Risk Management

Basic Principles

Financial and economic deregulation, globalization, and advances in IT are generating new business opportunities for financial institutions. The risks accompanying these new business opportunities are not only increasing in number but also growing in diversity and complexity. Accordingly, identifying, measuring, and controlling risks have never been more important in the management of a financial holding company.

SMFG has encapsulated the basic principles to be employed in risk management in the manual entitled *Regulations on Risk Management*. In the manual, we have specified the basic policies of risk management: 1) Set forth the basic policies to be followed by the whole Group after specifying the categories of risk to which these policies apply; 2) Provide all necessary guidance to Group companies to enable them to follow the basic risk management policies set forth by SMFG and set up their own appropriate risk management systems; 3) Monitor the implementation of risk management by all Group companies to ensure that their practices meet the relevant standards.

Types of Risk, and Risk Management System

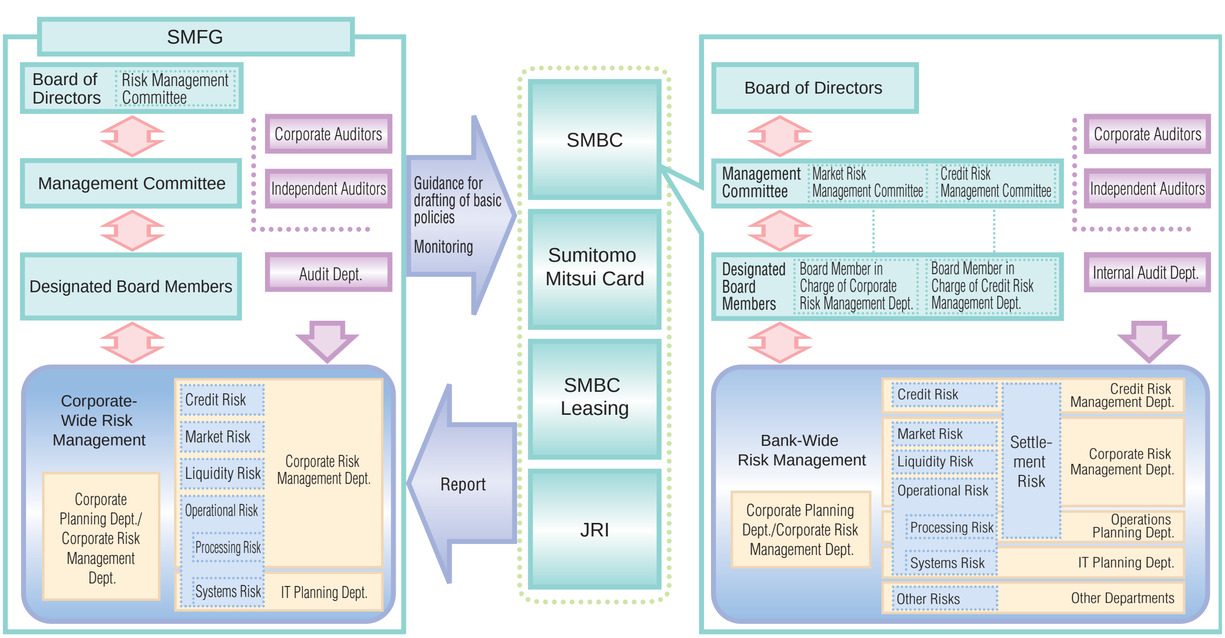
At SMFG, we classify risk into the following categories: (1) credit risk, (2) market risk, (3) liquidity risk and (4) operational risk (including processing risk and systems risk). In addition, we provide individually tailored guidance to help Group companies identify categories of risk that need to be addressed. Risk categories are constantly reviewed, and new categories may be added in response to changes in the operating environment. The Corporate Risk Management Department works with the Corporate Planning Department to comprehensively and systematically manage all these categories of risk across the entire Group.

Top management plays an active role in determining basic policies of risk management across the Group as a whole. The system works as follows: The basic policies of risk management are determined by the Management Committee and examined by the Board's Risk Management Committee before being authorized by the Board. The Management Committee, the designated Board members, and the relevant risk management departments perform risk management according to the basic policies.

Risk management systems are in place at the individual Group companies in accordance with the basic policies we have set out for Groupwide risk management. For example, at SMBC, specific departments have been appointed to oversee the handling of the four risk categories listed above, in addition to risks associated with settlement. Each risk category is managed taking into account the particular characteristics of that category. In addition, the Corporate Risk Management Department—independent of the operating units—comprehensively and systematically manages all categories of risk in cooperation with the Corporate Planning Department.

Furthermore, under our system top management plays an active role in the drafting of basic policies of risk management. The decision-making process for addressing credit, market and liquidity risks at the operating level is strengthened by the Credit Risk Management Committee and the Market Management Committee, which are subcommittees of the Management Committee. The Management Committee is also attended by the relevant department heads.

■ SMFG's Risk Management System



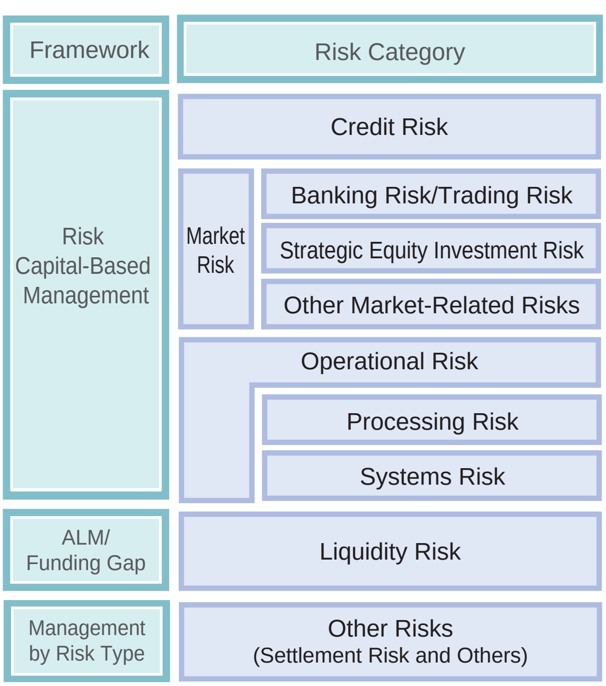
Risk Management Methods

SMFG's Groupwide basic risk management policies stipulate the basic risk management regulations that must be followed, and spell out risk management procedures from various perspectives. These include managing risk on a consolidated accounting basis, managing risk using quantification methods, ensuring consistency with business strategies, setting up a system of checks and balances, contingency planning for emergencies and serious situations, and verifying of preparedness to handle all conceivable risk situations. In addition, there are specific operational policies for implementing appropriate management of risk by all Group companies.

Under the Groupwide basic risk management policies, all Group companies periodically carry out reviews of said basic management policies for each risk category, or whenever deemed necessary, thus ensuring that the policies followed at any time are the most appropriate. The management of SMFG constantly monitors the conduct of risk management at Group companies, providing guidance when necessary.

Furthermore, in order to maintain a balance between risk and return as well as ensure the soundness of the Group from an overall perspective, we employ the risk capital-based management method, which allocates capital effectively to each department according to its role in our business strategies to keep total exposure to credit, market, and operational risks within the scope of our management resources, i.e., capital.

■ **Relationship between Risk Management Framework and Risk Category at SMBC**



In the case of SMBC, for example, sufficient capital is allocated to cover the bank's exposure to credit, market, and operational risks. In the credit and market risk categories, in particular, the maximum risk capital that can be allocated during a period is predetermined and risk capital limits are set as necessary within this limit to manage these risks. Liquidity risk is managed within the context of maximum limits set for asset liability management (ALM) and the funding gap. Other risk categories are managed with procedures closely attuned to the nature of the risk, as described in the following paragraphs.

Credit Risk

Credit risk is the possibility of a loss arising from a credit event, such as deterioration in the financial condition of a borrower, that causes an asset (including off-balance sheet transactions) to lose value or become worthless. Overseas credits also include an element of country risk, which is closely related to credit risk. This is the risk of loss caused by changes in foreign exchange, or political or economic situations.

All Group companies follow the basic policy established by SMFG to assess and manage credit risk on a Groupwide basis and further raise the level of accuracy and comprehensiveness of Groupwide credit risk management. Each Group company must comprehensively manage credit risk according to the nature of its business, and assess and manage credit risk of individual loans and credit portfolios quantitatively and using consistent standards. Credit risk is the most significant risk to which banks are exposed. Without effective credit risk management, the impact of the corresponding losses on operations can be overwhelming.

The purpose of credit risk management is to keep credit risk exposure to a permissible level relative to capital, to maintain the soundness of assets, and to ensure returns commensurate with risk. This leads to a loan portfolio that achieves high returns on capital and assets.

SMBC's credit management policy and system are described below.

1. Credit Policy

SMBC's credit policy comprises clearly stated universal and basic operating concepts, policies, and standards for credit operations, in accordance with the business mission and rules of conduct. SMBC is promoting the understanding of and strict adherence to its credit policy among all its managers and employees. By conducting credit risk management in line with global standards laid down by the New Basel Capital Accord, SMBC aims to enhance shareholder value and play a key part in society by providing high value-added financial services.

2. Credit Risk Assessment and Quantification

To effectively manage the risk involved in individual loans as well as the credit portfolio as a whole, SMBC first acknowledges that every extension of credit poses risks, assesses the credit risk posed by each borrower and loan using an internal rating system, and quantifies that risk for control purposes.

(1) Internal Rating System

SMBC's internal rating system consists of two indicators: the obligor grading, which indicates the creditworthiness of a borrower; and the facility grading, which shows the probability of collecting for each facility. Facility gradings are assigned based on the borrower's obligor grading and transaction terms such as guarantee, tenure, and collateral. Overseas credits are subjected to a further analysis that takes into account country ranking, an indicator derived from analyses of each country's political and economic situation, international balance of payments, and external debt burden. Self-assessment is the obligor grading process for lower categories, and the borrower categories used in self-assessment are consistent with the overall obligor grade criteria.

(2) Quantification of Credit Risk

Quantifying credit risk is more than just calculating the probability of default for a particular obligor. It must also reflect the concentration of risk toward a specific customer or industry and fluctuations in the value of collateral, such as real estate and securities. This range of data must be analyzed to quantify the risk of an entire portfolio or an individual loan.

To calculate credit risk, historical data for the obligor and facility are entered into a database, such parameters as the probability of a grade migration and the recovery ratio are set, and then the probability distribution of losses for the entire portfolio (amount of loss for a particular probability) is computed to determine the maximum potential loss in the future. SMBC obtains an understanding of the risk diversification effect and concentration risk by running a simulation of approximately 10,000 iterations. The quantified credit risk results are then used to formulate business plans and provide a standard against which individual credit applications are assessed.

■ **SMBC's Internal Rating System**

Obligor Grading: Grading	Subrating	Definition	Borrower Classification under Self-Assessment	Facility Grading: Grading	Subrating	Financial Reconstruction Law Based Disclosure Category (Domestic)
				S		Normal Assets
1	a	Extremely high probability of redemption	Normal Borrowers	I	a	
	b				b	
	c				c	
2	a	High probability of redemption		II	a	
	b				b	
	c				c	
3	a	Reasonable probability of redemption		III	a	
	b				b	
	c				c	
4	A	Redemption is likely, but the debtor may be affected by large shifts in business conditions or its industry.		IV	A	
	B				B	
	C				C	
5	A	No problem at present with redemption, but the future prospects are not solid and the debtor may be affected by trends in business conditions or its industry.		V	A	
	B				B	
	C				C	
6		No problem at present with redemption, but there are reasons for concern about the debtor's financial condition and the possibility of future problems with recovery.		VI		
7	A	Requires management because there are problems meeting loan conditions or with collection, the business is weak or unstable, or the financial position is poor.	Borrowers Requiring Caution A	VII	A	
	B		Borrowers Requiring Caution B		B	
	R	(Customers requiring caution among this rating)	Substandard Borrowers			Substandard Loans
8		Although the debtor is not bankrupt, its business is in difficulty, restructuring progress is poor, and it is recognized that the business may fall into bankruptcy.	Potentially Bankrupt Borrowers	VIII		Doubtful Assets
9		Although the debtor is not legally or formally in a state of bankruptcy, it is virtually bankrupt because its business is in deep trouble and there appear to be no prospects for restructuring.	Effectively Bankrupt Borrowers	IX		Bankrupt and Quasi-Bankrupt Assets
10		The debtor is legally and formally bankrupt.	Bankrupt Borrowers			

3. Framework for Managing Individual Loans

(1) Credit Assessment

Credit assessment involves a variety of financial analyses, including cash flow, to predict an enterprise's capability of loan repayment and its growth prospects. These quantitative measures, when combined with qualitative analyses of industrial trends, the enterprise's R&D capabilities, the competitiveness of its products or services, and its management caliber, result in a comprehensive credit assessment. The loan application is analyzed in terms of the intended utilization of the funds, the repayment schedule, and the state of its collateral. Thus, SMBC is able to arrive at an accurate and fair credit decision based on an objective examination of all relevant factors.

Increasing the transparency of loan conditions and approval standards for specific borrowing purposes and loan categories is a part of SMBC's ongoing review of lending practices, which includes the revision of all loan contract forms with the chief aim of clarifying lending conditions. SMBC is also making steady progress in rationalizing its credit assessment process. For example, its Business Support Offices offer the highly convenient *Business Select Loan*, which employs a credit-scoring model. In this and other ways, SMBC is building a system capable of efficiently meeting the funding requirements of businesses, especially small and medium-sized enterprises.

(2) Credit Monitoring System

In addition to analyzing loans at the application stage, the Credit Monitoring System is utilized to reassess obligor grading, and review self-assessment and credit policies so that problems can be detected at an early stage and quick and effective action can be taken. The system includes periodic monitoring carried out each time an obligor enterprise discloses financial results, as well as continuous monitoring performed each time the credit conditions change, as indicated in the diagram below.

4. Framework for Credit Portfolio Management

In addition to managing individual loans, SMBC applies the following basic policies to the management of the entire credit portfolio to maintain and improve its soundness and profitability over the medium to long term.

(1) Risk-Taking within the Scope of Capital

To keep credit risk exposure to a permissible level relative to capital, SMBC sets credit risk capital limits for internal control purposes and manages risk-taking within these limits under a regular monitoring system.

(2) Controlling Concentration Risk

Because concentration of credit risk in an industry or corporate group has the potential to substantially reduce the capital, SMBC implements measures to avoid excessive concentration of loans in an industry and to control large-scale credit provision to individual companies or corporate groups by setting guidelines for maximum loan amounts. To manage country risk, SMBC also has credit limit guidelines based on each country's creditworthiness.

(3) Balancing Risk and Return

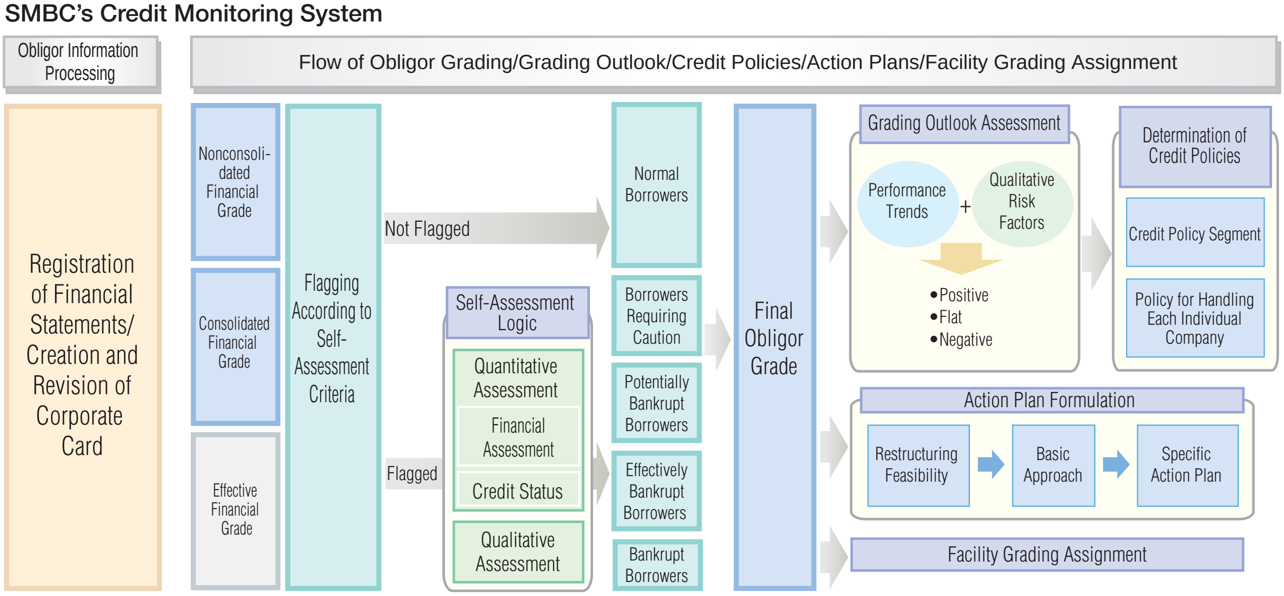
SMBC runs the credit operations on the basic principle of earning returns that are commensurate with credit risk. From fiscal 2002, SMBC began to negotiate with borrowers to gain their acceptance of suitable interest rate spreads based on a standardized interest rate structure.

Thus, SMBC is constantly seeking to further optimize the balance of risk and return so as to reduce the cost of managing credit and capital risks in order to improve net profit on core banking operations.

(4) Reduction and Prevention of Non-Performing Loans

In order to counter concerns of increasing losses from the deterioration of existing non-performing loans (NPLs) or the occurrence of new ones, SMBC is striving to respond quickly by

■ **SMBC's Credit Monitoring System**



preventing deterioration of existing loans and normalizing problem borrowers by reviewing loans to set new measures and clarify action plans, and by programs to strengthen the recovery of loan assets and secure additional collateral.

(5) Toward Active Portfolio Management

In addition to controlling the individual loan approval process, SMBC also actively manages the loan portfolio on an aggregate basis, and makes active use of the markets, such as credit derivatives and loan securitization, to proactively manage its portfolio.

5. Credit Risk Management System

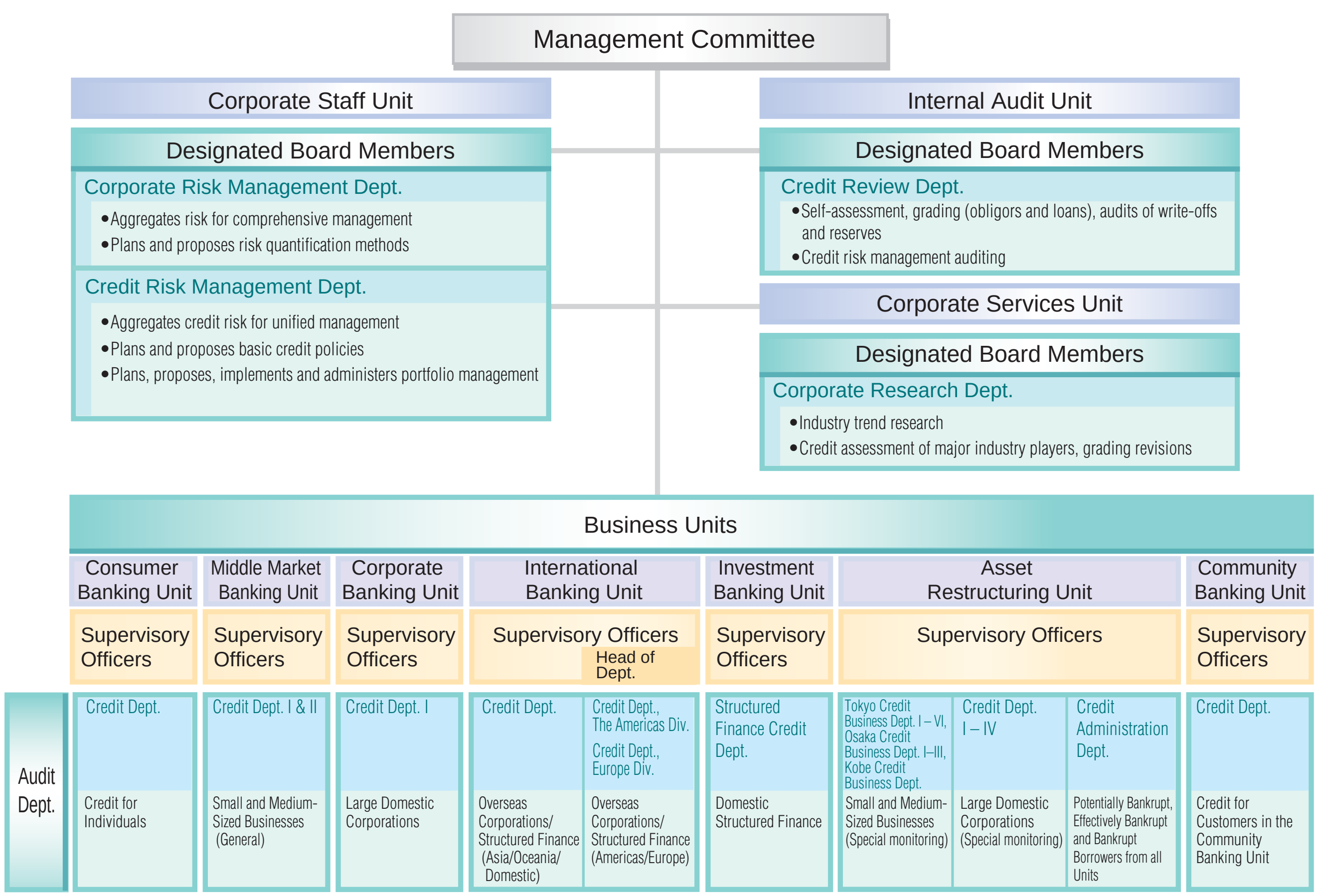
The Credit Risk Management Department within the Corporate Staff Unit is responsible for the comprehensive management of credit risk. This department determines credit policies, makes proposals on the internal rating system, plans credit limits and approval limits, and manages NPLs, loan securitization and other aspects of loan portfolio administration.

The Corporate Research Department within the Corporate Services Unit performs research on industries as well as investigates the business situations of borrower enterprises to detect early signs of problems or growth potential.

The credit departments within each business unit conduct credit risk management for loans handled by their business units and manage their business units' portfolios. The credit limits they use are based on the baseline amounts established for each grading category, with particular attention paid to evaluating and managing customers or loans perceived to have particularly high credit risk. The Asset Restructuring Unit was set up in fiscal 2002, and is staffed by specialists with the financial and business management know-how required for corporate revitalization and the off-balancing of NPLs. Entrusted with the task of revitalizing select problem companies, the Unit determines whether a company has the potential to revive itself and then provides support for its revitalization, or else proceeds with off-balancing.

The Credit Review Department, operating independently of the business units, audits asset quality, accuracy of gradings, self-assessment, and state of credit risk management, and reports the results directly to the Board of Directors and the Management Committee.

■ SMBC's Credit Risk Management System



Market and Liquidity Risks

Market and Liquidity Risk Management System

Market risk is the possibility that fluctuations in interest rates, foreign exchange rates, or stock prices will change the market value of financial products, leading to a loss.

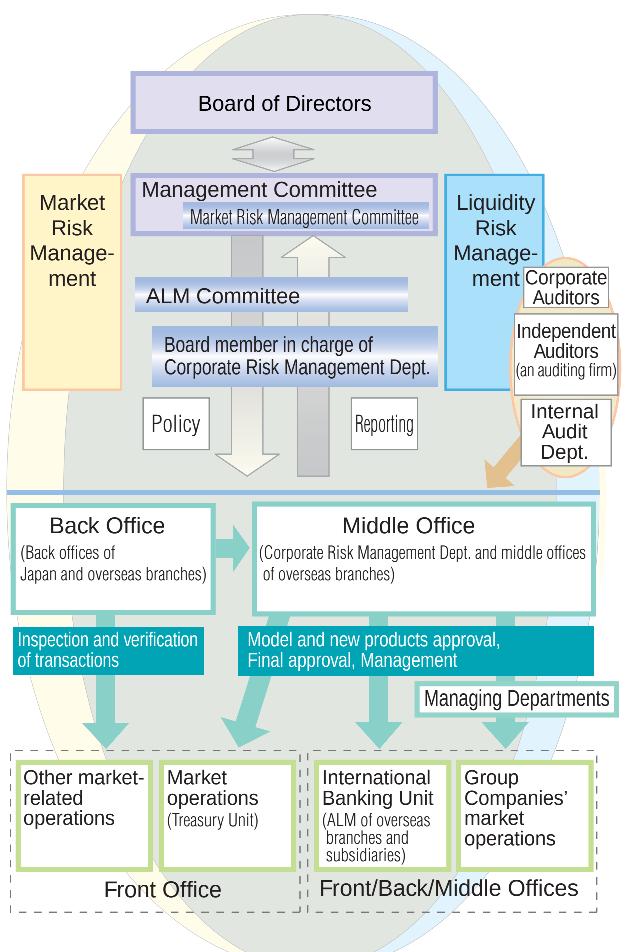
Liquidity risk is the possibility of encountering an obstacle to raising the funds required for settlement due either to a mismatch between the use and procurement of funds or to an unexpected outflow of funds, or being forced to borrow at higher interest rates than usual.

SMFG is working to further enhance the effectiveness of its quantitative management of market and liquidity risk across the entire Group by setting allowable risk limits; ensuring the transparency of the risk management process; clearly separating front-office, middle-office, and back-office operations; and establishing a highly efficient system of mutual checks and balances.

SMBC's Corporate Risk Management Department, which is independent of the business units that handle market transactions, manages market and liquidity risks together. The Department operates according to the principles of market risk and liquidity risk management determined by the Market Risk Management Committee in line with the basic policies of risk management followed by the entire Group, and sends daily risk reports to senior management via e-mail.

To prevent operational errors or the manipulation of transaction data, it is important to establish a system of checks and balances in the business units (front office). At SMBC, both the processing departments (back office) and the administrative departments (middle office) conduct backup checks. In addition, SMBC's independent Internal Audit Unit periodically performs comprehensive internal audits to verify that the risk management system is functioning properly.

■ SMBC's Market Risk and Liquidity Risk Management Organization Chart



Market Risk

The value-at-risk (VaR) method is used to control market risk. This method predicts the maximum potential loss for a given probability. The SMBC VaR model calculates the maximum loss through a Monte Carlo simulation of changes in profits and losses, i.e., 10,000 scenarios of market fluctuations based on historical data for one year. This method appropriately measures the risk of products that have option risk and calculates the VaR for trading operations making active use of derivatives.

Market risk can be divided into various factors: foreign exchange rate, interest rate, equity price, and option risk. Fine-tuned management for each risk category is achieved by employing the VaR method in conjunction with suitable indicators for managing the risk of individual financial instruments such as the basis-point-value (BPV) indicator, which measures the potential change in earnings stated at market value for every 0.01 percentage-point fluctuation in interest rates.

At SMBC, whenever the VaR, owing to sharp changes in the market, is likely to exceed the guidelines, which have been determined conservatively to maintain consistency with the market risk capital limit set according to the business strategy, contingency plans are put into effect and the ALM Committee convenes an extraordinary meeting. The market risk of its strategic equity investments held by units other than the Treasury Unit and the market risk taken by the major subsidiaries are also included in the integrated risk measurement performed by the Corporate Risk Management Department. The VaR is regularly calculated and reported to the Board of Directors and the Management Committee.

The VaR results of the trading and banking accounts on a consolidated basis for fiscal 2003 were as follows:

■ SMBC's VaR Results

(Billions of yen)

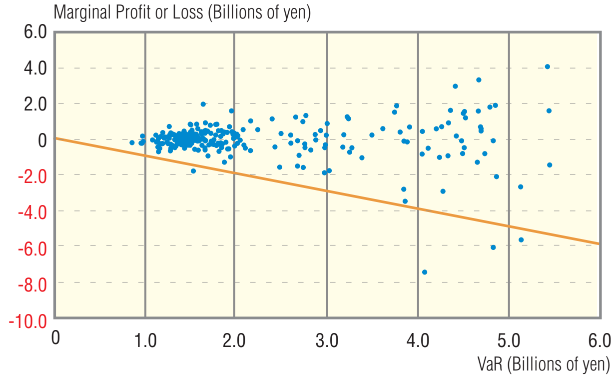
	Maximum	Minimum	Average	Last Day of Term
Trading Accounts	3.5	0.9	1.7	2.0
Banking Accounts	128.6	35.4	65.9	83.4

(VaR for a one-day holding period with one-sided confidence interval of 99.0%. The VaR model for trading accounts includes major consolidated subsidiaries. Figures for trading accounts exclude specific risks.)

The market occasionally undergoes extreme fluctuations that exceed projections. To manage market risk, therefore, it is important to run simulations (stress tests) of situations that may occur only once in many years. At SMBC, periodic stress tests are conducted to prepare for unforeseeable swings.

The internal model used by SMBC (SMBC VaR) has been periodically evaluated by an independent auditing firm and certified as appropriate. In addition, the relationship between the VaR calculated with the model and the actual profit and loss data is back-tested. The back-testing results for SMBC's trading accounts for fiscal 2003 are shown below. A data point below the diagonal line indicates a loss in excess of the predicted VaR for that day. The actual loss exceeded the model's predicted VaR on four days during the period, and in all four cases, this was the result of special market factors. This fact demonstrates that the SMBC VaR model, with a one-sided confidence interval of 99.0%, is sufficiently reliable.

■ SMBC's Back-Testing Results (Trading Accounts)



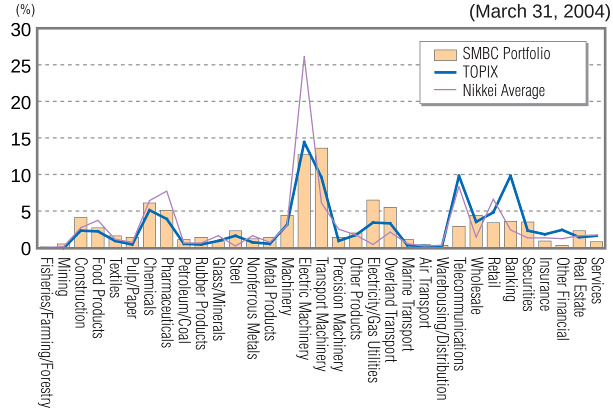
To manage the risk of yen-denominated banking accounts, SMBC uses gap analysis employing maturity ladders and the earnings-at-risk (EaR) model, in addition to the VaR model. In the case where an external factor, such as interest rates, moves in an unfavorable direction, the EaR model can indicate the largest estimated change in earnings (interest rate spread) for a set period at a given probability. Because strategy and budgetary planning is based on the earnings for a period, SMBC uses the EaR model to supplement the VaR model. Using Monte Carlo simulations to generate 1,000 scenarios, SMBC tests the magnitude of the effect that new deposits and loans will have on a period's earnings.

Stock price fluctuations have a major effect on financial statements. At SMBC, strengthening the management of stock price fluctuation risk is one of the most important management goals.

One of SMBC's highest priorities is to achieve a level of financial strength sufficient to weather the stock price fluctuations to which its cross-shareholdings are exposed. Accordingly, we are working to reduce the balance of cross-shareholdings. We have already brought the balance down below the limit allowable under government regulations and plan a further reduction to a level commensurate with the funds available for equity investment.

The Corporate Risk Management Department establishes limits on allowable risk related to strategic equity investment and monitors the observance of those limits, to keep the management of stock price fluctuation risk within acceptable parameters.

■ Composition, by Industry, of Listed Equity Portfolio



Liquidity Risk

At SMBC, liquidity risk is one of the major risks. So as not to be overly dependent on market-based funding to cover short-term cash outflows, SMBC's liquidity risk management is based on a framework consisting of setting funding gap limits and guidelines, maintaining a system of highly liquid supplementary funding sources, and establishing contingency plans.

In daily risk management operations, SMBC prevents a cumulative increase in liquidity risk by adjusting the funding gap limits and guidelines. For emergency situations, there are contingency plans in place to reduce the funding gap limits and guidelines and other measures. To prevent the possibility of market crises interfering with funding, SMBC carries highly liquid assets, such as U.S. Treasury securities, and has emergency borrowing facilities in place, which also enable foreign currency-denominated liquidity management.

Operational Risk

Operational risk is the possibility of losses arising from inadequate or failed internal processes, people and systems or from external events. SMFG is working to raise the level of sophistication of its management of operational risk across the whole Group by providing an effective framework for the identification, assessment, control and monitoring of significant risk factors and by establishing systems for contingency and business continuity plans.

On the basis of the basic risk management policies set forth by SMFG for all Group companies, SMBC's Corporate Risk Management Department is responsible for centrally overseeing all operational risk management, in addition to departments specifically responsible for controlling processing risk and systems risk.

To facilitate effective operational risk management, these departments in charge collect internal data on historical losses as a result of such risk factors, analyze a wide variety of scenarios, and undertake risk management according to the risk characteristic.

In addition, SMBC is controlling its exposure to operational risk through capital allocation based on simulations using a quantitative model.

Processing Risk

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

SMFG recognizes that all work processes inevitably involve a certain element of risk. We are therefore working to raise the level of sophistication of our management of processing risk across the whole Group by ensuring that each branch conducts its own regular investigations of processing risk; minimizing losses in the event of processing errors or negligence by drafting exhaustive contingency plans; and carrying out thorough quantification of the risks under management.

In the administrative regulations of SMBC, in line with the basic policies of risk management followed by the whole Group, the basic administrative regulations are summarized as "comprehending the risks and costs of administration and transaction processing, and managing them accordingly," and "seeking to raise the quality of administration to deliver high-quality service to customers." Adding new policies or making major revisions to existing ones for processing risk management requires the approval of both the Management Committee and the Board of Directors.

In the administrative regulations, SMBC has also defined specific rules for processing risk management. The rules allocate processing risk management tasks among six types of departments: the Operations Planning Department, compliance departments, operations departments, transaction execution departments (primarily front-office departments and branches), the Internal Audit Department, and the Customer Relations Department. In addition, there is a specialized group within the Operations Planning Department to strengthen administrative procedures throughout the SMBC Group.

Systems Risk

Systems risk is the possibility of a loss arising from the failure, malfunction, or unauthorized use of a computer system. SMFG recognizes that the provision of a reliable computer system is essential for the effective implementation of management strategy in view of the IT revolution. We strive to minimize systems risk by drafting regulations and specific management standards, including a security policy. We also have contingency plans with the goal of minimizing losses in the event of a systems failure. The development of such a systems risk management system ensures that the Group as a whole is undertaking adequate risk management.

At SMBC, safety measures are strengthened according to risk assessment based on the Financial Services Agency's *Financial Inspection Manual*, and the *Security Guidelines* published by The Center for Financial Industry Information Systems (FISC).

Because computer-related trouble at financial institutions now has greater potential to impact the public, and with systems risk diversifying owing to the IT revolution, the resulting expansion of networks and the rise in the number of personal computer users, the necessary steps are taken to ensure the smooth, secure operation of our information systems. We have duplicated all systems and infrastructures, and the computer centers in eastern and western Japan have been fully proofed against earthquakes and other disasters. To maintain the confidentiality of customer information and prevent information leaks, sensitive information is encrypted, unauthorized external access is blocked, and all known countermeasures to secure data are implemented. There are also contingency plans and training sessions held as required to ensure full preparedness in the event of an emergency. To maintain security, countermeasures are revised as new technologies and usage patterns emerge.

Settlement Risk

Settlement risk is the possibility of a loss arising from a transaction that cannot be settled as planned. Because this risk comprises elements of several types of risk, including credit, liquidity, processing, and systems risk, it requires interdisciplinary management. At SMBC, the Operations Planning Department is charged with coordinating the management of settlement risk with the Credit Risk Management Department, which oversees credit risk, and the Corporate Risk Management Department, which oversees liquidity risk.