

<Provisional Translation>

# **Financial Inspection Rating System**

## **-FIRST-**

**Financial Inspection Rating System for Deposit-taking Financial Institutions**

**July 2005**

**Financial Services Agency**

Inspection Bureau No. 370  
July 1, 2005

To: Local Finance Bureau (Branch) Directors  
Director-General, Okinawa General Bureau  
Inspection Administrators  
Financial Inspectors

From: Masao Nishihara, Director-General, Inspection Bureau, Financial Services  
Agency

### **Financial Inspection Rating System for Financial Inspections**

In December of last year, the Financial Services Agency (FSA) developed and released the "Program for Further Financial Reform - Japan's challenge: Moving toward a Financial Services Nation -", which charted the course of its actions in the coming two years. With the recognition that the current financial system is "entering a new forward-looking phase aiming at establishing a desirable financial system for the future, having now moved beyond the emergency reaction against the non-performing loans problem," the Program aims to achieve the creation of a desirable financial system not by the initiative of the "public sector" but by the effort of the "private sector." As one of the concrete measures to that end, it proposed "effective and selective measures with high adaptability on the part of the administration through, for instance, the application of a rating system in inspection that is formulated from various viewpoints, rather than just limited to financial conditions"; based on deliberation results etc. of the "Financial Inspection Rating System Study Group," we have just developed and decided to implement the Financial Inspection Rating System for financial institutions as shown below, which you are reminded to develop good knowledge of and thoroughly internalize.

## **1. Objectives**

Through rating-based evaluation, conducted as part of the inspection of a financial institution, of results of the inspection verified pursuant to the Financial Inspection Manual, the “Financial Inspection Rating System” is intended to promote efforts of the financial institution toward voluntary and sustained improvement in its management, as well as interactive discussions between inspectors and the financial institution. It is also intended to provide efficiency etc. for inspections and improve transparency etc. of financial administration by connecting the rating results to selective regulatory measures.

You are additionally advised, in implementing the “Financial Inspection Rating System”, to pay full attention to the "Financial Inspection Manual (Inspection Department No. 177) and the "Report of the Financial Inspection Rating System Study Group (June 2005)" (Appendix).

## **2. Rating Items**

There are nine items subject to rating: "compliance system," "customer protection management system," "risk management systems (common items)," "capital adequacy management system," "credit risk management system," "asset assessment management system," "market-related risk management system," "liquidity risk management system," and "operational risk management system."

## **3. Rating Method**

In accordance with the "Rating Grades and Evaluating Points (Examples)" (Attachment), each rating item shall be rated using four grades: A, B, C and D.

## **4. Financial Institutions Subject to Rating**

- Banks
- Credit associations and federation of credit associations
- Credit cooperatives and federation of credit cooperatives

## **5. Administrative Work etc.**

(1) At the time of inspection, an inspector shall, during the period of on-site inspection, first have an adequate exchange of views with the financial institution being inspected as to the relationships of facts relevant to the rating, as well as the evaluation thereof. As well, the inspector shall, during the on-site inspection completion procedures (exit meeting), hear the opinion of the financial institution about the rating results to check for points agreed and disagreed on at that point in time by and between the chief

inspector and the financial institution being inspected.

(2) If there is any disagreement in view as to the rating results following the completion of the on-site inspection, the financial institution being inspected may, pursuant to the opinion submission process, bring it to the attention of the Director-General of the Inspection Bureau and request a review.

(3) The financial institution being inspected shall be notified of the final rating results as part of the inspection result report.

#### **6. Reflection in Selective Regulatory Measures**

The rating results shall be reflected in the degree of subsequent inspections (frequency, scope and depth of inspection).

#### **7. Implementation Date etc.**

The Financial Inspection Rating System shall go through a period of trial application within the 2005 inspection administration year and then be implemented soon in or after the 2006 inspection administration year. The specific implementation date etc. shall be as directed separately. During the period of the trial application, the focus should be placed on the accumulation of data and know-how concerning the rating, and rating results *per se* shall, although they are to be reported to the financial institutions, not be reflected in selective regulatory measures.

<Provisional Translation>

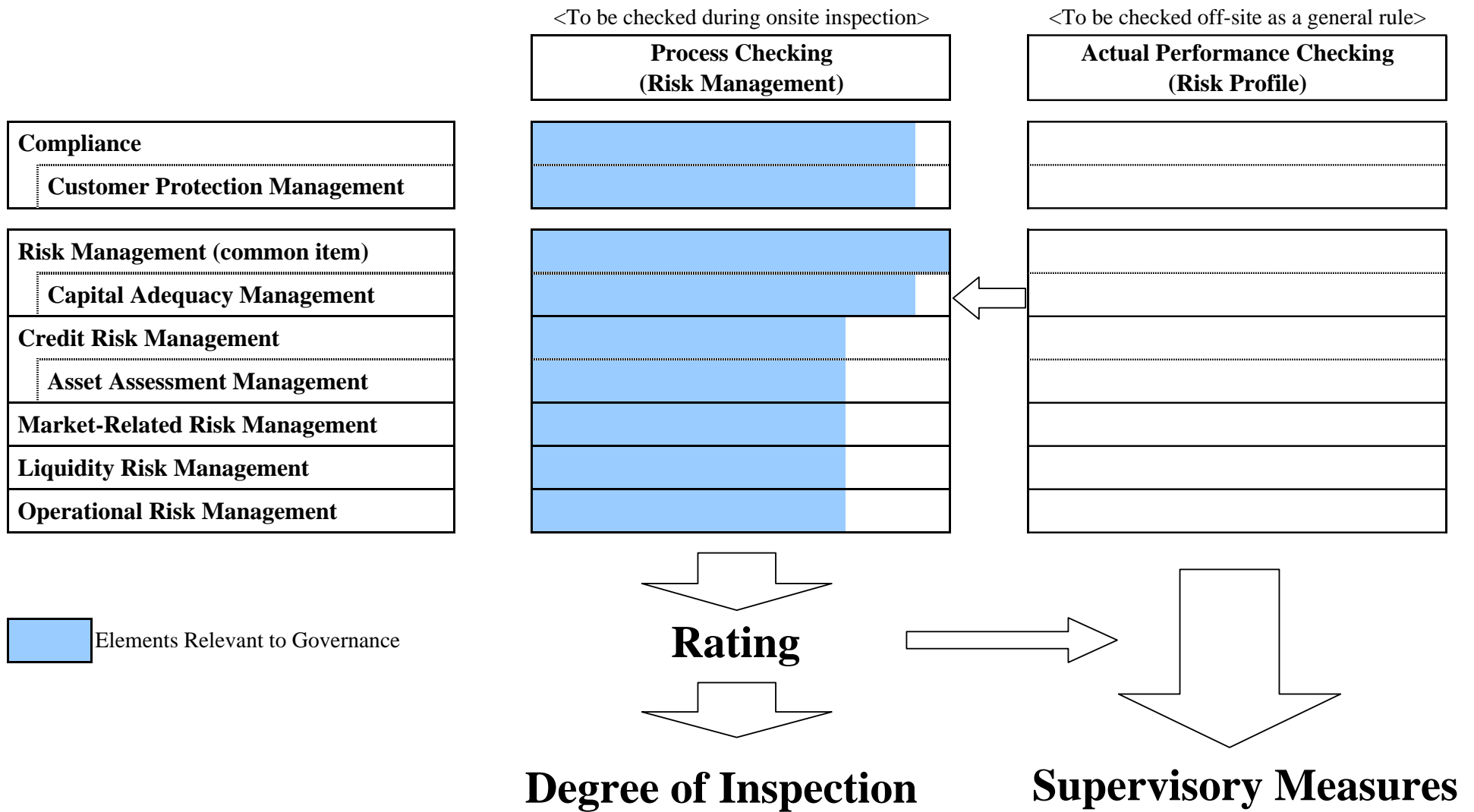
**(Attachment)**

**Rating Grades and Evaluating Points (Examples)  
Financial Inspection Rating System  
-FIRST-**

**July 2005**

**Financial Services Agency**

# Concept Illustration for the FIRST



Note: "Small- and medium-sized enterprise financing" should, in accordance with the Supplementary Issue to the Inspection Manual [For Small- and Medium-Sized Enterprise Financing], be evaluated as part of "credit risk management system" and "asset assessment management system."

# **Rating Grades and Evaluating Points (Examples)**

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## *Rating Grades*

### **1. Compliance System**

**A :**

As to the compliance system: A robust compliance system has been developed by the management. Weaknesses found are minor and have only a small effect on the appropriateness etc. of the ratee's operation as a financial institution.

**B :**

As to the compliance system: A sufficient compliance system has been developed by the management although minor statutory violation etc. was found. The minor weaknesses do not represent anything that has a serious effect on the appropriateness etc. of the ratee's operation as a financial institution, and have already been or can be expected to be addressed in a voluntary fashion.

**C :**

As to the compliance system: The current compliance system remains insufficient as, for instance, considerable statutory violation was found. The management's efforts concerning a statutory compliance system remain insufficient and need to be improved, seeing that the appropriateness etc. of the ratee's operation as a financial institution was also found to have been affected.

**D :**

As to the compliance system: The current compliance system was found to have a defect or serious defect as, for instance, serious statutory violation involving the management themselves was found. As a result, either there is apprehension about the occurrence of statutory violation that might threaten the ratee's existence as a financial institution, or such statutory violation is actually present.



## Compliance System

Note 1: [Priority in rating] ◎ Items of top priority; ○ Items of priority; △ Other items

Note 2: [Positioning in terms of governance] The shaded parts represent items which are subject to controls to be exercised by the management and, therefore, to which particular attention should be paid from the viewpoint of emphasizing governance.

Note 3: The items specified under “Evaluating Points (Examples)” represent illustrations of those matters which should particularly be noted when a rating is actually given, and do not cover every aspect to be examined during an inspection. In conducting an inspection, it is necessary to also take into consideration, while carefully comprehending the actual circumstances, matters that are not illustrated here.

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
Compliance System check list				
I . Establishment of compliance systems	1. Functions of the board of directors as the body making decisions on business-execution and supervising director activities	◎	Control by management	<ul style="list-style-type: none"> <li>- Note, for instance, how the representative directors have exercised leadership and how other directors have exerted their checking functions, in an attempt to establish a compliance system. In giving a rating, also make sure to do so upon checking by reference to meeting minutes etc.: how the representative directors have, during branch manager meetings etc., shown their commitment to establishing a compliance system; how other directors were exerting their checking functions when any officer etc. was involved with statutory violation etc., and; what was discussed in the board of directors meeting when the occurrence of statutory violation came to its attention.</li> <li>- While effectiveness needs to be ensured in the basic principles and compliance standards, with the size and profile of the financial institution also taken into consideration, pay attention in conducting an inspection not to meddle too much in any aspect that falls under the realm of corporate decision-making by the financial institution. In giving a rating, also note whether, for example, a strict position against antisocial elements, money laundering prevention, and customer information leakage prevention is expressly defined in the basic principles and compliance standards, and whether they have effective content suited to the actualities of the operation of the financial institution being inspected.</li> <li>- As to the functions of the board of auditors etc., note whether their independence and the effectiveness of operational audits and external audits in relation to the directors are ensured.</li> <li>- If any statutory violation involving the management themselves was found, note how the auditors were exerting their checking functions.</li> <li>- If the committee-based governance structure is applied, note that focus should not be placed on the decision <i>per se</i> to apply that structure, but what is important is that an effective auditing system has</li> </ul>
	2. Minutes etc. of board of directors meetings	◎		
	3. Functions of board of auditors etc.	◎		

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
		◎	Control by Management	<p>been ensured.</p> <p>In giving a rating, also note whether, with the reason and background etc. relevant at the time of the transfer to suited to the committee-based governance structure taken into consideration, effective auditing functions are ensured as suited to the corporate culture of the financial institution being inspected.</p> <p>- Note whether the management has truthfully ensured appropriate measures with respect to regulatory inspections, as well as reports and notices to be submitted to the authorities.</p>
	4. Check for basic compliance policies and standards	◎		
	5. Check for "specific actions as directors" related to compliance	◎		
II . Formation of compliance standards (behavioral rules)	Check for compliance manual	◎	Internal Control	<p>- As to the "compliance manual," it is important that it should have effective content in which the corporate culture etc. of the financial institution is taken into consideration, and should be thoroughly communicated and known to, and permeated among, every officer and employee.</p> <p>It is also important that any revision etc. should be made at an appropriate time and have content that covers actually-present issues and is suited to the existing circumstances of the financial institution being inspected.</p>
III . Establishment of checks to determine if compliance systems are functioning adequately	1. Check for compliance program	◎		
	2. Check for compliance environment	○		<p>- In rating any aspect of the compliance system during the examination of the "compliance environment," the rating needs to be determined according to the size and profile of the financial institution; however, in the case of any actual statutory violation, make sure to give a rating upon</p>

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
		○	Internal Control	<p>considering the impact that the said statutory violation has on the management of the financial institution, as well as the cause and background etc. of the violation, while bearing in mind that any statutory violation may not be forgiven due to the largeness or smallness of the financial institution's scale.</p> <p>In addition, the rating of the "compliance environment" shall be determined in consideration, also, of such matters as details of complaints from customers and incidents, actions taken to address them, and efforts that have been made in the area of compliance training.</p> <ul style="list-style-type: none"> <li>- If incidents of a similar nature have occurred or several incidents have occurred in succession, note, with their cause and background taken into consideration, the awareness of the management and the status of its efforts to prevent recurrence.</li> <li>- In examining any relevant aspect of the compliance system and personnel assignment etc., note, with the size and profile of the financial institution taken into consideration, whether effectiveness is ensured.</li> <li>- Note whether branch offices etc. have a practice, for the purpose of preventing terrorism funding and money laundering etc., of verifying the identity of a customer at the time of account opening, and promptly reporting to the supervising department at the headquarters on information about any suspicious transaction.</li> </ul>
IV. Sanctions (punishments) for compliance violations, enforcement of compliance rules	Check for "compliance review system"	◎	Control by Management	<ul style="list-style-type: none"> <li>- As to responses and improvement plans to be applied against statutory violations, it is important that strict and effective recurrence prevention measures should be established, in which causes and backgrounds of violation are taken into consideration. If the existing setup lacks strictness and remains a stopgap measure, comprehend once again the awareness of the management and the cause and background that explain why it remains insufficient, and then determine the rating.</li> <li>- In the case of cover-up of or tacit consent to any fact of statutory violation discovered, or in the case of failure to report to the authorities, determine the rating upon considering whether or not there was any involvement of the management, and how the fact of the cover-up etc. came to be discovered.</li> <li>- If any inaccurate disclosure of a non-performing loan amount was found, determine the rating upon checking for any deliberate intention.</li> </ul>
V. Laws and ordinances,	1. Outline of legal framework	△		<ul style="list-style-type: none"> <li>- Bear in mind that the laws and ordinances cited in the Financial Inspection Manual are only examples and, in the case of violation of any other law or ordinance etc., the rating should therefore need to be</li> </ul>

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
etc. to be complied with by financial institutions and their managers		△	Internal Control	determined also upon taking into consideration, for instance, the cause and background of the violation, as well as its effect on the operation of the financial institution being inspected.

■ Related items

Operational Risk Management System Checklist				
II . Auditing and correction of deficiencies 3 . Improperities	(1) Improperities	◎	Internal Control	- If incidents of a similar nature have occurred or several incidents have occurred in succession, note, with their cause and background taken into consideration, the awareness of the management and the status of its efforts to prevent recurrence.

	Improvement of the case pointed out with the last inspection	◎	Internal Control	- It is important that the management should take the initiative on and lead by example in the establishment and implementation of effective improvement plans. If the existing setup lacks strictness and remains a stopgap measure, comprehend once again the awareness of the management and the cause and background that explain why it remains insufficient, and then determine the rating.  - The rating for this item will serve as one element in judging whether the financial institution can be expected to take voluntary actions with respect to issues identified in the inspection underway.
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## *Rating Grades*

### **2. Customer Protection Management System**

**A :**

As to the customer protection management system: A system of providing explanations to customers and complaint handling functions that complement it, as well as a customer information management system, have been robustly developed by the management and are functioning. Weaknesses found are minor and have only a small effect on the appropriateness etc. of the ratee's operation as a financial institution.

**B :**

As to the customer protection management system: A system of providing explanations to customers and complaint handling functions that complement it, as well as a customer information management system, have been sufficiently developed by the management and are functioning. Although there are minor weaknesses, they do not represent anything that has a serious effect on the appropriateness etc. of the ratee's operation as a financial institution, and have already been or can be expected to be addressed in a voluntary fashion.

**C :**

As to the customer protection management system: The current system of providing explanations to customers, etc. or the current customer information management system remains insufficient, seeing that, for instance, considerable inadequacies were found in the system. The management's efforts concerning customer protection etc. remain insufficient and need to be improved, as the appropriateness etc. of the ratee's operation as a financial institution was also found to have been affected,.

**D :**

As to the customer protection management system: The current system of providing explanations to customers, etc. or the current customer information management system was found to have a defect or serious defect, seeing that, for instance, considerable inadequacies were found in the system. As a result, either there is apprehension that the ratee's existence as a financial institution might be threatened, or it actually is threatened, due to, among other consequences, customers leaving them.

## Customer Protection Management System

Note 1: [Priority in rating] ◎ Items of top priority; ○ Items of priority; △ Other items

Note 2: [Positioning in terms of governance] The shaded parts represent items which are subject to controls to be exercised by the management and, therefore, to which particular attention should be paid from the viewpoint of emphasizing governance.

Note 3: The items specified under “Evaluating Points (Examples)” represent illustrations of those matters which should particularly be noted when a rating is actually given, and do not cover every aspect to be examined during an inspection. In conducting an inspection, it is necessary to also take into consideration, while carefully comprehending the actual circumstances, matters that are not illustrated here.

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
				<ul style="list-style-type: none"> <li>- In rating the customer protection management system, note, in consideration of the policies etc, that the financial institution being inspected has articulated to secure customer protection in a specific fashion and improve the convenience for customers, whether effective measures are put into practice.</li> <li style="padding-left: 20px;">In giving the rating, also verify its appropriateness in accordance with applicable laws and ordinances, the Financial Inspection Manual, and the "Comprehensive Supervisory Guidance for Small- and Medium-Sized and Local Financial Institutions" (hereinafter referred to as the "Supervisory Guidance"), and then determine the rating.</li> </ul>
<b>Compliance System checklist</b>				
III. Establishment of checks to determine if compliance systems are functioning adequately	1. Check for compliance environment	○	Internal Control	<ul style="list-style-type: none"> <li>- If, after a complaint etc. was brought from a customer, similar complaints etc. were brought, or if it developed into an incident as no analysis or examination was conducted with respect to the cause with no appropriate prevention measures having been taken, note how the system of handling complaints etc. is operated.</li> <li>- Note whether the financial institution, in handling a complaint from a customer, facilitates or makes efforts to facilitate a solution upon obtaining as much comprehension and understanding as possible from the customer.</li> <li>- As to disclosure provided to customers, note its appropriateness or degree of satisfactoriness, e.g., whether its content represents specific and easy-to-understand information laid out from a customers' standpoint, rather than aiming to please everyone and being abstract.</li> <li>- Note whether branch offices etc. have a practice, for the purpose of preventing terrorism funding and money laundering etc., of verifying the identity of a customer at the time of account opening, and promptly reporting to the supervising department at the headquarters on information about any suspicious transaction.</li> </ul>

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
<b>Market Risk Management System Checklist</b>				
II . Establishment of appropriate risk management systems 2 . Management (1)Market-releted-management ①Customer risk management system	(1) Establishment of systems to manage and deal with disputes between the institution and its customers	○	Internal Control	<ul style="list-style-type: none"> <li>- If, after a complaint etc. was brought from a customer, similar complaints etc. were brought, or if it developed into an incident as no analysis or examination was conducted with respect to the cause with no appropriate prevention measures having been taken, note how the system of handling complaints etc. was developed.</li> <li>- Note whether the financial institution, in handling a complaint from a customer, facilitates or makes efforts to facilitate a solution upon obtaining as much comprehension and understanding as possible from the customer.</li> <li>- Note whether any actions are taken in selling financial products, to avoid providing any explanation that could be misunderstood as abuse of a dominant bargaining position.</li> <li>- Note the content and method of explanation and the method of confirming a customer's approval with respect to the nature of financial products as well as risks involved in those financial products, of which explanations are provided in order to ensure the effectiveness of measures taken to prevent any mix-up between deposits etc. and risk products, and note how the system for these purposes has been developed.</li> </ul>
	(2) Development of derivatives products	◎		
	(3) Sales to customers	◎	Internal Control	
	(4) Explanation of products to customers and confirmation of customer intent	◎		
	(5) Reporting of trades to customers	◎		
<b>Operational Risk Management System Checklist</b>				
II . Auditing and correction of deficiencies 3 . Improprieties	(2) Complaints etc. from customers	◎	Internal Control	<ul style="list-style-type: none"> <li>- If, after a complaint etc. was brought from a customer, similar complaints etc. were brought, or if it developed into an incident as no analysis or examination was conducted with respect to the cause with no appropriate prevention measures having been taken, note how the system of handling complaints etc. was developed.</li> <li>- Note whether the financial institution, in handling a complaint from a customer, facilitates or makes efforts to facilitate a solution upon obtaining as much comprehension and understanding as possible from the customer.</li> </ul>
	(3) Custmer protection	◎		
III . Operatinal Risk Management System				<ul style="list-style-type: none"> <li>- Note the content and method of explanation and the method of confirming a customer's approval with respect to the nature of financial products as well as risks involved in those financial products, of which explanations are provided in order to ensure the effectiveness of measures taken to prevent any mix-up between deposits etc. and risk products or insurance products, as well as note how the system for these</li> </ul>

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
2. RoE of operations division		◎	Internal Control	<p>purposes has been developed.</p> <ul style="list-style-type: none"> <li>- As to financing transactions involving derivatives etc., note whether the financial institution explains the nature of the products and the risks involved, except where a customer's knowledge and experience etc. spare the necessity of such explanations, by providing written documents in which they are laid out in a specific and easy-to-understand manner with the use of concrete examples etc. (including not only best-case scenarios but also maximum loss amounts imaginable under worst-case scenarios), and whether, where a customer himself/herself bears risk, the financial institution obtains confirmation, when necessary, that the customer has received explanations.</li> <li>- Note whether a system of providing explanations, when a customer so requests, of such matters as the applicable loan term agreement, maximum amount of security or guarantee, third-party guarantee, and proprietor guarantee, has been developed, in an attempt to obtain customers' comprehension and understanding for the purpose of preventing any dispute etc. from arising later.</li> <li>- Note whether, in reviewing a business relationship or refusing a customer's request, the financial institution properly and sufficiently explains the reason etc. to the extent possible for the purpose of obtaining comprehension and understanding from the customer.</li> <li>- In examining a system of customer information management, note, for instance, the following points: <ul style="list-style-type: none"> <li>i ) Whether a system of managing information has been developed, such as the establishment of a manual or implementation of security management measures, in an attempt to take appropriate actions for the purpose of preventing inappropriate acquisition and use, or leakage etc. of customer information, and whether contractors are supervised in order to ensure appropriate information management (including appropriate selection of contractors).</li> <li>ii ) Whether efforts are made to thoroughly familiarize employees etc. with the customer information management method etc. by, for instance, providing training on a regular basis.</li> <li>iii ) Whether a system that enables appropriate and prompt actions in the event of any incident, such as leakage etc. of customer information, has been developed (Together with this point, examine whether,</li> </ul> </li> </ul>



Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
		◎	Internal Control	<p>in the event of an incident such as information leakage etc., prompt reporting to the supervisory authorities, release of the fact situation etc., and notification to victims have been carried out, and also examine whether a system of checking for any missed report, release or notification has been established as a follow-up measure).</p> <p>In addition, whether the directors and auditors are involved in the establishment of recurrence prevention measures following any incident such as information leakage, and make efforts to ensure its effectiveness.</p> <p>iv) Whether an internal audit is conducted on a regular basis with respect to the customer information management system.</p> <p>v) Whether sensitive personal information is treated in a particularly strict and careful fashion.</p> <p>- Note whether branch offices etc. have a practice, for the purpose of preventing terrorism funding and money laundering etc., of verifying the identity of a customer at the time of account opening, and promptly reporting to the supervising department at the headquarters on information about any suspicious transaction.</p>
	(4) Customer protection	◎		
<b>Information Technology Risk Management System Checklist</b>				
V Organizational issues 1. Management organizations	(5) Internet Transactions management	◎	Internal Control	<p>- In examining a system of managing data on personal information, etc., note whether a management system has been developed that is in accordance with the "Guidelines for Personal Information Protection in the Financial Sector" and the "Working Guidance for Security Management Measures etc. under the Guidelines for Personal Information Protection in the Financial Sector."</p>
2. Computer system administration structure	(4) Protection of customers etc. data	◎		
<b>Supervisory Guidance</b>				
	<p>Refer to the following.</p> <ul style="list-style-type: none"> <li>- Identification customers, Reporting suspicious transaction</li> <li>-Explanation to loan customers, Due treatment of public complaints</li> <li>-Prevention of customer's misidentification</li> </ul>	◎	Internal Control	<p>- In rating the customer protection management system, bear in mind that it is necessary to also take into consideration, for example, the "Main Evaluating Points" for the items from the "Supervisory Guidance" that are specified on the left, in addition to the above "Evaluating Points in Rating (Examples)" for the "Financial Inspection Manual."</p>

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
	-Management of Customer information -Protection of illicit use of cash account -Outsource of Banking operations	◎	Internal Control	
	-Measures against counterfeit or stolen bank cash card	◎		- Bear in mind that it is necessary to take into consideration contents of concrete counter measures concerning the report of the “Counterfeit Bank Cash Card Study Group “etc.
	Improvement of the case pointed out with the last inspection	◎	Internal Control	<ul style="list-style-type: none"> <li>- It is important that the management should take the initiative on and lead by example in the establishment and implementation of effective improvement plans. If the existing setup lacks strictness and remains a stopgap measure, comprehend once again the awareness of the management and the cause and background that explain why it remains insufficient, and then determine the rating.</li> <li>- The rating for this item will serve as one element in judging whether the financial institution can be expected to take voluntary actions with respect to issues identified in the inspection underway.</li> </ul>

## *Rating Grades*

### **3. Risk Management Systems (Common Items)**

**A :**

As to the risk management systems: A robust management systems suited to the size and profile of the financial institution has been developed by the management. All major risks are effectively identified, comprehended and managed in a consistent fashion, and weaknesses found are minor and have only a small effect on the appropriateness etc. of the ratee's operation as a financial institution.

**B :**

As to the risk management systems: A sufficient management systems suited to the size and profile of the financial institution has been developed by the management. Major risks and problems are mostly identified, comprehended and managed. Although minor weaknesses were found, they do not represent anything that has a serious effect on the appropriateness etc. of the ratee's operation as a financial institution, and have already been or can be expected to be addressed in a voluntary fashion.

**C :**

As to the risk management systems: The current system remains insufficient as a risk management setup suited to the size and profile of the financial institution. The management's ability to manage risks remains insufficient and needs to be improved, because the appropriateness etc. of the ratee's operation as a financial institution was also found to have been affected.

**D :**

As to the risk management systems: The management's current system of managing risks was found to have a defect or serious defect. As a result, either there is apprehension about the occurrence of some incident or unexpected damage that may threaten the ratee's existence as a financial institution, or such incident or unexpected damage has actually occurred.

## Risk Management Systems (Common Items)

Note 1: [Priority in rating] ◎ Items of top priority; ○ Items of priority; △ Other items

Note 2: [Positioning in terms of governance] The shaded parts represent items which are subject to controls to be exercised by the management and, therefore, to which particular attention should be paid from the viewpoint of emphasizing governance.

Note 3: The items specified under “Evaluating Points (Examples)” represent illustrations of those matters which should particularly be noted when a rating is actually given, and do not cover every aspect to be examined during an inspection. In conducting an inspection, it is necessary to also take into consideration, while carefully comprehending the actual circumstances, matters that are not illustrated here.

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
<b>Risk Management Systems Checklist (Common Items)</b>				
I . Management oversight and the control culture 1 . Awareness of directors and role of board of directors	(1) Representative director's understanding of risk	◎	Internal Control	<ul style="list-style-type: none"> <li>- In rating the risk management systems (common items), bear in mind that each checklist item from the Financial Institution Manual makes up the basics of risk management that should naturally be exercised in operating a financial institution and, in particular, that the directors of a financial institution are required to be aware of and put into practice themselves. Specifically, examine its appropriateness in accordance with applicable laws and ordinances, the Financial Inspection Manual, and the Supervisory Guidance etc., and then determine a rating.</li> <li>- Note, for instance, how the representative directors have exercised leadership and how other directors have exerted their checking functions in an attempt to establish the risk management system. In so doing, bear in mind that the matter needs to be examined by taking into consideration the content of discussion in board of directors meetings etc.</li> <li>- Note whether the board of directors has developed management policies and management plans based on clear visions and strategies, and has also developed and made thoroughly known strategic goals and effective risk management policies which are based on those goals, and also whether it discusses and reviews them on an as-required basis according to, for example, any change of the environment surrounding the financial institution being inspected. In addition, pay attention not to meddle too much in any aspect that falls under the realm of corporate decision-making by the financial institution.</li> <li>- In noting, for instance, how the management policies etc. were developed or how the directors have performed their good stewardship obligations and good faith obligations, do so upon checking the details of discussion in board of directors meetings etc. by reference to the meeting minutes.</li> </ul>
	(2) Functions of the board of directors as the body making decisions on business-execution and supervising director activities	◎		
	(3) Minutes etc. of board of directors meetings for the institution as a whole	◎		
	(4) Establishment of management philosophies etc.	◎		
	(5) Articulation of strategic goals based on management philosophies etc. for the institution as a whole	◎		

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
	(6) Director's understanding and awareness of risk management	◎	Internal Control	<ul style="list-style-type: none"> <li>- Note whether the directors have expertise on banking operations and risks that banks are exposed to, and make efforts to establish and maintain appropriate risk management.</li> <li>- As to the setup of organizations for risk management, note, with the size and profile of the financial institution taken into consideration, whether effectiveness is ensured.</li> <li>- As to the functions of the board of auditors etc., note whether their independence and the effectiveness of operational audits and accounting audits in relation to the directors are ensured.</li> <li>- If the management is procrastinating on resolving any weakness that they are aware of to evade responsibility of negligence themselves, or if the management is improperly interfering with self-assessment results etc., note how the auditors have exerted their checking function.</li> <li>- As to audits by statutory auditors on the status of self-assessment and development of write-off and allowance arrangements, etc., note whether the audits are conducted as is deemed proper on the process of self-assessment etc., such as how self-assessment criteria were developed, rather than merely on the results of self-assessment etc.</li> <li>- If the committee-based governance structure is applied, note that focus should not be placed on the decision per se to apply that structure, but what is important is that an effective auditing system has been ensured.</li> </ul> <p>In giving the rating, also note whether, with the reason and background etc. relevant at the time of the transfer to the committee-based governance structure taken into consideration, effective auditing functions are ensured as suited to the corporate culture of the financial institution being inspected.</p>
	(7) Establishment of risk management guidelines	◎		
	(8) Establishment of organizations for risk management	◎		
	(9) Reporting on risk status to board of directors etc. and use of risk information in decision-making for the organization as a whole	◎		
	(10) Establishment of guidelines regarding the training and assignment of personnel for appropriate risk management	◎		
	(11) Functioning of the board of auditors	◎		

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
2. Awareness of roles of senior management	(1) Senior management's understanding and awareness of risk management	◎	Internal Control	<ul style="list-style-type: none"> <li>- Bear in mind that the risk manager assumes responsibility for implementing directions from the board of directors, such as the implementation of management strategies and policies and risk management policies, and the establishment of an internal control structure. Note, for example, whether effective rules and organizations have been put in place, which are based on policies articulated by the directors.</li> <li>- In examining any aspect of the development of organizations and personnel assignment etc. for risk management purposes, note, with the size and profile of the financial institution taken into consideration, whether effectiveness is ensured.</li> </ul>
	(2) Establishment of risk rules for risk management	◎		
	(3) Establishment of organizations for risk management	◎		
	(4) Appropriate risk management practice	◎		
	(5) Appropriate assignment of risk management staff	○		
	(6) Establishment of training systems for personnel development	△		
	(7) Personnel management designed to prevent incidents	○		
3. Control culture	Cultivation of a control culture emphasizing the importance of risk management	◎	Control by Management	<ul style="list-style-type: none"> <li>- Note whether the representative director, board of directors, and risk manager have responsibility for establishing a culture within the organization that promotes high ethical and integrity standards and emphasizes and demonstrates to all levels of personnel the importance of internal controls, and whether the current system is structured in such a manner that every officer and employee assumes some responsibility in the development of internal controls.</li> </ul>
II. Establishment of appropriate risk management systems	Identification of locus types of risks to be managed	◎	Internal Control	<ul style="list-style-type: none"> <li>- In giving a rating to a financial institution that is exposed to major and complicated risks, bear in mind that consideration needs to be given to if and how an "integrated risk management" system has been developed.</li> </ul> <p>* An "integrated risk management" system refers to an attempt to compare various risks involved and</p>
1. Risk recognition				

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
and assessment		◎	Internal Control	management strengths and to control the risks based on such comparison results, as well as to utilize them as a management index by connecting them with business plans and profit-making plans.
2. Control activities	(1) Appropriate risk management techniques and rules	○		
	(2) Establishment and review of rules in individual business divisions	○		
	(3) Comprehensive risk management	○		
3. Segregation of duties	Erection of a system of mutual checking	◎		- In examining any aspect of the development of a system of mutual checking, note, with the size and profile of the financial institution taken into consideration, whether effectiveness is ensured.
4. Information and communication	(1) Reports to the board of directors etc. from the risk management division	◎		- Reports submitted to the management need to be appropriate and comprehensive, and also need to have the effect of having the board of directors and the risk manager recognize for sure the locus and volumes etc. of the risks that the financial institution assumes. It is also necessary that the management strategies and policies, and risk management method articulated by the board of directors etc. should be communicated to regular employees for sure. In determining the rating, note whether such a system has been developed.
	(2) Content reports to the board of directors etc.	◎		
	(3) Availability of information systems etc.	◎		
III. Internal audit 1. Recognition of, and policies for internal audit functions, by representative directors and the board of directors	(1) Recognition of the importance of an internal audit	◎	Control by Management (Internal Audit)	- It is important for the representative directors and board of directors to be aware that an internal audit department is an extremely important agent acting for them, and the board of directors needs to use the reports submitted by the internal audit department by regarding them to be the results of checks of all operations of the financial institution that were conducted from an independent standpoint. In determining the rating, note whether the management of the financial institution has developed an effective internal audit system with such awareness.
	(2) Establishment of an organizational system for performing internal audit functions	◎		
				- In examining any relevant aspect of the risk management system and personnel assignment etc., note, with the size and profile of the financial institution taken into consideration, whether effectiveness is ensured. If there has not been any attempt made to designate a director exclusively in charge of internal audits, or to acquire and assign in the internal audit department personnel who are versed with the respective operations, note how the management views the matter and what kinds of actions it has taken.

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
		◎		<ul style="list-style-type: none"> <li>- If internal audit functions are outsourced to a third party in the case of internal audit on information technology risks etc., also note whether internal audits are conducted under appropriate control of the financial institution being inspected.</li> </ul>
	(3) Management of the internal audit department	◎		
2. Independent of the internal audit	(1) Independence of the internal audit department	○	Internal Audit	<ul style="list-style-type: none"> <li>- In examining any aspect of the independence of the internal audit department, note, with the size and profile of the financial institution taken into consideration, whether effectiveness is ensured. If concurrently serving two different posts is permitted, pay attention, with the cause and background of the double posting taken into consideration, to whether it is posing a hindrance to an attempt to ensure effectiveness of internal audits.</li> <li>- If the internal audit function is deemed not to be authorized (or not to be authorized in effect) to audit all operations of the financial institution, to obtain all information, and to interview all officers and employees, note the cause and background etc. of that situation.</li> <li>- If the internal audit department does not keep track of important information in terms of internal controls, such as information on incidents and complaints etc., on an as-required basis, also note the cause and background etc. of that situation.</li> </ul>
	(2) Extent of authority and responsibility of the internal audit	○	Control by Management (Internal Audit)	
	(3) Establishment of system conducive to obtaining information	○	Internal Audit	
3. Professional competence of internal auditors	Professional competence of internal auditors	◎	Internal Audit	<ul style="list-style-type: none"> <li>- If internal auditors are deemed not necessarily to have professional competence, note whether any measure intended to complement such lack has been taken.</li> </ul>
4. Internal audit rules	Internal audit rules	◎		
5. Internal audit planning	Internal audit planning	○	Control by Management (Internal Audit)	<ul style="list-style-type: none"> <li>- Note whether internal audit plans are developed to be efficient and effective ones in which the frequency and depth etc. are carefully set in consideration of the results of past internal audits etc. of the respective departments and branches and according to the type and degree of risks that auditees are exposed to, and also whether internal audits have been conducted in line with those plans.</li> </ul>



Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
		○	Control by Management (Internal Audit)	<ul style="list-style-type: none"> <li>- If the substance of internal audits remains only at a level of operational inspection that mainly results in the identification of mere inadequacies concerning clerical processing, rather than examining appropriateness and effectiveness of the internal control system etc., note the cause and background of that situation.</li> <li>- Note whether there is an established structure under which the results of self-inspection conducted by an auditee and the details of operational guidance given by the relevant main office department are reported to the internal audit department, and internal audit results are fed back to the respective departments and branch offices etc.</li> <li>- Note whether auditees have without delay improved on the problems pointed out during the internal audits, and whether the internal audit department has appropriately followed up on the status of improvement on the problems.</li> <li>- If any problem is found not to have been improved on, find out the cause and background of the situation, e.g., whether it is due to negligence on the part of the auditee, or there is something wrong with the identification of the problem during the internal audit per se, and then determine the rating.</li> <li>- Note whether auditees have without delay improved on the problems pointed out during the external audits, and whether the internal audit department has appropriately followed up on the status of improvement on the problems.</li> <li>- If, in addition to financial statement audits and examination of effectiveness etc. of the internal control system conducted as part of the said auditing procedures, any external audit that is not required under statute has been conducted, note whether it has been utilized effectively for the establishment of the financial institution's internal control system, rather than focusing only on whether such an external audit has been conducted or not. If there has been no attempt made to correct any problem identified during the external audit, find out the cause and background etc. of that situation and then determine the rating.</li> </ul>
6. Implementation of an internal audit	Implementation of an internal audit	◎	Internal Audit	
7. Reporting of internal audit results and correction of problems	(1) Reporting of internal audit results	◎		
	(2) Correction of problems	◎	Control by Management (Internal Audit)	
IV. External audit	(1) External audits	◎	Control by Management (External Audit)	

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
	(2) Relationship between external auditors and the internal audit department	◎		
	(3) Correction of problems	◎	External audit	

■ Related items

Credit Risk Management System Checklist

II . Establishment of appropriate risk management systems 3 . Credit management	(2) Role of screening and management division	◎	Internal Audit	<ul style="list-style-type: none"> <li>- Note whether, during credit audits, examination has been conducted on the existence of any improper loan transactions and on ensuring of appropriate credit management, in addition to the examination of accuracy etc. of credit ratings.</li> <li>- If credit exposures are found to be concentrated, check how the credit auditing division has examined them and note how the checking functions have been exerted.</li> <li>- Note whether credit audits have been conducted in consideration of views of external auditors on self-assessment criteria etc. and self-assessments etc.</li> </ul>
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Operational Risk Management System Checklist

II . Auditing and correction of deficiencies 1. Internal audits	Methods and content of internal audits	◎	Internal Audit	<ul style="list-style-type: none"> <li>- In rating any aspect of internal audits, note whether process checking has been conducted, such as analysis of the cause of an operational inadequacy, rather than simply pointing out an operational inadequacy.</li> </ul>
2 . correction of deficiencies	Reports of deficiencies to board of directors and senior management	◎		

Information Technology Risk Management System Checklist

III . Monitoring activities and correcting deficiencies 1. Internal audits	(1) Organization of internal audit division	◎	Internal control	<ul style="list-style-type: none"> <li>- As to internal audits on computer system risks, internal audits are sometimes in effect outsourced; in such a case, note whether appropriate management is in place with respect to the content of audits conducted by the outsourcee upon making it clear that the outsourcing is done in order to strengthen internal audit functions from the viewpoint of professional expertise, rather than leaving everything up</li> </ul>
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Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
	(2) Methods and content of audits performed by internal audit division	◎	Internal control	to the outsourcee.
2. External audits	Use of external audits	◎	External audit	
	Improvement of the case pointed out with the last inspection	◎	Internal control	<ul style="list-style-type: none"> <li>- It is important that the management should take the initiative on and lead by example in the establishment and implementation of effective improvement plans. If the existing setup lacks strictness and remains a stopgap measure, comprehend once again the awareness of the management and the cause and background that explain why it remains insufficient, and then determine the rating.</li> <li>- The rating for this item will serve as one element in judging whether the financial institution can be expected to take voluntary actions with respect to issues identified in the inspection underway.</li> </ul>

## *Rating Grades*

### **4. Capital Adequacy Management System**

**A :**

As to the capital adequacy management system: A robust management system suited to the size and profile of the financial institution has been developed by the management and, as a result, the equity capital is at a level that is quite satisfactory in terms of both quality and quantity.

**B :**

As to the capital adequacy management system: A sufficient management system suited to the size and profile of the financial institution has been developed by the management, and the equity capital is also at a sufficient level. Although minor weaknesses were found, they do not represent anything that has a serious effect on the appropriateness etc. of the ratee's operation as a financial institution, and have already been or can be expected to be addressed in a voluntary fashion.

**C :**

As to the capital adequacy management system: Either the current management system remains insufficient as a risk management setup suited to the size and profile of the financial institution, or the equity capital is at an insufficient level. The management's ability to manage remains insufficient and needs to be improved because, seen from the fact that, for instance, the capital adequacy ratio has not been calculated accurately, the appropriateness etc. of the ratee's operation as a financial institution was also found to have been affected.

**D :**

As to the capital adequacy management system: The current system of management was found to have a defect or serious defect. As a result, the equity capital is inadequate and therefore either there is apprehension that the ratee's existence as a financial institution might be threatened or it actually is threatened.

## Capital Adequacy Management System

Note 1: [Priority in rating] ◎ Items of top priority; ○ Items of priority; △ Other items

Note 2: [Positioning in terms of governance] The shaded parts represent items which are subject to controls to be exercised by the management and, therefore, to which particular attention should be paid from the viewpoint of emphasizing governance.

Note 3: The items specified under “Evaluating Points (Examples)” represent illustrations of those matters which should particularly be noted when a rating is actually given, and do not cover every aspect to be examined during an inspection. In conducting an inspection, it is necessary to also take into consideration, while carefully comprehending the actual circumstances, matters that are not illustrated here.

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)																	
Item	Check list																				
<b>Credit Risk Management Manual — Inspections of capital adequacy ratios</b>																					
Capital adequacy	I . Inspection of the accuracy of capital adequacy ratios	◎	Control by Management	<ul style="list-style-type: none"> <li>- In rating a capital adequacy management system, emphasis should be placed on the accuracy of the adequacy ratio calculation, rather than being concerned only about the level of capital adequacy ratio. Judgment should be made in a comprehensive fashion upon understanding fully the cause and background of any discrepancy in capital adequacy ratio before and after the inspection (such as the existence of any deliberate intention, clerical error, the lack of verification functions, difference in write-off and allowance amount due to an erroneous self-assessment). In so doing, also pay attention to the degree of impact that the problem with the management system has on corporate management of the financial institution being inspected.</li> <li>- If the post-inspection capital adequacy ratio is equal to or above the ratio as prescribed in "Prescribing Capital Adequacy Ratio Standards under the Provisions of Article 14-2 of the Banking Law" (Ministry of Finance Notice No. 55, March 31, 1993) (8% for institutions calculating their capital adequacy ratio according to the international standards, and 4% for institutions calculating their capital adequacy ratio according to the domestic standards), a rating of B or higher should be given as a general rule; however, for instance, the following points should be taken into account as negative factors in rating:               <ul style="list-style-type: none"> <li>- If, after the inspection was conducted, the accuracy of capital adequacy ratio calculation has been found to be low (for instance, where the rate of discrepancy in capital adequacy ratio before and after the inspection is 10% or higher), take that into account as a negative factor in rating.</li> <li>- If the financial institution deliberately skewed the accuracy of its capital adequacy ratio calculation method etc., that into account as a negative factor in rating.</li> <li>- If the financial institution deliberately skewed the accuracy of its capital adequacy ratio calculation method etc., also note, among other aspects, whether the management was involved or not, how audits were conducted by the internal audit department, and how the institution was submitting explanations</li> </ul> </li> </ul>																	
<b>Evaluating Points in Rating (Examples) (Accuracy of capital adequacy ratios)</b>																					
<p>• In verifying the capital adequacy management system, the gap in capital adequacy ratio before and after the inspection is used as one element in judging the accuracy of the capital adequacy ratio calculation.</p> <p>*The gap of the accuracy of capital adequacy = <math>\frac{\text{The capital adequacy ratio calculated by the institution} - \text{The capital adequacy ratio calculated by the FSA}}{\text{The capital adequacy ratio calculated by the institution}} \times 100</math></p> <table border="1" style="margin-left: auto; margin-right: auto; border-collapse: collapse; text-align: center;"> <thead> <tr> <th colspan="2"></th> <th colspan="2" style="text-align: center;">Capital adequacy ratio after the inspection ( ) : For the institutions calculating their capital adequacy ratio according to the domestic standards</th> </tr> <tr> <th colspan="2"></th> <th style="text-align: center;">8 % ( 4 % )</th> <th style="text-align: center;">4 % ( 2 % )</th> </tr> </thead> <tbody> <tr> <td rowspan="2" style="text-align: center; vertical-align: middle;">Accuracy of capital adequacy ratios (*The gap ratio in capital adequacy ratio)</td> <td style="text-align: center;">Small gap 10%</td> <td style="text-align: center;">"B" or higher as a general rule</td> <td style="text-align: center;">C</td> <td style="text-align: center;">D</td> </tr> <tr> <td style="text-align: center;">Not small gap</td> <td style="text-align: center;">"C" or higher as a general rule</td> <td style="text-align: center;">D</td> <td style="text-align: center;">D</td> </tr> </tbody> </table>							Capital adequacy ratio after the inspection ( ) : For the institutions calculating their capital adequacy ratio according to the domestic standards				8 % ( 4 % )	4 % ( 2 % )	Accuracy of capital adequacy ratios (*The gap ratio in capital adequacy ratio)	Small gap 10%	"B" or higher as a general rule	C	D	Not small gap	"C" or higher as a general rule	D	D
		Capital adequacy ratio after the inspection ( ) : For the institutions calculating their capital adequacy ratio according to the domestic standards																			
		8 % ( 4 % )	4 % ( 2 % )																		
Accuracy of capital adequacy ratios (*The gap ratio in capital adequacy ratio)	Small gap 10%	"B" or higher as a general rule	C	D																	
	Not small gap	"C" or higher as a general rule	D	D																	

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
				<p>and reports to the authorities, and, furthermore, bear in mind to examine any problem with respect to compliance as well.</p> <ul style="list-style-type: none"> <li>- In determining the rating, on the other hand, consider, for instance, the following points as positive factors in rating: <ul style="list-style-type: none"> <li>- The financial institution has properly managed required capital adequacy ratio by means of integrated risk management etc. under clear policies and strategies.</li> <li>* For the definition of "integrated risk management," refer to "Risk Management Systems (Common Items)."</li> <li>- The equity capital is quite satisfactory in terms of both quality and quantity in light of the financial institution's risk profile.</li> </ul> </li> </ul>
	<p>I Supplement Verification of the adequacy of calculation of market risk price</p> <p>II . Verification of the effect of write off and allowance results on capital adequacy</p> <p>III. Monitoring of the institution's response to declines in the capital adequacy ratio</p>	◎	Control by Management	<ul style="list-style-type: none"> <li>- Where a financial institution calculating its capital adequacy ratio according to the international standards applies the internal model in calculating an amount put at market risk, bear in mind that it is necessary to take into account in rating how a system of calculating an accurate risk volume etc. has been developed.</li> <li>- Appropriateness of self-assessment criteria, and write-off and allowance criteria etc., as well as appropriateness of their implementation, should be examined by referring to the items under "Asset Assessment Management System."</li> <li>- In deciding what to look at as benchmarks in rating, take into account, for instance, the following points as negative factors: <ul style="list-style-type: none"> <li>- The management does not have any clear policies and strategies etc. regarding the maintenance of a proper capital adequacy ratio, or efficient use of capital and has not conducted sufficient deliberation (for instance, no measure has been discussed even though the capital adequacy ratio is expected to drop by a substantial degree within a certain number of years (e.g., three years).</li> <li>- No measure has been discussed even though the capital adequacy ratio is expected to drop during the coming accounting year to a level near or below the level that triggers the early correction measures; or, for instance, although some measures have been planned, they have no likelihood of being carried out during the current accounting year</li> </ul> </li> </ul>

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
<b>Supervisory Guidance</b>				
	Calculation of the capital adequacy ratio	◎	Internal Control	<ul style="list-style-type: none"> <li>- In rating a capital adequacy management system, bear in mind that it is necessary to also take into consideration, for example, the "Points to Bear in Mind" for the items from the "Supervisory Guidance" that are specified on the left, in addition to the above "Evaluating Points in Rating (Examples)" for the "Financial Inspection Manual."</li> </ul>
	Improvement of the case pointed out with the last inspection	◎	Internal Control	<ul style="list-style-type: none"> <li>- It is important that the management should take the initiative on and lead by example in the establishment and implementation of effective improvement plans. If the existing setup lacks strictness and remains a stopgap measure, comprehend once again the awareness of the management and the cause and background that explain why it remains insufficient, and then determine the rating.</li> <li>- The rating for this item will serve as one element in judging whether the financial institution can be expected to take voluntary actions with respect to issues identified in the inspection underway.</li> </ul>

## *Rating Grades*

### **5. Credit Risk Management System**

**A :**

As to the credit risk management system: A robust management system suited to the size and profile of the financial institution has been developed by the management. Weaknesses found are minor and have only a small effect on the appropriateness etc. of the ratee's operation as a financial institution.

**B :**

As to the credit risk management system: A sufficient management system suited to the size and profile of the financial institution has been developed by the management. Although minor weaknesses were found in the area of screening and control etc., they do not represent anything that has a serious effect on the appropriateness etc. of the ratee's operation as a financial institution, and have already been or can be expected to be addressed in a voluntary fashion.

**C :**

As to the credit risk management system: The current system remains insufficient as a risk management setup suited to the size and profile of the financial institution. The management's ability to manage risks remains insufficient and needs to be improved because, seen from the fact, for instance, that some issue in the area of screening and control etc., or concentration of credit risk exposures was found as a result, the appropriateness etc. of the ratee's operation as a financial institution was also found to have been affected.

**D :**

As to the credit risk management system: The current system of management was found to have a defect or serious defect. As a result, either there is apprehension that the ratee's existence as a financial institution might be threatened, or it actually is threatened, because, for instance, concentration of credit risk exposures was found to be worsening, or asset quality of any borrower on which credit risk exposures concentrate was found to have been deteriorating.

\* In rating the credit risk management system regarding small- or medium-sized enterprises, or micro enterprises etc., make a judgment upon taking into consideration the purposes of the Supplementary Issue to the Financial Inspection Manual [For Small- and Medium-Sized Enterprise Financing].



## Credit Risk Management System

Note 1: [Priority in rating] ◎ Items of top priority; ○ Items of priority; △ Other items

Note 2: [Positioning in terms of governance] The shaded parts represent items which are subject to controls to be exercised by the management and, therefore, to which particular attention should be paid from the viewpoint of emphasizing governance.

Note 3: The items specified under “Evaluating Points (Examples)” represent illustrations of those matters which should particularly be noted when a rating is actually given, and do not cover every aspect to be examined during an inspection. In conducting an inspection, it is necessary to also take into consideration, while carefully comprehending the actual circumstances, matters that are not illustrated here.

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
<b>Credit Risk Management System Checklist</b>				
I . Awareness of risk management 1 . Awareness of directors and role of board of directors	(1) Articulation of strategic goals in line with management philosophies etc.	◎	Control by management	<ul style="list-style-type: none"> <li>- Give a rating upon noting whether strategic targets of the lending divisions etc., as well as credit risk management policies and credit policies developed on the basis of those targets, are specific and, with the size and profile of the financial institution taken into consideration, are effective as well. In so doing, pay attention not to meddle too much in any aspect that falls under the realm of corporate decision-making by the financial institution.</li> <li>- In rating the credit risk management system regarding small- or medium-sized enterprises, or micro enterprises etc., note whether an effective risk management system suited to the business model etc. of the financial institution being inspected has been developed. For instance, in the case of a business model under which a certain degree of likelihood of non-performing loans is assumed, note whether a risk management system commensurate with it has been developed.</li> <li>- Check, on the basis of board of directors meeting minutes etc., what kinds of deliberation the board of directors has conducted with respect to the adequateness of level of write-off and allowance amount. If the write-off and allowance amount has been set in consideration of a targeted financial closing, note how each director views it and how the mutual checking functions of the directors have been exerted.</li> <li>- Note whether the management is aware that developing an interest rate (proper loan rate) system based on proper credit risk volumes in accordance with credit ratings is an important issue relevant to profitability management of a financial institution, and whether a system of actively promoting such an action has been developed. Also bear in mind to take into consideration the size and profile of the financial institution.</li> </ul>
	(2) Director's understanding and awareness of risk management	◎		
	(3) Establishment of credit risk management guidelines	◎		

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
	(4) Establish of organizations for risk management	◎	Control by management	<ul style="list-style-type: none"> <li>- As to the setup of organizations for risk management, note, with the size and profile of the financial institution taken into consideration, whether effectiveness is ensured.</li> <li>- If any problem has arisen with respect to credit risk management, e.g., credit exposures are found to have been concentrated, check, by referring to board of directors meeting minutes etc., how the checking functions of other directors have been exerted over the director in charge of business promotion divisions etc., and determine a rating.</li> </ul>
	(5) Reporting on risk status to the board of directors and use of risk information in the organization as a whole	◎		
2. Awareness and role of senior management	(1) Establishment of rules for risk management	△	Internal Control	<ul style="list-style-type: none"> <li>- As to the development of an interest rate (proper loan rate) system based on proper credit risk volumes in accordance with credit ratings, note whether a structure in line with directions of the management has been developed. Note, for example, whether such attempts as establishment of management accounting, credit risk data accumulation, and development of internal criteria for interest rate determination have been made, and interest rates have been determined in a rational fashion. Also bear in mind to take into consideration the size and profile of the financial institution.</li> </ul>
	(2) Practice of appropriate risk management	○		
II. Establishment of appropriate risk management system 1. Awareness and evaluation of risk	(1) Establishment of integrated risk management system	◎	Internal Control	<ul style="list-style-type: none"> <li>- In giving a rating to a financial institution that is exposed to major and complicated risks, bear in mind that consideration needs to be given to if and how an "integrated risk management" system has been developed.  * For the definition of "integrated risk management," refer to "Risk Management System (Common Items)."</li> </ul>
	(2) Evaluation of integrated risk management systems	△		
2. Screening and management	(1) Establishment of screening and management	◎	Internal Control	<ul style="list-style-type: none"> <li>- As to the development of screening and management structure, note, upon taking into consideration the size and profile of the financial institution being inspected, whether effectiveness is ensured.</li> <li>- Note whether the financial institution, in offering credit, tries to collect every piece of information regarding the borrower in order to comprehend the borrower's conditions, as well as applies a sound loan system as a financial institution.</li> </ul>
	(2) Role of Screening and management division	◎		

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
				<ul style="list-style-type: none"> <li>- If it can be found, for instance, that efforts made to improve a "good judge" ability to discern the business potential of small- and medium-sized enterprises, and micro enterprises have strengthened the credit check system and are preventing loans from deteriorating, take that into account as a positive factor in rating.</li> </ul>
3. Credit Management	(1) Establishment of credit management division		Internal Control	<ul style="list-style-type: none"> <li>- As to credit management, note, for instance, the following points: <ul style="list-style-type: none"> <li>i ) How credit limits are determined and are adhered to (if a limit has been exceeded or is found to have been increased, note the cause and background of that situation)</li> <li>ii ) A credit management system applied to major borrowers (if the amount of credit given to a major borrower has increased, note the cause and background of that situation)</li> <li>iii ) If and how the financial institution tries to prevent loans from deteriorating (if problem loans are found to have increased, or where the definition etc. for problem loan has been changed, note the cause and background of that situation)</li> <li>iv ) Status of efforts in enhancing functions of business consulting and support for client companies</li> <li>v ) Status of business revamping efforts</li> </ul> </li> <li>- In examining any aspect of the asset portfolio status, note whether a system intended to ensure asset soundness has been developed, e.g., even if the financial institution has substantial credit exposures in a specific industry or a specific region, it has taken actions to hedge the risks by some means. Especially in rating a cooperative financial institution etc. that serves a limited geographical area, note whether, even if substantial credit exposures are found to be in a specific industry, an effective risk management system has been developed, e.g., whether portfolio management is exercised in consideration of the characteristics of the region.</li> <li>- If monitoring of borrowers that are small- and medium-sized enterprises or micro enterprises is, or business consulting and business improvement guideline etc. provided to them are found to be facilitating communication with the borrowers (ensuring close communication with borrowers) and make it possible to comprehend exact business conditions of the borrowers, take that into account as a positive factor in rating.</li> </ul>
	(2) Role of credit auditing division		◎	<ul style="list-style-type: none"> <li>- Setup of a credit auditing division should be examined by referring to the items under "Risk Management Systems (Common Items)."</li> </ul>

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
	(3) Role of risk management division	○	Internal Control	<ul style="list-style-type: none"> <li>- As to the role of a risk management division, note, with the size and profile of the financial institution being inspected taken into consideration, whether effectiveness is ensured.</li> <li>- As to problem loan management, note, for instance, whether such management represents an attempt toward business revamp etc., rather than thoughtless procrastination on solving the problem. Specific examples of Evaluating points are: <ul style="list-style-type: none"> <li>i ) If and how the financial institution being inspected has made efforts toward revamping borrowers' businesses</li> <li>ii ) Development of a management system run by a dedicated department other than sales divisions and branch offices</li> <li>iii ) Where any turnaround plan etc. has been drawn up, whether the plan is effective and feasible in terms of business revamp, instead of being a product of procrastination on solving the problem</li> <li>iv ) If and how the financial institution has made efforts to deal with problem loans by off-balance-sheet means such as debt securitization and bulk sale</li> </ul> </li> <li>- If it can be found that some attempt has been made to mitigate credit risks through efforts toward revamping businesses of small- and medium-sized enterprises and micro enterprises that are in or are falling into financial predicaments, take that into account as a positive factor in rating.</li> </ul>
4. Mnagement of problem credits	(1) Establishment of management systemfor problem credits	◎		
	(2) Role of problem credit management division	○		
5. Self-assessments on asset quality	See "credit risk Inspection Manual"			
6. Write-offs and allowances on asset quality	See "credit risk Inspection Manual"			

■ Related Item (Loan for small and medium-sized enterprises)				
The supplement to the Financial Inspection Manual: Treatment of Classifications regarding Credits to Small and Medium-sized Enterprises				
	<Intoroduction>	◎	Internal Control	<ul style="list-style-type: none"> <li>- If it can be found that the Supplementary Issue to the Financial Inspection Manual [For Small- and Medium-Sized Enterprise Financing] has been made known and followed thoroughly within the financial institution and has also been penetrated among the sales front and, as a result, efforts have been made to comprehend business conditions etc. of small- and medium-sized enterprises and to turn them around, and the system of management regarding credit risks has thereby been strengthened, take that into account as a positive factor in rating.</li> </ul>

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			

■ Related Item

Market Risk Management System Checklist				
II . Establishment of appropriate risk management systems 2 . Management (1) Market-releted management ⑧ Management of credit risks associated with market trading	(1) Measurement of credit risk associated with market trading	△	Internal Control	<ul style="list-style-type: none"> <li>- In rating credit risks associated with market trading, note whether an effective management system has been assured, upon taking into consideration the size and profile, as well as the credit policies and the asset portfolio status etc., of the financial institution being inspected, and then determine the rating.</li> <li>For example, check the following points and examine how effective they are:               <ul style="list-style-type: none"> <li>i ) Consistency between the credit policies and the securities management policies</li> <li>ii ) How loans and securities are managed in the aggregate when the borrower and issuer are the same entity</li> <li>iii ) How audits have been conducted by an internal audit department (credit auditing division)</li> </ul> </li> </ul>
	(2) Integrated on/off-balance-sheet management of positions, market price appraisals, and credit risks	△		
	(3) Clear systems for credit approval, independent credit approval functions	△		
	(4) Fomulation of credit limit rules and appropriate management of credit limit	△		
	(5) Use of risk mitigation measures	△		

	Improvement of the case pointed out with the last inspection	◎	Internal Control	<ul style="list-style-type: none"> <li>- It is important that the management should take the initiative on and lead by example in the establishment and implementation of effective improvement plans. If the existing setup lacks strictness and remains a stopgap measure, comprehend once again the awareness of the management and the cause and background that explain why it remains insufficient, and then determine the rating.</li> <li>- The rating for this item will serve as one element in judging whether the financial institution can be expected to take voluntary actions with respect to issues identified in the inspection underway.</li> </ul>
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## *Rating Grades*

### **6. Asset Assessment Management System**

**A :**

As to the asset assessment management system: Management systems such as a self-assessment system and a write-off and allowance system suited to the size and profile of the financial institution have been robustly developed by the management. Weaknesses found are minor and have only a small effect on the appropriateness etc. of the ratee's operation as a financial institution.

**B :**

As to the asset assessment management system: A sufficient management system suited to the size and profile of the financial institution has been developed by the management, and write-offs and allowances are secured at a sufficient level according to the degree of credit risks. Although minor inadequacies were found in the accuracy of self-assessment etc., they do not represent anything that has a serious effect on the appropriateness etc. of the ratee's operation as a financial institution, and have already been or can be expected to be addressed in a voluntary fashion.

**C :**

As to the asset assessment management system: Either the current management system remains insufficient as a management setup suited to the size and profile of the financial institution, or write-offs and allowances are not secured at a sufficient level according to the degree of credit risks. As, seen from the fact that, for instance, inadequacies have occurred in the self-assessment system or write-off and allowance system, the management's ability to manage remains insufficient, it needs to be improved because the appropriateness etc. of the ratee's operation as a financial institution was also found to have been affected.

**D :**

As to the asset assessment management system: The current system of management was found to have a defect or serious defect. As a result, either there is apprehension that the ratee's existence as a financial institution might be threatened or it actually is threatened, seen from the fact that a large amount of shortage is found in write-offs and allowances.

## Asset Assessment Management System

Note 1: [Priority in rating] ◎ Items of top priority; ○ Items of priority; △ Other items

Note 2: [Positioning in terms of governance] The shaded parts represent items which are subject to controls to be exercised by the management and, therefore, to which particular attention should be paid from the viewpoint of emphasizing governance.

Note 3: The items specified under “Evaluating Points (Examples)” represent illustrations of those matters which should particularly be noted when a rating is actually given, and do not cover every aspect to be examined during an inspection. In conducting an inspection, it is necessary to also take into consideration, while carefully comprehending the actual circumstances, matters that are not illustrated here.

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
Credit Risk Management Manual -Inspections of self-assessment on asset quality				
Inspections of self-assessments	I .Purpose of inspections of self-assessment	◎	Internal control	<ul style="list-style-type: none"> <li>- In rating the "asset assessment management system," determine the rating upon taking into consideration the size and profile of the financial institution inspected, as well as its business model, and, rather than focusing only on the rate of discrepancy (with inspector assessments) in classified-loans-to-total-assets ratio or in non-performing loan ratio, and the growth rate in write-off and allowance amount, fully comprehend the cause and background of why the discrepancy occurred and pay attention to find out if there is any problem with respect to the management system.</li> <li>- In the case of a financial institution that has chosen a high-risk, high-return business model, also conduct an examination from a viewpoint of whether a risk management system suited to the credit risks that it has assumed, rather than suited only to the level of non-performing loan ratio etc., has been developed, and whether the soundness of its operation as a financial institution is ensured.</li> <li>- Check, on the basis of board of directors meeting minutes etc., what kinds of deliberation the board of directors has conducted, in developing self-assessment criteria etc., on the appropriateness of its content. If self-assessment criteria have been established in consideration of the borrower classification etc. of any specific borrower and the level of non-performing loan ratio, note how each director views them and how the mutual checking functions of the directors have been exerted.</li> <li>- As to the status of self-assessment system development, note, with the size and profile of the financial institution being inspected taken into consideration, whether effectiveness is ensured.</li> </ul>
	II . Method of inspecting self-assessment standards			
	III. Verification of the institution's self-assessment systems 1. Formulation of self-assessment standards			
	2. Status of self-assessment systems	◎		

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
	3.Reporting of self-assessment results to the board of directors	◎	Control by management	<ul style="list-style-type: none"> <li>Note whether the director etc. in charge of a business promotion division has expressed any opinion on self-assessment results etc. in consideration of the borrower classification etc. of any specific borrower, and examine its appropriateness. Also note how the mutual checking functions of the directors have been exerted.</li> </ul>
	4.Auditing by auditors and external auditors of self-assessment systems	◎		
	IV.Verification of the appropriateness of self-assessment standards	◎	Internal control	<ul style="list-style-type: none"> <li>Note whether any attempts were made promptly to improve on the problems identified as a result of internal audits, external audits and public audits, and relevant departments have been thoroughly instructed to comply therewith.</li> <li>In examining the appropriateness of the content and implementation of self-assessment criteria, note, instance, the following points: <ul style="list-style-type: none"> <li>i ) Whether they have specific content, such as a description of judging criteria for loan repayment ability for etc., and whether it is reasonable.</li> <li>ii ) Whether judging criteria for borrower classifications or credit ratings are formulated, not only in qualitative terms but also in quantitative terms, so that the actual conditions of a borrower are reflected, and whether their content is reasonable.</li> <li>iii) Whether any criteria etc. by which to appropriately reflect the mark-to-market balance sheet of a borrower have been developed.</li> <li>iv) Whether, in calculating an estimated sale value of real estate offered as security, reasonable criteria for necessary or adjustment is reasonable.</li> <li>v ) Whether any appropriate judging criteria exist with respect to "possibility of recovery" in impairment accounting for securities, and the possibility of recovery has been examined fully under those criteria with respect to securities with a significantly depreciated market value.</li> </ul> </li> </ul>
	1.Definition of terms			
	2.Categories used in self-assessment standards			
	V.Verification of the appropriateness of self-assessment results	◎		
				<ul style="list-style-type: none"> <li>In examining the accuracy of self-assessment results, identify any problems lying in the system upon taking into consideration the pre-assessment level of classified loans ratio etc. and effects on write-offs and allowances, as well as the circumstances etc. existing at the time of the previous inspection, rather than focusing only on the smallness or largeness of the rate of discrepancy (with inspector assessments) in classified-loans-to-total-assets ratio or classified-loans-to-total-loans ratio, or in non-performing loan ratio. If, in particular, no improvement was found from the rate of discrepancy calculated at the time of the previous inspection, check the cause and background thereof, and identify what kinds of problems have arisen in terms of the system.</li> <li>In examining the accuracy of self-assessment results, bear in mind that examination points under the</li> </ul>



Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
		◎		Financial Inspection Manual [For Small- and Medium-Sized Enterprise Financing], etc. need to be taken into consideration as well.
	1.Base date			
	2.Sampling standards			
	3.Specific inspection methods			
	4.Self-assessment accuracy standards			

■ The related items ( treatment of classifications regarding credits to small and medium-sized enterprises)

Inspection of Credit Risk Manual (Attachment)

	1.Credit classification method  (3)Borrower classifications	◎	Internal control	- In examining the borrower classification for a small- and medium-sized enterprise or a micro enterprise etc., try to track down every basis of judgment that the financial institution being inspected used in conducting the self-assessment, and bear in mind that the actual business conditions of the small- and medium-sized enterprise or micro enterprise etc. need to be comprehended in detail, in such a manner as suited to its actual circumstances.
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The supplement to the financial inspection manual : treatment of classifications regarding credits to small and medium-sized enterprises

	[ The verification points ]			- As to "approach to borrowers" as indicated in the Supplementary Issue to the Financial Inspection Manual [For Small- and Medium-Sized Enterprise Financing], bear in mind that it is supposed to be taken into account as a positive factor in rating if a financial institution adequately comprehends the actual business conditions of its borrowers by means of physical visits and business management guideline etc. and, therefore, that the absence of any "approach to borrower" alone should not be taken into account negatively in rating.
	1.Identification with representatives	◎	Internal control	- Note whether, by means of monitoring of borrowers that are small- and medium-sized enterprises or micro enterprises, or business consulting and business improvement guideline etc. provided to them, exact business conditions of the borrowers have been comprehended through such communication with them (by ensuring close communication with borrowers), and whether they have been reflected appropriately in self-assessments etc.  Note, for instance, whether the financial institution has, by making efforts to prompt borrowers to prepare highly detailed financial statements, adequately comprehended the status of cash flow, as well as the status of not only assets but also liabilities, with those of their representatives etc. added up together, in an attempt to understand their actual business conditions.

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
	2.Growth potential that bases nature and these of technology, sales force of enterprise, and mnager	◎	Internal control	- Note whether the improved "good judge" ability to discern, for example, the business potential of small- and medium-sized enterprises, and micro enterprises has led to better understanding of a borrower's exact business conditions, and whether such understanding has been appropriately reflected in self-assessments etc.
	3.Management improvement plan			- Note whether the data that the financial institution prepared or analyzed and now uses as a basis of judgment for self-assessments were prepared upon communicating closely with borrowers through business consulting and business improvement guideline etc. and taking into consideration the borrowers' actual business conditions.
	4.Lending terms and the implementation situation			- Note the achievability of improvement in the business of the small- and medium-sized enterprise, or micro enterprise, with attention paid to its forecasted cash flow.
	5.Lending condition easing claim			- Note whether the financial institution being inspected comprehends the cause leading up to the change of terms etc. by communicating closely with the borrower.
	6.Drawing of enterprise and bussiness reproduction working and management necessary claim ahead			- Refer to the "Relevant Items" for [Small- and Medium-Sized Enterprise Financing] under "Write-Offs and Allowances."
	7.Handling of capital subordinated loan			- As to write-offs and allowances with respect to quasi-capital subordinated loans, note whether they are handled appropriately in accordance with the "Treatments in Auditing Concerning Accounting Procedures in the Case of Conversion of Bank Loans into Quasi-Capital Subordinated Loans" (November 2, 2004, Japanese Institute of Certified Public Accountants), etc.

Credit Risk Inspection Manual-Inspections of Write-offs and Allowances

Write-offs and Allowances	I .Purpose of inspectors of write-offs and allowances	◎	Internal control	- Check, on the basis of board of directors meeting minutes etc., what kinds of deliberation the board of directors conducted with respect to the appropriateness of the content of write-off and allowance criteria during its development etc. If write-off and allowance criteria have been established in consideration of a targeted financial closing etc., note how each director views them and how the mutual
	II .Method of inspecting write-offs and allowances			
	III.Verification of the institutions' write-off and allowance systems 1.Formulation of write-off and allowance standards			

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
		◎	Control by management	checking functions of the directors have been exerted.
	2.Status of write-off and allowance systems	◎		- As to the status of development of a write-off and allowance structure, note, with the size and profile of the financial institution being inspected taken into consideration, whether effectiveness is ensured.
	3.Reporting of write-off and allowance results to the board of directors	◎		- Note whether the director etc. in charge of a division responsible for financial closing procedures has expressed any opinion on write-off and allowance results etc. in consideration of a targeted financial closing etc., and examine its appropriateness. Also note how the mutual checking functions of the directors have been exerted.
	4.Auditing by auditors and external auditors of write-off and allowance systems	◎		
	IV. Verification of the appropriateness of write-off and allowance standards	◎	Internal control	- Note whether any attempts were made promptly to improve on the problems identified as a result of internal audits, external audits and public audits, and relevant departments have been thoroughly instructed to comply therewith.
	V. Verification of the appropriateness of write-off and allowance results	◎		- In examining the appropriateness of write-offs and allowances, identify any problems in the system upon taking into consideration the pre-assessment level of write-off and allowance amount etc. and effects on capital adequacy ratio, as well as the circumstances etc. existing at the time of the previous inspection, rather than focusing only on the smallness or largeness of the rate of growth in write-off and allowance amount. If, in particular, no improvement is found from the rate of growth calculated at the time of the previous inspection, check the cause and background thereof, and identify what kinds of problems have arisen in terms of the system.  - Note whether, in the calculation of uncollectibles ratio or probable loss ratio, necessary adjustments have been made on the basis of reasonable grounds, and appropriate figures of probable loss ratio etc. have been calculated.
	1.Base date			
	2.Specific inspection methods etc.			
	3.Standards for judging the appropriateness of write-offs and allowance			

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
■ The related items ( treatment of classifications regarding credits to small and medium-sized enterprises)				
The supplement to the financial inspection manual : treatment of classifications regarding credits to small and medium-sized enterprises				
	[ The verification points ] 6. Drawing of enterprise and bussiness reproduction working and management necessary claim ahead	◎	Internal control	- If the financial institution applies varied allowance rates, note whether, for instance, borrowers have been grouped under reasonable criteria and any arbitrary decision has been removed.
	Improvement of the case pointed out with the last inspection	◎	Internal control	- It is important that the management should take the initiative on and lead by example in the establishment and implementation of effective improvement plans. If the existing setup lacks strictness and remains a stopgap measure, comprehend once again the awareness of the management and the cause and background that explain why it remains insufficient, and then determine the rating.  - The rating for this item will serve as one element in judging whether the financial institution can be expected to take voluntary actions with respect to issues identified in the inspection underway.

## *Rating Grades*

### **7. Market-Related Risk Management System**

**A :**

As to the market-related risk management system: A robust management system suited to the size and profile of the financial institution has been developed by the management. Weaknesses found are minor and have only a small effect on the appropriateness etc. of the ratee's operation as a financial institution.

**B :**

As to the market-related risk management system: A sufficient management system suited to the size and profile of the financial institution has been developed by the management. Although minor weaknesses were found, they do not represent anything that has a serious effect on the appropriateness etc. of the ratee's operation as a financial institution, and have already been or can be expected to be addressed in a voluntary fashion.

**C :**

As to the market-related risk management system: The current system remains insufficient as a risk management setup suited to the size and profile of the financial institution. The management's ability to manage risks remains insufficient and needs to be improved, because the appropriateness etc. of the ratee's operation as a financial institution was also found to have been affected.

**D :**

As to the market-related risk management system: The management's current system of managing risks was found to have a defect or serious defect. As a result, either there is apprehension about the occurrence of some incident or unexpected damage that may threaten the ratee's existence as a financial institution, or such incident or unexpected damage has actually occurred.

## Market-Related Risk Management System

Note 1: [Priority in rating] ◎ Items of top priority; ○ Items of priority; △ Other items

Note 2: [Positioning in terms of governance] The shaded parts represent items which are subject to controls to be exercised by the management and, therefore, to which particular attention should be paid from the viewpoint of emphasizing governance.

Note 3: The items specified under “Evaluating Points (Examples)” represent illustrations of those matters which should particularly be noted when a rating is actually given, and do not cover every aspect to be examined during an inspection. In conducting an inspection, it is necessary to also take into consideration, while carefully comprehending the actual circumstances, matters that are not illustrated here.

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
<b>Market-Related Risk Management System Checklist</b>				
I . Awareness of risk management etc. 1.Awareness of directors and role of board of directors	(1)Articulation of strategic goals based on management policies for the institution as a whole	○	control by management	<ul style="list-style-type: none"> <li>- As to how the representative directors have exercised leadership toward the establishment of an appropriate market-related risk management system and how other directors have exerted their checking functions, bear in mind that a rating needs to be determined upon taking into consideration the content of discussion during board of directors meetings etc.</li> <li>- In judging whether the management has developed an appropriate market-related risk management system commensurate with profit targets etc., determine the rating upon taking into consideration the types, scale and complexity etc. of market trading that the financial institution engages in. Also, in the light of the fact that there were cases of huge losses in the past due to an insufficient system of mutual checking, determine the rating upon taking into consideration to what extent the management has been involved with the establishment of a system of mutual checking.</li> <li>- If the financial institution has invested in any product with complicated risk profile, such as structured bonds, check first whether the management comprehends the risk profile of that product. Then pay attention, with the institution's financial strength taken into account, whether the management has developed a risk management system commensurate with the risk profile of the product by, for instance, setting a position limit etc. that is in line with their strategic goals and risk management policies.</li> <li>- In examining the appropriateness of a position limit etc., pay attention not to meddle too much in any aspect that falls under the realm of corporate decision-making by the financial institution.</li> </ul>
	(2)Establishment of risk management systems	◎		
	(3)Formulation of concepts for establishment of position limits,etc.	◎		
	(4)Setting of appropriate position limits,etc.	◎		
2.Awareness and roles of senior management	(1)Formulation of risk management rules	◎	Internal control	<ul style="list-style-type: none"> <li>- As to the development etc. of rules for risk management purposes, determine the rating upon taking into consideration the size and profile of the financial institution, as well as whether they are actually effective.</li> <li>- As to personnel management for incident prevention purposes, determine the rating upon taking into consideration the size and profile of the financial institution, as well as whether they are actually</li> </ul>
	(2)Appropriate management of position limits, etc.	◎		
	(3)Personnel management of position limits,etc.	○		

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)	
Item	Check list				
		○		effective.	
II. Establishment of appropriate risk management systems	Establishment of integrated risk management organizations	○	Internal control	<ul style="list-style-type: none"> <li>- In giving a rating to a financial institution that is exposed to major and complicated risks, bear in mind that consideration needs to be given to if and how an "integrated risk management" system has been developed. <ul style="list-style-type: none"> <li>* For the definition of "integrated risk management," refer to "Risk Management System (Common Items).</li> </ul> </li> <li>- The customer risk management system should be examined by referring to the items under "Customer Protection Management System."</li> </ul>	
1.Risk recognition and assessment		○			
2.Management (1)Market-related risk management ①Customer risk management system	(1)Establishment of systems to manage and deal with disputes between the institution and its customers	○	control by management	<ul style="list-style-type: none"> <li>- Pay attention to the reasonableness, completeness in coverage, and consistency of the profit/loss examination method that the risk management division applies.</li> <li>- i ) Rate the market price appraisal rules upon taking into consideration the size and profile of the financial institution, as well as whether they are effective from a viewpoint of removing any arbitrary decision and assuring transparency. <ul style="list-style-type: none"> <li>ii ) Pay attention to whether the difference in market price calculation method between market trading and OTC trading is clearly stated.</li> </ul> </li> <li>- In examining what was checked by the risk management division and internal audit department etc. with respect to market price calculation, pay particular attention to the appropriateness of market price calculation for products with low market liquidity.</li> </ul>	
	(2)Development of derivatives products	◎			
	(3)Sales to customers	◎	Internal control		
	(4)Explanation of products to customers and confirmation of customer intent	◎			
	(5)Reporting of trades to customers	◎			
	②Performance management	Analysis of profit/loss status and checking for inappropriate handling	○		
	③Market price	(1)The maintenance of regulations	◎		Control by management
(2)Separation of specific and general transaction, and that of the executing and the current price assessment		○	Internal control		
(3) Securing of objectivity of price assessment calculation		○			

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
④Monitoring of price and risk	(1)Measurement of accurate market prices	◎	Internal control	<ul style="list-style-type: none"> <li>- Pay attention, with the size and profile of the financial institution taken into consideration, to whether comprehension of market prices and risk elements is effective.</li> <li>- In giving a rating to a financial institution that is exposed to major and complicated risks, bear in mind that consideration needs to be given to if and how an "integrated risk management" system has been developed.</li> <li>- If the effectiveness of the risk measurement functions is low, analyze the cause and also note whether they are making efforts to improve on it.</li> </ul>
	(2)Monitoing and measurement of risk factors	◎		
	(3)Measurement of risk with uniform indicators	○		
	(4)Establishment of organizations to verify appropriateness of model and manage model	○		
	(5)Verification of the effectiveness of risk measurement functions	○		
	(6)Appropriate implementation of stress testing	○		
	(7)Frequency of position monitoring, market price appraisal, and risk measurement	◎		
⑤Position limit, risk limit, and loss limit management	(1)Formulation of clear rules for position limit management, etc.	◎	Internal control	<ul style="list-style-type: none"> <li>- In examining how the position limits, risk limits or loss limits are maintained, bear in mind that, being an item of particular importance among the inspection items for a market-related risk management system, they need to be given more priority in rating in comparison to other items.</li> </ul>
	(2)Delegation of authority of position limits,etc.	◎		
	(3)Compliance with rules for position limit management, etc.	◎		
	(4)Position management,etc.	○		
⑥Market liquidity risk	(1)Appropriate management of market liquidity	◎	Control by management	<ul style="list-style-type: none"> <li>- As market liquidity risk is a rating item that assumes importance only when a large position has been taken relative to the market size, or when the market is disrupted, bear in mind that priority in rating may be lower depending on the scale or risk profile of the financial institution.</li> </ul>
	(2)Setting and review of position limits, etc.	◎		



Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
	(3)Operations taking account of market liquidity risk, etc.	△	Internal control	<ul style="list-style-type: none"> <li>- Operational management should be examined by referring to the items under "Operational Risk Management System."</li> <li>- Credit risk management with respect to market trading should be examined by referring to the items under "Credit Risk Management System."</li> <li>- As to the ALM Committee etc., bear in mind that a rating needs to be given as suited to the way it is actually utilized and is exerting its functions.</li> </ul>
	(4)Monitoring	△		
	(5)Reporting	◎	Control by management	
⑦Operational management	(1)Back-office processing in accordance with rules	○	Internal control	
	(2)Data cross-checking	○		
⑧Management of credit risks associated with market trading	(1)Measurement of credit risk associated with market trading	△		
	(2)Integrated on/off-balance-sheet management of positions, market price appraisals, and credit risks	△		
	(3)Clear systems for credit approval, independent credit approval functions	△		
	(4)Formulation of credit limit rules and appropriate management of credit limit	△		
	(5)Use of risk mitigation measures	△		
⑨Market risk rules and other risk management with internal models	See "Intenal models Checklist"	◎		
(2)ALM management ①ALM organizations	(1)Establishment of ALM Committee etc.	○		
	(2)Coordination between ALM Cmmittee etc. and relevant divisions	△		
	(3)Participation of directors in ALM Committee etc.	◎		
	(4)Installation of ALM systems	○		

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
②Interest-rate risk monitoring	(1)Multifaceted risk management using a variety of techniques	○	Internal control	<ul style="list-style-type: none"> <li>- While it is necessary to examine the clarity of the details of the establishment of position limits and risk limits etc., pay attention not to meddle too much in any aspect that falls under the realm of corporate decision-making.</li> <li>- If the financial institution has invested in any product with complicated risk profile, such as structured bonds, pay attention to whether a position limit etc. that is in line with the strategic goals and risk management policies has been set with the institution's financial strength taken into account and upon comprehending the risk profiles of that product.</li> <li>- As risk volumes of designated trading accounts may be substantially smaller than banking accounts, bear in mind that they need to be evaluated in rating with the size and profile of the financial institution taken into consideration.</li> </ul>
	(2)Analysis of interest-rate risk and use of analytical results	○		
③Foreign exchange risk monitoring	(1)Appropriate monitoring of foreign exchange risk	○		
	(2)Analysis of foreign exchange risk and use of analytical results	○		
④ALM operations	(1)Appropriate setting and review of position limits	◎	Control by management	
	(2)Appropriate risk control	◎		
	(3)Use of findings from ALM Committee etc. in management strategy	◎		
(3)Designated trading issues (verify only for financial institutions engaged in designated trading or establishing designated trading accounts)	(1)Formulation of rules	◎	Internal control	
	(2)Separation of organizations and personnel	○		
	(3)Bookkeeping/ledgers	△		
	(4)Prohibition against organizations trading for designated trading accounts from trading on other trading accounts	△		
	(5)Prohibition against arbitrary account selection	○		
	(6)Appropriateness of internal trading	△		

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
	(7)Assurance of objectivity in fair price calculations.	△	Internal control	<ul style="list-style-type: none"> <li>- As to the development of a system of mutual checking, bear in mind, with the size and profile of the financial institution taken into consideration, that such a system needs to be effective.</li> <li>- As this item is more like an item related to computer system risks, bear in mind that they should be given lower priority in rating for a "market-related risk management system."</li> </ul>
	(8) Information disclosure	△		
3.Segregation of duties	Erection of mutual-checking systems	◎		
4.Communication of information	(1)Risk management division's access to information	○		
	(2)Installation of dealing support systems	△		
	(3)Installation of computer systems suited to back-office processing	△		
	(4)Establishing of back-up systems	△		
	(5)Assurance of system safety	△		
	(6)Communication of information to the risk management division	○		
	Improvement of the case pointed out with the last inspection	◎	Internal control	<ul style="list-style-type: none"> <li>- It is important that the management should take the initiative on and lead by example in the establishment and implementation of effective improvement plans. If the existing setup lacks strictness and remains a stopgap measure, comprehend once again the awareness of the management and the cause and background that explain why it remains insufficient, and then determine the rating.</li> <li>- The rating for this item will serve as one element in judging whether the financial institution can be expected to take voluntary actions with respect to issues identified in the inspection underway.</li> </ul>

## *Rating Grades*

### **8. Liquidity Risk Management System**

#### **A :**

As to the liquidity risk management system: A robust management system suited to the size and profile of the financial institution, particularly the degree of its cash flow tightness, has been developed by the management. Weaknesses found are minor and have only a small effect on the ratee's cash flow as a financial institution.

#### **B :**

As to the liquidity risk management system: A sufficient management system suited to the size and profile of the financial institution, particularly the degree of its cash flow tightness, has been developed by the management. Although minor weaknesses were found, they do not represent anything that has a serious effect on the ratee's cash flow as a financial institution, and have already been or can be expected to be addressed in a voluntary fashion.

#### **C :**

As to the liquidity risk management system: The current system remains insufficient as a risk management setup suited to the size and profile of the financial institution, particularly the degree of its cash flow tightness. The management's ability to manage risks remains insufficient and needs to be improved, because the ratee's cash flow as a financial institution was also found to have been affected.

#### **D :**

As the a liquidity risk management system: The management's current system of managing risks was found to have a defect or serious defect as a risk management setup suited to the size and profile of the financial institution, particularly the degree of its cash flow tightness. As a result, either there is apprehension for the occurrence of some cash flow problem that may threaten the ratee's existence as a financial institution, or such cash flow problem is actually present.

## Liquidity Risk Management System

Note 1: [Priority in rating] ◎ Items of top priority; ○ Items of priority; △ Other items

Note 2: [Positioning in terms of governance] The shaded parts represent items which are subject to controls to be exercised by the management and, therefore, to which particular attention should be paid from the viewpoint of emphasizing governance.

Note 3: The items specified under “Evaluating Points (Examples)” represent illustrations of those matters which should particularly be noted when a rating is actually given, and do not cover every aspect to be examined during an inspection. In conducting an inspection, it is necessary to also take into consideration, while carefully comprehending the actual circumstances, matters that are not illustrated here.

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
<b>Liquidity Risk Management System Checklist</b>				
I . Awareness of risk management etc. 1.Awareness of directors and role of board of directors	(1)Understanding of cash flow risk	◎	Control by management	<ul style="list-style-type: none"> <li>- As to how the representative directors have exercised leadership toward the establishment of an appropriate liquidity risk management system and how other directors have exerted their checking functions, bear in mind that the rating needs to be determined upon taking into consideration the content of discussion during board of directors meetings etc.</li> <li style="padding-left: 20px;">In order to examine the management's understanding of cash flow risks, it is important to check first whether the management comprehends the degree of the financial institution's cash flow tightness. Check the content of various meeting minutes, such as those of the board of directors, management council, committee on liquidity risks, and ALM Committee.</li> <li style="padding-left: 20px;">Then note, for instance, whether the management has set strategic goals in which the degree of cash flow tightness is taken into consideration, and has developed an effective cash flow risk management system suited to the size and profile of the financial institution.</li> </ul>
	(2)Articulation of strategic goals with reference to cash flow risk	◎		
	(3)Establishment of cash flow risk management systems	◎		
	(4)Setting and review of limits	◎		
2.Awareness and roles of senior management	(1)Establishment of rules for cash flow risk management	◎	Internal control	<ul style="list-style-type: none"> <li>- Note whether the criteria for identifying the classification in degree of cash flow tightness that are laid down in the rules for cash flow management are realistic, and whether the management methods etc. laid down according to the classification in degree of cash flow tightness are appropriate and realistic.</li> </ul>
	(2)Appropriate cash flow risk management practice	◎		
II . Establishment of appropriate risk management systems 1.Risk recognition and assessment	(1)Analysis of cash flow risk factors and development of countermeasures	◎	Internal control	<ul style="list-style-type: none"> <li>- Determine the rating also upon taking into consideration whether information collected with respect to cash flow risks is reflected in current judgments on the classification in degree of cash flow tightness.</li> </ul>
	(2)Measurement of liquidity at consolidated subsidiaries	◎		
2.Cash flow risk management	(1)Implementation of liquidity assessments, management of risks on both the asset and liability sides	◎	Internal control	<ul style="list-style-type: none"> <li>- Note whether liquidity risks are evaluated from the viewpoint of, for example, the status of mismatch between the assets side, including loans and securities etc., and the liabilities side, including deposits and market-based fund-raising. Check the content of ALM Committee meeting minutes etc.</li> </ul>

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
	(2)Appropriateness of cash flow risk management	◎	Internal control	<ul style="list-style-type: none"> <li>Note whether its cash flow risk management is appropriate in light of the degree of cash flow tightness, and whether it represents an effective cash flow risk management setup suited to the size and profile of the financial institution.</li> <li>In the case of a financial institution that raises funds on the markets, determine the rating upon taking into consideration whether the risk management division comprehends: <ul style="list-style-type: none"> <li>i ) whether the amount raised on markets shows a decreasing trend;</li> <li>ii ) whether borrowing terms on markets are becoming shorter; and</li> <li>iii ) whether the number of fund sources shows a decreasing trend and there is a concentration on specific ones.</li> </ul> </li> <li>As to specific cash flow risk management methods, note whether they are appropriate in light of the degree of cash flow tightness, and whether they are effective ones suited to the size and profile of the financial institution.</li> </ul>
			Control by management	
	(3)Appropriateness of cash flow risk management method	◎	Internal control	
	(4)Awareness of liquidity risk in operations and administration	○		
	(5)Assurance of payment reserves and means of fund-raising	◎		
3.Communication of information	(1)Reports from business division etc. to cash flow risk management division	◎	<ul style="list-style-type: none"> <li>As to reporting from operational divisions to the risk management divisions, note whether a system of ensuring that necessary reports be made, in the form of, for example, rules requiring the operational divisions to report any large movements of funds, has been established.</li> <li>As to reporting to the management on cash flow information, note whether reports have been made appropriately with content and frequency suited to the degree of cash flow tightness.</li> </ul>	
	(2)Reports from risk management division to board of directors etc.	◎		Control by management
	(3) Reports from cash flow risk management division to board of directors etc.	◎		
	(4)Installation of systems for cash flow risk management	○		Internal control
4.Establishment of crisis management system	(1)Formulation of response plans for liquidity crises	◎	Control by management	<ul style="list-style-type: none"> <li>In the event of a liquidity crisis, normally it is difficult to raise funds on the markets, triggering countermeasures such as, on the assets side, restricting new lending deals and collecting loans, as well as making asset liquidation transactions and selling stock held for business relationship purposes, and, on the liabilities side, preventing large deposits from being withdrawn; note whether the financial institution being inspected has, judging from the status of its assets and liabilities, set any realistic countermeasures in place.</li> </ul>

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
	(2)Assurance of means of fund-raising	◎	Internal control	
	Improvement of the case pointed out with the last inspection	◎	Internal control	<ul style="list-style-type: none"> <li>- It is important that the management should take the initiative on and lead by example in the establishment and implementation of effective improvement plans. If the existing setup lacks strictness and remains a stopgap measure, comprehend once again the awareness of the management and the cause and background that explain why it remains insufficient, and then determine the rating.</li> <li>- The rating for this item will serve as one element in judging whether the financial institution can be expected to take voluntary actions with respect to issues identified in the inspection underway.</li> </ul>

## *Rating Grades*

### **9. Operational Risk Management System**

**A :**

As to the operational risk management system: A robust management system suited to the size and profile of the financial institution has been developed by the management. Weaknesses found are minor and have only a small effect on the appropriateness etc. of the ratee's operation as a financial institution.

**B :**

As to the operational risk management system: A sufficient management system suited to the size and profile of the financial institution has been developed by the management. Although minor weaknesses were found, they do not represent anything that has a serious effect on the appropriateness etc. of the ratee's operation as a financial institution, and have already been or can be expected to be addressed in a voluntary fashion.

**C :**

As to the operational risk management system: The current system remains insufficient as a risk management setup suited to the size and profile of the financial institution. The management's ability to manage risks remains insufficient and needs to be improved because, seen from the fact that, for instance, a computer system failure affecting customers or a considerable operational error etc. was found, the appropriateness etc. of the ratee's operation as a financial institution was also found to have been affected.

**D :**

As to the operational risk management system: The management's current system of managing risks was found to have a defect or serious defect. As a result, either there is apprehension for the occurrence of a serious computer system failure or operational error etc. that might threaten the ratee's existence as a financial institution, or such computer system failure or operational error etc. has actually occurred.



## Operational Risk Management System

Note 1: [Priority in rating] ◎ Items of top priority; ○ Items of priority; △ Other items

Note 2: [Positioning in terms of governance] The shaded parts represent items which are subject to controls to be exercised by the management and, therefore, to which particular attention should be paid from the viewpoint of emphasizing governance.

Note 3: The items specified under "Evaluating Points (Examples)" represent illustrations of those matters which should particularly be noted when a rating is actually given, and do not cover every aspect to be examined during an inspection. In conducting an inspection, it is necessary to also take into consideration, while carefully comprehending the actual circumstances, matters that are not illustrated here.

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
<b>Operational Risk Management System checklist</b>				
I . Awareness of risk management etc. 1.Awareness of directors and role of board of directors	Directors' understanding and awareness of risk management	◎	Control by management	<ul style="list-style-type: none"> <li>- As to how the representative directors have exercised leadership toward the establishment of an appropriate operational risk management system and how other directors have exerted their checking functions, bear in mind that the rating needs to be determined upon taking into consideration the content of discussion during board of directors meetings etc.</li> <li>- In the case of a small- and medium-sized financial institution for which it is difficult to measure risk volumes etc., such as probable loss amounts, it is desirable that operational loss amounts should be comprehended.</li> <li>- In rating any aspect of internal audits, note whether process checking has been conducted, such as analysis of the cause of an operational inadequacy, rather than simply pointing out an operational inadequacy.</li> <li>- Improprieties should be examined by referring to the items under "Statutory Compliance System."</li> <li>- Handling of complaints from customers etc. should be examined by referring to the items under "Customer Protection Management System."</li> <li>- As to the organization of clerical divisions, note, with the size and profile of the financial institution taken into consideration, whether they are organized in an effective fashion.</li> </ul>
2.Awareness and roles of senior management	Senior management's understanding and awareness of risk management	○	Internal control	
II . Auditing and correction of deficiencies 1.Internal audits	Methods and content of internal audits	○		
2.Correction of deficiencies	Reports of deficiencies to board of directors and senior management	○		
3.improprieties, etc	(1)Improprieties	◎		
	(2)Complaints etc. from customers	◎		
III. Operational risk management systems	(1)Organization of clerical division	○		

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
1.Role of operations division	(2)Formulation of rules etc.	○	Internal control	<ul style="list-style-type: none"> <li>- Note, with the size and profile of the financial institution taken into consideration, whether an effective internal control system has been developed. If any inadequacy was discovered during a self-inspection or internal audit, or if there were a large number of exceptional treatments, note whether appropriate improvement measures have been taken upon conducting process checking, such as analyzing the cause of the operational inadequacy etc., and whether, as a result, the number of operational inadequacies etc. shows a decreasing trend.</li> <li>- Determine the rating upon taking into consideration how the branch managers have exercised leadership toward the establishment of an appropriate operational risk management system.</li> <li>- Customer protection should be examined by referring to the items under "Customer Protection Management System."</li> <li>- Customer management should be examined by referring to the items under "Statutory Compliance System" and "Customer Protection Management System."</li> </ul>
	(3)Internal control	○		
2.Role of branch offices	(1)Role of branch manager	○		
	(2)Rigorous operational management	○		
	(3)Customer protection	◎		
	(4)Customer management	◎		
	(5)Functions of self-inspections	○		
IV. Handling of clerical work	(1)Internal operations	△		
	(2)outside liaison work			
	(3)Deposit operations			
	(4)Lending operations			
	(5)Securities operations			
	(6)Insurances operations			
	(7)Other operations			

■ Related items				
Market-Related Risk Management System Checklist				
II. Establishment of appropriate risk management systems	(1)Back-office processing in accordance with rules	○	Internal control	<ul style="list-style-type: none"> <li>- Note, with the size and profile of the market trading taken into consideration, whether an effective internal control system has been developed.</li> </ul>
(1)Market-related				

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
risk management				
⑦Operational management	(2)Data cross-checking	○		

Information Technology Risk Management System Ckecklist				
I . Awareness of risk management etc. 1.Awareness of directors and role of board of directors	Awareness of risk etc.	◎	Control by management	<ul style="list-style-type: none"> <li>- As to how the representative directors have exercised leadership toward the establishment of an appropriate computer system risk management system and how other directors have exerted their checking functions, bear in mind that the rating needs to be determined upon taking into consideration the content of discussion during board of directors meetings etc. It can be considered that, in managing computer system risks, setups, levels and methods of management vary to a greater degree in comparison to management of other types of risks, depending, in particular, on the scale and risk profile of, or business model (Internet-only bank etc.) designed by the financial institution, as well as on the form of outsourcing of the operation; with that in mind, note whether a effective management system has been developed.</li> <li>- Seeing that management strategies and computer system strategies in financial business are now mutually inseparable as a result of its transformation into an information-heavy industry, pay attention, in examining policies for computer system strategy, not to meddle too much in any aspect that falls under the realm of corporate decision-making.</li> <li>- Note whether the board of directors has established more effective risk management policies by reviewing security policies etc. on an as-required basis upon taking into consideration computer system risk problems of the past.</li> </ul>
	Articulation of strategic goals based on management Philosophies for the institution as a whole.	◎		
	Establishment of risk management guidelines	◎		
II . Establishment of appropriate risk management systems 1.Awareness and evaluation of risk	(1)Identification of the locus and types of risk to be managed	○	Internal management	
	(2)Awareness and evaluation of risk in transactions over internet	◎		
2.Division of responsibilities	Erection of mutual checking systems	◎		
III. Monitoring activities and correcting	(1)Organization of internal audit division	○	Internal audit	<ul style="list-style-type: none"> <li>- As to the development of a system of mutual checking, bear in mind, with the size and profile of the financial institution taken into consideration, that such a system needs to be effective.</li> <li>- As to internal audits on computer system risks, internal audits are sometimes in effect outsourced; in such a case, note whether appropriate management is in place with respect to the content of audits conducted by the outsourcee upon making it clear that the outsourcing is done in order to strengthen</li> </ul>

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
deficiencies 1.Internal audits		○	Internal audit	internal audit functions from the viewpoint of professional expertise, rather than leaving everything up to the outsourcee.
	(2)Methods and content of audits performed by internal audit division	○		
2.External audits	Use of external auditors	○	External audit	
IV. Planning and development systems 1.Planning and development organizations	(1)Planning and development organizaions	◎	Control by management	<ul style="list-style-type: none"> <li>- If the management does not include anyone who is versed with computer systems, note whether any effective action has been taken to complement such lack of professional competence.</li> </ul>
	(2)Development management	◎		
	(3)Formulation of rules and manuals	△	Internal control	
	(4)Testing	○		
	(5)Training	○		
2.Expansion into new areas	Expansion into new areas	△		
V. Organizational issues 1.Management organizations	(1)Security management	◎	Internal control	<ul style="list-style-type: none"> <li>- As to the security management system, bear in mind, with the size and profile of the financial institution taken into consideration, that such a system needs to be effective.</li> <li>- As to the data management system, bear in mind, with the size and profile of the financial institution taken into consideration, that such a system needs to be effective.</li> </ul>
	(2)Computer system management	△		
	(3)Data management	◎		
	(4)Network management	○		
	(5)Internet transactions management	○		
2.Computer system administration structure	(1)Clarification of work responsibilities	△	Internal control	<ul style="list-style-type: none"> <li>- Protection of data of customers etc. should be examined by referring to the items under "Customer Protection Management System."</li> </ul>
	(2)Computer system operation management	○		
	(3)Trouble management	○		
	(4)Protection of customers etc. data	◎		

Inspection manual etc.		Note1	Note2	Evaluating Points in Rating (Examples) (See Note 3)
Item	Check list			
	(5)Prevention of unlawful access	○	Internal control	<ul style="list-style-type: none"> <li>- If the computer system management is outsourced, such as by using a collective management service center etc., note, with the full awareness that any system failure etc. would hurt the convenience for customers of the financial institution being inspected, whether a system of managing matters with respect to the outsourcing, including assignment of outsourcing manager and a structure for monitoring and examination, has been developed.</li> <li>- Note whether the management itself exercises leadership in an attempt to take crisis management measures, such as crime prevention and disaster mitigation etc., and has in place a business contingency plan.</li> </ul>
	(6)Computer viruses etc.	△		
VI. Outsourcing management	(1)Planning and implementation of outsourcd work	○		
	(2)Risk management system of outsourced work	○		
	(3)Correction of problems	○		
VII. Crime prevention, disaster mitigation back-ups, and prevention, of unauthorized access	(1)Crime prevention	◎	Control by management	
	(2)Computer crimes and accidents	◎		
	(3)Disaster mitigation	◎		
	(4)Back-ups	◎		
	(5)Formulation of contingency plans	◎		
<b>System Integration Risk Management Checklist</b>				
	System integration risk	◎	Internal Control	<ul style="list-style-type: none"> <li>- As inadequacies in system integration risk management might trigger a systemic risk, priority in rating for this item should be elevated in the case of a financial institution that awaits system integration.</li> </ul>
	Improvement of the case pointed out with the last inspection	◎	Internal Control	<ul style="list-style-type: none"> <li>- It is important that the management should take the initiative on and lead by example in the establishment and implementation of effective improvement plans. If the existing setup lacks strictness and remains a stopgap measure, comprehend once again the awareness of the management and the cause and background that explain why it remains insufficient, and then determine the rating.</li> <li>- The rating for this item will serve as one element in judging whether the financial institution can be expected to take voluntary actions with respect to issues identified in the inspection underway.</li> </ul>

<Provisional Translation>

(Appendix)

## Report of the Financial Inspection Rating System Study Group

May 25, 2005

Financial Inspection Rating System Study Group

## Financial Inspection Rating System Study Group Member List

As of April 20, 2005

Chair	Shinsaku Iwahara	Professor of Law, Graduate School of Law and Politics, University of Tokyo
Acting Chair	Shuya Nomura	Professor, Graduate School of Law, Chuo University
Member	One Akiyama	President, Integrex Inc.
	Toru Umemori	Deputy Director-General, Financial Systems Department, and Deputy Director-General, Bank Examination and Surveillance Department, Bank of Japan
	Nana Ohtsuki	Director, Standard & Poor's (S&P)
	Rikushi Kawakami	Vice-President, A. T. Kearney, K.K.
	Mamoru Sakuma	General Manager, General Planning Department, Toho Bank, Ltd.
	Toshihiko Shibata	General Manager, General Planning Division, Johoku Shinkin Bank
	Toshihiko Fukuzawa	Head, Strategic Planning Group, Mizuho Bank, Ltd.
	Hiroshi Hosoda	Director Chief Analyst, Rating and Investment Information, Inc. (R&I)
	Osamu Honda	Deputy General Manager, Management Planning Department, Higashi-Nippon Bank, Ltd.
	Tsutomu Muramoto	Professor of Economics, Seijo University
	Kimitaka Mori	Certified Public Accountant (Executive Board Member of the Japanese Institute of Certified Public Accountants)
Satoru Watanabe	Head, Audit Office, Koutou credit corporation	
Susumu Atsuki	Deputy Director-General, Inspection Bureau, Financial Services Agency	
Kozo Kimura	Director, Evaluation Division, Inspection	

	Kenichi Meguro	Bureau, Financial Services Agency Inspection Administrator, Inspection Bureau, Financial Services Agency
	Haruyuki Wakasugi	Director, Market Risk Inspection Office, Inspection Bureau, Financial Services Agency
	Masahiko Furuya	Director, Planning and Coordination Office, Inspection Coordination Division, Inspection Bureau, Financial Services Agency
	Takashi Kamijo	Director of Training and Supervising Inspector, Inspection Bureau, Financial Services Agency
	Makoto Kubodera	Special Financial Inspector, Inspection Coordination Division, Inspection Bureau, Financial Services Agency (Certified Public Accountant)
	Shigehiro Kuwabara	Director, Supervisory Coordination Division, Supervisory Bureau, Financial Services Agency
	Mamoru Yoshizawa	Deputy Director, Banks Division I, Supervisory Bureau, Financial Services Agency
	Shigeo Higuchi	Deputy Director, Banks Division II, Supervisory Bureau, Financial Services Agency
	Shigehiko Sugihara	Deputy Director, Supervisory Coordination Division(Cooperative Financial Institutions Office), Supervisory Bureau, Financial Services Agency
Observer	Shuichi Sonoda	Inspection Administrator, Kanto Local Finance Bureau
	Yoshiya Go	Inspection Administrator, Kinki Local Finance Bureau



Headquarters      Toshitake Kurosawa      Director, Planning and Research Office,  
Inspection Coordination Division, Inspection  
Bureau, Financial Services Agency

## Financial Inspection Rating System Study Group Meeting Dates and Agendas

First Meeting: January 26, 2005

- Working agenda of the Group; discussion points etc.; overview of financial inspections

Second Meeting: February 9, 2005

- Ratings of private rating institutions; former rating system of Ministry of Finance

Third Meeting: February 17, 2005

- Rating system in the United States (CAMELS)

Fourth Meeting: February 23, 2005

- Financial institution supervision approach in the United Kingdom (ARROW); rating system of the Bank of Japan

Fifth Meeting: March 2, 2005

- Frequencies and scopes of inspection; overview of financial supervision

Sixth Meeting: March 16, 2005

- Discussion points concerning a rating system

Seventh Meeting: March 24, 2005

- CSR evaluation; statutory compliance systems (including customer protection management systems); risk management systems (general)

Eighth Meeting: March 30, 2005

- Action Program concerning the enhancement of Relationship Banking Functions (for the 2005 and 2006 business years); liquidity risk management systems; market-related risk management systems

Ninth Meeting: April 13, 2005

- Operational risk management systems; IT system risk management systems; credit risk management systems

Tenth Meeting: April 20, 2005

- Capital adequacy management systems; asset quality management systems; small- and medium-sized enterprise financing; rating grades and evaluating points (examples)

Eleventh Meeting: April 27, 2005

- COSO Report overview etc.; rating grades and evaluating points (examples)

Twelfth Meeting: May 11, 2005

- Rating grades and evaluating points (examples)

Thirteenth Meeting: May 18, 2005

- A sample of inspection reports of the Federal Reserve Bank of the United States; rating grades and evaluating points (examples); draft report

Fourteenth Meeting: May 25, 2005

- Basic guidelines for financial inspections (draft); draft report

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Appendix: Rating Grades and Evaluating Points (Examples)	

## Introduction

1. In December of last year, the Financial Services Agency (FSA) developed and released the "Program for Further Financial Reform - Japan's challenge: Moving toward a Financial Services Nation -" which charted the course of its actions in the coming two years. With the recognition that the current financial system is "entering a new forward-looking phase aiming at establishing a desirable financial system for the future, having now moved beyond the emergency reaction against the non-performing loans problem," the Program aims to achieve the creation of a desirable financial system not by the initiative of the "public sector" but by the effort of the "private sector." As one of the concrete measures to that end, it proposed "effective and selective measures with high adaptability on the part of the administration through, for instance, the application of a rating system in inspection that is formulated from various viewpoints, rather than just limited to financial conditions."
2. Accordingly, in January of this year, the Financial Services Agency established within its Inspection Bureau the "Financial Inspection Rating System Study Group," with external experts among its members, which subsequently met on fourteen occasions to discuss the matter. This Report presents its conclusions.

### 1. Basic Concepts for Financial Inspection

3. Japan's financial system is now facing a very important turning point. For a long period of time, the financial sector had been stuck in the throes of risks and losses of the whole Japanese economy, in the wake of the burst of the bubble economy; the sector however is finally seeing the light to a way out. The non-performing loans, accumulated as a result of taking excessive credit risks without backing of returns, has also been brought down finally to a manageable level. In the meantime, waves of deregulation, technological innovation and globalization appear to be opening up potentials for business models based on whole new risk-return profiles.

4. Under these circumstances, financial situations are arguably presented with, an opportunity to take a shift from the defensive risk management to a proactive risk management. "Risk management" means indeed evaluating risks in relation to returns, or securing returns by adequately controlling risks. Risks are also not something that should be assumed by financial institutions alone: they should be shared with borrowers and investors. Risk management is also a process in which financial institutions define their own business models in the economy and markets.
5. Another node tying markets and financial institutions is the quality of business management, or corporate governance. Governance has now become something more than what supports a corporate value, but rather a corporate value by and in itself. Just as stable profitability enhances capital adequacy, solid governance creates a corporate value and augments the market value of a corporation. Amidst the trends of deregulation and globalization, the significance of "corporate value" is being redefined, of which a core element is governance. Outward looking governance can be a nexus between internal control systems and external market disciplines.
6. The keyword that links a risk-return profile and governance is "strategy." Determining one's own risk appetite (risk tolerance) in an everchanging environment profile, building up a strategy directly connected to it, carrying out that strategy in a sure and effective fashion and, thereby creating a corporate value -- those are the modern-day functions that internal controls are expected to serve.
7. It should not be forgotten, however, that such a model and strategy of management in financial institution must first and foremost be based on a decision made by and at the responsibility of the "private sector." Involvement of the regulatory authorities is justified only to the extent necessary in light of stabilizing financial functions, protecting users and ensuring smooth financing, which fall under the responsibilities of the FSA (FSA Establishment Law, Article 3). In the case of a bank, for example, inspection and supervision are required only "to ensure sound and proper operations of banks" (Banking Law, Article 1); and even that would come only after the financial institution's own internal controls and

external audits, as well as market discipline-based surveillance. Involvement of the "public sector" should thus be limited.

8. Given these trends, it is important to reconfirm the basic concepts for financial inspection.
9. Financial inspection is performed for the purpose of securing financial soundness of a financial institution and appropriateness in its operation. It must, however, be based on the assumption of, and only complement, the financial institution's own internal controls and external audits, as well as market discipline-based surveillance (the subsidiary principle) and be performed in an efficient fashion while securing effectiveness (the effectiveness principle and the efficiency principle). It is the "Financial Inspection Manual" that promoted a shift to a new approach in inspection ("New Inspection Approach") based on these principles. Six years after the implementation of the Manual, the evolution in financial inspection is still in progress. The transition to the New Inspection Approach is continuing in the presence of emergency reaction against the non-performing loan problem. In retrospect, however, the past couple of years could also be considered to be the labor pain of the financial system reform that has had no choice but to weather through the storm of the non-performing loan problem. Inasmuch as the New Inspection Approach originally envisioned a phase where progress was made in all fronts of deregulation, including liberalization in interest rates, in the scope of business, and in market entry and exit, it was intended to establish a regime of ex-post checking in place of advance guidance, as well as process checking focused on the internal control system (governance) based on self-responsibility of a financial institution. The fact that the process of liberalizing market entry and exit, which also represented the final stage of deregulation, took some time is understandable, given the nature of the issue and the circumstances. In any event, one stage of the financial liberalization was completed with the removal of the so-called full deposit pay-off guarantee in April of this year. In this new phase, it is now high time to again confirm the original purpose and accelerate the transition to the New Inspection Approach.
10. First of all, financial inspection must be based on the assumption of, and must be

held within its role of "complementing," a financial institution's self-management based on the principle of self-responsibility (the subsidiary principle). It must limit itself in a supportive role in the process where the "private sector" develops vitality on its own initiative. The Financial Inspection Manual was indeed intended to achieve the "transition from regulator-led to a financial institution's self-management" in inspection style: this direction needs to be even more firmly established as a committed objective.

11. Inspections also need to be performed in an efficient and effective fashion to achieve an efficient resource allocation in both the regulatory authorities and the financial institutions (the efficiency principle). In particular, given the shift from the "emergency reaction" phase to a "forward-looking" one, the way inspections are performed also needs to be diversified and upgraded from one focused on credit risks, as has thus far been applied, to a new setup with more multi-faceted focuses but with high adaptability.
12. Furthermore, with inspections becoming increasingly diversified and upgraded, the inspection sections need to achieve a closer coordination with the supervision sections in order to secure soundness and appropriateness in the operations of financial institutions (the effectiveness principle). By definition, on-site inspections and off-site monitoring serve different functions. As on-site inspections involve physical visits to sales offices of financial institutions, efficiency in their implementation is highly demanded; their main focus would therefore be placed on those items which are particularly necessary to be checked on-site, such as verification of the status of risk management system. On the other hand, off-site monitoring has a comparative advantage in analysis of financial and other quantitative data from a cross-sectional and industry-wide viewpoint.
13. In a word, "it is neither possible nor necessary for financial inspection to inspect everything."



## 2. Significance of a Rating System

14. In line with the phase shift of the environment from the "public sector" to "private sector," and with the exit from "emergency reaction against the non-performing loan problem," the inspection methodologies must also shift themselves into something that contributes to providing the "private sector," *i.e.*, financial institutions themselves, with incentives toward voluntary improvement in management. Another point is that now that six years have passed since the implementation of the Financial Inspection Manual, we can observe a certain degree of convergence in perspectives of financial institution and of inspectors, the situation which is opening a way into risk management systems founded on the self-responsibility of financial institutions. With these circumstances in mind, showing financial inspection results with some kind of a graded evaluation, in addition to the description of raised issues as has thus far been provided, would presumably offer significant incentives for management improvement on the initiative of a financial institution. This means that doing so would also greatly motivate inspectors to exchange exhaustive dialogue with financial institutions and thereby to further fulfill their accountability for the results of their own inspections. The significance of a rating system rests with such outcomes.
15. Connecting the rating results with subsequent, selective regulatory measures, such as determining the frequencies and scopes of inspection, would also augment the relevance of the incentives, as well as enable more efficient and effective inspections. Furthermore, improved transparency in financial administration which would also result from such practice can be expected to contribute greatly to providing financial institutions with better predictability.
16. Private companies also engage in the rating of financial institutions, one example being rating services by rating institutions, but their purposes and methodologies are different. While private ratings are intended to show a debtor's ability to fulfill its obligation to investors and creditors, the purpose of a public rating system rests with providing financial institutions with incentives toward improvement in management through their voluntary and sustained efforts, as well as with reflecting rating results in the regulatory selective measures in the future.

Therefore, two separate processes would be necessary for the public authorities to achieve the purpose of the rating system: the first process involves evaluating a financial institution, and the second one involves connecting the rating results with selective measures of the public administration. These two processes, working together, would augment the significance of the rating system.

17. Aspects which might be varied according to the determination of the degree of inspection include the frequency, scope and depth of inspection. Given the current phase where the "emergency reaction against the non-performing loan problem" is becoming a thing of the past, evaluation criteria to be used in such determination would have to broadly contain elements of compliance and risk management systems, rather than being concentrated too much on the soundness of asset quality.
18. In addition, coordinating supervisory measures with the rating system will be critical from a viewpoint of securing effectiveness in inspections. For example, one possibility would be to use rating results as criteria or a factor in judgment in examining the degree of off-site monitoring, report submission requests, or other supervisory measures.

### **3. How A Rating System Should be Formulated**

19. Considering the points described above, the following viewpoints assume particular importance in examining how to formulate a rating system: firstly, whether the rating system serves as incentives toward a financial institution's voluntary improvement in its management; secondly, whether the rating system is in conformity with the missions of the FSA, in particular its financial inspections, and; further, whether the rating system is formulated so that it can truly contribute to the improvement of efficiency and effectiveness of inspections.

**(Evaluation Taking into Account A Financial Institution's Scale and Characteristics)**

20. Financial inspections evaluate the status of risk management according to the size and profile of a financial institution, in particular its risk-return profile, and naturally should not tend toward mechanical and categorical judgments. Inspections do not seek to require financial institutions to solely minimize risks that they take, either. Financial institutions are expected, rather, to engage in needed risk-taking through the implementation of appropriate risk management. The point is whether a financial institution has established its own business model, and has then set strategic targets that are commensurate with its risk appetite and strengths.
  
21. Efforts of regional financial institutions in providing smooth funding for local small- and medium-sized enterprises, as well as their contributions to the region through such efforts should also be understood in the aforementioned context. The nature of what is called "relationship banking" rests with making use of information that a financial institution has obtained through long-term relationships and keeping accurate track of the business conditions of borrower companies via intense communications including face-to-face contacts, and thereby enhancing its financial intermediation functions for small- and medium-sized enterprises and achieving better profitability on its own part. The basic role of the financial authorities is to exercise supervision in a comprehensive fashion by means of off-site monitoring, based on multi-faceted evaluation including such voluntary efforts by regional financial institutions. In performing an inspection, however, the authorities should, in adherence to the "Supplementary Issue to the Financial Inspection Manual (For Small- and Medium-Sized Enterprise Financing)," make it a point to examine whether a regional financial institution is repeatedly making efforts to establish an appropriate risk management system by, for instance, building up close relationships with small- and medium-sized enterprises etc.

(Reference)

"Enhancement of Relationship Banking Functions" (Excerpt from the Report of the Second Subcommittee, Sectional Committee on Financial System, Financial System Council, dated March 27, 2003)

If the ideal form of relationship banking exists in the vitalization of regional

economy through high-quality and easily accessible operations of relationship banking, the proper form of contribution to the region is presumably for a regional and small- and medium-sized financial institutions to fulfill its role of supplying smooth funding and various services etc. to its main customer base, which is made up of small- and medium-sized enterprises, in an appropriate and sustainable fashion, while also securing soundness in its operation.

22. In any event, inspections will, of course, need to enhance further than ever the coordination with the supervisory functions and need to take into adequate account the risk-return profile of each financial institution that has been learned through off-site monitoring etc.

#### **(Evaluation of Profitability)**

23. It stands to reason that the management of a financial institution should strive to secure returns in line with risks. However, whether the authorities should proactively check the status of such efforts by means of inspection is another matter. The missions of the FSA rest strictly with stabilizing financial functions, protecting users and ensuring smooth financing. The reason why the financial authorities are interested in the profitability of individual financial institutions is precisely because it greatly affects the soundness in financial matters. When the soundness in financial matters of a financial institution is deemed to require improvement, it is therefore necessary to examine whether the institution has profitability sufficient to improve the soundness, and whether it is capable of maintaining its presence sustainably in the financial system.
24. Further still, a certain degree of prudence will be required in meddling with how each financial institution defines its risk-return profile. That is because, with the backdrop of rapid progress in deregulation, technological innovation and globalization, the range of financial institutions' strategic "selection and concentration" is nowadays expanding by leaps and bounds, whereby they now make their own selection of a risk-return model suited to its own desire, upon the unbundling (or rebundling) of financial business categories by function, such as

financial manufacturing, financial distribution and financial information services. It is indeed because of this trend of the times that financial institutions are required to have good insight into accurately determining their own risk-return profile. For example, it has now become essential for a financial institution with major and complicated risks to accurately comprehend, through such approach as what is called "comprehensive risk management," the entirety of the risks that it has taken, as well as to develop a system that enables timely establishment of management strategies aimed at achieving returns. Determining what kind of risk-return profile is desirable for each financial institution is, of course, not something that the authorities should primarily be involved in. From a viewpoint of ensuring soundness in financial matters, however, it is of great significance whether or not each financial institution has the ability to select in a voluntary and timely fashion, upon contemplating its own strength, a risk-return profile that it believes to be desirable. Evaluation by the authorities will need to be conducted from such a viewpoint.

#### **(Evaluation of Governance)**

25. The quality of a financial institution's business administration (governance) presents critical importance in terms of financial institution management as well as of financial supervision. All management entities exist for the purpose of creating some value and providing their stakeholders with that value. It is precisely the role of governance to warrant the reliability of that process. Financial institutions are no exception. Stakeholders of financial institutions include, first and foremost, depositors and investors and then their users etc. It is the responsibility placed on the management of a financial institution to deal squarely with stakeholders and to reliably achieve the expected value. Solid governance is the source whereby a corporate value is created and a company's market value is augmented, and outward looking governance is the source whereby the appropriateness of financial institution management is warranted and the soundness is augmented.
26. The onus is primarily on the management to develop a robust statutory compliance system and a risk management system. What is meant by internal controls by the

management is to achieve the expected value and deliver it to stakeholders by identifying the financial institution's risk-return profile, setting clear strategic targets and controlling in a timely fashion, while accurately evaluating, any risks involved. Such internal controls led by the management must be spread into every part of the internal control system, and how thoroughly they are exercised is exactly the point on which evaluation of governance will be based.

27. For governance to function effectively, it is a prerequisite that components of the organization should be fulfilling the respective roles that they are in the first place required to serve. More specifically, it is important that, among others, bodies such as its board of directors or board of auditors should be able to check the management and that a system of check and balance is functioning effectively. In addition, it is also a prerequisite that each director should have sufficient qualities (knowledge, experience, and trust of society etc.) to execute his/her duties, as well as have an adequate sense of responsibility and ethics.

#### **4. Specific Framework of A Rating System**

28. With the points above considered, the specific framework of a rating system would be as shown in Appendix "Rating Grades and Evaluating Points (Examples)." The basic framework would be as follows:

##### **(Rating Items)**

29. Considering that financial institutions and inspectors are starting to see a certain convergence in their perspectives as a result of the so-called "Manual inspections" conducted in the past, and also from a viewpoint of securing the unity in practice, an appropriate course to take would be to structure the basic framework of a rating system after the manner of the current Financial Inspection Manual (see "Concept Illustration").

30. Likewise, it would also be appropriate to include, among rating items, those items for which criteria have already been defined by law or regulation and which are of particular importance from a viewpoint of depositor protection etc., such as "capital adequacy ratio" and "customer protection"

**(Rating Criteria)**

31. A perspective to be applied to rating criteria should, in accordance with the concepts of the Financial Inspection Manual, which places its basic emphasis on process checking, set the main target of evaluation on aspects of control systems, leaving as a secondary factor in judgment the issue of how many incidents or losses have actually resulted.
32. Additionally, from a viewpoint of taking governance seriously, adequate consideration should be taken in conducting an evaluation as to how extensively the management's internal controls have been set in place.
33. The scale of grading should be based on four grades: A, B, C and D. Having an even number of grades would enable a clearer indication of evaluation results than an odd-number grading scale, such as five-point grading, and would presumably contribute to the giving of incentives toward improvement in management and to highly adaptable measures from the public administration.
34. The approximate implications of each grade should be as follows:
  - i) Grade A implies that a robust system of controls has been developed by the management;
  - ii) Grade B implies that a sufficient system of controls has been developed by the management;
  - iii) Grade C implies that the management's development of a system of controls remains insufficient and needs improving; and
  - iv) Grade D implies that a defect or serious defect has been found in the system of controls.

35. In rating each item, attention should be paid to take into consideration the size and profile of the financial institution and not to tend toward mechanical and categorical judgments. In particular, it is imperative that the risk-return profile of the financial institution as has been learnt through off-site monitoring etc. should be taken into consideration, and evaluation should judge whether an effective system of controls commensurate with that profile has been developed by the management.
36. A composite rating should not be applied for the time being. This is out of concern that it is not necessarily easy to give an adequate weight to each item of evaluation at the onset of the rating system introduction and that if overall evaluation took on a life of its own, it might become exposed to unignorable reputational risk of which possibility of occurrence cannot be eliminated in the present state of affairs.

**(Linkage with Selective Regulatory Measures)**

37. Inspection would be conducted on an as-required basis in a timely and appropriate fashion by taking into account the size and profile of a financial institution, at which time rating results obtained thereby should also be reflected in the degree of subsequent inspections. As to, firstly, the frequency of inspection, for example:
- i) Where a financial institution has received no low grades in the individual items of evaluation (for example, it has received A and B grades only, and no C or lower grades), a longer-than-average inspection cycle would apply;
  - ii) Where a financial institution has received a small number of low grades in the individual items of evaluation (for example, it has received A, B and C grades only, with the number of C grades two or less), an average inspection cycle would apply;
  - iii) For any other cases, a shorter-than-average inspection cycle would apply; and
  - iv) In any event, a desirable course of action would be to make a final decision on specific criteria by considering the results actually obtained (grade distribution etc.) after the rating system is implemented for a certain length of time.



38. As to the scope of inspection, rating results should be reflected in such a manner, for instance, that any item which was evaluated highly in the previous inspection and on which no issue has been found in subsequent monitoring etc. by the supervisory authorities will be removed from the scope of examination in the next inspection. Further, rating results should be reflected in the depth of inspection in such a manner, for instance, any item which was evaluated highly in the previous inspection will be inspected in limited depth, while items with low ratings will be subject to inspection in extensive depth; for example, where a financial institution has received high evaluation results for its internal control system associated with self-assessment, a lower sampling rate will be applied in the examination of self-assessment.
39. As to the linkage between rating results and supervisory measures, first there is a system of statutory requests for report submission, such as one under Article 24 of the Banking Law, that always applies if any issue is raised in an inspection, irrespective of the rating results; in consideration of the Article 24 report, the rating results would then be used as a factor in judgment for the purpose of promptly facilitating the financial institution's voluntary efforts toward the securing of soundness and appropriateness in its operation.

**(Rating Procedures)**

40. It would be important at the time of inspection that the inspector should, during the period of on-site inspection, first have an adequate exchange of views with the financial institution being inspected as to the relationships of facts relevant to the rating, as well as evaluation thereof. As well, the chief inspector should then have an adequate exchange of views and check for points agreed and disagreed on as to the rating results during the exit meeting with the management of the financial institution being examined that would be held at the completion of the on-site inspection.
41. If there is any disagreement as to the rating results following the completion of the

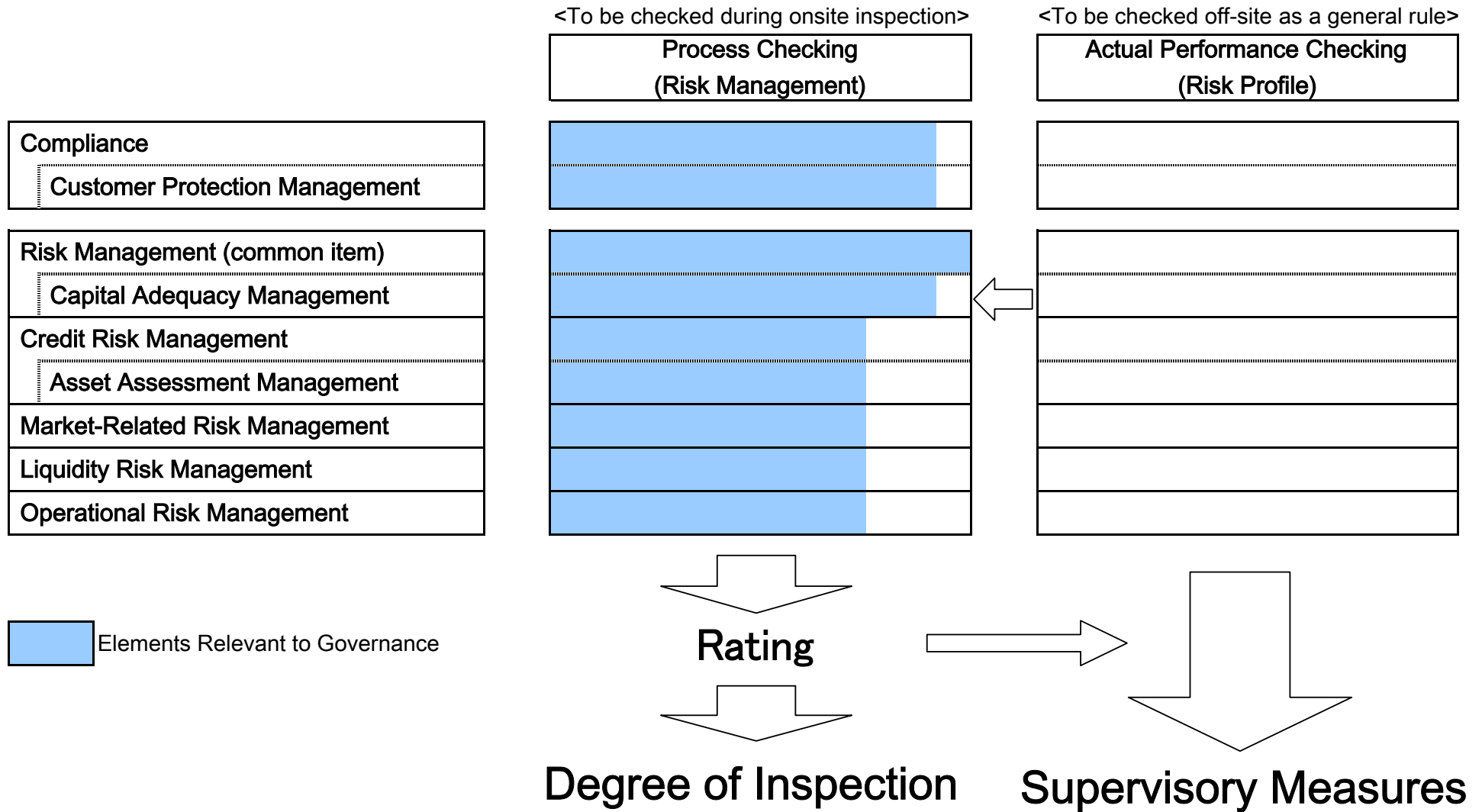
on-site inspection, the financial institution being inspected may, pursuant to the Inspection Appeal Process, bring it to the attention of the Director-General of the Inspection Bureau and request a review.

42. The financial institution being inspected would be notified of the final rating results as part of the inspection result report. The rating results of each financial institution themselves represent inspection results and therefore should not be disclosed externally.

## **5. Implementation Schedule**

43. The Study Group believes it appropriate to have the inspection rating system for deposit-taking financial institutions start its trial application during the 2005 inspection administration year and then have it implemented soon in or after the 2006 inspection administration year. During the period of the trial application, focus should be placed on the accumulation of data and know-how concerning the rating, and rating results *per se* should, although they are to be reported to financial institutions, not be reflected in selective regulatory measures.

# Concept Illustration for the FIRST



Note: "Small- and medium-sized enterprise financing" should, in accordance with the Supplementary Issue to the Inspection Manual [For Small- and Medium-Sized Enterprise Financing], be evaluated as part of "credit risk management system" and "asset assessment management system."