

# Comprehensive Risk Management System

## Comprehensive Risk Management

Risks assumed by banks include credit risks, market risks, liquidity risks and operational risks. At the Chugoku Bank, we have established a system for managing the various types of risks comprehensively through the establishment of a controller for risk management as well as various committees such as the Asset and Liability Management (ALM) Committee. We also specify those in charge of the various types of risks and analyze the status of these risks, and evaluate and manage them for the entire bank. We have also established a system to ensure proper risk management on a continual basis under which the Audit & Inspection Department monitors the status of risk management by the various divisions.

To enable an effective management framework for comprehensive risk management, the Chugoku Bank uses statistical methods to quantify and aggregate its credit, market, and operational risks in determining overall risk exposure. The Bank then compares this total amount of risk with its available capital to assess and verify its degree of capital adequacy, thereby ensuring sound operations.

In addition, the Bank implements stress tests in anticipation of risks that cannot be grasped through statistical methods. At the same time, the Bank has its own principle to conduct risk taking within the limit of core capital (Tier 1) excluding losses exposed in times of stress to ensure soundness. Furthermore, the Bank conducts risk management by establishing risk limits for each risk category and monitoring the risk levels regularly.

## Credit Risk Management

Credit risk refers to the losses incurred when the value of assets (including off-balance-sheet assets) decline or become worthless due to changes in the financial status of those to whom credit is provided.

The Bank's basic credit risk management policy is to, within the scope of its management capabilities, ensure that return is commensurate with risks in its transactions and to appropriately manage the credit risks of the diverse transactions of each of its divisions and business sections using credit risk assessment and management methods that suit the special characteristics of each transaction in order to maintain a sound asset structure. The Bank carries out its credit risk management appropriately based on its Credit Risk Management Standards and various detailed management methods provided for in the Bank's operating regulations.

Based on this framework, the Credit Rating Center and Credit Supervision Department manage the risks of the individual loans of the operational divisions (branches and loan sales departments at the headquarters). The Risk Management Department, which is completely independent of the loan sale, screening, and approval process, is responsible for managing overall credit risks. The Bank has also established an auditing system for credit risks, appointing a Credit Screening Supervisor in the Audit & Inspection Department who bears the responsibility for conducting internal audits for credit risks.

Specifically, credit risk management entails determining the overall condition of the customer's business through credit ratings, self-assessment, and other methods. This information is utilized to carry out credit screening for individual loans, administer the loans after they have been extended, and properly determine write-offs and reserves. From the perspective of loan portfolio management, the Chugoku Bank strives to strengthen control of credit risks and its ability to earn stable income by monitoring the loan balance composition and credit risks and cost adjusted income. Risk managers verify that calculated credit risk exposure is within the credit risk limits set under the credit risk management plan, conduct stress tests to assess the Bank's degree of capital adequacy, and report results regularly to the Board of Directors and other management bodies.

Credit concentration risks are managed by setting credit limits by debtor, industry and country. The status of these is reported to the Board of Directors on

a regular basis.

In addition, we have established the "Large Borrowers Credit Review Committee" to deal with the matter on an organizational level for strengthening our supervision of large borrowers.

## Market Risk Management

Market risk refers to the risks of incurring losses from fluctuations in profits arising from assets and liabilities and the risks of incurring losses from fluctuations in the value of assets and liabilities (including those off balance sheet) due to fluctuations in market risk factors such as interest rates, exchange rates and share prices.

The Bank's basic risk management policy for market risks is to determine and analyze risks from the point of view of both price and return on asset movements as well as assessing the risks from various angles, using stress tests and other methods. The Bank carries out its market risk management appropriately based on its Market Risk Management Standards, which stipulate the framework and systems for market risk management, and various detailed management methods provided for in the Bank's operating regulations.

The structure for market risk management is divided into the business operations division (front office) and the administrative division (back office). We have also established a risk management division (middle office). These serve as reciprocal restraints.

Trading limits and loss limits have been set for trading operations, the goal of which is to earn trading profit from buying and selling securities in market operations. These are managed to ensure that losses in excess of a certain amount do not occur. Banking operations (investment securities) are managed for risks by taking the risk-return balance into consideration through ALM analysis, VaR analysis and other means to ensure stable profits over the medium- to long-term. We have also established a system for the flexible management of market risks as well as credit risks and liquidity risks related to market operations.

Market risk management for the entire bank, including lending and deposit services, is carried out by analyzing risks from multiple aspects, such as the calculation of interest rate risks. The ALM Committee discusses the overall management of assets and liabilities and considers management and lending policies each month.

## Liquidity Risk Management

Liquidity risk refers to the risks of incurring losses (hereafter, "fund procurement risks") when it becomes difficult to secure the requisite funds or when procuring funds at a much higher than normal interest rate becomes necessary due to a mismatch between the timing of use and procurement or to an unexpected outflow of funds, or to risks incurred when transactions cannot be conducted or must be conducted at prices that are much more disadvantageous than normal due to market disruptions or other factors (hereafter, "market liquidity risks").

The Bank recognizes fund procurement as an important management issue and its basic fund procurement risks policy is to ensure a stable supply of funds. The Bank's basic policy for managing market liquidity risks is to take into consideration the special features of markets for individual products, such as market size, liquidity, and other factors and pay careful attention to their market liquidity. The Bank carries out its fund procurement risks and market liquidity risk management appropriately based on its Market Liquidity Risk Management Standards, which stipulate the framework and systems for fund procurement risks and market liquidity risk management.

Funds procurement risks are subject to strict management and this is divided between the funds procurement division, which procures funds, and the funds procurement risk management division, which monitors the status of the procurement of those funds.

The funds procurement management division carefully monitors the daily status of funds procurement for market operations and other operations and works to limit the risks involved in the procurement of funds.

The funds procurement risk management division determines the management policies for risks of procuring funds such as policies on holding highly liquid assets and setting limits on procurement from the market. The funds procurement risk management division monitors developments to ensure there are no problems with the status of funds procurement in the funds procurement management division.

Deposits comprise the vast majority of procurement for the Chugoku Bank and the procurement of funds is stable. However, we are working to diversify the means of procurement to prepare for unforeseen circumstances by procurement from the market utilizing marketable securities held by the Bank.

## Operational Risk Management

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Operational risk refers to risks of losses arising from bank operational processes, employee and officer activities or an unsuitable system or due to external circumstances.

The Chugoku Bank separates and manages operational risks in the six categories of 1) administrative, 2) system, 3) personnel, 4) tangible assets, 5) information assets, and 6) compliance and legal risks.

To support the management of operational risks, the Bank has established operational risk management standards developed from its basic risk management rules. Guided by these standards and rules, the Operational Risk

Management Center of the Administrative Planning Department is responsible for the integrated monitoring and management of overall operational risks. In addition, sections in charge of specific risks manage those individual risks in a more specialized level.

### Operational Risk Management Methods and Procedures

In conducting a business, operational risks should be avoided as much as possible.

To do so, we have established organizational structures and systems to properly manage operational risks and strive to prevent the occurrence of incidents and minimize their impact should they occur.

Specifically, the Chugoku Bank implements risk control self-assessment (RCSA) programs. In addition to assessing risks, these programs upgrade risk management measures, such as controlling, transferring, and avoiding risks, based on the formulation of measures to prevent recurrence. These procedures involve collecting and analyzing operational risk loss event data as a method of capturing risks and establishing response measures. Moreover, to increase the efficiency of operational risk management, the Bank is endeavoring to set up a Plan-Do-Check-Act (PDCA) cycle for risk management.

In addition to the previously mentioned RCSA programs and collecting and analyzing operational risk loss event data, the Chugoku Bank uses various standards to manage each operational risk. Through the establishment of operational, system, personnel, tangible assets, information assets, and compliance and legal risk management standards, the Bank endeavors to properly manage these risks.

