

Current Status of Problem Assets

SMBC has implemented various initiatives to strengthen its financial base. Initiatives range from reducing the amount of non-performing loans (NPLs) on our balance sheets to giving higher priority to the revitalization and reconstruction of our corporate clients. As a result, we were able, six months ahead of schedule, to achieve our goal of a 50% reduction in the NPL ratio, which is advocated in the government's Program for Financial Revival. While making steady progress in resolving our NPL problem, we will continue efforts to bolster our financial base.

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

1. 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 reserves. 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 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 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 of reserves.

SMBC's write-off and reserve 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 reserves.

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.
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. In addition, SMBC applies the discounted cash flow (DCF) method to large-scale claims for calculating individual amounts on the condition of rational estimates of future cash flows.
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)

Discounted Cash Flow Method

SMBC utilizes the discounted cash flow (DCF) method to calculate the amount of reserves required to cover possible losses on large-scale claims to substandard borrowers and potentially bankrupt borrowers. The DCF method is applied in cases where it is reasonable to estimate the future cash inflow of the borrower that can be used for repayment of the principal and the payment of interest on the debt. 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. In this way, we provide sufficient reserves against the risk of a future deterioration in asset quality.

One of the major advantages of the DCF method over conventional methods of calculating the amount of reserves required to cover possible loan losses is that it enables effective

evaluation of each individual borrower. In the case of this method, the required amount of reserves may vary according to the basic data used in applying the DCF method, such as estimated future cash flow based on the borrower's business reconstruction plan, the applied discount rate, and the probability of the borrower going into bankruptcy.

Thus, SMBC makes every effort to utilize timely and appropriate data to realize the most accurate estimates possible. The use of the DCF method for large-scale substandard borrowers was first introduced in fiscal 2002.

Having become accustomed to the practical application of the DCF method, SMBC extended its use to large-scale potentially bankrupt borrowers from the fiscal 2004 interim book closing. The DCF method was applied to approximately 60% of claims on potentially bankrupt borrowers, and the reserve ratio for the said claims stood at 68.1% as of the end of September 2004.

II. Credit Cost

The amount required for the disposal of NPLs—known as “credit cost”—refers to the additional provision for loan losses in the case of provisioning, and 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 2004 is shown in the table below.

■ Credit Cost (SMBC Nonconsolidated; six months ended September 30, 2004)

(Billions of yen)

Credit cost	¥ 805.5
Write-off of loans	348.8
Provision for specific reserve	403.8
Losses on loans sold to CCPC	—
Losses on sale of loans	55.7
Provision for loan loss reserve for specific overseas countries	(2.8)
Provision for general reserve for possible loan losses	(349.7)
Total credit cost	¥ 455.8
Reserve for possible loan losses	¥ 962.6
Amount of direct reduction	¥1,409.2

■ Credit Cost (SMFG Consolidated; six months ended September 30, 2004)

(Billions of yen)

Total credit cost	¥ 612.8
Reserve for possible loan losses	¥1,222.4
Amount of direct reduction	¥1,774.0

■ Reserve for Possible Loan Losses (September 30, 2004)

(Billions of yen)

	SMBC (Nonconsolidated)	SMFG (Consolidated)
Reserve for possible loan losses	¥962.6	¥1,222.4
General reserve	419.3	601.7
Specific reserve	538.4	615.8
Loan loss reserve for specific overseas countries	4.9	4.9

To completely resolve the issue of NPLs in fiscal 2004, SMBC made progress in off-balancing NPLs, and increased reserves for possible loan losses in order to become more resilient to risk. As a result, on a nonconsolidated basis, SMBC recorded credit cost in the amount of ¥455.8 billion.

We are not satisfied with halving the NPL ratio. We will continue efforts to improve asset quality with the ultimate objective of establishing a strong financial base that will enable the Group to weather any adverse business conditions, no matter how severe.

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 (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.

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.

Note: Based on the borrower's category under self-assessment, claims on the borrower are categorized as Classification I, II, III, and IV assets according to their default and impairment risk levels. (Please refer to page 17 for the asset classification table.)

□ 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 recognized 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

The amounts, as of September 30, 2004, of risk-monitored loans and problem assets are shown on the following page. As we have pledged to make fiscal 2004 the year for the complete resolution of the issue of NPLs, we took proactive measures to dispose of problem assets while simultaneously facilitating the revitalization and reconstruction of our borrowers. By these means, we

achieved our goal of reducing the NPL ratio by 50%. As a result, the balance of problem assets as defined in the Financial Reconstruction Law was ¥2,484.4 billion, down ¥326.8 billion from the end of March 2004. The NPL ratio improved to 4.4% from 8.9% at the end of March 2002, marking the attainment of a 50% reduction six months ahead of schedule.

■ Problem Assets Based on the Financial Reconstruction Law (September 30, 2004)

(Billions of yen)

	SMBC (Nonconsolidated)	Compared with March 31, 2004	SMFG (Consolidated)
Bankrupt and quasi-bankrupt assets	¥ 581.1	¥ 219.5	¥ 707.3
Doubtful assets	1,124.1	(78.6)	1,313.3
Substandard loans	779.2	(467.7)	945.0
Subtotal	¥ 2,484.4	¥(326.8)	¥ 2,965.6
Normal assets	53,673.4	799.0	57,067.8
Total	¥56,157.8	¥ 472.2	¥60,033.4
Amount of direct reduction	¥ 1,409.2		¥ 1,774.0

■ Risk-Monitored Loans (September 30, 2004)

(Billions of yen)

	SMBC (Nonconsolidated)	Compared with March 31, 2004	SMFG (Consolidated)
Bankrupt loans	¥ 59.2	¥ (8.0)	¥ 87.0
Non-accrual loans	1,552.4	91.6	1,844.1
Past due loans (3 months or more)	46.8	(0.8)	52.9
Restructured loans	732.4	(466.9)	884.7
Total	¥2,390.8	¥(384.1)	¥2,868.7
Amount of direct reduction	¥1,383.5		¥1,715.8

■ Classification under Self-Assessment, Disclosure of Problem Assets, and Write-Offs/Reserves (SMBC Nonconsolidated; September 30, 2004)

(Billions of yen)

Category of borrowers under self-assessment	Problem assets based on the Financial Reconstruction Law	Classification under self-assessment				(Billion yen)		Reserve for possible loan losses	Reserve ratio
		Classification I	Classification II	Classification III	Classification IV				
Bankrupt Borrowers	Bankrupt and quasi-bankrupt assets (1) ¥581.1	Portion of claims secured by collateral or guarantees, etc. (5) ¥561.6	Fully reserved ¥19.5	Direct write-offs (Note 1)		Specific reserve	¥26.1 (Note 2)	100% (Note 3)	
Effectively Bankrupt Borrowers									
Potentially Bankrupt Borrowers	Doubtful assets (2) ¥1,124.1	Portion of claims secured by collateral or guarantees, etc. (6) ¥461.6	Necessary amount reserved ¥662.5				¥512.3 (Note 2)	77.3% (Note 3)	
Borrowers Requiring Caution	Substandard loans (3) ¥779.2	Portion of substandard loans secured by collateral or guarantees, etc. (7) ¥381.9				General reserve	General reserve for substandard loans ¥160.6	38.7% (Note 3)	
	(Claims to substandard borrowers)							3.8% [10.1%] (Note 4)	19.1% (Note 3)
Normal Borrowers	Normal assets ¥53,673.4	Claims to normal borrowers					¥419.3	0.1% (Note 4)	
Loan loss reserve for specific overseas countries							¥4.9		
Total (4) ¥56,157.8		NPL ratio (A) / (4) 4.4% (Note 5)		Total reserve for possible loan losses (B) Specific reserve + General reserve for substandard loans		¥962.6 ¥699.0		Reserve ratio (B) / (D) 64.8% (Note 6)	
(A) = (1) + (2) + (3) ¥2,484.4		Portion secured by collateral or guarantees, etc. (C) = (5) + (6) + (7) ¥1,405.1		Unsecured portion (D) = (A) – (C) ¥1,079.3					
				Coverage ratio { (B) + (C) } / (A)		84.7%			

Notes: 1. Includes amount of direct reduction totaling ¥1,409.2 billion.

2. Includes reserves for assets that are not subject to disclosure under the Financial Reconstruction Law. (Bankrupt/Effectively Bankrupt Borrowers: ¥6.6 billion; Potentially Bankrupt Borrowers: ¥10.0 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

In the term under review, we continued to focus on off-balancing problem assets, and succeeded in off-balancing ¥904.0 billion worth of problem assets. 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, and steady progress is being made.

■ Breakdown of Off-Balancing (SMBC Nonconsolidated; September 30, 2004)

	March 31, 2003 ①	Fiscal 2003		March 31, 2004 ②	First half of fiscal 2004		September 30, 2004 ③
		New occurrences	Off-balanced		New occurrences	Off-balanced	
Bankrupt and quasi-bankrupt assets	¥ 524.9	¥ 125.7	¥ (289.0)	¥ 361.6	¥ 169.7	¥ 49.8	¥ 581.1
Doubtful assets	2,129.5	1,227.9	(2,154.7)	1,202.7	875.2	(953.8)	1,124.1
Total	¥2,654.4	¥1,353.6	¥(2,443.7)	¥ 1,564.3	¥1,044.9	¥(904.0)	¥1,705.2
				Increase/Decrease (②-①)			Increase/Decrease (③-②)
Bankrupt and quasi-bankrupt assets				¥ (163.3)			¥ 219.5
Doubtful assets				(926.8)			(78.6)
Total				¥(1,090.1)			¥ 140.9

4. Problem Assets by Region and Industry

■ Problem Assets by Domicile of Borrowers (SMBC Nonconsolidated; September 30, 2004)

	Financial Reconstruction Law Basis (Excluding normal assets)	Percentage	Risk-Monitored Loans	Percentage
Domestic	¥2,429.0	97.8%	¥2,343.4	98.0%
Overseas	55.4	2.2	47.4	2.0
Asia	17.0	0.6	12.9	0.5
Indonesia	3.1	0.1	3.1	0.1
Hong Kong	2.9	0.1	2.8	0.1
India	2.3	0.1	1.7	0.1
China	0.4	0.0	0.4	0.0
Others	8.3	0.3	4.9	0.2
North America	28.8	1.2	27.2	1.2
Central and South America	2.8	0.1	0.5	0.0
Western Europe	6.8	0.3	6.8	0.3
Eastern Europe	—	—	—	—
Total	¥2,484.4	100.0%	¥2,390.8	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, 2004)

	Financial Reconstruction Law Basis (Excluding normal assets)	Percentage	Risk-Monitored Loans	Percentage
Domestic	¥2,429.0	97.8%	¥2,343.4	98.0%
Manufacturing	81.5	3.3	80.3	3.4
Agriculture, forestry, fishery and mining	0.9	0.0	0.9	0.0
Construction	361.3	14.6	303.6	12.7
Transportation, communications, and other public enterprises	87.4	3.5	84.4	3.5
Wholesale and retail	300.8	12.1	298.4	12.5
Finance and insurance	47.6	1.9	46.1	1.9
Real estate	899.6	36.2	885.9	37.1
Services	417.4	16.8	413.9	17.3
Municipalities	—	—	—	—
Others	232.5	9.4	229.9	9.6
Overseas	¥ 55.4	2.2%	¥ 47.4	2.0%
Public sector	0.1	0.0	0.1	0.0
Financial institutions	2.5	0.1	0.3	0.0
Commerce and industry	52.8	2.1	47.0	2.0
Others	—	—	—	—
Total	¥2,484.4	100.0%	¥2,390.8	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.