

Risk Management

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The Return On Assets of banks is relatively lower due to the nature of the business of banking, and as a result, banks have to operate at high levels of gearing in the process of financial intermediation in order to generate adequate returns which are acceptable to the shareholders. Increasing levels of gearing coupled with growing sophistication of banking products and services, markets and technology exposes banks to a multitude of risks such as credit, liquidity, interest rate, foreign exchange rate, operational, legal, regulatory, reputational etc., which are interdependent to a great extent. Careful management of these risks not only prevents any potential losses but could also provide opportunities for new or greater business which could turn in huge rewards. Hence, Risk Management is about achieving the optimum trade-off between avoiding/protecting against a potential danger and an opportunity to enhance returns.

At Nations Trust Bank, we attempt to ensure that our risk taking is informed and prudent. Our efforts on Risk Management are geared to ensure that:

- (a) the total risk being taken is matched to the Bank's capacity for absorbing losses if things go wrong; and

- (b) to direct the scarce resource of capital to opportunities that are expected to create the maximum return with the minimum risk.

2008 was an eventful year for the Bank from the perspective of Risk Management as well.

Demonstrating the commitment of the Board to a strong and independent Risk Management function and in compliance with the guidelines issued by the Central Bank of Sri Lanka, a Board Integrated Risk Management Committee was set up during the year. The Bank also prepared and obtained the approval of the Board for a number of policies which will strengthen the Risk Management infrastructure. These included Risk Management Policy, Terms of Reference for the Board Integrated Risk Management Committee, Communications Policy and Code governing Share Dealing by Employees.

Under the aegis of the Board Integrated Risk Management Committee, the Bank tabulated the important Risk Indicators and their goals that need to be monitored by the Risk Management Committee. Commencing from 1st quarter of 2009, the Bank will report to the Risk Management Committee on the actual status of these risk indicators against the set risk goals.

CREDIT RISK

Credit Risk is defined as the risk of non-payment by a counterparty of capital and interest on due dates that can be attributed to one or more factors affecting a business in a given environment. Banks are therefore, attaching a greater emphasis and importance to Risk Management tools and control procedures to better understand its customers and their business performance in order to identify emerging trends and take proactive steps to minimise losses.

The Bank has therefore brought in improvements to the existing Risk Management systems and procedures to achieve this objective given the increasingly difficult environment for credit growth during 2008. Among them were the introduction of an additional mid-year financial and performance review of large credit exposures and a more stringent risk grading methodology of customers with greater focus on financial data. This has enabled reassessment of the overall credit quality of the Corporate and Wholesale book. Our automated early warning systems will continue to give adequate warnings on accounts which will need closer attention.

The asset writing strategy for the consumer lending area consisting of consumer loans and Credit Cards came under the close

scrutiny of a separate Consumer Credit Risk Committee that reviewed market developments and weakening disposable income levels of the average consumer during the year for appropriate risk control measures. The Bank also used the services of external consultants to review the collection processes and practices and introduce improvements while work on a credit scoring system is in progress for implementation in early 2009.

The Bank's Credit Management policies and guidelines are approved by the Board of Directors with a comprehensive mechanism to evaluate and approve Credit through delegated powers entrusted with the Head Office Credit Committee which, in turn, recommends to the Board Credit Committee proposals outside its authority.

The Credit Risk Management Division independently evaluates all credit proposals above a certain limit and monitors industry and sectoral exposures while also ensuring that regulatory guidelines pertaining to Single Borrower Limit and maximum aggregate limits to high exposure clients are complied with. It also monitors portfolio performance through periodic reviews and identifies early warning signals and emerging trends to take appropriate remedial action.

The Board Supervisory Committee reviews monthly a detailed analysis of non-performing loans and advances (NPLs), sector-wise NPL statistics; high risk exposures which is submitted to the Board for discussion. It also undertakes a comprehensive review of all high exposures on a quarterly basis to gauge and understand the quality of the Bank's lending portfolio and recommends suitable action to the Bank's Corporate Management.

The Bank adopts a conservative policy towards specific provisioning and begins provisioning on facilities that are in arrears for more than 90 days, which is more stringent than the requirement of the Central Bank of Sri Lanka.

The administration and management of credit is independent of the business units. The Credit Administration Unit deals with the operational issues relating to the granting of facilities including the control of security, loading of limits to the system and the provision of reports.

ASSET AND LIABILITY MANAGEMENT

Asset and Liability Management deals with the management of the market risks that arise from the Bank's structural position of assets and liabilities, On-Balance Sheet and Off-Balance Sheet, created in the process of financial intermediation. The Bank accords the highest importance to the Asset and Liability Management (ALM) function and has laid down a well structured procedure to ensure that the Bank is able to offer competitively priced products and services to customers whilst maintaining an appropriate risk/reward profile that creates shareholder value. This includes risk assessment in all dimensions including:

- Policy setting
- Structuring of the Bank's re-pricing and maturity schedules
- Undertaking financial hedge positions
- Capital budgeting
- Internal profitability measurement

ALM also includes contingency planning by analysing impact of unexpected changes in the environment in terms of interest rates, competitive conditions and economic fundamentals and plans as to how the Bank will respond to them.

Managing the risk that arises from the mismatches in various attributes of assets and liabilities is a key for the success of Bank's growth and profitability. The Asset and Liability Management Committee (ALCO) is chaired by the Chief Executive Officer and comprise the Heads of Business Units, Head of Credit Risk Management, Chief Financial Officer and Head of Internal Audit. ALCO, under delegated authority from the Board, sets policies in relation

to management of structural balance sheet exposures. The ALCO is also given specific authority by the Board to review and implement prudent Risk Management policies in the day-to-day operations of the Bank. ALCO reports to the Board and recommends changes of the policy beyond its authority of approval.

Exchange rate risk exposures, liquidity and interest rate risk profiles are analysed and reported at the ALCO meetings held monthly. The potential impact due to interest rate movements is also reviewed. The Bank also adopts a daily Risk Management process by reviewing Risk Management reports daily by the relevant Heads of Departments and other senior personnel in order to achieve the risk objectives of the Bank. Appropriate Balance Sheet strategies are discussed and implemented. ALCO monitors the structure/composition of Bank's assets and liabilities and decides on product pricing for deposits and advances. ALCO also decides on the transfer pricing policy of the Bank.

MARKET RISK

Market risk is the risk of potential for losses that will result due to unfavourable movements in factors such as interest rates, exchange rates, equity and commodity prices. It is the risk of losing money because the perceived value of an instrument has changed. The primary market risk to which the Bank is exposed to are interest rate risk and exchange rate risk. The Bank's exposure is controlled by limits approved by the Board, the monitoring of which is carried out by the ALCO. The market risks arising from interest and exchange rates volatility is centrally managed by the Treasury Division ensuring adherence to Board policy. The Foreign Exchange exposure is mainly derived from trade and remittance flows, trading activities by treasury and structural foreign currency translation exposure. The Settlement Department is independent of foreign currency dealing operations in order to reinforce the Bank's Risk Management

process. The Bank has set up an independent middle office for limit monitoring and deal tracking, which office reports to the Head of Credit Risk Management.

The Bank monitors continuously and takes necessary actions to manage the cost of funding to maintain acceptable margins in response to changing market conditions. The Value-At-Risk and the Duration concepts as well as dynamic gap planning are implemented and calculated daily to complement the traditional measures of notional and gap limits. Treasury Department is mainly responsible to ensure that exposures are within set parameters, which is reviewed by ALCO.

LIQUIDITY RISK

Given the dramatic events unfolding in the global financial markets and a slow down in the local financial services industry, liquidity has become a key business imperative.

Liquidity risk is the risk of being unable to ensure sufficient availability of Cash Flows to meet all financial obligations of the Bank as and when they fall due. Hence, the Bank's main objective in this regard is to ensure that sufficient cash flows are available to meet all of the Bank's financial commitments and to expand business, on a timely and cost-effective basis, under various market conditions. Apart from maintaining the statutory Liquid Assets Ratio above the minimum requirement of 20% at all times, the Bank has adopted a number of methods to manage liquidity at optimum levels.

The Maximum Cash Outflow report in the fortnightly ALCO pack categorises the assets and liabilities into suitable time buckets with Board approved exposure limits on each time bucket up to three months. ALCO reviews this report and effects corrective action as necessary to ensure that the outflows are within the approved limits. Board approved ALCO Terms of Reference and a Liquidity Policy are in place. Treasury division is responsible

for complying with the Liquidity Policy to ensure the Bank has sufficient cash flows to meet its financial obligations on a timely basis. The Bank also holds a sufficient level of highly liquid marketable assets such as Government of Sri Lanka Treasury Bills and Bonds. Taking cognisance of the market developments and with a view to strengthen the process of managing liquidity further, the Bank commenced stress testing of liquidity during the year. It assesses the funding capability of the Bank under normal market conditions as well as in times of distress due to market related or Bank specific factors under two different levels of contingency. In accordance with the Liquidity Policy, the ALCO which meets on a monthly basis under normal market conditions, is required to meet more frequently when abnormal market conditions (as defined in the policy) apply, to monitor and map out strategies to address liquidity concerns.

OPERATIONAL RISK

Operational risk can be defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Studies into recent bank failures demonstrate that it is often a breakdown of basic internal controls that have posed the greatest risk to financial institutions and that such instances may sometimes harm even the reputation of the Bank. Managing operational risk has in fact gained an added importance in the wake of phenomenal increase in volume of transactions, growing sophistication of financial technology, growth of e-commerce, greater outsourcing for transaction processing, complex support systems etc. the Bank has established a sound Management Information System, a strong internal control culture and contingency plans to address operational risks. By managing operational risks, the Bank expects to operate in full compliance with regulatory guidelines, maximise operational performance while simultaneously minimising operational losses.

Primary responsibility for managing operational risks rests with the business lines. Operational risk is mitigated by the implementation of internal controls. The Bank's processes and procedures are under continuous review. Where possible, identified operational risks are insured.

Regular reviews of the implementation of the Bank's procedures and internal controls and their effectiveness is carried out by the Internal Audit Department that reports to the Board Audit Review Committee.

Additionally, a Compliance Department has been set up with a member of the Corporate Management as the Chief Compliance Officer (CCO). Directly reporting to the CCO, the Manager - Compliance heads the Compliance Department and is primarily responsible for the implementation and monitoring of all regulatory controls and initiatives including all Anti-Money Laundering and Combat of Financing of Terrorism (AML/CFT) activities. Each business and support unit within the Bank has nominated an officer who will interact with the CCO and the Manager - Compliance for all AML/CFT, regulatory and compliance related matters.

CONCLUSION

Regulatory developments are making it compulsory that banks implement rigorous and robust Risk Management methodologies in their internal models. Basel II also places heavy reliance on the internal risk assessment and management techniques for the purpose of quantifying and allocating capital for credit, market and operational risks. Under a risk-focused approach to bank supervision, Regulators will be placing more and more emphasis on the soundness of the Risk Management practices of banks. Accordingly, the Bank has given due importance to the development and implementation of Risk Management capabilities and will continue to build it further in 2009.



Delivered to Your Door

With Nations Trust Bank's 'Banking at your Doorstep', you don't have to come to the bank the bank will come to you. Our best customers can now get a whole portfolio of valuable services delivered to their door!

