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 a 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.

- 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 scale and nature 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.

- 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?

(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?

- 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 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 equivalent organization 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 equivalent organization 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

(i) Does the Board of Directors or equivalent organization 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

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
(ii) 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?

(iii) Has the Board of Directors or equivalent organization 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

(iv) Does the Board of Directors or equivalent organization 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.

(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 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 equivalent organization 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?

(ii) Does the Board of Directors or equivalent organization 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 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 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.
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?

(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 equivalent organization 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 scale and nature 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

(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

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

(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 scale and nature 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 equivalent organization to the Board of Directors

(3) Development of Organizational Frameworks by Manager

(i) 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?

(ii) 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?

(iii) 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?\(^5\)

(iv) Does the Manager have in place a credit risk management computer system\(^6\) with the high reliability befitting the scale and nature of the financial institution’s business and its risk profile?

(v) 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?

(vi) 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 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

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\(^5\) 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 dataprocessing environment system, distribution processing system, or EUC (end user computing) type.
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 Credit Risk Management Division
(1) Roles and Responsibilities of Screening Division
(i) 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.
(ii) 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? 
(iii) Does the Screening Division review whether the Marketing and Sales Division is appropriately following its instructions?
(iv) 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?

(2) Roles and Responsibilities of Credit Management Division
(i) 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

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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.
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?

(ii) 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 scale and nature 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.”)

(iii) 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.)

(iv) 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 equivalent organization to the Board of Directors?

(v) Does the Credit Management Division identify credit risks when the institution introduces New
Products and starts business at new overseas offices and subsidiaries?

(vi) 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 equivalent organization 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

(i) 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 a 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

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
(ii) 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?

(iii) Does the problem Loan Management Division provide a system to report matters determined as necessary by the Board of Directors or equivalent organization to the Board of Directors with regard to the status of problem loans?

ones that calculates their capital adequacy ratios according to domestic standards.
### 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.

- 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) Credit Ratings

Does the institution have in place an appropriate credit rating system befitting the scale and nature 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?

(i) Does the institution assign a credit rating according to the level of credit risk involved in the obligator based on ratings assigned by rating agencies, information provided by credit investigation companies and the like? Are its rating categories consistent with the obligator categories?

(ii) 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?

(2) Credit Limits
(i) 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 equivalent organization to the Board of Directors?

(ii) 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 equivalent organization to the Board of Directors as necessary)? Does the division appropriately manage credit limits in accordance with the relevant rules and procedures?

(3) Management of Credit Concentration Risk
(i) 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?

(ii) Does the Board of Directors or equivalent organization to the Board of Directors itself have an accurate grasp on large-lot borrowers and actively involve itself in credit risk management thereof?

(iii) 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?

(4) Screening and Management of Individual Loan Applications
Does the institution have a sound screening system in place? For example, does it smoothly
disburse funds to customers conducting sound business operations, particularly small and medium-size companies, ban speculative real-estate loans and loans involving excessive financial engineering and refuse to provide financing to anti-social forces? Does it avoid using the financial inspection manual established by the authorities as an excuse for inappropriate practices such as refusing to extend loans to customers conducting sound business operations or retrieving loans from such customers?

(5) Management of Problem Loans

(i) In managing problem loans, does the institution appropriately examine the possibility of business rehabilitation of each obligator and make as much effort as possible to help a business turnaround of obligators determined as capable of achieving rehabilitation? When providing support for business rehabilitation, is the institution prepared to formulate a rehabilitation plan that would deserve the market’s appreciation by utilizing schemes such as a company division, DES (debt-equity swap), DDS (debt-debt swap) and a corporate rehabilitation fund as necessary and implement private or public bankruptcy procedures promptly?

(ii) When removing a problem loan from the balance sheet by a sale, liquidation (securitization) or other measures, is the institution prepared to make sure and verify that the relevant credit risk is clearly separated, making it unnecessary to continue to bear the credit risk in effect through credit enhancement or other means? When selling or liquidating a problem loan, does the institution ensure that due consideration is given to the protection of the original obligator and that the loan is not transferred to a party which may oppress the obligator or disrupt the obligator’s life or business?

(6) Approach to Business Rehabilitation of Small- and Medium-Size Companies

(i) With regard to borrowers which are small- or medium-size companies, does the institution conduct credit management carefully in light of the nature of such companies? For example, does it endeavor to fully grasp the actual status of the borrowing companies’ corporate management including information concerning qualitative factors such as the companies’ strength in terms of technology and sales as well as senior management’s capabilities by visiting the companies on an ongoing basis and conduct loan management accordingly? Is the institution actively involved in corporate and business rehabilitation through the provision of elaborate management consultations and guidance?

(ii) When providing credit to a small- or medium-size company, does the institution conduct credit management operations including credit rating management with due consideration for the overall status of the company’s corporate management in light of the nature of small- and medium-size companies in general, such as their vulnerability to the economic cycle and their liability to fall
into the status of having excess debt due to one-time factors.

(7) Check Items for Credit Risk Measurement Technique

(i) Establishment of Credit Risk Measurement System

a. Is there not any conceptual problem with the credit risk measurement system, and is the system operated without any lapse?

b. 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 scale and nature 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)

c. In the case where capital allocation management 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?

(ii) Appropriate Involvement of Directors and Corporate Auditors

a. 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

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10 See Checklist for Capital Management.
measurement technique by receiving training or through other means?

b. Approach to Credit risk Management

Do directors involve themselves actively in credit risk management that uses the credit risk measurement technique?

(iii) Credit risk Measurement

a. 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?

b. 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?

c. 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?

(iv) 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?
(v) Audit
a. Development of Auditing Program
   Has the institution developed an audit program that exhaustively covers audits of the
   credit risk measurement technique?
b. Scope of Internal Audit
   Is auditing conducted to check the following items?
   - Consistency of the credit risk measurement technique with the strategic objectives, the
     scale and nature 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.)
c. Utilization of the Results of Audits
   Does the Credit Management Division appropriately revise the credit risk measurement
   technique based on the results of audits?

(vi) Credit Risk Measurement Model Developed by Outsourcing Contractor\textsuperscript{11}
a. 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?
b. 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?

\textsuperscript{11} When the credit risk measurement is outsourced, the verification should be conducted by using the
check items listed in this paragraph.
(b) Are the consistency and the accuracy of data used in measurement secured?
(c) Is the measurement model selected suited to the scale and nature of the institution’s business and its risk profile?

c. 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?

(8) Credit Risk Management System under the Basel II Regime

Does the institution provide a system to conduct credit risk management under the Basel II regulations 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”

(i) In the case of institutions adopting The Standardized Approach

a. 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?

b. Risk Weightings Application

Does the institution categorize exposures appropriately and apply an appropriate risk weighting suited to each category? Does it appropriately calculate the credit equivalent amount of off-balance sheet transactions, derivatives and transactions with long settlement periods?

c. 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?

d. Treatment of Securitization Exposure

Is the unrated portion of the institution’s securitization exposure that must be deducted from its capital actually deducted from the capital?

(ii) In the case of institutions adopting The Internal Ratings-Based Approach

a. Internal Control

Do the Board of Directors or equivalent organization 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?

b. Calculation of Credit Risk Asset Amount

Does the institution appropriately calculate the amount of credit risk assets in each risk asset class?

c. 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?

d. 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?

e. 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?
f. 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?

g. 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?

h. Treatment of Securitization Exposure

Does the institution treat the securitization exposures that must be deducted from the capital and the I/O strips that have the credit enhancement function as deduction items? It should be noted that the amount equivalent to the capital increase due to a securitization deal may not be treated as a deduction item.

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?

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 deduct the securitization exposure from the capital?