Risk Management System

In order to fully justify the trust of customers and shareholders, the Bank must be able to ensure appropriate levels of earnings and stable operations, by dealing appropriately with various kinds of risk its operations are subject to, while remaining a soundly managed institution.

Based on our Comprehensive Risk Management Regulations laid down by the Board of Directors, the Bank decides on a detailed risk management policy for each fiscal year, and manages all categories of risk on an integrated basis.

For management of major categories of risk—credit, market, liquidity and operational risk—we have dedicated offices. The Risk Management Division manages risk centrally and comprehensively. To position us to deal appropriately with the increasing diversification and complexity of risk, we have established a Comprehensive Risk Management Committee and carry out regular audits through the Audit Division into the appropriateness and effectiveness of our risk management systems.

Under this risk management regime, we aim to ensure sound, profitable banking operations, while striking an ideal balance between capital adequacy, risk management and earnings imperatives.

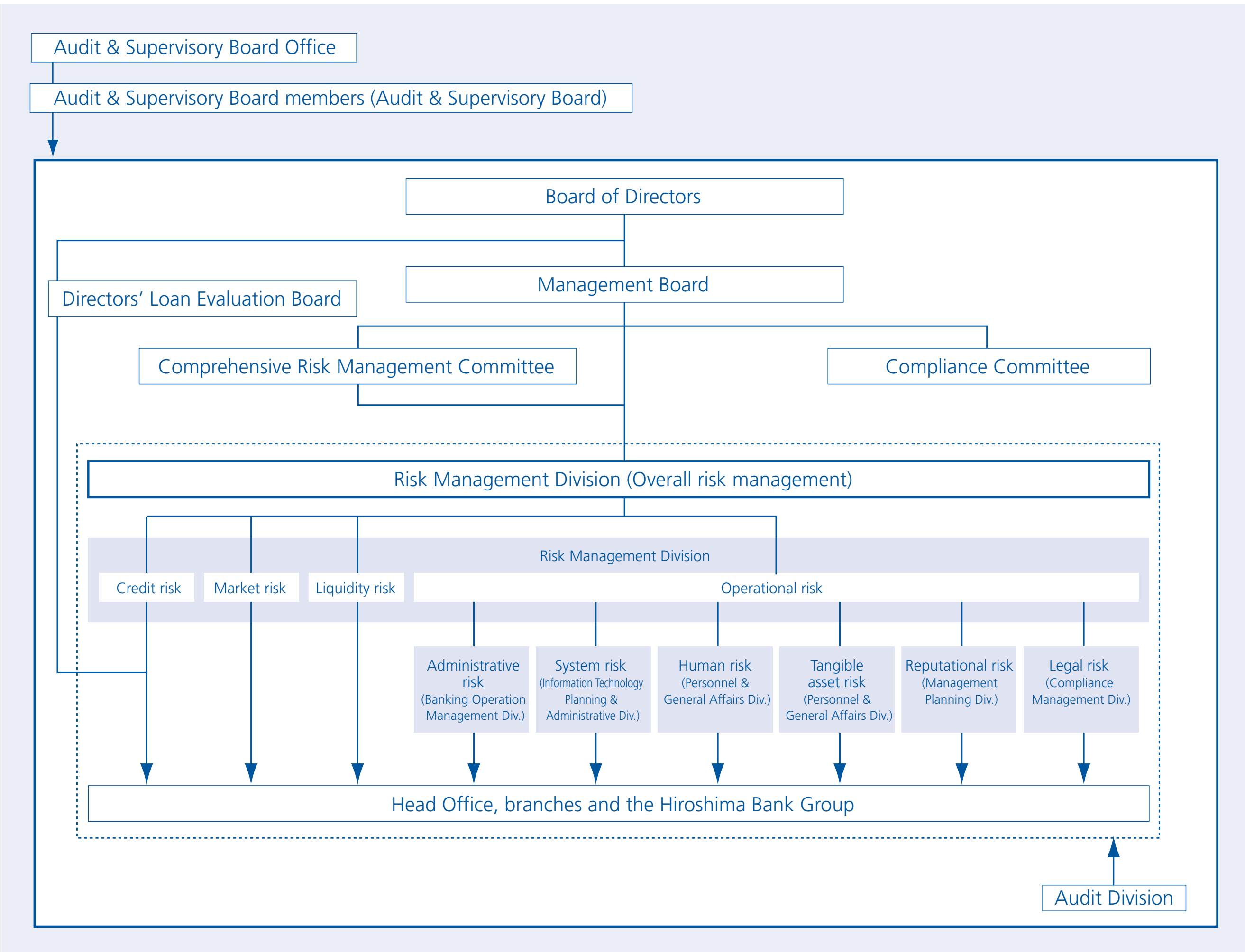
Comprehensive Risk Management

Comprehensive risk management is undertaken by measuring the various risks faced by the Bank using uniform benchmarks such as value at risk (VaR) and then measuring such risk against the Bank's corporate strength.

We set ceilings (risk capital allocations) for risk-monitored assets in the categories of credit risk, market risk, and operational risk, with dedicated offices controlling risk-monitored assets. Centralized appraisal of risk-monitored assets as a proportion of Bank capital is undertaken by the Risk Management Division. We have also created a system for risk management reports to be submitted regularly to the Board of Directors, with implementation of appropriate countermeasures.

In addition, we evaluate and review the adequacy of our capital ratio through periodic stress tests, which clarify the possible impact on capital and earnings of losses arising from risk that could not be evaluated using statistical methods.

Risk management framework (as of April 1, 2018)



Risk Management System

■ Credit risk

Credit risk is the risk of sustaining losses due to reduction or loss in value of assets due to deteriorating credit circumstances at a borrower.

Credit screening structure

For all major loans made by our branches, the Bank has in place a system of rigorous credit-screening carried out by a credit-screening department, which is independent of the marketing department. In addition to establishing teams for each sector, the credit-screening department has established dedicated teams to ensure sounder borrower finances and effective corporate rehabilitation, and also offers support to management trying to improve operations.

In approving a loan, the Bank not only follows the basic principles and rules for credit extension laid down by the Board of Directors, turning down any application that runs counter to the law or public morals, but also takes careful account of profitability and public benefit, in addition to fund use, repayment source, and guarantee and collateral arrangements.

In cases where customers apply for a review of borrowing terms, the Bank will give a considered response accounting for actual circumstances faced by the customer, in line with the Board of Directors' basic policy for management of funding facilitation. Appropriate and prompt credit screening is carried out after joint appraisal of a customer's needs and concerns—and is not just based on a mechanical, uniform judgment informed only by financial statements and other superficial statistics and industry-specific guidelines.

To strengthen and expand the credit screening system, the Bank seeks to appraise the creditworthiness of a given company through case-by-case credit management and takes continuous measures to improve the credit-screening skills of employees such as various kinds of training programs.

Risk-management using the borrower category system

We have introduced the borrower category system to clearly identify objective credit risk on loans we extend. Based on financial and other data indicating the level of creditworthiness of the borrower, we have divided borrowers into 12 grades, and continuously monitor changes in credit risk. We then carry out credit risk quantification based on these grades to assess credit risk on loan assets and management risk capital allocations.

We also accumulate and organize the data necessary for quantification of credit risks, such as the default rate within each grade and progress in asset recovery from customers in default, combined with our highly sophisticated quantification technologies, to obtain a still more detailed picture of risk-monitored assets.

Bank's own assessment

In parallel with the borrower category system, we conduct strict checks into the soundness of loan assets through annual assessment carried out by ourselves. Screening is carried out by particular Bank branches in light of the financial situation faced by the borrower, and the results are checked by the credit-screening department of the Head Office. In addition, the Risk Management Division extracts important information and conducts a rigorous review of screening due process and accuracy, and the Audit Division carries out the process audit. Based on this in-house assessment, in cases where there is no realistic prospect of asset recovery, provisions are made to the reserve for possible loan losses to cover the entire value of the sum at risk. This provision is then recorded as a loss for the fiscal year under review. In this way, we ensure asset soundness.

■ Market risk

Market risk is the risk of incurring losses due to fluctuation in interest rates, stock and bond prices and foreign exchange rates, leading to changes in the market value of assets we hold.

The Bank seeks to stabilize earnings by controlling interest rate and other market risk by expanding and strengthening asset-liability management (ALM), including not only securities holdings but also deposits and loans. Findings of ALM analysis and simulations are incorporated into annual management policy as a significant element in management planning judgments.

In addition, we have created frameworks to ensure stable earnings through rigorous management of market risk, enabling us to respond swiftly and appropriately to market movements. We set limits on risk-monitored assets and lay down hedging policy and reporting and consulting rules for when asset value falls. We monitor compliance with ceilings and other limits through major measures such as total value of positions, amount of risk-monitored assets and earnings performance, as well as management on a daily basis.

In addition, accounting is rigorously based on a holding-purpose category, using mark-to-market accounting principles, that enables us to reflect changing market prices appropriately and accurately in financial data.

Trading account risk

With regard to our trading accounts (for securities and off-balance-sheet transactions that involve short-term gains on sales or purchases and trading at the behest of customers), we have special management mechanisms in place, since these transactions differ qualitatively from banking account transactions (involving deposits and loans, investment securities, and related transactions). The Bank has set up designated trading accounts, and is strengthening their management using transparent accounting procedures based on mark-to-market principles.

For proprietary position dealing, we limit our position by complying with strict rules in terms of position limits and loss-cutting measures. For positions and transactions on behalf of customers, we follow a policy of square positions by fully covering them through the interbank market.

■ Liquidity risk

Liquidity risk is the risk of losses arising from unforeseen fund outflows leading to a drying up of cash flow, and the necessity of raising funds at higher rates than normal.

The Bank prepares for capital outflow under short-term stress conditions by holding highly liquid assets such as government bonds. Furthermore, to alleviate long-term fund procurement risk, the Bank manages the stability gap between loans with low liquidity and stable funding such as deposits and long-term market funding.

Furthermore, we monitor liquidity risk, cash flow, and matters that could affect cash flow, and have in place measures to ensure a swift and appropriate response to unexpected events.

■ Operational risk

Operational risk is the risk of losses arising due to failures in work processes and employee activities, computer system irregularities and the impact of external events.

To comprehensively and accurately manage operational risk, the Bank has divided such risk into a number of subcategories: administrative risk, system risk, human risk, legal risk, tangible asset risk, and reputational risk. Such risk is managed comprehensively.

Administrative risk

Administrative risk is the possibility of losses arising from negligent processing by employees, accidents, or unauthorized activities.

Through various training programs, the Bank ensures rigorous performance of administrative duties to high standards of accuracy, speed, propriety and courtesy. It has also compiled a procedure for administrative duties based on the five principles of making a record of everything, keeping a hard copy, self-responsibility, checking and confirming.

The Bank has a reporting system for relaying complaints and opinions from customers and details of major clerical errors and incidents. To better meet in-house regulations and ensure deeper staff commitment, we analyze factors and trends in matters raised in this feedback, and, where necessary, take effective countermeasures. In addition to proactively using underlying data to prevent recurrence of clerical errors, incidents and the like, we also identify and analyze potential administrative risk and take preventative measures.

System risk

System risk is the possibility of a loss arising from the failure, malfunction, or unauthorized use of computer systems.

The Bank has established a basic security policy for due protection of information assets and specific operating rules. Their management is geared to the degree of importance of information systems and of data.

Depending on their importance, IT systems use duplicated computers, communication lines, power supplies and other items. For core systems, we have backup centers located in both Hiroshima and Fukuoka, operated jointly with the Fukuoka Financial Group. We have taken measures to ensure that we can stay in business even in cases of major disasters.

For critical customer information (data), we use strict security controls, such as encryption and other measures, to prevent unauthorized external access and information leaks.

Moreover, in response to increasingly sophisticated and serious cyber attacks, the Bank has made the issue a management priority and conducts constant information collection and analysis regarding attack trends. The Bank has also established Hiroshima Bank CSIRT* as an organization to respond rapidly in the event of a cyber attack, thereby strengthening its security management stance.

Furthermore, to prepare for unexpected situations, cyber security incidents, and other events that can jeopardize the stable operation of computer systems, the Bank has formulated contingency plans and conducts regular drills.

* Computer Security Incident Response Team

Human risk

Human risk is the risk of losses arising from a fall in employee productivity or employee resignations, and employee acts leading to a loss of public confidence in the Bank.

We seek to optimize personnel management through employee education, training and work guidance, by ensuring appropriate personnel management based on job description and personnel policy. We also have in place preparations for dealing with pandemic influenza and other major disasters that could interrupt operations, with measures in place for each stage in the development of a possible pandemic. By increasing key staff at our Head Office, we aim to create a framework for continuing operations.

Legal risk

Legal risk is the risk of sustaining losses due to penalties or legal liabilities arising from legal violations or a breach of contract.

In addition to daily awareness-raising and training in compliance, we ensure appropriate management through steady implementation of legal checks and establishment of a legal consultation framework.

Tangible asset risk

Tangible asset risk is the risk of losses arising due to damage to tangible assets caused by disasters, illegal acts or inappropriate asset management.

We keep full records on locations and status of movable assets and real estate that we own, borrow or lend out, and have in place management mechanisms for anticipated damage caused by disaster, illegal behavior, etc.

Reputational risk

Reputational risk is the risk of losses arising due to a loss of confidence in the Bank on the part of customers and markets, as a result of the spreading of false information.

In addition to ensuring the highest standards of transparency in disclosure, we seek to prevent reputational risk from arising by monitoring the Bank's reputation.

Crisis Management System

In addition to the above risk management measures, we have compiled a business continuity plan (BCP), a plan to continue major operations on a priority basis in our Emergency Management Regulations to deal properly with risk in cases where earthquakes and other large-scale natural disasters disrupt our services. In this way, we have established our crisis management framework appropriately.