<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

		Bureau, Financial Services Agency
	Kenichi Meguro	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

<u>Financial Inspection Rating System Study Group Meeting Dates and Agendas</u>

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

Report of the Financial Inspection Rating System Study Group

Contents

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

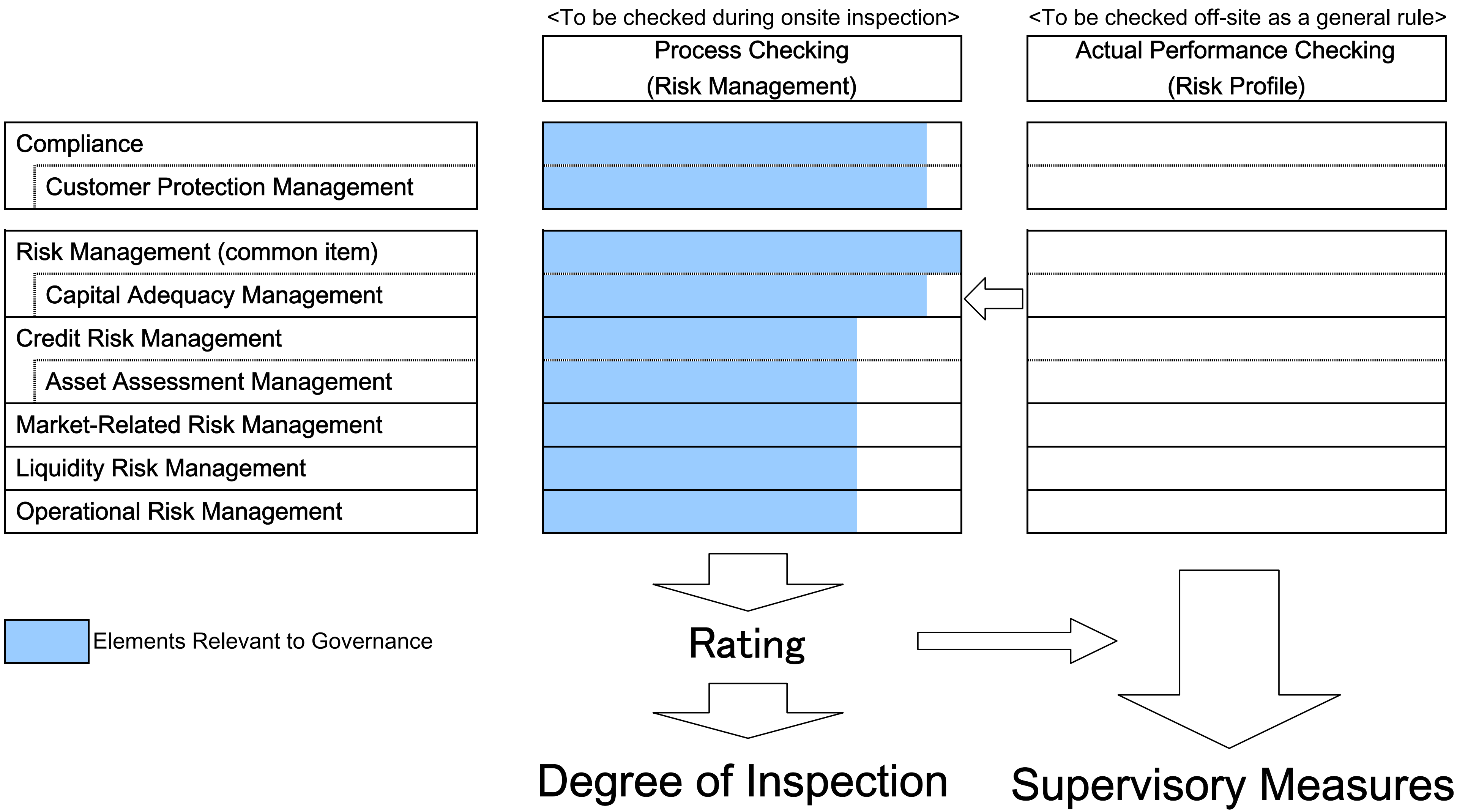
on-site inspection, the financial institution being inspected may, pursuant to the Inspection Appeal Process, bring it to the attention of the Director-General of the Inspection Bureau and request a review.

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."