(Provisional Translation)

Implementation Framework of the Second Pillar of Basel II

I. Key Features of the Second Pillar

Basel II (the new capital adequacy framework) establishes the following four key principles in the second pillar, standing apart from the first pillar (minimum capital requirements).

Principle 1: Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.

Principle 2: Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate action if they are not satisfied with the result of this process.

Principle 3: Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

Principle 4: Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

* Basel Committee on Banking Supervision, *"International Convergence of Capital Measurement and Capital Standards: A Revised Framework"*, June 2004.

II. Approach of the Financial Services Agency to the Second Pillar

The approach of the Financial Services Agency (FSA) to the second pillar of Basel II is the implementation of three-tier supervision. The first is to communicate the supervisory expectations and induce efforts of individual financial institutions to

achieve the comprehensive risk management (in response to Principle 1). The second is to review the effectiveness of the comprehensive risk management system (in response to Principle 2), and the third is to establish early warning thresholds for individual risks (in response to Principles 3 and 4).

The ultimate objective of the financial administration, in light of the second pillar of Basel II, is that each financial institution maintains and improves its soundness by advancing its own risk management function that is commensurate with its scale and risk profile, etc. Promoting these efforts, together with those for the third pillar of Basel II (market discipline), is consistent with the principles of financial supervision in Japan, where the principle of self-responsibility and market discipline form the foundation which is supplemented by supervisors.

Based on this approach, the supervisory perspectives to review a comprehensive risk management system will be included in supervisory guidelines so as to encourage each financial institution, having considered these perspectives, to build an appropriate and comprehensive risk management system in accordance with the scale of its business and risk profile, etc., and to build a process for assessing its capital adequacy in relation to its own risk.

The FSA will assess, review and evaluate the effectiveness of a comprehensive risk management system established by each financial institution via such mean as periodic reporting and interviews with the management of each institution, while assigning maximum respect to efforts to be made by each financial institution on its own initiative. FSA will conduct its supervisory reviews and evaluations in accordance with the "Evaluation of Comprehensive Risk Management System" that will be described in the subsequent section below.

In such a framework, the FSA anticipates that financial institutions will develop their own comprehensive risk management system that are in line with the supervisory perspectives clarified in the recently published "Comprehensive Guideline for Supervision of Major Banks, etc." Small- and medium-sized and regional financial institutions are also expected to have a suitable risk management system in relation to their own scale and risk profile, etc.

On the other hand, an appropriate mechanism for supervisory intervention on individual risk categories needs to be established in order to supplement the above-mentioned supervisory reviews/evaluations of the comprehensive risk management system based

on self-responsibility of each financial institution. For example, in order to avoid situations where an unsatisfactory management system of key individual risks affects the soundness of the financial institution, those financial institutions with a high probability of materializing such risks need to be observed with focused attention. In doing so, it is desirable to make use of existing frameworks as much as possible, considering the financial institutions' cost of complying with regulations and continuity of financial administration.

In particular, the key risks which are not covered by the first pillar shall be included in the existing "Early Warning System," and early warning thresholds for individual risks shall be utilized. When a financial institution falls below pre-determined levels for specific indicators concerning individual risks such as profitability, credit risk, market risk, and liquidity risk, the FSA will conduct interviews and/or request reports in order to accurately assess the current status of the concerned risks in light of the business models and comprehensive risk management system of the financial institution. Consequently, the FSA may encourage the financial institution to achieve a more appropriate risk management, with a view to supplementing its own efforts.

1. Evaluation of Comprehensive Risk Management System

Risk taking is an essential element in financial intermediation. As the financial institutions' operations continue to diversify, it is becoming increasingly important for the management of financial institutions to gain a comprehensive understanding of various risks and to prepare appropriate management systems on its own initiative to deal with such risks. When reviewing risk management systems of financial institutions, the fundamental role of the FSA is to supplement their own efforts to manage risks. Pursuant to this approach, the FSA will, in implementing the second pillar of Basel II, review whether each financial institution appropriately assesses and manages the entire risks including those risks which are not covered in the calculation of the minimum capital requirement under the first pillar.

(Reference) Examples of risks mentioned in "The International Convergence of Capital Measurement and Capital Standards: a Revised Framework" issued by the Basel Committee on Banking Supervision (June 2004). (This list is not exclusive.)

Credit risk, operational risk, market risk, interest rate risk in the banking book, liquidity risk and other risks (reputational risk, strategic risk, etc.)

Financial institutions need to establish a clear risk management policy that is commensurate with the size, characteristics and complexity of their businesses, and assess the various risks inherent in each business department aggregately and quantitatively. It is also necessary to maintain sufficient level of capital both in terms of quality and quantity in comparison with such aggregated risks. (Note)

Note: It has been recognized as the best practice to quantify the volume of risks in each business department to the extent possible, and allocate capital accordingly to each department within the range of the institution's overall level of capital. By doing so, the volume of risks taken by individual institutions can be limited within the scope of their capital. At the same time, financial institutions are expected to conduct an appropriate management of risks and returns in relation to their business plans, using, for instance, quantitative indicators such as risk-adjusted profit of each business department (comprehensive risk management).

For these reasons, the FSA will revise its guidelines for supervision in order to assess financial institutions' preparedness in terms of the comprehensive risk management system as well as the capita adequacy assessment process. However, as the scale and the risk profile of each financial institution could vary significantly, due care must be paid to avoid uniform and inflexible application of regulations. Rather, it is important to ensure that the FSA's review will be implemented in a manner that is in line with the actual development status of the risk management system at each financial institution. In doing so, the FSA will respect the internal management system and quantification method assumed by each financial institution to the maximum extent in accordance with the actual development status, and where necessary, it will foster a further advancement of risk management system at each institution.

With regards to major banks and other large banks, the comprehensive risk management system will be assessed based on the new perspectives provided in the "Comprehensive Guideline for Supervision of Major Banks, etc." Based on those assessments, the FSA may request individual financial institutions to submit business improvement reports or issue business improvement orders as necessary.

With regards to small- and medium-sized and regional financial institutions, in line with the provisions stipulated in the "Comprehensive Guideline for Supervision of Major Banks, etc.," the perspectives of the comprehensive risk management system will be laid out separately in the "Comprehensive Guideline for Supervision of Small- and Medium-Sized and Regional Financial Institutions," taking into account such factors as

the diversity of the scale and risk profile of each financial institution. Based on these guidelines, the FSA will review whether each financial institution has an appropriate comprehensive risk management system in place. When deficiencies are identified in the fundamental risk management system, the FSA will request a business improvement report or will issue a business improvement order as deemed necessary.

The FSA has already announced that it will focus on reviewing the comprehensive risk management system in the coming round of on-site inspections of financial institutions that already manage various risks in a comprehensive manner. In such review processes, both the Supervisory Bureau and the Inspection Bureau shall cooperate with each other as appropriate.

2. Enhancement of the Early Warning System

The FSA introduced an Early Warning System in 2002, as a framework whereby remedial actions are prompted to financial institutions with capital adequacy ratios above the required minimum (not subject to prompt corrective actions) at an early stage. The Early Warning System is a tool that enables the FSA to monitor such aspects of each financial institution as profitability, credit risk, market risk, and liquidity risk, and in accordance with the results of such monitoring, the FSA requests individual institutions to submit reports or order operational improvement as necessary if those financial institutions could not satisfy certain thresholds that are pre-determined for each of these risks commonly for each institution.

In light of such a characteristic and method of the Early Warning System, it would be an effective and efficient to utilize the existing early warning thresholds that focus on specific indicators for individual risks, as a tool to implement the second pillar of Basel II, together with the aforementioned FSA's approach to encourage each financial institution to make its own efforts to build a comprehensive risk management system, and to review its effectiveness. Such a combination of supervisory approaches would be desirable in terms of the compliance cost paid by financial institutions, and of the continuity of the financial administration.

With regards to the "interest rate risk in the banking book" and "credit concentration risk" which are explicitly regarded as important risks to be covered under the second pillar, the FSA will incorporate its supervisory measures for these two risks into the framework of the Early Warning System, so as to ensure that these risks are managed in

an appropriate manner on an individual basis. The details of the FSA's approach to these risks are described below.

(1) Interest rate risk in the banking book

Interest rate risk is regarded as a potentially significant risk in the framework of the second pillar of Basel II, and thus, the FSA will include a new standard on the interest rate risk in the banking book into the Early Warning System.

More specifically, in reviewing the interest rate risk in the banking book, an "outlier" level [= whether the interest rate risk amount in the banking book (*i.e.* a decline of the economic value of the overall positions of an financial institution, which is calculated as a result of either (1) an upward and downward 200 basis point parallel rate shock, (2) or 1st and 99th percentile of observed interest rate changes using a 1 year (240 working days) holding period and a minimum of 5 years of observations) exceeds 20% of the sum of Tier 1 and Tier 2 capital] will be set and appropriately monitored within the framework of the "Stability Improvement Measures" in the Early Warning System.

In conducting interviews and/or other supervisory measures, the FSA may focus as to whether each financial institution appropriately recognizes the present value of its positions and the volume of risks by product and by due date, in addition to major focus regarding the market risk that are contained in the current "Comprehensive Guideline for Supervision of Major Banks, etc."

In measuring the interest rate risk in the banking book, attention shall be paid to the following:

i) In calculating the interest rate risk amount with regard to the outlier level, the choice of the interest rate shock out of (1) or (2) above is the decision of the financial institution.

ii) The calculated risk amount of the interest rate risk could vary significantly depending on the definition of the so-called core deposits (of the deposits which have no clearly defined period for interest rate revision and are withdrawn as needed by the depositor, the deposits which are left with the financial institution for a long term without withdrawal). Hence, the definitions (a) and (b) below will be introduced in the guidelines for supervision. These definitions of core deposits must be used on a continuous basis unless there are rational reasons to change.

(a)The upper limit of the core deposits is defined as the minimum of the

following: (1) minimum balance in the last 5 years, (2) the balance after deducting the maximum annual outflow* in the last 5 years from the current balance, or (3) the equivalent of 50% of the current balance.

The maturity of up to 5 years (average 2.5 years) is assumed independently by the financial institution.

(b)Financial institutions can use their own definition of core deposits as long as depositors' behaviors are rationally modeled and the amount of core deposits is confirmed and allocated into each time band for internal management purposes.

iii) Advanced risk calculation methods based on the model used for internal management purposes to calculate the interest rate risk amount, can be used for measuring the interest rate risk in the banking book, provided that the financial institution can successfully demonstrate to the FSA the rationale of using such methods. (For example, risk calculation based on a cash flow that is different from the contractual cash flow, or risk calculation based on the forecasted customer-specific rate which does not perfectly coincide with the market rate.)

* When the interest rate had never risen for in most deposits for the last 5 years, maximum annual outflow must be the annual outflow amount at the time of the latest interest rate rise beyond the last 5 years

(2) Credit concentration risk

The second pillar of Basel II also emphasizes the importance of managing credit concentration risk, and thus, the FSA will also introduce the standard for the credit concentration risk in the Early Warning System.

More specifically, the FSA will conduct appropriate monitoring of credit concentration risk within the framework of the "Credit Risk Improvement Measures" in the Early Warning System. To achieve this end, certain thresholds will be set in terms of credit concentrations on a particular industry, and the capital adequacy ratio assuming that a risk to a specific large borrower had become apparent [= an assumption in which a certain amount of the unsecured portion of claims (net of loan-loss provisions)to large borrowers who are classified as "need special attention" or below was recognized as a loss.]

In conducting interviews and/or other measures, the FSA may focus as to whether each financial institution appropriately assesses the composition of positions and risk details by large borrower, corporate group, industry type, regions and country, in

addition to major points of observations regarding the management of large exposures as set forth in the current “Comprehensive Guideline for Supervision of Major Banks, etc.”

As a matter-of-course, it is necessary to clarify that credit decisions on individual counter parties should be made solely by the management of the financial institution concerned, and that the FSA’s review on credit concentration risk is ***not*** intended to instruct or participate in such decision-making.

(3) Consideration for the financial markets, etc.

In the framework of the Early Warning System, the FSA conducts interviews in order to analyze the cause, review the appropriateness of the risk management and remedial actions taken by financial institutions which fall below the pre-determined level. Also as necessary, the FSA requests a written report in accordance with Article 24 of the Banking Law, or issue a business improvement order in accordance with Article 26 of the Banking Law when the necessity is acknowledged to deliver a successful implementation of a business improvement plan.

In such a framework, supervisory actions such as interviews have to be taken as a part of the “Stability Improvement Measure” concerning the interest rate risk in the banking book, or of the “Credit Risk Improvement Measure” concerning the credit concentration risk of the financial institutions that fall below the above-mentioned threshold. Even in such circumstances, however, it does not mean that the management of the financial institutions concerned is automatically regarded as unsound, and thus, the FSA does not necessarily make an immediate request for improvement of the management.

Furthermore, even in the case where an improvement is needed in individual institutions, special attentions should be paid to appropriately select the method and the timing of the improvement plan in order to contain potential influences of the improvement actions on the financial market and financial intermediaries for small- and medium-sized enterprises.

If a need is recognized after the implementation of this supervisory framework, the FSA will flexibly review the framework as well as its implementation method.

3. Supervisory Approach for Small- and Medium-Sized and Regional Financial Institutions

The above framework also applies to small- and medium-sized and regional financial institutions. The fundamental approach of the FSA is to utilize the framework to review and evaluate the system for a comprehensive management of various risks at each financial institution, in tandem with the Early Warning System including those for the "interest rate risk in the banking book" and the "credit concentration risk."

It must be noted, however, that the comprehensive risk management is basically intended to apply for financial institutions with large-scale and complicated risks in order for them to assess and manage a wide range of risks as a whole. On the other hand, there exist some small- and medium-sized and regional financial institutions for which it may not be appropriate to immediately require a highly sophisticated comprehensive risk management system, in light of their scale and risk profile. Therefore, the Early Warning System will form the basis for the supervision of these financial institutions, and in the course of conducting interviews and requesting reports based on the Early Warning System, the FSA may encourage individual institutions – where necessary, to establish a desirable level of system for comprehensively managing various risks, commensurate with the scale and risk profile of each institution.

III. Future Schedule

In order to accommodate the second pillar of Basel II, supervisory measures will be implemented in accordance with the timetable as below.

(1) Assessment of comprehensive risk management system of major banks and other large banks. (October 2005)

Comprehensive risk management systems of major banks and other large banks have been evaluated via interviews and other means to assess the implementation status of the "Plans toward Enhancing Risk Management", which each bank submitted to the FSA in August 2005. Such evaluations are made based on the "Comprehensive Guideline for Supervision of Major Banks, etc.," published in October 28, 2005.

(2) Assessment of comprehensive risk management system of small- and medium-sized and regional financial institutions (March 2006)

In line with the "Comprehensive Guideline for Supervision of Major Banks, etc.," the perspectives for reviewing the comprehensive risk management system, which take the diversity of the scale and risk profiles of each financial institution into consideration, will be included in "the Comprehensive Guideline for Supervision of Small- and Medium- Sized and Regional Financial Institutions," by the end of March 2006. The guideline will be implemented after issuing its draft for public comment from interested parties for approximately one-month period.

(3) Enhancement of the Early Warning System (March 2006)

With regards to the interest rate risk in the banking book and the credit concentration risk, the "Comprehensive Guideline for Supervision of Major Banks, etc.," and the "Comprehensive Guideline for Supervision of Small- and Medium-Sized and Regional Financial Institutions" will be amended as necessary in order to provide appropriate monitoring within the frameworks of "Stability Improvement Measure" and "Credit Risk Improvement Measure" of the Early Warning System.

Although these amendments will be implemented after approximately one-month period of public consultation at the same time as (2) above, the FSA intends to implement the revised "Stability Improvement Measure" (introduction of the outlier standard for the interest rate risk in the banking book) from April 2007 in order to provide a sufficient preparation period.

(4) Implementation of a new "Stability Improvement Measure" (April 2007)

The FSA will implement the revised "Stability Improvement Measure" in the revised Early Warning System, and commence the supervision of the interest rate risk in the banking book, based on the outlier standard.