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 banking.

At SMBC, we have established *Regulations on Risk Management,* encompassing all the fundamentals required of a risk management framework. In addition to specifying the types and areas of the risks that are to be managed according to our strategic objectives, these rules define the basic principles for appropriately controlling each type of risk. These principles include "risk management on a consolidated basis," "risk management based on quantification," "ensuring consistency with the business strategy," "framework for checks and balances," and "verification of the actual situation by independent audit departments."

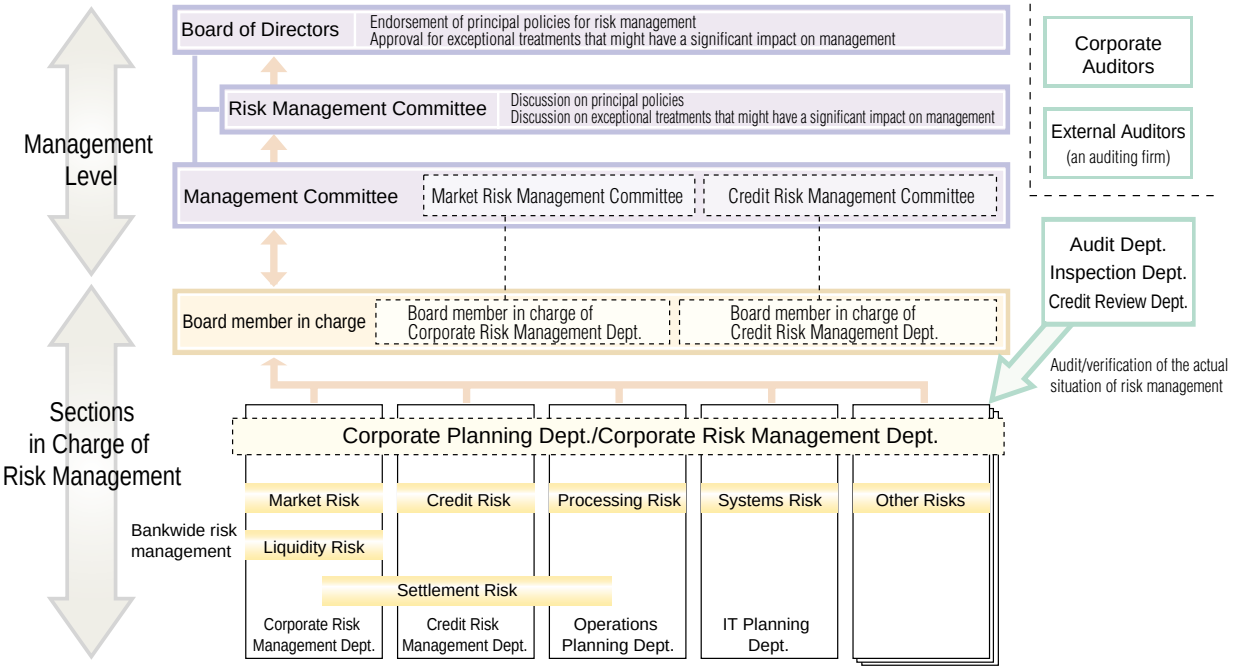
Risk Management System

Within the Bank, we classify risk into the following categories for control purposes: (1) credit risk, (2) market risk, (3) liquidity risk, (4) processing risk, (5) systems risk, and (6) other risk (settlement risk, legal risk, reputational risk, and others). Each department is charged with the control of risks at an appropriate level within its own business line. To control the risks included in items (1)–(5) above as well as settlement risk, we have designated certain departments as risk management departments to oversee specific risk control measures within each risk category. In addition, we established the Corporate Risk Management Department to be completely independent of the business units to manage these risks on a bankwide basis. This department works with the Corporate Planning Department to comprehensively and systematically manage risk.

The Bank's top management plays an active role in determining basic principles for risk management, reflecting the importance of risk management at SMBC. The system works as follows: The risk management departments supervising each risk category draft a principal policy for risk management for that category, which is then presented for approval by the Management Committee and considered by the Board's Risk Management Committee before being finalized by the Board. The Management Committee, the Board members, and the relevant risk management department heads perform risk management according to the principal policy.

To control market, liquidity, and credit risk, in particular, we have strengthened the decision-making system at the operating level through the Market Risk Management Committee and the Credit Risk Management Committee, which are subcommittees formed under the Management Committee that comprise the executive members of the Management Committee and the heads of the departments related to risk management.

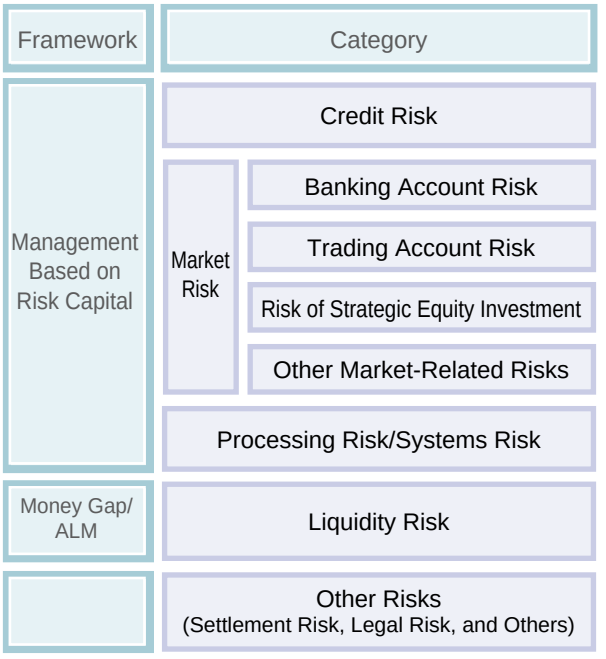
Also, to prepare for extraordinary events with the potential to have a crucial impact on the Bank's management and financial condition (stress situation), we are improving and strengthening our risk management system throughout the Bank.



Risk Management Methodologies

The risk management departments revise the basic risk management principles for each risk category on a regular basis, and whenever necessary, to ensure that the Bank's specific risk management policies promptly and accurately reflect new developments in the operating environment. Furthermore, in order to maintain a balance between risk and return as well as ensure the soundness of the Bank 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, processing, and systems risk within the scope of our management resources, i.e., capital. 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 guidelines are set as necessary within this limit to manage these risks. Liquidity risk is managed within a framework that includes plans for money gap and treasury funding. Other risk categories are managed with procedures closely attuned to the nature of the risk, as described in the following paragraphs.

■ **Correlation between Risk Management Framework and Risk Category**



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 that changes in currency values or political or economic situations cause a loss. Credit risk is the most significant risk to which banks are exposed. Without adequate credit risk management, the impact of the corresponding losses on a bank's operations can be overwhelming.

The purpose of credit risk management should be to avoid such credit events, to keep credit risk exposure within a bank's capital, to maintain the soundness of a bank's assets, and to ensure returns commensurate with risk. This allows a bank to build a loan portfolio that achieves highly efficient returns on capital and assets.

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 Bank's corporate philosophy and code of conduct. By promoting the understanding of and strict adherence to our credit policy among all Bank managers and employees, we aim to achieve the global standards of credit risk management stipulated in the New Basel Capital Accord and provide high value-added financial services.

2. Credit Risk Assessment and Quantification

To effectively manage the risk of individual loans as well as the credit portfolio as a whole, we first acknowledge that every credit poses risks. We then assess the credit risk posed by each borrower and loan using our internal rating system and quantify that risk for control purposes.

(1) Internal Rating System

The Bank'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 a borrower's obligor grading in consideration of transaction terms such as guarantee, tenor, and collateral. Overseas credits are subjected to a further analysis that takes into account the country ranking, an indicator derived from analyses of a country's political and economic situation, international balance of payments, and external debt burden. In order to maintain the consistency of the grading system as a whole, self-assessment is conducted to grade borrowers of low creditworthiness.

(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. We obtain an understanding of the risk dispersion 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.

■ Internal Rating System

Obligor's Grading				Facility Grading		Financial Reconstruction Law Based Disclosure Category (Domestic)
Grading	Subrating	Definition	Debtor Classification in Self-Assessment System	Grading	Subrating	
				S		Normal Assets
1	a b c	Extremely high certainty of redemption	Normal Borrowers	I	a b c	
2	a b c	High certainty of redemption		II	a b c	
3	a b c	Reasonable certainty of redemption		III	a b c	
4	A B C	Redemption is likely, but the debtor may be affected by large shifts in business conditions or its industry.		IV	A B C	
5	A B C	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 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 B C R	Requires management because there are problems meeting loan conditions or with collection, the business is weak or unstable, or the financial condition is poor.	Borrowers Requiring Caution A Borrowers Requiring Caution B Borrowers Requiring Caution C	VII	A B C	
		(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 are 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 Assessments

Credit assessments involve a variety of financial analyses, including cash flow, to predict an enterprise's capabilities for 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 also analyzed in terms of the intended utilization of the funds, the repayment schedule, and the state of its collateral. In this way, we are 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 our ongoing review of lending practices, and we are revising all loan contracts with the chief aim of clarifying the contractual conditions of the Bank's loans. We are making steady progress in rationalizing our credit assessment process. For example, our Business Support Offices now offer the highly convenient *Business Select Loan*, which employs a credit-scoring model. In this and other ways, the Bank 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 implemented in order to reassess the obligor's grading and review self-assessment 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, we apply 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

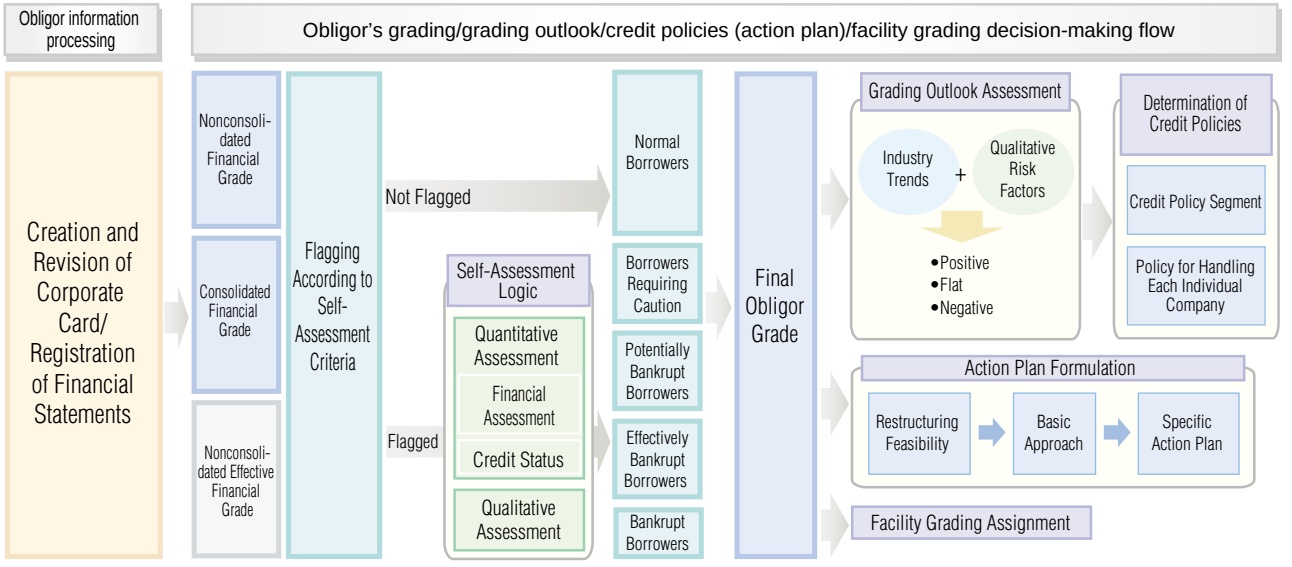
To control credit risk within the scope of our capital, we calculate the required credit risk capital through regular quantification of credit risk, and then set credit risk capital limits for internal control purposes and manage risk-taking activities within these limits.

(2) Controlling Concentration Risk

Because concentration of credit risk in an industry or corporate group has the potential to severely impact a bank's capital, SMBC implements credit control on those industries with excessive concentration risk. In addition to regular risk control and loan reviews, the Bank has also established other effective risk control methods such as credit limit guidelines for large-scale borrowers and corporate groups. To manage country risk, we also set up credit limit guidelines based on a country's creditworthiness.

(3) Balancing Risk and Return

We run our credit operations on the basic principle of earning returns that are commensurate with credit risk. From fiscal 2002, the year ending March 31, 2003, the Bank began to negotiate with borrowers to gain their acceptance of suitable interest rate spreads based on a standardized interest rate structure. This is part of the Bank's program to firmly establish a balanced risk/return management system, thereby ensuring that we are able to consistently generate an adequate profit after deducting the costs of credit and capital, as well as expenses.



(4) Reduction of Problem Loans

In order to counter concerns of increasing losses from the deterioration of existing problem loans or the appearance of new ones, we are striving to quickly reduce problem loans by conducting loan reviews to set new responses and clarify action plans, and by strengthening our recovery and asset value maintenance strategies.

(5) Toward Active Portfolio Management

In addition to controlling the individual loan approval process, we also actively manage our loan portfolio on an aggregate basis. The Portfolio Management Department spearheads the Bank's use of loan securitization in the markets to proactively manage our portfolio.

5. Credit Risk Management System

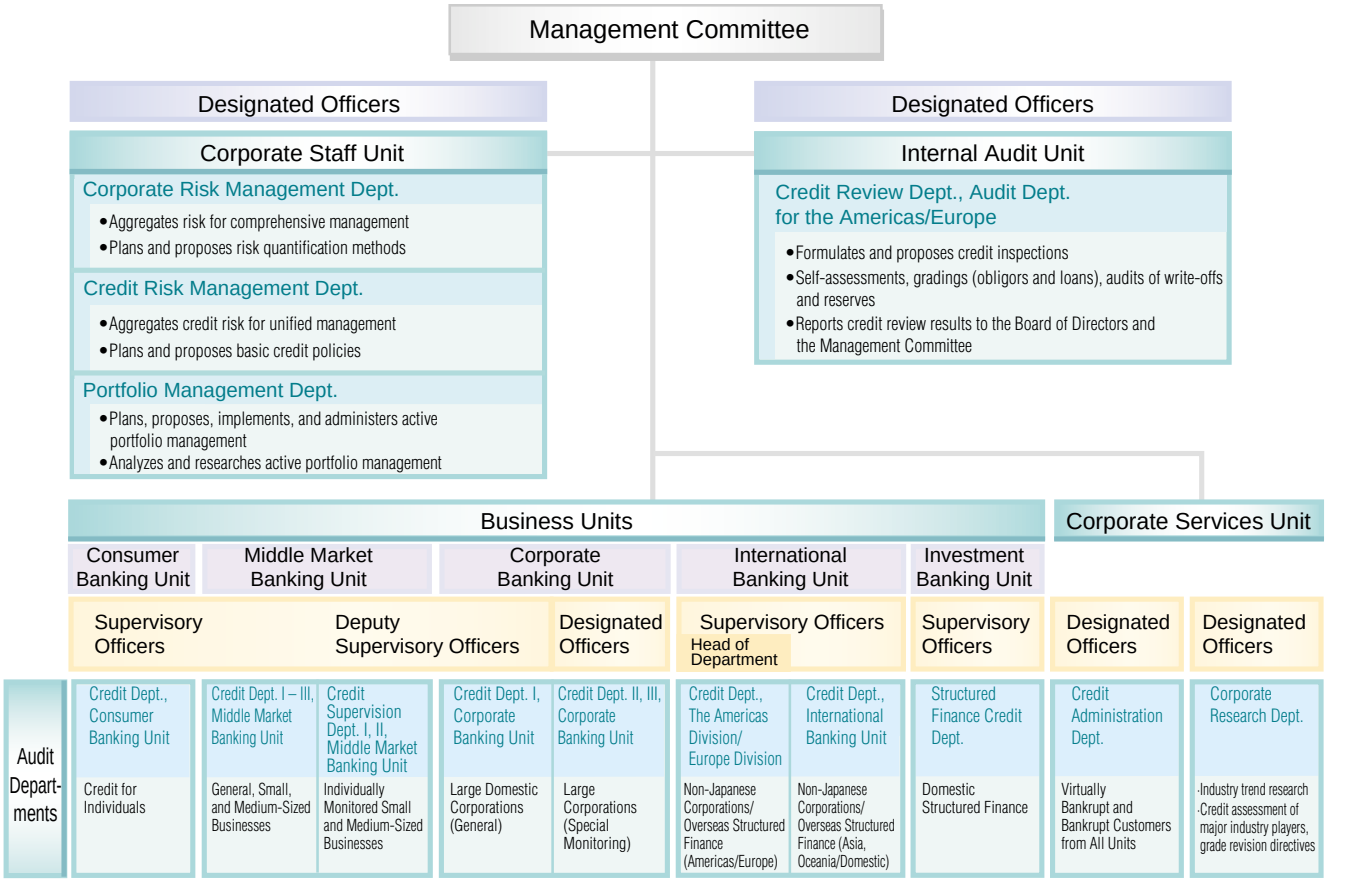
The Credit Risk Management Department within the Corporate Staff Unit is responsible for the comprehensive management of credit risk. This department determines credit policies, establishes the internal grading system, develops credit risk quantification methods, sets credit limits and approval limits, and manages problem loans and other aspects of the 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.

Each business unit's credit departments 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 grade category, with particular attention paid to evaluating and managing customers or loans perceived to have particularly high credit risk.

Bankrupt or effectively bankrupt companies are in principle handled by the Credit Administration Department, which works to recover nonperforming loans as quickly as possible.

The Credit Review Department, the Audit Department for the Americas, and the Audit Department for Europe operate independently of the business units, the Corporate Staff Unit, and the Corporate Services Unit. These departments audit the asset quality, accuracy of gradings, self-assessments, and state of credit operations, and report their audit results directly to the Board of Directors and the Management Committee.

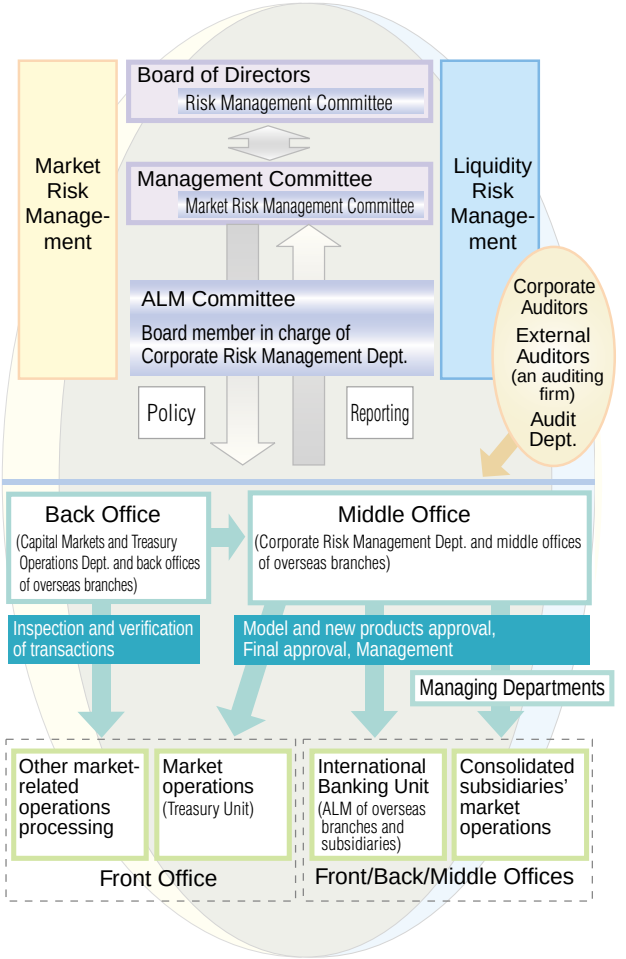


Market/Liquidity Risk

Market/Liquidity Risk Management System

The Corporate Risk Management Department, which is independent of the business units that handle market transactions, is constructing an integrated system to manage market and liquidity risk together. The department 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, the Bank's independent Internal Audit Unit periodically performs comprehensive internal audits to verify that our risk management system is functioning properly. To enhance our most sophisticated risk management methodologies, we adopt advanced financial theories, technologies, and infrastructures, develop systems, and hire and train experts.



Market 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.

The value-at-risk (VaR) method has proven effective in controlling 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 accurately 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. At SMBC, we achieve fine-tuned management for each risk category by employing the VaR method in conjunction with such suitable indicators for managing the risk of individual financial instruments 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. Whenever the VaR is likely to exceed the guidelines owing to sharp changes in the markets, we put contingency plans into effect and the ALM Committee convenes extraordinary meetings.

The market risk of our strategic equity holdings held by the units not in charge of market-related activities and the market risk taken by our 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 Management Committee.

The VaR results of the trading and banking accounts on a consolidated basis for fiscal 2001 were as follows:

■ VaR Results

(Billions of yen)

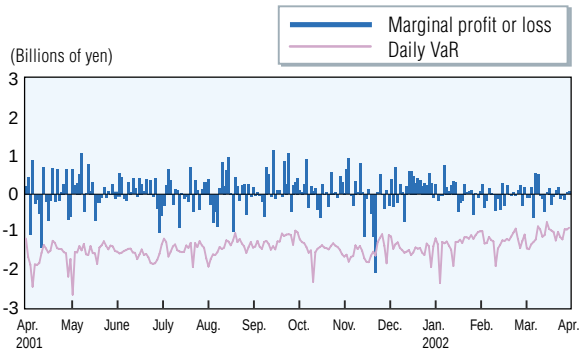
	Maximum	Minimum	Average	Last Day of Term
Trading Accounts	2.4	0.7	1.4	0.9
Banking Accounts	56.8	30.4	43.8	46.3

(Daily ALM risk level for the VaR model with one-sided confidence interval of 99.0%. Figures for trading exclude specific risks.)

The VaR model for trading includes major consolidated subsidiaries.

■ Marginal Profit or Loss/Daily VaR Results

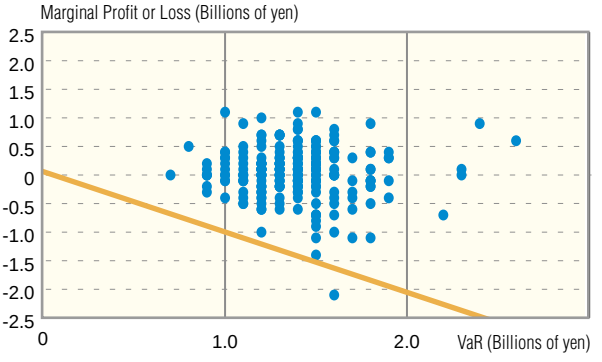
(Trading Accounts, for fiscal 2001)



The market occasionally undergoes extreme fluctuations that exceed expectations. 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, we run periodic stress tests to prepare for unforeseeable swings.

The internal model used by the Bank (SMBC VaR) has been periodically evaluated by an independent auditing firm and certified to be appropriate. In addition, we perform back-testing on the relationship between the VaR calculated with the model and the actual profit and loss data. The back-testing results for the trading accounts for fiscal 2001 are shown below. A data point below the diagonal line indicates a loss in excess of the predicted VaR for that day. On only one day during the period did an actual loss exceed our model's predicted VaR. This fact demonstrates that our VaR model, with a one-sided confidence interval of 99%, is sufficiently reliable.

■ Back-Testing Results (Trading Accounts)

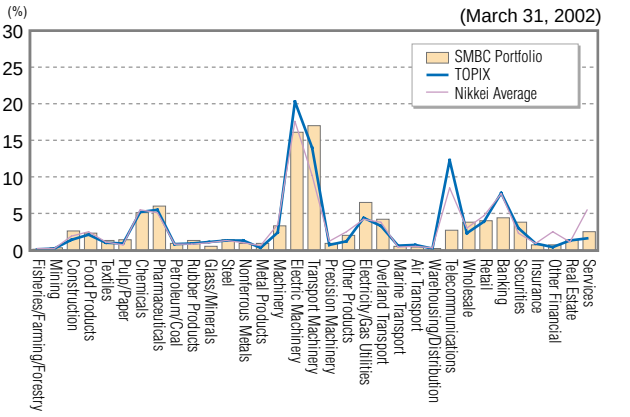


To manage the risk of our yen-denominated banking accounts, we use gap analysis employing maturity ladders and the earnings-at-risk (EaR) model, in addition to the VaR model. In the case where an external factor, such as interest rates, moves in an unfavorable direction, the EaR model can indicate the 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, we use the EaR model to supplement the VaR model. Using Monte Carlo simulations to generate 1,000 scenarios, we test the magnitude of the effect that new deposits and loans will have on a period's earnings.

In fiscal 2001, mark-to-market accounting was introduced, and the effect of stock price fluctuations on the Bank's financial statements increased. Based on this, we recognize that strengthening the management of stock price fluctuation risk is one of the Bank's most important management goals.

To lessen the impact of stock price fluctuations, we are working to reduce strategic equity holdings to a suitable level in accordance with our financial strength, as shown by such indicators as the Bank's shareholders' equity. More precisely, the Corporate Risk Management Department strictly establishes guidelines for limits on total allowable market risk, including risk related to strategic equity holdings, and manages those guidelines.

■ Composition, by Industry, of Listed Securities Portfolio



Liquidity Risk

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. At SMBC, we consider liquidity risk to be one of the major risks. We manage liquidity risk so that we are not overly dependent on market-based funding to cover short-term cash outflows. Our liquidity risk management is based on a framework consisting of setting limits and guidelines for funding gap, maintaining a system of highly liquid supplementary funding sources, and establishing contingency plans.

In our daily risk management operations, we avoid a gradual increase in liquidity risk by adjusting the funding gap limits and guidelines. For emergency situations, we have contingency plans in place to reduce the funding gap limits and guidelines and take other measures. To prevent the possibility of market crises interfering with funding, we carry highly liquid assets, such as U.S. Treasury bonds, and have emergency borrowing facilities in place, which also facilitates foreign-currency-denominated liquidity management.

Processing Risk

Processing risk is the possibility of losses arising from negligent administration by employees, accidents, or unauthorized activities. In our administrative regulations, the basic administrative policies 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." We have organized the Bank's systems to achieve these goals.

Adding new policies or making major revisions to existing ones with regard to processing risk management requires the approval of both the Management Committee and the Board of Directors.

In our operating regulations, we have 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, we have set up a specialized group within the Operations Planning Department to strengthen administrative procedures throughout the SMBC Group.

We include processing risk in our calculation of risk capital requirements and have allocated a certain percentage of risk capital to cover it, based on the quantification of the risk for fiscal 2002.

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 risk, liquidity risk, processing risk, and systems risk, it requires interdisciplinary management. 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. We are continuing to upgrade settlement risk management through such measures as participation in the CLS (Continuous Linked Settlement) Bank International settlement service, which aims to eliminate the settlement risk that arises from foreign exchange transactions.

Systems Risk

Systems risk is the possibility of a loss arising from the failure, malfunction, or unauthorized use of a computer system. We have instituted a number of basic policies to manage systems risk, including a security policy, usage regulations, and specific management procedures. We are further strengthening safety measures based on a needs assessment drawing on such references as the *Financial Inspection Manual* prepared by the Financial Services Agency, and the *Security Guidelines* published by the Center for Financial Industry Information Systems.

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 and the resulting expansion of networks and rise in numbers of personal computer users, we have taken the necessary steps to ensure the smooth, secure operation of our information systems. We have duplicated each system and infrastructure and fully proofed our east and west computer centers against earthquakes and other disasters. To maintain the confidentiality of customer information and prevent information leaks, we encrypt sensitive information, block unauthorized external access, and implement all known countermeasures to secure our data. We have also established contingency plans and conduct training as required to ensure that we are fully prepared in the event of an emergency. To maintain security, we will continue to revise our countermeasures as new technologies and usage patterns emerge.

We include systems risk in our calculation of risk capital requirements and have allocated a certain percentage of risk capital to cover it, based on the quantification of the risk for fiscal 2002.