

Governance for Enhancing Corporate Value

— Directions for Nanto Bank's Audit and Supervisory Committee —

Two years since we made the transition to a company with an audit and supervisory committee, Committee members Shuhei Aoki, Yoshihiko Kasuya, and Koushi Okamoto joined President and CEO Satoshi Ishida in a discussion of the efforts and challenges they have faced to date.



A look back over the two years since transitioning to a company with an audit and supervisory committee

Ishida: Two years have passed since the Bank became a company with an audit and supervisory committee. Two of our outside Audit and Supervisory Committee members have been involved in building a new governance system from the beginning. How would you evaluate the Committee's performance over this period?

Aoki: The past two years have marked the Committee's formative period. While carrying out routine duties, we have aligned on the Committee's perspective and activities through active discussion.

I feel that we are steadily achieving our goal of strengthening governance by transitioning to a company with an audit and supervisory committee. I believe this is the result of exploring the proper role and nature of companies with an audit and supervisory committee and then tailoring our work to the Bank's circumstances. When it comes to on-site audits, for example, unlike the Audit Department, whose conventional approach focuses on pointing out deficiencies, we adopt an approach that uses the "on-site view as a mirror and examines the appropriateness of management decisions reflected there." We continue to support the shift in the Department's approach toward risk-based and management audits.

Along with the advancement of internal audits, we have put a system in place to examine the legality and

appropriateness of business operations conducted by the Board of Directors and directors. I would say we are at a stage where the role the Audit and Supervisory Committee is expected to play is beginning to take shape on the way to strengthening our governance.

Kasuya: I have served as an audit and supervisory committee member and as an auditor at two listed companies myself, and I can say from my own experience that there are significant differences between the two roles. The most notable difference is that audit and supervisory committee members participate in decision-making as directors. Their responsibilities are consequently greater, and they are motivated to implement robust audits and oversight. I would say that our Bank's transition to a company with an audit and supervisory committee two years ago was timely. The duties of the Audit and Supervisory Committee members are to conduct accounting and operations audits, but we take a broader view of operations audits. In light of the Bank's current situation, wide-ranging, growth-oriented area audits are in order. The Audit and Supervisory Committee also discusses the direction of sales strategies and other matters, rather than treating them solely as matters for the executives.

Okamoto: As a full-time member, I provide a briefing at each Audit and Supervisory Committee meeting on any findings I have made in my daily audits. We then spend time frankly exchanging opinions on what kind of audit and supervisory activities the committee should undertake and what we should communicate. The details of these briefings are later conveyed to the relevant executives and department heads, and I am mindful of fulfilling my role as a full-time member of the Bank to ensure that the findings from the committee meetings do not remain limited to the committee. While a company's executive departments often fall into the trap of focusing on short-term performance in their discussions, the Audit and Supervisory Committee strives to maintain a focus on the necessary conditions for the Bank to continue growing in the medium to long term, and this perspective is clearly expressed in its discussions.



We recognize, moreover, that the current state of internal audits at the Bank is a transition stage from "Stage 1" to "Stage 2", as indicated by the Financial Services Agency. Our policy is to complete the transition to Stage 2 during the period of our Medium-Term Management Plan, and then to work beyond it towards Stage 3.

The Audit and Supervisory Committee's primary role is to audit and supervise the execution of the Directors' duties. Its role in the internal control process, meanwhile, is to monitor operations, including the activities of the Internal Audit Department. We recognize, however, that supporting enhancement of the Internal Audit Department is also an important task for the time being, and we are working to realize this role in actual practice.

Relationship with the Board of Directors

Ishida: The Audit and Supervisory Committee members are Directors and, as such, attend the Board of Directors meetings. Oversight of the Board of Directors is an important function of the Audit and Supervisory Committee, so I expect them to pay close attention to the topics, content, and direction of the Board of Directors' discussions. Their perspective stresses sustaining the Bank's medium- to long-term growth. This means examining whether decisions necessary to ensure this growth are being made through appropriate processes, and whether any risks have been overlooked. As an Audit and Supervisory Committee member, how do you view the current status of the Bank's Board of Directors and the functioning of the Audit and Supervisory Committee with respect to the Board of Directors?

Aoki: In my view, the large proportion of outside members on our Board of Directors enables us to conduct constructive discussions that maintain an appropriate degree of tension with the Bank's executive management. Going forward, we will want to enhance the functioning of the Board of Directors further by increasing the time devoted to occasional separate opinion-exchange meetings. These meetings can help to bridge the gap when Outside Directors, unaware of discussions taking place among the executive managers, are suddenly confronted with unanticipated proposals with little time to consider them and find themselves having to express their opposition or support immediately. As for the function of the Audit and Supervisory Committee members at Board of Directors meetings, I think we need a better system of communicating to both the internal and external Directors that the Audit and Supervisory Committee is overseeing them. I don't think there are many matters that call for feedback from Committee members to the Board



of Directors, but I think it would be a good idea to establish channels within the Board of Directors for Committee members to convey their opinions and questions to the Board of Directors.

In this connection, the Chairman of the Board has taken a big step forward this fiscal year by providing our members with an opportunity to speak at the end of each Board of Directors meeting by asking if there is anything the Audit and Supervisory Committee would like to add.

It's normally fine for us to answer, "Nothing in particular," but we can provide feedback when we consider it necessary. It is significant that we now have this opportunity to send the message that "the Audit and Supervisory Committee

members are watching."

Kasuya: As is the case with other banks, discussions on accounting matters and the defensive aspects of operations at meetings of Nanto Bank's Board of Directors and Audit and Supervisory Committee are conducted on a higher level than in other industries.

For this reason, I think the Board of Directors could be energized further if the outside members, in particular, would make greater use of the various perspectives they bring from their different career paths in growth-oriented areas, rather simply relying on checks and balances as Audit and Supervisory Committee members or dividing the Bank into executive and auditing factions.

Whether it's the Audit and Supervisory Committee or the Board of Directors, Nanto Bank personnel, like others in its industry, are adept at conducting discussions on accounting matters and defensive operation strategies on a high level compared with organizations in other industries. In that sense, I think the Board of Directors could be further invigorated if the outside members, in particular, were to make greater use of the various perspectives they bring from their different career paths in areas related to offensive operations, rather than just using their checks and balances as Audit and Supervisory Committee members or dividing the company into executive and auditing sides.



Ishida: Although I'm the chief executive, I sometimes make comments resembling those of an Outside Director or Audit and Supervisory Committee member at Management Meetings. I might ask the executive officer in charge questions focusing on whether the review process leading up to the meeting was appropriate, for instance, or whether there were any problems with the controls. When a problem arises, moreover, I often question whether the solution can be limited to a superficial cause analysis and implementation of countermeasures without probing the root cause. Ultimately, of course, I fulfill my obligation as the chief executive to reach a conclusion, but in the process, I consider it important to maintain a balanced perspective like that of an Outside Director or an Audit and Supervisory Committee member. This is why I make a point of asking questions of the members participating in Management Meetings. The two outside Audit and Supervisory Committee members have accorded our Board of Directors a certain level of praise, but this is a never-ending process. If training themselves in this way can equip our internal Directors to incorporate the perspectives of Outside Directors and Audit and Supervisory Committee members into their discussions, Board of Directors' meetings will become even more dynamic.

The appropriate direction for the Audit and Supervisory Committee

Okamoto: Returning to a question raised earlier, what measures should the Audit and Supervisory Committee take to effectively communicate the message that "the Audit and Supervisory Committee is watching" at Board of Directors' meetings? One answer is for the Committee members, including the external Audit and Supervisory Committee members, to acquire a more accurate understanding of the Bank's actual circumstances. Another is to determine KPIs that are as quantitative as possible at audit points and monitor them to lend greater weight to our communications and make our audit activities more efficient. So, what do you think about all this?

Kasuya: Strengthening the Committee's functions will require the Audit and Supervisory Committee members themselves to acquire a deeper understanding of the workplace. Not only the full-time Audit and Supervisory Committee Chairman, but also the external Audit and Supervisory Committee members, must make use of on-site audits and other opportunities to listen to feedback from the workplace. Obtaining information about the actual concerns of each department at the branch offices and Head Office, and uncovering the true causes of these concerns, can provide important clues to reveal problems involving management policies or oversight. We need to increase our opinion exchanges with executives leading the execution, in particular. After acquiring a better understanding of their thinking, I would strive as an Audit and Supervisory Committee member to offer useful opinions from a different perspective.

Aoki: Even if the Audit and Supervisory Committee communicates its observations, it will not be fulfilling its role if its comments are too general or, conversely, too similar to internal discussions. Communicating meaningful information requires us to clarify the "external" opinions of the Outside Audit and Supervisory Committee members and the opinions of the full-time committee members who attend internal meetings, and to exert an influence on the themes and discussions of the Board of Directors.

Without dismissing the value of quantitative KPIs as tools, it is fair to say that simply setting quantitative KPIs may not make our understanding of actual conditions more accurate. Quantitative monitoring may seem to be more scientific and to make it easier to manage the audit process, but there is reason for concern that oversimplification can cause analysts to miss the point or result in box-ticking work.

While evaluation requires intellectual perseverance, we consider it best to build an understanding that does not rely solely on numbers and to ensure persuasiveness by communicating as specifically and qualitatively as possible.

Okamoto: I'd like to see us place importance on setting quantitative KPIs, pursuing qualitative causes, and uncovering empirical risks through dialogue with the audited departments.

The updated Medium-Term Management Plan implemented this fiscal year focuses on human capital, and we will consider and monitor the status of its success in "creating human capital who think and act independently to solve local issues," as well as KPIs we believe will lead to changes leading to progress in this area. In discussing the results of our monitoring with executive management and the relevant departments, we encourage them to make greater use of the PDCA cycle. This process is expected to lead to an Audit and Supervisory Committee that contributes to overseeing business execution and increasing corporate value.

Ishida: In connection with the Medium-Term Management Plan implemented this fiscal year, and as a route to "creation of human capital," when the Audit and Supervisory Committee conducts an audit, I would ask that you discuss the best way to examine the root causes of the problems the audited department is facing with your General Manager and Deputy Manager. This process will lead to the creation of human capital, especially management talent, and it should be the very essence of the audit. If the department under audit lacks the ability to analyze the root causes, moreover, I would like you to raise this as a management issue at the Board of Directors Meeting.



In closing

Okamoto: In our efforts to enhance the effectiveness of the Audit and Supervisory Committee, we will not only consider the future direction and initiatives suggested in this roundtable discussion by the individual Audit and Supervisory Committee members and the expectations of the President, but we will also stimulate discussion within the Audit and Supervisory Committee on key points for objectively evaluating activities' effectiveness. This will involve raising questions, such as, "Are the legal requirements for ensuring the independence of the Audit and Supervisory Committee being realized in practice?" and, "Is cooperation among the internal and external directors, the Internal Audit Department, and the accounting auditors being meaningfully achieved or treated as a mere formality?" We will also conduct humble self-evaluations and implement the PDCA cycle ourselves.