

FUNDAMENTAL POLICIES AND THE ROLE OF MANAGEMENT

Banks must effectively manage various types of risks, such as market, credit, operational, and others. With the growing diversity and complexity of financial activities, risks have increased in magnitude and have come to have a major impact on the management of banks.

Members of the Bank’s top management are closely involved in the risk management process. Decisions regarding basic policies for market risk are made by the Management Committee following discussions within the ALM Committee, which includes members of senior management. For credit and other types of risks, the Management Committee appoints a member of the Board of Directors and appropriate departments to be in charge, and these departments carry out their operations and manage risk under the supervision of the director in charge who then reports to the Board of Directors.

ASSET/LIABILITY MANAGEMENT

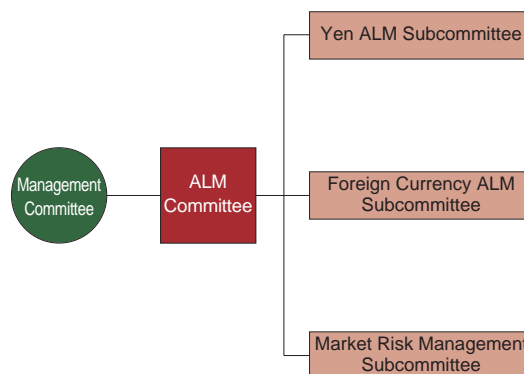
> ALM PROCESS

One of the key requirements for ALM is the understanding and active participation of top management in the ALM process. The Bank’s ALM Committee, which is chaired by a deputy president and includes senior managing directors and representatives from all sections responsible for risk management, conducts thorough discussions of ALM policy, risk limits, and related matters on a quarterly basis, and policies regarding these matters are set by the Management Committee.

The ALM Committee is responsible for overseeing the interest rate, foreign exchange currency, liquidity, and market risks of both banking and trading operations from an overall perspective. The committee’s objective is to avoid the assumption of excessive levels of risk.

Interest rate and other risks arising from day-to-day banking operations are managed by a limited number of authorized divisions with close contacts to the market. Subcommittees under the ALM Committee meet on a weekly or monthly basis, and professional staff from departments responsible for risk management assemble

to prepare suggestions that take into account recent developments.



> ALM OPERATIONS

The interest rate gaps of on-balance-sheet assets and liabilities inherent in the operations of Japan’s city banks are mainly those arising from yen deposits and loans. Deposits and loans are largely based on customer relationships and have substantial recurring and seasonal components.

The Bank makes use of Interest Rate Sensitivity Tables to manage interest rate gaps in its banking operations. This method is used together with BPV, VAR, and other methods to facilitate management from a diverse and multilayered perspective. Within the limitations set by DKB’s risk management policies and risk-taking limits, the Bank makes use of derivative instruments, principally swaps, to control overall risk and stabilize and maximize reported earnings in the medium-to-long term.

The assumptions underlying ALM operations are appropriate interest rate forecasts and accurate forecasts of interest rate gaps. Interest rate forecasts are prepared by ALM units that are constantly supervising market conditions and engaged in making precise analyses based on various scenarios. Forecasts of interest rate gaps are based on analyses of historical data on the recurring and cyclical features of the interest rate gaps of on-balance-sheet assets and liabilities. These analyses are then used to forecast the fluctuations in deposits, loans, and other items as well as increases and decreases by maturity accompanying changes in market interest rates.

> MANAGEMENT OF LIQUIDITY RISK

Liquidity risk is managed by accurately monitoring the volumes of deposits, loans, and other fund flows and the amount of market funds that must be raised as well as

Interest Rate Sensitivity Table

As of March 31, 1998

(¥ billion)

	One year or less	One to five years	Over five years	Total
Yen Assets				
Loans and bills discounted	¥24,095	¥3,703	¥ 854	¥28,654
Securities	3,359	1,054	1,377	5,790
Call loans, bills bought, due from banks	1,143			1,143
Subtotal	28,598	4,757	2,232	35,588
Yen Liabilities				
Deposits and negotiable certificates of deposit	25,959	2,574	12	28,546
Call money, bills sold, borrowed money	5,589	476	248	6,314
Other (net)	727			727
Subtotal	32,276	3,050	261	35,588
On-balance-sheet gap	(3,678)	1,707	1,970	—
Off-balance-sheet (derivatives)	541	(92)	(449)	—
Interest-rate sensitivity gap	(3,136)	1,615	1,521	—
Cumulative interest-rate sensitivity gap	(3,136)	(1,521)	0	—
Unrealized gains	50	110	81	241

Notes: 1. This table shows the maturity ladder for yen assets and liabilities in banking operations.

2. Assets and liabilities not sensitive to interest rate fluctuations and one-year swaps dated after the base date of this table are included in the category of maturities of one year or less.

3. The item "Unrealized gains" shows unrealized gains related to interest rates by period to maturity. These figures do not include unrealized gains on stocks and securities investment trusts. (For Market Value Information of Securities, please refer to page 68.)

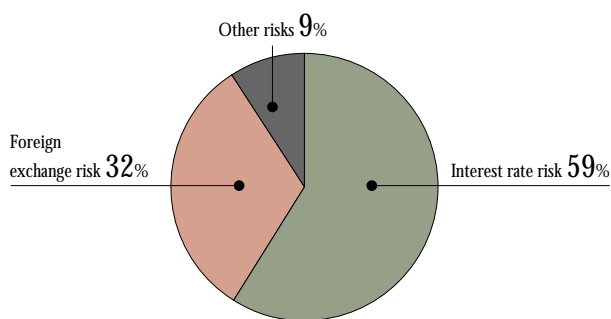
the amount of funds that it is possible to raise from the market. For foreign currencies, overseas offices monitor these aspects of their liquidity positions and the Head Office supervises liquidity from a centralized perspective on a daily basis. In addition, to prepare for worst-case scenarios, the Bank holds assets that can be easily converted to cash, establishes various kinds of risk management limits, and conducts risk management operations with close attention to detail.

MARKET RISK

The Market Risk Management Office is the focus of Bankwide activities to manage market risk arising from the Bank's operations. There are two key aspects to market risk management—measuring and preparing quick and accurate reports on risk and making use of this information in the management of day-to-day operations.

The Bank uses the VAR method to measure risk for all of its offices engaged in trading activities in Japan and overseas on a daily basis. The Bank's VAR model applies the variance-covariance approach to linear risks and mainly the Monte Carlo approach to nonlinear risks. At present, the model takes into account approximately 1,000 risk factors and about 217,000 correlation coefficients.

Breakdown of VAR by Type of Risk



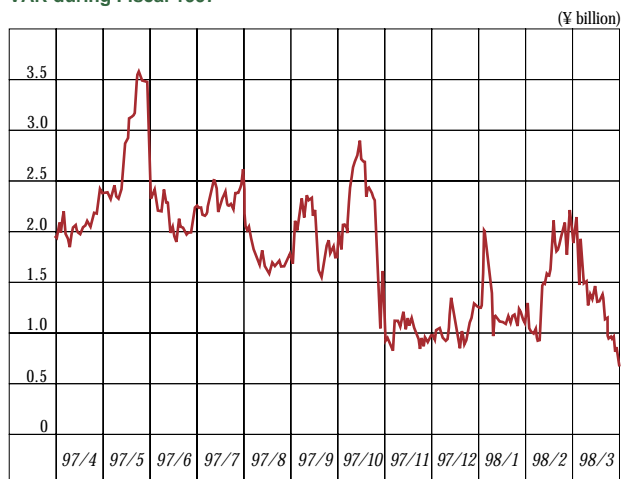
This pie chart shows average VAR during fiscal 1997, broken down by the type of market risk in the Bank's trading activities. Interest rate risk accounts for 59% of the total. "Other risks" include equity and options risks.

The Market Risk Management Office is an independent unit that specializes in the management of market risk on a Bankwide basis. In addition to the Market Risk Management Office, the Bank's offices engaged in trading activities, both in Japan and overseas, have middle offices separate from the front offices that are responsible for risk management. The Bank's backbone systems for market risk management are set forth in the Fundamental Policies for the Market Risk Management Structure.

To allow management's full commitment in the process, the office reports on market risk not only on a daily basis but also on a weekly and monthly basis, also providing reports on the results of stress testing. VAR limits for trading operations are set to incorporate the results of risk measurements into day-to-day risk management. The VAR limit for the Bank as a whole is determined by the Management Committee. Limits are also set at the divisional and office levels, and, thus, risk management activities are conducted at each level of the organization.

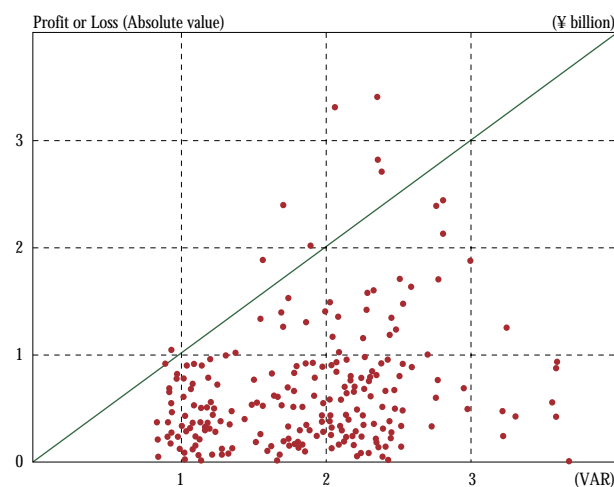
The validity of the VAR model in measuring market risk is checked through back testing. The result of the test is shown in the graph on the right, which suggests that the model is sufficiently accurate. In addition, stress testing is conducted to supplement any limitations of the VAR method, which is based on statistical assumptions.

VAR during Fiscal 1997



This graph shows the transition of VAR in the Bank's trading activities. The holding period is one business day and the confidence level is 97.7% (two standard deviations). Average VAR for the period was ¥1.8 billion, with a minimum of ¥700 million and a maximum of ¥3.7 billion.

Distribution of Profit/Loss and VAR



This graph compares daily VAR during fiscal 1997 with the absolute value of profits or losses. Points lying above the 45-degree line (upper left portion) indicate days when the absolute value of profits or losses was higher than VAR. As the graph shows, the absolute value of profit or loss was higher than VAR for nine, or 3.5%, of the days during the period. As the estimates of VAR were made using a confidence level of two standard deviations (97.7% for one tail and 95.4% for two tails), the probability of actual values exceeding VAR is estimated to be distributed around 4.6% (100% minus 95.4%). Accordingly, the 3.5% incidence of values exceeding VAR confirms the accuracy of the model.

CREDIT RISK

Credit risk refers to the risk of loss that a bank faces due to the possibility of counterparties in derivative transactions or borrowers declaring bankruptcy or experiencing a deterioration in business performance, making it impossible for them to meet their contractual obligations and for the Bank to recover the principal and/or interest. Of the various risks that banks face, credit risk ranks with market risk as having the largest potential impact. To maintain and enhance the quality of its asset portfolio, the Bank continues to upgrade the accuracy and sophistication of its credit risk management through the implementation of the measures described below.

> IMPROVEMENTS IN THE CREDIT RISK MANAGEMENT SYSTEM

There were limitations in the ability of the previous credit risk management system, which was based on the supervision of creditworthiness of individual companies, to respond to changes in the market structure, such as deregulation, developments in asset securitization, and the expanded use of derivative transactions as well as the sudden increase in nonperforming loans following the

collapse of Japan's bubble economy. As a result, the importance of establishing a portfolio management system—a risk management system capable of measuring the credit risk of the Bank's assets and controlling profit fluctuations arising from credit risk—has become apparent. With the objective of developing a credit risk management system in line with international standards, the Bank is upgrading its system according to the following schedule.

As the first step, the Bank thoroughly reviewed and upgraded its internal credit rating system in July 1997, in principle assigning new ratings to all obligors, including financial institutions. These ratings were used to uniformly measure the credit risk of all of the Bank's assets.

Second, in February 1998 the Bank began the statistical analysis of internal and external data on bankruptcies to provide estimates of expected losses and unexpected losses by region, industry, and credit rating.

From April 1998, the Bank is scheduled to upgrade its credit risk management processes by making these estimates of expected and unexpected losses more precise based on analyses of return adjusted for expected losses and the distribution of unexpected losses, with the aim of strengthening the management of its credit portfolio as well as controlling credit risk through the use of credit derivatives and securitization.

> IMPROVEMENTS IN EVALUATION AND MANAGEMENT OF INDIVIDUAL CREDIT FACILITIES

The aforementioned upgrade of the credit risk management system will become meaningful only when improvements are made in the evaluation and management of individual credits. For this purpose, the Bank is working to strengthen credit supervision and subsequent monitoring by analyzing companies through the use of financial analysis programs and conducting credit rating reviews on a regular basis.

In addition, authorization limits for branch managers will be set for individual branches, taking into account the transaction volume of each branch and the characteristics of the region. All applications for loans that exceed the branch manager's authorization limit or with anomalous terms and conditions must be submitted to

one of the Credit Supervision Divisions (CSDs) of the Head Office. The CSD in charge is clearly specified by location, industry, and size of the borrower. Each CSD is responsible for the comprehensive supervision of the borrower, including not only loans but also other transactions, such as derivatives. This system makes possible the centralized supervision of the total credit risk exposure to each client.

Moreover, in March 1998 the Bank issued a Code of Ethics & Basic Guidelines in Lending, clearly stating the Bank's fundamental credit policy and lending procedures. To ensure the soundness of DKB's assets, it is the Bank's policy to assure that this code is followed strictly, that absolutely no activities occur that go counter to the responsibilities the Bank must fulfill as a financial institution, and that all staff endeavor to work to ensure the soundness of the Bank's assets.

In addition to these activities, specialized units carry out research on specific industries, and, for corporate group borrowers, to further strengthen credit management of the Group as a whole, the Bank has developed plans to improve the analysis of cash flow and consolidated financial statements and to restructure systems for supervising the entire Group as a single entity.

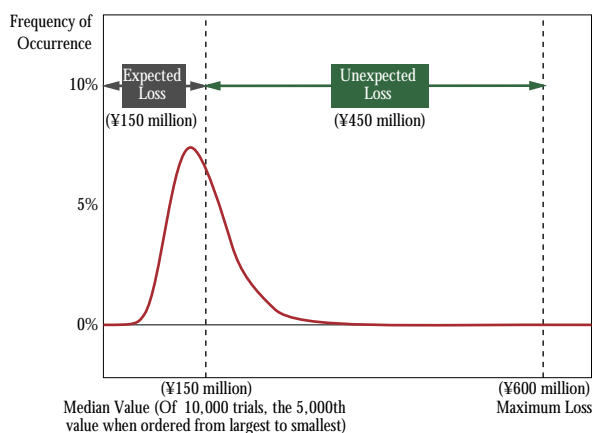
> QUANTIFICATION OF CREDIT RISK

The quantification of credit risk involves forecasting the extent to which cash flow for the repayment of principal and interest may be impaired in the case of default. In other words, changes in creditworthiness are measured as changes in the probability of default, and the impact on the Bank's income is measured through the estimation of expected loss and unexpected loss.

To provide an example of the measurement of expected loss and unexpected loss, suppose that the average default rate in a certain industry is 0.3% and that outstanding loans to 1,000 companies total ¥100 billion. The expected loss, however, is not equal to 0.3% of ¥100 billion, or ¥300 million, because loans outstanding are not ¥100 million per company. Instead, the amount of loan exposure varies from company to company. Thus, even if the probability of each borrower going into default is 0.3%, the actual losses will vary significantly depending on which borrowers actually default.

In addition, default rates will vary considerably depending on economic conditions and other factors, implying that losses may also fluctuate substantially. For this reason, credit risk is measured using the Monte Carlo Simulation (which generates a range of default rates through 10,000 trials). The median loss value is designated as the expected loss, and the difference between the largest loss and the median loss is defined as the unexpected loss.

Measurement of Expected & Unexpected Loss Amounts due to Loan Default (The Monte Carlo Simulation)



The amount of loss due to loan default varies greatly with the default ratio, as well as with which specific obligors actually default on their loans. The Monte Carlo Simulation generates 10,000 different loss distribution scenarios. By ordering the simulated loss amounts from largest to smallest, the expected loss amount (the median loss value in the simulation; ¥150 million in the example above) and the unexpected loss amount (the difference between the maximum loss and the expected loss; ¥450 million in the example above) can be determined.

OPERATIONAL RISK

In all aspects of banking operations, including deposits, foreign exchange, and lending, errors in the handling of important items—such as cash, promissory notes, checks, passbooks, and documents—may lead to serious incidents. In addition, problems may arise even when clerical operations are conducted accurately—as when customers report the loss of passbooks, documents, and cards—but processing is delayed, thus giving rise to problems.

Operational risk refers to the possibility that a bank may incur losses when incidents arise because clerical operations are not conducted accurately or in a timely

fashion. It is no exaggeration to say that operational risks are inherent in all processing activities handled by banks. In addition, clerical risk also includes risks due to external factors, such as those arising in foreign exchange operations because of fluctuations in foreign exchange rates and those due to the presence of physical distance and time zone differences among the Bank and counterparties in these transactions. If these procedures are followed accurately and speedily, operational risk can be prevented. In addition, to provide support for the accurate and speedy conduct of processing operations, the Bank has invested in processing equipment as well as upgraded its on-line computer systems and is working to make full use of and strengthen the checking functions that processing systems and computers can perform. For the functions of equipment and the checking capabilities of computer systems to be used most effectively, the proper knowledge of processing operations and supervisory know-how are indispensable. The Bank has therefore improved its educational programs and guidance systems by conducting various types of group training for various levels and operating sections as well as on-the-job training for operations supervisors conducted by the section specializing in processing operations. Moreover, the Bank is working to further improve its operational systems and reduce operational risks by concentrating standardized, high-volume clerical processing operations and activities within foreign exchange operations that require professional know-how to units specializing in these activities.

With the understanding that accurate and speedy processing are fundamental for gaining and maintaining customer trust, the Bank is therefore working in all related areas to prevent operational risk.

INFORMATION TECHNOLOGY (IT)

The widespread use of ATMs to deliver services to retail customers and electronic banking systems in the corporate sector have made computer systems indispensable in banking operations. If computer systems fail, however, operations come to a standstill. Accordingly, the Bank adopts the following measures to prevent IT risk.

> **BACKUP SYSTEMS**

If computers at the Bank's main computer center that provide on-line services become inoperative because of major natural disasters, systems are switched to backup computer centers instantaneously and operations at the Bank's offices continue uninterrupted. Similarly, if the telecommunications network linking the computer center and the Bank's offices fails, backup lines are available to allow service to continue.

> **ENSURING THE SAFETY OF STRUCTURES**

The structure of the building containing the computer systems is about 1.5 times stronger than conventional buildings, and floors have been designed to lessen the impact of earthquakes. Because of these preventative measures, the Bank's computer centers can withstand earthquakes of the same magnitude as the Great Hanshin-Awaji Earthquake. In addition, the computer centers have their own electric power generating equipment, water storage tanks, and other features that allow continued operation even during emergencies.

> **DATA SECURITY**

Measures have also been taken to prevent illicit access to the systems by installing a computer dedicated to monitoring and controlling data interchange with outside systems.

THE YEAR 2000 PROBLEM

Because some computer systems use only a two-digit code, corresponding to the last two numbers of years in the Western calendar, to identify dates, such systems will not be able to operate after the beginning of the year 2000. The Bank provides financial services to its customers through a variety of networks. To ensure that these services continue without interruption during and after the year 2000, the Bank has assigned high priority to resolve this problem and is taking appropriate measures, including the establishment of a task force that reports directly to management on a regular basis.

The installation of a new on-line system—linking branches and handling deposits, transfers, and loans—that is free of the year 2000 problem was completed at

the Bank's Chiba Operations Center in 1996. Thus, time deposits and housing loans that extend beyond 2000 will be handled without difficulty.

Some systems, however, such as those for supplying management information at the Bank's Head Office, corporate electronic banking systems, and systems for processing notes and checks, must be updated, but work is already in progress and completion is scheduled by the end of fiscal 1998.

To resolve this problem fully, especially for corporate electronic banking systems, the Bank's customers will also have to update their computer systems. To facilitate this process, the Bank is providing necessary information and assistance as well as working closely with its clients.