous periods and the subsequent actual defaults and/or bankruptcies for individual borrowers to review if the levels of the expected losses were adequate. If this review indicates that expected loss levels were inadequate, review the reasons why (for example, in the calculation of expected loss amounts in the past, were corrections for forecasts at the time of calculation appropriate?), and review if corrections to expected loss rates at the base date are appropriate.</p> <p>(7) Review of the amount collectible from cash flow, etc.</p> <p>If the financial institution excludes an amount</p>	<p>Note: “Collectible amount</p>

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
	<p>2. Using the remainder found by subtracting the collectible amount from the credit amount as the expected loss amount for credits that have a saleable market (deeming the rationally calculated saleable value as the collectible amount)</p>	<p>collectible from cash flow from the Category III amount for individual borrowers, review if the cash flow estimate is rational and that the remainder when the collectible amount is deducted from the Category III amount is treated as the expected loss amount.</p> <p>If the financial institution has a considerable number of borrowers classified as “in danger of bankruptcy” borrowers and omits considerations of credit security through collateral, etc., in favor of expected loss amounts based on group expected loss rates for borrowers below a set threshold value, review if the calculation of group expected loss rates is rational. In these cases, it is acceptable to calculate expected loss rates for “in danger of bankruptcy” borrowers below a set threshold value by treating such credits as single group. Review if the scope of credits for “in danger of bankruptcy” borrowers below a set threshold value is reasonable.</p> <p>2. Recording as allowance for doubtful accounts the expected loss amount found as the remainder when a saleable amount is deducted from the Category III amount</p> <p>If credits have a market on which they can be sold and the financial institution uses the amount at which the credit can be sold as the collectible amount, and the financial institution deducts this collectible amount from the credit amount to arrive at the remainder that is used as the expected loss amount, review if the calculation of the saleable amount for the credit is rational, and review if the remainder when the collectible amount is deducted</p>	<p>from cash flow” refers to the portion that is deemed certain of collection from the amount of current profits for the individual borrower adjusted for depreciation charges and other non-financial items in principle over a period of three years, or over a period of five years if the borrower has formulated a business improvement plan, etc.</p>

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
<p>2) Specific allowance for doubtful accounts and direct write-offs for “effectively bankrupt” and “bankrupt” borrowers</p> <p>3) Allowances for specific foreign credits</p>	<p>3. DCF method</p> <p>For credits to “effectively bankrupt” and “bankrupt” borrowers, use the total amount of credits for each individual borrower classified as Category III or Category IV as the expected loss amount, and either record allowance for doubtful accounts or make direct write-offs of the amount equivalent to the expected loss amount.</p> <p>For allowances for specific foreign credits, determine the countries to be covered based on their financial conditions, economic conditions, foreign exchange allowances and other factors, and clarify which credits to</p>	<p>from the Category III amount is used as the expected loss amount.</p> <p>3. Recording allowance for doubtful accounts based on the DCF method</p> <p>Review if the calculation is done according to the method of recording allowance for doubtful accounts based on the DCF method ((1) 2. 2) (1) through (4) above) for credits to “needs attention” borrowers.</p> <p>However, review if the cash flow forecast period is in principle about five years when it is possible to rationally estimate cash flow based on a business improvement plan, etc., and about three years in other cases.</p> <p>Review if for credits to “effectively bankrupt” and “bankrupt” borrowers, the financial institution uses the amount of credits for each individual borrower classified as Category III or Category IV as the expected loss amount and either records allowance for doubtful accounts or makes direct write-offs of the amount equivalent to the expected loss amount.</p> <p>Review if the financial institution uses the total amount of credits classified as Category III or Category IV as the expected loss amount, or that it does not deem the portion certain of collection all as Category II and deduct the collectible amount from the Category III amount.</p> <p>Review if the scope of countries and the scope of credits subject to allowances for specific foreign credits, and the methods of calculating the expected loss rates and expected</p>	

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
	<p>the foreign governments, etc., of these countries, foreign private companies in these countries, and overseas Japanese companies in these countries are subject to allowances for specific foreign credits.</p> <p>Multiply the relevant credits by the expected loss rate estimated from the financial conditions, economic conditions, foreign exchange allowances and other factors in specific countries to find the expected loss amount. Record the amount equivalent to this expected loss amount to the allowances for specific foreign credits.</p>	<p>loss amounts are rational. In particular, review if the calculations of the expected loss rates are rational in light of the saleable value for credits from specific countries on saleable markets, and the credit rating given to specific countries by ratings agencies.</p> <p>Review if allowances for specific foreign credits include expected loss amounts as found by multiplying all credits from relevant countries by the expected loss rate estimated from the financial conditions, economic conditions, foreign exchange allowances and other factors in the country. However, credits deemed collectible because they are secured with deposits, or because they are secured with guarantees or insurance from parties domiciled outside of the country in question, credits denominated in the local currency of the country in question, and credits employing structures that avoid transfer risks may be excluded.</p> <p>Specifically, review if for those credits to “normal” and “needs attention” borrowers that are subject to allowances for specific foreign credits, the financial institution records general allowance for doubtful accounts and also allowances the expected loss amount found by multiplying the amount of the credit by the expected loss rate that estimates the financial conditions, etc., in the country in question.</p> <p>For credits to “in danger of bankruptcy”, “effectively bankrupt,” and “bankrupt” borrowers that are subject to allowances for specific foreign credits, review if the financial institution records expected loss amounts based on</p>	

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
<p>4) Review of the appropriateness of the total value of allowance for doubtful accounts</p> <p>2. Allowances other than allowance for doubtful accounts</p> <p>(1) Allowance for specified debtor assistance</p>	<p>For allowances other than allowance for doubtful accounts, rationally estimate and record highly probable contingent losses, etc. Note that the names of the allowances used below are only examples and do not preclude the use of other names.</p> <p>If the financial institution is engaged in the rebuilding and support of borrowers that have fallen into difficult economic straits by relinquishing credits or providing cash grants, it shall in principle calculate the expected loss amount for the support and record the amount</p>	<p>the financial position, etc., of the individual borrower, and that it also records as allowances for specific foreign credits or individual allowance for doubtful accounts the expected loss amount found by multiplying the remainder when the initial expected loss amount is subtracted from the original credit to the borrower by the expected loss rate estimated from financial conditions, etc., in the country in question.</p> <p>Review if the total value of allowances is at a level sufficient for the degree of credit risk to which the financial institution under inspection is exposed.</p> <p>Review if the financial institution rationally estimates and record allowances for highly probably contingent losses, etc., with regard to allowances other than allowance for doubtful accounts.</p> <p>If the financial institution does not record allowance other than allowance for doubtful accounts even though it is exposed to the potential for highly probable contingent losses, etc., review if there is rational justification for not recording these allowances.</p> <p>Review if all borrowers expected to be given support by the relinquishment of credits or other cash grants, etc., are covered, and that the calculation of the expected loss amount from support to specific borrowers is rational.</p>	<p>Note: Standards for the total amount of allowance for doubtful accounts will be reviewed in the event of a change in the public notice regarding write-offs and allowances.</p>

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
	<p>equivalent to the expected loss amount as allowance for specified debtor assistance.</p> <p>Specifically, in calculating the allowances for support to consolidated subsidiaries of the financial institution under inspection (including affiliated “non-banks” and guarantee companies within the group), the financial institution shall calculate the amount for the remaining Category III and Category IV values after deducting (allocating to Category IV credits first) the collectible amount from the subsidiary (total amount recorded to capital plus the collectible amount from cash flow during the period of the business improvement plan) from the categorized amount for the subsidiary in light of the asset assessment results for the subsidiary, and shall use the same methods as for write-offs and allowances of the financial institution under inspection to calculate the write-off and allowance amount for the subsidiary which shall be recorded to allowance for specified debtor assistance as the expected loss amount from support to the subsidiary. In this case, the entire amount classified as Category IV at the very least and the amount from what is classified as Category III calculated using the same methods as the financial institution’s write-off and allowance criteria required for credits to “in danger of bankruptcy” borrowers shall be recorded to allowance for specified debtor assistance as the expected loss amount from support to the subsidiary.</p> <p>The expected loss amount from support rendered to specific borrowers through the relinquishment of credits</p>	<p>If the financial institution provides support by relinquishing credits, and the expected loss amount from this support is recorded as individual allowance for doubtful accounts, review if there is rational justification for recording such amount as individual allowance for doubtful accounts and that calculation of the expected loss amount is rational.</p>	

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
<p>(2) Other allowances for contingent losses</p>	<p>and cash grants, etc., should basically be recorded as the allowance for specified debtor assistance, but when support is rendered by relinquishing credits and the expected loss amount from support to specific borrowers with borrower classification of “in danger of bankruptcy” is within the scope of this credit, and when the amount of the expected loss amount is negligible so that there is little need to set allowance for specified debtor assistance, or when there is other rational justification, the amount may be recorded as individual allowance for doubtful accounts.</p> <p>Other than the case stated in (1) above, if there are contingent losses, etc. that are highly likely to occur in the future, the reasonably estimated amount that is expected to be borne in the future shall be regarded as the expected loss amount and recorded as other allowances for contingent losses.</p> <p>In particular, if the financial institution under inspection engages in credit liquidation schemes that take credits off balance sheet but do not fully transfer credit risks to third parties so that the financial institution retains all or a part of the credit risk, record the amount equivalent to the expected loss amount from the Category III portion and the amount of the Category IV portion to other allowances for contingent losses as the expected loss amount.</p>	<p>Review if future losses are rationally estimated and recorded as other allowances for contingent losses.</p> <p>In particular, when credit liquidation schemes are used to take credits off the balance sheet, review if the expected loss amount is recorded as other allowances for contingent losses as described at left.</p>	
<p>3. Valuation of securities</p>	<p>Evaluate securities according to the following</p>		

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
4. Valuation of derivative trading	<p>classifications 1. through 3.</p> <p>1. Valuation of bonds</p> <p>1) For bonds held to maturity and other bonds available for sale whose market value can be grasped, directly write off the Category IV portion as the expected loss amount.</p> <p>2) For bonds held to maturity and other bonds available for sale whose market value is deemed extremely difficult to grasp, calculate the expected loss amount using the same method as for allowances for doubtful accounts against credits. Record the amount equivalent to the expected loss amount from Category III to allowances, and record the Category IV portion to allowances as expected loss amounts or directly write off this amount.</p> <p>2. Valuation of stocks</p> <p>Record the amount equivalent to the expected loss amount from the Category III portion to allowances, and directly write off the Category IV portion as expected loss amounts.</p> <p>3. Valuation of foreign securities and other securities</p> <p>Perform the valuation according to the above classifications 1 and 2.</p> <p>Perform valuation of derivative trading that is not marked to market using the same methods as for credits.</p>	<p>Review if in the valuation of securities the financial institution has recorded the expected loss amount to allowances or has directly written off the expected loss amount as described at left.</p> <p>Review if valuation of derivative trading is performed as</p>	

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
<p>5. Valuation of other assets</p> <p>(1) Valuation of suspense payment</p> <p>(2) Valuation of chattel and real estate</p> <p>(3) Valuation of Golf association membership</p> <p>(4) Valuation of other assets</p>	<p>For suspense payments other than those similar to loans, record as allowances or directly write off the Category IV portion as the expected loss amount.</p> <p>For chattels and real estate, directly write off the Category IV portion.</p> <p>For golf association memberships, record as allowances or directly write off the Category IV portion as the expected loss amount.</p> <p>1. For purchasing credits classified with the same methods as used for credits and issued by “in danger of bankruptcy,” “effectively bankrupt”, or “bankrupt” borrowers, calculate expected loss amounts using the same methods as for allowances for doubtful accounts. Record the amount equivalent to the expected loss amount from the Category III portion to allowances. For Category IV purchasing credits, record the amount equivalent to the expected loss amount from the Category IV portion to allowances or directly write off</p>	<p>described at left.</p> <p>In the valuation of other assets, review if expected loss amounts are recorded as allowances or directly written off as described at left.</p> <p>For chattels and real estate, review if the impairment of fixed assets is appropriately performed in light of “Accounting Standards Regarding Impairment of Fixed Assets” (Business Accounting Council, August 9, 2002).</p> <p>If the financial institution classifies purchasing credits or loan credit investment loan trust beneficiary right certificates using the same method as it does for credits, review if the expected loss amounts are calculated using the same methods as for allowance for doubtful accounts.</p> <p>If the financial institution uses the same classification methods as for credits but has not recorded expected loss amounts to allowances or directly written them off, or if it needs to make classifications but has not done so and</p>	

Item	Review of the appropriateness of write-off and allowance criteria	Review of the appropriateness of write-off and allowance results	Remarks
	<p>this amount.</p> <p>2. For loan trust beneficiary right classified with the same methods as used for credits and used to liquidate credits from “in danger of bankruptcy,” “effectively bankrupt,” or “bankrupt” borrowers, calculate the expected loss amounts using the same methods as for allowance for doubtful accounts. Record the amount equivalent to the expected loss amount from the Category III portion to allowances. For Category IV trust beneficiary right, record the amount equivalent to the expected loss amount from the Category IV portion to allowances or directly write off this amount.</p> <p>For miscellaneous assets other than the above, record the amount equivalent to the expected loss amount from the Category III portion to allowances. Record as allowances or directly write off the Category IV portion as expected loss amounts.</p>	<p>therefore has not recorded allowances or made write-offs, review if there is rational justification for not doing so.</p> <p>For other assets other than the above, review if the expected loss amount is recorded to allowances or directly written off as described at left.</p>	

Checklist for Market Risk Management

I. Development and Establishment of Market Risk Management System by Management

【Checkpoints】

- Market risk is the risk of loss resulting from changes in the value of assets and liabilities (including off-balance sheet assets and liabilities) due to fluctuations in risk factors such as interest rates, foreign exchange rates and stock prices and the risk of loss resulting from changes in earnings generated from assets and liabilities. There are three material market risks as follows:
 - (1) Interest rate risk: The risk of loss resulting from changes in interest rates. As a result of a mismatch of interest rates on its assets and liabilities and/or timing differences in the maturity thereof, a financial institution may suffer a loss or a decline in profit due to changes in interest rates.
 - (2) Foreign exchange risk: The risk of loss resulting from the difference between assumed and actual foreign exchange rates in the case where a financial institution has a long position or short position on a net basis with regard to its assets and liabilities denominated in foreign currencies.
 - (3) Price Change Risk: The risk of loss resulting from a decline in the value of assets due to changes in the prices of securities, etc.

- The development and establishment of a system for market risk management is extremely important from the viewpoint of ensuring the soundness and appropriateness of a financial institution's business. Therefore, the institution's management is charged with and responsible for taking the initiative in developing and establishing such a system.

- It is important for the inspector to review whether the market risk management system developed is an appropriate one suited to the financial institution's strategic objectives, the scales and natures of its business and its risk profile. It should be noted that the type and level of the market risk measurement and analysis methods to be used by a financial institution should be determined according to the institution's strategic objectives, the diversity of its business and the level of complexity of the risks faced by it and therefore a complex or sophisticated market risk measurement and analysis methods are not necessarily suited to all financial institutions.

- This checklist sets forth a broad range of check items, from which the inspector should select ones to be applied to a specific financial institution in light of the institution's asset management strategy, investment style, volume of trading, risk profile, risk management method, measurement technique, and other factors. Check items accompanied by the phrase "for example," are literally cited merely as examples, and the inspector should decide on a case-by-case basis whether to apply the items to a specific institution in light of the scales and natures of the institution's

business and its risk profile, etc. Check items accompanied by phrases like “in the case where the institution is using...” with regard to a certain management method or measurement technique should be applied to the case where the institution is actually using such a method or technique and where the inspector judges that the institution should use such a method or technique.

- The inspector should determine whether the market risk management system is functioning effectively and whether the roles and responsibilities of the institution’s management are being appropriately performed by way of reviewing, with the use of check items listed in Chapter I., whether the management is appropriately implementing (1) policy development, (2) development of internal rules and organizational frameworks and (3) development of a system for assessment and improvement activities.

- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II. and later, it is necessary to exhaustively examine which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.

- If the institution’s management fails to recognize weaknesses or problems recognized by the inspector, it is also necessary to explore in particular the possibility that the Internal Control System is not functioning effectively and review findings thereof through dialogue.

- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Policy Development

(1) Roles and Responsibilities of Directors

Do directors attach importance to market risk management, fully recognizing that the lack of such an approach could seriously hinder attainment of strategic objectives? In particular, does the director in charge of market risk management review the policy and specific measures for developing and establishing an adequate market risk management system with a full understanding of the scope, types and nature of risks, and the techniques of identification, assessment, monitoring and control regarding market risk as well as the importance of market risk management, and with precise recognition of the current status of market risk management within the financial institution based on such an understanding? For example, does the director in

charge understand the limitations and weaknesses of market risk measurement and analysis methods (techniques, assumptions, etc.) and consider countermeasures to supplement such shortcomings?

(2) Development and Dissemination of Office (Trading, Banking) Divisions' Strategic Objectives

Has the Board of Directors developed strategic objectives for the Office (Trading, Banking) Divisions that are consistent with the institution-wide strategic objectives and disseminated them throughout the institution? When developing the strategic objectives for the Office (Trading, Banking) Divisions, does the Board of Directors give due consideration to the asset and liability structure (including off-balance sheet items), marketability and liquidity and take into account the status of its capital? For example, does it pay attention to the following matters?

- Does it make clear whether to aim at minimizing the risk or to aim at making a profit by aggressively taking and managing a certain amount of risk in deciding the levels of risk-taking and profit objectives?
- Does it avoid setting institution-wide and division-specific strategic objectives that sacrifice risk management for profit? In particular, does it avoid setting objectives that pursue short-term profit by disregarding long-term risk or avoid setting a performance appraisal system that reflects such inappropriate objectives?

(3) Development and Dissemination of Market Risk Management Policy

Has the Board of Directors developed a policy regarding market risk management (hereinafter referred to as the "Market Risk Management Policy") and disseminated it throughout the institution? Is the appropriateness of the Market Risk Management Policy secured by, for example, including clear statements on the following matters?

- The roles and responsibilities of the director in charge and the Board of Directors or equivalent organization to the Board of Directors with regard to market risk management
- The policy on organizational framework, such as establishment of a division concerning market risk management (hereinafter referred to as the "Market Risk Management Division"), the Office (Trading, Banking) Division, and the division that conducts back-office business concerning market transactions (hereinafter referred to as the "Back-Office Division") and the authority assigned thereto
- The policy regarding the establishing of market risk limits
- The policy on identification, assessment, monitoring, control and mitigation of market risks

(4) Revision of Policy Development Process

Does the Board of Directors revise the policy development process in a timely manner by reviewing its effectiveness based on reports and findings on the status of market risk management in a regular and timely manner or on an as needed basis?

2. Development of Internal Rules and Organizational Frameworks

(1) Development and Dissemination of Internal Rules

Has the Board of Directors or equivalent organization to the Board of Directors had the Manager of the Market Risk Management Division (hereinafter simply referred to as the “Manager” in this checklist) develop internal rules that clearly specify the arrangements concerning market risk management (hereinafter referred to as the “Market Risk Management Rules”) and disseminate them throughout the institution in accordance with the Market Risk Management Policy? Has the Board of Directors or equivalent organization to the Board of Directors approved the Market Risk Management Rules after determining if they comply with the Market Risk Management Policy after legal checks, etc.?

(2) Establishing of Appropriate Limits

Does the Board of Directors or equivalent organization to the Board of Directors in accordance with the Market Risk Management Policy and the Market Risk Management Rules, establish limits (risk limits, position limits, loss control limits, etc.) suited to each operation and each risk category by examining the details of operations of the various divisions and taking into consideration the position of each division in corporate management, the institution’s capital, earning power, risk management capability, human capacity, etc.?¹ Does the Board of Directors or equivalent organization to the Board of Directors review the details of each division’s operations and revise the method of establishing limits and the limits established in a regular and timely manner or on an as needed basis? Does the Board of Directors or equivalent organization to the Board of Directors compare the institution’s corporate strength and the quantity of market risk it faces and make sure that the quantity of market risk is not excessive in relation to the corporate strength? Does the Board of Directors or equivalent organization to the Board of

¹ There are hard limits and soft limits. Hard limits trigger compulsory reduction of risks and positions when they are exceeded, while soft limits do not necessarily trigger such reduction but require that the Board of Directors or equivalent organization to the Board of Directors discuss and decide what measures to take. Usually, hard limits are established in the trading account and soft limits are established in the banking account. However, the inspector should review whether the two types of limits are established appropriately in a manner suited to the actual status of transactions.

Directors pay attention to the following items, for example?

- In the case where the institution contains complex risks, does it conduct management of limits with due consideration for such risks?
- Does the institution give due consideration to market liquidity?

(3) Establishment of Market Risk Management Division

- 1) Does the Board of Directors or equivalent organization to the Board of Directors have the Market Risk Management Division established and have the division prepared to undertake appropriate roles in accordance with the Market Risk Management Policy and the Market Risk Management Rules?²
- 2) Has the Board of Directors allocated to the Market Risk Management Division a Manager with the necessary knowledge and experience to supervise the division and enabled the Manager to implement management business by assigning him/her the necessary authority therefor?
- 3) Has the Board of Directors or equivalent organization to the Board of Directors allocated to the Market Risk Management Division an adequate number of staff members with the necessary knowledge and experience to execute the relevant operations and assigned such staff the authority necessary for implementing the operations?³
- 4) Does the Board of Directors or equivalent organization to the Board of Directors keep the Market Risk Management Division independent from the Office (Trading, Banking) Divisions and Marketing and Sales Divisions and secure a check-and-balance system of the Market Risk Management Division?

(4) Development of Market Risk Management Systems in The Office (Trading, Banking) Divisions, Marketing and Sales Divisions, etc.

- 1) Does the Board of Directors or equivalent organization to the Board of Directors provide a system to fully disseminate the relevant internal rules and operational procedures to the divisions involving market risks to be managed (e.g., the Office (Trading, Banking) Division, Marketing and Sales Divisions, etc.) and ensure that such divisions observe them? For example, does the Board of Directors or equivalent organization to the Board of Directors instruct the Manager to identify the internal rules and operational procedures that should be observed by

² When the Market Risk Management Division is not established as an independent division (e.g., when the division is consolidated with another risk management division to form a single division or when a division in charge of other business also takes charge of market risk management or when a Manager or Managers take charge of market risk management instead of a division or a department), the inspector shall review whether or not such a system is sufficiently reasonable and provides the same functions as in the case of establishing an independent division commensurate with the scales and natures of the institution and its risk profile.

³ When a department or a post other than the Board of Directors or equivalent organization to the Board of Directors is empowered to allocate staff and assign them authority, the inspector shall review, in light of the nature of such a department or post, whether or not the structure of the Market Risk Management Division is reasonable in terms of a check-and-balance system and other aspects.

the Office (Trading, Banking) Divisions, The Marketing and Sales Divisions, etc. and to carry out specific measures for ensuring observance such as providing effective training on a regular basis?

- 2) Does the Board of Directors or equivalent organization to the Board of Directors provide a system to ensure the effectiveness of market risk management in the Office (Trading, Banking) Divisions, The Marketing and Sales Divisions, etc. through the Manager or the Market Risk Management Division?

(5) Arrangement for The System of Reporting to Board of Directors or equivalent organization to Board of Directors and Approval

Has the Board of Directors or equivalent organization to the Board of Directors appropriately specified matters that require reporting and those that require approval and does it have the Manager report the current status to the Board of Directors or equivalent organization to the Board of Directors in a regular and timely manner or on an as needed basis or have the Manager seek the approval of the Board of Directors or equivalent organization to the Board of Directors on the relevant matters? In particular, does it ensure that the Manager, without delay, reports to the Board of Directors or equivalent organization to the Board of Directors any matters that would seriously affect corporate management?

(6) System of Reporting to Corporate Auditor

In the case where the Board of Directors has specified matters to be directly reported to a corporate auditor, has it specified such matters appropriately and do they provide a system to have the Manager directly report such matters to the auditor?⁴

(7) Development of Internal Audit Guidelines and an Internal Audit Plan

Does the Board of Directors or equivalent organization to the Board of Directors have the Internal Audit Division appropriately identify the matters to be audited with regard to market risk management, develop guidelines that specify the matters subject to internal audit and the audit procedure (hereinafter referred to as “Internal Audit Guidelines”) and an internal audit plan, and approve such guidelines and plan?⁵ For example, does it have the following matters clearly specified in the Internal Audit Guidelines or the internal audit plan and provide a system to have these matters appropriately audited?

- Status of development of the market risk management system

⁴ It should be noted that this shall not preclude a corporate auditor from voluntarily seeking a report and shall not restrict the authority and activities of the auditor in any way.

⁵ The Board of Directors or equivalent organization to the Board of Directors only needs to have approved the basic matters with regard to an internal audit plan.

- Status of compliance with the Market Risk Management Policy, and Market Risk Management Rules, etc.
- Appropriateness of the market risk management computer systems⁶
- Appropriateness of the market risk management processes commensurate with the scales and natures of business and the risk profile
- Appropriateness of the use of market risk measurement and analysis methods (techniques, assumptions, etc.) taken into account the limits and the weaknesses thereof
- Validity of the market risk measurement and analysis methods (techniques, assumptions, etc.)
- Accuracy and completeness of the data used in market risk measurement and analysis
- Validity of scenarios, etc. used in stress tests
- Status of improvement of matters pointed out in an internal audit or on the occasion of the last inspection

(8) Revision of Development Process of Internal Rules and Organizational Frameworks

Does the Board of Directors or equivalent organization to the Board of Directors revise the development process of internal rules and organizational frameworks in a timely manner by reviewing their effectiveness based on reports and findings on the status of market risk management in a regular and timely manner or on an as needed basis?

3. Assessment and Improvement Activities

(1) Analysis and Assessment

1) Analysis and Assessment of Market Risk Management

Does the Board of Directors or equivalent organization to the Board of Directors appropriately determine whether there are any weaknesses or problems in the market risk management system and the particulars thereof, and appropriately examine their causes by precisely analyzing the status of market risk management and assessing the effectiveness of market risk management, based on all the information available regarding the status of market risk management, such as the results of audits by corporate auditors, internal audits and external audits, findings of various investigations and reports from various divisions? In addition, if necessary, does it take all possible measures to find the causes by, for example, establishing fact findings committees, etc. consisting of non-interested persons?

⁶ It should be noted that the computer system may be a centralized dataprocessing environment system, distribution processing system, or EUC (end user computing) type. The same shall apply hereafter.

2) Revision of Analysis and Assessment Processes

Does the Board of Directors or equivalent organization to the Board of Directors revise the analysis and assessment processes in a timely manner by reviewing their effectiveness based on reports and findings of investigations on the status of market risk management in a regular and timely manner or on an as needed basis?

(2) Improvement Activities

1) Implementation of Improvements

Does the Board of Directors or equivalent organization to the Board of Directors provide a system to implement improvements in the areas of the problems and weaknesses in the market risk management system identified through the analysis, assessment and examination referred to in 3. (1) above in a timely and appropriate manner based on the results obtained by developing and implementing an improvement plan as required or by other appropriate methods?

(2) Progress Status of Improvement Activities

Does the Board of Directors or equivalent organization to the Board of Directors provide a system to follow up on the efforts for improvement in a timely and appropriate manner by reviewing the progress status in a regular and timely manner or on an as needed basis?

(3) Revision of Improvement Process

Does the Board of Directors or equivalent organization to the Board of Directors revise the improvement process in a timely manner by reviewing its effectiveness based on reports and findings of investigations on the status of market risk management in a regular and timely manner or on an as needed basis?

II. Development and Establishment of Market Risk Management System By Manager

【Checkpoints】

- This chapter lists the check items to be used when the inspector reviews the roles and responsibilities to be performed by the Manager and the Market Risk Management Division.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II., it is necessary to exhaustively examine which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter 1. are not functioning appropriately and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Roles and Responsibilities of Manager

(1) Development and Dissemination of Market Risk Management Rules

Has the Manager, in accordance with the Market Risk Management Policy, identified risks, decided the methods of assessment and monitoring thereof and developed the Market Risk Management Rules that clearly define the arrangements on risk control and mitigation, based on a full understanding of the scope, types and nature of risk and the relevant market risk management technique? Have the Market Risk Management Rules been disseminated throughout the institution upon approval by the Board of Directors or equivalent organization to the Board of Directors?

(2) Market Risk Management Rules

Do the Market Risk Management Rules exhaustively cover the arrangements necessary for market risk management and specify the arrangements appropriately in a manner befitting the scales and natures of the financial institution's business and its risk profile? Do the rules specify the following items, for example?

- Arrangements on the roles, responsibilities, and organizational framework of the Market Risk Management Division, the Office (Trading, Banking) Division, and the Back-Office Division
- Arrangements on the identification of risks to be subjected to market risk management
- Arrangements on the market risk measurement and analysis methods (techniques, assumptions, etc.)
- Arrangements on the market risk monitoring method
- Arrangements on establishing market risk limits
- Arrangements on the periodic review of market risk measurement and analysis methods (techniques, assumptions, etc.)
- Arrangements on market value calculation;
- Arrangements on *TOKUTEL-TORIHAKI* (hereinafter referred to as the “Segregated Trading Book”) (Trading Book)
- Arrangements the system of on reporting to the Board of Directors or equivalent organization to the Board of Directors

(3) Development of Organizational Frameworks by Manager

- 1) Does the Manager, in accordance with the Market Risk Management Policy and the Market Risk Management Rules, provide for measures to have the Market Risk Management Division exercise a check-and-balance system in order to conduct the system of market risk management appropriately?
- 2) Does the Manager ensure that they report to the Comprehensive Risk Management Division without delay when detecting any weaknesses or problems of the market risk management system that may affect comprehensive risk management?
- 3) With regard to New Products as specified by the Comprehensive Risk Management Policy, etc., does the Manager provide a system to identify their inherent risks in advance and report to the Comprehensive Risk Management Division when requested by the division to do so?⁷
- 4) Does the Manager provide a system to promote the sophistication of the institution’s market risk management, including the expansion of coverage of market risk measurement and improvement in the precision thereof, in a manner befitting the scales and natures of the institution’s business and its risk profile, based on an understanding of the limitations and weaknesses of the market risk measurement and analysis methods (techniques, assumptions, etc.)?
- 5) Does the Manager provide a system to enable the Market Risk Management Division to obtain

⁷ See “Checklist for Business Management (Governance) (for Basic Elements),” I. 3. (4).

necessary internal data such as trading information and market data directly from the Office (Trading, Banking) Divisions in an appropriate manner? Does the Manager provide a system to enable the Market Risk Management Division to directly command and supervise middle offices, etc. at branches?

- 6) Does the Manager have in place a market risk management computer system with the high reliability befitting the scales and natures of the financial institution's business and its risk profile, in order to identify all important market risks faced by the institution?
- 7) Does the Manager ensure the system of training and education to enhance the ability of employees to conduct market risk management in an effective manner, thus developing human resources with relevant expertise?
- 8) Does the Manager provide a system to ensure that matters specified by the Board of Directors or equivalent organization to the Board of Directors are reported in a regular and timely manner or on an as needed basis? In particular, does the Manager provide a system to ensure that matters that would seriously affect corporate management are reported to the Board of Directors or equivalent organization to the Board of Directors without delay?

(4) Revision of Market Risk Management Rules and Organizational Frameworks

Does the Manager conduct monitoring on an ongoing basis with regard to the status of the execution of business at the Market Risk Management Division? Does the Manager review the effectiveness of the market risk management system in a regular and timely manner or on an as needed basis, and, as necessary, revise the Market Risk Management Rules and the relevant organizational framework, or present the Board of Directors or equivalent organization to the Board of Directors with proposals for improvement?

2. Roles and Responsibilities of Market Risk Management Division

(1) Identification and Assessment of Market Risks

1) Identification of Market Risks

- (i) Does the Market Risk Management Division identify market risks faced by the institution and the risks subject to market risk management commensurate with the size and nature of the identified risks? When identifying market risks, does the Manager ensure that the process covers the full scope of business including the banking and trading books, overseas offices, consolidated subsidiaries, etc., in addition to exhaustively covering the risk categories such as interest rate risk, foreign exchange risk, and stock price risk (or risk factors) involved in its assets and liabilities (including off-balance sheet assets and liabilities)?
- (ii) Of the risks held, does the institution identify the following risks, for example, and consider

whether or not to subject them to market risk management?

a. Interest rate risk:

The risk of the current value (or periodic profit) of assets and liabilities (including off-balance sheet assets and liabilities) being affected by changes in interest rates. Repricing risk, yield curve risk, basis risk, and optionality must be taken into consideration as possible sources of interest rate risk. The following are examples of items which contain interest rate risk.

- Deposits
- Loans
- Bonds
- Financial derivative products

b. Foreign exchange risk:

The risk of the current value (or periodic profit) of assets and liabilities (including off-balance sheet assets and liabilities) being affected by changes in foreign exchange rates. The following are examples of items that contain foreign exchange risk.

- Assets and liabilities denominated in foreign currencies
- Foreign exchange transactions
- Derivatives of foreign exchange transactions (forward contracts, futures, swaps, options, etc.)
- Assets and liabilities whose cash flow (redemption value, coupon rate, etc.) is determined in reference to foreign exchange rates

c. Stock risk:

The risk of the current value (or periodic profit) of assets and liabilities (including off-balance sheet assets and liabilities) being affected by changes in stock prices, stock index prices, etc. The following are examples of items that contain stock risk.

- Stocks
- Corporate bonds with equity-purchase warrants
- Stock derivatives (forward contracts, futures, swaps, options, etc.)
- Assets and liabilities whose cash flow (redemption value, coupon rate, etc.) is determined in reference to stock prices, stock index prices, etc.

d. Commodity risk:

The risk of the current value (or periodic profit) of assets and liabilities (including off-balance sheet assets and liabilities) being affected by changes in commodity prices, commodity index prices, etc. The following are examples of items that contain commodity risk.

- Commodity derivatives (forward contracts, futures, swaps, options, etc.)
- Assets and liabilities whose cash flow (redemption value, coupon rate, etc.) is determined

in reference to commodity prices, commodity index prices, etc.

e. Other market risks

Among risk factors that determine the current value other than the ones listed in a. to d. is, for example, the correlation between two or more indices in reference to which the cash flow of assets and liabilities (including off-balance sheet assets and liabilities) is determined.

- (iii) With regard to corporate bonds, credit derivatives, etc., does the Market Risk Management Division identify, for example, the risk that changes in the credit spread will affect the current value (or periodic profit) and consider whether or not to subject the risk to market risk management?⁸
- (iv) With regard to options transactions, does the Market Risk Management Division identify the following risks, for example, and consider whether or not to subject them to market risk management?
- The risk of the current value (or periodic profit) being affected by changes in volatility (vega risk)⁹
 - The non-linear portion of the risk produced for the current value by a change in the price of the underlying asset (gamma risk).¹⁰
- (v) In the case where there are risks not subject to market risk management, has the institution determined if their impact is negligible?
- (iv) When the institution handles New Products, purchases new products or starts business at overseas offices or subsidiaries, does the Market Risk Management Division sort out the inherent market risks in advance the risks subject to market risk management?

2) Measurement and Analysis of Market Risks

- (i) Does the Market Risk Management Division measure and analyze all of the risks subject to market risk management? Does it conduct market risk measurement and analysis in each of the areas that are consistent with the institution's organizational framework and the roles and responsibilities allocated thereto?
- (ii) Does the Market Risk Management Division measure the current value (market value) of the positions held by the institution with a frequency befitting the scales and natures of the institution's business and its risk profile?
- (iii) Does the Market Risk Management Division measure and analyze market risks in the banking and trading books with appropriate market risk measurement and analysis methods

⁸ In some cases, such risk is specified as credit risk, rather than market risk.

⁹ The vega risk is often specified as interest rate risk, foreign exchange risk, stock risk, commodity risk, etc. according to the type of the relevant underlying asset.

¹⁰ The gamma risk is often specified as interest rate risk, foreign exchange risk, stock risk, commodity risk, etc. according to the type of the relevant underlying asset.

(techniques, assumptions, etc.) befitting the scales and natures of the institution's business and its risk profile? Does the division conduct its risk measurement and analysis with due consideration for factors that may affect the current value of assets and liabilities (including off-balance sheet assets and liabilities) and factors that may affect the periodic profit thereof?

Note: The following are examples of measurement and analysis techniques regarding market risk.

- Analysis of the balance of positions, unrealized profits/losses and realized profits/losses
- Gap analysis and static and dynamic simulation analysis based on the replacing-based ladder and maturity ladder
- Sensitivity analysis (duration, BPV (basis point value), GPS (grid point sensitivity), etc.)
- Scenario analysis using static and dynamic simulation
- VaR (value at risk)
- EaR (earnings at risk)

(iv) Does the Market Risk Management Division ensure validity of the pricing model, the risk measurement and analysis techniques (or measurement models), the assumptions, etc? Are the pricing model, concepts and risk measurement techniques used by the institution generally accepted in the financial industry?

3) Risk Measurement with Uniform Yardstick

In the case where the quantity of market risks is measured with a uniform yardstick, does the Market Risk Management Division measure all of the risks identified as subject to market risk management with the use of a uniform yardstick? When there are risks that cannot be sufficiently grasped by a uniform yardstick or that have not been measured thereby, does the division take into consideration those risks identified as subject to market risk management by using supplementary information?

4) Stress Test

Does the Market Risk Management Division measure the amount of changes in the current value of assets and liabilities (including off-balance sheet assets and liabilities) under stress conditions in a regular and timely manner or on an as needed basis? Does the division conduct stress tests based on stress scenarios that take into consideration major changes in the external environment (economy, market, etc.) that have occurred in the past as well as the current external environment and the scales and natures of the institution's business and its risk profile?

(2) Monitoring

1) Monitoring of Market Risks

Does the Market Risk Management Division, in accordance with the Market Risk Management

Policy and the Market Risk Management Rules, conduct monitoring with regard to the status of market risks faced by the financial institution with an appropriate frequency in light of the financial institution's internal environment (risk profile, the status of risk limits usage, etc.) and external environment (economy, markets, etc.)? For example, with regard to the trading books, does the Market Risk Management Division monitor the positions and loss of major products on an as-needed basis during the daytime? Does the division conduct monitoring with regard to the status of internal and external environments and the validity of the assumptions?

2) Monitoring of Compliance with Risk Limits

Does the Market Risk Management Division appropriately monitor the status of compliance with the risk limits and the status of the use thereof?

3) Reporting to Board of Directors or equivalent organization to Board of Directors

Does the Market Risk Management Division, in accordance with the Market Risk Management Policy and the Market Risk Management Rules, provide in a regular and timely manner or on an as needed basis information necessary for the Board of Directors or equivalent organization to the Board of Directors to make an appropriate assessment and judgment with regard to the status of the market risk management and the status of market risks? Does the division report the following items, for example?

- The market risk profile and the trend thereof
- The status of compliance with the risk limits and the status of the application thereof
- The nature (limitations and weaknesses) and validity of the market risk measurement and analysis methods (techniques, assumptions, etc.)

4) Feedback to Office (Trading, Banking) Divisions, etc.

Does the Market Risk Management Division provide feedback for the results of its measurement, analysis and review with regard to the status of market risks to the Office (Trading, Banking) Division, etc?

(3) Control and Mitigation

1) Countermeasures to Case Where Unmanageable Market Risks Exist

In the case where risks not covered by market risk management have non-negligible effects or where risks to be controlled through market risk management cannot be managed appropriately, does the Market Risk Management Division provide information necessary for the Board of Directors or equivalent organization to the Board of Directors to make decisions as to whether the financial institution should withdraw from or downsize the business affected by those risks?

2) Countermeasures to Case Where Risk Limits are Exceeded

In the case where the financial institution has exceeded the risk limits, does the Market Risk Management Division provide information necessary for the Board of Directors or equivalent organization to the Board of Directors without delay to make decisions as to whether to take steps to mitigate positions and risks, etc?

(4) Review and Revision

1) Sophistication of Market Risk Management¹¹

Does the Market Risk Management Division conduct a review to grasp the limitations and weaknesses of market risk measurement and analysis methods (techniques, assumptions, etc.) and devise countermeasures to complement the said methods? Does it conduct investigations, analysis and feasibility studies in light of those limitations and weaknesses with a view to making risk management more sophisticated to suit the risk profile?

2) Revision of Market Risk Identification

Does the Market Risk Management Division check in a regular and timely manner or on an as needed basis whether or not the impact of risks not subject to market risk management has increased due to changes in the scales and natures of the institution's business and its risk profile or changes in the external environment (economy, market, etc.)? In the case where the impact is determined as significant, does the division take appropriate countermeasures?

3) Revision of Market Risk Assessment Method

(i) Does the Market Risk Management Division review in a regular and timely manner or on an as needed basis whether the coverage, frequency, technique of market measurement and analysis, etc. are suited to the institution's strategic objectives, the scales and natures of its business and its risk profile? When a revision is necessary, does the division make the revision based on the internal rules after following appropriate procedures?

(ii) Does the Market Risk Management Division conduct theoretical and empirical review of the pricing model, the market measurement and analysis techniques and the assumptions, etc. and make the revision thereof in a regular and timely manner or on an as needed basis? Does the division review and revise the market risk measurement method by comparing the measurement results with the actual trend of profits/losses?

4) Revision of Method of Establishing Limits and Limits Established

¹¹ It should be noted that sophistication of risk management includes not only expansion of scope of risk measurement and improvement in precision and other aspects of risk management but also enhancement of measures to complement the limits and weaknesses of the management and the technique of utilizing measurement results.

Does the Market Risk Management Division review in a regular and timely manner or on an as needed basis whether the method of establishing limits and the limits established are suited to the financial institution's strategic objectives, the scales and natures of its business and its risk profile? In the case where a revision is deemed necessary, does the division provide information necessary for the Board of Directors or equivalent organization to the Board of Directors without delay to make appropriate assessments and decisions?

5) Revision of Strategic Objectives, etc.

Does the Market Risk Management Division review the reasonableness of the risk-return strategy by comparing the results of market risk measurement and the trend of actual profits/losses? Does it provide information necessary for the Board of Directors or equivalent organization to the Board of Directors to revise the strategic objectives, etc.?

III. Specific Issues

【Checkpoints】

- This chapter lists the check items to be used when the inspector reviews specific issues particular to the actual status of market risk management.

- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter III., it is necessary to exhaustively examine which of the elements listed in Chapters I. and II. are absent or insufficient, thus causing the said problem, with the use of the checklists in those chapters, and review findings thereof through dialogue between the inspector and the financial institution.

- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter 1. are not functioning appropriately and review findings thereof through dialogue.

- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Conduct of Market Activities

(1) Appropriate Conduct of Market Activities

Do the Office (Trading, Banking) Divisions conduct market activities appropriately in accordance with the strategic objectives, the Market Risk Management Policy, the Market Risk Management Rules, etc.? Does the Market Risk Management Division conduct monitoring for whether the Office (Trading, Banking) Divisions are conducting risk control and other activities appropriately and report the status of activities to the Board of Directors or equivalent organization to the Board of Directors in a regular and timely manner or on an as needed basis? If it finds that market activities are not conducted in accordance with the strategic objectives, the Market Risk Management Policy, the Market Risk Management Rules, etc., does the Market Risk Management Division promptly take improvement measures?

(2) Transactions Based on Fair Prices

Do the Office (Trading, Banking) Divisions conduct transactions at fair prices? Does the Market Risk Management Division check whether the Office (Trading, Banking) Divisions are

conducting transactions at fair prices by using deviations from market rate as a basis for its judgment?

(3) Management of Limits

- 1) Do the internal rules, etc. specify the arrangements and procedures for prompt reporting to the Manager the delegation and the countermeasures to be taken when the risk limits, position limits and loss limits are exceeded or likely to be exceeded? Do the internal rules, etc. stipulate that once the limits (in case of hard-limit) are exceeded, the positions must not be maintained?
- 2) Does the institution delegate the authority concerning positions, profit objectives, loss control limits, etc. in writing to the director in charge, the Manager and dealers and make clear to dealers the focus of responsibility, for example by obtaining signed confirmation from dealers each time the limits are changed? Does the institution regularly (at least once every half year) revise the limits established for each division?
- 3) Are the internal rules etc. concerning the limits applied rigorously? In the case where any problem is detected in the internal rules or the enforcement thereof, are appropriate improvement measures taken?

(4) Analysis of Profit/Loss Status, etc. and Checks on Inappropriate Handling

Is there not any inappropriate practice using derivatives and other transactions for the purpose of manipulating the account settlement? In the case where the Office (Trading, Banking) Divisions, etc. generate excessive profits, does the Market Risk Management Division analyze the cause thereof and check whether or not the excessive profits result from inappropriate practices such as those deviating from the internal rules? Does the Market Risk Management Division inspect profits/losses to examine them in relation to the contract value, the notional amount and the trading volume, etc.?

(5) Reporting to Market Risk Management Division

Do the Office (Trading, Banking) Divisions provide all information concerning market risks without delay and accurately to the Market Risk Management Division? In the case where a problem related to market risk management occurs, is it ensured that the person in charge of the relevant activities and the relevant Office (Trading, Banking) Division report it to the Market Risk Management Division without delay and accurately, rather than try to resolve the problem on his or her own and within the division itself?

(6) Development of Mutual Check-and-Balance System

- 1) In the case where computer systems of the Office (Trading, Banking) Divisions, the Market Risk

Management Division and the Back-Office Division are not integrated, does the Market Risk Management Division obtain position information, etc. from both the Office (Trading, Banking) Divisions and the Back-Office Division and determine if there is no discrepancy between the two sets of information?

- 2) Does the Market Risk Management Division have a sufficient number of staff members to monitor transactions?
- 3) Does the Market Risk Management Division regularly examine and analyze profits/losses (including unrealized evaluation profits/losses) in the relevant business term to verify whether there is any irregularity. In such examination and analysis, does the division compare the losses/profits with the risk quantity, for example?
- 4) Is consideration given to the following matters in order to exercise a mutual check and balance system?

- Is familiarity between the chief dealer and the Back-Office Division Manager not creating a situation in which dealers are allowed to directly engage in system operation and issue instructions with regard to accounting?

- Are there any experienced dealers so trusted by others that their conduct of transactions is regarded as unquestionable? Is the institution aware that human risk increases when it depends too much on specific individuals and does it conduct management in a way so as to avoid such risk?

- Is the market-related organization not run in a way to hamper the function of a check-and-balance system, for example, with a confirmation section established under the Office (Trading, Banking) Division Manager or the same person serving as the Manager of both Market and Back-Office Divisions?

- Is dealer trading voice-recorded 24 hours a day and are the trades on the voice recording checked against trading records with sampling and other methods?

Are recorded tapes stored for a prescribed period of time? Are the tapes stored under the control of an organization segregated from the Market and Back-Office Divisions (e.g. the Market Risk Management Division, etc.) or a section of the Back-Office Division segregated from the responsibilities? It is desirable that telephone conversations involving the Back-Office Division be recorded, too, for follow-up checks. It should be noted that when comparing the trades on the voice recording with dealing tickets (trading records), it is necessary to check whether the all trades on the voice recordings are covered by dealing tickets, rather than checking the dealing tickets against the recordings.

- Is at-home dealing allowed only under restricted conditions for purposes such as avoiding risks related to off-hours trading? Does the institution specify the maximum trading volume and the types of transactions allowed for at-home trading and the dealers allowed

to engage in such trading (Do the internal rules specify these items)? Are answering machines and other similar devices used to voice-record at-home dealing?

- Are all dealers fully aware that dealing recordings are regularly checked against dealing tickets?

2. Assets and Liabilities Management

(1) Policy Development and Organizational Frameworks

1) Development of Strategic Objectives, etc.

- (i) Is an ALM Committee, etc.¹², as an entity that comprehensively manages assets and liabilities and participates in the development and implementation of the ALM strategies and the like, involved in the development of strategic objectives, etc. for the Office (Trading, Banking) Divisions?
- (ii) Does the ALM Committee, etc., in accordance with the strategic objectives, the Market Risk Management Policy and the Market Risk Management Rules, discuss the management of assets and liabilities, including long-term investments for business relationships and off-balance sheet assets and liabilities, and conduct risk control in relation to the institution's capital and other elements of institution's soundness? For example, does the ALM Committee, etc. control the level of interest rate risk in the banking book in relation to the capital?
- (iii) Does the ALM Committee, etc. make effective use of the results analyzed by divisions involved in interest and foreign exchange rate forecasts, risk measurement, and hedging transactions in their analysis and examination? With regard to interest rate risk in particular, are the results of assessments based on multifaceted and appropriate risk analysis and measurement reported accurately to the ALM Committee, etc., and are sufficient discussions conducted on the management of assets and liabilities? Does the ALM Committee, etc. also examine the possible impact of offsetting effects of assets in various risk categories?

2) Framework of ALM Committee, etc.

- (i) Is there an arrangement to ensure that important information related to the Office (Trading, Banking) Divisions is provided to the ALM Committee, etc. in a timely and appropriate manner? Is the definition of the important information that must be provided to the ALM Committee, etc. specified by the internal rules?
- (ii) Do the directors and Managers in charge of the relevant divisions attend all meetings of the ALM Committee, etc. and involve themselves in deliberations? When an incident that may

¹² In the case where an ALM Committee, etc. is not in place, the inspector should review whether an alternative risk management process is performing necessary functions.

seriously affect corporate management, such as a major change in the market environment, occurs, is a meeting of the ALM Committee, etc. held in a timely and appropriate manner with the participation of the representative directors?

(2) Appropriate Assets and Liabilities Management

1) Management of Limits

In comprehensive management of assets and liabilities, is management of limits conducted from the perspective of market risk management in accordance with the Market Risk Management Policy and the Market Risk Management Rules? Are limits established with due consideration for the capital and net profits from core businesses and are the limits established not excessive compared with the institution's corporate tolerance? Are long-term investments for business relationships and off-balance sheet assets and liabilities also taken into consideration in the setting of limits? Are alarm points set as necessary to issue warnings before the limits are reached? Are procedures in place for reporting and other measures to be taken when the alarm is triggered? Are the limits and alarm points revised in a regular and timely manner or on an as needed basis?

2) Risk Control

Are market risk elements such as changes in interest rates, foreign exchange rates and prices controlled in accordance with the strategic objectives, etc., the Market Risk Management Policy and the Market Risk Management Rules? Is the level of interest rate risk in the banking book controlled, for example?

3) Utilization of Examination by ALM Committee, etc. for Corporate Strategies

- (i) Are the results of analysis by the ALM Committee, etc. taken into consideration when the Board of Directors develops strategic objectives and the Market Risk Management Policy?
- (ii) Does the Market Risk Management Division review whether the market risk control is conducted in accordance with the strategic objectives, etc., the Market Risk Management Policy and the Market Risk Management Rules and the like and report its findings to the Board of Directors or equivalent organization to the Board of Directors? In the case where it finds otherwise, does the division take improvement measures without delay?

3. Funds

(1) Management of Screening

1) Decision-Making Process

When the institution purchases a fund, does it go through a decision-making process based on the internal rules, etc., with due recognition and understanding of the nature of the fund and the risks involved therein? For example, does the institution appropriately check the structure of the fund, the fund Manager risk and liquidity risk involved and the limitations of the institution's approach to management?

2) Screening at the Time of Purchase

When purchasing a fund, does the institution appropriately check the following items, for example, based on its selection criteria?

- Investment strategy
- Risk management policy, risk management method
- Volatility
- Profit stability
- Nature of leverage and leverage policy

3) Acquisition of Information

Does the contract provide for disclosure of information at appropriate intervals? Are details of the information disclosed sufficient in terms of risk management?

(2) Continuous Risk Management

1) Conduct of Appropriate Risk Management

Does the institution conduct risk management concerning the fund purchased based on sufficient understanding of the details of the fund, such as the presence or absence of an audit and the length of the cancellation period?

2) Grasp of Investment Status

Does the institution review, with the use of asset management reports and the like, whether the fund is managed in accordance with the investment strategies, investment guidelines, etc. explained in advance? Does the institution appropriately check any change in the investment style of the fund?

3) Acquisition of Information

Is the contract maintained in a way to ensure sufficient disclosure at appropriate intervals in terms of risk management, and are its terms observed?

(3) Others

1) Market-Value Evaluation

Does the institution review and check the validity of the various elements for determining the market value of the fund purchased, such as the assessment method of the fund's investment assets and other basic matters?

2) Risk Quantity Measurement, etc.

Does the institution measure the risk quantity appropriately in a manner befitting the nature of the fund? Is the risk quantity measured within the appropriate investment limitations established with due consideration for the institution's capital, profit-earning power, etc.?

4. Market Risk Measurement Technique¹³

(1) Establishment of Market Risk Measurement System

- 1) Is the market risk measurement system conceptually sound and implemented with integrity?
- 2) Is the role of the market risk measurement technique clearly positioned under the Market Risk Management Policy and implemented based on an understanding of the items listed below, for example? Does it determine if it is implemented with integrity to consolidated subsidiaries as well?
 - (i) The financial institution's strategic objectives, the scales and natures of its business and its risk profile
 - (ii) The basic design concept of the market risk measurement technique based on (i)
 - (iii) Identification and measurement of market risk based on (ii) (coverage, technique, assumptions, etc.)
 - (iv) The nature (limitations and weaknesses) of the market risk measurement techniques that derive from (iii) and the validity of the technique
 - (v) Details of backtesting to study (iv) (in the case where a statistical technique is employed to measure the risk quantity)
 - (vi) Details of stress tests to supplement (iv) (in the case where a statistical technique is used to measure the risk quantity)
- 3) In the case where capital allocation management¹⁴ is employed has the capital allocation management policy been developed based on the outcomes obtained through the calculation of the market risk measurement technique? When there are risks which are not measured with this technique, are there any reasonable grounds for excluding them from the measurement? Is the risk capital allocated with due consideration for the risks excluded from

¹³ Risk measurement techniques include not only statistical techniques but also BPV (basis point value), GPS (grid point sensitivity), etc.

¹⁴ See Checklist for Capital Management

the measurement?

(2) Appropriate Involvement of Directors, Corporate Auditors and Board of Directors or equivalent organization to Board of Directors

1) Understanding of Market Risk Measurement Technique

- (i) Do directors understand that decisions concerning the market risk measurement technique as well as the risk limits and the risk capital limits (in the case where capital allocation management is employed) have serious implications for the financial institution's corporate management and financial conditions?
- (ii) Does the director in charge of market risk management understand the market risk measurement technique required for the business of the financial institution and comprehend the nature (limitations and weaknesses) thereof?
- (iii) Do directors and corporate auditors seek to enhance their understanding of the market risk measurement technique by receiving training or through other means?

2) Approach to Market Risk Management

- (i) Do directors involve themselves actively in market risk management that uses the market risk measurement technique?
- (ii) Does the Board of Directors clearly define the basic concept of the market risk measurement technique deemed as necessary for the business of the financial institution?
- (iii) Does the Board of Directors or equivalent organization to the Board of Directors take into consideration the results of stress tests when developing the Market Risk Management Policy and the Market Risk Management Rules?

(3) Establishment of Independent Market Risk Management Division

1) Securing of Independence of Market Risk Management Division

Does the institution have the Market Risk Management Division in charge of designing and operating the market risk management system established independently from the Office (Trading, Banking) Divisions? In the case where the institution is subject to market risk capital requirement, is the same director not in charge of the Office (Trading, Banking) Divisions and the Market Risk Management Division?

2) Clarification of Roles and Responsibilities of Market Risk Management Division

Are the Market Risk Management Rules clearly defined the roles and responsibilities of the Market Risk Management Division?

3) Roles and Responsibilities of Market Risk Management Division

- (i) Does the Market Risk Management Division report the outcomes obtained through the use of the market risk measurement technique directly to the director in charge and the Board of Directors or equivalent organization to the Board of Directors?
- (ii) Has the Market Risk Management Division fully disseminated the internal rules and detailed operational procedures, etc. that must be observed to all of the relevant divisions?
- (iii) Does the Market Risk Management Division appropriately analyze and assess the outcomes obtained through the use of the market risk management technique?

(4) Deployment of Staff for Market Risk Management

- 1) Are staff members with expertise in using the market risk measurement technique and the pricing model secured according to the needs of the operations of the relevant divisions (the Office (Trading, Banking) Divisions, the Market Risk Management Division, the Back-Office Division, the Internal Audit Division, etc.)?
- 2) Does the Manager have sufficient knowledge and experience with regard to the market risk measurement technique and the pricing model?

(5) Framework for Research on Market Risk Measurement Technique

Is a framework in place for conducting research on the market risk measurement technique? Is research conducted on the following items, for example?

- Countermeasures of the limitations and weaknesses of the market risk measurement technique
- Preventing the market risk measurement technique from technology obsolescence
- Response to changes in the composition of market risks in the portfolio
- Elaboration and sophistication of the market risk measurement technique

(6) Development of Internal Rules, etc. Concerning Market Risk Measurement Technique

1) Development of Internal Rules

Has the institution developed the internal rules and detailed operational procedures that specify the policy concerning the use of the market risk measurement technique and the management and procedures thereof, and does it regularly revise the rules and detailed operational procedures? Is consistency secured between other internal rules and operational procedures concerning the market risk management system?

2) Compliance with Internal Rules

Does the institution provide a system to ensure compliance with the internal rules and detailed operational procedures, etc.?

(7) Incorporation of Market Risk Measurement Technique into Regular Market Risk Management

1) Compilation and Communication of Reports on Market Risk Measurement Results

- (i) Are the results of market risk measurement promptly reflected in risk reports and communicated to the Manager?
- (ii) Are appropriate measures taken when the results of the calculation of the market risk measurement technique show a breach of the limits established by the institution?
- (iii) Is a report that includes comments for consideration by the Manager and sums up the status of major market risks compiled regularly and communicated to the Manager?

2) Analysis and Utilization of Market Risk Measurement Results

- (i) Are the outcomes obtained through the use of the market risk measurement technique appropriately analyzed and utilized for market risk management?
- (ii) Do the relevant divisions utilize risk reports for their daily risk management business?
- (iii) Are the results of market risk measurement fully utilized for the development of strategic objectives, the Market Risk Management Policy and the Market Risk Management Rules as well as for monitoring? Are the results also taken into account in the development of the investment policy and the establishment of limits?
- (iv) Is analysis conducted on the relation among the market risk quantity calculated with the use of the market risk measurement technique, the limits and profit objectives established by the institution?
- (v) Are the outcomes obtained through the use of the market risk measurement technique (e.g. VaR) utilized for performance evaluation? Is performance evaluation conducted for each of the business units divided along the line of internal control for earning management, based on the risk-return analysis using the outcomes obtained through the use of the market risk measurement technique employed?

3) Appropriate Use of Market Risk Measurement Technique

- (i) When the institution modifies the market risk measurement technique, does it follow appropriate procedures?
- (ii) When the institution modifies the market risk measurement technique, does it disseminate the modification to the relevant divisions and consolidated subsidiaries after determining the modified technique's consistency with the Market Risk Management Policy?
- (iii) It is desirable for the Office (Trading, Banking) Divisions and the Market Risk Management Division to conduct market risk management by using the outcomes obtained through the use

of the same market risk measurement technique. When the techniques used by them are not the same, are the differences comprehended?

(8) Market Risk Measurement

1) Securing of Appropriateness of Market Risk Measurement Technique

- (i) Does the institution use a market risk measurement technique that covers all of the important market risks it takes? In the case where there are risks excluded from measurement, has the institution reviewed the judgment that those risks are not important?
- (ii) When employing market risk measurement technique, does the institution make the selection after weighing its calculation results against the outcomes obtained through the use of other techniques by using test data?

2) Reflection of Market Risk Measurement Technique in Computer System

- (i) Are changes in the risk measurement technique (measurement technique, assumptions, etc.) accurately reflected in computer systems?
- (ii) Is consistency secured between the systems used by the Office (Trading, Banking) Divisions, the Market Risk Management Division and the Back-Office Division? It is desirable that the Office (Trading, Banking) Divisions and the Market Risk Management Division use the same models (market risk measurement model, pricing model, risk factor calculation method, etc.). If this is not the case, does the institution comprehend the differences between the models used by the Office (Trading, Banking) Divisions and the Market Risk Management Division?

3) Data Input into Computer System

- (i) Does the institution obtain data at an appropriate time? Has it established detailed guidelines for detecting and handling extraordinary data and is it operating based on these guidelines?
- (ii) Does the institution check data for errors?
- (iii) Do external data used by the institution come from appropriate sources? In the case where data from multiple sources are used, is there a rational reason for this and is consistency among those data secured? Is there not any problem with consistency, timing, reliability, and independence of the data source?
- (iv) Are the accuracy and completeness of position data secured? For example, is the input process of transaction data conducted through a direct link? When the input process is manual, is a review conducted to verify the data accuracy?

4) Handling of New Products

Before introducing New Products, does the institution firmly comprehend the nature of the

market risks involved and build the risks into the market risk measurement technique? In the case where the institution decides not to apply the market risk measurement technique to the risks involved in New Products, are the grounds not to apply it reasonable?

(9) Measurement of General Market Risk (in the case where the quantity of general market risk is measured)

1) Market Risk Measurement

Does the institution use a measurement technique that covers all of the important risks it takes and conduct risk measurement appropriately? In the case where there are products and risk factors to which the market risk measurement technique is not applied in the calculation of the risk quantity, does the institution take steps to comprehend the quantity of the risks involved therein with the use of an alternative technique?

- Does the institution capture linear and non-linear risks when measuring its market risks?
- In the case where the institution takes optionality, does it capture the gamma and vega risks involved in options?
- In the case where the institution owns path-dependent products, does it capture the risks inherent in such products?
- In the case where the institution uses proxy variables in its risk measurement, does it capture residual risk?

2) Frequency of Risk Measurement

In the case where the institution uses the internal model approach, does it measure the VaR of its trading book exposure more than once per trading day and the stressed VaR more than once a week?

3) Confidence Level

In the case where the institution uses the internal model approach does it apply a one-tail confidence level of 99%? Does the accuracy of the outcome obtained through the use of the market risk measurement technique suit the confidence level applied? With regard to the outcome for use in internal control, in addition to verifying the accuracy of the results, are the grounds for the adoption of the confidence level applied clear?

- In the case where a parametric technique (variance-covariance method, etc.) is employed, is the assumption of distribution appropriate?
- In the case where a simulation method (historical simulation method, etc.) is employed, is the estimation of the distribution tail appropriate?
- In the case where the Monte Carlo simulation method is employed, are the precision of

random numbers and simulation times consistent with the confidence level applied?

4) Holding Period

In the case where the institution uses the internal model approach, is the holding period set at 10 trading days or longer? Is the institution's data sampling method appropriate for the holding period? With regard to the data sampling method for internal control, is the holding period adopted consistent with the position's liquidation horizon and the characteristics of positions, in addition to reviewing the data sampling method?

5) Historical Data Observation Period, Update Frequency, Handling of Deficient Data, etc.

- (i) Is the historical observation period one year or longer? Is the historical data observation period adopted valid?
- (ii) Are historical data updated at least once every month? When a problem that may undermine the validity of the update frequency, such as large fluctuations in market prices, occurs, does the institution take appropriate countermeasures based on recognition of the need to update historical data?
- (iii) Is the method of supplementing deficient data appropriate?
- (iv) In the case where the institution measures Stressed VaR, are the standards for selection/periodic review of historical data appropriate?

6) Consideration of Correlation

- (i) In the case where the institution takes into consideration the correlation between risks within each broad risk category (interest rate risk, foreign exchange risk, stock risk and commodity risk. Option volatility is included in a relevant risk category), does it determine the validity of the correlation with the use of historical data?
- (ii) In the case where the institution takes into consideration the correlation among broad risk categories, does it determine the reasonableness of the correlation and compile and store documents that explain this reasonableness?

7) Establishing Market Risk Factors

- (i) Are market risk factors established in a way to enable the institution to sufficiently capture the market risk inherent in the institution's portfolio?
 - Does the institution establish market risk factors with regard to the broad risk categories of interest rate, foreign exchange, stock and commodity risks?
 - Does the institution use all pricing factors (classification of factors that influence pricing of financial instruments such as interest rates, etc.) when setting market risk factors?

- Does the institution revise the market risk factors set in a manner befitting the change in its business, the market environment, etc.?
 - In the case where proxy variables are used, are they valid and conservative?
- (ii) Are interest rate risk factors established in a way to enable the institution to sufficiently capture the interest rate risk inherent in the institution's portfolio?
- Has the institution developed internal rules and detailed operational procedures concerning the yield curve formulation method?
 - Is there not any problem with the consistency of the establishing yield curve-related risk factors (currency, type, period) and the modeling approach with the nature of the institution's portfolio?
 - Does the institution capture spread risk?
- (iii) Are foreign exchange risk factors established in a way to enable the institution to sufficiently capture the foreign exchange risk inherent in the institution's portfolio?
- Is the institution's treatment of a currency which lacks market liquidity in its market risk measurement consistent with its treatment of such a currency in the business policy?
- (iv) Are stock risk factors established in a way to enable the institution to sufficiently capture the stock risk inherent in the institution's portfolio?
- Are the stock risk factors established in a manner consistent with the nature of market and investment (unlisted shares, funds, the level of diversification and concentration of issues, etc)?
- (v) Are commodity risk factors established in a way to enable the institution to sufficiently capture the commodity risk inherent in the institution's portfolio?
- (vi) Are risk factors that enable the institution to sufficiently capture the optionality risk inherent in the institution's portfolio established within each risk category?
- Has the institution developed internal rules and detailed operational procedures concerning the method of the volatility curve formulation?
 - Is there not any problem with the consistency of the establishing volatility risk factors (currency, type and term) and the modeling approach with the nature of the institution's portfolio?
- (vii) In the case where the institution's portfolio contains risks other than the ones mentioned in (ii) to (vi), are risk factors established in a way to enable the institution to sufficiently capture such risks?

8) Position Data

Does the institution establish relations between position data and risk factors in an accurate and appropriate manner? In mapping of assets related to two or more risk factors, does the

institution match the assets with the corresponding risk factors?

(10) Measurement of Specific Risks (in the case of financial institutions subject to market risk capital requirement, or that measure the risk quantity with regard to specific risks)

- 1) Does the institution measure all specific risks?
- 2) In the case where the institution measures specific risks with the use of the internal model approach, does it meet the following criteria?
 - Can the institution explain the past price changes concerning its portfolio?
 - Does the institution capture the impact of changes in its portfolio (including the level of risk concentration) on market risks as a whole?
 - Does the institution comprehend the impact on the market risk in its entirety caused by the changes in market environment?
 - Does the institution comprehend the difference between the risks involved in positions similar to each other but not identical given the difference in their maturities, levels of subordination and credit incidents involved, etc.?
 - Does the institution accurately capture event risk?
 - Can the institution show based on the results of backtesting that it accurately captures specific risks?
 - Does the institution, under realistic market scenarios, conservatively assess risks arising from less liquid positions or positions with limited price transparency?
- 3) In the case where the institution does not measure specific risks with the use of the internal model approach, does it use The Standardized Approach ?

(11) Measurement of Additional Risk (financial institutions subject to market risk capital requirements, or those measuring the amount of additional risks)

- 1) When measuring individual risks associated with bonds, etc, with the use of the internal model approach, does the financial institution measure the additional risks associated with such bonds, etc, with the use of the internal model approach and add such amount to the total amount equivalent to market risk?
- 2) Does the financial institution satisfy the following criteria when measuring the additional risks with use of the internal model approach?
 - The financial institution appropriately satisfies the criteria for internal credit risk rating methodology by adjusting for the characteristics of the position subject to measurements such as liquidity, concentration, hedging and optionality (in this case, the financial institution can have the premise that overall risk of its portfolio is at a certain, fixed level in

accordance with the status of its risk management).

- The additional risks should be calculated through the one-tail test at the 99.9% confidence level with a holding period of more than one year.
- The effect of amplification of the additional risks through default and the rating transition occurring in chain among obligors is taken into account.
- The distribution effect between the additional risks and other risks is not taken into account.
- The concentration risk is captured.
- No netting of exposure except netting of the short position and long position on the same financial instruments.
- Major basis risk is captured.
- When it is not certain that the maturity of bonds, etc. will exceed the liquidity horizon and this is deemed to cause material adverse effects, and potential risks to occur when such bonds, etc. are redeemed before the liquidity horizon are captured.
- In terms of the effect of re-balancing of a hedge in a period shorter than the liquidity horizon in a dynamic hedge, the effect of such dynamic hedge is recognized only when the following criteria are satisfied, thereby reflecting the risks that are not reduced through the dynamic hedging.
- The measurement model for the additional risks takes into account the effect of re-balancing of a hedge on the position subject to the measurement of the market risk-equivalent amount.
- The bank provides the explanation that the recognition of the re-balancing effects contributes to the improvement of risk identification.
- The bank provides the explanation that the liquidity of the financial market where the financial instruments are used for hedging is acceptable.
- Non-linear risks of bonds, etc. are captured.

3) Is the amount of the additional risks measured more than once a week?

(12) Measurement of Comprehensive Risk (financial institutions measuring comprehensive risk with the use of the internal model approach)

1) Does the financial institution satisfy the following criteria?

- The comprehensive risk model at least measures default risk; rating transition risk; risks associated with multiple defaults, credit spread and volatility of implied correlation; basis risk; and the risk associated with re-balancing of a hedge.
- The bank has adequate information regarding the financial market to capture major risks.
- The historical change in price as to the correlation-trading portfolio can be explained via the comprehensive risk model.

- There is a clear distinction between the position to which the internal model approach is applied and the position to which it is not applied.
 - Stress testing is performed on the comprehensive risk measurement model at least on a weekly basis.
 - The financial institution has established the framework for reporting to the FSA the overview of results of the stress testing on a quarterly basis (in a timely manner when such results show a lack of required capital for the comprehensive risk).
- 2) Does the financial institution measure the amount of the comprehensive risk more than once a week?

(13) Backtesting (in the case where a statistical technique is used to measure the risk quantity)

1) Implementation of Backtesting

- (i) Does the institution document the purpose, implementation method and frequency of backtesting as well as the analysis and reporting procedures thereof?
- (ii) Does the institution regularly conduct backtesting with the use of actual profits/losses or hypothetical profits/losses for no portfolio changes?
In order to review the appropriateness of the market risk measurement technique, does the institution use profits/losses befitting a statistical verification?
- (iii) In the case where the institution takes into consideration the correlation measured based on historical data within each broad risk category (interest rate risk, foreign exchange risk, stock risk and commodity risk; however, option volatility is included in a relevant risk category), does it conduct backtesting on a category-by-category basis in a manner befitting the nature of the business?

2) Analysis of Backtesting Results

- (i) When the actual profits/losses exceeds the outcome obtained through the use of the market risk measurement technique, does the institution analyze and study the cause thereof and revise the measurement model accordingly?
- (ii) Does the institution take appropriate responses according to the number of exceptions that actual profits/losses exceeded the outcomes obtained through the use of the market risk measurement technique?
- (iii) Does the institution comprehend, based on the results of backtesting, the nature of the market risk measurement technique (limitations and weaknesses) and risks not covered by the technique and ensure the reliability and appropriateness of the market risk measurement technique by taking necessary countermeasures?
- (iv) Are the results of backtesting and the results of the analysis and study thereof reported to the

director in charge and the Board of Directors or equivalent organization to the Board of Directors? Does the institution provide a system to ensure that when any problem with regard to the appropriateness of the market risk measurement technique is detected based on the results of backtesting and the analysis thereof, the problem is reported to the Board of Directors or equivalent organization to the Board of Directors without delay and countermeasures are formulated?

**(14) Calculation of Market Risk Equivalent Amount under Market Risk Capital Requirements
(in the case of financial institutions subject to market risk capital requirements)**

1) Calculation of Market Risk Equivalent Amount

Is the market risk equivalent amount calculated in accordance with the stipulation under the Notification?

2) Appropriate Response to Exceptions in Backtesting

Whenever a daily actual loss amount exceeds the relevant daily VaR five times or more during the most recent 250 trading days including the calculation base date, does the institution establish the system to analyze the cause and explain it clearly?

(15) Stress Tests (in the case where a statistical technique is used to measure the risk quantity)

1) Implementation of Stress Tests

- (i) Does the institution document the purpose, implementation method and frequency of stress tests as well as the analysis and reporting procedures thereof?
- (ii) Does the institution conduct stress tests in an appropriate manner in a regular and timely manner or on an as needed basis? If the institution is subject to market risk capital requirement, it should regularly conduct stress tests.
- (iii) Do the risk factors subject to stress tests cover material transactions? Does the institution revise risk factors not subject to stress tests as necessary?

2) Developing of Stress Scenario

Does the institution develop scenarios that take into consideration incidents that may seriously affect the financial institution and supplement the limitations and weaknesses of the market risk measurement technique?

- Does the institution develop stress scenarios, which apply market turmoil, where big price fluctuations and a rapid decline of liquidity occurred simultaneously in the past crises, to the current portfolio?
- Does the institution develop a worst-case scenario for its portfolio?

- Do the stress scenarios set by the institution reflect its risk nature? Do the scenarios take into consideration the nature of options and products similar in nature to options, for example?
- Does the institution set stress scenarios in case the assumptions of the market risk measurement technique, etc. are failing?

3) Utilization of Stress Test Results

Are the results of stress tests and the results of analysis and study thereof reported to the director in charge and the Board of Directors or equivalent organization to the Board of Directors? Does the institution provide a system to ensure that when a large amount of loss is expected as a result of a stress test, the case is reported to the Board of Directors or equivalent organization to the Board of Directors without delay and corrective measures are formulated? Does it utilize the test results in a way to reflect them in the investment policy, the establishing limits and the internal capital adequacy assessment?

(16) Review of Accuracy and Appropriateness of Market Risk Measurement Technique (in the case where a statistical technique is used to measure the risk quantity)

- 1) Are the accuracy and appropriateness of the market risk measurement technique assessed and challenged in the development stage and regularly thereafter by a person or persons with no involvement in the development of the market risk measurement technique and with sufficient capabilities? Is such a review also made in the case where a material modification of the market risk measurement technique, a structural change of the market or a change in the portfolio may undermine the accuracy and appropriateness of the technique?
- 2) Does the institution not underestimate risks in using the market risk measurement technique because of inappropriate assumptions, etc.?
- 3) Does the institution conduct backtesting in order to assess the accuracy and appropriateness of the market risk measurement technique? Does it seek to enhance the review by conducting medium- and long-term analysis, for example, in addition to backtesting required by regulation?
- 4) Does the institution obtain reasonable assessment results by reviewing the measurement model in an appropriate manner in light of the institution's portfolio and the structure of the market risk measurement technique?
- 5) Does a review using a hypothetical portfolio show that the market risk measurement technique appropriately captures the impact that may arise from the structural nature of the portfolio?

(17) Document of Records on Market Risk Management Technique (in the case where a statistical technique is used to measure the risk quantity)

Does the institution develop the system to keep meticulous records, for future reference, on the deliberation process with regard to the selection of the market risk measurement technique and the assumptions thereof and the grounds for the selection, in order to enable a follow-up review and utilize the records to make the measurement more sophisticated and elaborated? Does the institution keep records with regard to the following items, for example?

- The basic design concept
- Documents that explain the key points and details of the market risk measurement technique (measurement technique, assumptions, etc.)
- Results of deliberation with regard to the selection of the market risk measurement technique and the grounds for the selection
- Details of the implementation of assessment of the accuracy and appropriateness of the market risk measurement technique, results of assessment thereof and the grounds for the judgment
- Details of the implementation of backtesting and stress tests, results of assessment thereof and the grounds for the judgment
- The pricing model of each product

(18) Audits (in the case where a statistical technique is used to measure the risk quantity)

1) Development of Audit Program

Has the institution developed an audit program that exhaustively covers audits of the market risk measurement technique?

- Does a person in charge of internal audits have expertise in the market risk measurement technique?
- Is an internal audit conducted at least once a year?

2) Scope of Internal Audits

Is auditing conducted to check the following items?

- Consistency of the market risk measurement technique with the strategic objectives, the scales and natures of the business and the risk profile
- Appropriateness of employing the market risk measurement technique in light of the nature (limitations and weaknesses) thereof
- Appropriate documentation of records on the market risk measurement technique and timely updating thereof
- Appropriateness of the deployment of staff members with expertise in the use of the market risk measurement technique and pricing models
- Integration of the results obtained through the use of the market risk measurement

technique into daily management of market risks

- Appropriateness of the approval process of a new model that includes pricing models and a market risk measurement technique
- Appropriate reflection of any modification of the process of market risk management in the measurement technique
- Validity of the scope of measurement conducted with the market risk measurement technique
- Absence of any deficiency in the information system for the management
- Reasonableness of the logic of pricing models
- Validity of the market risk measurement technique and the assumptions, etc.
- Accuracy and completeness of data used in market risk measurement
- Consistency, timeliness, reliability and independence of data source used when the market risk measurement technique is applied
- Adequacy of the process and results of backtesting
- Adequacy of the process and results of stress tests
- Appropriateness of the regular review of the market risk measurement technique

3) Utilization of the Results of Internal Audits

Does the Market Risk Management Division appropriately revise the market risk measurement technique based on the results of internal audits?

4) Utilization of the Results of External Audits

Are external audits conducted in an appropriate manner (in terms of coverage, frequency and depth) with due consideration for the nature of the institution's business and the status of implementation of internal audits? Does the Market Risk Management Division appropriately revise the market risk measurement technique based on the results of external audits?

5. Market Risk Measurement Model Developed by Outside Vendor¹⁵

(1) Appropriateness of Market Risk Measurement System

- 1) Does the person in charge of market risk measurement at the financial institution have sufficient knowledge with regard to the measurement technique and understand the modeling process of market risk measurement?
- 2) Do the institution's Market Risk Management Division and the Internal Audit Division conduct a theoretical and empirical verification of the validity of the measurement technique?

¹⁵ In the case where the market risk measurement is outsourced, the review should be conducted by using the check items listed in this paragraph.

(2) Appropriateness of Market Risk Measurement Model

- 1) Is there not any “black box” with regard to the measurement model? If there is one, has the validity of the measurement model been verified ?
- 2) Are the consistency and the accuracy of data used in measurement secured?
- 3) Is the measurement model selected suited to the scales and natures of the financial institution’s business, and its risk profile?

(3) Management of Developer of Market Risk Measurement Model

- 1) Is the developer consigned with the development of the market risk measurement model capable of ensuring continuous management of the model and promoting sophistication and elaboration of the model? Does the institution regularly evaluate the developer?
- 2) Does the developer provide sufficient user support (training, consulting and maintenance) with regard to market risk measurement?
- 3) Is it ensured that the developer reports to the institution on the status of its verification of the validity of the measurement model in a regular and timely manner or on an as needed basis?

6. Installation of Computer System

(1) Dealing Support System

Does the institution have a dealing support system that enables mark-to-market evaluation of dealer-by-dealer (or unit-by unit) positions and office-by-office positions with regard to all major products it handles? Does it have a system that enables management of profits on a dealer-by-dealer or a position-by-position basis?

(2) Installation of ALM System

Does the institution have a system in place for assets and liabilities management? For example, does it have a system that uses a multifaceted risk-return analysis technique that covers the institution’s market risks including interest rate risk such as repricing risk, yield curve risk and basis risk as well as foreign exchange risk and price change risk and that is befitting the scales and natures of the institution’s business, and its risk profile?

(3) Computer System for Back-Office Processing

Does the institution have accounting and information support systems that can fully perform basic back-office processing, settlement and management concerning all transactions in which the institution is involved?

7. Calculation of Market Prices

(1) Development of Internal Rules

In order to exclude arbitrariness from accounting processes and ensure transparency, it is necessary for the Board of Directors or equivalent organization to the Board of Directors to establish internal rules and enforce them on a continuous basis. Does the institution specify the following items at a minimum? Does the institution attach due importance to the internal rules and, when revising the rules, does it follow procedures same as those followed when they are established?

- 1) Power and responsibilities of the Manager in charge of the division that calculates market values.
- 2) Obligation to comply with internal rules and procedures for revising the rules
- 3) The basic concept concerning the calculation of market values
 - Calculation of market values by a division independent from organizations that conduct *TOKUTEI-TORIHIKI* (hereinafter referred to as the “Segregated Trading”) and non-segregated trading transactions
 - The method of market value calculation. (In the case where the method of calculating market values is specified by other documents, the internal rules should make reference thereto.)
 - The method of involvement of an organization performing front-office functions in the calculation of market values in the case where such involvement is necessary

(2) Independence of Market Value Calculation Division

Are divisions in charge of market trading and the calculation of market values separately established in order to secure fairness in market value calculation? Aren't the Office (Trading, Banking) Divisions intervening in the Market Value Calculation Division in a way to undermine the objectivity of the calculation?

(3) Securing of Objectivity of Market Value Calculation

- 1) Has the institution established a market value calculation manual in accordance with the internal rules and does it follow the manual on a continuous basis? When it becomes necessary to modify the calculation method because of an accounting system reform and the development of a new technique or for other reasons, does the institution promptly make modification in accordance with the internal rules? Does it make clear the status of such modification?
- 2) Has the manual for market value calculation been approved in an appropriate manner by the person with the approval authority after being checked by a division (such as the Risk

Management Division and the Internal Audit Division) independent from the Office (Trading, Banking) Divisions (divisions performing so-called front-office functions) and a division responsible for the development of financial products, in order to secure fairness and validity of the manual? Is the status of use of the manual regularly checked by a division independent from the Office (Trading, Banking) Divisions, a division in charge of the development of financial products and a division in charge of market value calculation?

- 3) Does the institution calculate market values appropriately based on “Accounting Standards concerning Financial Products” (Accounting Standards Board of Japan), etc.? Does it conduct market value calculation on its own? In the case where the institution obtains market value information from third parties, does it obtain such information regularly and review the validity of the market values for itself?
- 4) Does the institution include the status of securing of objectivity of market value calculation among its important internal audit items?

8. Issues Related to Segregated Trading (in the case of institutions which have segregated trading books)

(1) Development of Internal Rules

In order to exclude arbitrariness and ensure transparency in segregated accounting, it is necessary for the Board of Directors or equivalent organization to the Board of Directors to establish clear internal rules and enforce them on a continuous basis. Does the institution specify the following items at a minimum in addition to the items listed in Chapter III. 7. (1) above? Does the institution attach due importance to the internal rules, and, when revising the rules, does it follow procedures same as those followed when they are established?

- 1) Clear operational procedures concerning segregated accounting based on the legal definition of “segregated trading purposes”
 - Definition of segregated trading purposes
 - Clear organizational divisions (divisions of personnel into units) and independent decision-making power
 - Restrictions on concurrent service of dealers in organizations involved in segregated trading and other organizations
 - Ban on transfers between accounts (excluding the case where such transfers are conducted within the limitations allowed according to an application filed with the authority in accordance with laws)
 - Limiting of counterparties for segregated trading securities to market and recognition of the hedging purpose

- 2) Power and responsibilities of the Manager in charge of a division that conducts segregated trading
- 3) Responsibilities to comply with internal rules and procedures for revising internal rules
- 4) Methods concerning internal trading and management thereof
 - Definition of internal trading and coverage thereof
 - The basic policy on internal trading
 - Approval of internal trading by an organization independent from a front-office organization
 - Approval procedures of internal trading and documents to be stored
- 5) Rules concerning commissioned trading

(2) Separation of Organizations and Personnel

It is desirable that an organization engaged in transactions related to the segregated trading book (an organization performing so-called front-office functions at a minimum) be a unit (e.g. section, group, department) or larger in size and be separate in terms of organizational structure and personnel from an organization that is engaged in similar transactions but also conducts transactions related to the non-segregated trading book, which has a different purpose.

It should be noted that such an organizational division is not necessarily required in the case where segregated trading and assets involved in such transactions are clearly segregated from other types of transactions and assets involved therein from an objective viewpoint and it is thus deemed that there is no concern that accounting manipulation would be conducted (e.g. in the case where the segregated trading division is concurrently engaged in transactions other than those listed as segregated transactions).

(3) Book-Keeping

With respect to the books for the segregated trading book, are segregated transactions and assets involved in them clearly distinct from other transactions and assets involved therein?

(4) Ban on Transactions Related to Non-Segregated Trading Book by Segregated Trading Division

Is an organization engaged in transactions related to the segregated trading book not involved in transactions related to the non-segregated trading book (and vice versa)? (This shall not apply to the case where segregated transactions and assets involved in such transactions are clearly distinguished from other types of transactions and assets involved from an objective viewpoint and it is thus deemed that there is no concern that accounting manipulation would be conducted.)

(5) Ban on Arbitrary Account Choice

Does the institution not decide in an arbitrary manner whether to enter a transaction in the segregated or non-segregated trading book, for example deciding to process a transaction that should be handled in the non-segregated trading book as a segregated transaction in dealing with a market risk-related problem?

(6) Adequateness of Internal Trading

With regard to internal trading within a financial institution, there is concern that the institution may take advantage of the differences between accounting systems in posting profits/losses. In order to exclude arbitrary trading, does the institution conduct internal trading appropriately in accordance with the “Documents Noting Matters Related to the Handling of Internal Trades” (or internal rules concerning the segregated trading book)?

(7) Securing of Objectivity of Market Value Calculation

Does the institution include the following items in particular among the check items concerning internal control in order to secure objectivity of market value calculation in the segregated trading book?

- 1) Is there no deviation from the scope of transactions specified in the ordinance? (Inter-account transactions are not allowed for exchange transactions, securities-related transactions and acquisitions and transfers of monetary receivables)
- 2) Is an internal check and balance system functioning effectively to ensure that internal trading is conducted in accordance with the internal rules? For example, is internal trading conducted at market price?
- 3) Are internal transactions indicated as such on trading tickets and the records thereof stored separately?
- 4) Is there not any intentional profit/loss adjustment?

(8) Disclosure

Does the institution disclose the following items with regard to appropriate segregated accounting and obtaining and management of objective market prices?

- 1) Framework of segregated trading book (definition of “trading for the segregated trading purpose,” specific products eligible for segregated trading, organizational divisions, etc.)
- 2) Measures to secure objectivity of market prices
- 3) Financial information concerning the segregated trading book

Checklist for Liquidity Risk Management

I. Development and Establishment of Liquidity Risk Management System

Checkpoints

- Liquidity risk is the risk that a financial institution will incur losses because it finds it difficult to secure the necessary funds or is forced to obtain funds at far higher interest rates than under normal conditions due to a mismatch between the maturities of assets and liabilities or an unexpected outflow of funds (referred to as funding-liquidity risk). It is also the risk that a financial institution will incur losses because it is unable to conduct market transactions or is forced to conduct transactions at far more unfavorable prices than under normal conditions due to a market crisis and the like (referred to as market-liquidity risk).
- The development and establishment of a system for liquidity risks management is extremely important from the viewpoint of ensuring the soundness and appropriateness of a financial institution's business. Therefore, the institution's management is charged with and responsible for taking the initiative in developing and establishing such a system.
- It is important for the inspector to review whether the liquidity risk management system developed is an appropriate one suited to the financial institution's strategic objectives, the scales and natures of its business and its risk profile.
- This checklist is compiled on the assumption that at the institution inspected, the Liquidity Risk Management Division is dedicated to the task of liquidity risk management and the Funds Management Division is dedicated to the task of funds management. The inspector should bear in mind that the scope of the roles and responsibilities of such divisions varies from institution to institution and review whether the liquidity risk management system as a whole is functioning effectively.
- The inspector should determine whether the liquidity risk management system is functioning effectively and whether the roles and responsibilities of the institution's management are being appropriately performed by way of reviewing, with the use of check items listed in Chapter I., whether the management is appropriately implementing (1) policy development, (2) development of internal rules and organizational frameworks and (3) development of a system for assessment and improvement activities.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II. and later, it is necessary to exhaustively examine which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector

and the financial institution.

- If the institution's management fails to recognize weaknesses or problems recognized by the inspector, it is also necessary to explore in particular the possibility that the Internal Control System is not functioning effectively and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Policy Development

(1) Roles and Responsibilities of Directors

Do directors attach importance to liquidity risk management, fully recognizing that the lack of such an approach could lead directly to bankruptcy in some cases? In particular, does the director in charge of liquidity risk management review the policy and specific measures for developing and establishing an adequate liquidity risk management system with a full understanding of the scope, types and nature of risks, and the techniques of identification, assessment, monitoring and control regarding liquidity risk as well as the importance of liquidity risk management, and with precise recognition of the current status of liquidity risk management within the financial institution based on such an understanding?

(2) Development and Dissemination of Liquidity Strategy

Has the Board of Directors developed a liquidity strategy consistent with the strategic objectives of the financial institution as a whole and disseminated it throughout the institution? When developing the liquidity strategy, does the Board of Directors also ensure its consistency with the strategic objectives of operational divisions, take account of the assets and liabilities structure, marketability and liquidity on a currency-by-currency basis, a product-by-product basis and a term-by-term basis as well as its capital status?

(3) Development and Dissemination of Liquidity Risk Management Policy

Has the Board of Directors established a policy regarding liquidity risk management (hereinafter referred to as the "Liquidity Risk Management Policy") and disseminated it throughout the institution? Is appropriateness of the Liquidity Risk Management Policy secured by, for example, including clear statements on the following matters?

- The roles and responsibilities of the director in charge and the Board of Directors or equivalent organization to the Board of Directors with regard to liquidity risk management
- The policy on organizational framework, such as establishment of a division concerning liquidity risk management (hereinafter referred to as the “Liquidity Risk Management Division”) and a division concerning funds management (hereinafter referred to as the “Funds Management Division) and the authority assigned thereto
- The policy on setting of liquidity risk limits
- The policy on the allocation of the roles and responsibilities of the Liquidity Risk Management Division and the Funds Management Division
- The policy on identification, assessment, monitoring, control and mitigation of liquidity risks
- The policy on liquidity crisis management

(4) Revision of Policy Development Process

Does the Board of Directors revise the policy development process in a timely manner by reviewing its effectiveness based on reports and findings on the status of liquidity risk management in a regular and timely manner or on an as needed basis?

2. Development of Internal Rules and Organizational Frameworks

(1) Development and Dissemination of Internal Rules

Does the Board of Directors or equivalent organization to the Board of Directors have the Manager of the Liquidity Risk Management Division develop internal rules that clearly specify the arrangements concerning liquidity risk management (hereinafter referred to as the “Liquidity Risk Management Rules”) and disseminate them throughout the institution in accordance with the Liquidity Risk Management Policy? Has the Board of Directors or equivalent organization to the Board of Directors approved the Liquidity Risk Management Rules after determining if they comply with the Liquidity Risk Management Policy after legal checks, etc.?

(2) Establishing of Appropriate Limits

Does the Board of Directors or equivalent organization to the Board of Directors in accordance with the Liquidity Risk Management Policy and the Liquidity Risk Management Rules, establish appropriate limits suited to the scales and natures of the institution’s business and its risk profile, financial conditions and fund-raising capacity (funding gap limits from the viewpoint of funds risk and position limits from the viewpoint of market liquidity risk)? Does the Board of Directors or equivalent organization to the Board of Directors revise the method of establishing limits and the limits established in a regular and timely manner or on an as needed basis?

(3) Establishment of Liquidity Risk Management and Funds Management Divisions

- (i) Does the Board of Directors or equivalent organization to the Board of Directors have a Liquidity Risk Management Division and a Funds Management Division established and have the divisions prepared to undertake appropriate roles in accordance with the Liquidity Risk Management Policy and the Liquidity Risk Management Rules?¹
- (ii) Has the Board of Directors allocated to the Liquidity Risk Management Division and the Funds Management Division Managers with the necessary knowledge and experience to supervise these divisions and enabled the Managers to implement management business by assigning them the necessary authority therefor?
- (iii) Has the Board of Directors or equivalent organization to the Board of Directors allocated in the Liquidity Risk Management Division and the Funds Management Division an adequate number of staff members with the necessary knowledge and experience to execute the relevant operations and assigned such staff the authority necessary for implementing the operations?²
- (iv) Does the Board of Directors or equivalent organization to the Board of Directors secure a check-and-balance system of the Liquidity Risk Management Division by ensuring its independence from the Funds Management Division, the Office (Trading, Banking) Divisions, Marketing and Sales Divisions, etc.?

(4) Development of Liquidity Risk Management System in Funds Management Division, Office (Trading, Banking) Divisions, Marketing and Sales Divisions, etc.

- (i) Does the Board of Directors or equivalent organization to the Board of Directors provide arrangements to fully disseminate the relevant internal rules and operational procedures to divisions exposed to liquidity risks subject to risk management (e.g. Funds Management Division, Office (Trading, Banking) Divisions, Marketing and Sales Divisions) and have such divisions observe them? For example, does the Board of Directors or equivalent organization to the Board of Directors instruct the Manager of the Liquidity Risk Management Division to identify the internal rules and operational procedures that should be observed by such divisions and to carry out specific measures for ensuring observance such as providing effective training

¹ When the liquidity risk management division and the funds management division are not established as independent divisions (e.g. when divisions in charge of other business also take charge of liquidity risk management and funds management operations or when Managers, instead of divisions or departments take charge of liquidity risk management and funds management), the inspector shall review whether or not such a system is sufficiently reasonable and provides the same functions as in the case of establishing independent divisions commensurate with the scales and natures of the institution and its risk profile.

² When a department or a person in a post other than those relating to the Board of Directors or equivalent organization to the Board of Directors is empowered to allocate staff and assign them authority, the inspector shall review, in light of the nature of such a department or post, whether or not the structures of the Liquidity Risk Management Division and the Funds Management Division are reasonable in terms of a check-and-balance system and other aspects.

on a regular basis?

- (ii) Does the Board of Directors or equivalent organization to the Board of Directors provide a system to ensure the effectiveness of liquidity risk management in the Funds Management Division, the Office (Trading, Banking) Divisions, Marketing and Sales Divisions, etc. through the Manager or the Liquidity Risk Management Division?

(5) System for Reporting to Board of Directors or equivalent organization to Board of Directors and Approval

Has the Board of Directors or equivalent organization to the Board of Directors appropriately specified matters that require reporting and those that require approval and does it have the Managers of the liquidity risk management and Funds Management Divisions report the current status to the Board of Directors or equivalent organization to the Board of Directors in a regular and timely manner or on an as needed basis or have the Managers seek the approval of the Board of Directors or equivalent organization to the Board of Directors on the relevant matters? In particular, does it ensure that the Managers report to the Board of Directors or equivalent organization to the Board of Directors without delay any matters that would seriously affect corporate management?

(6) System for Reporting to Corporate Auditor

In the case that the Board of Directors has specified matters to be directly reported to a corporate auditor, has it specified such matters appropriately and do they provide a system to have the Manager of the Liquidity Risk Management Division directly report such matters to the auditor?³

(7) Development of Internal Audit Guidelines and an Internal Audit Plan

Does the Board of Directors or equivalent organization to the Board of Directors have the Internal Audit Division appropriately identify the matters to be audited with regard to liquidity risk management, develop guidelines that specify the matters subject to internal audit and the audit procedure (hereinafter referred to as “Internal Audit Guidelines”) and an internal audit plan, and approve such guidelines and plan?⁴ For example, does it have the following matters clearly specified in the Internal Audit Guidelines or the internal audit plan and provide a system to have these matters appropriately audited?

- Status of development of the liquidity risk management system
- Status of compliance with the Liquidity Risk Management Policy, Liquidity Risk

³ It should be noted that this shall not preclude a corporate auditor from voluntarily seeking a report and shall not restrict the authority and activities of the auditor in any way.

⁴ The Board of Directors or equivalent organization to the Board of Directors only needs to have approved the basic matters with regard to an internal audit plan.

Management Rules, etc.

- Appropriateness of the liquidity risk management computer system⁵
- Appropriateness of the liquidity risk management processes commensurate with the scales and natures of the business and risk profile
- Validity of the methods of liquidity risk analysis and assessment and the underlying assumptions, etc.
- Validity of the method of liquidity risk measurement (technique, assumptions, etc.)(in the case where liquidity risk is measured)
- Effectiveness of the liquidity crisis management
- Status of improvement of matters pointed out in an internal audit or on the occasion of the last inspection

(8) Revision of Development Process of Internal Rules and Organizational Frameworks

Does the Board of Directors or equivalent organization to the Board of Directors revise the development process of internal rules and organizational frameworks in a timely manner by reviewing their effectiveness based on reports and findings on the status of liquidity risk management in a regular and timely manner or on an as needed basis?

3. Assessment and Improvement Activities

1) Analysis and Assessment

(1) Analysis and Assessment of Liquidity Risk Management

Does the Board of Directors or equivalent organization to the Board of Directors appropriately determine whether there are any weaknesses or problems in the liquidity risk management system and the particulars thereof, and appropriately review their causes by precisely analyzing the status of liquidity risk management and assessing the effectiveness of liquidity risk management, based on all information available regarding the status of liquidity risk management, such as the results of audits by corporate auditors, internal audits and external audits, findings of various investigations and reports from various divisions? In addition, if necessary, does it take all possible measures to find the causes by, for example, establishing fact findings committees, etc. consisting of non-interested persons?

(2) Revision of Analysis and Assessment Processes

Does the Board of Directors or equivalent organization to the Board of Directors revise the

⁵ It should be noted that the computer system may be a centralized data processing environment system, distribution processing system, or EUC (end user computing) type. The same shall apply hereafter.

analysis and assessment processes in a timely manner by reviewing their effectiveness based on reports and findings on the status of liquidity risk management in a regular and timely manner or on an a needed basis?

2) Improvement Activities

(1) Implementation of Improvements

Does the Board of Directors or equivalent organization to the Board of Directors provide a system to implement improvements in the areas of the problems and weaknesses in the liquidity risk management system identified through the analysis, assessment and review referred to in 3. 1) above in a timely and appropriate manner based on the results obtained by developing and implementing an improvement plan as required or by other appropriate methods?

(2) Progress Status of Improvement Activities

Does the Board of Directors or equivalent organization to the Board of Directors provide a system to follow up on the efforts for improvement in a timely and appropriate manner by reviewing the progress status in a regular and timely manner or on an as needed basis?

(3) Revision of Improvement Process

Does the Board of Directors or equivalent organization to the Board of Directors revise the improvement process in a timely manner by reviewing its effectiveness based on reports and findings on the status of liquidity risk management in a regular and timely manner or on an as needed basis?

II. Development and Establishment of Liquidity Risk Management System by Managers

Checkpoints

- This chapter lists the check items to be used when the inspector reviews the roles and responsibilities that must be performed by the Liquidity Risk Management and Funds Management Divisions as well as their Managers. The inspector should bear in mind that the scope of the roles and responsibilities of such divisions varies according to the scales and natures of businesses of financial institutions and their risk profile, etc. and review whether the liquidity risk management as a whole is functioning effectively.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II., it is necessary to exhaustively examine which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter 1. are not functioning appropriately and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Roles and Responsibilities of Managers of the Liquidity Risk Management Division and the Funds Management Division

(1) Development of Liquidity Risk Management Rules

Has the Manager, in accordance with the Liquidity Risk Management Policy, identified risks, decided the methods of assessment and monitoring thereof and developed the Liquidity Risk Management Rules that clearly define the arrangements on risk control and mitigation, based on a full understanding of the scope, types and nature of risk and the relevant liquidity risk management technique?

Have the Liquidity Risk Management Rules been disseminated throughout the institution upon approval by the Board of Directors or equivalent organization to the Board of Directors?

(2) Liquidity Risk Management Rules

Do the Liquidity Risk Management Rules exhaustively cover the arrangements necessary for the liquidity risk management and specify the arrangements appropriately in a manner befitting the scales and natures of the financial institution's business and its risk profile? Do the rules specify the following items, for example:

- Arrangements on the roles, responsibilities, and organizational framework of the Liquidity Risk Management Division and Funds Management Division
- Arrangements on criteria for identifying and reporting factors that may affect liquidity risks
- Arrangements on the methods of liquidity risk analysis and assessment
- Arrangements on the liquidity risk monitoring method
- Arrangements on the establishing of liquidity risk limits
- Arrangements on categorization of the urgency level of funds needs and judgment criteria
- Arrangements on the methods of management, reporting, decision-making and response with regard to the urgency level categorization of funds needs
- Arrangements on response by the financial institution as a whole in the event of a liquidity crisis
- Arrangements on reporting to the Board of Directors or equivalent organization to the Board of Directors

(3) Development of Contingency Plan for Liquidity Crisis

Does the Manager of the Liquidity Risk Management Division develop a contingency plan for a liquidity crisis in accordance with the Liquidity Risk Management Policy and the Liquidity Risk Management Rules? Does the contingency plan clearly specify the definition of a liquidity crisis, the procedures for dissemination and reporting in the event of a liquidity crisis (such as procedures for reporting directly to the representative directors), the method to respond to a liquidity crisis (securing of fund-raising instruments), the decision-making authority/the line of command, etc.? Is the contingency plan disseminated throughout the institution upon approval by the Board of Directors or equivalent organization to the Board of Directors?

(4) Development of Organizational Frameworks by Managers of the Liquidity Risk Management Division and Funds Management Division

- (i) Do the Managers of the Liquidity Risk Management Division, in accordance with the Liquidity Risk Management Policy and the Liquidity Risk Management Rules, provide for measures to have the Liquidity Risk Management Division exercise a check-and-balance system in order to conduct liquidity risk management appropriately?
- (ii) Does the Manager of the Liquidity Risk Management Division provide a system to report promptly to the Comprehensive Risk Management Division when detecting any weaknesses or

problems of the liquidity risk management system that may affect comprehensive risk management?

- (iii) Does the Manager of the Liquidity Risk Management Division provide a system to identify the risks inherent in New Products as specified in the Comprehensive Risk Management Policy, etc. in advance and report them to the Comprehensive Risk Management Division when requested to do so by the division?⁶
- (iv) Do the Managers of the Liquidity Risk Management and Funds Management Divisions identify information necessary for conducting liquidity risk management in a manner suited to the institution's risk profile, such as information concerning movements in large-lot transactions, and provide a system to obtain such information from the divisions holding it in a regular and timely manner or on an as needed basis?
- (v) Do the Managers of the Liquidity Risk Management and Funds Management Divisions have in place a liquidity risk management computer system with the high reliability suited to the scales and natures of the financial institution's business and its risk profile?
- (vi) Do the Managers of the Liquidity Risk Management and Funds Management Divisions ensure the provision of training and education to enhance the ability of employees to conduct liquidity risk management in an effective manner, thus developing human resources with relevant expertise?
- (vii) Do the Managers of the Liquidity Risk Management and Funds Management Divisions provide a system to ensure that matters specified by the Board of Directors or equivalent organization to the Board of Directors are reported in a regular and timely manner or on an as needed basis? In particular, do the Managers provide a system to ensure that matters that would seriously affect corporate management are reported to the Board of Directors or equivalent organization to the Board of Directors without delay?

(5) Revision of Liquidity Risk Management Rules and Organizational Frameworks

Do the Managers of the Liquidity Risk Management Division conduct monitoring on an ongoing basis with regard to the status of the execution of business operations at the Liquidity Risk Management Division and the Funds Management Division? Do the Managers review the effectiveness of the liquidity risk management system in a regular and timely manner or on an as needed basis, and, as necessary, revise the Liquidity Risk Management Rules and the relevant organizational framework, or present the Board of Directors or equivalent organization to the Board of Directors with proposals for improvement?

2. Roles and Responsibilities of Liquidity Risk Management Division

⁶ See "Checklist for Business Management (Governance) (for Basic Elements)," I. 3. (4).

1) Identification and Assessment of Liquidity Risks

(1) Identification of Factors that May Affect Liquidity Risks

- (i) Does the Liquidity Risk Management Division identify endogenous and exogenous factors that may affect liquidity risks? Does the division, based on an understanding that credit, market and operational risks may affect liquidity risks, identify large-lot fund movements, deterioration in the account settlement condition, a sharp market decline, and malfunctioning of the administrative processing computer system, for example, as factors that may affect liquidity risks?
- (ii) Does the Liquidity Risk Management Division identify the focus of liquidity risks and their impacts in advance when the financial institution starts the handling of New Products, purchases new products, introduces a new computer system and begins business at overseas offices and subsidiaries?

(2) Comprehensive Management of Liquidity Risks

Does the Liquidity Risk Management Division, in addition to managing liquidity risks on an office-by-office basis and a currency-by-currency basis, manage liquidity risks in an integrated manner? Does the division have a grasp on the funds status of consolidated subsidiaries that may affect the financial institution's liquidity risks?

(3) Assessment of Liquidity Risks

- (i) Does the Liquidity Risk Management Division conduct analysis and assessment of liquidity risks in a manner befitting the scales and natures of the institution's business and its risk profile? Does its assessment of liquidity risks reflect the analysis of the following items, for example?
 - Nature of various currencies handled in and outside Japan
 - Product-by-product liquidity status (market size, depth, etc)
 - Deviation of loan provision and deposit-taking plans from the actual results
 - Overall funds status of the institution as a whole and office-by-office and currency-by-currency funds status
 - Breakdown of funds raised and invested by currency, product and maturity and outstanding amounts thereof
 - Status of market-based fund-raising
 - Balances of the credit received and provided on a contract basis
 - Status of dependency on specific sources for fund procurement (concentration risk)
 - Status of dependency on the Bank of Japan for fund procurement
 - Outstanding amount of payment reserve assets

- Status of collateral management

- (ii) Does the Liquidity Risk Management Division analyze and assess liquidity risks based on two or more scenarios that take account of both endogenous and exogenous factors commensurate with the status of assets and liabilities management and the capital status?

(4) Judgment of Urgency Level of Funds Needs

Does the Liquidity Risk Management Division, in coordination with the Funds Management Division, collect and analyze information concerning internal environments such as the institution's risk profile and external environments such as the economic and market conditions and appropriately judge the current urgency level category of funds needs that should be applied to the institution?

(5) Method of Liquidity Risk Measurement

In the case where the Liquidity Risk Management Division measures liquidity risks as such and measures liquidity risks within the operational risk category, does it ensure the consistency of the measurement method (technique, assumptions, etc.) with the methods of monitoring various liquidity risks and evaluating capital buildup?

2) Monitoring

(1) Monitoring of Liquidity Risks

Does the Liquidity Risk Management Division, in accordance with the Liquidity Risk Management Policy and the Liquidity Risk Management Rules, obtain reports from the Funds Management Division, collect information concerning the internal environments such as the institution's risk profile and external environments such as the economy and the market, analyze the reports and information and monitor these conditions on an ongoing basis? Is the information examined by the division useful for liquidity risk management?

(2) Monitoring of Status of Compliance with Limits

Does the Liquidity Risk Management Division appropriately monitor the status of compliance with the funds gap limits, limits on market-based fund-raising and position limits established by the institution and the status of the use thereof?

(3) Monitoring of Appropriateness of Judgment of Urgency Level Category of Funds Needs

Does the Liquidity Risk Management Division monitor the status of various indexes used as criteria for judging the urgency level category of funds needs and the appropriateness of the criteria?

(4) Reporting to Board of Directors or equivalent organization to Board of Directors

Does the Liquidity Risk Management Division, in accordance with the Liquidity Risk Management Policy and the Liquidity Risk Management Rules, provide in a regular and timely manner or on an as needed basis information necessary for the Board of Directors or equivalent organization to the Board of Directors to make an appropriate assessment and judgment with regard to the status of the liquidity risk management and the status of the risks? Does the division report the following items, for example?

- Factors that may seriously affect liquidity risks
- External environment conditions such as the economic and market conditions
- Urgency of funds needs
- Level and trend of liquidity risk
- Status of compliance with limits and use thereof

(5) Feedback to Funds Management and The Office (Trading, Banking) Divisions

Does the Liquidity Risk Management Division feed back the results of its assessment, analysis and examination of the status of liquidity risks to the Funds Management and the Office (Trading, Banking) Divisions, etc.?

3) Control and Mitigation

(1) Response to Breach of Risk Limits

In the case where the financial institution has exceeded the funds gap limits, limits on market-based fund-raising and position limits, etc., does the Liquidity Risk Management Division provide information necessary for the Board of Directors or equivalent organization to the Board of Directors without delay to decide what measures should be taken?

(2) Response to Change in Urgency Level of Funds Needs

In the case where the urgency level category of funds needs applied to the institution changes or is likely to change, does the Liquidity Risk Management Division provide information concerning the urgency of funds needs, future prospects and other matters to the Board of Directors or equivalent organization to the Board of Directors without delay in order to enable the development of countermeasures?

(3) Securing of Funding Instruments in the Event of a Liquidity Crisis

Does the Liquidity Risk Management Division constantly keep track of the outstanding amount of assets that can be immediately sold or used as collateral in and outside Japan (e.g.

government bonds) and the amount of funds that can be raised from yen investments, yen conversions, etc. and the possible timing of such funding? Does the division also secure funding instruments in anticipation of a future liquidity crisis, for example by having the Funds Management Division obtain credit lines from central banks and commercial banks?

4) Verification and Revision

(1) Verification of Validity of Identification of Factors Affecting Liquidity Risks and Revision of Criteria for Reporting Thereof

Does the Liquidity Risk Management Division verify and revise the validity of identification of endogenous and exogenous factors that may affect liquidity risks in a regular and timely manner or on an as needed basis?

Does it review the appropriateness of the criteria for reporting of such factors in a regular and timely manner or on an as needed basis in light of internal environments such as the scales and natures of the institution's business and its risk profile as well as external environments such as market and economic conditions, and revise the criteria?

(2) Revision of Methods of Liquidity Risk Analysis and Assessment

Does the Liquidity Risk Management Division review in a regular and timely manner or on an as needed basis whether the methods of analyzing and assessing liquidity risks are suited to the scales and natures of the institution's business and its risk profile as well as external environments, and revise the methods? In particular, is it ensured that the assumptions used in analysis and assessment remains effective on an ongoing basis?

(3) Revision of Method of Establishing Limits and Limits Established

Does the Liquidity Risk Management Division review in a regular and timely manner or on an as needed basis whether the method of establishing limits and the limits established are suited to the scales and natures of the institution's business and its risk profile, financial conditions and funding capacity by conducting an impact evaluation under two or more stress scenarios and analyzing and assessing endogenous and exogenous factors that may affect liquidity risks?

When a revision is deemed as necessary, does the Liquidity Risk Management Division provide information necessary for the Board of Directors or equivalent organization to the Board of Directors without delay to make appropriate assessment and judgment?

(4) Revision of Urgency Level Category of Funds Needs and Judgment Criteria

Does the Liquidity Risk Management Division review the appropriateness of the urgency level category of funds needs, the judgment criteria and the methods of management, reporting and

decision-making in a regular and timely manner or on an as needed basis by conducting an impact evaluation under two or more stress scenarios and verifying the effectiveness of countermeasures from the following viewpoints, and conduct a revision thereof?

- Is the categorization of the urgency level of funds needs an appropriate one that takes account of specific funds statuses (e.g. “normal” “needs care,” and “crisis”) and the corresponding countermeasures?
- Does the institution ensure that the categorization judgment criteria are sufficiently specific and easy-to-understand to enable appropriate and timely action? For example, does the institution set two or more judgment criteria items such as the ratings assigned to the institution by credit rating agencies, the institution’s stock price, corporate bond spread, deposit balance trend, and extra interest cost imposed on its market-based funding and the shortening of the maturity of funds raised from the market as a way to determine the urgency level of its funds needs in an appropriate and timely manner or on an as needed basis?
- Are the methods of management, reporting and decision-making effective ones that take account of a broad range of countermeasures in terms of both assets and liabilities and enable responses suited to the urgency level of funds needs?

(5) Revision of Liquidity Crisis Contingency Plan

Does the Liquidity Risk Management Division regularly review the effectiveness of a contingency plan to be implemented in the event of a liquidity crisis by having the Funds Management Division, Marketing and Sales Division, etc. conduct crisis simulation exercises? When a need to revise the contingency plan arises due to a change in the environment surrounding the institution, does the division revise without any delay upon approval by the Board of Directors or equivalent organization to the Board of Directors (by the Board of Directors in the case of an important revision)?

3. Roles and Responsibilities of Funds Management Division

(1) Appropriate Funds Operation and Management

Does the Funds Management Division, in accordance with the liquidity strategy, the Liquidity Risk Management Policy, the Liquidity Risk Management Rules, etc., conduct appropriate funds operation based on the analysis of information collected with regard to internal environment such as the institution’s risk profile and external environment such as the economic and market environments? In its funds operations, does the division conduct liquidity assessment in terms of both assets and liabilities and comprehend the status of securing of liquidity such as the amount

of funds that can be raised and the timing thereof and the value of collateral that can be provided and the timing thereof?

(2) Compilation of Funds Timetable

Does the Funds Management Division compile a timetable of planned funds operations broken down by office and currency on daily, weekly, monthly and quarterly bases?

(3) Grasp of Impact on Funds Management

Does the funds management manage the following items so as to grasp their impact on funds management?

- Centralized control of large-lot fund movements
- Management of procurement of market-based funds
- Management of the structure of funds invested and raised broken down by product, currency and maturity
- Management of collateral
- Management of deposit maturity
- Balances of the credit received and provided on a contract basis
- Management of payment reserve assets
- Cash management (including management of ATMs)
- Currency-by-currency funds management
- Funds management with due consideration for exchanges between different currencies

(4) Grasp of Amounts of Planned Fund Investment and Possible Funding

Does the Funds Management Division, based on information from Marketing and Sales Division, etc., keep track of the amount of funds to be invested (the amount of loans and guarantees to be provided) and the amount of funds that can be raised (funds that can be raised from the interbank and open markets, deposits expected to be taken and cancelled, etc.)? Does the Funds Management Division make sure to obtain necessary reports and information from Marketing and Sales Division in a timely manner so as to accurately grasp the amounts of funds to be invested and funds that can be raised? In order to grasp these amounts, does the division give due consideration to the following items?

- Off-balance sheet transactions
- Commitment lines
- Current account overdrafts
- Grasp of actual investment maturities (e.g. in the case where funds are nominally invested for the short term but actually invested for the long term)

- Status of dependency on specific sources for fund procurement (concentration risk)
- Dependency on the Bank of Japan for fund procurement
- Urgency level of funds needs (e.g. “normal,” “needs care” and “crisis”)
- Reserves for deposit withdrawals (cash on hand, funds deposited at other institutions)

(5) Liquidity Crisis Management

Does the Funds Management Division at all times conduct funds management in light of the trading environment so as to keep the institution ready to liquidate assets smoothly in the event of a liquidity crisis through means such as the sale of securities?

(6) Control and Mitigation of Liquidity Risks

- (i) Does the Funds Management Division control liquidity risks in accordance with the liquidity strategy, the Liquidity Risk Management Policy, the Liquidity Risk Management Rules, etc.?
- (ii) Does the Funds Management Division conduct funds operations in a manner complying with the limits set?

(7) Securing of Funding Instruments in the Event of Liquidity Crisis

Does the Funds Management Division constantly keep track of the outstanding amount of assets that can be immediately sold or used as collateral in and outside Japan (e.g. government bonds) and the amount of funds that can be raised from yen investments, yen conversions, etc. and the possible timing of such funding? Does it also secure funding instruments in anticipation of a possible liquidity crisis by obtaining credit lines from central banks and commercial banks?

(8) Reporting to Liquidity Risk Management Division

Does the Funds Management Division report to the Liquidity Risk Management Division on a regular basis or as necessary according to the level of urgency the results of its analysis of information collected with regard to internal environment such as the institution’s risk profile and external environment such as the economic and market conditions as well as the current status of funds management and future prospects?

(9) Reporting to Board of Directors or equivalent organization to Board of Directors

Does the Funds Management Division report to the representative directors and the director in charge the current status of funds management and future prospects on a regular basis or as necessary according to the level of urgency? Does it also make such a report to the Board of Directors or equivalent organization to the Board of Directors in a regular and timely manner or on an as needed basis? Does the Board of Directors or equivalent organization to the Board of

Directors review whether the findings of such reports are in compliance with the Liquidity Risk Management Policy?

III. Specific Issues

Checkpoints

- This chapter lists the check items to be used when the inspector reviews specific issues particular to the actual status of liquidity risk management.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter III., it is necessary to exhaustively examine which of the elements listed in Chapters I. and II. are absent or insufficient, thus causing the said problem, with the use of the checklists in those chapters, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter 1. are not functioning appropriately and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Roles and Responsibilities of The Office (Trading, Banking) Divisions and The Marketing and Sales Divisions

(1) Investment with Due Consideration for Market Liquidity Risk

Do the Office (Trading, Banking) Divisions make investments with due consideration for the size and depth of the market and liquidity for each product? When investing in a long-term investment product for which early redemption of the contract is difficult⁷, for example, do the Office (Trading, Banking) Divisions take account of various risks (credit, market risks, etc) involved in the gap between the maturities of funds invested and raised and consider an extraordinary long-term financing plan?

(2) Reporting of Factors Affecting Liquidity Risks

In the case where a factor affecting liquidity risks and meeting the criteria for reporting arises, do the Office (Trading, Banking) Divisions and The Marketing and Sales Divisions report it

⁷ Including structured bonds and loans which require high fees and penalties in the event of an early redemption

promptly to the Liquidity Risk Management Division and the Funds Management Division in accordance with the relevant internal rules and operational procedures?

2. Roles and Responsibilities of ALM Committee, etc.⁸

(1) Development of Liquidity Strategy

- (i) Is an ALM Committee, etc., as an entity that participates in the development and implementation of the investment strategy, involved in the development of a liquidity strategy?
- (ii) Does the ALM Committee, etc., in accordance with the liquidity strategy, the Liquidity Risk Management Policy and the Liquidity Risk Management Rules, discuss the management of assets and liabilities, including long term investment for business relationships and off-balance sheet assets and liabilities, from the viewpoint of liquidity by making effective use of the findings of the analysis and examination conducted by the relevant divisions? Does the ALM Committee, etc. report its findings to the Board of Directors?

(2) Framework of ALM Committee, etc.

Is there a system to ensure that important information related to the Funds Management Division and the Office (Trading, Banking) Divisions is provided to the ALM Committee, etc. in a timely and appropriate manner? Is the definition of the important information that must be provided to the ALM Committee, etc. specified by the internal rules?

⁸ In the case where an ALM Committee, etc. is not in place, the inspector should review whether an alternative risk management process is performing necessary functions.

Checklist for Operational Risk Management

I. Development and Establishment of Comprehensive Operational Risk Management System by Management

Checkpoints

- Operational risk is the risk of loss resulting from inadequate operation processes, inadequate activities by officers and employees and inadequate systems or from external events (the type of risk included in the calculation of the capital adequacy ratio) and the risk defined by the financial institution as operational risk (the type of risk not included in the calculation of the capital adequacy ratio).
- Comprehensive Operational Risk Management refers to identification, assessment, monitoring, control and mitigation regarding operational risk in a comprehensive manner as a financial institution as a whole.
- The development and establishment of a system for comprehensive operational risk management is extremely important from the viewpoint of ensuring the soundness and appropriateness of a financial institution's business. Therefore, the institution's management is charged with and responsible for taking the initiative in developing and establishing such a system.
- When reviewing a financial institution's comprehensive operational risk management system, the inspector should examine whether the system is an appropriate one commensurate with the scales and natures of the institution's business and its risk profile as well as the levels of complexity and sophistication of the operational risk quantification (measurement) technique used by the institution (including The Basic Indicator Approach and The Standardized Approach).
It should be noted that the type and level of the operational risk quantification technique to be used by a financial institution should be determined according to the institution's strategic objectives, the diversity of its business and the level of complexity of the operational risks faced by it and therefore a complex or sophisticated operational risk quantification technique is not necessarily suited to all financial institutions.
- The inspector should determine whether the comprehensive operational risk management system is functioning effectively and whether the roles and responsibilities of the institution's management are being appropriately performed by way of reviewing, with the use of check items listed in Chapter I, whether management is appropriately implementing (1) policy development, (2) development of internal rules and organizational frameworks and (3) development of a system for assessment and improvement activities.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II.

and later, it is necessary to exhaustively examine which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.

- If the institution's management fails to recognize weaknesses or problems recognized by the inspector, it is also necessary to explore in particular the possibility that the Internal Control System is not functioning effectively and review findings thereof through dialogue.

- The inspector should review the status of improvements with regard to those issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Policy Development

(1) Roles and Responsibilities of Directors

Do directors attach importance to comprehensive operational risk management, fully recognizing that the lack of such an approach could seriously hinder attainment of strategic objectives? In particular, does the director in charge of such risk management examine the policy and specific measures for developing and establishing an adequate comprehensive operational risk management system with a full understanding of the scope, types, and nature of operational risks and the techniques of identification, assessment, monitoring and control regarding operational risks as well as the importance of comprehensive operational risk management, and with precise recognition of the current status of the comprehensive operational risk management system within the financial institution based on such understanding?

(2) Development and Dissemination of Operational Risk Management Policy

Has the Board of Directors established a policy regarding operational risk management (hereinafter referred to as the "Operational Risk Management Policy") and disseminated it throughout the institution? Is the appropriateness of the Operational Risk Management Policy being secured by way of, for example, clear statements on the following matters?

- The roles and responsibilities of the director in charge and the Board of Directors or equivalent organization to the Board of Directors with regard to comprehensive operational risk management
- The definition of operational risk at the financial institution
- The policy on organizational framework, such as establishment of a division concerning

- comprehensive operational risk management (hereinafter referred to as the “Comprehensive Operational Risk Management Division”) and the authority assigned thereto
- The policy regarding identification, assessment, monitoring, control and mitigation of operational risks

(3) Revision of the Policy Development Process

Does the Board of Directors revise the policy development process in a timely manner by reviewing its effectiveness based on reports and findings on the status of comprehensive operational risk management in a regular and timely manner or on an as needed basis?

2. Development of Internal Rules and Organizational Frameworks

(1) Development and Dissemination of Internal Rules

Does the Board of Directors or equivalent organization to the Board of Directors have the Manager of the Comprehensive Operational Risk Management Division (hereinafter simply referred to as the “Manager” in this checklist) develop internal rules that clearly specify the arrangements concerning comprehensive operational risk management (hereinafter referred to as the Operational Risk Management Rules”) and disseminate them throughout the institution in accordance with the Operational Risk Management Policy? Has the Board of Directors or equivalent organization to the Board of Directors approved the Operational Risk Management Rules after determining if they comply with the Operational Risk Management Policy after legal checks, etc.?

(2) Establishment of the System of Comprehensive Operational Risk Management Division

- 1) Does the Board of Directors or equivalent organization to the Board of Directors have a Comprehensive Operational Risk Management Division established and have the division prepared to undertake appropriate roles in accordance with the Operational Risk Management Policy and the Operational Risk Management Rules.¹
- 2) Has the Board of Directors allocated to the Comprehensive Operational Risk Management Division a Manager with the necessary knowledge and experience to supervise the division and enable the Manager to implement management operations by assigning him/her the

¹ When the Comprehensive Operational Risk Management Division is not established as an independent division (e.g., when the division is consolidated with another risk management division to form a single division or when a division in charge of other business also takes charge of comprehensive operational risk management or when a Manager or Managers take charge of comprehensive operational risk management instead of a division or a department), the inspector shall review whether or not such a system is sufficiently reasonable and provides the same functions as in the case of establishing an independent division in light of the scale and nature of the institution and its risk profile.

necessary authority therefor?

- 3) Has the Board of Directors or equivalent organization to the Board of Directors allocated to the Comprehensive Operational Risk Management Division an adequate number of staff members with the necessary knowledge and experience to execute the relevant operations and assigned such staff the authority necessary for implementing the business?²
- 4) Does the Board of Directors or equivalent organization to the Board of Directors secure a check-and-balance system of the Comprehensive Operational Risk Management Division against operational divisions?

(3) Development of Comprehensive Operational Risk Management System in Operational Divisions, Sales Branches, etc.

- 1) Does the Board of Directors or equivalent organization to the Board of Directors provide a system to fully disseminate the relevant internal rules and operational procedures to operational divisions, sales branches, etc. and have them observe the rules and operational procedures? For example, does the Board of Directors or equivalent organization to the Board of Directors instruct the Manager to identify the internal rules and operational procedures to be observed by operational divisions and sales branches and to carry out specific measures for ensuring observance such as providing effective training on a regular basis?
- 2) Does the Board of Directors or equivalent organization to the Board of Directors provide a system to ensure the effectiveness of comprehensive operational risk management in operational divisions, sales branches, etc. through the Manager or the Comprehensive Operational Risk Management Division? For example, is a person in charge of comprehensive operational risk management assigned to each operational division and sales branch for coordination with the Manager?

(4) System for Reporting to Board of Directors or equivalent organization to Board of Directors and Approval

Has the Board of Directors or equivalent organization to the Board of Directors appropriately specified matters that require reporting and those that require approval and does it have the Manager report the current status to the Board of Directors or equivalent organization to the Board of Directors in a regular and timely manner or on an as needed basis or have the Manager seek the approval of the Board of Directors or equivalent organization to the Board of Directors on the relevant matters? In particular, does it ensure that the Manager reports to the Board of

² When a department or a post other than the Board of Directors or equivalent organization to the Board of Directors is empowered to allocate staff and assign them authority, the inspector shall review, in light of the nature of such a department or post, whether or not the structure of the Comprehensive Operational Risk Management Division is reasonable in terms of a check-and-balance system and other aspects.

Directors or equivalent organization to the Board of Directors without delay any matters that would seriously affect corporate management or significantly undermine customer interests?

(5) System for Reporting to Corporate Auditor

In the case where the Board of Directors has specified matters to be directly reported to a corporate auditor, has it specified such matters appropriately and do they provide a system to have the Manager directly report such matters to the auditor?³

(6) Development of Internal Audit Guidelines and Internal Audit Plan

Does the Board of Directors or equivalent organization to the Board of Directors have the Internal Audit Division appropriately identify the matters to be audited with regard to comprehensive operational risk management, develop guidelines that specify the matters subject to internal audit and the audit procedure (hereinafter referred to as “Internal Audit Guidelines”) and an internal audit plan, and approve such guidelines and plan?⁴ For example, does it have the following matters clearly specified in the Internal Audit Guidelines or the internal audit plan and provide a system to have these matters appropriately audited?

- Status of development of the comprehensive operational risk management system
- Status of observance of the Operational Risk Management Policy, the Operational Risk Management Rules, etc.
- Appropriateness of the comprehensive operational risk management processes commensurate with the scales and natures of the business, and its risk profile
- Status of improvement of matters pointed out in an internal audit or on the occasion of the last inspection

(7) Revision of the Development Process of Internal Rules and Organizational Frameworks

Does the Board of Directors or equivalent organization to the Board of Directors revise the development process of internal rules and organizational frameworks in a timely manner by reviewing its effectiveness based on reports and findings on the status of comprehensive operational risk management in a regular and timely manner or on an as needed basis?

3. Assessment and Improvement Activities

(1) Analysis and Assessment

1) Analysis and Assessment of Comprehensive Operational Risk Management

Does the Board of Directors or equivalent organization to the Board of Directors appropriately

³ It should be noted that this shall not preclude a corporate auditor from voluntarily seeking a report and shall not restrict the authority and activities of the auditor in any way.

⁴ The Board of Directors or equivalent organization to the Board of Directors only needs to have approved the basic matters with regard to an internal audit plan.

determine whether there are any weaknesses or problems in the comprehensive operational risk management system and the particulars thereof, and appropriately review their causes by precisely analyzing the status of comprehensive operational risk management and assessing the effectiveness of comprehensive operational risk management, based on all information available regarding the status of comprehensive operational risk management, such as the results of audits by corporate auditors, internal audits and external audits, findings of various investigations and reports from various divisions? In addition, if necessary, does it take all possible measures to find the causes by, for example, establishing fact findings committees etc. consisting of non-interested persons?

2) Revision of Analysis and Assessment Processes

Does the Board of Directors or equivalent organization to the Board of Directors revise the analysis and assessment processes in a timely manner by reviewing their effectiveness based on reports and findings on the status of comprehensive operational risk management in a regular and timely manner or on an as needed basis?

(2) Improvement Activities

1) Implementation of Improvements

Does the Board of Directors or equivalent organization to the Board of Directors provide a system to implement improvements in the areas of the problems and weaknesses in the comprehensive operational risk management system identified through the analysis, assessment and examination referred to in 3. (1) above in a timely and appropriate manner based on the results obtained by developing and implementing an improvement plan as required or by other appropriate methods?

2) Progress Status of Improvement Activities

Does the Board of Directors or equivalent organization to the Board of Directors provide a system to follow up on the efforts for improvement in a timely and appropriate manner by reviewing the progress status in a regular and timely manner or on an as needed basis?

3) Revision of the Improvement Process

Does the Board of Directors or equivalent organization to the Board of Directors revise the improvement process in a timely manner by reviewing its effectiveness based on reports and findings on the status of comprehensive operational risk management in a regular and timely manner or on an as needed basis?

II. Development and Establishment of Comprehensive Operational Risk Management System by Manager

Checkpoints

- This chapter lists the check items to be used when the inspector reviews the roles and responsibilities to be performed by the Manager and the Comprehensive Operational Risk Management Division.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II., it is necessary to exhaustively examine which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter I. are not functioning appropriately and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to those issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Roles and Responsibilities of Manager

(1) Development and Dissemination of Operational Risk Management Rules

Has the Manager, in accordance with the Operational Risk Management Policy, identified the risks, decided the methods of assessment and monitoring thereof and developed the Operational Risk Management Rules that clearly define the arrangements on risk control and mitigation, based on a full understanding of the scope, types and nature of risks and the comprehensive operational risk management technique? Have the Operational Risk Management Rules been disseminated throughout the institution upon approval by the Board of Directors or equivalent organization to the Board of Directors?

(2) Operational Risk Management Rules

Do the Operational Risk Management Rules exhaustively cover the arrangements necessary for comprehensive operational risk management and specify the arrangements appropriately in a manner befitting the scales and natures of the financial institution's business, and its risk profile?

Do the rules specify the following items, for example?

- Arrangements on the roles, responsibilities and the organizational framework of the Comprehensive Operational Risk Management Division
- Arrangements on the framework for comprehensive management by the Comprehensive Operational Risk Management Division of the Administrative Risk Management Division and the Information Technology Risk Management Division (hereinafter referred to as the “Operational Risk Management Divisions”)
- Arrangements on the identification of risks to be subjected to comprehensive operational risk management
- Arrangements on the qualitative risk management technique for operational risks
- Arrangements on the scope of the quantification of operational risk and the technique thereof
- Arrangements on reporting of loss incidents to the Comprehensive Operational Risk Management Division
- Arrangements on the method of risk monitoring
- Arrangements on reporting to the Board of Directors or equivalent organization to the Board of Directors
- Arrangements on the procedures for allocating gross profit to the operation categories listed in Attachment 1 of “Criteria for Judging Whether A Financial Institution’s Capital Is Sufficient in Light of the Assets Held, etc. under the Provision of Article 14-2 of the Banking Law” (Notification No. 19 of 2006, the Financial Services Agency)” (hereinafter referred to as the “Notification”) and on the criteria for revising the procedures. This shall apply to financial institutions that use The Standardized Approach.

(3) Development of Organizational Frameworks by Manager

- 1) Does the Manager, in accordance with the Operational Risk Management Policy and the Operational Risk Management Rules, provide for measures to have the Comprehensive Operational Risk Management Division exercise a check-and-balance system in order to conduct comprehensive operational risk management system appropriately?
- 2) Does the Manager make sure to report without delay to the Comprehensive Risk Management Division when detecting any limitations or weaknesses of the comprehensive operational risk management system that may affect comprehensive risk management?
- 3) Does the Manager provide a system to identify risks inherent in New Products as specified in the Comprehensive Risk Management Policy, etc. in advance and report them to the Comprehensive Risk Management Division when requested to do so by the division?⁵

⁵ See “Checklist for Business Management (Governance) (for Basic Elements),” I. 3. (4).

- 4) Does the Manager have in place an operational risk management computer system⁶ with the high reliability suited to the scales and natures of the financial institution's business, and its risk profile?
- 5) Does the Manager ensure the system of training and education to enhance the ability of employees to conduct comprehensive operational risk management in an effective manner, thus developing human resources with relevant expertise?
- 6) Does the Manager provide a system to ensure that matters specified by the Board of Directors or equivalent organization to the Board of Directors are reported in a regular and timely manner or on an as needed basis? In particular, does the Manager provide a system to ensure that matters that would seriously affect corporate management are reported to the Board of Directors or equivalent organization to the Board of Directors without delay?

(4) Revision of Operational Risk Management Rules and Organizational Frameworks

Does the Manager conduct monitoring on an ongoing basis with regard to the status of execution of operations at the Comprehensive Operational Risk Management Division?

Does the Manager review the effectiveness of the comprehensive operational risk management system in a regular and timely manner or on an as needed basis, and, as necessary, revise the Operational Risk Management Rules and the relevant organizational frameworks or present the Board of Directors or equivalent organization to the Board of Directors with proposals for improvement?

2. Roles and Responsibilities of Comprehensive Operational Risk Management Division

(1) Risk Identification and Assessment

1) Identification of Operational Risk

- (i) Does the Comprehensive Operational Risk Management Division obtain data collected by operational divisions and sales branches, etc. as necessary to identify operational risk?
- (ii) Does the Comprehensive Operational Risk Management Division, in accordance with the Operational Risk Management Policy and the Operational Risk Management Rules, broadly specify internal and external factors that may produce adverse effects on the financial institution's business based on an understanding of the possibility that operational risk may emerge in any division or department?
- (iii) Does the Comprehensive Operational Risk Management Division identify operational risk when the financial institution starts the handling of New Products, introduces a new

⁶ It should be noted that the computer system may be a centralized data processing environment system, distribution processing system, or EUC (end user computing) type.

computer system and begins business at overseas offices and subsidiaries?

2) Operational Risk Assessment

- (i) Does the Comprehensive Operational Risk Management Division appropriately assess operational risk with the use of scores (CSA, etc.) and financial and management indicators?
- (ii) Does the Comprehensive Operational Risk Management Division analyze the causes of operational risk loss incidents during the operational risk assessment process, thus fully grasping the financial institution's operational risk?

3) Operational Risk Quantification (Measurement)

Does the Comprehensive Operational Risk Management Division quantify (measure) operational risk in a manner suited to the scales and natures of the financial institution's business, and its risk profile?

- (i) When calculating the operational risk quantity by applying weighting factors to financial indicators (gross profit, expenses, etc.) as a quantification technique, does the Comprehensive Operational Risk Management Division appropriately determine the type of indicators used and the level of weightings applied? Does the division revise the indicators used and the weightings applied in light of improvement in the level of comprehensive operational risk management, changes in internal and external environments and occurrence of significant internal losses with the use of a scoring technique?
- (ii) Does the Comprehensive Operational Risk Management Division pay attention to the check items listed in Chapter III. 2. of this checklist when using the operational risk measurement technique?

(2) Monitoring

1) Monitoring of the Operational Risk

Does the Comprehensive Operational Risk Management Division, in accordance with the Operational Risk Management Policy and the Operational Risk Management Rules, conduct monitoring with regard to the status of operational risks with an appropriate frequency in light of the financial institution's internal environment (risk profile, etc.) and external environment?

2) Reporting to Board of Directors or equivalent organization to Board of Directors

Does the Comprehensive Operational Risk Management Division, in accordance with the Operational Risk Management Policy and the Operational Risk Management Rules, report in a regular and timely manner or on an as needed basis information necessary for the Board of Directors or equivalent organization to the Board of Directors to make an appropriate

assessment and judgment with regard to the status of the comprehensive operational risk management?

3) Feedback to Operational Risk Management Divisions

Does the Comprehensive Operational Risk Management Division feed back the results of its assessment, analysis and review with regard to the status of operational risks to the relevant Operational Risk Management Divisions?

(3) Control and Mitigation

1) Operational Risk Control

Does the Comprehensive Operational Risk Management Division provide information necessary for the Board of Directors or equivalent organization to the Board of Directors to make decisions with regard to how to control the important operational risk assessed?

2) Operational Risk Mitigation

Does the Comprehensive Operational Risk Management Division pay attention to the possible occurrence of new risk when implementing measures to mitigate operational risk (including insurance contracts)?

(4) Review and Revision

Does the Comprehensive Operational Risk Management Division grasp changes in operational environment and risk profile as well as the limitations and weaknesses of the operational risk assessment method, and regularly review whether the method suits the scales and natures of the financial institution's business and its risk profile, and revise the method?

III. Specific Issues

Checkpoints

- This chapter lists the check items to be used when the inspector reviews specific issues particular to the actual status of comprehensive operational risk management.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter III., it is necessary to exhaustively examine which of the elements listed in Chapter I. and II are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter I. are not functioning appropriately and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to those issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Appropriateness of Calculation of Operational Risk Equivalent Amount

(1) Checkpoints for Institutions in Case of The Use of The Basic Indicator Approach and The Standardized Approach

Has the institution decided whether or not to exclude expenses that do not constitute outsourcing costs from services transaction expenses? In the case where such costs are excluded from services transaction expenses, has the institution developed criteria that specify expenses that do not constitute outsourcing costs? (Expenses that constitute outsourcing costs may be restrictively specified.)

(2) Checkpoints for Institutions in Case of Use of The Standardized Approach

- 1) Has the institution calculated gross profits generated from all its business without any overlap based on the procedures for allocating gross profits to the operation categories listed in Attachment 1 of the Notification?
- 2) When an allocated value for a certain business category of Attachment 1 of the Notification (a figure obtained by multiplying the allocated profit with the weighing factor applicable

according to the business category in Attachment 1 of the Notification) is a negative number, does the institution decide whether or not to offset the negative number with a positive number for another operation category? When conducting such offsetting, does the institution ensure that objective judgment can be made?

- 3) In the case where a category in the criteria used for the calculation of the credit risk asset amount and market risk equivalent amount is similar to a category in Attachment 1 of the Notification, are the two categories compatible? When that is not the case, is the reason thereof explicitly specified?
- 4) Does the institution have objective criteria for judging whether or not a certain business is attendant to business included in any of the business categories listed in Attachment 1 of the Notification? When there is a business attendant to business included in two or more of those business categories, does the institution have criteria for allocating gross profits from such a business?
- 5) In the case where gross profits from a certain business cannot be allocated to a specific business category, does the institution specify the name of the business and the reason for the inability to allocate gross profits?
- 6) Has the institution developed its criteria for allocating gross profits to two or more of the categories listed in Attachment 1 of the Notification based on financial accounting or management accounting?

2. Check Items in Case of Employment of Operational Risk Measurement Technique

(1) Establishment of Operational Risk Measurement System

- 1) Is the operational risk measurement system conceptually sound and implemented with integrity?
- 2) Is the role of the operational risk measurement technique (model) clearly positioned under the Operational Risk Management Policy and implemented based on an understanding of the items listed below, for example? Does it determine if it is implemented with integrity to consolidated Subsidiaries as well?
 - (i) The financial institution's strategic objectives, the scales and natures of its business, and its risk profile
 - (ii) The fundamental design concept of the operational risk measurement technique based on (i)
 - (iii) Identification and measurement of operational risk based on (ii) (scope, techniques, assumptions, etc.)
 - (iv) The nature (limitations and weaknesses) of the operational risk measurement technique that derives from (iii) and the validity of the technique
 - (v) Details of the method of validating (iv)

- 3) In the case where capital allocation management⁷ is employed, has the capital allocation management policy been developed based on the outcomes obtained through the calculation of the operational risk measurement technique? When there are risks which are not measured with this technique, are there any reasonable grounds for excluding them from the measurement? Is the risk capital allocated with due consideration for the risks excluded from the measurement?

(2) Appropriate Involvement of Directors and Corporate Auditors

1) Understanding of Operational Risk Measurement Technique

- (i) Do directors understand that decisions concerning the operational risk measurement technique as well as the risk limits and the risk capital limits (in the case where capital allocation management is employed) have serious implications for the financial institution's corporate management and financial conditions?
- (ii) Does the director in charge of operational risk management understand the operational risk measurement technique required for the business of the financial institution and comprehend the nature (limitations and weaknesses) thereof?
- (iii) Do directors and corporate auditors seek to enhance their understanding of the operational risk measurement technique by participating in training or through other means?

2) Approach to Comprehensive Operational Risk Management

Do directors involve themselves actively in comprehensive operational risk management based on the operational risk measurement technique?

(3) Operational Risk Measurement

1) Measurement of Operational Risk Quantity with Universal Yardstick

Does the institution grasp the operational risk quantity with the use of a uniform standard applicable to various types of operational risk? It is desirable that the uniform yardstick is used to grasp and measure all necessary operational risk elements. If there are risks that are not sufficiently grasped and measured with the uniform yardstick, does the institution ensure that all necessary elements are taken into consideration in corporate management decisions by utilizing supplementary information?

Is the measurement of the operational risk quantity conducted with a rational, objective and precise statistical technique such as a VaR method, for example?

⁷ See Checklist for Capital Management.

2) Appropriateness of Measurement Technique

In the case where the measurement technique involves calculation of the maximum loss at a certain confidence level as the operational risk quantity by processing individual operational loss incidents statistically, is attention paid to the following matters?

- Are internal loss incidents used appropriately? Are scenarios formulated based on the results of the assessment of external information and operational processes, etc. taken into consideration as loss incidents?
- Is the confidence level and holding period set by the institution appropriate?
- Is the measurement technique a rational one that appropriately covers low-frequency, large-scale loss incidents?

3) System to Review and Manage Operational Risk Measurement Technique, etc.

Is the validity of the operational risk measurement technique and the assumptions thereof, etc. verified during the development of the technique and thereafter on a regular basis by a person or persons with no involvement in the development and with sufficient capabilities? If any deficiency is recognized in the operational risk measurement technique or the assumptions thereof, is a corrective action taken appropriately?

Are there frameworks and internal rules in place to prevent the operational risk measurement technique and the assumptions thereof from being altered on unreasonable grounds, and is the operational risk measurement technique managed appropriately in accordance with the internal rules?

(4) Records on Operational Risk Measurement Technique

Is there a system to keep records, for future reference, on the review process with regard to the selection of operational risk measurement technique and the assumptions thereof and the grounds for the selection process, in order to enable a follow-up review and utilize the records to make the measurement more sophisticated and elaborated?

(5) Audit

1) Development of Auditing Program

Has the institution developed an audit program that exhaustively covers audits of the operational risk measurement technique?

2) Scope of Internal Audit

Is auditing conducted to check the following items?

- Consistency of the operational risk measurement technique with the strategic objectives, the scales and natures of the business, and the risk profile

- Appropriateness of employing the operational risk measurement technique in light of the nature (limitations and weaknesses) thereof
- Appropriate documentation of records on the operational risk measurement technique and timely updating thereof
- Appropriate reflection of any modification of the process of comprehensive operational risk management in the measurement technique
- Validity of the scope of measurement conducted with the operational risk measurement technique.
- Absence of any deficiency in the information system for the management

3) Utilization of the Results of Audits

Does the Comprehensive Operational Risk Management Division appropriately revise the operational risk measurement technique based on the results of audits?

(6) Operational Risk Measurement Model Developed by Outsourcing Contractor⁸

1) Appropriateness of Operational Risk Measurement System

- (i) Does the person in charge of operational risk measurement at the financial institution have sufficient knowledge with regard to the measurement technique and understand the modeling process of operational risk measurement?
- (ii) Do the institution's Comprehensive Operational Risk Management Division and the Internal Audit Division conduct a theoretical and empirical validate of the validity of the measurement technique?

2) Appropriateness of Operational Risk Measurement Model

- (i) Is there not any "black box" with regard to the measurement model? If there is one, has the validity of the measurement model been validated?
- (ii) Are the consistency and the accuracy of external data, internal data and scenario data secured?
- (iii) Is the measurement model selected suited to the scales and natures of the financial institution's business, and its risk profile?

3) Management of Developer of Operational Risk Measurement Model

- (i) Is the developer consigned with the development of the operational risk measurement model capable of ensuring continuous management of the model and promoting sophistication and elaboration of the model? Does the institution regularly evaluate the developer?
- (ii) Does the developer provide sufficient user support (training, consulting and maintenance) with regard to operational risk measurement?

⁸ When the operational risk measurement is outsourced, it should be reviewed by using the check items listed in this paragraph.

- (iii) Is it ensured that the developer reports to the institution on the status of its validation of the validity of the measurement model in a regular and timely manner or on an as needed basis?

3. Operational Risk Management Concerning Outsourced Business⁹

(1) Selection of Outsourcing Contractors

Before a business is outsourced, does the Comprehensive Operational Risk Management Division, in coordination with the Outsourcing Manager,¹⁰ identify the operational risk inherent in the outsourced business and ensure the business is consigned to a party capable of implementing the business aptly, fairly and efficiently after recognizing possible risk management problems related to the quality of service, the reliability of service continuity, etc.? In selecting the outsourcing contractor, does the division check the following points, for example, from the viewpoint of operational risk management?

- Is the outsourcing contractor capable of providing a sufficient level of service in terms of reasonableness as a service provided by a financial institution?
- Are the financial and corporate management conditions of the outsourcing contractor sufficient to allow it to provide service and bear possible losses in accordance with the outsourcing contract?
- Is there not any problem from the viewpoint of the reputation¹¹ of the employing financial institution?

(2) Terms of Outsourced Contract

Does the Comprehensive Operational Risk Management Division, in coordination with the Outsourcing Manager, provide for measures to make sure that the outsourced contract specifies the level of service to be provided by the outsourcing contractor and the sharing of responsibilities (e.g. the responsibility of the outsourcing contractor in the case where the service provided fails to meet the contract terms and the arrangement for sharing losses that may arise in relation to the outsourcing)

(3) Monitoring of Outsourcing Contractors

Does the Comprehensive Operational Risk Management Division provide for measures to regularly conduct monitoring with regard to the outsourced business in coordination with the

⁹ As the forms of outsourcing and the types of outsourced business are diverse, it is necessary in the review of operational risk management concerning outsourced business to review in light of the details of the outsourced business and the level of importance thereof, for the outsourcing institution, etc.

¹⁰ It should be noted that this shall not prevent the Manager of the Comprehensive Operational Risk Management Division from concurrently serving as the Outsourcing Manager.

¹¹ Including, for example, the existence of a relationship between outsourcing contractors and anti-social forces.

Outsourcing Manager?

(4) Correction of Problems

Does the Comprehensive Operational Risk Management Division provide for measures to take corrective action without delay in coordination with the Outsourcing Manager when detecting any problems?

4. Administrative Risk Management System

With regard to the administrative risk management system, see Attachment 1.

5. Information Technology Risk Management System

With regard to the information technology risk management system, see Attachment 2.

6. System for Managing Other Operational Risks

With regard to a system for managing operational risks as defined by the financial institution other than administrative risks and information technology risks (hereinafter referred to as the “Other Risk Management System”), see Attachment 3.

(Attachment 1)

I. Development and Establishment of Administrative Risk Management System by Management

Checkpoints

- Administrative risk is the risk of a financial institution incurring a loss from the neglect by officers and employees to conduct administrative work properly, accidents caused by them and violation of Laws conducted by them in the course of the administrative work process.
- The development and establishment of a system for managing administrative risks is extremely important from the viewpoint of ensuring the soundness and appropriateness of a financial institution's business. Therefore, the institution's management is charged with and responsible for taking the initiative in developing and establishing such a system.
- The inspector should determine whether the administrative risk management system is functioning effectively and whether the roles and responsibilities of the institution's management are being appropriately performed by way of reviewing, with the use of check items listed in Chapter I., whether the management is appropriately implementing (1) policy development, (2) development of internal rules and organizational frameworks and (3) development of a system for assessment and improvement activities.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II. and later, it is necessary to exhaustively examine which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize weaknesses or problems recognized by the inspector, it is also necessary to examine in particular the possibility that the Internal Control System is not functioning effectively and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to those issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Policy Development

(1) Roles and Responsibilities of Directors

Do directors attach importance to administrative risk management, fully recognizing that the lack of such an approach could seriously hinder attainment of strategic objectives? In particular, does the director in charge of administrative risk management examine the policy and specific measures for developing and establishing an adequate administrative risk management system with a full understanding of the scope, types and nature of administrative risks, and the identification, assessment, monitoring and control technique as well as the importance of administrative risk management, and with precise recognition of the current status of administrative risk management within the financial institution based on such understanding?

(2) Development and Dissemination of Administrative Risk Management Policy

Has the Board of Directors established a policy regarding administrative risk management (hereinafter referred to as the “Administrative Risk Management Policy”) and disseminated it throughout the institution? Is the appropriateness of the Administrative Risk Management Policy secured by way of, for example, clear statements on the following matters?

- The roles and responsibilities of the director in charge and the Board of Directors or equivalent organization to the Board of Directors with regard to administrative risk management
- The policy on organizational framework, such as establishment of a division concerning administrative risk management (hereinafter referred to as the “Administrative Risk Management Division”) and the authority assigned thereto
- The policy regarding identification, assessment, monitoring, control and mitigation of administrative risks

(3) Revision of the Policy Development Process

Does the Board of Directors or equivalent organization to the Board of Directors revise the policy development process in a timely manner by reviewing its effectiveness based on reports and findings on the status of administrative risk management in a regular and timely manner or on an as needed basis?

2. Development of Internal Rules and Organizational Frameworks

(1) Development of Internal Rules

Does the Board of Directors or equivalent organization to the Board of Directors have the Manager of the Administrative Risk Management Division (hereinafter simply referred to as the

“Manager” in this checklist) develop internal rules that clearly specify the arrangements concerning administrative risk management (hereinafter referred to as the “Administrative Risk Management Rules”) and disseminate them throughout the institution in accordance with the Administrative Risk Management Policy? Does the Board of Directors or equivalent organization to the Board of Directors approve the Administrative Risk Management Rules after determining if they comply with the Administrative Risk Management Policy after legal checks, etc.?

(2) Establishment of the System of Administrative Risk Management Division

- 1) Does the Board of Directors or equivalent organization to the Board of Directors have an Administrative Risk Management Division established and have the division prepared to undertake appropriate roles in accordance with the Administrative Risk Management Policy and the Administrative Risk Management Rules?¹
- 2) Has the Board of Directors allocated to the Administrative Risk Management Division a Manager with the necessary knowledge and experience to supervise the division and enable the Manager to implement management operations by assigning him/her the necessary authority therefor?
- 3) Has the Board of Directors or equivalent organization to the Board of Directors allocated to the Administrative Risk Management Division an adequate number of staff members with the necessary knowledge and experience to execute the relevant operations and assigned such staff the authority necessary for implementing operations?²
- 4) Does the Board of Directors or equivalent organization to the Board of Directors secure a check-and-balance system of the Administrative Risk Management Division against operational divisions?

(3) Development of Administrative Risk Management System in Operational Divisions and Sales Branches, etc.

- 1) Does the Board of Directors or equivalent organization to the Board of Directors provide a system to fully disseminate the relevant internal rules and operational procedures to operational divisions and sales branches, etc. and have such divisions and branches observe them? For example, does the Board of Directors or equivalent organization to the Board of Directors

¹ When the Administrative Risk Management Division is not established as an independent division (e.g., when the division is consolidated with another risk management division to form a single division or when a division in charge of other business also takes charge of administrative risk management or when a Manager or Managers take charge of administrative risk management instead of a division or a department), the inspector shall review whether or not such a system is sufficiently reasonable and provides the same functions as in the case of establishing an independent division commensurate with the scale and nature of the institution and its risk profile.

² When a department or a post other than the Board of Directors or equivalent organization to the Board of Directors is empowered to allocate staff and assign them authority, the inspector shall review, in light of the nature of such a department or post, whether or not the structure of the Administrative Risk Management Division is reasonable in terms of a check-and-balance system and other aspects.

instruct the Manager to identify the internal rules and operational procedures that should be observed by operational divisions and sales branches and to carry out specific measures for ensuring observance such as providing effective training on a regular basis?

- 2) Does the Board of Directors or equivalent organization to the Board of Directors provide a system to ensure the effectiveness of administrative risk management in operational divisions and sales branches, etc. through the Manager or the Administrative Risk Management Division?

(4) System for Reporting to Board of Directors or equivalent organization to Board of Directors and Approval

Has the Board of Directors or equivalent organization to the Board of Directors appropriately specified matters that require reporting and those that require approval and does it have the Manager report the current status to the Board of Directors or equivalent organization to the Board of Directors and the Comprehensive Operational Risk Management Division in a regular and timely manner or on an as needed basis or have the Manager seek the approval on the relevant matters? In particular, does it ensure that the Manager reports to the Board of Directors or equivalent organization to the Board of Directors and the Comprehensive Operational Risk Management Division without delay any matters that would seriously affect corporate management or significantly undermine customer interests?

(5) System for Reporting to Corporate Auditor

In the case where the Board of Directors has specified matters to be directly reported to a corporate auditor, has it specified such matters appropriately and do they provide a system to have the Manager directly report such matters to the auditor?³

(6) Development of Internal Audit Guidelines and Internal Audit Plan

Does the Board of Directors or equivalent organization to the Board of Directors have the Internal Audit Division appropriately identify the matters to be audited with regard to administrative risk management, develop guidelines that specify the matters subject to internal audit and the audit procedure (hereinafter referred to as “Internal Audit Guidelines”) and an internal audit plan, and approve such guidelines and plan?⁴ For example, does it have the following matters clearly specified in the Internal Audit Guidelines or the internal audit plan and provide a system to have these matters appropriately audited?

- Status of development of the administrative risk management system

³ It should be noted that this shall not preclude a corporate auditor from voluntarily seeking a report and shall not restrict the authority and activities of the auditor in any way.

⁴ The Board of Directors or equivalent organization to the Board of Directors only needs to have approved the basic matters with regard to an internal audit plan.

- Status of observance of the Administrative Risk Management Policy, Administrative Risk Management Rules, etc.
- Appropriateness of the administrative risk management processes commensurate with the scales and natures of the business, and the risk profile
- Status of improvement of matters pointed out in an internal audit or on the occasion of the last inspection

(7) Revision of the Development Process of Internal Rules and Organizational Frameworks

Does the Board of Directors or equivalent organization to the Board of Directors revise the development process of internal rules and organizational frameworks in a timely manner by reviewing its effectiveness based on reports and findings on the status of administrative risk management in a regular and timely manner or on an as needed basis?

3. Assessment and Improvement Activities

(1) Analysis and Assessment

1) Analysis and Assessment of Administrative Risk Management

Does the Board of Directors or equivalent organization to the Board of Directors appropriately determine whether there are any weaknesses or problems in the administrative risk management system and the particulars thereof, and appropriately examine their causes by precisely analyzing the status of administrative risk management and assessing the effectiveness of administrative risk management, based on all information available regarding the status of administrative risk management, such as the results of audits by corporate auditors, internal audits and external audits, findings of various investigations and reports from various divisions? In addition, if necessary, does it take all possible measures to find the causes by, for example, establishing fact findings committees, etc. consisting of non-interested persons?

2) Revision of the Analysis and Assessment Processes

Does the Board of Directors or equivalent organization to the Board of Directors revise the analysis and assessment processes in a timely manner by reviewing their effectiveness based on reports and findings on the status of administrative risk management in a regular and timely manner or on an as needed basis?

(2) Improvement Activities

1) Implementation of Improvements

Does the Board of Directors or equivalent organization to the Board of Directors provide a

system to implement improvements in the areas of the problems and weaknesses in the administrative risk management system identified through the analysis, assessment and examination referred to in 3. 1) above in a timely and appropriate manner based on the results obtained by developing and implementing an improvement plan as required or by other appropriate methods?

2) Progress Status of Improvement Activities

Does the Board of Directors or equivalent organization to the Board of Directors provide a system to follow up on the efforts for improvement in a timely and appropriate manner by reviewing the progress status in a regular and timely manner or on an as needed basis?

3) Revision of the Improvement Process

Does the Board of Directors or equivalent organization to the Board of Directors revise the improvement process in a timely manner by reviewing effectiveness based on reports and findings on the status of administrative risk management in a regular and timely manner or on an as needed basis?

II. Development and Establishment of Administrative Risk Management System By Manager

Checkpoints

- This chapter lists the check items to be used when the inspector reviews the roles and responsibilities to be performed by the Manager and the Administrative Risk Management Division.

- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II., it is necessary to exhaustively examine which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.

- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter I. are not functioning appropriately and review findings thereof through dialogue.

- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Roles and Responsibilities of Manager

(1) Development and Dissemination of Administrative Risk Management Rules

Has the Manager, in accordance with the Administrative Risk Management Policy, identified the risks, decided the methods of assessment and monitoring thereof and developed the Administrative Risk Management Rules that clearly define the arrangements on risk control and mitigation, based on full understanding of the scope, types and nature of risks and the administrative risk management technique?

Have the Administrative Risk Management Rules been disseminated throughout the institution upon approval by the Board of Directors or equivalent organization to the Board of Directors after confirmation by the Comprehensive Operational Management Division?

(2) Administrative Risk Management Rules

Do the Administrative Risk Management Rules exhaustively cover the arrangements necessary for the Administrative Risk management and specify the arrangements appropriately in a manner befitting the scales and natures of the financial institution's business, and its risk profile? Do the

rules specify the following items, for example?

- Arrangements on the roles, responsibilities and the organizational framework of the Administrative Risk Management Division
- Arrangements on the identification of risks to be subjected to the administrative risk management
- Arrangements on the method of the administrative risk assessment
- Arrangements on the method of risk monitoring
- Arrangements on reporting to the Board of Directors or equivalent organization to the Board of Directors and the Comprehensive Operational Risk Management Division.

(3) Development of Organizational Frameworks by Manager

- 1) Does the Manager, in accordance with the Administrative Risk Management Policy and the Administrative Risk Management Rules, provide for measures to have the Administrative Risk Management Division exercise a check-and-balance system in order to conduct administrative risk management system appropriately?
- 2) Does the Manager ensure the system of training and education to enhance the ability of employees to conduct administrative risk management in an effective manner, thus developing human resources with relevant expertise?
- 3) Does the Manager provide a system to ensure that matters specified by the Board of Directors or equivalent organization to the Board of Directors are reported to the Board of Directors or equivalent organization to the Board of Directors and the Comprehensive Operational Risk Management Division in a regular and timely manner or on an as needed basis? In particular, does the Manager provide a system to ensure that matters that would seriously affect corporate management are reported to the Board of Directors or equivalent organization to the Board of Directors and the Comprehensive Operational Risk Management Division without delay?
- 4) Does the Manager provide arrangements, in coordination with a person in charge of personnel management, etc., to ensure that employees (including Managers) stay away from the workplace for one full week on end at least once per year for purposes such as holidays, training or provisional internal transfer from the viewpoint of preventing inappropriate incidents? Does the Manager oversee such arrangements and ensure the implementation of the relevant measures?
- 5) Does the Manager, in coordination with a person in charge of personnel management, etc., ensure that personnel rotations are conducted appropriately so as to prevent a certain employee from engaging in the same business at the same department for a long period of time from the viewpoint of preventing inappropriate incidents? In the case where an employee must engage in the same business at the same department for a long period of time for an unavoidable reason,

are there other arrangements to ensure the prevention of inappropriate incidents? Does the Manager oversee such arrangements and ensure the implementation of the relevant measures?

6) With regard to contract workers, etc., does the Manager oversee personnel management with due consideration for the following points from the viewpoint of preventing inappropriate incidents?

- Is the scope of business that can be undertaken by contract workers, etc. clearly defined?
- Is there a system to ensure that personnel and labor management (including the provision of training) is conducted in light of the nature of contract workers, etc. such as a lack of personnel information concerning them compared with regular employees and the fact that a check-and-balance system functions against such workers on a daily basis?

(4) Revision of Administrative Risk Management Rules and Organizational Frameworks

Does the Manager conduct monitoring on an ongoing basis with regard to the status of the execution of operations at the Administrative Risk Management Division? Does the Manager review the effectiveness of the administrative risk management system in a regular and timely manner or on an as needed basis, and, as necessary, revise the Administrative Risk Management Rules and the relevant organizational frameworks or present the Board of Directors or equivalent organization to the Board of Directors with proposals for improvement?

2. Roles and Responsibilities of Administrative Risk Management Division⁵

(1) Roles and Responsibilities of Administrative Supervisory Division

1) Does the Administrative Supervisory Division have administrative rules in place? Are the administrative rules comprehensive, appropriately specified in accordance with Laws (including but not limited to laws and regulations, etc.) and suited to the scales and natures of the financial institution's business, and its risk profile? Do the rules stipulate matters concerning administrative work not only at sales branches, etc. but also at operational divisions?

Do the administrative rules stipulate the following items clearly and exhaustively?

- Procedures for handling of cases not covered by the administrative rules and cases where there are differences of interpretation concerning the administrative rules.
- Procedures concerning exceptional cases such as handling of cash, physical certificates, and important documents

⁵ It should be noted that the purpose of this inspection item is not to review whether or not divisions such as the Administrative Supervisory Division and the administrative guidance division have been established as administrative risk management divisions but to review whether or not the functions required for such divisions are being performed.

- 2) Does the Administrative Supervisory Division, in coordination with other relevant risk management divisions, etc. provide a system to analyze the causes of problems detected as a result of auditing, inappropriate incidents, accidents related to operational processes, complaints and inquiries, etc. and consider measures to prevent the recurrence thereof? Does the division revise and improve the administrative rules as necessary?
- 3) Does the Administrative Supervisory Division revise and improve the administrative rules as necessary according to changes in external environments such as legal amendments?
- 4) Does the Administrative Supervisory Division provide for measures to consistently check the administrative risk management system at operational divisions and sales branches, etc.?
- 5) Does the Administrative Supervisory Division provide a system to prevent the Managers of operational divisions and the heads of sales branches from concealing violation of Laws?
- 6) Has the Administrative Supervisory Division developed standards and guidelines for implementing self-inspections by operational divisions and sales branches, etc. based on the opinions of the Internal Audit Division?
- 7) Does the Administrative Supervisory Division receive reports on the results of self- inspections by operational divisions and sales branches, etc.? Does it review the effectiveness of the self-inspections?

(2) Roles and Responsibilities of Administrative Guidance Division

- 1) Does the Administrative Guidance Division provide guidance and training to ensure appropriate administrative processes at operational divisions and sales branches, etc.?
- 2) Does the Administrative Guidance Division utilize the results of auditing by the Internal Audit Division to enhance the level of administrative work at operational divisions and sales branches, etc.?
- 3) Does the Administrative Guidance Division promptly and accurately respond to inquiries from operational divisions and sales branches, etc.?

III. Specific Issues

Checkpoints

- This chapter lists the check items to be used when the inspector reviews specific issues particular to the actual status of administrative risk management.

- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter III., it is necessary to exhaustively examine which of the elements listed in Chapter I. and II are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.

- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter I. are not functioning appropriately and review findings thereof through dialogue.

- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Administrative Process System at Operational Divisions and Sales Branches, etc.

(1) Roles of Operational Division and Sales Branch Managers

Do the Managers of operational divisions and sales branches, etc.

- 1) maintain a constant grasp of administrative risks related to administrative processes?
- 2) check the status of administrative processes and compliance with the administrative rules and items involving various risks?
- 3) endeavor to prevent situations in which persons in charge of examining administrative processes and giving approval thereof fail to perform their proper functions because of excessive workloads?
- 4) have a grasp on problems related to administrative processes at the operational divisions or sales branches of which they are in charge and make improvements?
- 5) strictly handle exceptional cases in particular?
- 6) handle cases not covered by the administrative rules in a responsible manner in coordination with the Administrative Supervisory Division and the relevant operational divisions?

(2) Strict Administrative Management

- 1) Are administrative processes conducted strictly?
- 2) Is it ensured that examination and approval procedures are implemented strictly, rather than conducted formally or perfunctorily?
- 3) When accidents or inappropriate incidents involving cash occur, are they immediately communicated to the Managers of the Operational Division or sales branch and also reported to the Administrative Supervisory Division and the Internal Audit Division, etc.?
- 4) Are exceptional cases always processed upon approval from the Operational Division Managers, sales branch Managers or Managers in charge of relevant business, etc.?
- 5) When operational divisions or sales branches handle cases not covered by the administrative rules, are such cases always processed based on the instructions from the operational division or sales branch Manager in coordination with the Administrative Supervisory Division and other relevant operational divisions?

(3) Appropriateness of Self-Inspection

- 1) Are effective self-inspections conducted in a regular and timely manner or on an as needed basis by operational divisions and sales branches, etc. in accordance with the standards and guidelines for implementing such inspections in order to prevent accidents, inappropriate incidents and violation of Laws and avoid the spread of damage to customers?
- 2) Are the results of self-inspection reported in a regular and timely manner or on an as needed basis by the relevant operational divisions and sales branches to the Administrative Supervisory Division and the Internal Audit Division?
- 3) Are the results of self-inspection utilized to improve administrative work at operational divisions and sales branches?

2. Administrative Management System Concerning Market Transactions

(1) Strict Administrative Processes

Are foreign exchange, fund, securities transactions and derivatives thereof handled strictly in accordance with the internal rules and operational procedures concerning the market transactions as follows, for example?

- 1) Does the Administrative Management Division of Market-Trading have an exhaustive grasp on all transactions (e.g. final confirmation of system input, confirmation with ticket stamping and serial numbers, etc.)
- 2) Are transaction details input without delay?
- 3) Are corrections of dealing ticket errors detected in the confirmation and adjustment stages

- approved by the Manager of the Administrative Management Division of Market-Trading?
- 4) Are dealing tickets marked as pending for future processing stored and recorded appropriately?
 - 5) Is confirmation transmitted by someone other than the person responsible for the transaction?
 - 6) Are confirmations and dealing tickets checked against each other appropriately?
 - 7) Are dealing tickets, dealing sheets and confirmations kept and stored appropriately?
 - 8) Is documentary evidence such as transaction data held at the Office (Trading, Banking) division and the Administrative Management Division of Market-Trading subjected to checks by the Internal Audit Division and stored for a period specified by the internal rules and operational procedures, etc. (minimum of one year)?

(2) Check of Transaction Details and Balance, etc.

Are transaction data from the Office (Trading, Banking) Division and the Administrative Management Division of Market-Trading cross-checked? When errors are detected, are the causes examined promptly and supplementary measures taken in accordance with the prescribed methods?

For example, in securities trading, does the institution regularly (at least once per month) check positions as shown in the dealing system of the Office (Trading, Banking) Division against the securities balances on the accounts of the Back-Office Division that have been confirmed with financial instruments firms and the Custody Division, etc.?

3. Checklist for Field Inspection

- (1) This checklist provides examples of items to be checked when the inspector conducts field inspections on the status of administrative risk management of financial institutions, and it does not exhaustively cover all business of financial institutions.
- (2) In conducting field inspections on a financial institution, the inspector should not necessarily examine all of the items listed in this checklist if it has been confirmed that the Internal Audit Division of the institution is functioning effectively, because checks on the actual status of administrative processes are conducted by the division. On the other hand, if the Internal Audit Division is not functioning effectively, it is necessary to conduct more in-depth inspections with regard to items not listed in this checklist as well.
- (3) When the institution inspected has only recently begun to engage in new business and handle new products, checks should be conducted thereon even if those business and products are not covered by this checklist.
- (4) It should be noted that the purpose of this checklist is not pointing out minor administrative mistakes but reviewing the functioning of the risk management system.

Items	Details
1. Internal Operations	<p>Is attention paid to the following matters, for example, in handling of internal operations?</p> <ol style="list-style-type: none"> (1) Management of cash and physical certificates etc. <ol style="list-style-type: none"> 1) Balance management by executive personnel 2) Communication of incidents involving cash (2) Transactions treated as exceptional cases <ol style="list-style-type: none"> 1) Details of criteria for handling of exceptional cases 2) Causes of exceptional cases and records thereof 3) Approval of branch Managers or other executives and a follow-up review 4) Appropriateness of supplementary processing of exceptional cases 5) Incidents such as high frequency of exceptional cases (3) Transactions using executive keys <ol style="list-style-type: none"> 1) Checks for base-date transactions and other unusual transactions 2) Selection of important transactions requiring executive keys (4) Status of overdrafts <ol style="list-style-type: none"> 1) Determination of customers allowed overdrafts, such as customers for whom there is no settlement concern 2) Prior approval of transactions that involve financial burdens

	<ul style="list-style-type: none"> (5) Handling of documents and passbooks, etc. (6) Collection of fees, payment of costs (7) Handling of loss of certificates, passbooks, cards, etc. (status of setting of codes) (8) Management of general transfers and transfers prior to liquidation (9) Management of objects held in custody at branches (10) Management of CD cards (11) Handling of bills and checks, domestic exchange/transfer, foreign exchange (12) Items related to terrorism financing and money laundering <ul style="list-style-type: none"> 1) Review at the time of transaction, compilation and storage of records on the review at the time of transaction, storage of transaction records 2) Notification by financial institutions, etc. to the authorities with regard to suspicious transactions (Article 9, Act on Prevention of Transfer of Criminal Proceeds) 3) Concealment and receipts of criminal profits (Articles 10 and 11, Law for Punishment of Organized Crimes, Control of Crime Proceeds and other matters) (13) Status of management and adjustment of pending cases (14) Personnel management of employees
<p>2. Outside Liaison Work</p>	<p>Is attention paid to the following matters, for example, in handling of outside liaison work?</p> <ul style="list-style-type: none"> (1) Allocations of roles and job rotation for outside liaison personnel (2) Complaints and inquiries from customers (3) Delivered funds and transfer requests made via telephone (4) Issuance and collection of receipts (5) Handling of physical certificates etc. between the outside liaison division and internal administrative divisions (6) Long-term custody of cash, passbooks, and ledgers, etc. (7) Prevention of incidents at customers using cash collection service (8) Outside payments
<p>3. Deposit Business</p>	<p>Is attention paid to the following matters, for example, in handling of deposit business?</p> <ul style="list-style-type: none"> (1) Provision of information to depositors <ul style="list-style-type: none"> 1) Display of major deposit interest rates at branches 2) Fee lists for perusal in branches

	<ul style="list-style-type: none"> 3) Indication of deposit products covered by deposit insurance 4) Provision of information regarding details of the entire product lineup 5) Appropriate provision of information concerning interest rates used as a basis for setting floating deposit rates and the methods of setting fixed deposit rates when there are such interest rates and methods <p>(2) Cooperative deposits, “Buzumi-Ryodate” deposits</p> <ul style="list-style-type: none"> 1) Prevention of excessive cooperative deposits, excessive “Buzumi-Ryodate” deposits, “Buzumi” deposits, and excessive “Ryodate” deposits. 2) Measures to prevent deposit solicitation campaigns from becoming excessive 3) Due consideration for business plans that emphasize term-end figures <p>(3) “Betsudan” deposits and provisional receipts and payments</p> <p>(4) Handling of products without principal guarantee</p> <p>(5) Illegal practices such as the provision of loans tied to deposits</p>
<p>4. Lending Business</p>	<p>Is attention paid to the following matters, for example, in handling of lending business?</p> <ul style="list-style-type: none"> (1) Identity (confirmation of the intentions of the borrower, guarantor, and provider of collateral, etc.) (2) Appraisal and management of collateral property <ul style="list-style-type: none"> 1) Appropriateness of objective appraisals made by real estate appraisers or made with the use of standard values etc. and self appraisal by branches 2) Recording of data concerning collateral property and guarantee certificates, etc. on collateral ledgers, management ledgers, and the like 3) Provision and renewal of fire insurance 4) Collateral value and probability of recovering loans via collateral 5) Confirmation of intentions of joint guarantors (guarantee confirmation) (3) Loans for insurance premium payment (4) Management of progress with regard to loan applications (5) Status of handling of rejected applications (6) Credit management of large-lot borrowers and loss-making borrowers (7) Management of late repayments (8) Exclusive jurisdiction of branch Managers
<p>5. Securities Business</p>	<p>Is attention paid to the following matters, for example, in handling of securities business?</p>

	<p>(1) Over-the-counter bond sales</p> <ol style="list-style-type: none"> 1) Securing of business operations pertaining to prohibited acts such as providing false indications with regard to transactions, promoting large-volume sales of specific securities held by the institution, and acts involving the use of credit provision. 2) Development of internal rules and operational procedures that are in accordance with laws and rules such as the Financial Instruments and Exchange Act and rules set by the Japan Securities Dealers Association and the like 3) Full dissemination to all employees <p>(2) Investment trust sales</p> <ol style="list-style-type: none"> 1) Appointment of internal control supervisory Managers, sales Managers, internal control Managers, etc. 2) Securing of business operations pertaining to prohibited acts such as solicitation of investment with positive judgment statements, discretionary account trading, loss compensation, provision of additional profits, etc., based on the principles of “self responsibility” and “suitability”. 3) Development of internal rules and operational procedures that are in accordance with laws and rules such as the Financial Instruments and Exchange Act, the Law concerning Investment Trusts and Investment Corporations and rules set by the Japan Securities Dealers Association and the like. 4) Appropriate and sufficient explanation to customers of the risk of principal loss 5) Establishment of a space dedicated to direct sales and redemptions, etc. of investment trusts that is separated from spaces for other services (This shall apply to institutions lending spaces for investment trust sales) 6) Full dissemination to all employees
6. Insurance Business	<p>Is attention paid to the following matters, for example, in handling of insurance business?</p> <ol style="list-style-type: none"> (1) Establishment of the system of allocation of responsibilities such as the appointment of Managers in charge, etc. (2) Development of internal rules and operational procedures in accordance with the Insurance Business Law, etc. (3) Full dissemination to all employees (4) Securing of appropriate operations

<p>7. Other Business</p>	<ol style="list-style-type: none"> 1) Full implementation of measures to prevent inappropriate practices such as taking advantage of a superior position to offer insurance products 2) Provision of appropriate and sufficient explanation of risks, etc. involved in insurance products to customers <p>Is attention paid to the following matters, for example, in handling of other business?</p> <ol style="list-style-type: none"> (1) Derivatives products <ol style="list-style-type: none"> 1) Qualifications and product knowledge of persons selling derivatives products 2) Appropriate and sufficient explanation to customers with regard to the fact that derivative products involve the risk of principal loss, etc. 3) Status of sending and storing of market price reports (2) Commodities funds <ol style="list-style-type: none"> 1) Securing of business operations pertaining to the protection of investors, including those concerning the prohibition of practices such as lending names, lending money and mediating loans, and inappropriate solicitation. 2) Appropriate and sufficient explanation to customers with regard to the fact that derivative products involve the risk of principal loss, etc. 3) Full dissemination to all employees (3) Mortgage securities <ol style="list-style-type: none"> 1) Securing of business operations functions pertaining to rules intended to protect purchasers, including those concerning the prohibition of lending names and inappropriate solicitation 2) Appropriate and sufficient explanation to customers with regard to the details of products, including explanation of whether the contract guarantees the principal 3) Full dissemination to all employees (4) Loan cash receipts and disbursements trusts <ol style="list-style-type: none"> 1) Solicitation suited to the knowledge and experience of the customer 2) Appropriate and sufficient explanations to customers 3) Full dissemination to all employees (5) Small-lot credit sales (6) Liquidation of credits from local public bodies etc. (7) Liquidation of general loan credits (8) Loan participation (9) Foreign exchange
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	(10) Money exchange
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(Attachment 2)

I. Development and Establishment of Information Technology Risk Management System by Management

Checkpoints

- Information technology risk is the risk that a financial institution will incur loss because of a breakdown or malfunctioning of computer systems or other computer system inadequacies, or because of improper use of computer systems.
- The development and establishment of a system for information technology risk management is extremely important from the viewpoint of ensuring the soundness and appropriateness of a financial institution's business. Therefore, the institution's management is charged with and responsible for taking the initiative in developing and establishing such a system.
- The inspector should determine whether the information technology risk management system is functioning effectively and whether the roles and responsibilities of the institution's management are being appropriately performed by way of reviewing, with the use of check items listed in Chapter I., whether the management is appropriately implementing (1) policy development, (2) development of internal rules and organizational frameworks and (3) development of a system for assessment and improvement activities.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II. and later, it is necessary to exhaustively examine which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.
- If any problem is detected in the information technology risk management system and it is necessary to conduct more in-depth, detailed reviews, the inspector should refer to "Safety Standards for the Computer Systems of Financial Institutions," "the accompanying explanatory materials of Safety Standards for the Computer Systems of Financial Institutions" (edited by the Public Interest Incorporated Foundation Center For Financial Industry Information System), etc.
- The inspector should also use this checklist to examine the risk that information held by the institution that must be protected will be altered, deleted or leaked to the outside by officers and employees of the institution or outsiders.
- If the institution's management fails to recognize weaknesses or problems recognized by the inspector, it is also

necessary to explore in particular the possibility that the Internal Control System is not functioning effectively and review findings thereof through dialogue.

- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.
- The inspector should pay sufficient attention to the level of importance and nature of individual computer systems in conducting inspection of Information Technology Risk Management.
 - The level of importance of computer systems refers to the scale of effects of the systems on customer transactions and corporate management decisions.
 - The nature of computer systems refers to specific features of centralized data processing environment systems, decentralized systems such as client/server computer systems configurations, End-user systems and the like, and the suitable management technique differs according to the system type.

1. Policy Development

(1) Roles and Responsibilities of Directors

- 1) Do directors attach importance to information technology (IT) risk management (including actions for preventing problems with systems and for quick recovery upon the occurrence of problems), fully recognizing that the lack of such an approach could seriously hinder the attainment of strategic objectives?
- 2) Does the Board of Directors appoint a director in charge of managing IT systems comprehensively (the “Director in Charge of IT Systems”), fully acknowledging the importance of the IT risk? It is noted that the Director in Charge of IT risk should be able to implement his or her tasks appropriately with sufficient knowledge of and experience with IT systems.
- 3) Does the Director in Charge of IT Systems examine the policy and specific measures for developing and establishing an adequate information technology risk management system with a full understanding of the scope, types and nature of risks, and the techniques of risk identification, assessment, monitoring and control regarding information technology risk, as well as the importance of information technology risk management, and with precise recognition of the current status of information technology risk management within the financial institution based on such understanding?

(2) Clarification of Strategic Objectives

Does the Board of Directors, in light of information technology innovation, incorporate an information technology strategy in the strategic objectives as part of the financial institution's corporate management policy? Does it clearly specify the following items in the information technology strategy, for example?

- Priorities concerning computer system development
- Programs to promote efficient use of information
- Computer system investment plans

(3) Development and Dissemination of Information Technology Risk Management Policy

Has the Board of Directors established a policy regarding information technology risk management (hereinafter referred to as the "Information Technology Risk Management Policy") and disseminated it throughout the institution? Is the appropriateness of the Information Technology Risk Management Policy being secured by way of, for example, including clear statements on the following matters?

- The roles and responsibilities of the director in charge and the Board of Directors or equivalent organization to the Board of Directors with regard to information technology risk management
- The policy on organizational framework, such as establishment of a division concerning information technology risk management (hereinafter referred to as the "Information Technology Risk Management Division") and the authority assigned thereto
- The policy regarding identification, assessment, monitoring, control and mitigation of information technology risks
- The security policy (basic policy concerning the proper protection of the institution's information assets that stipulates 1) information assets to be protected, 2) reasons for protection and 3) the locus of responsibility for protection, etc.)¹

(4) Revision of the Policy Development Process

Does the Board of Directors revise the policy development process in a timely manner by reviewing its effectiveness based on reports and findings on the status of information technology

¹ - "Security policy" covers not only information stored in computer systems and recording media but also information printed on paper.

- Refer to "Handbook for Security Policy Development in Financial Institutions" (edited by the Public Interest Incorporated Foundation Center For Financial Industry Information System)

risk management in a regular and timely manner or on an as needed basis?

2. Development of Internal Rules and Organizational Frameworks

(1) Development/Dissemination of Internal Rules

Has the Board of Directors or equivalent organization to the Board of Directors had the Manager of the Information Technology Risk Management Division (hereinafter simply referred to as the “Manager” in this checklist) develop internal rules that clearly specify the arrangements concerning information technology risk management (hereinafter referred to as the “Information Technology Risk Management Rules”) and disseminated them throughout the institution in accordance with the Information Technology Risk Management Policy? Has the Board of Directors or equivalent organization to the Board of Directors approved the Information Technology Risk Management Rules after determining if they comply with the Information Technology Risk Management Policy after legal checks, etc.?

(2) Establishment of System of Information Technology Risk Management Division

- 1) Does the Board of Directors or equivalent organization to the Board of Directors have the Information Technology Risk Management Division established and have the division prepared to undertake appropriate roles in accordance with the Information Technology Risk Management Policy and the Information Technology Risk Management Rules?²
- 2) Has the Board of Directors allocated to the Information Technology Risk Management Division a Manager with the necessary knowledge and experience to supervise the division and enabled the Manager to implement management operations by assigning him/her the necessary authority therefor?
- 3) Has the Board of Directors or equivalent organization to the Board of Directors allocated to the Information Technology Risk Management Division an adequate number of staff members with the necessary knowledge and experience to execute the relevant operations and assigned such staff the authority necessary for implementing the operations?³
- 4) Does the Board of Directors or equivalent organization to the Board of Directors secure a check-

² When the Information Technology Risk Management Division is not established as an independent division (e.g., when the division is consolidated with another risk management division to form a single division or when a division in charge of other business also takes charge of information technology risk management or when a Manager or Managers take charge of information technology risk management instead of a division or a department), the inspector shall review whether or not such a system is sufficiently reasonable and provides the same functions as in the case of establishing an independent division commensurate with the scale and nature of the institution and its risk profile.

³ When a department or a post other than the Board of Directors or equivalent organization to the Board of Directors is empowered to allocate staff and assign them authority, the inspector shall review, in light of the nature of such a department or post, whether or not the structure of the Information Technology Risk Management Division is reasonable in terms of a check-and-balance system and other aspects.

and-balance system of the Information Technology Risk Management Division against operational divisions?

(3) Development of Information Technology Risk Management System in Operational Divisions, Sales Branches, etc.

- 1) Does the Board of Directors or equivalent organization to the Board of Directors provide a system to fully disseminate the relevant internal rules and operational procedures to operational divisions, sales branches, etc. and have such divisions and branches observe them? For example, does the Board of Directors or equivalent organization to the Board of Directors instruct the Manager to identify the internal rules and operational procedures that should be observed by operational divisions, sales branches, etc. and to carry out specific measures for ensuring observance such as providing effective training on a regular basis?
- 2) Does the Board of Directors or equivalent organization to the Board of Directors provide a system to ensure the effectiveness of information technology risk management in operational divisions, sales branches, etc. through the Manager or the Information Technology Division?

(4) System for Reporting to Board of Directors or equivalent organization to Board of Directors and Approval

Does the Board of Directors or equivalent organization to the Board of Directors appropriately specify matters that require reporting and those that require approval and have the Manager report the current status to the Board of Directors or equivalent organization to the Board of Directors and the Comprehensive Operational Risk Management Division in a regular and timely manner or on an as needed basis or have the Manager seek the approval on the relevant matters? In particular, does it ensure that the Manager reports to the Board of Directors or equivalent organization to the Board of Directors and the Comprehensive Operational Risk Management Division without delay any matters that would seriously affect corporate management or significantly undermine customer interests?

(5) System for Reporting to Corporate Auditor

In the case where the Board of Directors has specified matters to be directly reported to a corporate auditor, has it specified such matters appropriately and do they provide a system to have the Manager directly report such matters to the auditor?⁴

(6) Development of Internal Audit Guidelines and an Internal Audit Plan

⁴ It should be noted that this shall not preclude a corporate auditor from voluntarily seeking a report and shall not restrict the authority and activities of the auditor in any way.

Does the Board of Directors or equivalent organization to the Board of Directors have the Internal Audit Division appropriately identify the matters to be audited with regard to information technology risk management, develop guidelines that specify the matters subject to internal audit and the audit procedure (hereinafter referred to as “Internal Audit Guidelines”) and an internal audit plan, and approve such guidelines and plan? ⁵For example, does it have the following matters clearly specified in the Internal Audit Guidelines or the internal audit plan and provide a system to have these matters appropriately audited?

- Status of development of the information technology risk management system
- Status of observance of the Information Technology Risk Management Policy, the Information Technology Risk Management Rules, etc.
- Appropriateness of the information technology risk management processes commensurate with the scales and natures of the business and risk profile
- Status of improvement of matters pointed out in an internal audit or on the occasion of the last inspection

(7) Revision of the Development Process of Internal Rules and Organizational Frameworks

Does the Board of Directors or equivalent organization to the Board of Directors revise the development process of internal rules and organizational frameworks in a timely manner by reviewing its effectiveness based on reports and findings on the status of information technology risk management in a regular and timely manner or on an as needed basis?

3. Assessment and Improvement Activities

(1) Analysis and Assessment

1) Analysis and Assessment of Information Technology Risk Management

Does the Board of Directors or equivalent organization to the Board of Directors appropriately determine whether there are any weaknesses or problems in the information technology risk management system and the particulars thereof, and appropriately examine their causes by precisely analyzing the status of information technology risk management and assessing the effectiveness of information technology risk management, based on all information available regarding the status of information technology risk management, such as the results of audits by corporate auditors, internal audits and external audits, findings of various investigations and reports from various divisions? In addition, if necessary, does it take all possible measures to find the causes by, for example, establishing fact findings committees etc. consisting of non-

⁵ The Board of Directors or equivalent organization to the Board of Directors only needs to have approved the basic matters with regard to an internal audit plan.

interested persons?

2) Revision of the Analysis and Assessment Processes

Does the Board of Directors or equivalent organization to the Board of Directors revise the analysis and assessment processes in a timely manner by reviewing their effectiveness based on reports and findings on the status of information technology risk management in a regular and timely manner or on an as needed basis?

(2) Improvement Activities

1) Implementation of Improvements

Does the Board of Directors or equivalent organization to the Board of Directors provide a system to implement improvements in the areas of the problems and weaknesses in the information technology risk management system identified through the analysis, assessment and examination referred to in 3. (1) above in a timely and appropriate manner based on the results obtained by developing and implementing an improvement plan as required or by other appropriate methods?

2) Progress Status of Improvement Activities

Does the Board of Directors or equivalent organization to the Board of Directors provide a system to follow up on the efforts for improvement in a timely and appropriate manner by reviewing the progress status in a regular and timely manner or on an as needed basis?

3) Revision of the Improvement Process

Does the Board of Directors or equivalent organization to the Board of Directors revise the improvement process in a timely manner by reviewing its effectiveness based on reports and findings on the status of information technology risk management in a regular and timely manner or on an as needed basis?

II. Development and Establishment of Information Technology Risk Management System by

Manager

Checkpoints

- This chapter lists the check items to be used when the inspector reviews the roles and responsibilities to be performed by the Manager and the Information Technology Risk Management Division.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter II., it is necessary to exhaustively examine which of the elements listed in Chapter I. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter I. are not functioning appropriately and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Roles and Responsibilities of Manager

(1) Development and Dissemination of Information Technology Risk Management Rules

Has the Manager, in accordance with the Information Technology Risk Management Policy, identified the risks, decided the methods of assessment and monitoring thereof and developed the Information Technology Risk Management Rules that clearly define the arrangements on risk control and mitigation, based on a full understanding of the scope, types and nature of risks and the technique of managing information technology risk? Have the Information Technology Risk Management Rules been disseminated throughout the institution upon approval from the Board of Directors or equivalent organization to the Board of Directors after confirmation by the Comprehensive Operational Risk Management Division?

(2) Information Technology Risk Management Rules

Do the Information Technology Risk Management Rules exhaustively cover the arrangements necessary for information technology risk management and specify the arrangements

appropriately in a manner befitting the scales and natures of the financial institution's business, and its risk profile. Do the rules specify the following items, for example?

- Arrangements on the roles, responsibilities and organizational framework of the Information Technology Risk Management Division
- Arrangements on the identification of risks to be subject to the information technology risk management
- Arrangements on the method of assessing information technology risks
- Arrangements on the method of monitoring information technology risks
- Arrangements on system to report to the Board of Directors or equivalent organization to the Board of Directors and the Comprehensive Operational Risk Management Division

(3) Development of Organizational Frameworks by Manager

- 1) Does the Manager, in accordance with the Information Technology Risk Management Policy and the Information Technology Risk Management Rules, provide for measures to have the Information Technology Risk Management Division exercise a check-and-balance system in order to conduct information technology risk management appropriately?
- 2) Does the Manager ensure the system of training and education to enhance the ability of employees to conduct information technology risk management in an effective manner, thus developing human resources with relevant expertise?
- 3) Does the Manager provide a system to ensure that matters specified by the Board of Directors or equivalent organization to the Board of Directors are reported to the Board of Directors or equivalent organization to the Board of Directors and the Comprehensive Operational Risk Management Division in a regular and timely manner or on an as needed basis? In particular, does the Manager provide a system to ensure that matters that would seriously affect corporate management are reported to the Board of Directors or equivalent organization to the Board of Directors and the Comprehensive Operational Risk Management Division without delay?
- 4) Has the Manager assigned a security Manager responsible for overseeing appropriate management to ensure that security is maintained in accordance with the prescribed policies, standards and procedures and assigned the security Manager the authority necessary for implementing management business?
- 5) Has the Manager, with a view to securing safe and smooth operation of computer systems and the prevention of violation of Laws, specified the procedures for computer system management, assigned a computer system Manager responsible for ensuring appropriate system management and assigned the said Manager the authority necessary for implementing management operations? Has the Manager also assigned system Managers with regard to systems designed, developed and operated by user divisions on their own, such as an end-user

computing (EUC) system? It is desirable that a system Manager be assigned to all systems and operations.

- 6) Has the Manager assigned a data Manager responsible for securing the confidentiality, completeness and usability of data and assigned the data Manager the authority necessary for implementing management operations?
- 7) Has the Manager assigned a network Manager responsible for overseeing the status of network operation and controlling and monitoring access and assigned the network Manager the authority necessary for implementing management operations?

(4) Revision of Information Technology Risk Management Rules and Organizational Frameworks

Does the Manager conduct monitoring on an ongoing basis with regard to the status of the execution of operations at the Information Technology Risk Management Division? Does the Manager review the effectiveness of the information technology risk management system in a regular and timely manner or on an as needed basis, and, as necessary, revise the Information Technology Risk Management Rules and the relevant organizational framework or present the Board of Directors or equivalent organization to the Board of Directors with proposals for improvement?

2. Roles and Responsibilities of Information Technology Risk Management Division

(1) Awareness and Assessment of Information Technology Risk

- 1) Is the Information Technology Risk Management Division aware of risks common to computer systems in general, and does it conduct assessments thereof, including an assessment of risks involved in various systems for different operational functions, such as the accounting system, information support system, external settlement system, securities system, and international system?
- 2) Is the Information Technology Risk Management Division aware of risks concerning computer systems developed by user divisions on their own such as an EUC system, and has it assessed the risks?
- 3) Does the Information Technology Risk Management Division acknowledge and assess risks periodically or as required, considering the increasing variety of risks caused by the large-volume transactions as a result of the change in external environment such as the diversification of channels to access customers, the expansion of networks, and the increased complexity and areas affected by the system problems?
- 4) Does the Information Technology Risk Management Division acknowledge and assess risks

as to the processing capability of relevant systems, for example, by capturing the system limit such as the maximum number of transactions unrecorded on the bankbook that the system can hold per account?

- 5) Does the Information Technology Risk Management Division acknowledge and assess risks as to the related systems upon the introduction of new products or the modification of product details, regardless of the development of new systems?
- 6) Is the Information Technology Risk Management Division aware of risks involved in transactions conducted over the Internet, and does it understand the scope of the risks and assessed the risks? For example, is the division aware of the risk that problems related to the absence of face-to-face contact, troubleshooting, and involvement of third parties, etc. may arise and has it assessed the risk?

(2) Monitoring of IT Risks

- 1) Does the Information Technology Risk Management Division conduct monitoring with regard to the status of information technology risks of the financial institution with an appropriate frequency in light of the external environment as well as the internal environment of the financial institution (risk profile, etc.) in accordance with the Information Technology Risk Management Policy and the Information Technology Risk Management Rules, etc.?
- 2) Does the Information Technology Risk Management Division, in accordance with the Information Technology Risk Management Policy and the Information Technology Risk Management Rules, etc., provide information necessary for the Board of Directors, etc., and the division managing the operational risk comprehensively to make appropriate assessments and decisions with regard to the status of information technology risks in a regular and timely manner or on an as needed basis?

(3) Controlling and Reducing IT Risks

1) Controlling IT Risks

Does the Information Technology Risk Management Division consider the system and administrative measures against the risks that the performance variables will go beyond the limit set out under the existing systems? Does the division provide sufficient information so that the Board of Directors, etc., are able to make decision on the methods for controlling important risks identified through the assessment?

2) Reducing IT Risks

Does the Information Technology Management Division pay attention to the possibility of new risks when implementing measures for IT risk reduction?

(4) Review and Revision

Does the Information Technology Risk Management Division regularly review whether the information technology risk management method is suited to the scales and natures of the financial institution's business, and its risk profile, and revise the method, taking into account the change in its business environment and risk profile?

III. Specific Issues

Checkpoints

- This chapter lists the check items to be used when the inspector reviews specific issues particular to the actual status of information technology risk management.
- If any problem is recognized as a result of reviews conducted with the use of the check items listed in Chapter III., it is necessary to exhaustively examine which of the elements listed in Chapter I. and II. are absent or insufficient, thus causing the said problem, and review findings thereof through dialogue between the inspector and the financial institution.
- If the institution's management fails to recognize problems recognized by the inspector, it is also necessary to strictly explore in particular the possibility that the systems and processes listed in Chapter I. are not functioning appropriately and review findings thereof through dialogue.
- The inspector should review the status of improvements with regard to the issues pointed out on the occasion of the last inspection that are not minor and determine whether or not effective improvement measures have been developed and implemented.

1. Information Security Management

(1) Roles and Responsibilities of Security Manager, etc.

1) Roles and Responsibilities of Security Manager

- (i) Does the security Manager oversee security related to all the following areas: system planning, development, operation, and maintenance?
- (ii) Does the security Manager report security problems related to serious system malfunctioning, accidents and crime, etc. to the Information Technology Risk Management Division?
- (iii) Does the security Manager ensure security with regard to the following items, for example?
 - a. Physical security
 - Measures to prevent physical intrusion and crime prevention equipment
 - Enhancement of computer operation environment
 - System for maintenance and inspection of equipment, etc.
 - b. Logical security
 - The check-and-balance between the divisions involved in system development and operation and within each division

- System for development management
 - Measures to prevent electronic intrusion
 - Program management
 - Response to system problems
 - Assessment and management of outside software packages at the time of introduction
 - Operational security management, etc.
- (iv) Does the security Manager supervise security matters related to system, data and network management?

2) Roles and Responsibilities of System Manager

- (i) Does the system Manager regularly inspect computer system assets and make appropriate adjustments by procuring new assets and disposing of unnecessary ones?
- (ii) Does the system Manager conduct appropriate and sufficient management with regard to all facilities and equipment installed at operational divisions, sales branches, etc. and computer centers?
- (iii) Does the system Manager conduct appropriate and sufficient management with regard to computers used outside the premises of the institution?

3) Roles and Responsibilities of Data Manager

- (i) Does the data Manager ensure safe and smooth management of data by specifying procedures for data management and approval of data use, etc. as part of the internal rules and operational procedures and the like and fully disseminating them to relevant parties?
- (ii) Does the data Manager conduct appropriate and sufficient management to ensure protection of data and prevention of unauthorized use of data?

4) Roles and Responsibilities of Network Manager

- (i) Does the network Manager ensure appropriate, efficient and safe network operation by specifying procedures for network management and approval of network use, etc. as part of the internal rules and operational procedures and the like and fully disseminating them to relevant parties?
- (ii) Does the network Manager have in place measures to provide a backup in the event of a network breakdown?

(2) Prevention of Unauthorized Use

- 1) Does the institution have in place a system to review the authenticity of the user or the computer terminal connected with the computer system in a manner suited to the nature of the

relevant business and the connection method in order to prevent unauthorized use?

- 2) Does the institution regularly obtain records of system operations as evidence for future audits and regularly check them in order to keep surveillance on the status of unauthorized access?
- 3) Does the institution specify the methods of establishing and managing the rights to the use of computer terminals and access to data and files in light of the level of importance thereof?

(3) Computer Viruses, etc.

Does the institution provide for a system to prevent the intrusion of computer viruses and other unauthorized programs and promptly detect such an intrusion if any and remove the intruding program?

- Infection with computer viruses
- Registry of programs that have not undergone legitimate procedures
- Intentional alteration of legitimate programs

(4) Management of Transactions Conducted over Internet

- 1) Does the institution provide a system to accept complaints and consultations from customers?
- 2) Does the institution have in place a supplementary system in case a system breakdown or malfunctioning makes appropriate processing impossible? Is the allocation of responsibilities in the event of a system breakdown specified?
- 3) Does the institution provide countermeasures to prevent misrecognition of the service provider that may arise from Web site links, etc.?
- 4) Does the institution disclose, on its Web site, for example, information concerning details of its financial conditions and business as well as details of the services provided through transactions conducted over the Internet?
- 5) Does the institution review customer identification at the time of transaction from the viewpoint of preventing money laundering?
- 6) Does the institution provide a system to prevent leakage of customer information and alteration etc. thereof, etc. attempted by intruding outsiders and insiders using unauthorized access?
- 7) Does the institution, in light of the fact that transactions conducted over the Internet involve no face-to-face contact, store records on transactions with customers for a certain period of time as necessary without alteration or deletion?
- 8) Does the institution protect customers against unauthorized use by providing the function of allowing them to check the status of their own use?
- 9) Does the institution seek to prevent phishing in a manner befitting its business, by, for example, providing for measures to allow users to review the authenticity of the Web site accessed?

(5) Measures to Cope with Forged or Stolen Cash Cards

- 1) Does the institution assess the security level of the ATM system, etc. according to a prescribed standard in order to prevent use of forged or stolen cash cards? Does the institution take appropriate measures after considering what to do in terms of organizational and technical aspects based on the security level assessment?
- 2) Does the institution provide for measures to prevent unauthorized withdrawals, such as adopting an appropriate identification technology and installing information systems equipped with the function of preventing information leakage?
- 3) Does the institution make sure to take appropriate measures when abnormal transactions are detected by establishing criteria for abnormal transactions and specifying how to respond to such transactions?

2. System Planning, Development and Operation, etc.

(1) System of Mutual Check and Balance between System Development and Operation Divisions

Does the institution have system development and operation divisions established separately with separate responsibilities in order to prevent personal mistakes and malicious acts? In the case where it is difficult to establish clearly separate divisions for system development and operation due to the lack of a sufficient number of staff members, does the institution seek to introduce a check-and-balance system by rotating persons in charge of system development and operation regularly, for example? With regard to EUC and other systems for which organizational division of system development and operation is difficult, does the institution use the Internal Audit Division, etc. to exercise check and balance?

(2) System of System Planning and Development

1) Planning and Development System

- (i) Does the institution have in place internal rules and operational procedures with regard to system planning and development with a view to introducing highly reliable and efficient systems?
- (ii) Does the institution establish a cross-divisional examination organization, such as computerization committees, and conduct deliberations when engaging in system planning and development, for example?
- (iii) Does the institution have medium and long-term development plans in place?
- (iv) Does the financial institution continuously make efforts to identify risks inherent to the

existing systems and invest in maintenance and improvement?

- (v) Does the Board of Directors receive information concerning deliberations on effects of investment in each system as necessary according to the level of the importance of the relevant system? (The Board of Directors should always receive reports concerning deliberations on effects of investment in the system division as a whole.)
- (vi) Does the institution have clear rules for approval of the planning, development and shift of system development projects?
- (vii) Is a revision of a product system implemented upon approval?

2) Development Management

- (i) Is the method of documentation and programming related to system development standardized?
- (ii) Is a Manager assigned for each development project, and do the Board of Directors and the division managing the operational risks comprehensively check the progress status in light of the level of importance and nature of the relevant system?

3) Development of Internal Rules and Operational Procedures, etc.

- (i) Does the institution develop internal rules and operational procedures, etc. concerning system design, development and operation and does it revise the rules and operational procedures in a manner befitting its actual operating conditions?
- (ii) Does the institution establish standard documentation rules concerning system design plans, and does it compile documents in accordance with the rules?
- (iii) Do the computer systems developed leave auditing trails (journals and other records that allow tracing of the processing history) according to the purpose of the use, etc.?
- (iv) Are manuals and documents related to development compiled in ways that can be easily understood by third parties with relevant expertise?

4) Tests, etc.

- (i) Is appropriate and sufficient testing conducted according to testing plans?
- (ii) Is a system for testing structured in a way to prevent inadequate tests and reviews that would cause problems with long-lasting effects on customers or serious miscalculations in risk management-related documents and materials that are used for corporate management decision-making?
- (iii) Is general testing conducted appropriately, with involvement of user divisions, for example?
- (iv) Is acceptance made by executives and employees with sufficient knowledge?

5) Decision on System Transition

- (i) Does the institution have a Manager assigned with clear responsibility for system transition?
- (ii) Does the institution develop system transition plans? Has it assigned clear roles and responsibilities to the system development and operation, user divisions, etc.?
- (iii) Does the institution have criteria for judgments with regard to system transition and make decisions based on them?

6) Post-System Transition Review

- (i) Does the institution conduct a post-system transition review after a certain period from the start of operation?
- (ii) Does the institution conduct examination and assessment with regard to the fulfillment of the user requirements and the cost-effectiveness in the post-system transition review?
- (iii) Are the results of the post-system transition review reflected in future improvement plans for the relevant system?
- (iv) Are the results of the post-system transition review reported to the Managers of the system development division and user divisions, etc?
- (v) Does the institution have user divisions conduct sample checks as necessary after new products and arrangements are introduced?

7) Human Resource Development

Does the financial institution develop/implement specific plans for the succession of the mechanisms and the development technologies of the existing systems and for the development of human resource with relevant expertise? Does the institution provide training in ways to nurture staff adept not only in technology but also in the function skills for which system development is conducted? Does it train staff adept in derivatives, electronic payments, electronic transactions and other areas requiring high degrees of specialization, as well as in new technologies, for example?

(3) System of System Operation Framework

1) Clarification of Separation of Responsibilities

- (i) Does the institution clearly separate responsibilities for system data reception, operation, operation results review, and data and program storage?
- (ii) Does the institution ban system operators from accessing data and programs outside of their areas of responsibility?

2) System Operation Management

- (i) Are regular operations implemented based on work schedules, instructions, etc.?

- (ii) Are operations implemented based on approved work schedules, instructions, etc?
- (iii) Are all operations recorded, and does the Manager of the system operation division check them with the use of prescribed checklists?
- (iv) Does the institution have important operations conducted by two or more persons? Are operations automated as much as possible?
- (v) Does the institution provide arrangements to prepare report outputs and obtain and keep work histories so as to enable the Manager of the system operation division to check the results of operation processes?
- (vi) Does the institution in principle ban system developers from accessing operations? When a developer must access operations for reasons such as system problems, does the institution ensure that the Manager of the relevant operation verifies the identity of the developer and conducts follow-up inspections of the access records?

3) Product Data Management

- (i) Does the institution specified the policy and procedures concerning the provision of product data for use in system testing?
- (ii) Is management of product data provided for use in system testing conducted appropriately, in accordance with the policy and procedures specified by the institution?

4) System Problem Management

- (i) Does the institution develop a framework to ensure that the Information Technology Risk Management Division and other relevant divisions promptly work together to resolve issues in the event of major system problems that may seriously affect corporate management and report to the Board of Directors, etc., and to the division managing the operational risks comprehensively? Further, does the financial institution establish a procedure that requires the reporting of maximum possible risks, etc., not minimum possible risks (for example, a requirement to report the maximum possible impacts of an event if such event will likely impact the customer's position materially)?
- (ii) In preparation for the occurrence of a system problem, does the financial institution establish a framework to take necessary actions assuming the worst case scenario?
- (iii) Does the financial institution make clear the methods/details for providing information to the related departments and for handling customers appropriately in the case of system problem?
- (iv) In the case of a system problem, does the financial institution establish a clear chain of command covering outsourcing contractors? Additionally, does the financial institution establish a clear support system such as advance registration of human resources to

promptly acquire supporting human resources with knowhow and experience both internally (within/outside the IT system division) and externally, including outsourcing contractors?

- (v) Has the financial institution set up a framework for record-keeping and reporting to the Information Technology Management Division based on the internal rules and operational procedures upon the occurrence of a system problem?
- (vi) Does the institution establish a system to ensure that problems occurring at the outsourcing contractor consigned with system operation are reported to the institution?
- (vii) Does the financial institution periodically analyze the details of a system problem that has occurred and take appropriate actions?
- (viii) Does the financial institution have a mechanism in the system such as routing the part with a problem in order to minimize the effects of the system problem?

(4) System Audit

- 1) Does the Internal Audit Division independent from the system division regularly conduct a system audit?
- 2) Does the financial institution implement an internal audit by the staff adept in system-related matters and utilize an external audit by system audit firms, etc?

3. Crime Prevention, Back-up and Prevention of Unauthorized Use

(1) Crime Prevention

- 1) Does the institution have an anti-crime organization and have a Manager with clear responsibility thereof?
- 2) Does the institution exercise appropriate and sufficient supervision over entry into and exit from work areas, handling of important keys, etc. in order to prevent acts that may threaten the safety of computer systems?

(2) Computer Crimes and Accidents

Does the institution provide a system to ensure that sufficient attention is paid to the risk of computer crimes and accidents (intrusion of unauthorized programs such as viruses, destruction of CDs/ATMs and cash theft therefrom, card fraud, theft of information by outsiders, leakage of information by insiders, hardware problems, software problems, operation errors, transmission line failures, power outages, external computer failures etc.) and that follow-up checks such as inspections are conducted?

(3) Disaster Mitigation

- 1) Does the institution have a disaster mitigation organization in place to mitigate damage and help continue business in the event of disaster and have a Manager assigned with clear responsibility thereof?
- 2) When there is a disaster-mitigation organization, is it organized along the line of the institution's business and is there a Manager with clear responsibility for all business categories?
- 3) Does the institution have measures in place to cope with fire, earthquakes, and flooding?
- 4) Does the institution have prescribed emergency evacuation areas for important data etc.?

(4) Back-up

- 1) Does the institution create back-ups to prepare for damage to and failure of important data files and programs and have a management method thereof specified?
- 2) Does the institution take care to ensure decentralized storage and remote-location storage with regard to the back-ups created?
- 3) Does the institution document its back-up cycle?
- 4) With regard to the systems that are material to the business operation, does the financial institution establish a framework for continuing business smoothly in the event of a disaster, system problem, etc., by setting up an off-site backup system in advance?

(5) Development of Contingency Plan

- 1) Does the institution have contingency plans in place to prepare for malfunctioning of computers systems due to disaster and other events? In addition, are the specific roles, responsibilities, and required actions of the directors identified? Does the institution implement training to ensure that directors can take a leading role and fulfill such roles and responsibilities effectively?
- 2) Does the institution seek approval of the Board of Directors when it develops contingency plans or conduct important revisions of the plans? (Does it seek the approval of the Board of Directors or equivalent organization to the Board of Directors for other, less important revisions?)
- 3) Does the institution refer to the "Handbook for Contingency Planning in Financial Institutions" (edited by the Public Interest Incorporated Foundation Center for Financial Industry Information System) when developing contingency plans?
- 4) When developing contingency plans, does the institution assume not only emergencies arising from disasters but also system problems from other factors, etc., within and outside the institution? Further, does the financial institution consider sufficient risk scenarios including

substantial delays in batch processing?

- 5) When developing contingency plans, does the institution analyze possible effects on the settlement systems and possible damage to customers?
- 6) Does the institution review the assumed scenario in its contingency plans as necessary, considering the cases of system problems at other financial institutions and the results of discussion at the Central Conference for Disaster Prevention, etc.?
- 7) Is training based on the contingency plan conducted periodically on a company-wide basis and jointly with outsourcing contractors, etc., including the outsourcing center, etc., who are contracted with multiple financial institutions?

4. Management of Outsourcing Contractors⁶

(1) Management of Outsourced Operation

1) Selection of Outsourcing Contractors

Does the Information Technology Risk Management Division,⁷ in coordination with the staff in charge at the outsourcing contractor, identify the system risk inherent to the outsourced operation, acknowledge issues in managing risk such as the quality of the outsourcing service and the certainty as to the contractor's ability to continue providing the outsourcing service, thereby taking measures for contracting with an outsourcing contractor that is capable of fulfilling the outsourcing contract accurately, fairly and efficiently? When selecting an outsourcing contractor, does the financial institution pay attention to the points from the viewpoint of IT risk management as listed below?

- Whether the outsourcing contractor is able to provide an adequate level of services from the perspective of rationality of the financial institution
- Whether the financial/management condition of the contractor is at a satisfactory level for providing outsourcing services in line with the contract and for indemnifying for potential loss and damages adequately
- Whether there is any issue in entering into contract from the viewpoint of the financial institution's reputation, etc.⁸

2) Details of Outsourcing Contract

Does the Information Technology Risk Management Division,⁷ in cooperation with the

⁶ There are various types of outsourcing contract and business outsourced. Thus, the review for this item should be performed considering the business outsourced and the importance of such business to the financial institution.

⁷ This is not intended to interfere with the management under the comprehensive operational risk management division.

⁸ For example, include the existence of a relationship between the outsourcing contractor and anti-social forces.

outsourcing contractor, take measures to review whether the outsourcing contract include provisions as to the level of service, the sharing of roles/responsibilities between the financial institution and the outsourcing contractor (e.g., the responsibility of the outsourcing contractor when the service is not provided in line with the outsourcing contract, or the responsibility for indemnifying for potential loss/damage in relation to the outsourcing contract), the audit right, and the procedure for re-commissioning?

3) Monitoring of Outsourcing Contractors

Does the Information Technology Risk Management Division,⁷ as the consigner of the outsourcing contract, implement necessary measures such as sending its own staff to the contractor to periodically monitor whether the contractor is fulfilling the outsourced operation appropriately in coordination with the person in charge at the outsourcing contractor? Does the division establish a framework to receive reporting as to the status of internal control, development, operation management of the outsourcing center undertaking the outsourcing from a multiple number of financial institutions?

Further, given the progress of system sharing, etc., is there a framework whereby the consigner under the outsourcing contract can monitor and follow up the customer data management conducted by the outsourcing contractor?

4) Audit of Outsourcing Contractor

Are the important outsourcing contractors, such as an outsourcing center contracted by a multiple number of financial institutions, audited by the internal audit division or system audit firms, etc.?

5) Resolving Issues

Does the Information Technology Risk Management Division,⁷ in coordination with the outsourcing contractor, promptly resolve issues in the event that problems, etc., are identified?

(2) Review at System-Related Outsourcing Contractor

- 1) Is the outsourcing contractor aware of information technology risk with regard to the system in its entirety for which it has begun operations and does it assess the risk?
- 2) Does the outsourcing contractor regularly subject the operations to audits by way of outsourcing institutions or external audits? In the case of an external audit, does the outsourcing contractor report the results of the audit to the outsourcing institution?
- 3) Does the outsourcing contractor meet the security level required by the financial institution, etc. and is there a prior agreement on the details thereof between the outsourcing contractor and the financial institution, etc.?
- 4) Is it ensured that user review or testing by the financial institution, etc. is conducted at the planning, design/development and testing stages?

- 5) Is it ensured that objective assessment is conducted the Quality Control Division, etc. with regard to the status of compliance with standard development rules and the status of quality control?
- 6) With regard to the status of system operation, have matters to be reported to the financial institution, etc. been specified, and does the outsourcing contractor report regularly?
- 7) Are there a prescribed system and procedures for the outsourcing contractor to report system problems?
- 8) When the outsourcing contractor undertakes business with two or more financial institutions, does it provide a system to make judgments with regard to the effects of a problem in a system for one of the institutions in regards to the business of others and take appropriate measures?

5. Status of Systems to Facilitate Smooth Refund of Insured Deposit

- (1) Does the financial institution establish a framework to facilitate measures to comply with Paragraph 4, Article 55-2, and Paragraph 1, Article 58-3 of the Deposit Insurance Act?⁹
- (2) Does the financial institution appropriately manage a database and systems related to the aggregation of names? Specifically, does the financial institution appropriately conduct the following?
 - 1) Does the institution provide a system to ensure that data concerning aggregation of names are appropriately maintained and registered?
 - 2) Are data for aggregation of names (names written in “kana” letters for aggregation of names, birth dates, etc.) accurately registered? Does the institution review the status of registration?
- (3) Does the financial institution appropriately manage a system to facilitate smooth insurance payment/refunding in relation to insured deposits, etc., upon an insurance event and the implementation of necessary measures to handle other insurance events?
- (4) Does the financial institution take appropriate system measures in response to programming modification and system alteration in relation to the introduction of new products and system upgrades?
- (5) Does the financial institution have in place the procedural documents/manuals for the following tasks?¹⁰
 - 1) Tasks necessary from the point of occurrence of an insurance event to the submission of electromagnetic recording tapes, etc., to Deposit Insurance Corp. (Paragraph 3, Article 55-2

⁹ Please refer to the “Related Check Items under Paragraph 4, Article 55-2 and Paragraph 1, Article 58 of the Deposit Insurance Act” (Reference Material to Guidelines for Supervision).

¹⁰ Please refer to the “Checkpoints as to the Procedural Documents/Manuals for Smooth Implementation of Measures Upon Insurance Event as Stipulated under Article 55-2 and Article 58-3 of the Deposit Insurance Act” (Deposit Insurance Corp).

of the Deposit Insurance Act)

- 2) Tasks necessary from the point the financial institution receives the data on claims for deposit, etc., from Deposit Insurance Corp. to the end of the processing of such data under the system for refund of the deposit, etc. (Item 1, Paragraph 1, Article 1 of the Cabinet Ordinance Concerning Measures Specified in Paragraph 1, Article 58-3 of the Deposit Insurance Act)
- 3) Tasks necessary to refund settlement deposits without the use of the data noted above in (2) (Item 2, Paragraph 1, Article 1 of the above mentioned cabinet ordinance)
- 4) Tasks necessary to submit data about changes in the amount of deposit, etc., after the insurance event to Deposit Insurance Corp. (Item 3, Paragraph 1, Article 1 of the above mentioned cabinet ordinance)
- 5) Tasks necessary in relation to the offsetting of claims over depositors, etc., with the insured deposit, etc., and the purchase of claims over deposits, etc. (Item 4, Paragraph 1, Article 1 of the above mentioned cabinet ordinance)

6. Risk Management System Concerning System Integration

Risk management related to system integration should be reviewed based on “Checklist for System Integration Risk Management (Approval No. 567 dated Dec. 26, 2002).

(Attachment 3)

Development and Establishment of Other Operational Risks

Checkpoints

- “Other operational risks” of a financial institution are the risks defined by the institution as operational risks excluding administrative risks or information technology risks.
- The development and establishment of a system for managing operational risks other than administrative and information technology risks is extremely important from the viewpoint of ensuring the soundness and appropriateness of a financial institution’s business. Therefore, the institution’s management is charged with and responsible for taking the initiative in developing and establishing such a system.
- The inspector should determine whether the system for managing other operational risks is functioning effectively and the roles and responsibilities of the management are being performed appropriately by referring, as necessary, to the checklists for the administrative risk management system and the information technology risk management system, etc.

1. Roles and Awareness of Directors

Do directors attach importance to the management of operational risks as defined by the institution excluding administrative and information technology risks, fully recognizing that the lack of such an approach could seriously hinder the attainment of strategic objectives? In particular, does the director in charge of such risk management examine the policy and specific measures for developing and establishing an adequate system for managing other operational risks with a full understanding of the scope, types, and nature of other operational risks and the techniques of identifying, assessing, monitoring and controlling the said risks as well as the importance of the risk management, and with a precise recognition of the current status of the risk management within the financial institution based on such understanding?

2. Roles and Responsibilities of Major Divisions Responsible for Managing Other Operational Risks

(1) Legal Risk Management Division

With regard to legal risks as defined by the financial institution, such as loss and damage arising

from failure to perform duties owed to customers due to negligence and inappropriate business market practices (including fines imposed as a regulatory measure or in relation to dispute settlement, penalties for breach of contract and damages), is a division in charge of legal risk management aware of risks faced by the institution and does it appropriately conduct management thereof? For example, with regard to items listed in the “Checklist for Legal Compliance” and the “Checklist for Customer Protection Management” does the Legal Risk Management Division recognize risks that constitute legal risks as defined by the institution as such and appropriately conduct management thereof?

(2) Human Risk Management Division

With regard to human risks as defined by the financial institution such as loss and damage arising from complaints/unfair treatment (issues related to pay, allowances dismissal, etc.), discriminatory practices (sexual harassment and the like), is a division in charge of human risk management aware of risks faced by it and does it conduct appropriate management thereof? As a way to ensure appropriate risk management, does the institution provide training and education so as to enhance the ability of operational divisions and sales branches, etc. to manage such risks, for example?

(3) Tangible Asset Risk Management Division

With regard to tangible asset risks as defined by the financial institution such as destruction of and damage to tangible assets arising from disasters and other events, is a division in charge of tangible risk management aware of risks faced by the institution and does it conduct appropriate management thereof?

(4) Reputational Risk Management Division

With regard to reputational risks as defined by the financial institution such as loss and damage arising from deterioration in the institution’s reputation and circulation of unfounded rumors, is a division in charge of reputational risk management aware of risks faced by the institution and does it conduct appropriate management thereof? As a way to ensure appropriate risk management, does the division take the following measures, for example?

- Has the Reputational Risk Management Division specified how operational divisions and sales branches, etc. are to respond to circulation of unfounded rumors?
- Does the Reputational Risk Management Division regularly check whether there are unfounded rumors circulating in each media category (e.g. the Internet, speculative news reports, etc.)?

3. Appropriateness of Crisis Management System

- (1) Does a person or division in charge of crisis management conduct regular inspections and practices in normal times as part of efforts to avoid or mitigate risk in the event of an emergency?
- (2) Do the crisis management manual and the like note the importance of initial responses such as accurate grasp of the situation, objective judgment of the situation, and information dissemination immediately after the occurrence of the emergency?
- (3) Are the crisis management manual and the like constantly revised in light of changes in the actual status of business and risk management?
- (4) Do the crisis management manual and the like clarify the system of assignment of responsibilities in the event of an emergency and specify a system and procedures for communication of the emergency within the institution and to other parties concerned (including the relevant authorities)?
- (5) Does the business continuity plan (BCP) provide for measures to enable early recovery from damage caused by terrorism, large-scale disasters, etc. and continuance of the minimum necessary business for the maintenance of the functions of the financial system? Does the BCP have clear provisions with regard to the following matters, for example?
 - Measures to secure the safety of customer data and the like in the event of disasters, etc. (storage of information printed on paper in electronic media, creation of back-ups of electronic data files and programs, etc.)
 - Measures to secure the safety of computer system centers, etc. (allocation of back-up centers, securing of staff and communication lines, etc.)
 - Avoidance of geographical concentration of back-up measures
 - A specific target period for recovery, through provisional measures such as manual operations and processing by back-up centers, of operations vital for the maintenance of the functions of the financial system, such as acceptance of individual customers' requests for cash withdrawal and remittance and processing of large-lot, large-volume settlements conducted through the interbank market and the interbank settlement system?
- (6) Are a system and procedures for communicating and collecting information in the event of an emergency sufficient in light of the level of crisis envisioned and typical cases of emergency assumed? Does the institution make daily efforts to disseminate and collect information in a sophisticated manner?