



**SMBC**

SUMITOMO MITSUI BANKING CORPORATION  
EUROPE LIMITED

## Pillar 3 Disclosures

(As of 31<sup>st</sup> March 2009)

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## Contents

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1. Overview .....	4
2. Governance.....	6
3. Risk Management Framework .....	8
4. Integrated Risk Management Framework .....	9
5. Credit Risk Management.....	13
6. Market Risk Management .....	19
7. Liquidity Risk Management .....	21
8. Operational Risk Management.....	23
9. Capital Structure .....	24
10. Capital Adequacy .....	25
11. Credit Risk Exposures.....	27

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## **Document disclaimer**

- The purpose of the Pillar 3 disclosures as contained within this Disclosure Document is solely to explain the basis according to which Sumitomo Mitsui Banking Corporation Europe Limited (“SMBCE” or “the Bank”) complies with certain capital related requirements and to provide information about the management of risks relating to those requirements.
- This Disclosure Document does not constitute any form of financial statement on behalf of the Bank and should be read in conjunction with the Bank’s Annual Report & Financial Statements.
- This Disclosure Document reflects, where appropriate, information which is contained within the Bank’s Annual Report & Financial Statements.
- The Information has been subject to internal review, but has not been audited by the Bank’s external auditors.
- Although Pillar 3 disclosures are designed to provide transparent capital disclosure by banks on a common basis, the information contained in this particular Disclosure Document may not be directly comparable with that made available by other banks. This may be due to a number of factors such as:
  - The mix of approaches allowed under the Capital Requirements Directive (“CRD”),
  - The mix of corporate exposure types between banks,
  - The different risk appetites and profiles of banks,
  - The different waivers applied for and allowed by the FSA.
- Pillar 2 capital requirements are excluded from this Disclosure Document, but nevertheless play a major role in determining both the total capital requirements of the Bank and any surplus capital available.

## 1. Overview

### 1.1 Background

The ongoing capital requirements for international banks are now governed on an overall basis by a capital accord formulated by the Basel Committee on Banking Supervision, known as Basel 2. The framework involves a three-pillar approach, with each individual Pillar being an important and mutually reinforcing element in determining the overall capital which an institution needs to have in place:

- Pillar 1 is Minimum & Enhanced Capital Requirement (quantification of credit risk, market risk and operational risk).
- Pillar 2 is Supervisory Review (involving Individual Capital Guidance & Assessment by the regulator based on consideration of Risk and Business & Control Risk Factors. This enables capture of other wider general risks).
- Pillar 3 is Market Discipline (this involves frequent and forward looking disclosure set by the regulator).

In the case of banks in the EU, implementation of Basel 2 has been achieved via the Capital Requirements Directive (“CRD”). The CRD came into effect in the EU as at the beginning of 2007. This provided the formal legislative framework to be reflected in the detailed rules and requirements which are imposed by each local regulator, e.g. the Financial Services Authority (“UK FSA”) in the case of SMBCE.

In the UK, these are covered by the FSA’s rules contained in BIPRU (The Prudential Sourcebook for Banks, Building Societies and Investment), and GENPRU (the General Prudential Sourcebook).

BIPRU Section 11 lays out the disclosure requirements applicable to banks and building societies, in accordance with Pillar 3. The Section 11 requirements are designed to promote market discipline by providing market participants with key information on a firm’s risk exposures, risk management processes, and hence capital adequacy. Improved public disclosures of such information lead to increased transparency and should lead directly to more effective market discipline.

On 6<sup>th</sup> December 2007, the FSA granted SMBCE permission to use an Internal Ratings Based (“IRB”) approach to credit risk and capital management, alongside the Standardised approach for certain assets (as outlined in more detail in subsequent sections of this document). Therefore, the Bank became fully subject to the relevant BIPRU and GENPRU requirements from 1<sup>st</sup> January 2008.

## 1.2 Disclosure overview

In accordance with the BIPRU section 11 requirements, the Bank has therefore prepared this Disclosure Document. The Bank's initial Disclosure Document presents the internal status as at 31<sup>st</sup> March 2009, being the end of the first financial year throughout which the new regime has been applicable to the Bank.

The Disclosure Document contains both qualitative and quantitative information, concerning the following areas:

- **Governance** (section 2);
- **Risk Management**; both in relation to overall risk management issues and specific risk categories (sections 3 – 8);
- **Capital structure and adequacy** (sections 9 – 10)

In addition section 11 provides a more detailed analysis of the Bank's credit portfolio and associated capital requirements in relation thereto.

## 1.3 Basis and Frequency of Disclosures

These disclosures are based on 31<sup>st</sup> March 2009 year end data.

After due consideration of the size and complexity of operations, the Bank has determined that the Disclosure Document will be formally updated on an annual basis, to reflect the situation as at the end of each financial year. However, any material change in the approaches or permissions used to calculate capital requirements will be disclosed as it arises.

## 1.4 Consolidation basis

SMBCE is regulated and authorised as a UK bank by the Financial Services Authority ("FSA").

SMBCE is required by the FSA to produce consolidated regulated reports, including its branches in France and Italy, in order to assess its capital resources and capital requirements.

This Disclosure Document therefore relates to the SMBCE Consolidated regulated group.

## 1.5 Location and verification

This Disclosure Document has been reviewed by the Bank's senior management but has not been subject to external audit. However, where data is equivalent to that included in the Bank's Annual Report and Financial Statements, then such data has been subject to external audit during the formal review and verification process.

The Disclosure Document is published on the Bank's corporate website, which is felt to be the most appropriate mechanism to ensure that there is maximum transparency as per BIPRU Section 11.

This can be found at <http://www.smbcgroup.com/emea/emea/info/index>

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## 2. Governance

### 2.1 Overview

The Bank has in place a structure to ensure responsibilities are clear for the management of all significant risks. Key elements of these responsibilities are as follows:

**The SMBCE Board** is responsible for the exercise of effective management oversight of key risks.

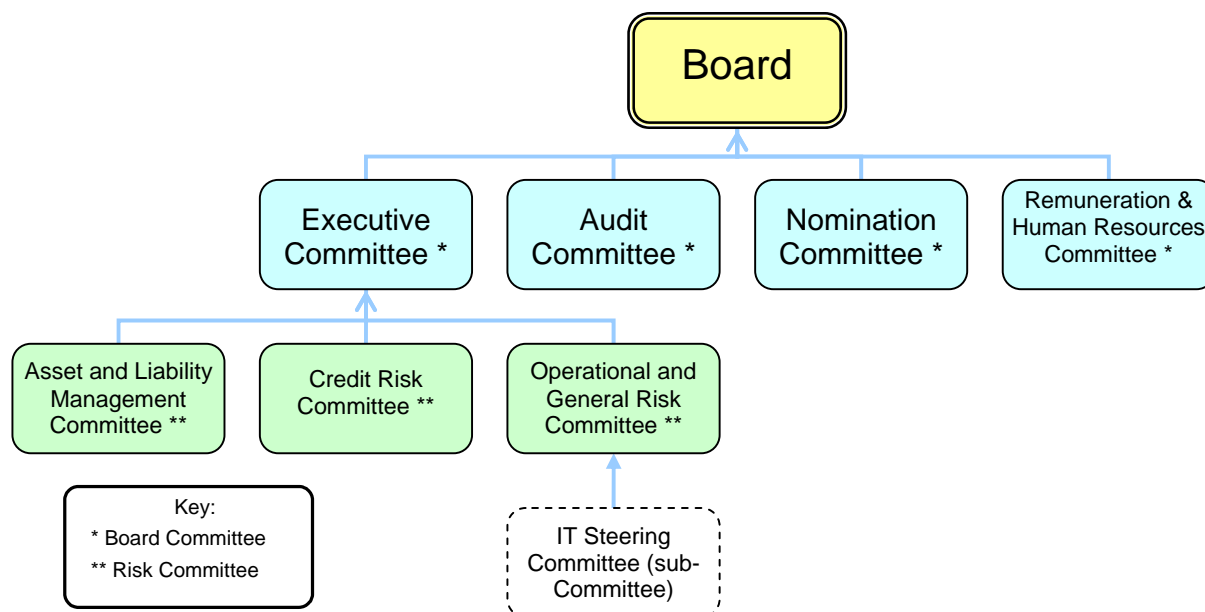
**The Executive Committee** is responsible for oversight of the Risk Committees. As part of this responsibility, the Executive Committee reviews and monitors the most significant risk issues, reporting issues of the greatest significance to the Board.

**Risk Committees** - The Bank has established three Risk Committees, which report to the Executive Committee. These Committees have responsibility for considering the risks to which the Bank is exposed, as follows:

- Credit Risk issues are monitored at the Credit Risk Committee;
- Market and Liquidity Risk issues are monitored at the Asset and Liability Management Committee;
- Operational Risks are monitored at the Operational and General Risk Committee (“OGRC”).

In addition, the OGRC has responsibility for examining the risks associated with new products and services, and major project and business change activity. This committee also examines a number of other risk areas, including: IT, the business continuity plan, human resources, legal, regulatory compliance, and reputational risk. The OGRC has also established a sub-committee, the IT Steering Committee, which is primarily responsible for examining IT projects and IT policies and strategies including global initiatives and how these apply to the Bank.

The Committee structure is represented in the diagram below:



Please note that the Nomination Committee was established during FY 2009. While the Remuneration & Human Resources Committee was also constituted as a Board Committee in FY 2009, a meeting of Directors, at which largely the same issues were considered, had been held since FY 2003.

## 2.2 Relationship with Parent

As a 100% subsidiary of Sumitomo Mitsui Banking Corporation (“SMBC”), SMBCE will in general seek to ensure alignment of strategy in important areas and to ensure cost-effective and consistent approaches across the group, where appropriate.

The Bank therefore follows overall SMBC group policy in assessing and managing risks and uncertainties.

However, the Bank’s management will at all times ensure local relevance in order to support achievement of local objectives.

## 3. Risk Management Framework

### 3.1 Importance of Risk Management

Risk management is a key discipline to manage and grow the Bank in order to:

- Optimise the return to, and protect the interests of, stakeholders (including the shareholders, customers and staff);
- Safeguard the Bank's assets and protect its reputation;
- Improve the Bank's operating performance; and
- Fulfill the Bank's strategic objectives.

### 3.2 Classification of Principal Risks

As a banking institution, the Bank is exposed to certain fundamental risks and uncertainties in conducting its business. The Bank classifies the principal risks into 5 categories, as shown below:

- **Credit risk:** risk of any losses the Bank may incur due to reduction or loss of the value of assets (including off balance-sheet assets) arising from any credit events, such as the deterioration of a borrower's financial standing.
- **Market risk:** 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.
- **Liquidity risk:** 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.
- **Operational risk:** the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events, including legal risks.
- **Business Environment risk:** the risk to earnings and capital arising from changes in the business environment and from adverse business decisions, improper setting of or implementation of strategy or lack of responsiveness to changes in the business environment.

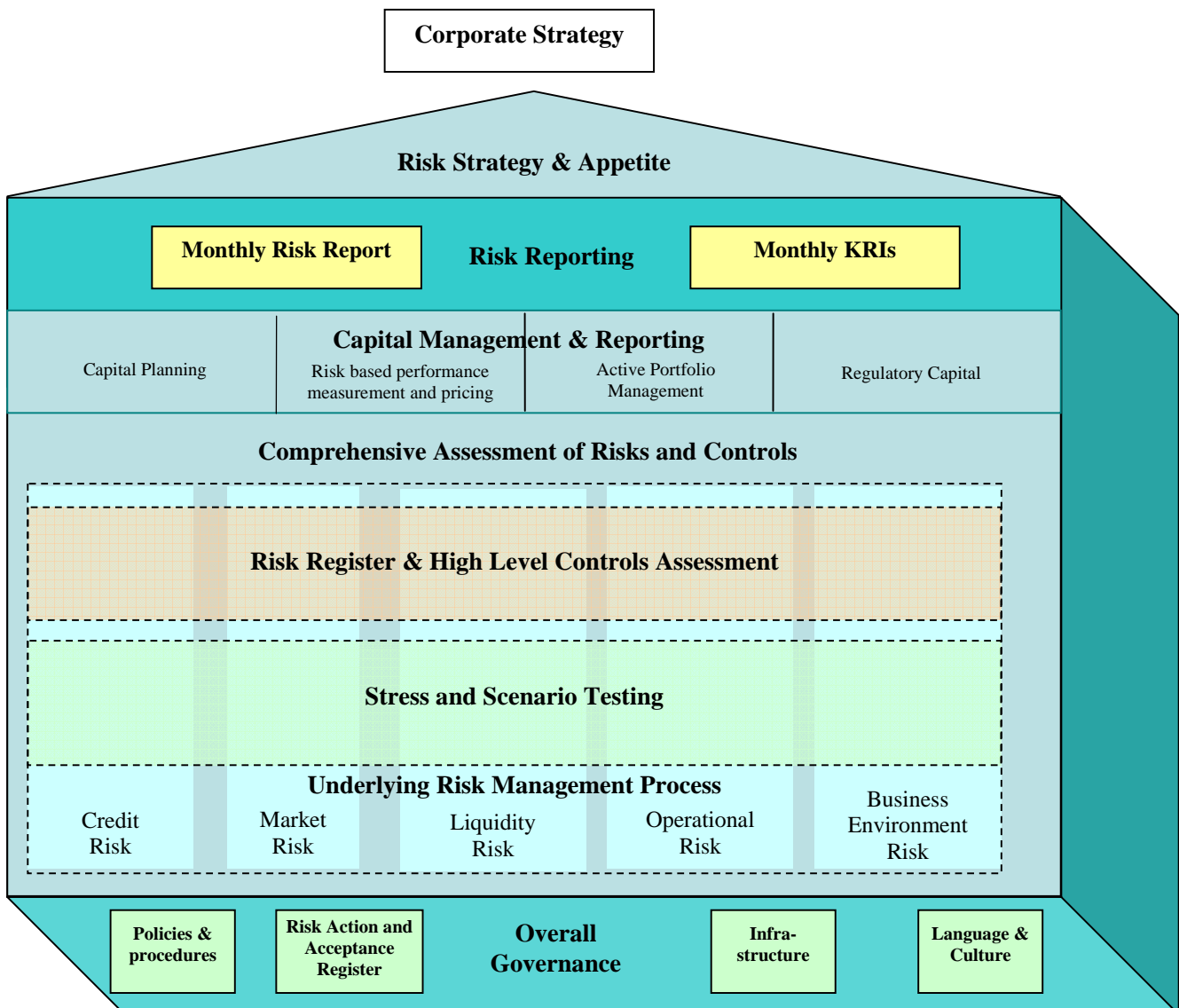
The above list should not be considered exhaustive as the Bank is also exposed to other potential risks and uncertainties.

## 4. Integrated Risk Management Framework

### 4.1 Overview

To assist in the timely identification and holistic management and reporting of key risks, SMBCE has established an Integrated Risk Management (“IRM”) Framework, which contains a number of key elements. This is represented diagrammatically below, whilst sections 4.3 to 4.7 provide more detail of various aspects:

### 4.2 Integrated Risk Management Framework



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### 4.3 Corporate Strategy

A Corporate Strategy is produced annually for SMBCE and approved by the Board. This sets out the key products and markets for the Bank, the targets for these and outlines the plans to achieve these targets. The Bank recognises the importance of ensuring that it has a process to assess the risks to achievement of the Corporate Strategy and seeks to ensure that adequate controls are in place to mitigate those risks. The Corporate Strategy therefore emphasises the importance of ensuring that the overall risk management approach is appropriate and relevant for the organisation. Risk Management Department (“RMD”) is closely involved in review and establishment of the Corporate Strategy and ensures that any relevant risk aspects are being appropriately captured in elements of the IRM Framework, e.g. in updates to the Bank’s Risk Register (see section 4.7 below) as necessary.

### 4.4 Risk Strategy and Appetite

Embedded within the Corporate Strategy is a confirmation of the Bank’s overall risk strategy and confirmation of Risk Appetite.

This sets out the tolerance for risk in terms of limits, which (where appropriate) have been defined in terms of economic capital. Risk appetite levels have been agreed by management and the Board.

The Bank has established both warning limits and absolute limits to ensure that movements in economic capital across the risk spectrum, and hence position against the defined risk appetite, can be monitored closely, with appropriate understanding at the senior management level of the current risk status.

### 4.5 Risk Reporting

RMD produces a monthly Risk Report for the Bank’s Executive Committee. This contains all pertinent information relating to the current status of the five principal risk categories, and includes:

- Economic capital, assessed against key thresholds (or risk appetite);
- Monthly Key Risk Indicators;
- Any relevant regulatory matters;
- Relevant significant Audit findings;
- Other relevant information specific to the risk type (e.g. Money Gap limits, liquidity ratios, guideline limit excesses for Market Risk, Loss Data and results of Risk and Control Assessments for Operational Risk etc); and
- An overall assessment of the level of risk (made by RMD).

The Risk Report includes an updated Regulatory Capital calculation. It also contains details of the current stress testing.

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## **4.6 Capital Management and Reporting**

The Bank has always understood the fundamental role of capital in supporting the risks arising from its business activities. The Bank will at all times ensure the adequacy of levels of internal capital (according to both regulatory and internal criteria).

### **4.6.1 Economic Capital**

Economic Capital is used throughout the business for risk-based pricing, via the Risk Adjusted Return on Capital (“RAROC”) methodology. Economic capital is also used in relation to the overall management and monitoring of risks, as per the Risk Report.

### **4.6.2 Regulatory Capital**

Regulatory capital is monitored by the Finance and Control Group and daily information is provided around the Bank. An analysis of the current regulatory capital position is included in the monthly report by Finance and Control to the Executive Committee.

The Bank undertakes an Internal Capital Adequacy Assessment Process (“ICAAP”) which is an internal assessment of its capital needs. This makes use of regulatory capital calculations for Pillar 1 risks, as well as internal calculations of other capital calculations arising under Pillar 2. This is summarised in the ICAAP documentation.

The Bank has an ICAAP Policy, which emphasises the importance that is placed upon ensuring that the Bank has robust risk and capital assessment and management processes in place internally, and that these are regularly reviewed and updated. Both the ICAAP Policy and the ICAAP documentation are updated annually and subject to formal review and approval by appropriate Committees and the Board (with whom ultimate responsibility lies).

During 2008, the FSA formally assessed the Bank’s ICAAP related documentation as part of their Supervisory Review and Evaluation Process (“SREP”) and established an Individual Capital Guidance (ICG) level for the Bank.

## 4.7 Comprehensive Assessment of Risks and Controls.

This is performed in three ways:

- i) **Risk Register and High Level Controls Assessment (“HLCA”)** – The Bank maintains a Risk Register which reflects the key risks to the attainment of the business objectives established by the management of the Bank, as reflected in the most recent Corporate Strategy. These risks are categorised under the five principal risk categories shown in section 3.2.

The Risk Register also contains details of the key controls in place to mitigate the key risks. The Risk Register is used to support the semi-annual HLCA which involves the assessment by control owners of the effectiveness of those controls. If the control is not considered to be fully effective, then the decision will be made to either:

- Mitigate the risk: improve the control environment to the point where the residual risk is within business appetite, either through reducing the likelihood of the risk materialising, or mitigating the impact if the risk does materialise; or
- Accept the risk. This is performed on a Risk vs Return basis, and typically would be followed where the cost of an acceptable solution exceeds the expected benefit.

Both risk mitigation action items and risk acceptances are controlled through a Risk Action and Acceptance Register. The status of all items is reported on a monthly basis to the Operational and General Risk Committee (“OGRC”) and other internal bodies as appropriate.

- ii) **Stress Testing** – Stress testing is a key tool to model the impact of low-frequency, extreme impact events which might not be appropriately captured by more normal risk management techniques. The Bank is currently placing a high priority upon expanding and enhancing its work in this area. This is regarded as being particularly important, taking into account both the turbulent market conditions and also emerging regulatory requirements, such as those contained in the FSA’s Consultation Paper CP 08/24.
- iii) **Underlying Risk Management Processes** – these are all undertaken at the functional level, and are addressed in more detail in subsequent sections.

## 5. Credit Risk Management

### 5.1 Current status

SMBCE obtained approval from the UK FSA to calculate its Pillar 1 credit risk capital calculations using a Foundation Internal Ratings-Based (“IRB”) approach from 1<sup>st</sup> January 2008, using internal Probability of Default (“PD”) rates, with Loss Given Default (“LGD”) as per regulatory guidance for Japanese corporate, financial institutions and sovereign lending only.

Other assets are rated using the non-Japanese corporate model are calculated for regulatory capital purposes according to the Standardised Approach.

Specialised lending uses supervisory slotting calculations.

### 5.2 Board responsibility

As the most senior body within the Bank, SMBCE’s Board has responsibility for approval of certain key operating policies, including those which relate to the governance of Credit Risk. The Board oversees all elements of the Bank’s Credit Risk management structures and, in order to perform its role effectively, receives regular reports on all critical credit-related issues.

The Credit Risk Committee (“CRC”) is the internal committee directly responsible for strategic matters associated with the governance of credit risk. The CRC reports to the Executive Committee, which in turn reports to the Board.

On a practical basis, the SMBCE Board has established the rules for approval of individual transactions, which is a key part of the Bank’s day-to-day governance of credit risk. Specific approval authority levels have been established and these are reviewed on an annual basis. The General Manager of Credit Department, the COO and the CEO have authority to approve transactions up to certain limits. Should a transaction exceed the COO and CEO’s approval authority, the approval of a meeting comprising the CEO, one non-executive Director and one executive Director acting together is also necessary.

Although SMBCE is an independent entity, the Board does operate within the context of the overall corporate governance structure of the SMBC group. The SMBC group has adopted an integrated approach to various aspects of credit risk management on a global basis, to ensure that resources and structures are harnessed in the most effective manner.

### 5.3 Importance of independent credit assessment

SMBCE utilises obligor and facility grading systems to assess the credit risk of individual transactions and capture the credit risk of the credit portfolio. Generally, the credit risk of the portfolio can be divided between credit cost (Expected Loss ["EL"]) and credit risk capital (Unexpected Loss ["UL"]). The Bank provides against EL with loss provisions and against UL with necessary capital. All credits include probability of default, regardless of quality; thus, the credit risk of the credit portfolio must be controlled by assigning Obligor Grades and Facility Grades. To support any credit decision, the credit risk associated with the specific transaction which is under consideration must be assessed.

SMBCE's assessments do not necessarily match external ratings (ratings published by rating agencies) for a variety of reasons, including:

- Rating agencies do not always have the same perspective as banks;
- Rating agencies may have access to different information;
- Rating assessment models used by rating agencies may take a different approach, such as Moody's KMV EDF<sup>1</sup> model; and
- Rating agencies may also have different updating schedules.

### 5.4 Rating systems

SMBCE utilises a number of different internally developed rating systems and processes in the credit assessment process, reflecting different asset classes involved, with separate systems used for different assets including:

- Corporates (both Japanese and non-Japanese)
- Banks
- Securities companies
- Insurance companies
- Public Sector (including central governments and central banks)
- Project finance
- Aircraft finance
- Ship finance
- Property finance
- Purchased Claims

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1, EDF is the expected default frequency within one year calculated based on stock price movement and other factors.

## 5.5 Assignment of Obligor and Facility Grades

In the case of both Obligor grades and Facility Grades, detailed procedures document the approach which must be followed to ensure that the assessment is carried out appropriately.

An Obligor Grade indicates the credit risk of a company. To ensure allocation of obligor rating (and hence to assign an appropriate level in terms of internal PD), the first step is to undertake a detailed analysis of credit quality by use of the appropriate model. Obligor Grades are determined through a 3-step process – quantitative assessment, qualitative assessment, and self-assessment. Maintaining the integrity of Obligor Grades is critical for transaction and portfolio decision-making.

Obligor Grades range from 1a (the least risky) to 10 (the riskiest), with a common scale on a global basis across the SMBC group.

As part of this approach, and reflecting different market conditions, the Bank differentiates between Japanese and non-Japanese customers. Japanese corporates are assigned a “J series” Obligor grade and non-Japanese corporates are distinguished as being “G series”. The Bank also adopts a consolidated approach to assignment of grades to subsidiaries, meaning that when a Consolidated Subsidiary Grade is assigned, the same notation and methodology as those of the parent company are applied. Thus, almost all overseas Japanese companies will have J-grades.

A Facility Grade indicates the credit risk of an individual transaction and is determined by modifying the Obligor Grade according to the level of risk associated with conditions of the facility itself. The Facility Grade procedures require a formal assessment of pertinent factors, such as:

- Guarantees
- Third party assurances
- Tenor
- Collateral
- Purpose/structure
- Country ceiling/ transfer risk

## 5.6 Country Ceiling

In general, an Obligor Grade will not exceed the sovereign (government or central bank) grade of the country of domicile. In line with the approach of S&P, Moody's and other rating agencies which assess country risk and use the ratings as the ceiling for individual obligor rating SMBCE applies the country rating ceiling.

## 5.7 Internal Rating System grades

The calibration of the internal grade structure is shown below:

G grade	J grade	Borrower's Category
Code	Code	
G1	J1	Normal Borrowers
G2	J2	
G3	J3	
G4	J4	
G5	J5	
G6	J6	
G7	J7	Borrowers requiring caution
G7R	J7R	Substandard Borrowers
G8	J8	Potentially Bankrupt Borrowers
G9	J9	Virtually Bankrupt Borrowers
G10	J10	Bankrupt Borrowers

As the internal rating system, G7R and J7R or below grades are recognised as “Default” in terms of CRD in line with BIPRU default definition.

## 5.8 Use of the IRB approach

The use of the IRB approach forms an integral part of the Bank's credit approval process.

Each transaction is accompanied by an analysis of the return generated on a risk-adjusted basis to assess the profitability of transactions considering credit cost (i.e. expected loss) and capital cost, via the calculation of the "Risk Adjusted Return on Capital" or "RAROC", and "Sumitomo Mitsui Value Added" or "SMVA". These calculations take into account the economic capital which will be required to support any particular transaction, including Credit, Market, Operational and Liquidity Risk capital allocations. Tools, training and guidance are provided to business areas to ensure that this assessment is done in a consistent manner.

Another factor which will be taken into account is the extent to which provision of credit to a customer, industry group or country may give rise to particular concentrations of exposure.

There are, of course, wide-ranging requirements in terms of the supporting analysis and evaluation which have to be provided to ensure a thorough assessment of the transaction. For example, although not directly IRB-related, the Bank has established guidelines to ensure appropriate consideration is given to regulatory issues, social responsibility and environmental impact. This approach controls the extent to which these factors could give rise to risks (such as legal or reputational risk) of relevance to capital requirements under the Bank's ICAAP.

## 5.9 Use of Collateral and Other Credit Risk Mitigation

SMBCE uses various types of collateral to mitigate credit risk inherent within transactions, including:-

- Financial Collateral – Japanese Government Bonds, Cash and/or eligible guarantees (including Formal Guarantee and Credit Default Swaps ("CDS")) and / or Letters of Credit.
- Fixed charges over cash balances, tangible assets (e.g. aircraft and ships) and property in the form of buildings, plant and machinery.
- Assignments over receivables, ancillary instruments such as insurance policies, shares and share pledges.

It should be noted that in regulatory capital calculations, SMBCE recognises the collateral only if it is categorised as being collateral where the current value is easy to evaluate and is very stable, and there is strong liquidity. This only includes deposits and government bonds. The effect of collateral is recognised by applying supervisory, post hair-cut LGDs on each transaction under the comprehensive method.

## 5.10 Validation of rating systems

The rating systems used are subject to annual validation (both in terms of the rating models and parameters used) to ensure that they retain a sufficient degree of default discrimination power and are functioning effectively. The validation work encompasses critical factors such as:

- Default discrimination power of Obligor Grades
- Cross-sectional validation of actual default rate of each grade
- Consistency with external ratings

Backtesting of parameters is also conducted to ensure that the current Probability of Default (“PD”) estimates are reasonable. Adjustments will be made to the estimation method or aspects of the rating systems as necessary.

## 5.11 Securitisation

SMBCE utilises securitisations in order to enhance capital efficiency by freeing up capital, particularly in the area of Project Finance. In securitisations, credit derivatives are used to transfer underlying obligor risk to external counterparties. For the purposes of portfolio management across business units SMBCE securitises pools of lending assets.

Where the securitisation exposures are rated by an eligible External Credit Assessment Institution (“ECAI”) SMBCE uses the Ratings Based Method for calculating regulatory capital requirements. Where these grades are not available SMBCE employs the Supervisory Formula method.

Such structures have formed and continue to form an important part of SMBCE’s commercial lending practices, particularly as they relate to Project Finance. Although a niche participant in the securitisation market to date, SMBCE has been one of the most active originators of securitisations referencing a range of project finance lending positions.

SMBCE makes use of both publicly rated and unrated securitisation techniques. Decisions about which approach is adopted will tend to result from prevailing market conditions, operational considerations and the particular requirements of the target group of investors. In calculating its capital requirements under Basel II SMBCE uses both the Ratings-Based Approach (“RBA”) where the securitisation exposures are rated by an eligible ECAI and the Supervisory Formula (“SF”) where external ratings are not available.

List of securitisations SMBCE has originated to date:

Deal Name	Closing	Deal Type	Portfolio Amount	Assets	SMBCE role
Profile I	Dec-05	Synthetic CDO	GBP 383m	UK PFI/PPP project loans	Originator
SMART PFI 2007 GmbH	Mar-07	Synthetic CDO	GBP 400m	UK PFI/PPP project loans	Originator

## 6. Market Risk Management

### 6.1 Market Risk Management

The Bank recognises market risk, as defined in Section 3.2 of this Disclosure Document, as being one of the principal risk categories arising in its activities.

For regulatory capital purposes, the Bank calculates its market risk capital requirements according to the Standardised methodology.

### 6.2 Market Risk Management Framework

The Bank has in place well defined policies and procedures for the identification, measurement and control of market risk. Embedded within these is a framework of management responsibilities.

The Board oversees the market risk management process. The corporate governance framework for market risk management ensures that appropriate controls, policies and senior management oversight form the basis of the Bank's approach to market risk management.

### 6.3 Market Risk Management System

The Board has delegated to the General Manager of Treasury Department ("GM of TD") the executive responsibility to prudently manage the general market risk of SMBCE within the limits and guidelines established by the Board. These are aligned appropriately with limits and guidance from Corporate Risk Management Department of SMBC.

The Board has also delegated to the General Manager, Risk Management Department, who also acts as the Bank's Chief Risk Officer ("GM of RMD & CRO"), the responsibility for middle office and risk management. RMD is entirely independent of Treasury Department. RMD is therefore responsible for identifying, measuring, monitoring and analysing SMBCE's market risk exposure and reporting to the management of SMBCE.

The principal aspects of the governance and control of market risk are set out in the Market Risk Policy (Interest Rate Risk in the Banking Book) and Market Risk Policy (Trading Book), updated on an annual basis, both of which are key operating policies of the Bank approved by the Board. Key aspects include Market Risk Measurement and Stress Testing, as follows:

## **i) Market Risk Measurement**

SMBCE separates market risk related activities between its Banking book and its Trading book. The accounting, risk control and capital (regulatory and economic) for each of these is established to be appropriate to the nature and scale of the activities conducted. The nature of the Banking book is to generate profit through the management of interest rates, terms and other aspects of assets (loans, bonds) and liabilities (deposits etc.) by market operations.

While market risk capital for regulatory capital purposes is calculated according to the Standardised methodology, SMBCE also measures and controls market risk using Value at Risk (VaR). VaR is a measure of the maximum expected loss in a portfolio to a given degree of confidence over a specified period. SMBCE has adopted SMBC's approach to the calculation of VaR and uses a 99% confidence interval and a one-day time horizon. SMBCE currently uses an historical simulation to generate the VaR result using data from a four-year observation period, updated monthly.

The limitations to VaR are well recognised, for example the use of historical data as a guide to future price movements and the assumption that open positions can be hedged within the specified holding period. Therefore the Bank subdivides market risk into key types for which foreign exchange risk and interest rate risk are the main categories. Risk management for each category is fine-tuned by employing suitable sensitivity limits such as foreign exchange exposure and Basis Point Value (BPV) limits. BPV measures the potential change in portfolio fair value for an instantaneous 0.01% rise in interest rates.

Foreign exchange and Interest rate risk (in both banking and trading books) are monitored on a daily basis. Reporting on risk versus limit is submitted to senior management on a same day basis.

## **ii) Stress Testing**

SMBCE prepares interest rate risk stress tests on a monthly basis consisting of six rate shift scenarios applied to the Banking (and Trading) book positions with a maximum loss scenario reported to management. Foreign exchange stress tests are also conducted on a monthly basis where potential US dollar appreciation and depreciation is applied to the banks open currency positions. A maximum loss scenario is calculated and reported to Management.

## 7. Liquidity Risk Management

### 7.1 Liquidity Risk Management

The Bank recognises liquidity risk, as defined in Section 3.2 of this Disclosure Document, as being one of the principal risk categories arising in its activities.

### 7.2 Liquidity Risk Management Framework

The Bank has in place well defined policies and procedures for the identification, measurement and control of liquidity risk. Embedded within these is a framework of management responsibilities.

The Board oversees the liquidity risk management process. The corporate governance framework for liquidity risk management ensures that appropriate controls, policies and senior management oversight form the basis of the Bank's approach to liquidity risk management.

### 7.3 Liquidity Risk Management System

The Board has delegated to the General Manager of Treasury Department ("GM of TD") the executive responsibility to prudently manage the liquidity risk of SMBCE within the limits and guidelines established by the Board. These are aligned appropriately with limits and guidance from Corporate Risk Management Department of SMBC.

The Board has also delegated to the General Manager, Risk Management Department, who also acts as the Bank's Chief Risk Officer ("GM of RMD & CRO"), the responsibility for middle office and risk management. RMD is entirely independent of Treasury Department. RMD is therefore responsible for identifying, measuring, monitoring and analysing SMBCE's liquidity risk exposure and reporting to the management of SMBCE.

Given the market turmoil over the course of the past year, the Bank is placing considerable emphasis upon ensuring that the mechanisms in place to assist in liquidity planning are suitably robust.

In particular, as a subsidiary of a global financial institution, management of the Bank are reviewing these mechanisms on an ongoing basis taking into account emerging regulatory requirements which may be imposed locally by the FSA (as per Policy Statement 09/16).

The principal aspects of the governance and control of liquidity risk are set out in a Liquidity Risk Policy, updated on an annual basis, which is a key operating policy of the Bank approved by the Board. Key aspects include Money Gap limit control, as well as participation in SMBC's global contingency funding supplementary liquidity plans and stress testing, as follows:

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**i) Money Gap Limit**

The Money Gap Limit is the maximum amount of net funding calculated on a cashflow basis

**ii) Contingency Planning**

SMBCE's contingency plan consists of four phases based on the funding situation, market conditions etc.

**iii) Supplementary Liquidity**

SMBC's supplementary liquidity programme, which is followed by SMBCE, requires that in each key business centre the local entity is responsible for ensuring the "at sight" availability of an agreed amount of its home currency. This is a mutually supportive scheme by which SMBC entities support one another to ensure sufficiency of liquidity in any single currency across the group.

**iv) Stress Testing**

Internal stress testing is conducted on a monthly basis and reported at Asset and Liability Management Committee. The scenarios utilised in the stress tests are in line with current regulatory requirements, being idiosyncratic and systemic in nature. Current measures employed are considered to have proven to be robust, notwithstanding the difficult liquidity situation prevailing in the global financial markets.

## 8. Operational Risk Management

### 8.1 Overview

The Bank has an established Operational Risk management function whose purpose is to develop, implement and maintain the Bank's Operational Risk strategy and framework to mitigate the risk of losses from inadequate or failed internal processes, people and systems, or from external events.

The Bank's framework for Operational Risk management aims to minimise the occurrence and impact of Operational Risk events, in particular avoiding extreme or catastrophic events, in order to support the Bank's achievement of its strategic objectives.

To achieve this, the Bank has established a suitable Operational Risk management governance structure and framework of processes to:

- ensure an appropriate understanding and awareness of Operational Risk at all levels of the Bank;
- effectively anticipate operational risks and implement appropriate mitigation in line with the Bank's Operational Risk appetite;
- effectively manage Operational Risk events to minimise their reoccurrence; and
- implement the Bank's Operational Risk capital strategy to ensure the Bank is adequately capitalised for Operational Risk requirements.

The Bank's regulatory capital requirements for operational risk are calculated according to The Standardised Approach ("TSA") under which gross income is regarded as a proxy for the Operational Risk exposure within each business line. The capital charge for Operational Risk is calculated based upon gross income for the preceding three years.

The Bank's activities are closely aligned with those adopted across SMFG globally. Since 31st March 2008, SMBC has adopted the Advanced Measurement Approach ("AMA") for calculation of operational risk capital requirements on a consolidated basis across the group as a whole.

## 9. Capital Structure

### 9.1 Overview

All figures in USD 000's

	31 March 2009	31 March 2008
<b>Tier 1 core capital</b>		
Permanent share capital	1,600,000	1,200,000
Profit & Loss and other reserves	121,500	208,900
<b>Qualified tier 2 capital</b>		
Fixed term preference shares	0	500,000
Subordinated debt	800,000	0
	<u>2,521,500</u>	<u>1,908,900</u>

### 9.2 Restructuring of capital

On 27<sup>th</sup> May 2008 the Bank undertook a restructuring of its capital. On this date, the Bank:

- Issued additional Ordinary share capital of USD 400 million, comprising 400,000 shares of USD 1,000 each.
- Redeemed its entire Preference Share capital of USD 500 million.
- Drew down a new USD 800 million subordinated loan from SMBC.

The result of this restructuring was to increase the Bank's regulatory capital from USD1.84 billion to USD2.54 billion, comprising Tier 1 share capital of USD1.6 billion, Tier 2 capital of USD0.8 billion, with the balance comprising reserves.

This increase was undertaken to ensure capacity to pursue an appropriate business strategy, reflecting market conditions.

### 9.3 Securitisation first losses

As per FSA BIPRU guidelines (para. 9.10.2) SMBCE has elected to include any first loss positions arising from securitisation transactions as additions to Credit Risk rather than deduct the exposure value from capital resources.

### 9.4 Expected loss excesses

SMBCE's collective provisions are equal to the Expected Losses on those assets. Therefore, there is no requirement or opportunity to deduct 50% of excesses from capital.

## 10. Capital Adequacy

### 10.1 Capital requirements for Credit Risk

All figures in USD 000's

	31 March 2009	31 March 2008
<b>Standardised Approach</b>		
Corporate exposures	575,146	522,508
<b>Internal Ratings Based Approach - Foundation</b>		
Central governments and central banks	3,365	3,648
Banks	72,788	115,544
Corporate exposures – excluding specialised lending	46,927	53,251
Corporate exposures – specialised lending	138,267	156,736
Total IRB	261,347	329,179
Total Credit Risk Capital Requirement	836,493	851,686

#### Notes:

1. The Standardised Approach is used for non-Japanese corporate customer exposures and is calculated as credit risk-weighted asset amount x 8%.
2. Foundation IRB Approach is used for all other asset classes, including Specialised Lending via the Supervisory Slotting Criteria. It is calculated as per FSA guidelines using Bank estimates of Probability of Default (PD). The credit risk-weighted asset amount x 8% is then multiplied by a scaling factor of 1.06.
3. Figures include securitisation first losses, as additions to Credit Risk rather than deductions from capital resources.

## 10.2 Capital requirements for Market Risk

	31 March 2009	31 March 2008
<b>Standardised Method</b>		
Interest rate risk	15,900	23,500
Options transactions	4,800	800
Foreign Exchange risk	4,000	6,900
	<hr/>	<hr/>
	24,700	31,200
	<hr/>	<hr/>

## 10.3 Capital requirements for Operational Risk

	31 March 2009	31 March 2008
<b>The Standardised Approach</b>		
	50,904	41,388
	<hr/>	<hr/>
	50,904	41,388
	<hr/>	<hr/>

## 10.4 Capital Adequacy ratio, Tier 1 capital adequacy ratio and total capital requirement

	31 March 2009	31 March 2008
<b>Total capital adequacy ratio</b>	22.12%	15.47%
<b>Tier 1 capital adequacy ratio</b>	15.10%	11.27%
<b>Total capital requirements</b>	912,097	951,737
8% of credit risk-weighted assets	836,493	851,686
Capital requirements for Market Risk	24,700	31,200
Capital requirement for Operational Risk	50,904	41,388
Capital floor add-on <sup>1</sup>	0	27,462

<sup>1</sup> Add-on for the amount by which total credit risk falls below regulatory capital floor of 80% (2008: 90%).

## 11. Credit Risk Exposures

### 11.1 By approach

	Exposure At Default “EAD”
Standardised	8,455,712
FIRB	11,671,188
FIRB – Specialised Lending	3,133,861
	23,260,761

### 11.2 By exposure type

Exposure type	EAD	Specific provisions
Finance and insurance	10,189,745	201,632
Govt. & local authorities	282,077	0
Manufacturing	2,729,124	8,311
Wholesale	472,896	0
Services	173,026	0
Other corporate exposures	5,122,548	18,653
Transport	1,911,761	6,386
Energy	801,514	0
Infrastructure	1,480,857	0
Co-Investment	97,013	0
	23,260,761	234,982

### 11.3 By residual maturity

Maturity band	EAD
To 1 year	11,523,662
More than 1 year to 3 years	4,094,182
More than 3 years to 5 years	3,360,887
More than 5 years to 7 years	982,503
More than 7 years	3,299,527
	<u>23,260,761</u>

### 11.4 By geographic area

Country region	EAD	Specific provisions
United Kingdom	6,831,700	18,866
France	3,100,752	17,865
Italy	714,915	0
Other Europe	8,090,041	198,251
Eastern Europe	1,544,858	0
Japan	552,254	0
Other Asia	255,970	0
Africa	334,945	0
Latin America	100,115	0
Middle East	638,973	0
North America	849,411	0
Oceania	246,827	0
	<u>23,260,761</u>	<u>234,982</u>

### 11.5 Exposures subject to IRB approach – Corporate exposures

Grade	EAD			Weighted average risk-weight
	On balance sheet	Off balance sheet	Total	
J1 - J2	978,376	361,153	1,339,529	12.3%
J3 - J4	284,877	290,717	575,594	47.0%
J5 - J6	30,318	7,346	37,664	127.6%
J7A - 7B	13,504	888	14,392	173.9%
Others	0	25,249	25,249	0.0%
J7R - J10	0	0	0	
	<u>1,307,076</u>	<u>685,353</u>	<u>1,992,428</u>	

### 11.6 Exposures subject to IRB approach – Sovereign exposures

Grade	EAD			Weighted average risk-weight
	On balance sheet	Off balance sheet	Total	
G1 - G2	1,240,392	0	1,240,392	0.0%
G3 - G4	0	0	0	0.0%
G5 - G6	0	0	0	0.0%
G7A - 7B	0	18,750	18,750	224.3%
Others	0	0	0	0.0%
G7R - G10	0	0	0	
	<u>1,240,392</u>	<u>18,750</u>	<u>1,259,142</u>	

### 11.7 Exposures subject to IRB approach – Bank exposures

Grade	EAD			Weighted average risk-weight
	On balance sheet	Off balance sheet	Total	
J1 - J2	121,343	230,288	351,630	6.0%
J3 - J4	30,000	105	30,105	36.7%
J5 - J6	0	434	434	162.8%
J7A - 7B	0	0	0	0%
Others	0	0	0	0%
J7R - J10	0	0	0	
	<u>151,343</u>	<u>230,827</u>	<u>382,170</u>	

Grade	EAD			Weighted average risk-weight
	On balance sheet	Off balance sheet	Total	
G1 - G2	6,526,452	740,813	7,267,264	6.4%
G3 - G4	411,161	22,140	433,301	78.6%
G5 - G6	83,353	3,996	87,349	123.0%
G7A - 7B	4,550	0	4,550	221.5%
Others	4,089	10,550	14,639	9.3%
G7R - G10	207,270	12,558	219,828	
	<u>7,236,874</u>	<u>790,057</u>	<u>8,026,932</u>	

### 11.8 Exposures subject to IRB approach – All exposures

Grade	EAD			Weighted average risk-weight
	On balance sheet	Off balance sheet	Total	
J1 - J2	1,099,719	591,440	1,691,159	11.0%
J3 - J4	314,877	290,822	605,700	46.5%
J5 - J6	30,318	7,780	38,098	128.0%
J7A - 7B	13,504	888	14,392	173.9%
Others	0	25,249	25,249	0%
J7R - J10	0	0	0	
	<u>1,458,418</u>	<u>916,180</u>	<u>2,374,598</u>	

Grade	EAD			Weighted average risk-weight
	On balance sheet	Off balance sheet	Total	
G1 - G2	7,766,844	740,813	8,507,657	5.5%
G3 - G4	411,161	22,140	433,301	78.6%
G5 - G6	83,353	3,996	87,349	123.0%
G7A - 7B	4,550	18,750	23,300	223.8%
Others	4,089	10,550	14,639	9.3%
G7R - G10	207,270	12,558	219,828	
	<u>8,477,267</u>	<u>808,807</u>	<u>9,286,074</u>	

Co-investment	2,153	8,363	10,516	90.0%
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Total	<u>9,937,838</u>	<u>1,733,350</u>	<u>11,671,188</u>	
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### 11.9 Specialised lending by exposure and weighting

Slotting Criteria	Risk-weight	EAD
Strong	<b>50%</b> <b>70%</b>	2,493,529
Good	<b>70%</b> <b>90%</b>	503,855
Satisfactory	<b>115%</b>	25,168
Weak	<b>250%</b>	35,512
		<u>3,058,064</u>

#### Other assets under EL methodology

Co-investment transactions	<u>75,797</u>
Total EL method	<u>3,133,861</u>

### 11.10 Standardised Approach by risk weighting

CQS	S&P ratings	Moody's ratings	Weight	EAD
1	AAA to AA-	Aaa to Aa3	20.0%	178,064
2	A+ to A-	A1 to A3	50.0%	687,998
3	BBB+ to BBB-	Baa1 to Baa3	100.0%	990,106
4	BB+ to BB-	Ba1 to Ba3	100.0%	60,524
No ECAI grade <sup>1</sup>			20.0%	265
			50.0%	10,000
			100.0%	6,023,172
LFG <sup>2</sup>			150.0%	505,583
				<u>8,455,712</u>

<sup>1</sup> Default weight depends on exposure class for all transactions without an external grade from an approved ECAI. All SMBCE Standardised Approach assets are corporates.

<sup>2</sup> Leveraged Finance Group (LFG) assets default to 100% but an adjustment is made to assume that CQS5 @ 150% would be applied if external grade were found.