Asset Quality

I. Self-Assessment, Write-Offs, and Provisions

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 Guidelines* 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 the efforts to bolster risk management throughout the Group, all 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

Asset Write-Offs and Provisions

In cases where claims have been determined 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 "direct write-off," or else by the recognition of a loan loss provision on a contra-asset account in the amount deemed uncollectible, referred to as "indirect write-off." Recognition of indirect write-offs is generally known as "provision for reserve for possible loan losses."

SMBC's write-off and provision standards 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 discount 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 the repayment of principal and interest received can be reasonably estimated. 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 DCF formula input values, such as the discount rate and the probability of the borrower going into bankruptcy, SMBC uses the best available data to calculate the estimates.

II. Credit Cost

Credit cost, with respect to provisioning, is the total amount of provisions newly made, and in the case of write-offs, it is the amount of provisions already made deducted from the uncollectible amount. The credit cost for the first half of fiscal 2008 for SMBC was ¥224.1 billion, a year-on-year increase of ¥109.9 billion, due principally to the unexpected costs related to the deterioration in the financial condition of borrowers against a backdrop of financial market turmoil and global economic slowdown.

◆ Credit Cost (SMBC Nonconsolidated; six months ended September 30, 2008)

(Billions of yen)

Credit cost	¥224.1
Provision for general reserve for possible loan losses	3.7
Write-off of loans	119.4
Provision for specific reserve for possible loan losses	86.4
Losses on sale of loans	14.6
Provision for loan loss reserve for specific overseas countries	0.0
Gains on collection of written-off claims	(0.0)
Reserve for possible loan losses	¥639.0
Amount of direct reduction	¥446.1

Note: Bracketed amount indicates gains.

◆ Credit Cost (SMFG Consolidated; six months ended September 30, 2008)

(Billions of yen)

Total credit cost	¥302.1
Reserve for possible loan losses	¥899.9
Amount of direct reduction	¥639.4

◆ Reserve for Possible Loan Losses (September 30, 2008)

(Billions of yen)

	SMBC (Nonconsolidated)	SMFG (Consolidated)
Reserve for possible loan losses	¥639.0	¥899.9
General reserve	434.6	614.0
Specific reserve	204.4	285.9
Loan loss reserve for specific overseas countries	0.0	0.0
Amount of direct reduction	¥446.1	¥639.4

III. Disclosure of Problem Assets and Off-Balancing

Disclosure of Problem Assets

Problem assets are loans and other claims 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. The following tables explain the asset classification stipulated by the Financial Reconstruction Law and the differences between risk-monitored loans and problem assets.

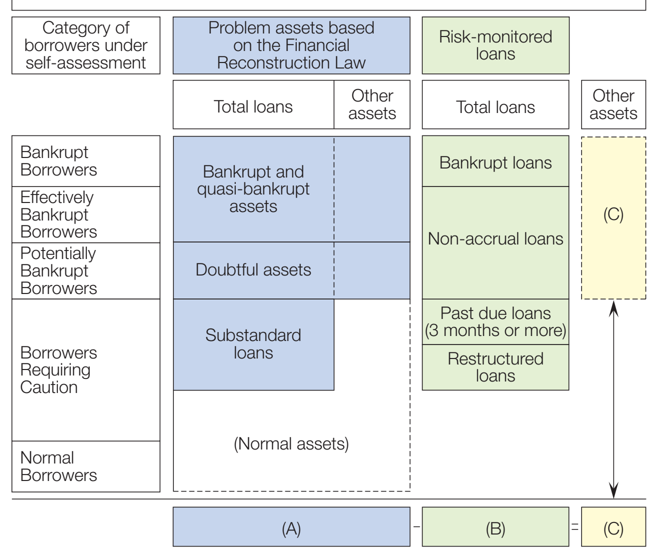
The disclosure of risk-monitored loans under the Banking Law corresponds exactly to the disclosure of problem assets based on the Financial Reconstruction Law, except for such non-loan assets as those related to securities lending and foreign exchanges, accrued interest, suspense payments, customers’ liabilities for acceptances and guarantees, and bank-guaranteed bonds sold through private placements, none of which are subject to disclosure.

Since overdue interest from borrowers classified under self-assessment as Potentially Bankrupt Borrowers, Effectively Bankrupt Borrowers, and Bankrupt Borrowers is, as a rule, not recognized as accrued interest, the amount is not included in the problem assets disclosed on the basis of the Financial Reconstruction Law.

Classification of Problem Assets Based on the Financial Reconstruction Law

Bankrupt and quasi-bankrupt assets	This category is defined as the sum of claims on Bankrupt Borrowers and Effectively Bankrupt Borrowers under self-assessment, excluding Classification IV assets, which are fully written off. Classification III assets are fully covered by reserves, and Classification I and II assets, the collectible portion, are secured by collateral, guarantees, or other means.
Doubtful assets	This category is defined as claims on Potentially Bankrupt Borrowers under self-assessment. Specific reserves are set aside for Classification III assets, and Classification I and II assets, the collectible portion, are secured by collateral, guarantees, or other means.
Substandard loans	This category is defined as claims on Borrowers Requiring Caution under self-assessment. This category comprises past due loans (three months or more) and restructured loans.
Normal assets	This category is defined as the term-end sum of loans, securities lending, import and export, accrued interest, suspense payments, customers’ liabilities for acceptances and guarantees, and bank-guaranteed bonds sold through private placements that are not included in the other three categories.

Problem Assets Based on the Financial Reconstruction Law and Risk-Monitored Loans



Problem Asset Disclosure Amounts

The amounts of problem assets and risk-monitored loans, as of September 30, 2008, are shown in the table below. The balance of problem assets held by SMBC was ¥1,076.9 billion, an increase of ¥273.0 billion from the previous fiscal year-end amount of ¥803.9 billion.

In view of the recent deterioration in the business environment, SMBC will continue to actively take steps to prevent the generation of new nonperforming loans—such as enhancing measures to monitor and improve the creditworthiness of borrowers in order to maintain and increase asset quality—and further strengthen the soundness of its credit portfolio.

◆ Problem Assets Based on the Financial Reconstruction Law (September 30, 2008)

(Billions of yen)

	SMBC (Nonconsolidated)	Compared with March 31, 2008	SMFG (Consolidated)
Bankrupt and quasi-bankrupt assets	¥ 269.1	¥ 151.3	¥ 402.2
Doubtful assets	525.8	123.8	650.5
Substandard loans	282.0	(2.1)	416.4
Subtotal	¥ 1,076.9	¥ 273.0	¥ 1,469.1
Normal assets	65,343.4	1,415.3	70,667.1
Total	¥66,420.3	¥1,688.3	¥72,136.2
Amount of direct reduction	¥ 446.1		¥ 639.4

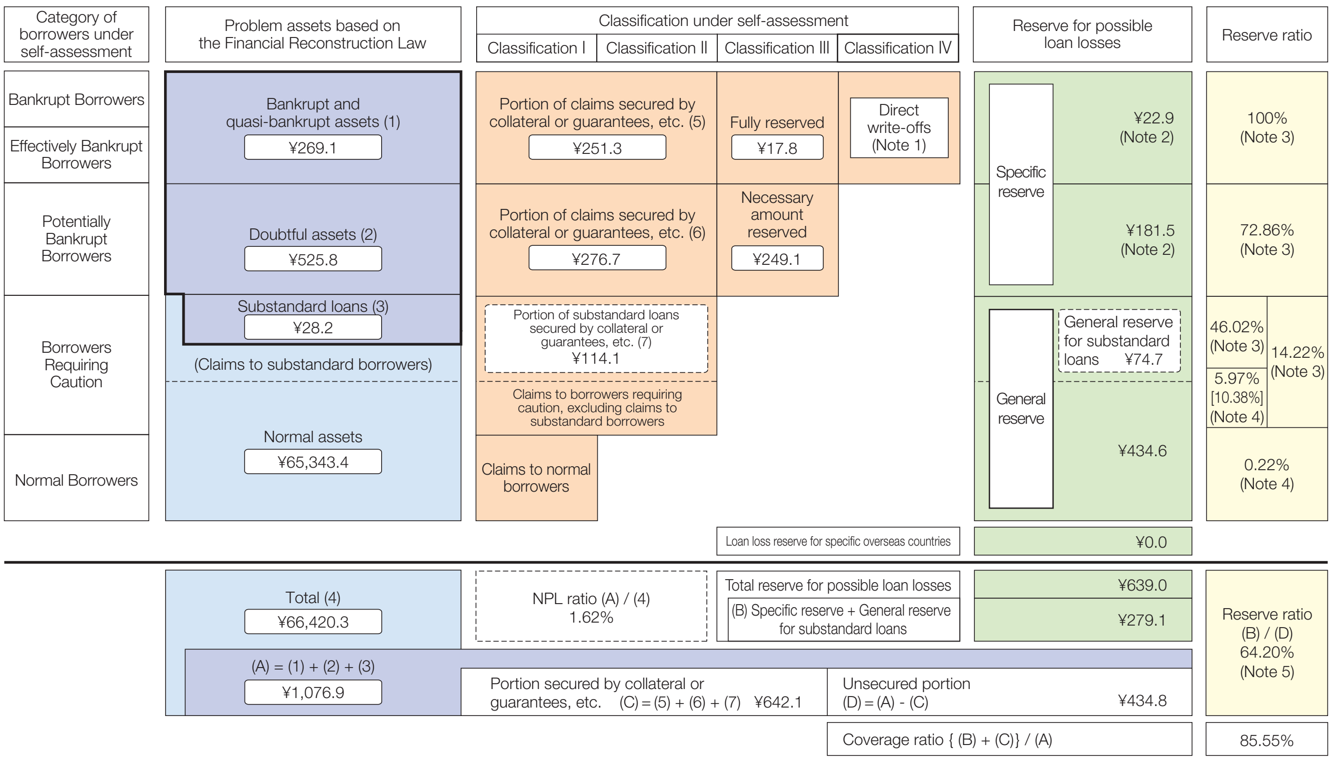
◆ Risk-Monitored Loans (September 30, 2008)

(Billions of yen)

	SMBC (Nonconsolidated)	Compared with March 31, 2008	SMFG (Consolidated)
Bankrupt loans	¥ 166.7	¥117.9	¥ 235.5
Non-accrual loans	581.0	143.3	771.9
Past due loans (3 months or more)	37.6	13.9	41.7
Restructured loans	244.4	(16.0)	366.3
Total	¥1,029.7	¥259.1	¥1,415.4
Amount of direct reduction	¥ 393.5		¥ 543.7

◆ Classification under Self-Assessment, Disclosure of Problem Assets, and Write-Offs/Reserves (SMBC Nonconsolidated; September 30, 2008)

(Billions of yen)



Notes: 1. Includes amount of direct reduction totaling ¥446.1 billion.
2. Includes reserves for assets that are not subject to disclosure under the Financial Reconstruction Law. (Bankrupt/Effectively Bankrupt Borrowers: ¥5.1 billion; Potentially Bankrupt Borrowers: ¥7.9 billion)
3. Reserve ratios for claims on Bankrupt/Effectively Bankrupt Borrowers, Potentially Bankrupt Borrowers, Substandard Borrowers, and Borrowers Requiring Caution: The proportion of each category's total unsecured claims covered by the reserve for possible loan losses.
4. Reserve ratios for claims on Normal Borrowers and Borrowers Requiring Caution (excluding claims to Substandard Borrowers): The proportion of each category's total claims covered by reserve for possible loan losses. The reserve ratio for unsecured claims on Borrowers Requiring Caution (excluding claims to Substandard Borrowers) is shown in brackets.
5. Reserve ratio = (Specific reserve + General reserve for substandard loans) ÷ (Bankrupt and quasi-bankrupt assets + Doubtful assets + Substandard loans - Portion secured by collateral guarantees, etc.)

Off-Balancing Problem Assets

The off-balancing (also known as "final disposal") of problem assets refers to the removal of such assets from SMBC's balance sheet by way of sale, direct write-offs, or other means.

SMBC off-balanced ¥185.0 billion in problem assets during the period under review.

◆ Breakdown of Off-Balancing (SMBC Nonconsolidated; September 30, 2008)

(Billions of yen)

	March 31, 2007 ①	Fiscal 2007		March 31, 2008 ②	First half of fiscal 2008		September 30, 2008 ③
		New occurrences	Off-balanced		New occurrences	Off-balanced	
Bankrupt and quasi-bankrupt assets	¥108.9	¥ 71.8	¥ (62.9)	¥117.8	¥168.0	¥ (16.7)	¥269.1
Doubtful assets	300.1	382.9	(281.0)	402.0	292.1	(168.3)	525.8
Total	¥409.0	¥454.7	¥(343.9)	¥519.8	¥460.1	¥(185.0)	¥794.9

	Increase/Decrease (② - ①)	Increase/Decrease (③ - ②)
Bankrupt and quasi-bankrupt assets	¥ 8.9	¥151.3
Doubtful assets	101.9	123.8
Total	¥110.8	¥275.1