Credit Risk Management System Checklist and Manual

Credit risk is the risk that a financial institution will incur losses because the financial position of a borrower has deteriorated to the point that the value of an asset (including off-balance-sheet assets) is reduced or extinguished. Among credit risks, the risk that the financial institution will incur losses because of political or economic conditions in the country of a foreign borrower is referred to as “country risk.”

Inspectors will verify and inspect the credit risk management systems of financial institutions using the Risk Management Systems Checklists (Common Items) and this checklist. They will also inspect the self-assessments on asset quality, write offs and reserves, and capital adequacy ratios etc. of the financial institution using the “Credit Risk Inspection Manual.”

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

Notes on the use of this manual in inspections

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

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

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

Explanation of check points

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

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

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

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

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

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

Credit Risk Management System Checklist

Item	Risk Management System Check Point	Explanation of Risk Management Check Points	Remarks
I. Awareness of risk management etc. 1. Awareness of directors and role of board of directors	(1) Articulation of strategic goals in line with management philosophies etc.	(1) Does the institution set clearly strategic goals for the lending divisions etc. in line with management philosophies etc. for the financial institution as a whole? Are the strategic goals for the lending divisions etc. appropriate from the perspective of risk management that results? For example, do they eliminate a concentration of credit risks from efforts to achieve short-term profits by lending to specific industries or groups?	
	(2) Directors' understanding and awareness etc. of risk management	(2) Do directors understand the need, from the perspective of credit risk management, of integrated management of not only lending but all assets and off-balance-sheet items for which there are credit risks (including the credit risks associated with market transactions) at the financial institution and, to the extent permitted under applicable laws and ordinances, its consolidated subsidiaries and subsidiaries falling under the equity method? Do directors understand credit risk management techniques (including the content of credit ratings and portfolio management) and monitoring techniques? Are they aware of the need, from the perspective of credit risk management, for credit ratings, portfolio management, and self-assessments on asset quality? Do directors in charge of these and related areas have deep understandings and awarenesses of these issues? Does the board of directors verify that write-offs and reserves are at levels commensurate to credit risks? If the board of directors uses quantifications of credit risk in the management of the institution, does it understand quantification techniques, data availability issues, the relationship between credit risk exposure and capital adequacy, and other issues in the use of this information?	

Item	Risk Management System Check Point	Explanation of Risk Management Check Points	Remarks
	(3) Establishment of credit risk management guidelines	(3) Does the board of directors articulate credit risk management policies in light of strategic goals? Does the institution have a set credit policy that contributes to credit risk management? This would include the scope of lending, credit rating standards, portfolio management guidelines (for example, prevention of concentrations of lending by setting lending ceilings for specific industries and groups), and decision-making authority.	
	(4) Establishment of organizations for risk management	(4) Has the board of directors provided for appropriate management of credit risk by, for example, erecting an appropriate screening and management system that separates the business promotion divisions from the screening and management division so that the screening and management division is not influenced by the business promotion divisions, or by erecting an appropriate credit management system with the establishment of a credit auditing division and risk management division?	Note: ① "Business promotion divisions" refers to branch offices and business divisions within the head office. ② "Screening and management division" refers to a division that screens proposed lending and manages credits. ③ "Credit auditing division" refers to a division that is independent of the business promotion divisions (for example, the credit screening office or inspections department) and the screening and management division, and which carries out audits of self-assessments etc. and of credit management and credit management status. ④ "Risk management division" refers to a division that manages overall credit risks, including off-balance-sheet assets.
	(5) Reporting on risk status to the board of directors etc. and use of risk information in decision-making for the organization as a whole	(5) Does the board of directors etc. receive regular reports on credit risks (including the status of concentrated lending to specific industries or groups)? Does it verify adherence to credit risk management policies based on measured risk information? Does the board of directors receive reports on credit risks at other times as necessary in addition to regular reports? Does the board of directors make necessary decisions according to predetermined policies, issue instructions to reduce credit risk exposure by diversifying risks, or otherwise make use of risk information in risk management?	

Item	Risk Management System Check Point	Explanation of Risk Management Check Points	Remarks
2. Awareness and roles of senior management	(1) Establishment of rules for risk management	(1) Does senior management establish rules for credit risk management in accordance with credit risk management policies and with the approval of the board of directors etc? Does it review these rules as necessary? Do rules for credit risk management include the scope of lending, credit ratios, portfolio management, decision-making authority, screening guidelines, credit audit methods and other relevant matters?	Note: "Senior management" refers to branch office managers and persons in senior managerial positions (including directors) with equivalent levels of responsibility, and so throughout.
	(2) Appropriate risk management practice	(2) Does senior management practice effective credit risk management in individual divisions in accordance with risk management policies and risk management rules, and does it bear the responsibility for risk management? It is desirable that internal models etc. based on credit ratings be used to quantify credit risks for credit risk management purposes, and that the institution set credit risk limits commensurate to appropriate profitability, allocations of managerial resources, and capital adequacy. It is also desirable that such systems have adequate computer system support.	
II. Establishment of appropriate risk management systems 1. Awareness and evaluation of risk	(1) Establishment of integrated risk management systems	(1) Does the institution practice integrated credit risk management that includes, to the extent permitted under applicable laws and ordinances, its consolidated subsidiaries and subsidiaries falling under the equity method? Does the institution practice integrated management that covers not only lending but all assets and off-balance-sheet items for which there are credit risks including the credit risks associated with market transactions)?	

Item	Risk Management System Check Point	Explanation of Risk Management Check Points	Remarks
	(2) Evaluation of new products and activities	(2) When introducing new products and activities, does the risk management division evaluate the locus etc. of credit risk, seek opinions from the legal affairs division and inspections division etc. when necessary, report to the board of directors etc. on its risk evaluation findings, and seek the approval of the board of directors etc. for the introduction of new products and activities?	
2. Screening and management	(1) Establishment of screening and management system	(1) Is the screening and management division insulated from the influence of the business promotion divisions, for example, by being independent of the business promotion divisions and not having directors concurrently overseeing both the screening and management division and the business promotion divisions? If the screening and management division is not independent of the business promotion divisions or if a director concurrently oversees both the screening and management division and the business promotion divisions, has the institution provided for checking functions to ensure that screening and management is appropriate?	
	(2) Role of screening and management division	(2) Does the screening and management division provide appropriate screening and management of loans, for example, by accurately measuring the borrower's financial position, the use to which the funds will be put, and the resources from which the loan will be repaid, and utilizing this information to verify the accuracy of credit ratings? Does the screening and management division etc. check that business promotion divisions are appropriately following its instructions, that they have sound lending stances (providing a smooth flow of funding to borrowers engaged in sound businesses, especially medium, small, and micro businesses etc., banning speculative real estate lending and lending for excessively speculative financial schemes, and refusing to supply funds to antisocial elements), and that they are not engaged in inappropriate collections of funds?	

Item	Risk Management System Check Point	Explanation of Risk Management Check Points	Remarks
		Does the screening and management division communicate to business promotion divisions that the Financial Inspection Manuals created by the authorities are not to be used as an excuse for refusing to lend to borrowers engaged in sound businesses, for recalling funds from such borrowers, or for other inappropriate handling? Does it check to ensure that the business promotion divisions are not engaged in inappropriate handling?	
3. Credit management	(1) Establishment of credit management division	(1) Do the business promotion divisions and screening and management division have systems in place for integrated management of credits (for example, the status of business conditions in the borrower's industry) that covers, to the extent permitted under applicable laws and ordinances, the financial institution, its consolidated subsidiaries, and its subsidiaries falling under the equity method? Is a specific division assigned to verify the levels of write-offs and reserves? Does this division very that the levels of write-offs and reserves are commensurate to credit risks, and does it report the amount of write-offs and reserves accurately to the board of directors? Is a specific division assigned to manage portfolio status (including the concentration of lending in specific industries and groups)? Does this division engage in appropriate portfolio management and does it report regularly on the status of the portfolio to the board of directors?	
	(2) Roles of credit auditing division	(2) Does the institution have a credit auditing division that verifies the accuracy of credit ratings, the status of borrower credit management, and other relevant information? Does this division verify the appropriateness of credit management and report its findings to the board of directors etc? If a business promotion division or a screening and management division manages the portfolio, does the credit auditing division verify the appropriateness of portfolio management?	

Item	Risk Management System Check Point	Explanation of Risk Management Check Points	Remarks
		Do financial institutions calculating their capital adequacy ratios according to the Basle standards have specialized systems for their crediting auditing (including systems in which the risk management division performs credit audits)? It would also be desirable for financial institutions calculating their capital adequacy ratios according to domestic standards to have specialized systems for their credit auditing divisions.	
	(3) Roles of risk management division	(3) Does the institution have a risk management division that provides integrated management of assets with credit risk exposure and off-balance-sheet items? Does it practice integrated credit risk management? Do financial institutions calculating their capital adequacy ratios according to the Basle standards have specialized systems for their risk management division (including systems in which the risk management division performs credit audits)? It would also be desirable for financial institutions calculating their capital adequacy ratios according to domestic standards to have specialized systems for their risk management divisions.	
4. Management of problem credits	(1) Establishment of management system for problem credits	(1) Is there a specific division assigned to manage and collect problem credits? Does it appropriately manage problem credits? Does the institution specify the range of credits that particularly require management as problem credits? Do financial institutions calculating their capital adequacy ratios according to the Basle standards have specialized divisions for managing and collecting problem credits? It would also be desirable for financial institutions calculating their capital adequacy ratios according to domestic standards to have specialized systems for managing and collecting problem credits.	

Item	Risk Management System Check Point	Explanation of Risk Management Check Points	Remarks
	(2) Role of problem credit management division	(2) Does the division responsible for managing and collecting problem credits articulate clear guidelines for working with problem borrowers and manage the business conditions etc. at problem borrowers accordingly? Are problem borrowers given appropriate guidance in rebuilding, or are they liquidated or collected, based on the guidelines for working with problem borrowers?	
5. Self-assessments on asset quality	See “Credit Risk Inspection Manual.”		
6. Write-offs and reserves	See “Credit Risk Inspection Manual.”		

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Inspections of Credit Risk

The prompt corrective actions are based on capital adequacy ratios, and because of this, capital adequacy ratios must be calculated from accurate financial statements. The creation of accurate financial statements will entail appropriate write-off and reserve allocations and also appropriate self-assessments on asset quality, since self-assessments form the preparatory stage for write-off and reserve allocations.

Therefore, in inspections of credit risk, inspectors will need to go beyond confirmations of appropriateness of self-assessment standards and verifications of the accuracy of self-assessment results to verify the total amount of write-offs and reserves that the institution is claiming and the appropriateness of those levels. They must place particular emphasis on verifying that the institution's total write-offs and reserves are at levels commensurate to credit risks.

- Inspections of self-assessments on asset quality

I. Purpose of inspections of self-assessments on asset quality

Asset quality assessments consider the assets held by the financial institution separately and individually in order to classify them according to their collection risk and price-decline risk. This serves as a measure of the safety and the certainty of the assets that stand behind the deposits of depositors or, in other words, the degree of risk to which deposits are exposed because of the potential, for example, for assets to be defaulted on. When the financial institution performs this assessment on its own, it is referred to as a "self-assessment."

Self-assessments are a tool that financial institutions can use to manage their credit risks, and they also serve as the preparatory stage for appropriate write-offs and reserves. Similarly, external auditors can refer to self-assessments in their audits of financial statements to evaluate the effectiveness of the financial institution's self-assessments and other internal controls.

When inspecting self-assessments, inspectors should assume that financial institutions have indeed performed self-assessments and that these self-assessments have been audited by external auditors. Based on these assumptions, inspectors should verify the status of the systems that the institution has put in place for self-assessments, the appropriateness of its self-assessment standards, and the accuracy of its self-assessment results, and should then determine if the institution's self-assessment standards, which are the preparatory stage for write-offs and reserves, are rational and whether the self-assessment results appropriately reflect the asset quality of the financial institution under inspection.

In inspections of cooperative financial institutions, inspectors should be aware that cooperative financial institutions are only required to select external auditors in a limited number of cases.

II. Method of inspecting self-assessment standards

Inspectors shall begin by performing "process examination." That is, they will first verify the status of the systems that the institution has put in place for self-assessments and the appropriateness of the institution's self-assessment standards. Having done this, they will then verify the results of self-assessments, in principle by means of sampling.

Should there be problems identified during inspectors, the inspectors shall endeavor to exchange opinions with the financial institution. For example, inspectors shall provide the financial institution under inspection with the viewpoints of the authorities, shall fully recognize the thinking of the financial institution in this regard, and shall directly confirm the viewpoint of the external auditors in the presence of the financial institution.

III. Verification of the institution's self-assessment systems

Inspectors shall verify the status of the systems that the institution has put in place for self-assessments by checking the items listed below.

1. *Formulation of self-assessment standards*

Do self-assessment standards conform to all applicable laws and ordinances and to the framework set forth in the inspection manual?

Have formal bank procedures been followed by the board of directors in determining and codifying self-assessment standards?

Do self-assessment standards specify the scope of assets subject to self-assessment, the divisions responsible for performing self-assessments (sales-related divisions (business offices, head-office sales divisions, head office loan approval divisions (loan management division, loan review division etc.) or asset auditing divisions) and auditing divisions (credit auditing office, inspection division etc.)), and the lines of responsibility for self-assessment standards and their formulation?

Are the opinions of the auditing division and compliance management divisions sought in the formulation and revision of self-assessment standards, not just the opinions of divisions performing self-assessment standards?

Have self-assessment manuals been formulated and codified for the use of business offices etc. in appropriately performing self-assessments?

2. *Status of self-assessment systems*

Are there sufficient checks on sales-related divisions in self-assessment standards? For example, 1) a system in which the businesses office and head-office sales divisions perform primary assessments, the head office loan approval division performs secondary assessments, and then an asset auditing division independent of the sales-related divisions audits the results, or 2) a system in which self-assessments are performed with the cooperation of the sales-related divisions by an asset assessment division that is independent of the sales-related divisions. Is the system able to accurately perform self-assessments?

Are personnel versed in self-assessments assigned to the divisions performing self-assessments and the auditing divisions?

Do asset auditing divisions and asset assessment divisions provide needed training and supervision to sales-related divisions?

Is the auditing division independent of the sales-related divisions? Do directors in charge of sales-related divisions have concurrent responsibilities for auditing divisions? If directors in charge of auditing divisions are also in charge of sales-related divisions, are there sufficient checks in place to ensure that audits are appropriate?

Does the auditing division verify that self-assessments are performed appropriately and in accordance with the self-assessment standards and self-assessment manual?

It is desirable that the auditing division does not just verify the accuracy of self-assessment results but also verifies the accuracy of credit ratings and credit follow-up and management.

Does the financial institution keep sufficient records and documents in its divisions that government inspectors, auditors and others are able to verify the performance of self-assessments after-the-fact?

3. Reporting of self-assessment results to the board of directors

Are self-assessment results reported regularly and appropriately to the board of directors?

Does the board of directors receive timely reports on the status of self-assessment systems (changes in divisions performing or auditing self-assessments etc.)?

4. Auditing by auditors and external auditors of self-assessment systems

Do auditors and external auditors who are not subject to the influence of the directors appropriately audit the status of self-assessment system as described in 1-3 above?

IV. Verification of the appropriateness of self-assessment standards

Inspectors shall check whether the self-assessment standards formulated by the financial institution are clear and appropriate and whether their framework is in line with the framework described in the Attachment. If the financial institution uses an original framework for its self-assessment standards, inspectors shall verify the relationship between the institution's framework and the model framework in the Attachment, and shall determine whether individual rules within the institution's self-assessment standards are rational (for example, the collateral appraisal rules, or simplified securities appraisal rule).

1. Definition of terms

(1) Credit rating: A rating of the borrower's degree of credit risk. Credit ratings are essential to credit risk management and form the basis for accurate self-assessments and appropriate write-offs and reserves. Credit ratings must also be consistent with borrower classifications.

(2) Borrower classifications: A judgement of the borrower's ability to repay the obligation as determined from the borrower' financial position, cash flow, profitability and other considerations. Depending on results, the borrower is classified as "normal", "needs attention", "in danger of bankruptcy", "effectively bankrupt", or "bankrupt".

(3) The assignment of assets to Categories II, III, or IV during self-assessment standards is referred to as "classification", and asset that have been assigned to Categories II, III, or IV are referred to as "classified assets." Not assigning assets to Categories II, III, or IV is 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".

(4) "Credit categories" are as defined in the asset assessment standards set forth in the "Law Regarding Emergency Measures to Revitalize Financial Functions" (Law No. 132 of 1998; "Emergency Revitalization Law" hereinafter) Article 6:2 and the "Concomitant Ordinances for the Law Regarding Emergency Measures to Revitalize Financial Functions" (Prime Minister's Office Ordinance No. 65 of 1998; "Emergency Revitalization Law Ordinances" hereinafter) Article 4. Credit categories are based on the financial position and the business results of the borrower, and consist of "Non-classified credits," "special attention credits", "risk credits", "unrecoverable/valueless credits", categories.

2. Categories used in self-assessment standards

Self-assessment standards shall classify assets in four groups according to the repayment risk and the loss of value risk: I, II, III, IV.

(1) Category I (unclassified assets) consists of assets not assigned to Category II, Category III, or Category IV. These are assets with no problems in terms of repayment 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 a loss amount 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 without value." Category IV assets are not, however, assets that are absolutely uncollectable or without 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. Verification of the appropriateness of self-assessment results

Inspectors shall use the methods described in the attachment to verify that self-assessments are being performed appropriately and in accordance with the self-assessment standards. This verification process should endeavor to form an accurate picture of the institution's systems for self-assessments, reporting of self-assessment results to the board of directors, and internal and external auditing of self-assessment systems.

Therefore, when inspectors deem self-assessment results to be inappropriate, they shall endeavor to fully confirm and accurately identify the causes therefor (because of self-assessment standards or because of the way in which self-assessments are performed) and future improvements to be made by the financial institution under inspection.

1. Base date

The day that serves as the base for verification of the accuracy of self-assessment results (the "base date" hereinafter) shall in principle be the last day of the accounting period (including mid-term accounting periods and so throughout) directly prior to the accounting period in which the inspection is performed (or the "advance notice date" for inspections made with advance notice). However, if the inspection date is prior to a board of directors meeting to determine final accounts for the preceding accounting period, the base date shall be the final day of the second preceding accounting period.

(1) The determination of the base date shall take into account the nature of the assets held by the financial institution under inspection, the inspection period and other relevant matters. If it is likely that there will be a board of directors meeting held to review final accounts during the inspection period and if the nature of the assets held by the financial institution under inspection would warrant the inspection of the accuracy of the self-assessment results from the accounting period immediately prior, then the base date shall be the last day of the accounting period immediately prior to the inspection.

(2) All financial institutions are required to perform self-assessments as of the last day of the accounting period, but there may be cases in which, for convenience in processing, the institution establishes a provisional base date for its self-assessments. In these cases, inspectors should verify that the provisional base date is in principle within three months of the last day of the accounting period. Note that, from the perspective of credit risk management, it is desirable that the institution engage in credit management. This management should consist of on-going monitoring of the financial position of the borrower, the status of the collateral and guarantee, and other relevant information, and the institution should review credit ratings, credit categories, and classifications as warranted by changes in conditions at the borrower. When the financial institution under inspection handles credits in this manner without establishing provisional base dates, then inspectors should verify that credit rating reviews and the like are performed in an appropriate and timely manner.

2. *Sampling standards*

The chief inspector shall determine sampling standards according to the size of the financial institution under inspection, the nature of its assets, the results from the last inspection, the number of inspectors assigned to the institution, the period of the inspection, and other relevant information. The chief inspector may change sampling standards after an on-site inspection has begun as necessary to ensure the effectiveness of the inspection.

The chief inspector shall endeavor to improve the efficiency of inspections. For example, if no particular problems are found in the nature of the assets held by the financial institution under inspection and the results from the last inspection were good, the chief inspector may reduce the sampling rate.

3. *Specific inspection methods etc.*

The following methods shall be used to verify the accuracy of self-assessment results.

(1) Scope of verification

The scope of accuracy verifications shall be assets on the base date sampled according to the sampling standards described in Item 2 above. Priority attention shall be given to verification of the accuracy of self-assessments for assets from borrowers classified as other than “normal” in the self-assessments performed by the financial institution under inspection. Should the results of verifications of the self-assessment standards of the financial institution under inspection indicate problems in the sampling standards of the financial institution under inspection, and should there be the potential for non-“normal” borrowers to have been classified as “normal”, the inspection shall also place priority on verifying the accuracy of self-assessments of credits from borrowers classified as “normal”.

(2) Specific verification methods

Inspectors shall use the materials (worksheets etc.) employed by the financial institution under inspection in its self-assessments to verify the accuracy of self-assessments according to the self-assessment standards of the financial institution under inspection, paying particular attention to borrowers classified as other than “normal”. More concretely, inspectors shall verify the accuracy of borrower classifications and credit categories, and classified amounts.

1) When the financial institution under inspection uses provisional base dates to perform its self-assessments, inspectors shall use materials from the provisional base date to verify the accuracy of borrower classifications, credit categories, and classified amounts as at the provisional base date. They shall next verify that the institution has clear standards for revisions between the provisional base date and the actual base

date, and that these standards are rational. Finally, they shall verify that necessary revisions are made to self-assessment results between the provisional and actual base dates.

Should the provisional base date not be within three months of the last day of the accounting period, inspectors shall verify that necessary revisions are performed in an appropriate manner when there are changes in conditions between the provisional base date and the final day of the accounting period.

In determining whether the standards for revisions between the provisional base date and the actual base date are rational, inspectors shall make a general judgement that considers the size of the assets held by the financial institution under inspection, the businesses in which it is engaged, and the impact on write-offs and reserves.

2) For developments that occur after the final day of the accounting period, inspectors shall use the sampling standards described in Item 2 above to sample assets that meet set standards, shall study the assets in detail and shall verify that changes have been reflected in the current accounting period. When verifying developments after the final day of the accounting period, inspectors shall note the need to verify that the institution has rational standards for initiating reviews because of subsequent developments, as was the case in Paragraph 1 above.

Serious subsequent developments (primary developments) need to be reflected in the current accounting period. Should inspectors discover that subsequent developments have occurred that are potentially serious given the size of the asset held by the financial institution under inspection, but that these developments have not been reflected on the current accounting period, they shall seek an opinion from the institution's external auditors.

4. *Self-assessment accuracy standards*

Should the results of verifications of the accuracy of self-assessments indicate that any of the following apply to the self-assessment results of the financial institution under inspection, inspectors shall judge the self-assessments as inaccurate."

Note that judgements of the accuracy of self-assessments must be based on borrower conditions (financial position etc.) on the provisional base date or base date, not on the inspection date.

(1) There are problems with the appropriateness of the self-assessment standards and because of this there are misjudgements in the borrower classifications, credit categories, or classified amounts on the provisional base date or base date.

(2) Assets sampled and assessed by the financial institution under inspection according to its own self-assessment sampling standards:

1) Were assessed as of the base date, but the borrower classifications, credit categories, or classified amounts as of the base date were wrong.

2) Employed assessment as of the provisional base date in lieu of assessment as of the base date, but the borrower classifications, credit categories, or classified amounts as of the provisional base date were wrong.

3) Were accurately assessed as of the provisional base date, but important subsequent changes in borrower conditions, loan repayment status, appraised collateral value, amount of credit or other matters required, according to the institution's self-assessment standards, a review on the base date, which was not done, so that the borrower classifications, credit categories, or classified amounts as of the base date were wrong.

(3) Other assets that the chief inspector specifically designates for sampling:

Are designated as “classified assets.”

However, when the financial institution under inspection has established a sampling exclusion threshold below which credits are not sampled, these credits shall be excluded if the threshold is deemed rational in light of a general evaluation of the institution’s asset size and nature, and the influence on write-offs and reserves etc.

Attachment

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
1. Credit classification method	"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. 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. 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.		Note: "Institutions calculating their capital adequacy ratios according to international standards" refers to financial institutions calculating their capital adequacy ratios according to the Basle 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.
(1) Basic concepts	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. Note that institutions calculating their capital adequacy ratios according to international standards are required to	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.	

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
	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.		
(2) **Credit ratings**	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.	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. 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 internal data is inadequate. 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 auditing division checks the accuracy of the credit rating.	Note: "Ratings agency" refers to an institution performing ratings in accordance with the "designation of ratings agencies and ratings pursuant to the provisions of Article 9-3:4:e of the Ministry of Finance Ordinance on Disclosure of Corporate Information."
(3) **Borrower classifications**	Borrowers are to be classified as follows in light of conditions etc. at the borrower as evidenced in principle by credit ratings. (Project finance credits do not need to follow these classifications.)	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 risk. Borrower classifications would require comprehensive judgement. Begin by considering repayment ability as evidenced by the borrower's financial position, cash flow, and profitability etc., 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.	Note: "Project finance" refers, for example, to a non-recourse loan that is used to finance a specific project (business), 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. Note: "Cash flow" refers to current profits adjusted for depreciation charges and other non-asset items, and so throughout.

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		Particularly for medium, small, and micro companies, consider the company's technology skills, sales capacity and growth potential, 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. When factoring in the existence of a parent company for 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. If the borrower is using official financing ("government funding" hereinafter), for example, central or local government 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.	
1) "Normal"	A "normal" borrower has strong results and no particular problems with its financial position.	Verify if these borrowers are actually "normal" borrowers.	
2) "Needs attention"	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 and management. It is desirable that "needs attention" borrowers be divided into "special attention" borrowers and other borrowers.	Verify if these borrowers are actually "needs attention" borrowers. If the institution divides "needs attention" borrowers into "special attention" borrowers and others borrowers, verify that the classifications are appropriate. 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. If borrowers meet criteria A-C below, check whether they are "needs attention" in light of the considerations to the left. Do not immediately classify them as "needs attention".	Note: "Borrowers needing special attention" are "needs attention" borrowers for which all or part of the credits require special attention, and so throughout.

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		A. 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". "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. 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. 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. Reviews of borrower classification entail a comprehensive judgement 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. B. The following kinds of borrowers may be classified as "normal" even if they are in the red. 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. Reviews of borrower classification entail a comprehensive judgement that takes into account the nature of the industry, 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	

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		attention" merely because it does not formally meet these standards. a) Losses are caused by transient factors such as losses on the sale of fixed asset, and the borrower is certain to return to profitability in a short period of time. b) Medium, small, and micro companies that are in the red, but there are deemed to be no particular problems with the recoverability of the credit. C. A borrower that has dishonored bills, accommodation bills, or has discount bills for which there are doubts regarding payment at maturity 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 bill etc.	
3) "In danger of bankruptcy"	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. so 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.). 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 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.	Verify that these borrowers are actually "in danger of bankruptcy" borrowers. 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 "need attention borrower." 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 plan etc. Reviews of borrower classification entail a comprehensive judgement 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 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.	

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		In particular, medium, small, and micro companies may not always formulate business improvement plans etc., and in these cases, inspectors should consider the company's technology skills, sales capacity and growth potential, 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. 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. A. 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. However, this may include business improvement plans etc. with periods of between five and ten 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. B. 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 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. C. 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.	

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		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. D. 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 relinquishment of credits, cash gifts, or other provisions of funds to the borrower. However, this shall include cases in which the institution has already provided funds to the borrower (relinquishment of credits, cash gifts) 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. 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 relinquishment of credits etc.	
4) "Effectively bankrupt"	An "effectively 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 for all purposes bankrupt. Specifically, this refers to borrowers who are still formally in business but whose financial position includes large amounts of non-performing assets or excessive	Verify that these borrowers are actual "effectively bankrupt" borrowers. If the borrower is not legally or formally bankrupt but has voluntarily gone out of business or otherwise effectively ceased operations, verify that it has been classified as "effectively bankrupt". A. 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	

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	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 natural disasters, accidents, rapid changes in business conditions and the like, 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.	improvement plans etc. and have no hope of a rapid recovery in their results in the future and no forecast for the completion of 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 "effectively bankrupt". B. "In effect been in arrears for a prolonged period of time" shall be interpreted in principle as effective arrears of six months or longer that are not deemed transient arrears.	
5) "Bankrupt"	A "bankrupt" borrower is legally and formally bankrupt. This would include bankruptcy, liquidation, reorganization, rehabilitation, composition, and suspension of dealings on the bill exchange.	Verify that these borrowers have been classified as "bankrupt".	
(4) Adjustment for collateral	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. Use the following to calculate appraised collateral value and estimated disposal value.	Verify that assets secured with collateral have been categorized, and that the appraised value and estimated disposal value are rational, as described left.	
1) Superior collateral	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.	Verify that the instruments listed left are categorized as "superior collateral." A. Note that for "insurance and mutual-aid policies with returns at maturity," the estimated disposal value is the amount received were the policy cancelled on the base date. B. "Government bonds and other securities of high creditworthiness" refers to the securities listed in 2.(2)1), the equities not subject to classification as listed in 2.(3)1), and the foreign securities not subject to classification as listed in 2.(4)1) when	Note: "Commercial bills of certain settlement" includes cases in which separate deposits are retained for provisional payments against bills. Note: "Deposits etc.," "government bonds and other securities of high creditworthiness," and "commercial bills of certain settlement" shall not be deemed superior collateral if

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		these instruments are deemed to be safe and have no particular problems. If an asset is secured with securities other than “government bonds and other securities of high creditworthiness,” these securities must satisfy the requirements of liquidity—they must be easily disposable. C. “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.	there are any impediments to collection by disposal of collateral.
2) **Ordinary collateral**	Collateral other than “superior collateral” that is disposable from an objective perspective. For example, real estate collateral, industrial factory foundation collateral etc.	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. 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 is appropriately managed.	
3) **Appraised collateral value**	An appraised value (market value) calculated objectively and rationally.	Verify that appraised collateral values are calculated objectively and rationally. A. For borrowers categorized as “in danger of bankruptcy”, “effectively bankrupt”, and “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 it would be desirable that they be 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 or provisional base date.	

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		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. It is desirable that appraisals of real estate value be performed by qualified real estate appraisers for properties above a certain threshold value. It is desirable that appraisals of rental office buildings and the like utilize the "returns method" in addition to "recent sales" and "official land prices" and the like. B. 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.	
4) Estimated disposal value	A value based on the appraised value in 3) above considered certain to be recovered were the collateral 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.	Verify that the estimated disposal value is calculated in an objective and rational manner based on the appraised value of the collateral. A. Verify that the multipliers used to calculate the estimated disposal value are rational. Estimated disposal values may be deemed appropriate if they are below the values arrived at when the appraised value is multiplied by the multipliers shown below. Real estate collateral Land: 70% of appraised value Building: 70% of appraised value Securities collateral Government bonds: 95% of appraised value Government-guaranteed bonds: 90% of appraised value Listed equities: 70% of appraised value Other securities 85% of appraised value B. 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 been actually been	Note: "Other securities" refers to municipal bonds (both publicly and privately placed), public corporation bonds without government guarantees, bank debentures, exchange-listed industrial bonds

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		disposed, and comparisons of disposal prices and estimated disposal value document that disposal prices are higher than estimated disposal value, and this assertion can be confirmed, it may be deemed "rational justification." C. If there is a recent appraised value from a real estate appraiser 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 is used as the estimated disposal value. Note that for prices other than appraised values from 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.	from corporate issuers, and securities investment trust beneficiary certificates.
(5) Adjustment for guarantees etc.	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 be deemed Category II.	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 procedures for the guarantee. 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 final settlement date, 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 final settlement date of the next accounting term.	
1) Superior guarantees etc.	A. 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	Verify that the guarantees described left have been categorized as superior guarantees. A. "Public credit guarantee institutions" refers to institutions that are established by law and allowed to provide guarantee services. Examples include the Credit Guarantee Association, the Agriculture, Forestry and Fishing Guarantee Fund, and the Agriculture, Forestry and Fishing Guarantee Association. Note that there are some types of guarantees from public credit guarantee institutions that do not guarantee the full value of the asset.	

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	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.	If any of the following apply, a guarantee is to be deemed to satisfy the "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" clause and therefore the guarantee is not to be deemed a "superior guarantee." a) The bank has not claimed subrogated repayment from the guarantee institutions etc. because of poor business conditions etc. at the guarantee institution, or the bank has claimed subrogated repayment but has not received it for these reasons. (This excludes the public credit guarantee institutions in A above.) b) 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. c) The financial institution receiving the guarantee has no intention of seeking fulfillment of the guarantee for other reasons.	
	B. Guarantees from non-financial institutions will be deemed superior guarantees 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.	B. 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.	
	C. "Home loan guarantee insurance" and the like from the Housing Loan Corporation and other public insurance companies, and "home loan guarantee insurance" and similar	C. Examples of public insurance other than that from the Housing Loan Corporation would include "export bill insurance" and "overseas investment insurance" provided under the trade insurance system.	

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	policies from private insurance companies.		
2) **Ordinary guarantees**	Guarantees other than superior guarantees. For example, guarantees from non-financial institutions (other than those in 1) B. above) and individuals that have sufficient guarantee resources.	Verify that the guarantees described left are categorized as ordinary guarantees.	
3) **Guarantee reservation and management supervision pledges**		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.	
(6) **Credits not subject to classification**	The following credits are not subject to classification. 1) Discount bills of certain settlement, 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. 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.	Verify that the credits described to the left have been treated as “credits not subject to classification.” 1) Bills issued by borrowers the credits of which have been categorized as “in danger of bankruptcy”, “effectively bankrupt”, or “bankrupt”, shall not be treated as discount bills of certain settlement for self-assessment purposes. “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. 2) Operating capital for borrower classifications “in danger of bankruptcy, ” “effectively 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 judgements of conditions at the borrower.	Note: “Specific repayment sources” refers to the monies from capital increases, bond issues, sale 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 is certain to be allocated to repayment, provided that the certainty of deposit can be verified from the capital increase or bond issue prospectus, the sales contract, the agency commission, fund transfer requests, or other

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		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. 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. Normal operating capital = Sales credits [accounts receivable + bills receivable (excluding discount bills)] + Inventory assets (ordinary inventory goods excluding non-performing inventories) - Purchasing liabilities [accounts payable + bills payable (excluding bills payable for facilities)] If more than one financial institution is lending operating capital, multiply by the lending share of the financial institution under inspection.	documents. Note: "Normal operating capital" refers to operating capital deemed to be perennially necessary in order to conduct normal business.
	3) Credits with superior guarantees and insurance and mutual-aid credits of certain payment.	3) 3. When the use of funds from credits with superior guarantees is designated as "operating capital," and the total of this 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.	
	4) Credits held against companies in which the government is a shareholder or against local governments.	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. Specifically, when there is rational justification that support from the government-invested company or support from the local	

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	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.	government is certain, study the borrower category with reference to the nature of 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.	
(7) Credit categorization standards	Categorize credits according to the borrower classification. It is acceptable, however, to categorize project finance credits according to the degree of risk of collection without regard to borrower classification. It is also acceptable to categorize home loans and other standardized loans to individuals according to simplified criteria, for example, arrears status.	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 that are not categorized according to borrower classification, verify that categorization has been done according to the degree of risk of collection. When categorization is according to simplified standards, verify the rationality of the standards and the application of the standards.	
1) "Normal" credits	Credits to normal borrowers are non-classified.	Verify that credits to normal borrowers are non-classified.	
2) "Need attention" credits	Credits to "needs attention" borrowers are in principle assigned to Category II when they meet the requirements listed in A through E below for the portion in excess of the estimated disposal value for superior collateral or in excess of the guarantee for superior guarantees etc. A. Dishonored bills, accommodation bills, and discount bills doubtful to be settled at maturity. B. Funds to compensate for losses or defaulted credits, funds to support or undertake the obligations of poorly-performing affiliates etc. Note: Credits to borrowers with losses carried over and non-performing asset etc. shall in principle	Verify that the credits described left have been categorized as "need attention" credits. Below are the interpretations to be used for the categorized credits left. B. Calculate the bank's (cooperative's, association's) lending commensurate to carried over losses etc. and the bank's (cooperative's, association's) share of lending as follows: Bank's (cooperative's, association's) lending commensurate to carried over losses etc. = Amount of carried over losses etc. x bank's (cooperative's,	

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	be categorized in this category when they are deemed to have been used to cover losses carried over etc. regardless of the name 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 closes carried over etc. taking account of the amount of the borrower's losses carried over and non-performing assets etc. and the bank's (cooperative's, association's) share of lending to the borrower.	association's) share of lending Bank's (cooperative's, association's) share of lending = Bank's (cooperative's, association's) total lending (excluding discount bills) / Total borrowings of the borrower (excluding discount bills)	
	C. 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.	C. "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 the institutions has 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 are allowed repayment in full on the date of maturity without a rational reason therefore. "Credits with extremely long repayment contracts" refer to loans of equipment funds that have repayment periods longer than the useful life of the equipment in question, or to 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. Additionally, when a borrower is using government funding, inspectors should make a comprehensive judgement 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	

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
	D. Credits with problems in fulfillment (principal repayment or interest payment effectively in arrears) or credits deemed to have a high potential for repay problems in the future. E. Credits for which the financial position etc. of the borrower indicates a greater than normal collection risk.	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.	
3) "In danger of bankruptcy" credits	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. 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.	Verify that credits to "in danger of bankruptcy" borrowers have been categorized as described left. Refer to the following for interpretations of "collectable amounts." A. "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. B. "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 create a liquidation balance sheet for the borrower, assuming the estimated liquidation dividend etc. is rational. If an "amount deemed collectable from liquidation dividends" is categorized as Category II, verify that the estimated liquidation dividend etc. is rational.	

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
4) **"Effectively bankrupt" and "bankrupt" credits**	All credits to "effectively bankrupt" and "bankrupt" 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 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, no hope of collection. 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.	Verify that credits to "effectively bankrupt" and "bankrupt" borrowers have been categorized as described left. Credits to "effectively 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 estimated disposal values of superior collateral and ordinary collateral." Refer to the following for interpretations of "collectable amounts." A. "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 IV. Verify that this has been done. B. For "effectively 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 create a liquidation balance sheet for the borrower, assuming the estimated liquidation dividend etc. is rational. 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 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 create a liquidation balance sheet for the borrower,	

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
		assuming the estimated liquidation dividend etc. is rational. 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. C. Verify that categorization has in principle been made as follows for borrowers that have been the subject of a filing for rehabilitation under the Corporate Reorganization and 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. a) Are rehabilitation collateral rights in principle assigned to Category II? b) 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? c) Are relinquished credits assigned to Category IV? If progress is generally according to plan (for example, the borrower has achieved in generally 80% of the sales etc. and current profits targeted in the rehabilitation plan etc.) after a certain period of time has elapsed from the formulation of the rehabilitation plan etc. and the borrower classification and category are reviewed, verify that categorization and classification are according to the degree of collection risk.	
(8) Credits to foreign governments etc.	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 political or	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 left have been categorized.	

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
	economic conditions in the country in question. 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 (“deferral of debt repayment etc.” hereinafter). 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 consider likely to occur in the near future.		
(9) Credits to foreign private companies and to Japanese companies abroad	Categorize credits to foreign private companies and Japanese companies abroad according to the criteria found in (7) above. However, when arrears etc. are clearly the result of the country's foreign exchange balance, categorize according to the criteria in (8) above. Note that self-assessments should take account of the nature of business dealings in the country, its markets, and the status of collateral.	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. Verify that the institution understands the nature of business dealings in the country, its markets, and the status of collateral.	
(10) Interest receivable similar to loans		For interest receivable that is similar to loans, verify that the institution is in principle not posting those for “in danger of bankruptcy, ” “effectively bankrupt, ” and “bankrupt” borrowers as assets. Verify in particular that it is not posting uncollected interest from “effectively bankrupt” and “bankrupt” as assets. However, when the institution posts uncollected interest as assets in light of the potential to collect this interest because of protection measures etc., verify that this uncollected interest is categorized according to the degree of collection risk.	

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
		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.	
(11) Relationship with credit categories under the Law Regarding Emergency Measures to Revitalize Financial Functions	Below is the relationship between the credit categories set forth in Article 4 of the Law Regarding Emergency Measures to Revitalize Financial Functions and the borrower classifications etc. in this inspection manual. Note that under the provisions of Article 3:2:1 of the Law Regarding Emergency Measures to Restore the Soundness 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 Law Regarding Emergency Measures to Revitalize Financial Function are: banks, trust banks, long-term credit banks, shinkin banks, credit cooperatives, labor credit associations, National Association of Shinkin Banks, National Central Society of Credit Cooperatives, National Federation of Labor Credit Associations, Central Cooperative Bank for Agriculture and Forestry, Credit Federation of Agricultural Cooperatives, Credit Federation of Fishery Cooperatives, and bank holding companies etc.	Verify that classification is made 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 Concomitant Orders to the Law Regarding Emergency Measures to Revitalize Financial Functions. Article 6 of the Law Regarding Emergency Measures to Revitalize Financial Functions requires that the results of asset assessments be reported to the Financial Reconstruction Commission. Article 7 requires that they be published. Article 78 and Article 86 of the law provide for penal measures should the reports to the Financial Reconstruction Commission be falsified. Therefore, if the results of self-assessments 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 conducted, or by other factors) and the future improvements to be made by the financial institution under inspection.	
1) "Non-classified" credits	"Non-classified" credits are "credits with no problems in terms of the financial position or business performance of the borrower; all credits not classified as "special attention", "risk", "unrecoverable or valueless credits. "Non-classified" credits are credits to "normal" borrowers and credits to "needs attention" borrowers that do not fall into the category "special attention".	Verify that the credits described left have been categorized as "normal" credits.	

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
2) **"Special attention" credits**	"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 Concomitant Orders to the Law Regarding Emergency Measures to Revitalize Financial Functions). Manage "special attention" credits separately from other "needs attention" credits.	Verify that the credits described left have been categorized as "special attention" credits. In doing this, refer to 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 Article 1-10-3-2-3 of the official Business Processing Guidelines (deposit-taking financial institutions). Verify that the institution categories credits that are not formally in arrears but are in fact three or more months behind as "special attention" credits. Note: To verify whether credits are not actually in arrears, check internal sign-off documents and trace funds provided to the borrower, looking for loans disbursed near the repayment date used as funds to repay principal and interest.	
3) **"Risk" credits**	"Risk" 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.	Verify that the credits described left have been categorized as "risk" credits.	
4) **"Unrecoverable or valueless" credits**	"Unrecoverable or valueless" credits are "credits to borrowers that have fallen into bankruptcy, corporate rehabilitation, composition or the like, or similar credits." These are credits to "effectively bankrupt" borrowers and "bankrupt" borrowers.	Verify that the credits described left have been categorized as "unrecoverable or valueless".	
(12) **Credits to consolidated subsidiaries**		Verify that credits to consolidated subsidiaries (including affiliated "non-banks") have been categorized as follows. 1) Credits to consolidated subsidiaries of the financial institution under inspection Credits to consolidated subsidiaries should in principle be assessed according to the self-	

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
		assessment methods of the financial institution under inspection and assigned a borrower classification according to an accurate measurement of the financial position etc. of the consolidated subsidiary. However, in cases in which it is difficult to assess 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 shall be made according to asset assessment results made with methods similar to the self-assessment methods of the financial institution under inspection. 2) Credits to consolidated subsidiaries of other financial institutions Categorize according to the same methods as credits for non-financial institutions.	
2. Securities categorization method **(1) Basic concepts**	When assessing securities, categorize them in terms of their marketability and safety. Judgements of safety are in principle made with the same concepts as used for credits and will depend on the financial position etc. of the issuer of the security. However, it is acceptable to use simplified criteria for the issuer's financial position etc. when classifying securities.	Verify that securities are categorized accurately in terms of marketability and safety.	
(2) Bonds		Verify that bonds are classified as described left. For judgements of safety in particular, verify that categorizations are made with the same concepts as used for credits based on the financial position etc. of the issuer.	
1) Bonds not subject to classification	The following bonds are not subject to classification. A. Government bonds, local government bonds B. Government-guaranteed bonds (public	Verify that no bonds from issuers with any other than a "normal" borrower classification are treated as non-categorized.	

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
	corporations etc.) C. Special bonds (issued by public corporations or companies in which the government has invested but not government-guaranteed). D. Bank debentures E. All bonds from issuing companies that have been rated BBB (triple B) or better in their most recent rating by a ratings agency. F. All industrial bonds issued by companies issuing exchange-listed industrial bonds; all bonds selected for over-the-counter price quotations. However, the bonds described in E and F shall be classified if a study of the financial position of the issuer or the nature of the industrial bond based on the same concepts as for credits indicates problems with safety.		
2) Bond classification method	A. Study the financial position of the issuers of all bonds except those listed in A-F in 1) above using the same concepts as for credits. If the study reveals no particular problems with safety, or if there is a superior guarantee from a financial institution etc., treat the bond as non-classified. B. The book value of bonds described in the proviso to 1) above and bonds other than as described in A above is assigned to Category II; the estimated loss for bonds likely to generate losses is assigned to Category IV. Note that privately-placed bonds are categorized according to the degree of risk of loss of value using the same method as for credits. If the institution does not have credits against the issuer of the bond, it may categorize the bond according to simplified criteria.	Verify that the estimated loss has been assigned to Category IV for bonds issued by parties with borrower classifications of “effectively bankrupt” or “bankrupt”. Verify that privately-placed bonds are categorized using the same methods as credits.	

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
(3) Equities	The following equities are not subject to classification.	Verify that equities are categorized as described left. For the safety standard in particular, verify that the institution has studied the financial position of the issuer of the equity using in principle the same concepts as for credits.	
1) Equities not subject to classification	A. Exchange-listed equities, over-the-counter-registered equities, and unlisted equities issued by exchange-listed companies. B. Equities issued by companies in which the government has invested (excluding liquidation companies). C. Equities from issuing companies the bonds of which have been rated BBB (triple B) or better in their most recent rating by a ratings agency. However, the equities described above shall be classified if a study of the financial position of the issuer based on the same concepts as for credits indicates problems with safety.	Verify that no equities from issuers with any other than a "normal" borrower classification are treated as non-classified.	
2) Equity categorization method	A. Study the financial position of the issuers of all equities except those listed in A-C in 1) above using the same concepts as for credits. If the study reveals no particular problems with safety, treat the equity as non-classified. B. Categorize the equities described in the proviso to 1) above and equities other than as described in A above according to the degree of risk of loss of value using in principle the same concepts as for credits. However, the book value of categorized exchange-listed equities and over-the-counter-registered equities that are categorized should be assigned to Category II. In cases in which the asset position of the issuer has significantly worsened, assign to	A. Verify that equities issued by parities with borrower classifications of "in danger of bankruptcy" (excluding exchange-listed equities and over-the-counter-registered equities) are in principle assigned to Category III. B. Verify that equities issued by parties with borrower classifications of "effectively bankrupt" or "bankrupt" are in principle assigned to Category IV. C. If the institution holds equities subject to classification as part of a securities investment trust or designated money in trust account etc. in order to avoid classification, verify that the equity is categorized according to the degree of risk of loss of value. D. If the institution uses the cost method to appraise exchange-listed equities, verify that its standards for mandatory appraisal reductions under the Commercial Code are rational. Specifically, verify	

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
	Category IV an amount equivalent to the reduction in book value when decreases in the net assets of the issuer mandate reductions in the book value of the equity, except when the asset position is deemed likely to recover in a reasonable period of time. If the institution does not have credits against the issuer of the equity, it may categorize the equity according to simplified criteria.	that at the very least, the institution assigns an amount equivalent to the difference between the market value and the book value of the equity to Category IV when the market value of a listed equity has lost 50% or more against the book value. However, it shall be acceptable to deem an equity as having no possibility of price recovery if its price has not been above 50% of book value at least once in the past year. Verify that the same method is used to categorize over-the-counter-registered equities when the cost method is used for appraisal purposes.	
(4) Foreign securities		Verify that foreign securities are categorized as described left.	
1) Foreign securities not subject to classification	The following foreign securities are not classified. A. All equities issued by companies listed on foreign or domestic exchanges and all bonds issued by companies issuing listed bonds. B. Bonds selected for over-the-counter price quotations on either foreign or domestic markets. C. 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. D. Equities and bonds issued by financial institutions licensed etc. by governments of countries with which Japan has relations. E. 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. However, the foreign securities described above shall be categorized if a	Verify that no foreign securities from issuers with any other than a "normal" borrower classification are treated as non-classified.	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 Interamerican Development Bank (IDB), the European Bank for Reconstruction and Development (EBRD), the African Development Bank (AfDB), and the Asian Development Bank (ADB).

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
	study of the asset and/or financial position of the issuer based on the same concepts as for credits indicates problems with safety.		
2) Foreign security classification method	A. Study the asset and financial position of the issuers of all foreign securities except those listed in A-F in 1) above using the same concepts as for credits. If the study reveals no particular problems with safety, or if there is a superior guarantee from a financial institution etc. (including a financial institution licensed by the government of a country with which Japan has relations), treat the foreign securities as non-categorized. B. The book value of foreign securities described in the proviso to 1) above and bonds other than as described in A above is in principle assigned to Category II; the estimated loss for foreign securities likely to generate losses is assigned to Category IV. Note that foreign equities and privately-placed bonds are categorized according to the degree of risk of loss of value using the same method as for credits when deemed appropriate to do so. If the institution does not have credits against the issuer of the foreign security, it may categorize the foreign security according to simplified criteria.	Verify that those foreign securities for which it is deemed appropriate to categorize using the same methods as for bonds and equities are categorized according to these methods.	
(5) Other securities	Categorize other securities in a manner similar to 1) to 4) above. Beneficiary certificates for loan trusts are non-classified. Categorize beneficiary certificates for securities investment trusts according to the degree of risk of loss of value.	Verify that investment trust beneficiary certificates for which there are quoted base prices or the like are categorized according to the degree of risk of loss of value.	

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
3. Method of categorization for other assets (i.e., assets other than credits and securities)	Categorize assets other than credits and securities as follows. Use the same methods as for credits when performing categorization for self-assessments of assets and off-balance-sheet instruments with credit risks other than credits and securities. Pay particular attention to liquidation techniques 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 securitization instrument and categorize according to the degree of risk of loss of value for the credit risk portion held by the financial institution under inspection.	Verify that assets other than credits and securities are categorized as described left. Verify that asset and off-balance-sheet instruments with credit risks other than credits and securities 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.	
(1) Suspense payments	Categorize all suspense payments other than those that are similar to loans (suspense payments related to claims or loans resulting from subrogated repayment based on guarantees) according to the collection risk and the degree of risk of loss of value.	Verify that all suspense payments other than those that are similar to loans are categorized according to collection risk and degree of risk of loss of value.	
(2) Chattels and real estate	Categorize the book value of owned chattels and real estate not used for business purposes (offices, branch offices etc.) as Category II. However, in cases in which the estimated disposal value of the owned chattel or real estate is significantly below the book value and there is little likelihood of it recovering in a reasonable period of time, and when there is deemed to be a need to reduce the book value to correspond with the decrease in estimated disposal value, assign the estimated disposal value to Category II and the difference between the estimated disposal value and the book value to Category IV.	Verify that chattels and real estate have been categorized as described left. Verify that real estate listed on the books as "business real estate" is categorized as owned chattels and real estate if 1) it is for the purpose of employee welfare but seldom used, or 2) it is not in actuality used for business purposes and it is not certain that it will be used for business purposes in the future. At the very least, when the estimated disposal value of owned chattels and real estate is substantially below the book value (as a rule of thumb, the estimated disposal value is at least 50% below the book value) and when there is deemed to be little likelihood of the estimated disposal value recovering, verify that the difference between the book value and the estimated disposal value is assigned to Category IV.	

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
(3) Golf club memberships	Assign to Category II except for those held for welfare purposes. 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 "effectively 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. When golf club memberships are held not as "other assets" but on securities accounts, use appropriate securities methods for their categorization. If the institution does not have credits against the issuer of the membership, it may use simplified criteria in categorization.	Verify that golf club memberships are categorized as described left. When memberships are held on securities accounts, verify that they are categorized as described left.	
(4) Miscellaneous assets	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.	Verify that miscellaneous assets are categorized as described left. A. For purchasing credits issued by 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. Note that banks that have established special transaction accounts and use those accounts to purchase on a continual basis purchasing credits issued by non-financial institution 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 17-10 (ban on inter-account transfers) of the Concomitant Orders to the Banking Law (Law No. 10 of 1982). Verify that this has not taken place. B. When the financial institution under inspection uses trust schemes to liquidate credits, and the financial institution under inspection holds	

Item	Verification of the appropriateness of self-assessment standards	Verification of the appropriateness of self-assessment results	Remarks
		beneficiary certificates in the loan credit trust scheme, verify that these loan credit trust beneficiary certificates are categorized using the same methods as credits.	

Inspections of Write-offs and Reserves

I. Purpose of inspectors of write-offs and reserves

Write-offs and reserves are a means of estimating in an timely and appropriate manner the losses etc. on credits etc. expected to be incurred by the financial institution in the future based on self-assessment. There is a strong need for financial institutions to maintain the soundness of their assets in order to fulfill their public and social responsibilities, and provisions of write-offs and reserves according to the degree of credit risk are vital in accomplishing this. It is therefore necessary to for financial institutions to provide appropriate levels of write-offs and reserves for the credit risks they hold.

Article 3:2:2 of the Law Regarding Emergency Measures to Revitalize Financial Functions requires financial institutions to provide appropriate reserves as set forth by the Financial Revitalization Commission in light of their self-assessment results.

In addition to these laws etc., financial institutions are also required to provide for write-offs and reserves under the Commercial Code and the corporate accounting principles, and external auditors are required to appraise the effectiveness of internal controls on write-offs and reserves when they audit financial statements.

Therefore, when inspecting write-offs and reserves, inspectors should assume that financial statements have been audited by external auditors and verify the status of systems and processes for write-offs and reserves, the appropriateness of write-offs and reserves levels and rationality of write-offs and reserves calculations, and whether the total value of write-offs and reserves is commensurate to the degree of credit risk to which the financial institution under inspection is exposed.

Notes:

1. Default reserve criteria shall be revised as required by any future modifications to write-off and reserve provisions by the Financial Revitalization Commission.

2. Appraisals of credits using the discount present value method may be introduced taking into account deliberations in the Corporate Accounting Commission etc. and the status of utilization at financial institutions.

II. Method of inspecting write-offs and reserves

Inspectors shall begin by performing “process examination.” That is, they will first verify the status of the systems that the institution has put in place for write-offs and reserves and the appropriateness of the institution's write-off and reserve levels. Having done this, they will then verify whether write-offs and reserves have been provided for in an appropriate manner.

Should there be problems identified during inspections, the inspectors shall endeavor to exchange opinions with the financial institution. For example, inspectors shall provide the financial institution under inspection with the viewpoints of the authorities, shall fully recognize the thinking of the financial institution in this regard, and shall directly confirm the viewpoint of the accounting auditors in the presence of the financial institution.

III. Verification of the institutions' write-off and reserve systems

Inspectors shall verify the status of the systems that the institution has put in place for write-offs and reserves by checking the items listed below.

1. Formulation of write-off and reserve standards

Do write-off and reserve standards conform to all applicable laws and ordinances, to corporate accounting principles, and to the framework set forth in the inspection manual?

Have formal bank procedures been followed by the board of directors in determining and codifying write-off and reserve standards?

Do write-off and reserve standards specify the scope of assets subject to write-offs and reserves, the divisions responsible for performing and auditing write-offs and reserves, and the lines of responsibility for write-off and reserve standards and their application?

Are the opinions of the auditing divisions (credit auditing office, inspections division etc.) and compliance management divisions sought in the formulation and revision of write-off and reserve standards, not just the opinions of divisions performing self-assessments (sales-related divisions and assets assessment divisions)?

Have write-off and reserve manuals been formulated and codified for use in appropriate provisions of write-offs and reserves?

From the perspective of assuring the reliability of financial institution soundness, it is desirable that the specific content of write-offs and reserves be actively disclosed along with the disclosure of self-assessment results under the provisions of Article 7 of the Law Regarding Emergency Measures to Revitalize Financial Functions.

2. Status of write-off and reserve systems

Are there sufficient checks on divisions performing self-assessments and divisions performing settlement so that write-off and reserve values are calculated appropriately? For example, 1) a system in which divisions performing self-assessments calculate individual default reserve amounts and the auditing division audits this amount and calculates general default reserve amounts, or 2) a system in which individual default reserve amounts are calculated with the cooperation of the sales-related divisions by an asset assessment division that is independent of the sales related divisions, and the asset assessment division calculates general default reserve amounts, or 3) a system in which divisions performing self-assessments calculate individual default reserve amounts, settlement-related divisions calculate general default reserve amounts, and auditing divisions audit the results of these calculations.

Are personnel versed in write-offs and reserves assigned to the divisions performing self-assessments and the auditing divisions?

Do the auditing divisions etc. provide requisite education and training for divisions performing self-assessments etc?

Is the auditing division independent of the divisions performing self-assessments and divisions performing settlement (the Head Bookkeeping Office etc.)? Do directors in charge of divisions performing self-assessments and divisions performing settlement have concurrent responsibilities for auditing divisions? If directors in charge of auditing divisions are also in charge of divisions performing self-assessments and divisions performing settlement, are there sufficient checks in place to ensure that audits are appropriate and not subject to the influence of the financial institution's results etc?

Does the auditing division verify that write-offs and reserves are performed appropriately and in accordance the write-off and reserve standards and write-off and reserve manual?

It is desirable that the auditing division does not just verify the accuracy of write-off and reserve results but also verifies the appropriateness of reserve rates, the appropriateness of the total reserve amount etc, and the appropriateness etc. of the reserve amount etc. in the previous term.

Does the financial institution keep sufficient records and documents in its divisions that government inspectors, auditors and others are able to verify the performance of write-offs and reserves after-the-fact?

3. Reporting of write-off and reserve results to the board of directors

Are write-off and reserve results reported regularly and appropriately to the board of directors?

Does the board of directors receive timely reports on the status of write-off and reserve systems (changes in divisions performing or auditing write-offs and reserves etc.)?

4. Auditing by auditors and external auditors of write-off and reserve systems

Do auditors and external auditors who are not subject to the influence of the directors appropriately audit the status of write-off and reserve systems as described in 1-3 above?

IV. Verification of the appropriateness of write-off and reserve standards

Inspectors shall check whether the write-off and reserve standards formulated by the financial institution are clear and appropriate, whether their framework is in line with the standards set forth by the Financial Revitalization Commission pursuant to Article 3:2:2 of the Law Regarding Emergency Measures to Revitalize Financial Functions and with the framework described in the Attachment, whether they are justified by the Commercial Code and corporate accounting principles etc., and whether they are based on self-assessment results. If the financial institution uses an original framework for its write-off and reserve standards, inspectors shall verify the relationship between the institution's framework and the model framework in the Attachment, and shall determine whether individual rules within the institution's write-off and reserve standards are rational (for example, rules for calculating reserve rates based on credit ratings, rules for calculating reserve rates based on industry or location etc.), and shall verify that specific costs and losses that are highly probable to be incurred in the future are estimated rationally.

Inspectors shall also verify that the basic concepts employed in write-off and reserve standards are consistent and continuous, and that there is a rational reason for any changes in the basic concepts used in write-off and reserve standards.

V. Verification of the appropriateness of write-off and reserve results

Inspectors shall use the methods described in the Attachment to verify that write-offs and reserves are being calculated appropriately and in accordance with the write-off and reserve standards. This verification process should endeavor to form an accurate picture of the institution's systems for write-offs and reserves, reporting of write-off and reserve results to the board of directors, and internal and external auditing of write-off and reserve systems.

Note that write-off and reserve results will effect an institution's capital adequacy ratio and therefore when the results of write-off and reserve calculations are deemed to be inappropriate, inspectors must fully endeavor to confirm and accurately identify the causes for the inaccuracy (because of write-off and reserve standards or because of the way in which write-offs and reserves are performed, or because of poor business results) and improvements to be made by the financial institution under inspection in the future.

1. Base date

The base date shall be handled as per V:1 of the self-assessment manual.

2. Specific inspection methods etc.

(1) Scope of verification

The scope of appropriateness verifications shall be write-off and reserve results for all assets on the base date. Priority attention shall be given to verification of the accuracy of write-offs and reserves for credits to borrowers classified as “in danger of bankruptcy”, “effectively bankrupt”, or “bankrupt”. Should borrowers that should have been classified as “in danger of bankruptcy”, “effectively bankrupt”, or “bankrupt” be found to be classified as “normal” or “needs attention” in self-assessments, verification shall place priority on determining whether the needed write-off and reserve amounts have been calculated for these credits.

(2) Specific verification methods

Inspectors shall, in accordance with the borrower classifications from self-assessments, use the materials employed by the financial institution under inspection in its write-off and reserve calculations to verify the accuracy of write-offs and reserves according to the write-off and reserve standards of the financial institution under inspection.

Should borrower classifications be changed in inspections, inspectors shall accurately measure the additional write-off and reserve amount required assuming that write-offs and reserves are calculated according to the write-off and reserve standards of the financial institution under inspection using the new borrower classifications. Note that inspectors will also need to verify that the write-off and reserve standards of the financial institution under inspection are rational in these cases.

3. Standards for judging the appropriateness of write-offs and reserves

Should the results of verifications of the appropriateness of write-offs and reserves indicate that any of the following apply to the write-off and reserve results of the financial institution under inspection, inspectors shall judge it inappropriate.

(1) There are problems with the appropriateness of write-off and reserve levels because inappropriate write-off and reserve amounts were calculated on the base date.

(2) The institution failed to apply appropriate write-off and reserve levels for borrower classifications and credit categories in light of self-assessment results.

(3) Appropriate write-offs and reserves were not made because of mistakes in self-assessment results.

Attachment

Item	Verification of the appropriateness of write-off and reserve standards	Verification of the appropriateness of write-off and reserve results	Remarks
1. Default reserves	Default reserves shall be made at least for credits (loans and credits similar to loans) using rational estimates of losses highly likely to be incurred in the future. In the calculation of default reserves there should be a consistent linkage between the results of self-assessments based on credit ratings and write-offs and reserves. In other words, perform self-assessments based on credit ratings that take account of borrower credit risks, and calculate write-offs and reserves based on the results of these self-assessments. Note that for institutions utilizing rational and appropriate internal models to quantify credit risks, the total default reserves must fully meet the expected default loss value for the portfolio as a whole as deduced from the quantification of credit risks.	Verify calculations of default reserves in principle by verifying that there is a consistent linkage between self-assessments and write-offs and reserves that takes account of credit ratings and that write-offs and reserves are in line with write-off and reserve standards. Next, verify that the total write-offs and reserves of the financial institution under inspection are at sufficient levels for the credit risks to which the institution is exposed. If the institution employs a rational and appropriate internal model to quantify credit risks, verify that the total default reserves are at levels above the expected default losses deduced from the quantification of credit risks.	
(1) General default reserves	In calculating, ordinary default reserves, for credits against "normal" borrowers and credits against "needs attention" borrowers, calculate past default rates and bankruptcy probabilities in principle for each credit rating or at least for each borrower classification using the methods shown below. Find the loss rate expected to be incurred in the future (the expected loss rate), and calculate an 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. Post default reserves at values commensurate to the expected loss amount. The basic principle for calculating general default reserves is to calculate expected loss amounts using a migration analysis of individual credit ratings and/or borrower classifications. In addition, it is desirable that general default reserves be calculated in light of the	Verify that calculations of general default reserves for "normal" borrowers and "needs attention" borrowers rationally estimate expected loss amounts based on write-off and reserve standards for each credit rating and/or borrower classification. Specifically verify the following items. 1) Verification of average time to maturity If the institution calculates expected loss amounts over a set period in the future by average time to maturity, verify that the average time to maturity is rational. Specifically, verify how the institution reflects average time to maturity in credits associated with current account overdrafts, how it reflects average time to maturity for credits that have in fact become long-term, fixed credits even though contractual periods are short-term, and other issues that would impinge upon the rationality of average time to maturity.	

Item	Verification of the appropriateness of write-off and reserve standards	Verification of the appropriateness of write-off and reserve results	Remarks
	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 institution's portfolio (borrower industry, borrower location, credit amount, size of borrower, individual/company etc.). The expected loss rate is determined after making needed adjustments for changes in economic conditions, changes in credit policies, changes in portfolio make-up (credit ratings, borrower industry, borrower location, credit amount, size of borrower, individual/company, credit security etc.), and correcting this for past default rates and/or bankruptcy probability forecasts. Should there be a rapid worsening of economic conditions in particular, the weight of more 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. General default reserve calculation method Expected loss amount calculation method Expected loss amount = Credit amount x Expected loss rate Examples of specific methods for calculating expected loss rate 1) Using Default rates Default write-off loss amount / Credit amount 2) Using bankruptcy probability Bankruptcy probability x (1 - forecast collection rate) (Note: There is also a method that substitutes unsecured percentage or	If the institution categorizes credits to "needs attention" borrowers by degree of credit risk to calculate expected loss amounts for specific categories over a set period in the future, verify that the future periods used for individual credit risk categories are rational. 2) Verification of default rates and bankruptcy probabilities If the institution employs a method based on default rates, verify 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. If the institution employs a method based on bankruptcy probabilities, verify that the number of bankruptcies at the very least reflects all loans to "effectively bankrupt" and "bankrupt" borrowers. It is appropriate that the number of bankruptcies reflects the number of loans to "in danger of bankruptcy" borrowers in some form. Verify that the method for doing so is rational, for example, adding to the number of bankruptcies a number found by multiplying the number of "in danger of bankruptcy" loans by the bankruptcy probability. If the institution does not reflect the number of "in danger of bankruptcy" loans in the number of bankruptcies, fully verify that the total amount of general default reserves are at levels commensurate to the credit risk exposure of the financial institution under inspection, that calculations of expected loss amounts in earlier periods were at sufficient levels, and that the institution compares expected loss amounts based on default rates. If the institution employs migration analysis by credit rating or borrower classification for the calculation of default rates, verify that there is rational justification for this analysis. If the institution employs a method that uses bankruptcy probabilities and there is a likelihood that large losses will be incurred so that the expected loss amount as calculated from default rates is higher than the expected loss amount as calculated from bankruptcy probabilities, it is desirable that the institution	

Item	Verification of the appropriateness of write-off and reserve standards	Verification of the appropriateness of write-off and reserve results	Remarks
	average loss percentage for "1 - forecast collection rate."	post as default reserves the expected loss amount calculated using the default rate-based method. 3) Verification of exclusion of abnormal values If the institution excludes losses or bankruptcies associated with specific borrowers from its default rates and/or bankruptcy probabilities because these values are "abnormal," verify that there is rational justification for the exclusion. Specifically, if the institution excludes losses and 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," verify that the losses and bankruptcies are reflected in calculations of default reserves in some form, for example, by including them in calculations of expected loss amount for credits to "in danger of bankruptcy" borrowers. Verify whether the institution excludes as "abnormal" values losses and/or bankruptcies associated with specific industries and/or locations by claiming that there are sharp differences between losses and bankruptcies in these industries and/or locations and losses and/or bankruptcies in other industries and/or locations. In these cases it is not appropriate to exclude losses and/or bankruptcies to specific industries and/or locations as "abnormal." Rather, it is desirable that the institution group credits by industry and/or location, calculate default rates and/or bankruptcy probabilities for each group, find expected loss rates for each, and calculate expected loss amounts as the credits to each group multiplied by the expected loss rate for the group. 4) Verification of calculation period for default rates and bankruptcy probabilities Verify that calculations of expected loss amounts are based at the very least on default rates and bankruptcy probabilities for the preceding three calculation periods. If the calculation period is not three past	

Item	Verification of the appropriateness of write-off and reserve standards	Verification of the appropriateness of write-off and reserve results	Remarks
		periods, verify that there is a rational reason why, for example, 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 verify that the methods used to calculate expected loss amounts during the interim are rational. 5) Verification of expected loss rates Verify that the financial institution under inspection captures changes in economic conditions that would effect the borrower's business, changes in credit policies, changes in portfolio make-up, and other relevant information in the determination of expected loss rates. If the institution corrects rates for changes in economic conditions etc., verify that there is rational justification for the corrections in light of the way in which the institution captures changes in economic conditions etc. If the financial institution under inspection has identified large changes in economic conditions etc., but has not made necessary corrections, verify that there is rational justification for not making corrections. 6) Verification of expected loss amounts from previous periods Compare expected loss amounts and actual defaults and/or bankruptcies from previous periods to verify that levels were adequate. If this verification indicates that expected loss levels were inadequate, verify the reasons why (for example, did past calculations of expected loss amounts correct for forecasts at the time of calculation?), and verify that expected loss rates are corrected at the base date.	
1) **Default reserves for credits to "normal" borrowers**	Default reserves 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 in the future.	Verify that default reserves for credits to "normal" borrowers are rationally estimated based on write-off and reserve standards and utilizing an 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. When the institution estimates the expected loss amount for the next one year, verification of the	

Item	Verification of the appropriateness of write-off and reserve standards	Verification of the appropriateness of write-off and reserve results	Remarks
	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).	rationality of the "set period in the future" vis a vis the average time to maturity may be omitted.	
2) **Default reserves for credits to "needs attention" borrowers**	Default reserves for credits to "needs attention" 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 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. 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 "special attention" borrowers and estimate expected loss amounts for the average time to maturity or the next one year for other "need attention" borrowers. 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 "needs attention" borrowers by the	Verify that default reserves for credits to "needs attention" borrowers are rationally estimated based on write-off and reserve standards and utilizing an 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 "needs attention" borrowers are categorized by degree of credit risk. If the institution calculates an expected loss amount for a set period in the future based on credit risk categories, verify that the calculation of the expected loss amount is rational. If the institution calculates a three-year expected loss amount for "special attention" borrowers and a one-year expected loss amount for other borrowers, verification of the rationality of the "set period in the future" vis a vis the average time to maturity may be omitted.	Note: To be reviewed in the event of a change in the standards promulgated by the Financial Revitalization Commission for "special attention" borrowers. Note: "Credits to 'special attention' borrowers" refers to credits to "needs attention" borrowers when all or part of the credits to the borrower have been classified as requiring special attention, and so throughout.

Item	Verification of the appropriateness of write-off and reserve standards	Verification of the appropriateness of write-off and reserve results	Remarks
	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).		
(2) Specific default reserves and direct write-offs	For specific default reserves and direct write-offs, calculate in principle an expected loss amount for each individual "in danger of bankruptcy", "effectively bankrupt", and "bankrupt" borrower, and either post as default reserves or directly write off an amount equivalent to the expected loss amount. Calculate required amounts for individual default reserves each period.	Verify that individual write-off amounts and direct write-offs are calculated in principle by estimating an expected loss amount for each individual "in danger of bankruptcy", "effectively bankrupt", and "bankrupt" borrower, and that an amount equivalent to the expected loss amount is either posted as default reserves or directly written off.	
1) Specific default reserves for credits to "in danger of bankruptcy" borrowers	For reserves against credits to "in danger of bankruptcy" borrowers, estimate in principle an expected loss amount for a set period in the future deemed rational for credits to each individual "in danger of bankruptcy" borrower and post an amount equivalent thereto as default reserves. It is acceptable to estimate an expected loss amount for the next three years. Sample calculations of expected loss amount for credits to "in danger of bankruptcy" borrowers A. Using Category III credit amounts multiplied by expected loss rate as the expected loss amount (including the use of a remainder after the amount collectible from rationally estimated cash flow is deducted) When using Method A above, in principle calculate a past default rate and/or bankruptcy probability for each credit rating or at least for each borrower classification of "in danger of bankruptcy" borrowers, find a loss rate expected for the future (expected loss rate), and in principle multiply the amount of Category III credits to the individual borrower by the expected loss rate to calculate an expected loss amount. Post an	For individual write-offs and reserves against credits to "in danger of bankruptcy" borrowers, verify that the estimated loss value has been rationally estimated for a set period in the future. Specifically, verify the items below and verify that estimates cover the full value of Category III loans, including the difference between the appraised value and estimated disposal value of general collateral. A. Using Category III credit amounts multiplied by expected loss rate as the expected loss amount a) Verification of the "set period in the future" Verify that the "set period in the future" used to estimate expected loss amounts is rational. However, this verification may be omitted if the institution estimates expected loss amounts for a three-year period. b) Verification of default rates and bankruptcy probabilities If the institution employs a method based on default rates, verify that the expected loss amount reflects the amount	

Item	Verification of the appropriateness of write-off and reserve standards	Verification of the appropriateness of write-off and reserve results	Remarks
	amount equivalent to the expected loss amount to default reserves. The expected loss rate should in principle be determined for each individual borrower based on past default rates and/or bankruptcy probabilities corrected 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. 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 Category III credits 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). 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 reserve 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 post an amount equivalent to the expected loss amount as default reserves. In such cases, the scope of credits to “in danger of bankruptcy” borrowers below a set threshold value for which group expected loss rates are applied 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	of all losses, including direct write-offs, indirect write-offs, relinquished credits, and losses on credits sold. If the institution employs a method based on bankruptcy probabilities, verify that the number of bankruptcies at the very least reflects all loans to “effectively bankrupt” and “bankrupt” borrowers. c) Verification of exclusion of abnormal values If the institution excludes losses or bankruptcies associated with specific borrowers from its default rates and/or bankruptcy probabilities because these values are “abnormal,” verify that there is rational justification for the exclusion. d) Verification of calculation period for default rates and bankruptcy probabilities Verify that calculations of expected loss amounts are based at the very least on default rates and bankruptcy probabilities for the preceding three calculation periods. If the calculation period is not three past periods, verify that there is a rational reason why, for example, 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 verify that the methods used to calculate expected loss amounts during the interim are rational. e) Verification of expected loss rates Verify that the financial institution under inspection captures changes in economic conditions forecasts for the industry etc. of the borrower, and local economic conditions for the business territory of the borrower. If the financial institution under inspection has identified large changes in economic conditions etc., but has not made necessary corrections	

Item	Verification of the appropriateness of write-off and reserve standards	Verification of the appropriateness of write-off and reserve results	Remarks
	be rigorous and clear.	for individual borrowers, verify that there is rational justification for not making corrections. f) Verification of expected loss amounts from previous periods Compare expected loss amounts for individual borrowers and actual defaults and/or bankruptcies for individual borrowers from previous periods to verify that levels were adequate. If this verification indicates that expected loss levels were inadequate, verify the reasons why (for example, did past calculations of expected loss amounts correct for forecasts at the time of calculation?), and verify that expected loss rates are corrected at the base date. g) Verification of amount collectible from cash flow etc. If the institution excludes an amount collectible from cash flow from the Category III amount for individual borrowers, verify that 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. If the financial institution has a considerable number of borrowers classified as "in danger of bankruptcy" borrowers and omits considerations of credit security in favor of expected loss amounts based on group expected loss rates for borrowers below a set threshold value, verify that 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 as a single group. Verify that the scope of credits for "in danger of bankruptcy" borrowers below a set threshold value is rational.	Note: "Collectible amount 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.

Item	Verification of the appropriateness of write-off and reserve standards	Verification of the appropriateness of write-off and reserve results	Remarks
	B. Using a remainder found by subtracting a collectible amount from the credit amount as the expected loss amount for credits that have a saleable market (deeming a rationally calculated saleable value as the collectible amount)	B. Posting as default reserves an expected loss amount found as the remainder when a saleable amount is deducted from the Category III amount If credits have a market on which they can be sold and the institution uses the amount at which the credit can be sold as the collectible amount, and the institution deducts this collectible amount from the credit amount to arrive at a remainder that is used as the expected loss amount, verify that the calculation of the saleable amount for the credit is rational, and verify that the remainder when the collectible amount is deducted from the Category III is used as the expected loss amount.	
2) Specific default reserves and direct write-offs for "effectively bankrupt" and "bankrupt" borrowers	For credits to "effectively bankrupt" and "bankrupt" borrowers, use the amount of credits for each individual borrower classified as Category III or Category IV as the expected loss amount and ether post default reserves or make direct write-offs of an amount equivalent to the expected loss amount.	Verify that for credits to "effectively bankrupt" and "bankrupt" borrowers, the institution uses the amount of credits for each individual borrower classified as Category III or Category IV as the expected loss amount and either posts default reserves or makes direct write-offs of an amount equivalent to the expected loss amount. Verify that the institution uses the total amount of credits classified as Category III or Category IV as the expected loss amount, and that it does not deem the portion certain of collection as Category II and deduct the collectible amount from the Category III amount.	
3) Reserves against specific foreign credits	For reserves against specific foreign credits, determine the countries to be covered based on their financial conditions, economic conditions, foreign exchange reserves and other factors, and clarify which credits to the governments of these countries, private companies in these countries, and Japanese companies in these countries are subject to reserves against specific foreign credits. Multiply the relevant credits by an expected loss rate estimated from the financial conditions, economic conditions, foreign exchange reserves and other factors in specific countries to find an expected loss amount. Post an amount equivalent to this expected loss amount to the reserves against	Verify that the scope of countries and scope of credits subject to reserves against specific foreign credits, and the methods of calculating expected loss rates and expected loss amounts are rational. In particular, verify that calculations of 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. Verify that reserves against specific foreign credits include expected loss amounts as found by multiplying all credits from relevant countries by an expected loss rate estimated from the financial conditions, economic conditions, foreign exchange reserves 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	

Item	Verification of the appropriateness of write-off and reserve standards	Verification of the appropriateness of write-off and reserve results	Remarks
	specific foreign credits.	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. Specifically, verify that for those credits to "normal" and "needs attention" borrowers that are subject to reserves against specific foreign credits, the institution posts ordinary default reserves and also reserves against an expected loss amount found by multiplying the amount of the credit by an expected loss rate that estimates financial conditions etc. in the country in question. For credits to "in danger of bankruptcy", "effectively bankrupt", and "bankrupt" borrowers that are subject to reserves against specific foreign credits, verify that the institution posts expected loss amounts based on the financial position etc. of the individual borrower, and that it also posts as reserves against specific foreign credits or individual default reserves an expected loss amount found by multiplying the remainder when the initial expected loss amount is subtracted from the original credit to the borrower by an expected loss rate estimated from financial conditions etc. in the country in question.	
4) Verification of the appropriateness of the total value of default reserves		Verify that the total value of credits is at a level sufficient for the degree of credit risk to which the financial institution under inspection is exposed.	Note: Standards for the total amount of default reserves will be reviewed in the event of a change in the write-off and reserve standards promulgated by the Financial Revitalization Commission
2. Reserves other than default reserves	For reserves other than default reserves, rationally estimate and post highly probable contingency amounts. Note that the names of reserves used below are only examples and do not preclude the use of other names.	Verify that the institution rationally estimates and posts reserves for highly probably contingency losses in addition to default reserves. If the institution does not post reserves other than default reserves even though it is exposed to the potential for highly probably contingency losses, verify that there is rational justification for not posting these reserves.	.
(1) Reserves against losses from the sale of credits	If the price of collateral real estate securing credits sold to a joint credit purchasing agency has fallen or in other similar conditions, calculate an expected loss	Verify that calculation of the market price of real estate collateralizing sold credits is rational, that reserve standards are rational, and that these standards are at least at the levels described left.	

Item	Verification of the appropriateness of write-off and reserve standards	Verification of the appropriateness of write-off and reserve results	Remarks
	amount deemed like to be incurred as a result of the fall in the price of the sold credit, and post an amount equivalent to the expected loss amount as reserves against losses from the sale of credits. At the very least, when the market price of sold credits is more than 50% below the initial selling price, that portion of the difference between the initial selling price and the market price of the sold credit to be borne by the selling financial institution shall be posted as reserves. Likewise, if the credit is deemed certain of sale by the end of the next settlement period, that portion of the difference between the initial selling price and the estimated selling price of the collateral real estate to be borne by the selling financial institution shall be posted as reserves. Note: The expected loss amount from a fall in the price of collateral real estate is not an expected loss amount from a default of the credit to the joint credit purchasing agency, and it is therefore not appropriate to classify the borrower as "in danger of bankruptcy", "effectively bankrupt", or "bankrupt" for the joint credit purchasing agency or to post individual default reserves. However, credits to the joint credit purchasing agency are subject to ordinary default reserves (except for credits for which there is a rational justification for exclusion from ordinary default reserves).		
(2) **Reserves against support for specific borrowers**	If the institution is engaged in the rebuilding and support of borrowers that have fallen into difficult economic straits by relinquishing credits or providing cash grants, they shall in principle calculate an expected loss amount for the support and post an amount equivalent to the expected loss amount as reserves against support for specific borrowers. Specifically, in calculating the reserves for support to consolidated subsidiaries of the financial institution under inspection (including affiliated "non-banks"), the	Verify that all borrowers expected to be given support by relinquishment of credits or other cash grants etc. are covered, and that the calculation of expected loss amount from support to specific borrowers is rational. If the institution provides support by relinquishing credits and the expected loss amount from this supports posted as individual default reserves, verify that there is rational justification for posting it as individual default reserves and that calculation of the expected loss amount is rational.	

Item	Verification of the appropriateness of write-off and reserve standards	Verification of the appropriateness of write-off and reserve results	Remarks
	institution shall calculate an amount for the remaining Category III and Category IV values after deducting (allocating to Category IV credits first) a collectible amount for the subsidiary (total amount posted to capital plus 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 reserves to calculate a write-off and reserve amount for the subsidiary which shall be posted to reserves against support for specific borrowers as the expected loss amount from support to the subsidiary. In this case, the entire amount classified as Category IV and an amount from that is classified as Category III calculated using the same methods as the institution's write-off and reserve standards require for credits to "in danger of bankruptcy" borrowers shall be posted to reserves against support for specific borrowers as the expected loss amount from support to the subsidiary. The expected loss amount from support rendered to specific borrowers through relinquishment of credits and cash grants etc. should basically be posted to the reserves against support for specific borrowers, but when support is rendered by relinquishing credits and the expected loss amount from support to specific borrowers with borrower classifications 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 reserves against support for specific borrowers, or when there is other rational justification, the amount may be posted as individual default reserves.		
(3) Other reserves against contingency losses	If the institution is exposed to the potential for highly probable contingency losses other than (1) and (2) above, post a rationally estimated amount likely to be	Verify that future losses are rationally estimated and posted to other reserves against contingency losses. In particular, when credit liquidation schemes are used to take credits off balance sheet, verify that an	

Item	Verification of the appropriateness of write-off and reserve standards	Verification of the appropriateness of write-off and reserve results	Remarks
	borne to other reserves against contingency losses as the expected loss amount. 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 institution retains all or a part of the credit risk, post an amount equivalent to the expected loss amount from the Category III portion and the full amount of the Category IV portion to other reserves against contingency losses as the expected loss amount.	expected loss amount is posted to other reserves against contingency losses as described left.	
3. Securities appraisal	In appraising securities, post an amount equivalent to the expected loss amount from the Category III portion to reserves against investment losses, and directly write off the entire Category IV portion.	Verify that in the appraisal of securities the institution has posted an expected loss amount to the reserves against investment losses or has directly written off an expected loss amount as described left.	
(1) Bond appraisal	For privately-placed bonds issued by “in danger of bankruptcy”, “effectively bankrupt”, or “bankrupt” borrowers, calculate expected loss amounts using the same methods as for default reserves. Post an amount equivalent to expected loss amount from the Category III portion to reserves against investment losses, and directly write off the entire Category IV portion.	Verify that bond appraisal methods are rational, and that the institution posts the expected loss amount to reserves against investment losses or directly writes it off. If the institution classifies privately-placed bonds using the same method as it does for credits, verify that expected loss amounts are calculated using the same methods as default reserves. If the institution uses the same classification methods as for credits but has not posted expected loss amount to reserves against investment losses or directly written them off, or of it needs to make classifications but has not and therefore has not posted reserves or made write-offs, verify that there is rational justification for not doing so.	
(2) Equity appraisal	For equities issued by “in danger of bankruptcy”, “effectively bankrupt”, or “bankrupt” borrowers (excluding exchange-listed equities and over-the-counter-registered equities), calculate expected loss amounts using the same methods as for default reserves. Post an amount equivalent to expected loss amount from the Category III portion to reserves against investment losses, and directly write off the entire	Verify that equity appraisal methods are rational, and that the institution posts the expected loss amount to reserves against investment losses or directly writes it off as described left. If the original cost method is used, and there are clear standards for mandatory write-downs of value pursuant to the provisions of the Commercial Code, verify that these standards are rational. If the institution classifies equities using the same method as it does for credits, verify that expected loss	

Item	Verification of the appropriateness of write-off and reserve standards	Verification of the appropriateness of write-off and reserve results	Remarks
	Category IV portion. If there is a recognized need to reduce book values, directly write off the Category IV portion as an expected loss amount.	amounts are calculated using the same methods as default reserves. If the institution uses the same classification methods as for credits but has not posted expected loss amount to reserves against investment losses or directly written them off, or of it needs to make classifications but has not and therefore has not posted reserves or made write-offs, verify that there is rational justification for not doing so.	
(3) Foreign security appraisal	For foreign securities 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 default reserves. Post an amount equivalent to expected loss amount from the Category III portion to reserves against investment losses, and directly write off the entire Category IV portion.	Verify that foreign security appraisal methods are rational, and that the institution posts the expected loss amount to reserves against investment losses or directly writes it off as described left. If the institution classifies foreign securities using the same method as it does for credits, verify that expected loss amounts are calculated using the same methods as default reserves. If the institution uses the same classification methods as for credits but has not posted expected loss amount to reserves against investment losses or directly written them off, or of it needs to make classifications but has not and therefore has not posted reserves or made write-offs, verify that there is rational justification for not doing so.	
(4) Securities investment trust beneficiary certificate appraisal	The Category IV portion for securities investment trust beneficiary certificates is directly written off as the expected loss amount.	Verify that expected loss amounts are written off for securities investment trust beneficiary certificates as described left.	
4. Appraisal of other assets		In the appraisal of other assets, verify that expected loss amounts are posted as reserves or directly written off as described left.	
(1) Suspense payment appraisal	For suspense payments other than those similar to loans, post as reserves or directly write off the Category IV portion as the expected loss amount.		
(2) Chattel and real estate appraisal	For chattels and real estate, post as reserves or directly write off the Category IV portion as the expected loss amount.		

Item	Verification of the appropriateness of write-off and reserve standards	Verification of the appropriateness of write-off and reserve results	Remarks
(3) Golf club membership appraisal	For golf club memberships, post as reserves or directly write off the Category IV portion as the expected loss amount.		
(4) Miscellaneous assets appraisal	A. 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 default reserves. Post an amount equivalent to expected loss amount from the Category III portion to reserves against investment losses or to default reserves. For Category IV purchasing credits, post an amount equivalent to expected loss amount from the Category IV portion to reserves against investment losses or to default reserves, or directly write off this amount. B. For loan credit investment trust beneficiary certificates classified with the same methods as used for credits and used to liquidated credits from "in danger of bankruptcy," "effectively bankrupt," or "bankrupt" borrowers, calculate expected loss amounts using the same methods as for default reserves. Post an amount equivalent to expected loss amount from the Category III portion to reserves against investment losses or to default reserves. For Category IV purchasing credits, post an amount equivalent to expected loss amount from the Category IV portion to reserves against investment losses or to default reserves, or directly write off this amount.	If the institution classifies purchasing credits or loan credit investment trust beneficiary certificates using the same method as it does for credits, verify that expected loss amounts are calculated using the same methods as default reserves. If the institution uses the same classification methods as for credits but has not posted expected loss amount to reserves against investment losses or directly written them off, or of it needs to make classifications but has not and therefore has not posted reserves or made write-offs, verify that there is rational justification for not doing so.	

Inspections of capital adequacy ratios

I. Inspections of the accuracy of capital adequacy ratios

When inspecting the capital adequacy ratio of the financial institution under inspection, verify that calculations of the portions relevant to credit risk are accurate and in conformance with "Standards for Capital Adequacy Ratios Pursuant to Article 14-2 of the Banking Law (Ministry of Finance Notice No. 55).

Place priority in inspections on whether capital adequacy ratios are calculated appropriately in light of the "Supervisory Guidelines (issued by the FSA)", paying particular attention to the following.

1. Verify that the tax effect equivalent (amount commensurate to deferred tax assets) used in the capital account is calculated appropriately. If the tax effect equivalent posted is higher than estimated income tax for the next five years (before adjustments for future increases or decreases in temporary term-end differences) multiplied by an effective tax rate, verify that there are rational reasons for this.

2. If the institution has borrowed subordinated loans or issued subordinated bonds, verify that the subordinated borrowings are eligible for inclusion as owned capital in the capital adequacy regulations.

3. If the institution has utilized debt-based methods to raise capital that include special clauses to add on "step up interest rates" or the like, verify that the step up interest rates etc. are not excessive.

4. If the institution issues preferred investment certificates in foreign special purpose companies, verify that these preferred investment certificates fully conform to the intentions of the Basle Agreement.

5. If the institution has issued bank guarantees etc. (including credit liabilities that have an effect equivalent to a guarantee) for assets held and these guarantees etc. extend across settlement terms or are issued on the last day of the settlement term, verify that it has not reduced its risk assets even if the time to maturity for the guarantee is less than one year.

However, this excludes cases in which there is a justifiable reason for the guarantee etc. and continuing reductions of credit risks can be expected.

6. If the institution transfers credits with repurchase agreements that extend across settlement terms, verify that the contracts do not give incentives to exercise repurchase rights and repurchase credits within one year from the settlement term.

7. Verify that there are no other reductions etc. of risk assets contrary to the intentions of the capital adequacy regulations.

II. Verification of the effect of write-off and reserve inspection results on capital adequacy ratios

If the results of inspections of write-offs and reserves indicate insufficient write-off and reserve levels, endeavor to calculate additional required write-off and reserve values and the degree of impact this will have on the capital adequacy ratio. In other words, verify the degree to which the capital adequacy ratio will be reduced if additional required write-offs and reserves are made.

Specifically, handle these situations as described below, taking care to form a consensus among the chief inspector, the financial institution under inspection, and the external auditors.

1. Study write-off and reserve levels

Write-off and reserve levels shall be deemed inadequate in the following cases.

(1) Verifications of self-assessment standards and/or self-assessment results indicate inappropriate self-assessment standards or inaccurate self-assessment results, so that changes in borrower classifications etc. result in an increase in classified amounts (assigned to Category II, Category III, or Category IV), and therefore predict an increase in write-off and reserve values.

(2) Verifications of write-off and reserve standards and/or write-off and reserve results indicate inappropriate write-off and reserve standards and/or inappropriate calculations of write-off and reserve values so that an increase in the write-off and reserve values is forecast.

2. Calculation of additional required write-off and reserve values

Pay close attention to the following in calculating additional required write-off and reserve values, and endeavor to fully exchange opinions with the financial institution under inspection and external auditors.

(1) For the case in 1(1)

If the write-off and reserve standards of the financial institution under inspection are deemed appropriate, calculate additional required write-off and reserve values based on the write-off and reserve standards.

If the write-off and reserve standards of the financial institution under inspection are deemed inappropriate, calculate additional required write-off and reserve values based on write-off and reserve standards found as described in (2)1 below.

(2) For the case in 1(2)

1) If the write-off and reserve standards of the financial institution under inspection are deemed inappropriate, fully exchange opinions with the financial institution under inspection and external auditors regarding the parts deemed inappropriate, determine how to improve write-off and reserve standards, and calculate additional required write-off and reserve values based on the corrected write-off and reserve standards.

2) If the write-off and reserve results of the financial institution under inspection are deemed inappropriate, calculate the write-off and reserve values had appropriate write-offs and reserves been provided based on the write-off and reserve standards of the financial institution under inspection, and calculate the additional write-off and reserve required.

III. Monitoring of the financial institution's response to declines in the capital adequacy ratio

To monitor the financial institution's response to declines in the capital adequacy ratio, calculate the capital adequacy ratio assuming that additional required write-offs and reserves had been provided for during the settlement term, provide the results of these calculations to the financial institution under inspection, and confirm them with the institution.

Inspectors should accurately monitor the responses being considered by the financial institution under inspection in providing for additional required write-offs and reserves in the future. Specifically, inspectors should accurately monitor the response of the financial institution under inspection regarding write-off resources (profit forecasts, asset sales etc.), capital increase plans, and risk asset measures.

Study the appropriateness of this response, verify what the capital adequacy ratio will be in the next settlement term as a result of provisions of additional required write-offs and reserves as called for in appropriate response plans, and endeavor to form a consensus among the chief inspector, the financial institution under inspection and the external auditors.

In addition, verify whether the capital adequacy ratio this settlement term and next settlement term could be at levels that would invoke Prompt Corrective Actions as set forth in Article 21-2 etc. of the Concomitant Orders to the Banking Law (1982 Ministry of Finance Ordinance).

In doing this, verify whether the institution falls under the provisions of Article 21-3:2 or 3 of the Concomitant Orders.