

Credit Risk Inspection Manual

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Inspections of Credit Risk

The systems of prompt corrective actions are based on solvency margin ratios, and because of this, solvency margin ratios must be calculated from accurate financial statements. The creation of accurate financial statements will entail appropriate write-off and allowances allocations and also appropriate self-assessments, since self-assessments form the preparatory stage for write-off and allowances 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-off and allowances that the insurance company is claiming and the appropriateness of those levels. They must place particular emphasis on verifying that the company's total write-off and allowances 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 insurance company separately and individually in order to classify them according to their unrecovery risk and impairment risk. This serves as a measure of the safety and the certainty of the assets that stand behind the reserves for insurance transaction set aside for the future payment to policyholders or, in other words, the degree of risk to which the reserves are exposed because of the potential, or example, for drop in asset quality. When the insurance company performs this assessment on its own, it is referred to as a "self-assessment."

Self-assessments are a tool that insurance companies can use to manage their credit risks, and they also serve as the preparatory stage for appropriate write-off and allowances. Similarly, accounting auditors can verify self-assessments in their audits of insurance companies to evaluate the effectiveness of the insurance companies' self-assessments and other internal controls. When inspecting self-assessments, inspectors should assume that insurance companies have indeed performed self-assessments and that these self-assessments have been audited by accounting auditors. Based on these assumptions, inspectors should verify the status of the structure that the insurance company 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 verify if the insurance company's self-assessment standards, which are the preparatory stage for write-off and allowances, are rational and whether the self-assessment results appropriately reflect the asset quality of the insurance company under inspection.

II. Method of verifying self-assessment standards

Inspectors shall begin by performing "process checking." That is, they will first verify the status of the structure that the insurance company has put in place for self-assessments and the appropriateness of the insurance company'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 inspections, the inspectors shall endeavor to exchange opinions with the insurance company. For example, inspectors shall provide the insurance company under inspection with the viewpoints of the authorities, shall fully recognize the thinking of the insurance company in this regard, and shall directly confirm the viewpoint of the accounting auditors in the presence of the insurance company.

III. Verification of the insurance company's self-assessment structure

Inspectors shall verify the status of the structure that the insurance company 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 this "inspection manuals"?

Was self-assessment standards approved by the board of directors in formally internal procedure and written?

Do self-assessment standards specify the scope of assets subject to self-assessment, the divisions responsible for performing self-assessments (asset-related divisions, head office division of approving for loans (loan management division or loan screening division, etc) or asset assessment divisions) and internal audit divisions (credit auditing office, internal audit division, etc.), and the lines of responsibility for self-assessment standards and their formulation?

Are the opinions of internal audit 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 use by the self-assessment performing division in appropriately performing self-assessment?

2. Status of self-assessment structure

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

Are personnel versed in self-assessments assigned to the divisions performing self-assessments and internal audit division?

Do credit audit division and asset assessment divisions provide needed training and consultation to asset-related divisions?

Is internal audit division independent of the asset-related divisions? Do directors in charge of asset-related divisions have additional responsibilities for internal audit divisions? If directors in charge of internal audit divisions are additional in charge of asset-related divisions, are there sufficient checks in place to ensure the audits are appropriate?

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

It is desirable that internal audit 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 insurance company keep sufficient records and documents in its divisions that government inspectors, accounting 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 structure (changes in divisions performing or auditing self-assessments, etc.)?

4. Auditing by auditors and accounting auditors of self-assessment structure

Do auditors and accounting auditors who are not subject to the influence of the directors appropriately audit the status of self-assessment structure 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 insurance company are clear and appropriate and whether their framework conforms to the framework described in "Attachment". If the insurance company uses an original framework for its self-assessment standards, inspectors shall verify the relationship between the insurance company's framework and the model framework in "Attachment", and shall determine whether individual rules within the insurance company'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 debtor's degree of credit risk. "Credit ratings" are essential to credit risk management and form the basis for accurate self-assessments and appropriate write-off and allowances. "Credit ratings" must also be consistent with debtor classifications.
- (2) "Debtor classification": A judgement of the debtor's capacity to repay the obligation as determined from the debtor's financial position, financing, profitability and other considerations. Depending on results, the debtor is classified as "normal", "needs attention", "in danger of bankruptcy", "de facto bankrupt" or "bankrupt".
- (3) Assignment of assets to Categories II, III, or IV during self-assessment standards is referred to as "classification", and assets that have been assigned to Categories II, III, or IV are referred to as "classified assets." No classified assets to Categories II, III, or IV are referred to as "non-classified," and all assets other than "classified assets" (i.e., 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 Insurance Business Law Article 111, paragraph 1 (including pursuant to the provisions set forth in Article 199 of the same law, and so throughout) and its Enforcement Regulations Article 59-2, paragraph 1-5-3. Credit categories are based on the financial position and the business results of the debtor, and consist of "Normal credits", "Need control credits", "In danger of credits", "Credits of bankrupt/reorganization", categories.

2. Categories used in self-assessment

Self-assessment shall classify assets in four classes (I, II, III, IV) according to the degree of the unrecovery risk and the loss of value risk.

- (1) Category I consists of assets not classified to Category II, Category III, or Category IV. These are assets with no problems in terms of unrecovery risk or loss of value risk.
- (2) Category II consists of "assets deemed to include a higher than normal repayment risk because of conditions for ensuring the integrity of the credit have not been fully met or because there are questionable on credit." Category II may include both assets keep with collateral and guarantees, and un-kept assets.
- (3) Category III consists of "assets for which there are serious doubts about final recovery 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 insurance companies to estimate a loss amount and it is appropriate that insurance companies 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 unrecoverable or no value.” Category IV assets are not, however, assets that are absolutely unrecoverable or no value. Partial recovery may indeed be possible at some point in the future, but the asset is unrecoverable or without value on the assessment “base date ”.

V. Verification of the accuracy of self-assessment results

Inspectors shall use the methods described in “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 insurance company’s structure for self-assessments, reporting of self-assessment results of the board of directors, and auditing of self-assessment structure by auditors and accounting auditors

The results of category classifications shall make available for public view in accordance with the provision of Insurance Business Law Article 111, Paragraph 1.

Therefore, when inspectors deem self-assessment results to be inaccurate, 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 insurance company 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 immediately before the accounting period of inspection starting date (or the “presign date” for presigned inspections). However, if the inspection starting date is prior to a board of directors meeting to determine final accounts for the preceding account period, “base date ” shall be the final day of the second preceding account period.

(1) The determination of “base date” shall take into account the nature of the assets held by the insurance company 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 insurance company under inspection would warrant the inspection of the accuracy of the self-assessment results from the accounting period immediately before, then “base date” shall be the last day of the accounting period immediately before the inspection.

(2) All insurance companies are required to perform self-assessments as of the last day of the accounting period, but there may be cases in which, on business, the insurance company establishes a “provisional base date ” for its self-assessments. In these cases, inspectors should verify that “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 insurance company engages in credit management. This management should consist of continual monitoring of the financial position of the debtor, the status of the collateral and guarantee, and other relevant information, and the insurance company should review credit ratings, credit categories, and classifications as warranted by changes in conditions at the debtor. When the insurance company under inspection handles credits in this manner without establishing “provisional base date ”s, then inspectors should verify that credit rating reviews and the like are performed in an appropriate and timely manner.

2. Standards of sampling

The chief inspector shall determine standards of sampling according to the size of the insurance company under inspection, the nature of its assets, the results from the last inspection, the number of inspectors, the period of the inspection, and other relevant information. The chief inspector may change standards of sampling 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 insurance company under inspection and the results from the last inspection were good, the chief inspector may reduce the sampling rate.

3. Specific verification methods, etc.

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

(1) Scope of verification

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

(2) Specific verification methods

Inspectors shall use the materials (worksheets, etc.) employed by the insurance company under inspection in its self-assessments to verify the accuracy of self-assessments according to the self-assessment standards of the insurance company under inspection, paying particular attention to debtors classified as other than "normal." More specifically, inspectors shall verify the accuracy of debtor classifications and credit categories, and classified amounts.

1) When the insurance company under inspection uses "provisional base date" to perform its self-assessments, inspectors shall use materials from "provisional base date" to verify the accuracy of debtor classifications, credit categories, and classified amounts as at "provisional base date". They shall next verify that the insurance company has clear standards for revisions between "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 "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 "provisional base date" and the final day of the accounting period.

In determining whether the standards for revisions between "provisional base date" and the actual base date are rational, inspectors shall make a general judgment that considers the size of the assets held by the insurance company under inspection, the businesses in which it is engaged, and the impact on write-off and allowances.

2) For subsequent events after the final day of the accounting period, inspectors shall use the standards of sampling 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 account period. When verifying developments after the final day of the

accounting period, inspectors shall note the need to verify that the insurance company has rational standards or initiate reviews because of subsequent events, as was the case in Paragraph 1) above.

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

4. Standards for judging the accuracy of self-assessments

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 insurance company under inspection, inspectors shall judge the self-assessments as inaccurate.

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

- (1) There are problems with the appropriateness of the self-assessment standards and because of this there are misjudgments in the debtor classifications, credit categories, or classified amounts on "provisional base" date or "base date".
- (2) Assets sampled according to its own self-assessment standards of sampling and assessed by the insurance company under inspection:
 - 1) Were assessed as of "base date", but the debtor classifications, credit categories, or classified amounts as of "base date" were wrong.
 - 2) Employed assessment as of "provisional base date" in lieu of assessment as of "base date"; but the debtor classifications, credit categories, or classified amounts as of "provisional base date" were wrong.
 - 3) Were accurately assessed as of "provisional base date", but there were important subsequent changes in debtor conditions, loan repayment status, appraised collateral value, amount of credit or other matters required, and according to the insurance company's self-assessment standards, a review on "base date" was necessary but not done, so that the debtor classifications, credit categories, or classified amounts as of "base date" were wrong.
- (3) Other assets that the chief inspector specifically designates for sampling:

Are designated as "classified assets."

However, when the insurance company 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 insurance company's asset size and nature, and the influence on write-off and allowances, etc.