

Annual Report for FY2007
(Abstract)

The CRD Association

I. Overview of business: offensive and defensive

We established the basic principles for improving existing services and exploring new ones this year. These principles reflect our awareness of business environment that 1) our main service, the CRD models, has been utilized as a tool to determine insurance and guarantee rates in the public credit insurance schemes of SMEs, and 2) few financial institutions have become CRD members* and existing members may leave if we fail to meet their expectations of our services. (*On a side note, eight new members have joined in this financial year and two more members are expected in 2008 as of March 2007, in addition to the 196 existing members.)

1. Maintenance of the high quality of CRD services

(1) Maintenance of the quality of CRD model services

a) Quality control guidelines and independent evaluation committee

CRD models 3 and 4 have been involved in the credit insurance scheme for SMEs since April 2006, and are becoming more pervasive in financial institutions to make their risk control more sophisticated. This increased use of our models motivated us to formulate guidelines on quality control for them in August 2007. Moreover, based on the guidelines, we formed an independent evaluation committee for CRD models (chaired by Soichiro Moridaira, professor at the Graduate School of Finance at Waseda University) so that we could objectively evaluate the accuracy of our models.

b) Validation of CRD models 3 and 4

We conducted validation work by ourselves late in the 2007 financial year to ensure that our models conformed to criteria set by the relevant legislation on risk measurement models. After four meetings followed by the validation work, the committee wrote a report on the evaluation of our models 3 and 4. The report finds model 3 to be free of problems in quality and model 4 to be without serious problems if we continue using it. We informed the 22nd board meeting (March 19, 2008) of the results and findings, and distributed the report to all members. The abstract of the paper has also been uploaded to our website.

c) Support for appropriate use

We provided considerable information on how to input financial statements, in response to over 300 questions from credit guarantee corporations between the end of FY2006 and Autumn FY2007. We also provided *the user interface: the 9th version* in August for the convenience of users and presented it at the seminar on model operation held by the National Federation of Credit Guarantee Corporations. The interface is used as the part of the guidelines for choosing flexible guarantee rates by the federation, being of good help in the appropriate operation of our models.

We accepted requests regarding our model 4 from the National Federation of Credit Guarantee Corporations in February 2008, including 1) consolidation of industry sectors for inputting data, and 2) revision of the built-in data adjustment mechanism. We are now considering whether these modifications are feasible in FY2008, in response to these requests.

d) Validation of CRD models 1 and 2

We worked on periodic validation of our models 1 and 2, which continue to be used in financial institutions and credit guarantee corporations for their tie-up financial instruments or usual review processes. This validation work, initiated in spring 2008, will be finalized around July.

(2) The CRD institute for better support services for risk control

We launched the CRD institute as an in-house organization at the beginning of 2008 to meet increasing demands from financial institution members for more advanced risk control, and to provide them with better consulting services for the purpose.

In our range of consulting services relevant to controlling credit risk, we have the services of validating internal rating systems, building rating systems for sole proprietors, selling a system for credit risk quantification, calculating default correlations across business sectors, or building industry-specific models. We now consider consulting services to be the new core of our business, and we intend to make them more customer-oriented and customer-specific.

(3) Improving the quality of our services

a) Improving data quality

Our database, with over 2.4 million businesses* or 11 million financial statements, has developed to become the leading database for credit risk of SMEs in Japan. (*no duplication base, inclusive of sole proprietors, as of March 2007.)

We continuously seek to improve the quality of accumulated data, from which the variety of our services comes. We have improved the system processes for data gathering and collection in the database. In particular, we added a function to eliminate irrelevant data from the name identification process (May 2007) and checked the consistency of sole proprietor data more rigorously when we cleaned them.

Regarding business sector codes, we still request our members to change to new ones. Thirty-five members have already provided data with new codes, as of March 2007. This shift will be accelerated as the process continues of unifying the information systems of credit guarantee corporations. As for nonfinancial data, we have made some progress toward formatting the database by holding seminar meetings about these data from April 2007.

b) Improving the quality of online/offline services

We upgraded our offline scoring service (in October), improved the method for sampling requested data (in December), and enabled downloading of all financial indicators for SMEs at one time (in December), in response to requests from members. Moreover, overhaul of our online services, which began in April 2008, has made more statistics information downloadable and compatible with new business sector codes.

2. Increased efforts for new services

(1) Active support for the needs associated with risk control

a) Strengthened consulting services for financial institutions

We actively met the demands from financial institution members for

support in advanced credit risk control, with the awareness of the need to provide services more relevant to the demands of existing members. The activities include, but are not limited to, restructuring rating systems, validating internal rating systems, building rating systems for sole proprietorship, and estimating recovery rates of loans. More financial institution members have been present at meetings for exchange information recently, and the meeting was thus held in Osaka for the first time in February, in response to requests from members. For the first time, we also sold the rating agency the statistical information used for SME ratings.

b) Provision of the credit risk quantification system, CRISP

In April, we began providing a simple and reasonable system for quantifying credit risk, development of which commenced in 2006. The characteristic of this system is that default correlation estimates across business sectors for each region, which are the key to accurate quantification, are calculated using the huge volumes of default data and that these estimates are built in it. This system is available to our members at a reasonable annual cost.

c) Calculation of default correlation estimates

We launched a new paid service for calculating default correlation estimates to input on any non-CRISP quantification system. Our default correlation estimates are superior in that they use default data in our database, reflecting the conditions of SMEs better than other standard estimates calculated from information such as stock price data.

(2) Addressing the needs associated with public SME policies

a) Provision of system support for business shutdown, TSS

We launched a new system in October to assist in deciding whether to shut down businesses with little possibility of recovery. This system was rented to local branches of those commercial and industrial organizations that guide the public program for SMEs and help them streamline their current businesses or start new ones. This rollout was completed in March.

b) MSS use in provincial foundations

We also rented a system for diagnosing business conditions of SMEs to the local foundations with the approval of local governments, which lend

or lease production equipment to SMEs. Three foundations subscribe to the MSS service, under special membership status, as of April.

c) Continued use of CSS at provincial councils to revitalize SMEs

We have previously rented a system to support the restructuring of SMEs, CSS, to provincial councils for five years under a contract that expired in May. We decided to continue the service to these councils with special membership status, because more than ten councils desired continued use.

3. Stabilized business operations and strengthened corporate governance

(1) Stabilized business operations

We enhanced our human resources with expertise in credit risk control or statistical data analysis so that we could produce services with greater added value and respond to more diverse and advanced needs from our members. As of April 2008, our office consists of three full-time directors and 24 workers (inclusive of two loaned and one temporary worker), and we can see our business operation consolidating and stabilizing. We have introduced the information system to aid in the utilization of information of each member in September, by which we expect to provide services more efficiently and without omission.

(2) Strengthened corporate governance

a) Establishment of fundamental policies for internal control

We have already improved our internal control since FY2006 by formulating codes of conduct or rules regarding management of confidential information. We formulated new fundamental policies for internal control in July, following the idea in the Code of Corporation Law, that business entities should establish control to ensure appropriate operations. We educate all office workers to fully understand and follow the codes.

b) Strengthened security for confidential information

As our business encompasses a more diversified range of activities and more frequently involves confidential information of members, we have enhanced our security management by counseling independent professionals through inspections and advice, or by specifying rules for

the management of confidential information in case of compulsory inspections.

We formulated a new rule that intellectual property from members must be returned to us. We expect the new rule to enhance information security and decrease the cost of custody for members. We also formed an organizational framework to periodically back up and retain data and programs, against the devastating possibility that the NAS corporation, to which we delegate the custody and operation of data, might cease to operate.