

# Risk Management

## Basic Approach

As risks in the financial services increase in diversity and complexity, risk management—identifying, measuring, and controlling risk—has 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 for risk management: 1) Set forth SMFG's Groupwide basic policies for risk management 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; and 3) Monitor the implementation of risk management by all Group companies to ensure that their practices meet the relevant standards.

## (1) Types of Risk to Be Managed

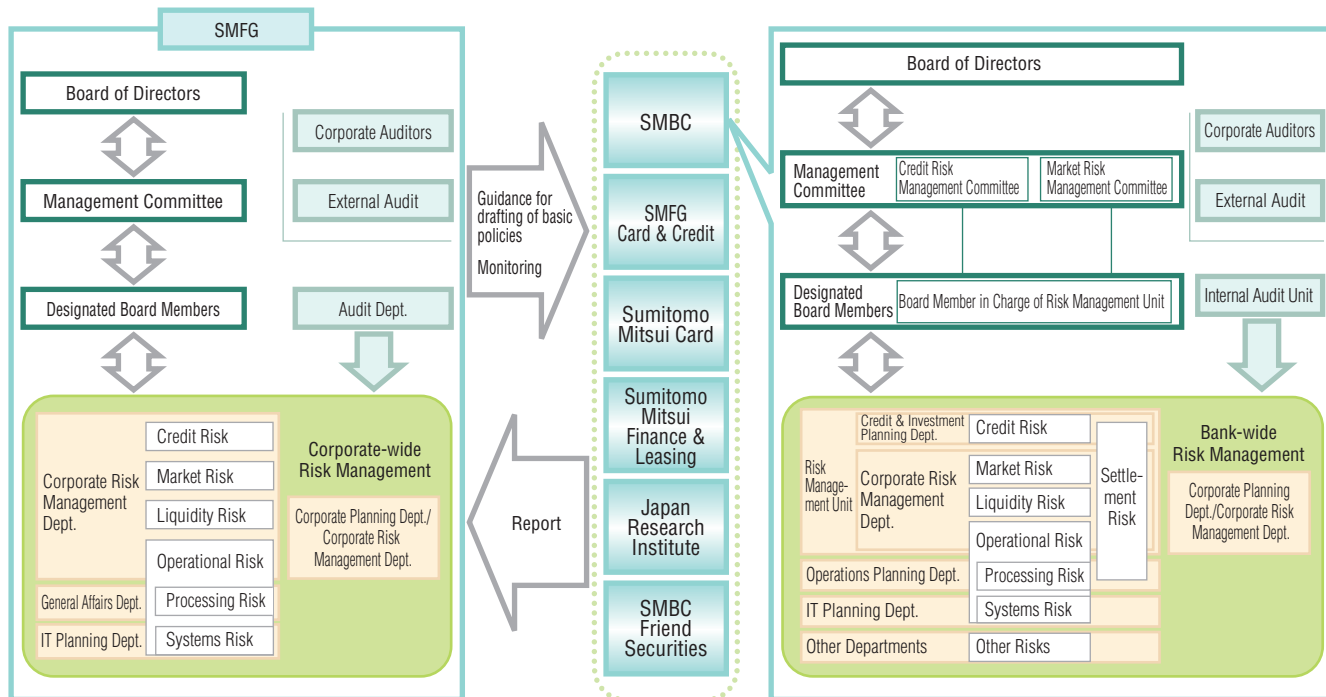
At SMFG, we classify risk into the following categories: (1) credit risk, (2) market risk, (3) liquidity risk and (4) operational risk (including processing risk and systems risk). In addition, we provide individually tailored guidance to help Group companies identify categories of risk that need to 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.

## (2) Fundamental Principles and Basic Policies for Risk Management

SMFG's Groupwide basic policies for risk management stipulate the fundamental principles for risk management 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 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 SMFG's Groupwide basic policies for risk management, all Group companies periodically carry out reviews of the 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.

## SMFG's Risk Management System



## Risk Management System

Top management plays an active role in determining SMFG's Groupwide basic policies for risk management. The system works as follows: The basic policies for risk management are determined by the 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 SMFG's Groupwide basic policies for 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 Risk Management Unit has been established— independent of the business units—and the risk management framework has been strengthened by consolidating the functions for managing major risks—credit, market, liquidity and operational—into the Risk Management Unit and enhancing our across-the-board risk monitoring ability. A board member is assigned to oversee the Risk Management Unit comprising the Corporate Risk Management Department and Credit & Investment Planning Department. The Corporate Risk Management Department—the unit's planning department—comprehensively and systematically manages all categories of risk in cooperation with the Corporate Planning Department. Moreover, the Internal Audit Unit—independent of all business units—conducts periodic audits to ensure that the management system is functioning properly.

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

## Risk Capital-Based Management

### (1) Framework

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. We measure "risk capital" based on value at risk (VaR), etc. as a uniform basic measure of credit, market, and operational risk, taking account of the special characteristics of each type of risk and the business activities of each Group company. We then allocate capital appropriately and effectively to each unit to keep total exposure to various risks within the scope of our resources, i.e., capital. In this framework, risk capital includes credit concentration risk and interest rate risk in the banking book which are taken into account under the Second Pillar of Basel II. In addition, we conduct capital risk-based management activities on a consolidated basis, including each Group company.

Liquidity risk is managed within the context of cash-flow plans and funding gap. Other risk categories are managed with procedures closely attuned to the nature of the risk, as described in the following paragraphs.

## ■ Risk Management Framework

| Framework                     | Risk Category                               |   |
|-------------------------------|---|---|
| Risk Capital-Based Management | 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.  |
|                               | Market Risk                                 | Banking Risk/Trading Risk   |
|                               |   | Strategic Equity Investment Risk  |
|                               |   | Other Market-Related Risks  |
|                               | Operational Risk                            | Operational risk is the possibility of losses arising from inadequate or failed internal processes, people, and systems or from external events.  |
|                               |   | Processing Risk   |
|                               |   | Systems Risk  |
| ALM/<br>Funding Gap           | Liquidity Risk                              | Liquidity risk is the risk that there may be difficulties in raising funds needed for settlements, as a result of the mismatching or uses of funds and sources of funds or unexpected outflows of funds, circumstances that may make it necessary to raise funds at higher rates than normal. |
| Management<br>by Risk Type    | Other Risks<br>(Settlement Risk and Others) | —   |

## (2) Risk Capital Limit

In the case of credit and market risk, we set maximum risk capital limits, which indicate the maximum risk that may be taken during the period, taking account the level of stress stipulated in business plans. In addition, for operational risk, we also allocate risk capital, and, for the Group as a whole, we set total risk capital allocations within SMFG's capital. In the case of credit and market risk, risk capital limits are sub-divided into guidelines or ceilings for each business including VaR and loss limits. Therefore, by strictly observing the VaR and loss limits, and other factors, SMFG maintains the soundness of the Group as a whole.

## Implementation of Basel II

The Basel Capital Accord, an international agreement for ensuring the soundness of banks through adherence to BIS capital adequacy regulations, was revised in response to the diversification of the banking business and the increasing sophistication of risk management technology. The revised BIS regulations, known as Basel II, became effective from March 31, 2007 in Japan.

Basel II requires banks to implement internal controls to serve as the basis for capital calculation, and to strengthen their risk management framework. It also requires disclosure of information to encourage market discipline in risk management.

We have been implementing initiatives to strengthen our risk management framework, taking into account Basel II and other considerations. At March 31, 2009, we introduced the advanced internal ratings-based (IRB) approach in Basel II.

Details of the initiatives are provided below, and detailed information on the capital ratio is provided in the discussion on Capital Ratio Information appearing in the Financial Section and Corporate Data.

## Credit Risk

### 1. Basic Approach to Credit Risk Management

#### (1) Definition of 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.

#### (2) Fundamental Principles for Credit Risk Management

All Group companies follow the fundamental principles 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 SMFG is 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 Groupwide assets, and to ensure returns commensurate with risk. This leads to a loan portfolio that achieves high returns on capital and assets.

## (3) 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 risk-sensitive credit management, SMBC aims to enhance shareholder value and play a key part in society by providing high-value-added financial services.

## 2. Credit Risk Management System

At SMBC, the Credit & Investment Planning Department within the Risk Management Unit is responsible for the comprehensive management of credit risk. This department drafts and administers credit policies, the internal rating system, credit authority guidelines, and credit application guidelines, and manages non-performing loans (NPLs) and other aspects of credit portfolio management. The department also cooperates with the Corporate Risk Management Department in quantifying credit risk (risk capital and risk-weighted assets) and controls the bank's entire credit risk. Further, the Credit Portfolio Management Department within the Credit & Investment Planning Department has been strengthening its active portfolio management function whereby loan securitization and other market transactions are used to stabilize the portfolio's credit risk for a more sophisticated portfolio.

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 Administration Department is responsible for handling NPLs of borrowers classified as potentially bankrupt or lower, and draws up plans for their workouts, including write-offs, and corporate rehabilitation. The department closely liaises with the Group company SMBC Servicer Co., Ltd., which engages in related services, and works to efficiently reduce the amount of NPLs by such means as the sell-off of claims.

The credit departments within each business unit conduct credit risk management along with branches, for loans handled by their units and manage their 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 cus-

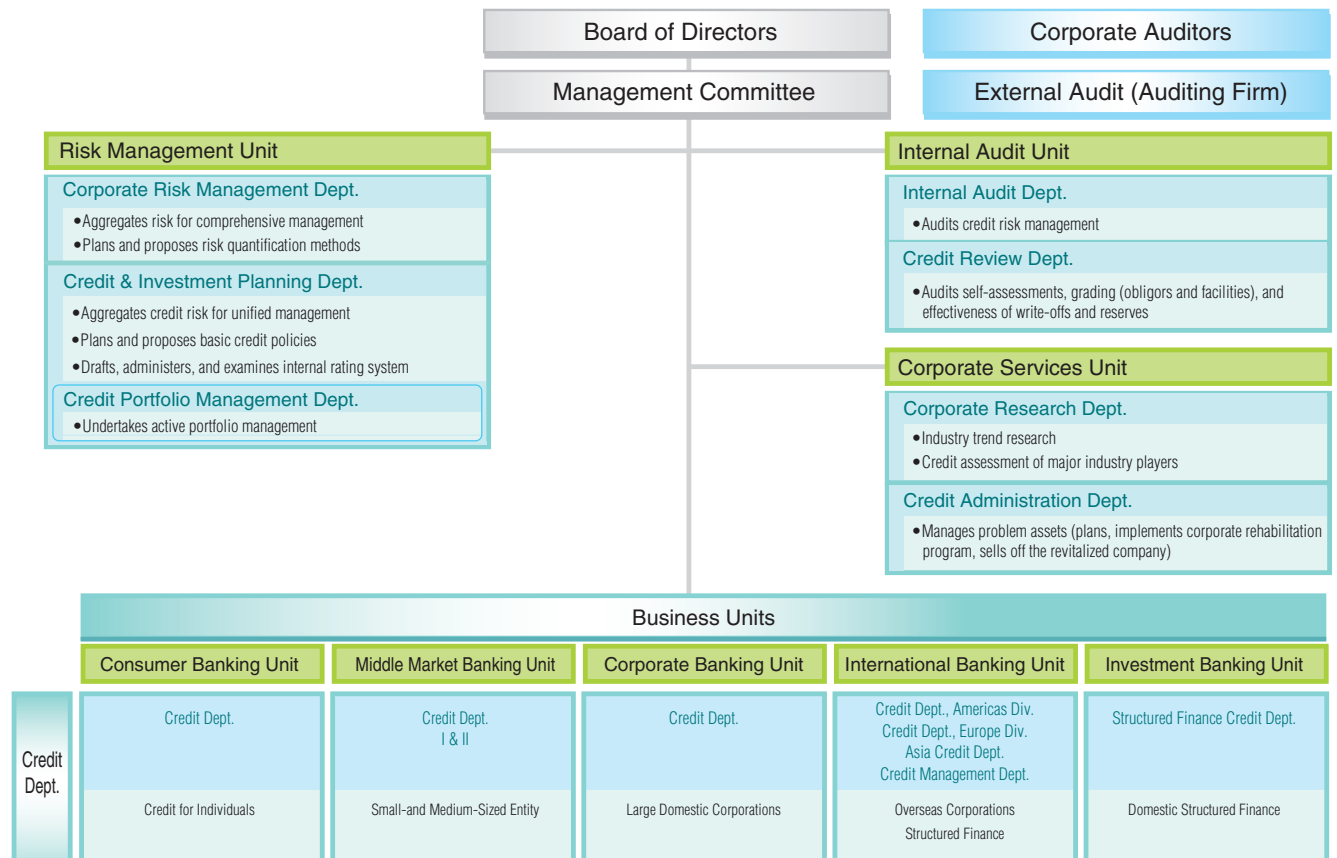
tomers or loans perceived to have particularly high credit risk.

The Internal Audit Unit, operating independently of the business units, audits asset quality, accuracy of gradings and self-assessment, and state of credit risk management, and reports the results directly to the Board of Directors and the Management

Committee.

SMBC has established the Credit Risk Committee, as a consultative body, to round out its oversight system for undertaking flexible and efficient control of credit risk, and ensuring the overall soundness of the bank's loan operations.

## ■ SMBC's Credit Risk Management System



## 3. Credit Risk Management Methods

### (1) Credit Risk Assessment and Quantification

At SMBC, to effectively manage the risk involved in individual loans as well as the credit portfolio as a whole, we first acknowledge that every loan entails credit risks, assess the credit risk posed by each borrower and loan using an internal rating system, and quantify that risk for control purposes.

#### (a) Internal Rating System

There is an internal rating system for each asset control category set according to portfolio characteristics. For example, credits to commercial and industrial (C&I) companies, individuals for business purposes (domestic only), sovereigns, public-sector entities, and financial institutions are assigned an "obligor grade," which indicates the borrower's creditworthiness, and/or "facility grade," which indicates the collectibility of assets taking into account transaction conditions such as guarantee/collateral, and tenor. An obligor grade is determined by first assigning a

financial grade using a financial strength grading model and data obtained from the obligor's financial statements. The financial grade is then adjusted taking into account the actual state of the obligor's balance sheet and qualitative factors to derive the obligor grade. In the event that the borrower is domiciled overseas, internal ratings for credit are made after taking into consideration country rank, which represents an assessment of the credit quality of each country, based on its political and economic situation, as well as its current account balance and external debt. Self-assessment is the obligor grading process for assigning lower grades, and the borrower categories used in self-assessment are consistent with the obligor grade categories.

Obligor grades and facility grades are reviewed once a year, and, whenever necessary, such as when there are changes in the credit situation.

There are also grading systems for small-and medium-sized entity (SME) loans, loans to individuals, and project finance and other structured finance tailored according to the risk

characteristics of these types of assets.

The Credit & Investment Planning Department centrally manages the internal rating systems, and properly designs, operates, supervises, and validates the grading models. It validates the grading models (including statistical validation) of main assets following the procedures manual once a year, to ensure their effectiveness and suitability.

## (b) Quantification of Credit Risk

Credit risk quantification refers to the process of estimating the degree of credit risk of a portfolio or individual loan taking into account not just the obligor's probability of default (PD), but also the concentration of risk in a specific customer or industry and the loss impact of fluctuations in the value of collateral, such as real estate and securities.

Specifically, first, the PD by grade, loss given default (LGD), credit quality correlation among obligors, and other parameter values are estimated using historical data of obligors and facilities stored in a database to calculate the credit risk. Then, based on these parameters, we run a simulation of 10,000 iterations of simultaneous default using the Monte Carlo method to calculate our maximum loss exposure to the estimated amount of the maximum losses that may be incurred. Based on these quantitative results, we allocate risk capital. Please note that the PD and LGD values are, in principle, the same values as those used for calculating the capital ratio.

## ■ SMBC's Obligor Grading System

| Obligor Grade        |                      | Definition   | Borrower Category              |
|----------------------|----------------------|--|--------------------------------|
| Domestic (C&I), etc. | Overseas (C&I), etc. |  |                                |
| J1                   | G1                   | Very high certainty of debt repayment  | Normal Borrowers               |
| J2                   | G2                   | High certainty of debt repayment   |                                |
| J3                   | G3                   | Satisfactory certainty of debt repayment   |                                |
| J4                   | G4                   | Debt repayment is likely but this could change in cases of significant changes in economic trends or business environment  |                                |
| J5                   | G5                   | No problem with debt repayment over the short term, but not satisfactory over the mid to long term and the situation could change in cases of significant changes in economic trends or business environment |                                |
| J6                   | G6                   | Currently no problem with debt repayment, but there are unstable business and financial factors that could lead to debt repayment problems   |                                |
| J7                   | G7                   | Close monitoring is required due to problems in meeting loan terms and conditions, sluggish/unstable business, or financial problems   | Borrowers Requiring Caution    |
| J7R                  | G7R                  | (Of which Substandard Borrowers)   | Substandard Borrowers          |
| J8                   | G8                   | Currently not bankrupt, but experiencing business difficulties, making insufficient progress in restructuring, and highly likely to go bankrupt  | Potentially Bankrupt Borrowers |
| J9                   | G9                   | Though not yet legally or formally bankrupt, has serious business difficulties and rehabilitation is unlikely; thus, effectively bankrupt  | Effectively Bankrupt Borrowers |
| J10                  | G10                  | Legally or formally bankrupt   | Bankrupt Borrowers             |

Risk quantification is also executed for purposes such as to determine the portfolio's risk concentration, or to simulate economic movements (stress tests), and the results are used for making optimal decisions across the whole range of business operations, including formulating business plans and providing a standard against which individual credit applications are assessed.

## (2) Framework for Managing Individual Loans

### (a) Credit Assessment

At SMBC, credit assessment of corporate loans 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 and the repayment schedule. Thus, SMBC is able to arrive at an accurate and fair credit decision based on an objective examination of all relevant factors.

Increasing the understandability to customers 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 loan contract forms with the chief aim of clarifying lending conditions utilizing financial covenants.

SMBC is also making steady progress in rationalizing its

credit assessment process. To respond proactively and promptly to customers' funding needs—particularly those of SMEs—we employ a standardized credit risk assessment process for SMEs that uses a credit-scoring model. With this process, we are building a regime for efficiently marketing our *Business Select Loan* and other SME loans.

In the field of housing loans for individuals, we employ a credit assessment model based on credit data amassed and analyzed by SMBC over many years. This model enables our loan officers to efficiently make rational decisions on housing loan applications, and to reply to the customers without delay. It also facilitates the effective management of credit risk, as well as the flexible setting of interest rates.

We also provide loans to individuals who rent out properties such as apartments. The loan applications are subjected to a precise credit risk assessment process utilizing a risk assessment model that factors in the projected

| Financial Reconstruction Law Based Disclosure Category (Domestic) |
|---|
| Normal Assets   |
| Substandard Loans   |
| Doubtful Assets   |
| Bankrupt and Quasi-Bankrupt Assets                                |

revenue from the rental business. The process is also used to provide advice to such customers on how to revise their business plans.

#### (b) Credit Monitoring System

At SMBC, in addition to analyzing loans at the application stage, the Credit Monitoring System is utilized to reassess obligor grades 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 credit conditions change, as indicated in the diagram below.

### (3) 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 mid to long term.

#### (a) 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. Under these limits, separate guidelines are issued for each business unit and marketing unit, such as for real estate finance, fund investment, and investment in securitization products. Regular monitoring is conducted to make sure that these guidelines are being followed, thus ensuring appropriate overall management of credit risk.

#### (b) Controlling Concentration Risk

Because the concentration of credit risk in an industry or corporate group has the potential to substantially impair capital, SMBC implements measures to prevent the excessive concentration of loans in an industry and to control large exposure 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.

#### (c) Researching Borrowers More Rigorously and Balancing Risk and Returns

Against a backdrop of drastic change in the business environment, SMBC rigorously researches borrower companies' actual conditions. It runs credit operations on the basic principle of earning returns that are commensurate with the credit risk involved, and makes every effort to reduce credit and capital costs as well as general and administrative expenses.

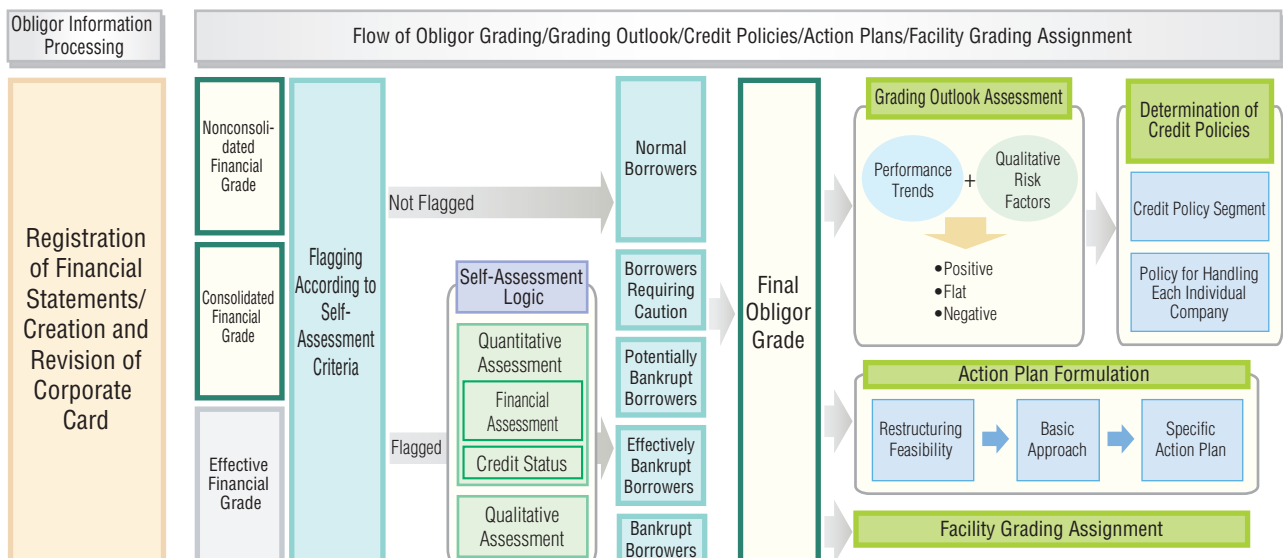
#### (d) Prevention and Reduction of Non-Performing Loans

On NPLs and potential NPLs, SMBC carries out regular loan reviews to clarify handling policies and action plans, enabling it to swiftly implement measures to prevent deterioration of borrowers' business situations, support business recoveries, collect on loans, and enhance loan security.

#### (e) Toward Active Portfolio Management

SMBC makes active use of credit derivatives, loan asset sales, and other instruments to proactively and flexibly manage its portfolio to stabilize credit risk.

### ■ SMBC's Credit Monitoring System





#### (4) Self-Assessment, Asset Write-Offs and Provisions, and Disclosure of Problem Assets

##### (a) Self-Assessment

SMBC conducts rigorous self-assessment of asset quality using criteria based on the *Financial Inspection Manual* of the Financial Services Agency and the *Practical Guideline* published by the Japanese Institute of Certified Public Accountants. Self-assessment is the latter stage of the obligor grading process for determining the borrower's ability to fulfill debt obligations, and the obligor grade criteria are consistent with the categories used in self-assessment.

At the same time, self-assessment is a preparatory task for ensuring SMBC's asset quality and calculating the appropriate level of write-offs and provisions. Each asset is assessed individually for its security and collectibility. Depending on the borrower's current situation, the borrower is assigned to one of five categories: Normal Borrowers, Borrowers Requiring Caution, Potentially Bankrupt Borrowers, Effectively Bankrupt Borrowers, and Bankrupt Borrowers. Based on the borrower's category, claims on the borrower are classified into Classification I, II, III, and IV assets according to their default and impairment risk levels, taking into account such factors as collateral and guarantees. As part of our efforts to bolster risk management throughout the Group, our consolidated subsidiaries carry out self-assessment in substantially the same manner.

| Borrower Categories, Defined   |  |
|--------------------------------|--|
| Normal Borrowers               | Borrowers with good earnings performances and no significant financial problems                  |
| Borrowers Requiring Caution    | Borrowers identified for close monitoring  |
| Potentially Bankrupt Borrowers | Borrowers perceived to have a high risk of falling into bankruptcy                               |
| Effectively Bankrupt Borrowers | Borrowers that may not have legally or formally declared bankruptcy but are essentially bankrupt |
| Bankrupt Borrowers             | Borrowers that have been legally or formally declared bankrupt                                   |

| Asset Classifications, Defined |  |
|--------------------------------|--|
| Classification I               | Assets not classified under Classifications II, III, or IV   |
| Classification II              | Assets perceived to have an above-average risk of uncollectibility   |
| Classification III             | Assets for which final collection or asset value is very doubtful and which pose a high risk of incurring a loss |
| Classification IV              | Assets assessed as uncollectible or worthless  |

##### (b) Asset Write-Offs and Provisions

In cases where claims have been determined to be uncollectible, or deemed to be uncollectible, write-offs signify the recognition of losses on the account books with respect to such claims. Write-offs can be made either in the form of loss recognition by offsetting uncollectible amounts against corresponding balance sheet items, referred to as a direct write-off, or else by recognition of a loan loss provision on a contra-asset account in the amount

deemed uncollectible, referred to as an indirect write-off. Recognition of indirect write-offs is generally known as provision for the reserve for possible loan losses.

SMBC's write-off and provision criteria for each self-assessment borrower category are shown in the table below. As part of our overall measures to strengthen risk management throughout the Group, all consolidated subsidiaries use substantially the same standards as SMBC for write-offs and provisions.

| Self-Assessment Borrower Categories      |                  | Standards for Write-Offs and Provisions  |
|--|------------------|--|
| Normal Borrowers                         |                  | The expected loss amount for the next 12 months is calculated for each grade based on the grade's historical bankruptcy rate, and the total amount is recorded as "provision for the general reserve for possible loan losses."  |
| Borrowers Requiring Caution              |                  | These assets are divided into groups according to the level of default risk. Amounts are recorded as provisions for the general reserve in proportion to the expected losses based on the historical bankruptcy rate of each group. The groups are "claims on Substandard Borrowers" and "claims on other Borrowers Requiring Caution." The latter group is further subdivided according to the borrower's financial position, credit situation, and other factors. Further, when cash flows can be estimated reasonably accurately, the discounted cash flow (DCF) method is applied mainly to large claims for calculating the provision amount. |
| Potentially Bankrupt Borrowers           |                  | A provision for the specific reserve for possible loan losses is made for the portion of Classification III assets (calculated for each borrower) not secured by collateral, guarantee, or other means. Further, when cash flows can be estimated reasonably accurately, the DCF method is applied mainly to large claims for calculating the provision amount.  |
| Effectively Bankrupt/ Bankrupt Borrowers |                  | Classification III asset and Classification IV asset amounts for each borrower are calculated, and the full amount of Classification IV assets (deemed to be uncollectible or of no value) is written off in principle and provision for the specific reserve is made for the full amount of Classification III assets.  |
| Notes                                    | General reserve  | Provisions made in accordance with general inherent default risk of loans, unrelated to specific individual loans or other claims  |
|  | Specific reserve | Provisions made for claims that have been found uncollectible in part or in total (individually evaluated claims)  |

##### Discounted Cash Flow Method

SMBC uses the discounted cash flow (DCF) method to calculate the provision amounts for large claims on Substandard Borrowers and Potentially Bankrupt Borrowers when the cash flow from repayment of principal and interest received can be estimated reasonably accurately. SMBC then makes provisions equivalent to the excess of the book value of the claims over the said cash inflow discounted by the initial contractual interest rate or the effective interest rate at the time of origination. One of the major advantages of the DCF method over conventional methods of calculating the provision amount is that it enables effective evaluation of each individual borrower. However, as the provision amount depends on the future cash flow estimated on the basis of the borrower's business reconstruction plan and the DCF formula input values, such as the discount rate and the probability of the borrower going into bankruptcy, SMBC makes every effort to utilize up-to-date and correct data to realize the most accurate estimates possible.

#### (c) Disclosure of Problem Assets

Problem assets are loans and other claims of which recovery of either principal or interest appears doubtful, and are disclosed in accordance with the Banking Law (in which they are referred to as "risk-monitored loans") and the Financial Reconstruction Law (where they are referred to as "problem assets"). Problem assets are classified based on the borrower categories assigned during self-assessment. For detailed information on results of self-assessments, asset write-offs and provisions, and disclosure of problem assets at March 31, 2009, please refer to page 153.

## 4. Market Credit Risk Management

Financial products, such as funds, securitized products, and credit derivatives, that have indirect risk arising from the assets underlying these products, such as bonds, loan obligations, and other assets (the underlying assets), are recognized as transactions that combine the characteristics of the credit risk of the underlying assets and "market risk" that arises from the buying and selling of these products. This is referred to as market credit risk.

For these types of products, we manage credit risk using the methods of analysis and assessment in detail of characteristics of underlying assets, but, for the sake of complete risk management, we also apply the methods for management of market risk described in the following section "Market and Liquidity Risks."

In addition, we have established guidelines based on the characteristics of these types of risk and appropriately manage the risk of losses.

## Market and Liquidity Risks

### 1. Basic Approach to Market and Liquidity Risk Management

#### (1) Definitions of Market and Liquidity Risk

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.

#### (2) Fundamental Principles for Market and Liquidity Risk Management

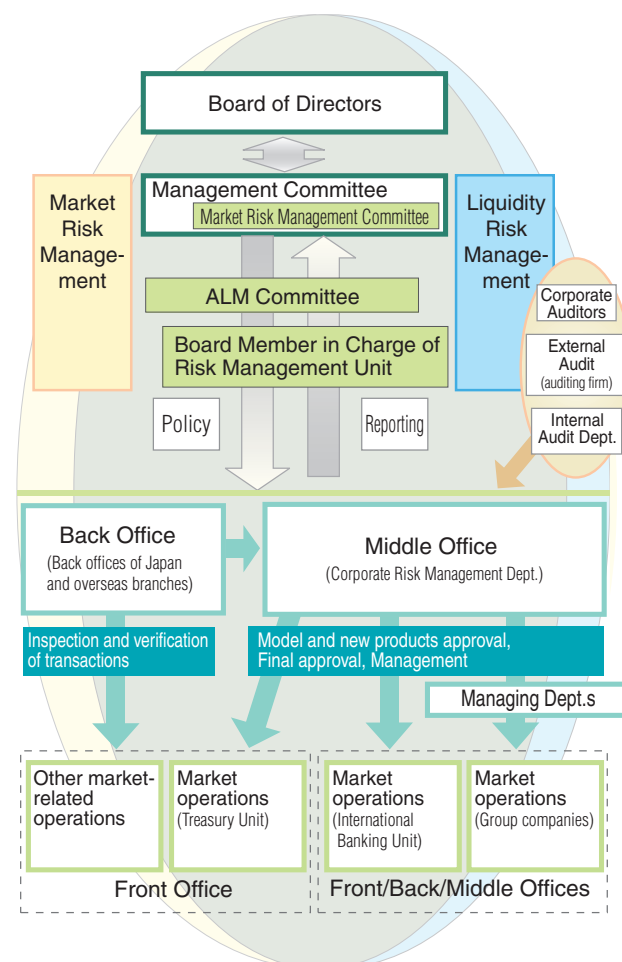
SMFG is working to further enhance the effectiveness of its quantitative management of market and liquidity risks across the entire Group by setting allowable risk limits; ensuring the transparency of the risk management process; clearly separating front-office, middle-office, and back-office operations;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

## 2. Market and Liquidity Risk Management System

On the basis of SMFG's Groupwide basic policies for risk management, SMBC's Board of Directors authorizes important matters relating to the management of market and liquidity risks, such as basic policies and risk limits, which are decided by the Management Committee. Additionally, the SMBC's Corporate Risk Management Department, which is independent of business units that directly handle market transactions, manages market and liquidity risks in an integrated manner. The department not only monitors the current risk situations, but also reports regularly to the Management Committee and the Board of Directors. Furthermore, SMBC's ALM Committee meets on a monthly basis to examine reports on the state of observance of the bank's limits on market and liquidity risks, and to review and discuss the SMBC's ALM policies.

To prevent unforeseen processing errors as well as fraudulent transactions, it is important to establish a system of checks on the business units (front office). At SMBC, both the processing departments (back office) and the administrative departments

### ■ SMBC's Market Risk and Liquidity Risk Management System





(middle office) conduct the checks. In addition, SMBC's independent Internal Audit Unit periodically performs comprehensive internal audits to verify that the risk management system is functioning properly.

### 3. Market and Liquidity Risk Management Methods

#### (1) Market Risk Management

SMBC manages market risk by setting maximum limits for "VaR" and maximum loss. These limits are set within the "market risk capital limit" which is determined taking into account the bank's shareholders' equity and other principal indicators of the bank's financial position and management resources.

Market risk can be divided into various factors: foreign exchange rate, interest rate, equity price, and option risks. Finetuned management of 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 BPV indicator.

Please note that, in the case of interest rate fluctuation risk, the methods for recognizing the dates for maturity of demand deposits (current accounts and ordinary deposit accounts that can be withdrawn at any time) and the method for estimating the time of cancellation prior to maturity of time deposits and consumer loans differ substantially. At SMBC, the maturity of demand deposits that are expected to be left with the bank for a prolonged period is regarded to be five years (2.5 years on average). The cancellation prior to maturity of time deposits and consumer loans is estimated based on historical data.

#### (a) VaR Results

The results of VaR calculations for fiscal 2008 are shown in the table below. SMBC's internal VaR model makes use of historical data to prepare scenarios for market fluctuations, and, by conducting simulations of gains and losses, the model estimates the

maximum losses that may occur (This is known as the historical simulation method). This internal SMBC model is evaluated periodically by an independent auditing firm to assess its appropriateness and accuracy.

#### (b) Back-Testing Results

The relationship between the VaR calculated with the model and the actual profit and loss data is back-tested daily. The back-testing results for SMBC's trading accounts for fiscal 2008 are shown below. A data point below the diagonal line indicates a loss in excess of the predicted VaR for that day; however, as in fiscal 2007, there were no such excess losses during fiscal 2008. This demonstrates that the SMBC VaR model, with a one-sided confidence interval of 99.0%, is sufficiently reliable.

#### Glossary

##### 1. VaR (Value at risk)

The largest predicted loss that is possible given a fixed confidence interval. For example, VaR indicates, for a holding period of one day and a confidence interval of 99.0%, the maximum loss that may occur as a result of market fluctuations in one day with a probability of 1%.

##### 2. BPV (Basis point value)

The amount of change in assessed value as a result of a one basis point (0.01%) movement in interest rates.

##### 3. Trading

A market operation for generating profit by taking advantage of short-term fluctuations in market values and differences in value among markets.

##### 4. Banking

A market operation for generating profit through management of interest rates, terms, and other aspects of assets (loans, bonds, etc.) and liabilities (deposits, etc.).

#### ■ VaR Results

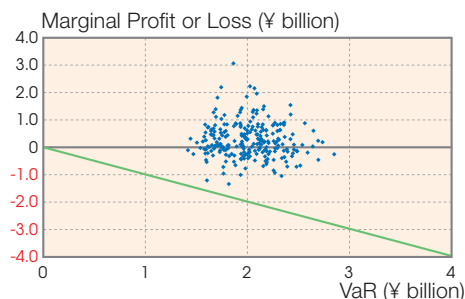
(Billions of yen)

|            | SMFG (consolidated) |              | SMBC (consolidated) |              | SMBC (nonconsolidated) |              |
|------------|---------------------|--------------|---------------------|--------------|------------------------|--------------|
|            | Trading Book        | Banking Book | Trading Book        | Banking Book | Trading Book           | Banking Book |
| June 2008  | 1.9                 | 31.4         | 1.9                 | 28.3         | 1.1                    | 24.9         |
| Sept. 2008 | 2.1                 | 29.0         | 2.1                 | 26.0         | 1.6                    | 23.0         |
| Dec. 2008  | 2.1                 | 36.6         | 2.1                 | 34.4         | 1.9                    | 31.4         |
| Mar. 2009  | 2.0                 | 41.4         | 2.0                 | 39.2         | 1.6                    | 35.9         |
| Maximum    | 2.8                 | 43.9         | 2.8                 | 41.8         | 2.3                    | 38.9         |
| Minimum    | 1.4                 | 26.9         | 1.4                 | 24.0         | 1.1                    | 20.9         |
| Average    | 2.0                 | 34.2         | 2.0                 | 31.5         | 1.5                    | 28.2         |

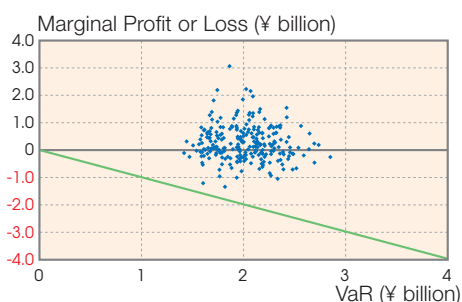
Note: VaR for a one-day holding period with a one-sided confidence interval of 99.0% [computed daily using historical simulation method (based on four years of historical observations)]. The VaR model for the trading book includes principal consolidated subsidiaries. Figures for the trading book exclude specific risks.

## ■ Back-Testing Results (Trading Book)

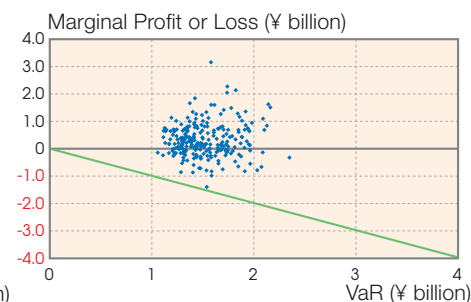
### SMFG (consolidated)



### SMBC (consolidated)



### SMBC (nonconsolidated)



### (c) Stress Testing

The market occasionally undergoes extreme fluctuations that exceed projections. To manage market risk, therefore, it is important to run simulations of situations that may occur only once in many years (stress tests). At SMBC, monthly stress tests using scenarios of past market fluctuations, those not related to past market fluctuations, and specific-factor driven market fluctuations are conducted to prepare for unforeseeable swings.

### (d) Outlier Framework

In the event the economic value of a bank declines by more than 20% of the sum of Tier I and Tier II capital ("outlier ratio") as a result of interest rate shocks, the bank falls into the category of "outlier bank," as stipulated under the Second Pillar of Basel II.

As of March 31, 2009, the outlier ratio was less than 9%, substantially below the 20% criterion.

### (e) Managing Risk of Stocks Held for Strategic Purposes

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

SMBC has been reducing strategic equity investments, and the balance now stands at less than 50% of Tier I capital.

## (2) Liquidity Risk

At SMBC, liquidity risk is regarded as 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 setting 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.

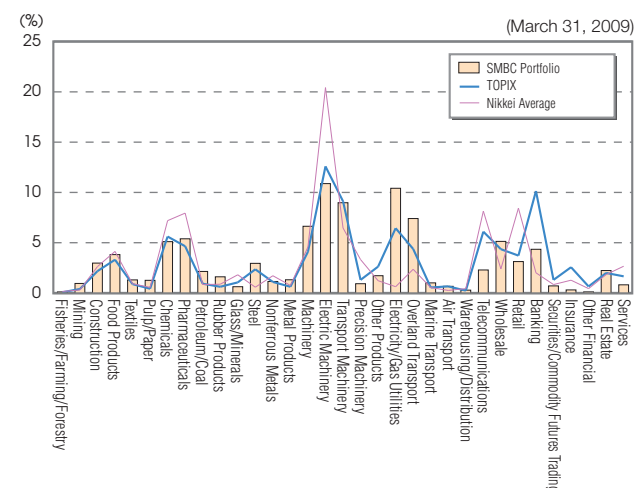
## ■ Decline in Economic Value Based on Outlier Framework

(Billions of yen)

|                                      | SMBC (consolidated) |                | SMBC (nonconsolidated) |                |
|--------------------------------------|---------------------|----------------|------------------------|----------------|
|                                      | March 31, 2008      | March 31, 2009 | March 31, 2008         | March 31, 2009 |
| Total                                | 407.4               | 588.4          | 398.5                  | 561.7          |
| Impact of yen interest rates         | 154.2               | 272.4          | 149.7                  | 249.3          |
| Impact of U.S. dollar interest rates | 196.1               | 202.4          | 193.9                  | 200.0          |
| Impact of Euro interest rates        | 36.7                | 60.4           | 36.6                   | 60.1           |
| Percentage of Tier I + Tier II       | 5.4%                | 8.6%           | 5.8%                   | 8.9%           |

Note: "Decline in economic value" is the decline of present value after interest rate shocks (1st and 99th percentile of observed interest rate changes using a 1-year holding period and 5 years of observations).

## ■ Composition, by Industry, of Listed Equity Portfolio



## Operational Risk

### 1. Basic Approach to Operational Risk Management

#### (1) Definition of Operational Risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Specifically, Basel II—which, in addition to processing risk and systems risk, also covers legal risk, personnel risk, and physical asset risk—defines the following seven types of events that may lead to the risk of loss: (1) internal fraud, (2) external fraud, (3) employment practices and workplace safety, (4) clients, products and business practices, (5) damage to physical assets, (6) business disruption and system failures, and (7) execution, delivery, and process management.

#### (2) Fundamental Principles for Operational Risk Management

SMFG and SMBC have drawn up the *Regulations on Operational Risk Management* to define the basic rules to be observed in the conduct of operational risk management across the entire Group. Under these regulations, SMFG and SMBC have been working to enhance the operational risk management framework across the whole Group by establishing an effective system for identification, assessment, controlling, and monitoring of material operational risk and a system for executing contingency and business continuity plans. In view of the inclusion of operational risk in the framework of the capital adequacy requirements of Basel II, SMFG has been working on a continuing basis to create a more sophisticated quantification model and to enhance operational risk management throughout the Group.

### 2. Operational Risk Management System

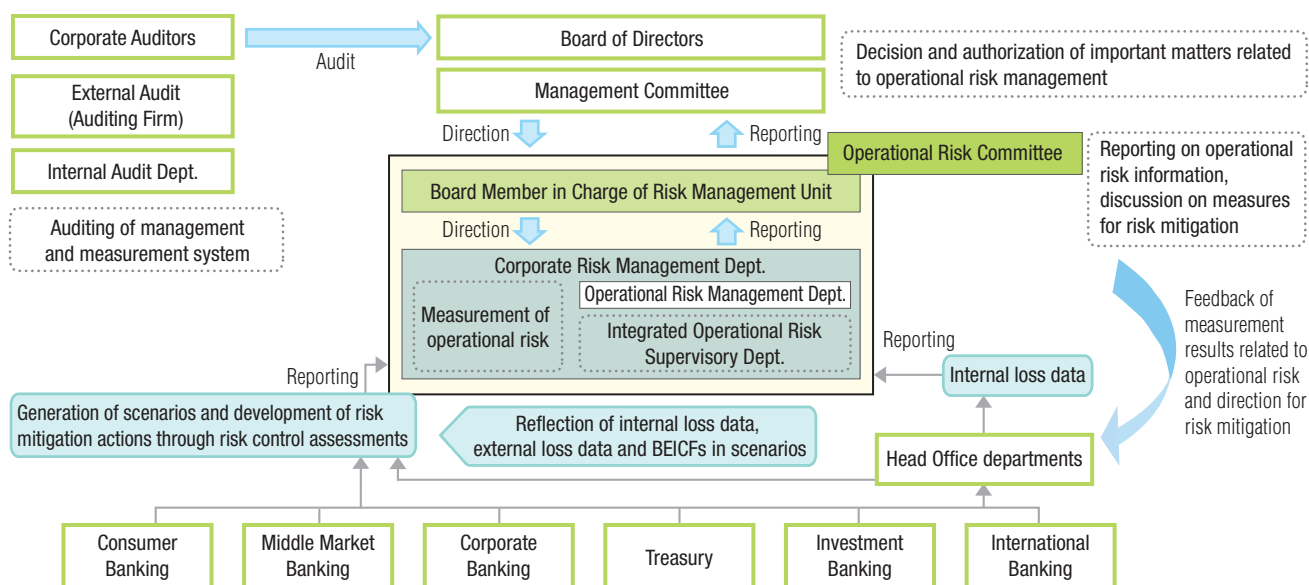
SMFG has designed and implemented an operational risk management framework for Groupwide basic policies for risk management.

At SMBC, the Management Committee makes decisions on important matters such as basic policies for operational risk management, and these decisions are authorized by the SMBC Board of Directors. In addition, SMBC has established its Operational Risk Management Department, within the Corporate Risk Management Department as an integrated operational risk management department. This department works together with other departments responsible for controlling processing risk and systems risk.

The operational risk management framework is described in more detail in the later part of this section, but it can be outlined as follows: operational risk is managed by (1) collecting and analyzing internal loss data, and (2) comprehensively identifying risk scenarios in each business process through a regular risk control assessment to estimate the loss severity and frequency. Operational risk impact is assessed for each risk scenario. When high-severity scenarios are identified, each branch/department establishes a risk mitigation plan and the Operational Risk Management Department monitors the progress. Furthermore, operational risk is quantified using the internal loss data and scenarios, and the results of quantification are used to manage and reduce operational risk.

The generation of internal loss data, scenarios identified through risk control assessments, and status of risk mitigation

### ■ SMBC's Operational Risk Management System



activities are regularly reported to the director in charge of the Operational Risk Management Department. In addition, there is the Operational Risk Committee, comprising all relevant units of the bank, where operational risk information is reported and risk mitigation plans are discussed. In this way, we realize a highly effective operational risk management framework. The operational risk situation is also reported to the Management Committee and the Board of Directors on a regular basis, for review of the basic policies on operational risk management. Moreover, the bank's independent Internal Audit Department conducts periodic audits to ensure that the operational risk management system is functioning properly.

### 3. Operational Risk Management Methodology

As previously defined, operational risk covers a wide range of events, including the risk of losses due to errors in operation, system failures, and natural disasters. Also, operational risk events can occur virtually anywhere and everywhere. Thus, it is essential to check whether material operational risks have been overlooked, monitor the overall status of risks, and manage/control them. To this end, it is necessary to be able to quantify risks using a measurement methodology that can be applied to all types of operational risk, and to comprehensively and comparatively capture the status of and changes in potential operational risks of business processes. Also, from the viewpoint of internal control, the measurement methodology used to create a risk mitigation plan must be such that the implementation of the plan quantitatively reduces operational risk.

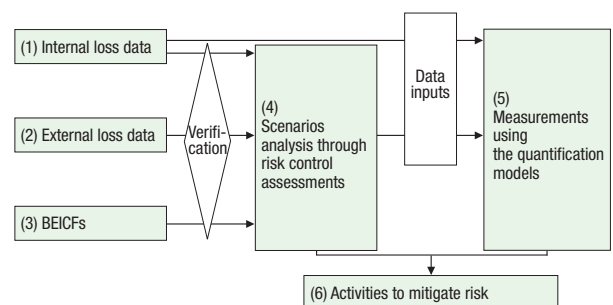
SMFG and SMBC have received an approval from Japan's Financial Services Agency for the application of the Advanced Measurement Approaches (AMA), which is the most sophisticated measurement method out of the three cited methods under Basel II for measurement of operational risk. SMFG and SMBC have adopted the AMA for operational risk management and for calculating operational risk-weighted assets. It has been used for calculating the capital adequacy ratio since March 31, 2008.

When using the AMA, regulations require that the internal measurement system (hereinafter, the "quantification model") must use four data elements (hereinafter, the "four elements"): namely, internal loss data, external loss data, Business Environment and Internal Control Factors (BEICFs), and scenarios analysis through risk control assessments. In addition, the operational risk equivalent amount (hereinafter, "required capital") calculated under the AMA must cover the maximum loss comparable to a one-year holding period and a 99.9 percentile confidence interval.

The basic framework of the AMA quantification model of SMFG and SMBC is outlined in the diagram below. Among the four elements, collected internal loss data and the results of scenarios analysis through risk control assessment are input directly into the quantification model described later in this section to calculate required capital and risk-weighted assets (= required capital divided by 8%). In addition, external loss data and BEICFs are used in verifying the assessment of scenarios, along with internal loss data, to increase objectivity, accuracy, and completeness.

The specific content and method of collection and use of the four elements are described below. At present, 20 Group companies have adopted the AMA, including SMFG and SMBC, and all Group companies collect and make use of the four elements.

#### Basic Framework of Operational Risk Measurement of SMFG and SMBC



### (1) Internal Loss Data

Internal loss data are defined as “the information on events in which SMFG and SMBC incur losses resulting from the realization of operational risk.” At SMFG and SMBC, internal loss data are collected for all cases where the gross loss amount is at least one yen (the threshold amount), and seven years of internal loss data are directly used in the quantification of required capital for operational risk.

### (2) External Loss Data

External loss data are defined as “the information on events in which other banks, etc., incur losses resulting from the realization of operational risk.” SMFG and other Group companies collect external loss data where such losses may occur within the Group. Please note that SMFG and SMBC have compiled external loss data for more than 6,000 cases over the past eight years, which are indirectly used in quantifying required capital for operational risk.

### (3) Business Environment and Internal Control Factors (BEICFs)

BEICFs are defined as “indicators of operational risk profiles of SMFG and SMBC that reflect underlying business risk factors and an assessment of the effectiveness of the internal control factors.” The Group periodically collects data relating to changes in laws and regulations, changes in internal rules and processes, and launch of new business and products pertinent to the Group’s business operations.

### (4) Scenario Analysis through Risk Control Assessments

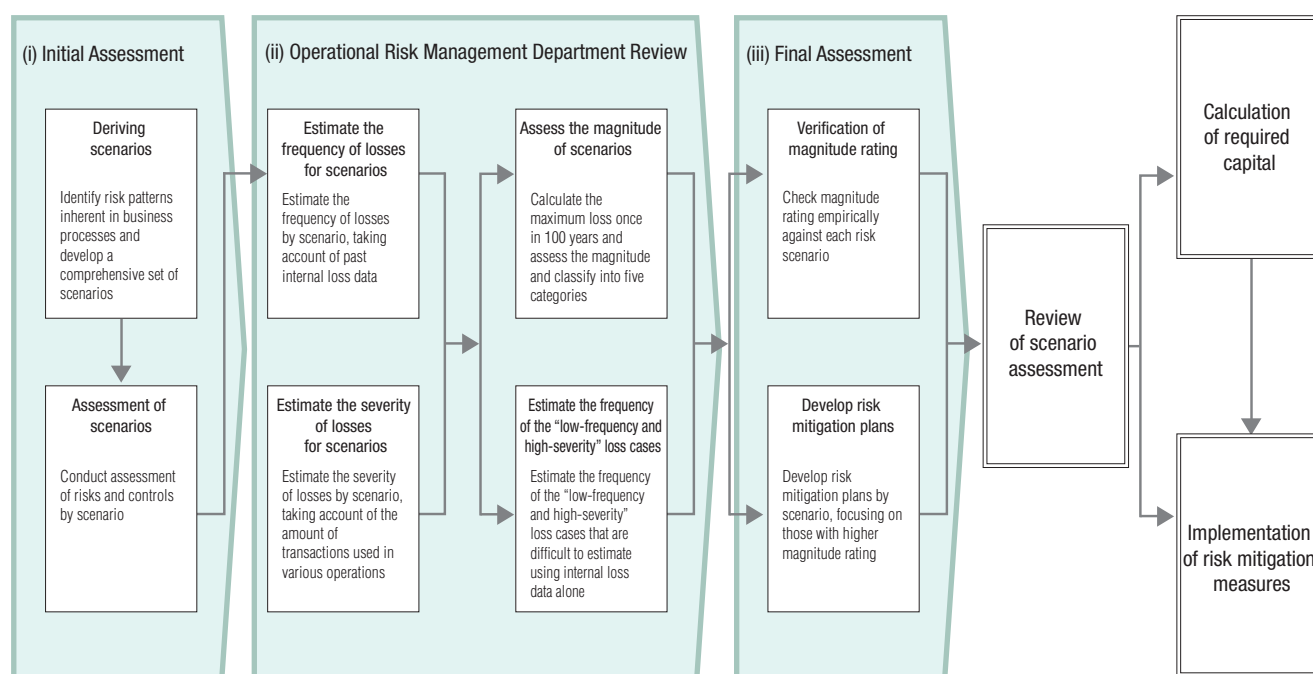
Risk control assessment is defined as “risk management methodology to (a) identify material operational risks, and describe them in terms of risk scenarios, (b) assess the risks and the effectiveness of controls, and (c) estimate the frequency and severity of risk scenarios.” SMFG and SMBC apply this methodology to their principal business activities.

The purpose of risk control assessment is to identify material and potential operational risks pertinent to business processes, to measure them, and to develop and carry out a risk mitigation plan to manage the risks. Another purpose of risk control assessment is to estimate the frequency of low-frequency and high-severity events for each scenario (which may be difficult to estimate using internal loss data alone).

During the process of periodic risk control assessment, operational risks inherent in various business processes are recognized as “scenarios.” The risk and control conditions for each scenario are assessed, and the frequency of occurrence and amount of losses are estimated based on them. The assessment process comprises three steps: (i) initial assessment, (ii) Operational Risk Management Department review, and (iii) final assessment. Through the process, the frequency of “low-frequency and high-severity” events for each scenario are estimated in terms of four loss amounts (¥100 million, ¥1 billion, ¥5 billion, and ¥10 billion). Please note that SMFG and SMBC have identified more than 9,000 risk scenarios for the Group on a consolidated basis.

As an effective mechanism for mitigating operational risks,

### ■ Flowchart for Risk Control Assessment (Example)





the maximum loss occurring once in 100 years (hereinafter, “scenario exposure”) is calculated for each scenario derived through the risk control assessment, and then a magnitude rating is provided by classifying them into five categories according to the severity of loss. Risk mitigation plans are developed by the relevant business units for those scenarios with high-severity risk identified through magnitude rating.

The principal features of this risk control assessment method are (1) “objectivity,” which is realized by estimating the frequency of losses based on historical internal loss experience and by estimating the severity of losses based on the transaction amounts pertinent to the scenarios, and (2) an appropriate level of “sensitivity,” because changes in the business environment and the implementation of risk mitigation measures can be reflected in the frequency and severity of losses by changing the assessment of risk and control as well as transactions amounts.

## (5) Measurement Using Quantification Models

SMFG, SMBC, and other Group companies using the AMA measure the maximum operational loss with a 99.9 percentile confidence interval and a holding period of one year (hereinafter referred to as 99.9% VaR) by using the four elements. In addition, 99.9% VaR is measured on an SMFG consolidated basis, SMBC consolidated basis, and SMBC nonconsolidated basis. The operational risk is measured for each of seven event types defined under Basel II, and then, by calculating the simple sum for all event types, 99.9% VaR is measured for each company

applying the AMA. Meanwhile, the Basic Indicator Approach (BIA) is applied to estimate maximum operational risk losses for Group companies other than those applying the AMA. Then, the required capital and risk-weighted assets for SMFG and SMBC Group are measured by aggregating these figures.

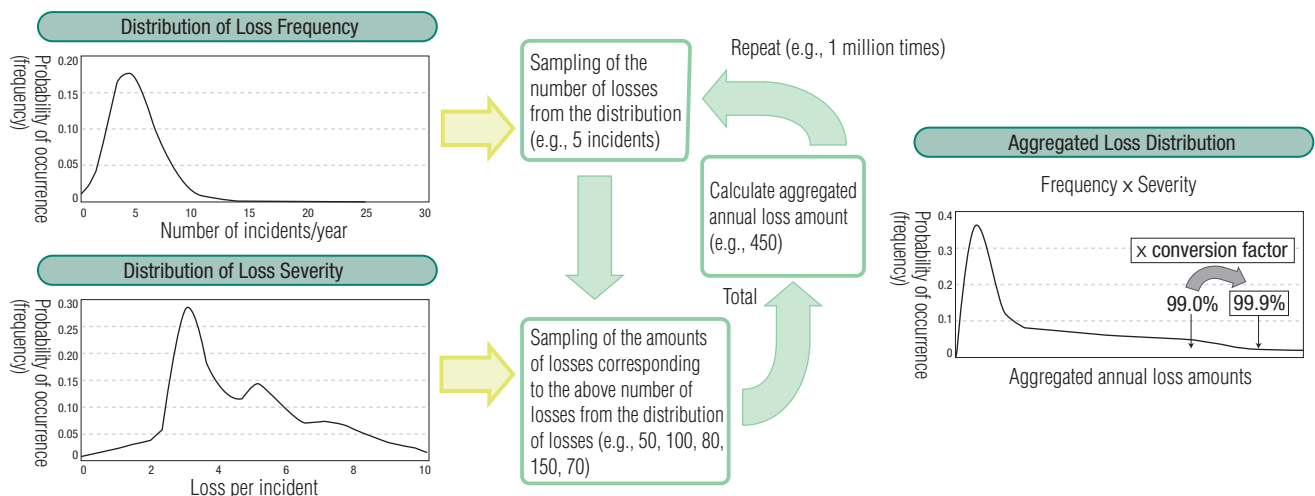
The outline of the quantification model for SMBC is as follows. First, we generate a loss frequency distribution (number of loss incidents over a one-year period) based on the number of historical internal losses. Then, we generate a loss severity distribution (amount of loss per loss incident) based on internal losses and frequency of “low-frequency and high-severity” events obtained through the risk control assessment.

By using the loss frequency and loss severity distributions, the aggregated loss severity distribution is generated by conducting Monte Carlo simulations and by generating various combinations of loss occurrence and loss amount which are simulated by changing these two factors. 99.0% VaR is calculated from the resulting aggregated loss severity distribution.

Finally, we multiply 99.0% VaR by a conversion factor mentioned later in the section of “Capital Ratio Information” to compute 99.9% VaR.

This quantification model takes into account not only empirical internal loss data but also potential risk (scenarios) identified in the risk control assessment. An important feature of this model is that it enables us to measure and reflect the “low-frequency and high severity” events of operational risk. Moreover, by introducing a conversion factor, it is unnecessary to directly estimate

## ■ Measurement Using Quantification Models



99.9% VaR, which tends to have a lower accuracy, and stable estimation results can be obtained by estimating 99.0% VaR which can be estimated with higher accuracy.

Please note that the accuracy of quantification model outputs described above is secured through the regular ex ante and ex post facto verification processes.

The breakdown of risk-weighted assets by event type for the Group on a consolidated basis, computed with the previously described quantification method, is as follows.

## ■ Breakdown of Consolidated Risk-Weighted Assets by Event Type

(March 31, 2009)

| Event Type                                      | Percentage |
|---|------------|
| (1) Internal fraud                              | 9%         |
| (2) External fraud                              | 8%         |
| (3) Employment practices and workplace safety   | 2%         |
| (4) Clients, products, and business practices   | 24%        |
| (5) Damage to physical assets                   | 11%        |
| (6) Business disruption and system failures     | 4%         |
| (7) Execution, delivery, and process management | 42%        |

Note: Only risk-weighted assets calculated under the AMA.

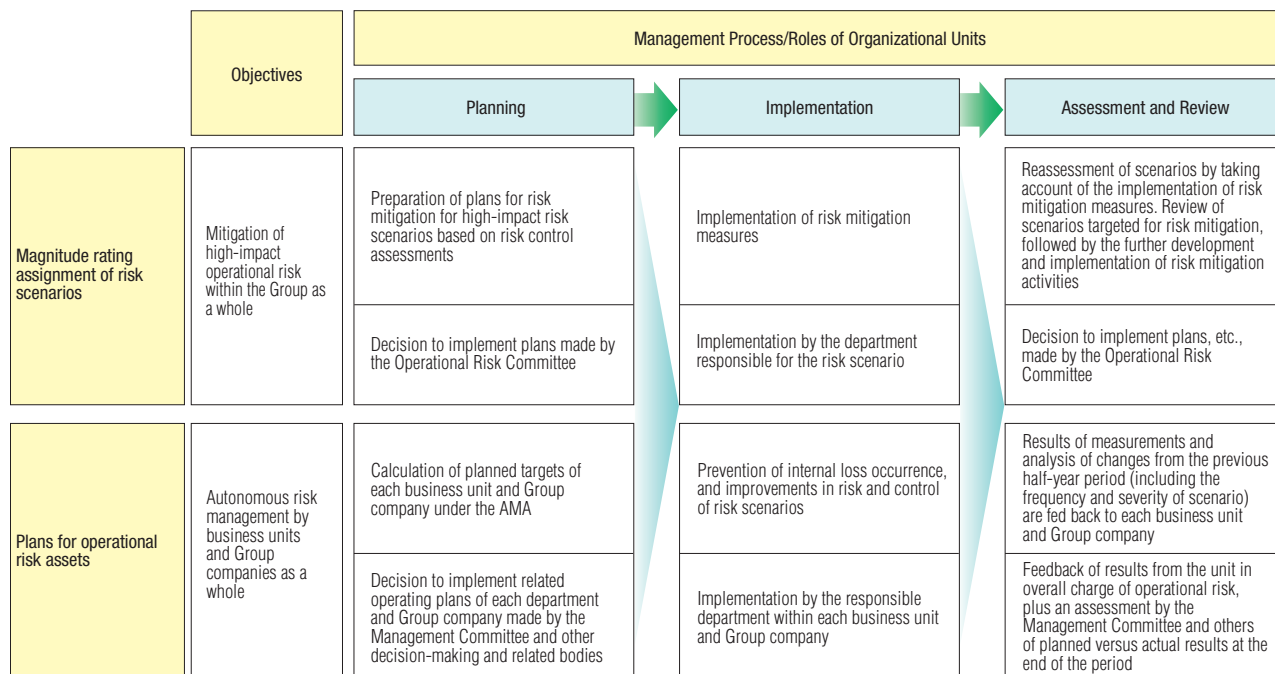
## (6) Risk Mitigation Initiatives

To mitigate risk using the quantitative results of the AMA, SMFG and SMBC implement risk mitigation measures to high-severity risk scenarios identified in the previously mentioned magnitude rating.

In addition to the above, the operational risk-weighted assets calculated using the quantification methods are allocated to the business units of SMBC and other Group companies, as part of initiatives to mitigate risk for the Group as a whole.

Specifically, (1) at the beginning of each fiscal year, the operational risk-weighted assets calculated using the internal loss data and the scenario exposure determined from the risk control assessment are allocated to each business unit and Group company, (2) during the fiscal year, each business unit and Group company work to prevent the realization of operational risk and improve scenario control by implementing risk mitigation measures, (3) during the first and second halves of the fiscal year, the measurements of risk-weighted assets of each business unit and Group company and an analysis of factors causing the change from the previous half-year period (including the frequency and severity of scenario) are fed back to the business units and Group companies for revising their plans, and, (4) finally, at the end of the fiscal year, by comparing the planned versus actual results, we endeavor to enhance the awareness of operational risk, improve the effectiveness of operational risk management, and mitigate operational risk within the Group as a whole.

## ■ SMFG's Operational Risk Mitigation Activities on a Semi-Annual Basis



#### 4. Processing Risk

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

SMFG recognizes that all operations entail processing 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 risk under management.

In the administrative regulations of SMBC, in line with SMFG's Groupwide basic policies for risk management, the basic administrative regulations are defined 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: operations planning departments, compliance departments, operations departments, transaction execution departments (primarily front-office departments, branches, and branch service offices), internal audit departments, and the customer support departments. In addition, there is a specialized group within the Operations Planning Department to strengthen administrative procedures throughout the Group.

#### 5. Systems Risk

Systems risk is the possibility of a loss arising from the failure, malfunction, or unauthorized use of computer systems.

SMFG recognizes that reliable computer systems are 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 system 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).

Computer-related trouble at financial institutions now has greater potential to impact society, with systems risk diversifying owing to the IT revolution, the resulting expansion of networks and the rise in the number of personal computer users. To prevent any computer system breakdowns, we have taken numerous measures, including constant maintenance of our computer system to ensure steady and uninterrupted operation, duplication of various systems and infrastructures, and the establishment of a disaster-prevention system consisting of computer centers in eastern and western Japan. And 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 necessary 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 responsible for coordinating the management of settlement risk with the Credit & Investment Planning Department, which oversees credit risk, and the Corporate Risk Management Department, which oversees liquidity risk.