May 15, 2018

Summary of Results of Investigation by Crisis Management Committee

Suruga Bank Ltd.
Crisis Management Committee[1]
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Member: Tadashi Kunihiro, Attorney-at-law
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The following is a summary of the results of the investigation conducted by the Crisis Management Committee.

We will deliver all sources of evidence obtained through the investigation of the Crisis Management Committee (including audio data of hearings, e-mails and files obtained through digital investigations and the like) to the Third Party Committee. We will, if requested by the Third Party Committee, also provide our full cooperation with its investigations.

<Whole Picture of "Share Houses">

Based on the press a release issued by Suruga Bank (the "Bank") today, we understand the complete picture of the loans provided in respect of "share houses" to be as follows (as at the end of March 2018).

Number of Customers: 1,258

Total Amount of Loan Outstanding from Customer: JPY 203,587 million

<Scope of Crisis Management Committee's Investigation>

The Crisis Management Committee's investigation covered the following:

(i) Loans granted in respect of share houses by the Yokohama-Higashiguchi, Shibuya and Futakotamagawa branches of the bank;

(ii) The credit screening systems and sales promotion practices (in connection to (i) above); and

(iii) The internal control and governance systems (in connection to (i) above).

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[1] Since Messrs. Kubori and Kunihiro have been retained by the Bank for services other than those in this case, the Crisis Management Committee does not constitute a third party committee (as such term is defined in the "Guidelines for Third Party Committees on Corporate Misconduct", published by the Japan Federation of Bar Associations).

<Examples of Problems discovered>

1. Prices of real estate sold to the customers are seemed to have been inflated.

The actual scheme of the share house business conducted by Smart Days has been assumed to be as follows: Smart Days (or an affiliate thereof) acts as an intermediary purchaser and seller in the course of sale of the site for the share house from the original owner thereof to the new owner (i.e., share house investors who are the Bank's customers ("customers")), and Smart Days uses the resale margins to cover up the losses it has incurred as a result of its acting as guarantor for the customer of the rental of the share house, some of which were vacant. This seems, on hindsight, to be a shoestring operation; however, it is unclear when such a situation actually began.

In fact, no objective evidence is available that would enable verification of the amount of margins delivered to Smart Days through such scheme. However, there is a possibility that the customers likely purchased real estate at prices that are significantly higher than the price they would have paid had they purchased such real estate directly from the original owner due to the lack of such margin.

A key reason why customers thought such high prices to be reasonable, is seemed to be that they misunderstand that the purchase prices were endorsed by the Bank because they received the results of real estate appraisals conducted at the Bank, and were told that the Bank would provide a loan in the amount up to 90% of the purchase price of the real estate based on such appraisal.

The Bank could have anticipated the possibility of the appraisal results that it disclosed to the relevant real estate agent being used in this way, and it is therefore difficult to accept the argument that the Bank had nothing to do with this scheme.

2. Manipulation and Fabrication of Bank Books Showing Own Fund Balances

(1) Manipulation and Fabrication of Bank Books

A real estate agent affiliated with Smart Days manipulated and fabricated a significant number of bank books and the like that are used to prove the amount of the sufficient own fund balances of customers who sought loans from the Bank.

It is one of the Bank's rules to verify the authenticity of documents to prove the amount of customer's own fund (such as bank books and the like) submitted to it against the originals thereof; however, in many cases the Bank failed to do so. With respect to internet banking services, the Bank in many cases only performed confirmation by looking at printouts of websites.

When providing a loan, Yokohama-Higashiguchi Branch requested from its customers to complete "Confirmation Letter of Own Funds" by filling in details of the amount of their own funds therein and to affix their own signatures and seal impressions thereto. This practice initially begun as a supplement or alternative to the said original confirmation process, because the procedures such as the checking of original documents (including bank books and the like) cannot be fully enforced due to increase of the number of cases where the confirmation of the amount of the own fund is made only by internet banking services, for which no bank books are issued, and due to the lack of enough administrative resources. This practice, however, led to the neglect of primary confirmation processes.

(2) Dual Contract

There are a considerable number of instances where a purchase agreement of the real estate “for the purpose of submission to the Bank” were prepared by a real estate agent affiliated with Smart Days and customers, separately from the actual purchase agreement between the real estate agent and the customer (a dual contract practice). The agreement for submission to the Bank contained an overstated purchase price with an intention to obtaining a loan in an amount that is more than the relevant customer could have obtained.

Details of the method used here are as described in items (i) to (v) below. The following explanation is simplified for the sake of clarity.

(i) Two types of agreements are executed between a real estate agent and a customer: a purchase agreement for the purpose of submission to the Bank (the “Bank Contract”) and the actual purchase agreement between the real estate agent and the customer (the “Real Contract”). The Bank Contract is submitted to the Bank. The Real Contract between the real estate agent and the customer is executed in the form of an amendment to the Bank Contract or a separate purchase agreement. The Real Contract is dated on or around the same date as the date of the Bank Contract.

<Real Contract> <The Bank Contract>

Purchase Price	JPY 85 million	Purchase Price	JPY 100 million
Land	JPY 50 million	Land	JPY 65 million
Building	JPY 35 million	Building	JPY 35 million
Own Funds	0	Own Funds	JPY 15 million

(ii) The Bank makes the decision to provide a loan of JPY 85 million to the customer, based on the Bank Contract.

(iii) The customer is required to show existence of own funds of JPY 15 million to the Bank. If case where the customer has insufficient own funds, the amount of his/her own fund was fabricated by way of (a) (b) below:

  (a) The real estate agent receives a bank book or the like from the customer, and shows it to the Bank after fabricating information therein to indicate that as if the customer has a deposit of JPY 15 million.

  (b) The real estate agent temporarily pays the own funds of the customer (by way of a transfer of JPY 15 million to the customer's bank account at the Bank under the name of the customer by the day immediately before the date of the Bank's provision of the loan), to pretend as if the customer has such own funds.

(iv) The Bank then provides a loan of JPY 85 million. As the result, the customer can obtain a JPY 85 million loan even without the requisite own funds.

(v) After the loan has been provided, the customer pays the JPY 85 million that he/she has received as a loan to the real estate agent as the purchase price, and (in the event of (b) above) returns to the real estate agent the JPY 15 million that was provided temporarily by the real estate agent. (As a factual matter, the land price and miscellaneous expenses are paid off first, and the price of the building is then paid in installments based on the progress of the building construction).

In this case, an amendment agreement or the like is then executed between the customer and the real estate agent upon execution of the land purchase agreement. The actual purchase price would be lower, i.e., a sum equal to the amount of purchase price set forth in the Bank Contract less an amount equivalent to the customer's own funds. (Although the Bank has not received any such amendment agreement, several agreements were presented by customers during the consultation with the Bank for the loan repayment.)

Customers understood that the Bank required the customers to have their own funds in an amount that is equal to 10% or more of the purchase price; however, the customers themselves also entered into the amendment agreement. Accordingly, it appears that the customers were knowingly using this method to fabricate the amount of their own funds.

(3) Knowledge of the Bank Employees

If the Bank side had not been aware of the abovementioned method performed by the real estate agent (jointly with the Bank's customers), the Bank would be considered the one who had been deceived. This means that it would have been a victim. On the other hand, if the Bank had been aware of the abovementioned method, it would mean that the Bank had inappropriately provided loans, in violation of its internal rules requiring a customer to have its own funds that are at least 10% of the purchase price.

In this regard, there is no physical evidence which directly shows that the Bank's employees were clearly aware of the said dual contract practice or fabrication of amount of the own fund, and all Bank's employees (other than one person described below) denied having any knowledge of the dual contract practice at a hearing conducted by the Crisis Management Committee.

On the other hand, all Bank's employees at the Yokohama-Higashiguchi Branch was aware of the fact that they were providing loans to "*Kabocha no Basha*" share houses, and it seems unlikely that they did not know the fact that "*Kabocha no Basha*" launched promotions of loans requiring "zero own fund (no own funds required)." Furthermore, several sales employees said that there were some cases that they felt doubtful of the amount of the own funds shown by customers in light of their age, income and the like. Accordingly, it would be natural to think that they were aware of "some trickery" involved with respect to the existence of own funds; however, as a practical matter, no measure was taken to pursue any such doubt because "objective evidence" of customers' own funds were presented.

In this regard, the following statement by a Bank's employee would seem indicative of the view commonly held by the Bank's sales employees:

> "(Regarding the *Kabocha no Basha*) I know promotion of investments in share houses with "zero own fund" were widely made. This is not in line with the Bank's policy requiring 10% own funds. Since documents such as the purchase agreement and Confirmation Letter of Own Funds were submitted by customers, I suppose that almost all the employees of the Bank had a way of thinking like that the Bank has nothing to do with how customers actually consummated the deal, even if any real estate agent has anything to do with it. Such way of thinking was the easiest approach to deal with such kind of matters. The Bank's employees make some communications with customers, such as, "The amount of the purchase price is XX.", "The amount of the relevant loan is YY since the Bank will provide a loan of up to 90% (of the purchase price).", and then, such customers say "Yes.". After such communications, the Bank's employees asked no in-depth questions to customers, as long as they receive the

original of the purchase agreement with the requisite tally impressions and affixed stamps."

With respect to one particular Bank's employee, the following facts were confirmed. The employee received, via e-mail, files containing two different provisional calculations "for the Bank Contract" and "for the Real Contract", respectively, from a real estate agent for *Kabocha no Basha*. Thereafter, an agreement containing the purchase price described as being "for the Bank Contract" in the files was submitted by the customer, and a loan was then provided to the customer. Accordingly, it shows that this particular Bank's employee were aware of the existence of the dual contracts and the fabrication of amount of the own funds (although the Bank's employee claimed to have "no recollection" of such files at a hearing conducted by the Crisis Management Committee, which claim is hard to believe).

There is no direct evidence indicating that these files were forwarded by that employee to other Bank's employees. However, it is undeniable that there is the possibility that the dual contract practice or fabrication of the amounts of the own funds were orally conveyed to other Bank's employees or such recognition was shared (even if in a vague manner) among Bank's employees.

It is believed that a considerable number of the Bank's employees were aware of the possibility that customers' own funds were fabricated[2].

3. Combined Sale of "Free Loans"

In the Yokohama-Higashiguchi Branch, at the initiative of a branch manager, sale "free loans" was made as conditions to the provision of a loan for the share houses investments by Bank's employees and real estate agents ("sales channels" as explained below).

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<Plausible Causes of This Situation>

1. Problems of So-called Sales Channel Business

In providing loans to the share house owners, the Bank utilized the "sales channel business" method (i.e. a method in which "sales channels" such as Smart Days or its affiliated real estate agent introduced individual investors to the Bank). The sales channel seemed, superficially regarded, to be convenient for the Bank.

However, the reality was that while the sales channels raised the price of real estate through resale or

[2] A thorough investigation will be conducted, on the degree of awareness and involvement of the Bank's employees, the number of persons involved and the like, by the Third Party Committee.

otherwise, they forced the Bank to provide excessive amounts of loan as a result of the dual contract practice and, in addition, forced the Bank to shoulder the higher risks involved in providing loans on the basis of fabricated amounts of the own funds of customers.

The direct cause of this situation was the failure to access the danger of such bad sales channels and the lack of risk awareness, which resulted in the Bank’s involvement in the business with such sales channels.

2. Inadequate Internal Controls (Incomplete Screening Function)

Loan screening is an essential function for a bank. The soundness of a loan should be maintained by the screening department's check based on the equal authority of the screening department and the sales department.

Under the Bank’s organizational rules, the sales department is not superior to the screening department. However, due to company-wide pressure for continued growth in sales and profits year-on-year, the following situation occurred: as a matter of facts, the sales department came to have more power than the screening department, in some cases, the sales department executives took menacing action and applied pressure on the responsible persons in the screening department when the latter showed reluctance to approve a loan, and in such cases, it was hard for the screening department to fend off such pressure.

As the result, with respect to the share house loan, it became difficult to fully perform the screening function, which should have served as a cornerstone in order to ensure soundness in the banking services.

3. Absence of Business Risk Analysis

When contemplating a new business (that is, the provision of loans for investments in newly-built share houses in this case), it is necessary to evaluate the risks associated with the business and formulate a risk management policy in advance, before deciding whether to enter into the business. Furthermore, it is essential to continue to monitor the business once it has commenced.

However, the Bank viewed the share house loan only as an extension of its apartment loan business, and did not conduct any preliminary risk evaluation on the basis that share house loan was a new business. In addition, even after it began providing loans on the share house owners, (and despite the fact that the occupancy rates of the shared houses was a key indicator of the success of the new business) the Bank left its supervision of the occupancy rates and other related matters to the relevant real estate agents.

Such an incomplete approach to risk assessment and the failure to put in place appropriate countermeasures resulted in an increase in the loans provided.

4. Absence of Compliance Due to Sense of Superiority of the Sales Department

In the field of sales, the amount of outstanding lending of the Bank was naturally placed above anything else. The sales employees of the Bank failed to appreciate that they were the ones who undertook risks and should keep compliance by themselves. The screening department in turn failed to fully perform its function of restraining the sales department in an environment in which the sales department was treated as being more important.

The compliance department also failed to perform its function of keeping sales in check from an independent position.

Furthermore, the internal audit department failed to conduct a risk-based audit with a focus on the risks associated with the share house loan.

In this way, the Bank's "3 lines of defense" failed to function properly with respect to the share house loan.

5. Dulled Reception to Risk Information

Although information was provided pointing out the problems relating to certain sales channels from outside to the Bank on several occasions, sufficient action was not taken at the time.

6. Incomplete Governance

Until February 2017, no discussion took place regarding the Smart Days-related loans at the meetings of the Board of Directors and Management Council.

Management personnel did not understand the aggregate size of the loans related to the share house loan, and the Bank's governance with respect to this problem failed to function.

7. Failure to Operate in a Customer-Oriented Manner (Risks Associated with Conduct)

Banks are public organizations in the sense that they have a responsibility to provide financial infrastructure to society and therefore, banks are subject to stricter regulations compared to regulations governing money-lending institutions, non-banking institutions or the like. In view of this, it is not sufficient for banks to simply follow narrowly defined compliance systems (i.e., compliance with rules, including existing laws and regulations), rather, any improper behavior by a bank that fails to meet societal needs for "customer-oriented business operations" will be harshly viewed from the perspective of social justice and will be a high risk ("Conduct Risk").

In the Smart Days share house loan cases, the Bank also has been a victim in the sense that it had been deceived by bad sales channels and forced to take on bad debts.

From the macroeconomic perspective of the social responsibility of banks, however, there are also some major problems with the Bank side in this case. If the Bank had taken the approach of "maintaining a high degree of professional knowledge and professional ethics, providing customers with services in a fair and faithful manner, and acting in the best interests of customers" (Principle 2 of the Principles for "Customer-Oriented Business Operations"), it could have identified the problems with Smart Days' share house business at an earlier stage and, accordingly, it should have been possible for the Bank to withdraw from this business earlier, to avoid being involved with many customers and suffering a loss. However, at the Bank, the sales department was the one involved in providing loans to customers together with Smart Days, and the system of keeping the sales department in check was not fully functioning, which resulted in a worsening of the situation.

Such failure to appreciate the Conduct Risk, i.e. failure to recognize of "Customer-Oriented Business Operations", is one of the plausible underlying causes of the problems in this case.

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