Risk Management

Management Strategy and Risk Capital Allocation

The Bank defines "risk capital" as an integrated control approach to risk that groups risk into categories, namely (1) credit risk, (2) market risk, (3) interest rate risk and (4) operational risk, and measures exposures relating to each risk category.

Risk Capital

An approach to defining the type and total amount of risk (risk appetite) the Bank thinks it should be willing to adopt so it can attain its management plan goals within the limits of the Group's management strength. The Bank measured the risk capital based on a stress test in response to environmental changes, and operated its management plan and risk appetite in an integrated manner, by incorporating the results of the risk capital to the budget compilation process in fiscal 2017.

Monitoring of Allocated Risk Capital

By tracking business performance adjusted for allocated risk capital on a monthly basis, risk capital is effectively put to work as a tool to comprehensively manage progress toward management plan goals from a risk-taking perspective. Moreover, risk capital budgeting is useful for judging business performance when monitoring of this performance adjusted for allocated risk capital is combined with risk-return monitoring as an indicator of whether allocated risk capital has been effectively deployed.

Shinsei Bank Group's Portfolio

The Group's nonperforming loan ratio (nonconsolidated) decreased to 0.17% as of March 31, 2018, because deteriorated credit standing had little negative impact on the Group's corporate loans and real estate-related loans centered on non-recourse loans. Meanwhile, as a result of higher growth of the unsecured personal loan balance at subsidiaries with a higher risk-monitored loan ratio, the Group's risk-monitored loan ratio (consolidated) increased to 1.53% as of March 31, 2018.

Risk Factors and Future Policy

In the Bank's three-year Medium-Term Management Plan that commenced in fiscal 2016, we grouped our businesses into "Growth Areas," "Stable Revenue Areas," "Strategic Initiative Areas" and "Curtailment Areas," and put forward consumer finance and structured finance in particular as growth areas.

While the external environment has continued to improve, we must continue to monitor the downside risks to the global economy from such factors as the future adjustments to U.S. monetary policy, the impact of the U.K.'s exit from the EU, geopolitical risks and the impact of such factors on financial markets. Risk management operations will continue efforts to accurately understand both domestic and overseas environments and develop a recognition that is shared by senior management on risk preferences and comprehension of the risk profile of the Group's portfolio from multiple angles using more-advanced stress tests and other means.

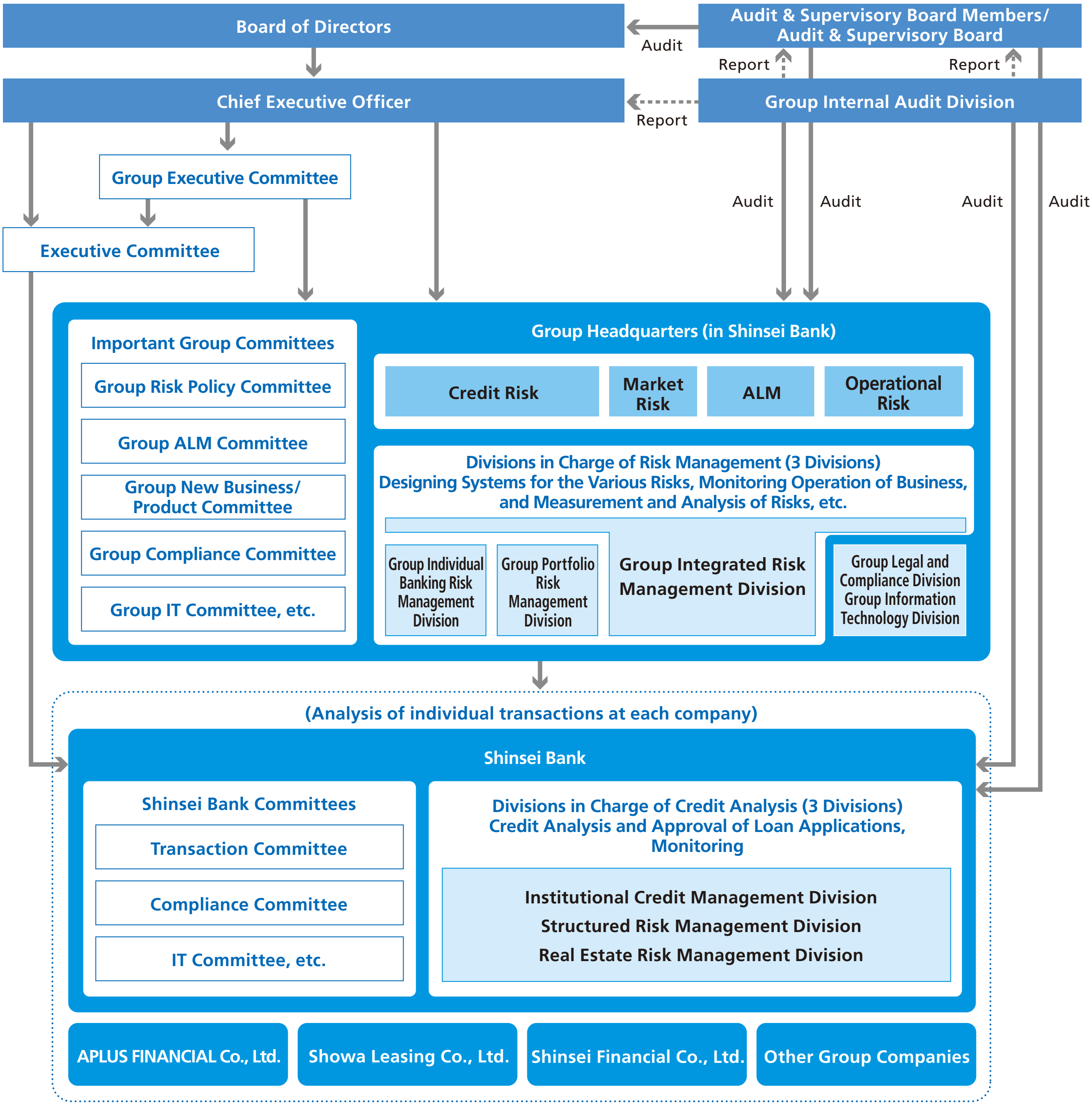
Also, an appropriate system with checks and balances is applied to initiatives in growth areas led by business promotion sections and implementation of business strategies. Through advanced measurement of risk-return and a stronger monitoring function, we are working to bolster and improve our risk management posture through flexibility in reviewing and revising risk strategies as the need arises.

Risk Management

Overview of the Group's Risk Management Systems

To ensure its risk management is effective, the Bank has established various specific committees such as the "Group Risk Policy Committee," "Transaction Committee," "Group Asset and Liability Management (ALM) Committee" and "Market Business Management Committee." All these committees are able to function effectively as bodies responsible for making important risk judgments by constantly improving their composition and functions in response to changes in the operating environment. The Group Risk Policy Committee, whose members include senior management such as the CEO, Chief Officer of the Group head of corporate planning

Risk Management System Chart (as of May 1, 2018)



and finance and the Group head of risk management, performs the crucial role of setting and coordinating the appropriate and optimal level of risk taking by concurrently reviewing the Bank's risk management policies and business strategy. Shinsei Bank has established the "Risk Management Policy" as its fundamental policy on risk management and basic recognition of risk categories based upon its understanding of the totality of risks faced by the entire Shinsei Bank Group and the need to actively manage them.

Basic Concept regarding Risk Management

Financial institutions are exposed to various risks, including credit risk, market risk, interest rate risk, liquidity risk and operational risk. To maintain highly profitable and stable operations, a financial institution must make the control of these risks a management priority. For that purpose, the Bank must be able to ascertain that risks are taken in line with Bank-wide policies as well as individual operational policies, and remain within appropriate limits. To strengthen the required monitoring functions and further develop its risk management framework, the Bank established two risk management groups: 1) credit analysis divisions responsible for credit analysis, loan application approvals and monitoring and 2) divisions responsible for overall risk management, measuring and analyzing credit, market and other risks, and integrating functions for examining and verifying fair value.

Definitions of Risk Categories

Risk Categories	Definition
Credit Risk	Credit risk is the risk of incurring losses due to deterioration in the financial condition of a borrower resulting in an erosion or total loss of asset value (including off-balance assets).
Market Risk	Market risk is the risk of incurring losses due to changes in the value of assets or liabilities through fluctuations of various risk factors such as interest rates, foreign exchange rates, stock prices, etc.
Liquidity Risk	Liquidity risk (fund-raising risk) is the risk of incurring losses due to difficulties in securing necessary funds or the need to raise funds at an interest rate that is substantially higher than normal stemming from mismatches in the maturities of assets and liabilities or an unexpected outflow of funds.
Operational Risk	Operational risk refers to the risk of incurring losses resulting from inadequate or failed internal processes, personnel and systems or from external events.

For the details of each risk management, please see "Capital Adequacy Requirement (Basel Accord) Pillar III (Market Discipline) Disclosure" (pages 195-238).

Risk Management

Credit Risk

Institutional Business Credit Risk Management

The Bank has clearly set out its basic policy for credit provision operations and specific guidelines for credit risk management. Credit risk management processes for institutional customer businesses are broadly grouped into credit risk management for individual transactions and portfolio-based credit risk management.

Credit Risk Management for Individual Transactions

(1) Organization and Structure

Regarding credit assessments for institutional business, an effective system of checks and balances on sales promotion divisions is established by veto rights of risk management divisions.

(2) Obligor Rating Systems

Using credit estimation models including a model benchmarking the credit ratings of external credit rating agencies, we calculate model ratings and apply adjustments to these based on qualitative factors, and use this method to determine credit rankings.

Portfolio-Based Credit Risk Management

(1) Monitoring Analysis System

At Shinsei Bank, we perform analysis that derives from unique entry points based on the risk profiles of each product and monitor risk diversification status by segments such as industry, ratings, products and regions, to report to the appropriate management layer.

(2) Quantifying Credit Risk

By factoring measured expected losses and unexpected losses into loan spreads, we can harness this data to ensure an appropriate risk-return in each transaction.

(3) Credit Concentration Guideline

Our credit concentration management framework consists of industry concentration guidelines and obligor Group concentration guidelines, and, in the event that credit concentration exceeds the guideline, we conduct reviews and adopt countermeasures.

Individual Business Credit Risk Management

Risk management for our Consumer Finance Businesses encompasses all operations from loan application assessment (entry-point credit) to managing risks after a contract is signed (credit monitoring) and, if needed, loan collection operations.

The Group Individual Banking Risk Management Division is in charge of risk management for products for individual customers, including our Consumer Finance Businesses. The division holds a monthly risk performance review meeting with other risk-related divisions, including the Chief Officer of the Group head of risk management at the Bank as well as risk officers from subsidiaries, in order to share information and promote a shared awareness of risks. The division also provides operational support and advice to relevant units of the Bank and its subsidiaries relating to overall risk management concerning credit administration policies and credit strategies.

Risk-related divisions at Group subsidiaries carry out appropriate risk control through a process that incorporates scoring models into credit administration processes, while using credit-related databases of customer attributes stemming from the nature of their businesses, credit information and transaction history. The scoring models, i.e., initial credit score, score at credit monitoring stages, collection strategy scores, etc., were developed using statistical methodologies, and, to maintain the accuracy of the scoring models in line with the level achieved when it was first developed, model performance is constantly monitored and the model is subject to fine tuning as needed.

The Group Individual Banking Risk Management Division is working to elevate its scoring model development and enhance the entire Group's credit provision capabilities in ways that help maximize earnings of the entire Group in the medium and long terms.

Credit costs are crucial to the management of profitability in the Consumer Finance Business. We, therefore, conduct monitoring while tracking multiple leading indicators and verification metrics at the portfolio level to enable us to quickly grasp any deterioration in the portfolio's overall asset quality and take timely action to improve its profitability.

Credit Risks on Market-Related Transactions

Counterparty credit risk attendant with market transactions such as derivative transactions are managed based on estimations of the fair value and future value fluctuations of relevant transactions.

Self-Assessment

Asset self-assessments are a part of credit risk management. Financial institutions examine and analyze their asset holdings so they can grasp the actual state of their assets as steps in preparing for appropriate asset write-downs and write-offs as well as reserve provisioning.

At Shinsei Bank, sales promotion divisions and credit analysis divisions conduct asset appraisals, and risk management divisions that are independent of sales promotion and credit analysis verify appraisal results.

Measures to Meet Basel Accord Requirements

In order to comply with the credit risk regulations under the Basel Accord, Shinsei Bank has adopted the Foundation Internal Ratings-Based (F-IRB) Approach. Based on this framework, we have secured strict internal controls vis-à-vis our internal ratings system, the foundation of credit risk management, and we conduct estimations of parameters such as the design and operation of our internal rating system and default rates. The benefits of our internal rating system are reflected not only in internal control of credit risk but also in calculations of regulatory capital requirements.

Market Risk

Market Risk Management Policy

In accordance with the "Trading Business Risk Management Policy," market risks in the trading business are managed through a series of processes with the Group Executive Committee determining overall market risk and loss limits. The Group Integrated Risk Management Division monitors on a daily basis the status of compliance with these limits, and the Market Business Management Committee reviews every month trends at individual businesses, the status of profits and losses, market risk conditions and overall business risks, including the risks of products handled.

VaR Data for Fiscal Year-End, Maximum, Minimum and Average during Fiscal 2016 and 2017

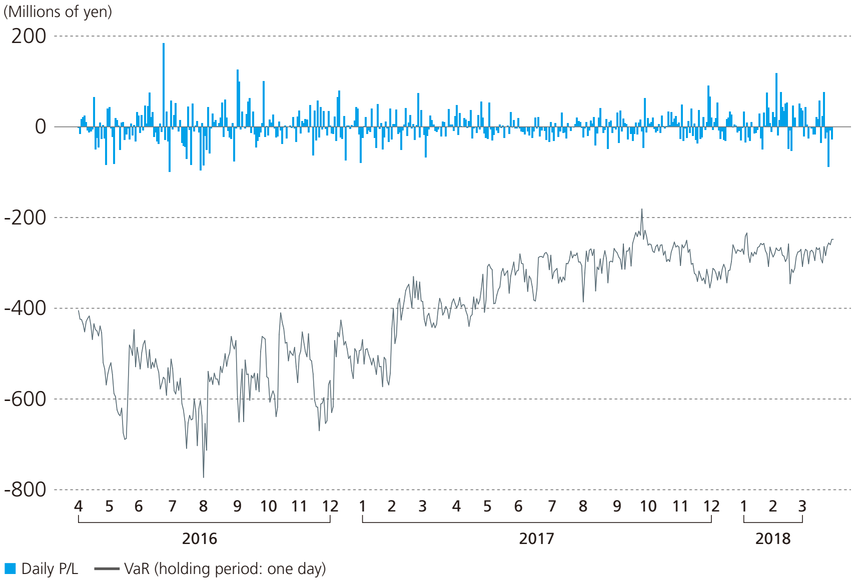
	Millions of yen			
	FY2016		FY2017	
	Consolidated	Nonconsolidated	Consolidated	Nonconsolidated
FY End VaR	1,231	1,155	783	740
FY VaR				
Maximum	2,444	1,998	1,391	1,353
Average	1,627	1,367	956	917
Minimum	1,042	919	572	540

Stressed VaR Data for Fiscal Year-End, Maximum, Minimum and Average during Fiscal 2016 and 2017

	Millions of yen			
	FY2016		FY2017	
	Consolidated	Nonconsolidated	Consolidated	Nonconsolidated
FY End VaR	3,171	2,992	3,915	3,690
FY VaR				
Maximum	4,248	3,604	4,161	4,017
Average	2,923	2,485	2,869	2,728
Minimum	2,050	1,843	1,832	1,755

Risk Management

VaR and Daily Profit and Loss (Backtesting) (FY2017, Consolidated basis)



Backtesting on the VaR Model Applied to the Trading Account
Backtesting involves comparing fixed position virtual losses to estimated VaR to confirm the reliability of the VaR method.

Assumptions of Shinsei's VaR Model
Method: Historical simulation method
Confidence level: 99%
Holding period: 10 days
Observation days: 250 days
Coverage: Trading account

Trading Book

Market risk in the trading book is managed through techniques such as VaR. VaR is the maximum loss amount expected due to future price fluctuations within a given probability range, assuming a specific position is held over a specific time horizon. In addition, we measure multi-faceted risks using sensitivity analysis for various factors. In calculating the amounts equivalent to market risk, the Bank's VaR model is based on a historical simulation method and uses a 99% confidence level, a 10-day holding period and an observation period of 250 days (see the previous page). The effectiveness of the VaR model is verified through backtesting, which examines how frequently actual daily loss exceeds daily VaR for a one-day holding period.

Interest Rate Risk

Interest rate risk is the risk of eroding profits or incurring losses due to market interest rate fluctuations amid mismatches in the interest rate or maturities of assets and liabilities. To measure interest rate risk exposure, we calculate the decrease in the economic value of the banking book from an unexpected 1% interest rate increase [a 1% parallel upward shift in interest rates for loan originations (bank assets) and core deposits (bank liabilities)]. This calculated exposure is used for internal controls. As interest rate risk exposure is significantly impacted by the recognition of asset and liability maturities and loan prepayments, we are endeavoring to appropriately capture interest rate risk.

Risk relating to Marketable Credit Instruments

Investments in structured bonds, funds, securitized instruments, etc., are generally held until maturity, although some instruments can be traded on the market. Such instruments have a complex risk profile that includes market risk and liquidity risk in addition to credit risk related to their underlying assets and counterparties. The Bank has established a system to ensure appropriate management of these risks, and regularly reviews its investment policies based on the investment environment. The Transaction Committee, Market Business Management Committee and the Group Risk Policy Committee strive to promote appropriate management of risks through regular reviews of risk exposure.

Liquidity Risk Management

Liquidity Risk Management Policy

As for funding liquidity risk, pursuant to the "Liquidity Risk Management Policy," the Group Treasury Division, a fund-raising management unit, and the Group Integrated Risk Management Division, a funding liquidity risk management unit, have been put in place, and the Group ALM Committee receives reports on the following designated liquidity risk management indicators: "funding gap limit," "minimum liquidity reserves," "liquidity stress tests" and "liquidity coverage ratio." The levels of funding liquidity risk consist of "Normal," "Need for Concern," "Crisis" and "Risk Administration Mode," with the Group ALM Committee determining the current mode. The response framework for each specific mode is set forth in the "Funding Liquidity Contingency Plan," and regular training is provided.

Operational Risk

Operational Risk Management Policy

To ensure comprehensive management of operational risks, the Bank has established an operational risk management policy that defines risks and sets forth its basic policy and organizational structures for risk management as well as procedures for identifying, evaluating, monitoring, reporting and controlling/mitigating risk. The Group Integrated Risk Management Division, a unit responsible for Group-wide operational risk management, evaluates, analyzes and reports on operational risk to management. Moreover, for each domain of operational risk such as administrative risk and systems risk, specialized risk management divisions that are independent from business divisions implement measures to manage operational risks according to the attributes of each category.

Risk Management Frameworks for Administrative Risks

Administrative and systems risks refer to the risk of "incurring losses from inaccuracies in clerical tasks due to the carelessness of executives or employees, or errors or misconduct in their performance of work duties." As for administrative risks, we recognize appropriate management of them is extremely important to our ability to offer services that our customers trust. We strive to improve the level of our administrative work performance by clarifying the content of procedures through efforts to revise terminology, hold training seminars, provide guidance on administrative work and improve administrative workflows. Specifically, our efforts to improve administrative risk management include establishing a system of branch self-audits where autonomous checks are performed at the work-task level and creating a database documenting past errors that enables analysis of the causal factors behind errors that will help prevent reoccurrence in the future.

Risk Management Frameworks for Systems Risks

Systems risks includes the risk of companies or individuals incurring losses from the disappearance of valuable data of customers as a result of information systems shutting off and software or hardware failures. Through consecutive reviews of systems risks, we are identifying and evaluating the risks, and working to improve quality in systems development and prevent systems failures and ensure rapid recoveries when problems occur by improving our systems operating capabilities. In fiscal 2018, we are planning to renew our core operational systems, and will manage risks for safe operations of new systems. We have endeavored to improve the level of systems risk management and information security for the entire Group, including subsidiaries. Moreover, we have taken appropriate steps based on the latest trends in technology to respond to cyber-security problems that have recently come to be seen as a social threat; so, we are working to ensure the safety of customer information and assets.