Risk Management

Our Approach

SMBC Group introduced its Risk Appetite Framework to ensure that risk and return levels are appropriate. Risk Appetite Framework is the framework for controlling group-wide risks, which clarifies the types and levels of risk that we are willing to take on or are prepared to tolerate (risk appetite) in order to grow profits based on an accurate view of the operating environment and the risks. Accordingly, Risk Appetite Framework is one of two pivots of our business management alongside business strategy.

Risk Appetite Framework

Risk Appetite Framework is the framework for controlling group-wide risks, which clarifies the types and levels of risk that we are willing to take on or are prepared to tolerate in order to grow profits (risk appetite). SMBC Group has defined risk appetites for specific risk categories and has created documents detailing policies with regard to Risk Appetite Framework as well as information on specific risk appetites.

Individual risk appetites have been established for specific business units or strategies as necessary based on the overall risk appetite of SMBC Group.

Risk Appetite Framework Positioning

Environment / Risk View

Risk Appetite Framework | Two pivots of our business management | Business Strategy

Risk Appetite Composition

Categories

Soundness | Profitability | Liquidity | Credit | Market | Operational | Conduct*

Established for each category

Risk Appetite Statement
- A qualitative explanation of our approach to risk taking and risk management for various risk categories

Risk Appetite Measures
- Quantitative Risk Appetite Measures that function as benchmarks for risks that we are considering taking and for risk/return

* Conduct Risk Management
SMBC Group defines conduct risk as the risk that our conduct negatively affects customers, market integrity, or effective competition. This risk is managed by implementing preventive measures through Risk Appetite Framework.

Operation of Risk Appetite Framework

The process of formulating business strategies and policies for each fiscal year entails setting risk appetites. These risk appetites are set by the Management Committee and the Board of Directors based on consideration of the current and future operating environment, Top Risks that threaten to significantly impact management, and risk analyses (stress testing) that illustrate the impact if a risk should be realized.

The outlooks for the operating environment and risks, including Top Risks, are continuously updated over the course of the fiscal year and the risk appetite situation is monitored regularly. Risk Appetite Measures and business strategies are revised as necessary. Three risk management levels are set for Risk Appetite Measures, which are monitored accordingly.

Comprehensive Risk Management

The risks needing to be managed have been defined as credit risk, market risk, liquidity risk, and operational risk. Appropriate management of these risks is practiced. In addition, Group companies manage risk in accordance with the characteristics of their particular businesses. These risk categories are continuously reviewed and new ones may be added in response to changes in the operating environment.

Thorough assessments of the operating environment and risks, including Top Risks, are carried out to ensure effective operation of Risk Appetite Framework, after which risks are managed systematically through frameworks for risk analysis via stress testing and risk capital management.

Top Risks

SMBC Group identifies those risks that threaten to significantly impact management as Top Risks.

The selection of Top Risks involves comprehensive screening of risk factors, evaluation of each risk scenario's possibility of occurrence and potential impact on management, and discussion by the Risk Management Committee and the Management Committee. Top Risks are utilized to enhance risk management by being incorporated into discussions of Risk Appetite Framework and the formulation of business strategies and into the creation of risk scenarios for stress testing.

Please see page 91 for Top Risks.

Stress Testing

At SMBC Group, we use stress testing for the development and implementation of forward-looking business strategies, seeking to analyze and comprehend the impact on SMBC Group's businesses of changes in economic or market conditions.

In our stress testing, we formulate multiple risk scenarios based on the aforementioned Top Risks, discussions with experts and related departments, and macroeconomic indicators such as GDP, stock prices, interest rates, and foreign exchange rates.

When developing business strategies, we formulate scenarios assuming stressed business environments such as serious economic recessions and market disruption to assess risk-taking capabilities at SMBC Group and verify whether adequate soundness can be maintained under stress.

In addition, we conduct detailed stress testing of credit risk, market risk, and liquidity risk, based on which it develops and revises strategies for risk taking.

Risk Management Categories

Risk Capital-Based Management

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.

Market Risk
Market risk is the possibility that fluctuations in interest rates, foreign exchange rates, stock prices, or other market prices will change the market value of financial products, leading to a loss.

Operational Risk
Operational risk is the possibility of losses arising from inadequate or failed internal processes, people, and systems or from external events.

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Liquidity Risk
Liquidity risk is defined as uncertainty around the ability of the firm to meet debt obligations without incurring unacceptably large losses. Examples of such risk include the possible inability to meet current and future cash flow / collateral needs, both expected and unexpected. In such cases, the firm may be required to raise funds at less than favorable rates or be unable to raise sufficient funds for settlement.

Management by Risk Type

Conduct risk, etc.

Risk Capital Management

In managing credit risk, market risk, and operational risk affecting entire SMBC Group, we apply a uniform standard, risk capital*1 based on value at risk (VaR),*2 for use in monitoring and managing risks. This standard is applied while taking into account the characteristics of each risk and of the businesses of our Group companies. Specific risk capital measures include setting upper limits for risk exposure based on group-wide and business unit risk appetite and group-wide management constitution. Each business unit operates business operation within that limit. Through these precautions, we practice management that maintains an appropriate balance between risks and returns based on a comprehensive perspective and secure sufficient financial soundness.

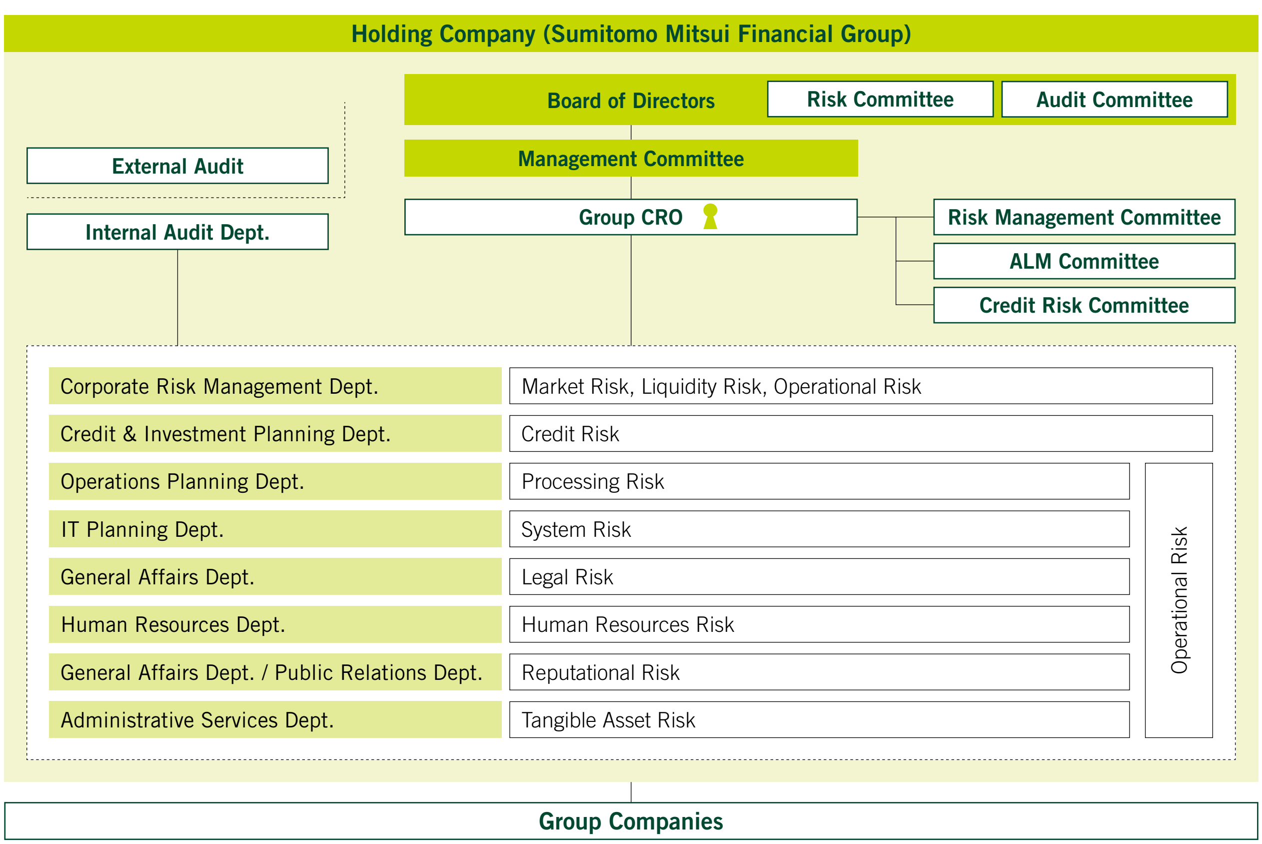
*1 Risk capital: The amount of capital required to cover the theoretical maximum potential loss arising from risks of business operations.
*2 VaR: The maximum loss that can be expected to occur with a certain degree of probability when holding a financial asset portfolio for a given amount of time.

Risk Management System

Top management plays an active role in the risk management process out of recognition for the importance of risk management. The group-wide basic policies for risk management are determined by the Management Committee before being authorized by the Board of Directors.

In line with these basic policies for risk management, the functions for managing major risks are consolidated within the Risk Management Unit, which is independent from business units. In addition, the Internal Audit Dept. conducts internal audits on the status of risk management to verify that risk is appropriately managed. Risk management systems are in place at individual Group companies that have been established based on the characteristics of their particular businesses and in accordance with the basic policies. Furthermore, SMBC Group is strengthening group-wide risk management systems through the Group CRO Committee, which consists of the Group CRO and risk management representatives from strategically important Group companies.

SMBC Group's Risk Management System



Three Lines of Defense

The Basel Committee on Banking Supervision's "Corporate governance principles for banks" recommends "three lines of defense" as a framework for risk management and governance. Based on this framework, we have defined our three lines of defense with the aim of achieving more effective and stronger risk management and compliance systems through the clarification of roles and responsibilities.

Definition of our Three Lines of Defense

First Line

■ Business Units

The Business Units shall be risk owners concerning their operations and shall be responsible for the following in accordance with the basic principles provided by Second Line.

- Identification and evaluation of risks encountered in the business activities
- Implementation of measures for minimizing and controlling risks
- Monitoring of risks and reporting within First Line and to Second Line
- Creation and fostering of a sound risk culture*

Second Line

■ Risk Management and Compliance Departments

The Risk Management and Compliance Departments shall assume the following functions and responsibilities in order to manage the risk management and compliance systems.

- Drafting and development of basic principles and frameworks concerning risk management and compliance
- Oversight, monitoring, and development of training programs for First Line

Third Line

■ Audit Department

Independent from First Line and Second Line, the Audit Department shall assess and verify the effectiveness and appropriateness of activities of First Line and Second Line, and report these results to the Audit Committee and the Management Committee. The Department shall provide recommendations regarding identified issues / problems.

* Creation and fostering of a sound risk culture
In order to create and foster a sound risk culture, we established principles of action for all areas of daily risk management and compliance activities, which clearly identify the values to be shared by and the behaviors expected of Group employees, and we conduct thorough training for them based on the principles.

Implementation of the Basel Capital Accord

The Basel III regulatory framework was established on March 31, 2013, based on the lessons learned from the global financial crisis that spanned in 2008. This framework is designed to maintain sound operating standards at internationally active banks.

The Basel Committee on Banking Supervision has been engaged in discussions regarding the revision of risk weighted asset calculation methods as well as the revision of minimum capital levels (so-called "capital floors") and other capital ratio regulations. With the exception of some issues yet to be resolved, the final version of the regulatory framework was disclosed in December 2017, and an agreement was reached to implement the regulations in a phased manner beginning in 2022 with full implementation targeted for 2027.

The implementation of these regulations is anticipated to lead to an increase of approximately 25% in the risk weighted assets of us. Nevertheless, we expect to be able to post a CET1 ratio, an indicator for which a financial target has been set, of 10% on March 31, 2019, achieving the Medium-Term Management Plan target for this indicator a year ahead of schedule. This feat will be accomplished through the conversion of two Kansai region banks into equity-method investees, which was conducted in fiscal 2017, and through the reorganization of joint leasing operations scheduled for November 2018.

SMBC Group is committed to steadily accelerating the development of disciplined business operations that are mindful of risks and returns from the perspectives of both risk and regulatory environments.

Declaration of Cyber Security Management

In light of the rising cyber threat, SMBC Group has established its Declaration of Cyber Security Management and is moving forward with a management-spearheaded drive to strengthen cyber security measures.

Specific policies of this declaration are as follows.

1. Define cyber risk as one of Top Risks, regularly discuss and verify this risk at meetings of the Management Committee and the Board of Directors, and allocate the necessary resources
2. Establish a dedicated division to formulate measures for normal operating situations and procedures for corresponding to the emergency situations and implement related exercises
3. Continuously develop human resources and implement cyber security measures utilizing the latest technologies while also instituting measures across the supply chain at subcontractors and business partners
4. Expand the range of cyber security measures available to customers and monitor illegal transactions to enable them to use financial services safely and with peace of mind
5. Contribute to the improvement of cyber security measures throughout society via appropriate and timely reports to regulatory authorities and active provision of information to security-related institutions