

Current Status of Problem Assets

SMBC continued to take measures in fiscal 2006 to further reinforce its financial soundness with the aim of achieving sustainable growth. In fiscal 2006, improvements in asset quality reduced the total credit cost to ¥89.5 billion, which was ¥141.4 billion less than in fiscal 2005.

As of the end of March 2007, the balance of non-performing loans (NPLs)—referred to as “problem assets” under the Financial Reconstruction Law—stood at ¥738.7 billion, and the NPL ratio (the ratio of problem assets to total assets) was 1.2%. We will continue to leverage the know-how we have accumulated in the course of implementing NPL workouts to actively develop business opportunities in corporate revitalization support services and new business areas.

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

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 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

2. 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		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 (DFC) 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 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.

II. Credit Cost

Credit cost, in the case of provisioning, is the total amount of provisions newly made, and in the case of write-offs, it is the amount

of provision already made deducted from the uncollectible amount. The credit cost for fiscal 2006 is shown in the table below.

■ Credit Cost (SMBC Nonconsolidated; year ended March 31, 2007)

(Billions of yen)

Credit cost	¥ 89.5
Provision for general reserve for possible loan losses	(41.7)
Write-off of loans	50.5
Provision for specific reserve for possible loan losses	44.4
Losses on sale of loans	37.3
Provision for loan loss reserve for specific overseas countries	(0.5)
Gains on collection of written-off claims	(0.5)
Reserve for possible loan losses	¥677.5
Amount of direct reduction	¥298.3

■ Credit Cost (SMFG Consolidated; year ended March 31, 2007)

(Billions of yen)

Total credit cost	¥145.0
Reserve for possible loan losses	¥889.1
Amount of direct reduction	¥490.1

Note: Gains on collection of written-off claims are included in total credit cost. Bracketed amount indicates gains.

■ Reserve for Possible Loan Losses (March 31, 2007)

(Billions of yen)

	SMBC (Nonconsolidated)	SMFG (Consolidated)
Reserve for possible loan losses	¥677.5	¥889.1
General reserve	530.8	683.6
Specific reserve	144.8	203.6
Loan loss reserve for specific overseas countries	1.9	1.9
Amount of direct reduction	¥298.3	¥490.1

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. 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 securities lending, import and export, 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, 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	Ⓒ
Effectively Bankrupt Borrowers			Non-accrual loans	
Potentially Bankrupt Borrowers			Past due loans (3 months or more)	
Borrowers Requiring Caution	Substandard loans		Restructured loans	
Normal Borrowers	(Normal assets)			
		Ⓐ	Ⓑ	Ⓒ

2. Problem Asset Disclosure Amounts

The amounts of problem assets (as defined in the Financial Reconstruction Law) and risk-monitored loans, as of March 31, 2007, are as follows. The balance of problem assets held by SMBC as of the end of March 2007 was ¥738.7 billion, a decline of ¥221.4 billion compared with the ¥960.1 billion recorded at the previous term-end. The NPL ratio improved by 0.5 percentage

point from the end of fiscal 2005, to 1.2%. We will continue working to prevent the reoccurrence of further NPL problems through support for corporate revitalization and by helping our customers to upgrade their borrower categories. In parallel with these initiatives, we will continue taking proactive measures to further enhance the soundness of the bank’s credit portfolio.

■ Problem Assets Based on the Financial Reconstruction Law (March 31, 2007)

	SMBC (Nonconsolidated)		SMFG (Consolidated)
		Compared with March 31, 2006	
Bankrupt and quasi-bankrupt assets	¥ 108.9	¥ (55.6)	¥ 193.8
Doubtful assets	300.1	(173.3)	384.8
Substandard loans	329.7	7.5	506.0
Subtotal	¥ 738.7	¥ (221.4)	¥ 1,084.6
Normal assets	60,542.2	4,557.3	64,815.6
Total	¥61,280.9	¥4,335.9	¥65,900.2
Amount of direct reduction	¥ 298.3		¥ 490.1

Note: From fiscal 2006, SMBC has included bank-guaranteed bonds sold through private placements (SMBC guarantees all or part of the principal repayment and interest payment) among the items subject to disclosure as problem assets under the Financial Reconstruction Law.

■ Risk-Monitored Loans (March 31, 2007)

(Billions of yen)

	SMBC (Nonconsolidated)	Compared with March 31, 2006	SMFG (Consolidated)
Bankrupt loans	¥ 33.8	¥ (7.1)	¥ 60.7
Non-accrual loans	357.6	(193.5)	507.3
Past due loans (3 months or more)	20.6	(2.9)	22.0
Restructured loans	309.1	10.4	477.4
Total	¥721.1	¥(193.1)	¥1,067.4
Amount of direct reduction	¥266.9		¥ 430.3

■ Classification under Self-Assessment, Disclosure of Problem Assets, and Write-Offs/Reserves (SMBC Nonconsolidated; March 31, 2007)

(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) ¥108.9	Portion of claims secured by collateral or guarantees, etc. (5) ¥97.3	Fully reserved ¥11.6	Direct write-offs (Note 1)	Specific reserve ¥15.7 (Note 2)	100% (Note 3)	
Effectively Bankrupt Borrowers							
Potentially Bankrupt Borrowers	Doubtful assets (2) ¥300.1	Portion of claims secured by collateral or guarantees, etc. (6) ¥138.7	Necessary amount reserved ¥161.4		General reserve ¥129.1 (Note 2)	80.0% (Note 3)	
Borrowers Requiring Caution	Substandard loans (3) ¥329.7 (Claims to substandard borrowers)						Portion of substandard loans secured by collateral or guarantees, etc. (7) ¥107.0
	Normal assets ¥60,542.2	Claims to borrowers requiring caution, excluding claims to substandard borrowers	General reserve ¥530.8	General reserve for substandard loans ¥98.9	44.9% (Note 3) 6.5% [12.7%] (Note 4) 18.5% (Note 3)		
Normal Borrowers		Claims to normal borrowers			0.3% (Note 4)		
					Loan loss reserve for specific overseas countries ¥1.9		
Total (4) ¥61,280.9		NPL ratio (A) / (4) 1.2% (Note 5)		Total reserve for possible loan losses ¥677.5		Reserve ratio (B) / (D) 61.6% (Note 6)	
(A) = (1) + (2) + (3) ¥738.7		Total reserve for possible loan losses (B) Specific reserve + General reserve for substandard loans ¥243.7					
		Unsecured portion (D) = (A) – (C) ¥395.7					
				Coverage ratio { (B) + (C) } / (A) 79.4%			