

# Asset Quality

The Japanese economy has not yet started to fully recover from the prolonged period of deflation under which it has been laboring. Despite this, SMBC is working to reduce the ratio of problem assets to total assets by approximately fifty percent as early as possible within fiscal 2004, as called for in the government's Program for Financial Revival.

The Asset Restructuring Unit, established in December 2002, has been playing the central role in SMBC's efforts to reconstruct and reorganize corporate customers. We will also continue to utilize a variety of methods, including investment banking techniques, to accelerate the removal of problem assets from the balance sheet.

## I. Self-Assessment, Write-Offs, and Reserves

### 1. Self-Assessment

SMBC conducts rigorous self-assessment of asset quality twice a year 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 substrates are consistent with the categories used in self-assessment.

Self-assessment is a preparatory task for calculating the appropriate level of write-offs and reserves to ensure SMBC's asset quality, and 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 collateral, guarantees, etc. 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 business performance and in good financial standing without identified 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 noncollectibility
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

2. Asset Write-Offs and Reserves

In cases where claims have been determined to be uncollectible, or deemed to be uncollectible, write-offs signify the recognition of losses on 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 account in the amount deemed uncollectible, referred to as an indirect write-off. Recognition of indirect write-offs is generally known as provision of reserves.

SMBC has write-off and reserve criteria for each self-assessment borrower category, as follows.

Self-Assessment Borrower Categories		Standards for Write-Offs and Reserves
Normal Borrowers		Amounts are recorded as general reserves in proportion to the expected losses over the next 12 months based on the historical bankruptcy rate for each obligor grading.
Borrowers Requiring Caution		These assets are divided into groups according to the risk of default. Amounts are recorded as general reserves in proportion to the expected losses based on the historical bankruptcy rate for each group. The groups are "claims to substandard borrowers," and "claims to other borrowers requiring caution" excluding claims to substandard borrowers. For the latter, the borrower's financial position and credit situation are additionally taken into account for establishing sub-groups. Additionally, SMBC uses the discounted cash flow (DCF) method to calculate the amount of reserve for possible losses on large-scale claims on substandard borrowers etc.
Potentially Bankrupt Borrowers		SMBC sets specific reserves for possible loan losses on the portion of Classification III assets (calculated for each borrower) not secured by collateral, guarantee, or other means.
Effectively Bankrupt/Bankrupt Borrowers		SMBC calculates the amount of Classification III assets and Classification IV assets for each borrower, and writes off the full amount of Classification IV assets (deemed to be uncollectible or of no value) and sets aside specific reserves for possible loan losses against the full amount of Classification III assets.
Notes	General reserve	Provisions made in accordance with general inherent default risks of loans, unrelated to specific individual loans or other claims
	Specific reserve	Provisions made for claims that have been found uncollectable in part or in total (individually evaluated claims)

Since fiscal 2002, SMBC has been using the discounted cash flow (DCF) method to calculate the amount of reserves for possible losses on large-scale claims to substandard borrowers. The DCF method is applied in cases where it is reasonable to estimate the cash inflow available for collecting the claims principal and interest, and provisions will then be made equivalent to the excess of claims book value over the said cash inflow discounted by the initial contractual interest rate or effective

interest rate at the time of debt purchase. In this way, we have provided sufficient protection against the risk of a future deterioration in asset quality.

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 reserves.

## II. Credit Cost

The amount required for the disposal of problem assets—known as “credit cost”—refers to the additional provision for loan losses in the case of provisioning, or the difference between the amount

of uncollectible loans and provisions already made in the case of write-offs. The credit cost for the first half of fiscal 2003 is shown in the table below.

### ■ Credit Cost (SMBC Nonconsolidated; six months ended September 30, 2003)

(Billions of yen)

Credit cost	¥ 588.5
Write-off of loans	337.9
Transfer to specific reserve	217.3
Transfer to reserve for losses on loans sold	(0.4)
Losses on loans sold to CCPC	0.7
Losses on sale of delinquent loans	35.0
Transfer to loan loss reserve for specific overseas countries	(2.0)
Transfer to general reserve for possible loan losses	(229.1)
Total credit cost	¥ 359.4
Reserve for possible loan losses	¥1,519.0
Amount of direct reduction	¥1,320.8

### ■ Credit Cost (SMFG Consolidated; six months ended September 30, 2003)

(Billions of yen)

Total credit cost	¥ 441.5
Reserve for possible loan losses	¥1,699.4
Amount of direct reduction	¥1,693.3

### ■ Reserve for Possible Loan Losses (September 30, 2003)

(Billions of yen)

	SMBC (Nonconsolidated)	SMFG (Consolidated)
Reserve for possible loan losses	¥1,519.0	¥1,699.4
General reserve	880.3	945.5
Specific reserve	629.2	744.4
Loan loss reserve for specific overseas countries	9.5	9.5

Amid a business environment in which deflationary pressure has not yet started to ease on a full-scale basis, we are actively pressing ahead with the further removal of problem assets from our balance sheet and facilitating the radical restructuring

of borrowers' business operations to accelerate their financial rehabilitation. As a result of these measures, total credit cost for the first half of fiscal 2003 came to ¥359.4 billion.

### III. Disclosure of Problem Assets and Off-Balancing

#### 1. 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 (risk-monitored loans) and the Financial Reconstruction Law (problem assets based on the

Financial Reconstruction Law). 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.

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, and customers' liabilities for acceptances and guarantees that are not included in the other three categories.

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

Category of borrowers under self-assessment	Problem assets based on the Financial Reconstruction Law		Risk-monitored loans	
	Total loans	Other assets	Total loans	Other assets
Bankrupt Borrowers	Bankrupt and quasi-bankrupt assets		Bankrupt loans	(C)
Effectively Bankrupt Borrowers			Non-accrual loans	
Potentially Bankrupt Borrowers	Doubtful assets		Past due loans (3 months or more)	
Borrowers Requiring Caution	Substandard loans		Restructured loans	
	(Normal assets)			
Normal Borrowers				
	(A)	−	(B)	= (C)

The disclosure of risk-monitored loans corresponds exactly to the disclosure of problem assets based on the Financial Reconstruction Law, except for such non-loan assets as securities lending, import and export, accrued interest, suspense payments, and customers' liabilities for acceptances and guarantees, which are not 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 recorded as accrued interest, the amount is not included in the problem assets disclosed on the basis of the Financial Reconstruction Law.

#### 2. Problem Asset Disclosure Amounts

SMBC's problem assets based on the Financial Reconstruction Law and risk-monitored loans at the end of September 2003 are as shown on the following page. In addition to a decrease of ¥498.3 billion in doubtful assets (compared with the end of March 2003), attributable to progress made in final disposal, substandard loans fell by ¥877.6 billion over the same six-month period

as a result of accelerated efforts to upgrade borrowers to higher categories through restructuring and corporate rehabilitation. As a consequence, the balance of problem assets based on the Financial Reconstruction Law decreased by ¥1,394.7 billion compared with the end of March 2003.

## ■ Problem Assets Based on the Financial Reconstruction Law (September 30, 2003)

(Billions of yen)

	SMBC (Nonconsolidated)	Compared with March 31, 2003	SMFG (Consolidated)
Bankrupt and quasi-bankrupt assets	¥ 506.1	¥ (18.8)	¥ 641.0
Doubtful assets	1,631.2	(498.3)	1,851.1
Substandard loans	1,729.3	(877.6)	1,960.7
Subtotal	¥ 3,866.6	¥(1,394.7)	¥ 4,452.8
Normal assets	56,623.8	(689.5)	59,375.5
Total	¥60,490.4	¥(2,084.2)	¥63,828.3
Amount of direct reduction	¥ 1,320.8		¥ 1,693.3

## ■ Risk-Monitored Loans (September 30, 2003)

(Billions of yen)

	SMBC (Nonconsolidated)	Compared with March 31, 2003	SMFG (Consolidated)
Bankrupt loans	¥ 146.0	¥ (26.5)	¥ 179.5
Non-accrual loans	1,957.7	(432.4)	2,287.3
Past due loans (3 months or more)	94.5	(20.2)	101.6
Restructured loans	1,634.8	(857.4)	1,853.9
Total	¥3,833.0	¥(1,336.5)	¥4,422.3
Amount of direct reduction	¥1,291.3		¥1,634.3

## ■ Classification under Self-Assessment, Disclosure of Problem Assets, and Write-Offs/Reserves (SMBC Nonconsolidated; September 30, 2003)

(Billions of yen)

Category of borrowers under self-assessment	Problem assets based on the Financial Reconstruction Law	Classification under self-assessment				Reserve for possible loan losses	Reserve ratio		
		Classification I	Classification II	Classification III	Classification IV				
Bankrupt Borrowers	Bankrupt and quasi-bankrupt assets (1) ¥506.1	Portion of claims secured by collateral or guarantees, etc. (5) ¥491.6	Fully reserved ¥14.5	Direct write-offs (Note 1)		Specific reserve ¥20.3 (Note 2)	100% (Note 3)		
Effectively Bankrupt Borrowers									
Potentially Bankrupt Borrowers	Doubtful assets (2) ¥1,631.2	Portion of claims secured by collateral or guarantees, etc. (6) ¥755.6	Necessary amount reserved ¥875.6			¥608.9 (Note 2)	69.5% (Note 3)		
Borrowers Requiring Caution	Substandard loans (3) ¥1,729.3	Portion of substandard loans secured by collateral or guarantees, etc. (7) ¥669.8				General reserve for substandard loans ¥335.3	30.5% (Note 3)	19.3% (Note 3)	
	(Claims to substandard borrowers)						5.5% [12.2%] (Note 4)		
Normal Borrowers	Normal assets ¥56,623.8	Claims to normal borrowers				General reserve ¥880.3	0.2% (Note 4)		
Loan loss reserve for specific overseas countries						¥9.5			
Total (4) ¥60,490.4		Problem asset ratio (A) / (4) 6.4% (Note 5)		Total reserve for possible loan losses (B) Specific reserve + General reserve for substandard loans		¥1,519.0	Reserve ratio (B) / (D) 49.5% (Note 6)		
(A) = (1) + (2) + (3) ¥3,866.6		Portion secured by collateral or guarantees, etc. (C) = (5) + (6) + (7) ¥1,917.0		Unsecured portion (D) = (A) – (C) ¥1,949.6		¥964.5			
Coverage ratio { (B) + (C) } / (A)							74.5%		

Notes: 1. Includes amount of direct reduction totaling ¥1,320.8 billion.

2. Includes reserves for assets that are not subject to disclosure under the Financial Reconstruction Law. (Bankrupt/Effectively Bankrupt Borrowers: ¥5.8 billion; Potentially Bankrupt Borrowers: ¥9.9 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 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. Ratio of problem assets to total assets subject to Financial Reconstruction Law

6. Reserve ratio = (Specific reserve + General reserve for substandard loans) ÷ (Bankrupt and quasi-bankrupt assets + Doubtful assets + Substandard loans - Portion secured by collateral or guarantees, etc.)

### 3. Off-Balancing Problem Assets

Work-out of problem assets refers to the removal of such assets from bank balance sheets by way of sale, direct write-off or other means. In April 2001, the Japanese government passed the Emergency Economic Package, with the objective of simultaneously revitalizing the financial system and industry. Specific

measures contained in the package include “the radical disposal of problem assets.” This provision requires Japan’s major banks to dispose of loans categorized as “claims to potentially bankrupt borrowers” and worse. From fiscal 2001 onward, existing loans must be off-balanced within two years, and new loans within three years.

#### ■ Breakdown of Off-Balancing (SMBC Nonconsolidated; September 30, 2003)

	March 31, 2002 ①	Fiscal 2002		March 31, 2003 ②	First half of fiscal 2003		September 30, 2003 ③
		New occurrences	Off-balanced		New occurrences	Off-balanced	
Bankrupt and quasi-bankrupt assets	¥ 498.2	¥ 108.9	¥ (82.2)	¥ 524.9	¥ 67.8	¥ (86.6)	¥ 506.1
Doubtful assets	2,982.3	1,293.3	(2,146.1)	2,129.5	602.0	(1,100.3)	1,631.2
Total	¥3,480.5	¥1,402.2	¥(2,228.3)	¥2,654.4	¥669.8	¥(1,186.9)	¥2,137.3
				Increase/Decrease (②-①)			Increase/Decrease (③-②)
Bankrupt and quasi-bankrupt assets				¥ 26.7			¥ (18.8)
Doubtful assets				(852.8)			(498.3)
Total				¥ (826.1)			¥ (517.1)

### 4. Problem Assets by Region and Industry

#### ■ Problem Assets by Domicile of Borrowers (SMBC Nonconsolidated; September 30, 2003)

	Financial Reconstruction Law Basis		Risk-Monitored Loans	
	Financial Reconstruction Law Basis	Percentage	Risk-Monitored Loans	Percentage
Domestic	¥3,741.3	96.8%	¥3,716.9	97.0%
Overseas	125.3	3.2	116.1	3.0
Asia	61.1	1.6	57.7	1.5
Indonesia	27.1	0.7	27.1	0.7
Hong Kong	3.9	0.1	3.9	0.1
India	4.6	0.1	3.2	0.1
China	2.3	0.1	2.3	0.1
Others	23.2	0.6	21.2	0.5
North America	53.8	1.4	52.2	1.4
Central and South America	5.6	0.1	1.4	0.0
Western Europe	4.8	0.1	4.8	0.1
Eastern Europe	—	—	—	—
Total	¥3,866.6	100.0%	¥3,833.0	100.0%

Note: “Domestic” means the total for domestic branches, excluding the special account for international financial transactions. “Overseas” means the total for overseas branches, including the special account for international financial transactions. The above countries and areas are categorized by the obligor’s domicile.

#### ■ Problem Assets by Type of Borrowers (SMBC Nonconsolidated; September 30, 2003)

	Financial Reconstruction Law Basis		Risk-Monitored Loans	
	Financial Reconstruction Law Basis	Percentage	Risk-Monitored Loans	Percentage
Domestic	¥3,741.3	96.8%	¥3,716.9	97.0%
Manufacturing	171.6	4.4	170.9	4.5
Agriculture, forestry, fishery and mining	3.6	0.1	3.6	0.1
Construction	318.2	8.2	317.5	8.3
Transportation, communications, and other public enterprises	111.9	2.9	111.3	2.9
Wholesale and retail	536.6	13.9	530.8	13.9
Finance and insurance	91.7	2.4	89.9	2.3
Real estate	1,396.2	36.1	1,391.0	36.3
Services	836.9	21.7	829.7	21.6
Municipalities	—	—	—	—
Others	274.6	7.1	272.2	7.1
Overseas	¥ 125.3	3.2%	¥ 116.1	3.0%
Public sector	11.4	0.3	11.4	0.3
Financial institutions	0.8	0.0	0.7	0.0
Commerce and industry	113.1	2.9	104.0	2.7
Others	—	—	—	—
Total	¥3,866.6	100.0%	¥3,833.0	100.0%

Note: “Domestic” means the total for domestic branches, excluding the special account for international financial transactions. “Overseas” means the total for overseas branches, including the special account for international financial transactions.