Risks Closely Managed and Controlled

We managed risks optimising the risk-return trade off

The Bank has in place a risk governance structure at Board and Management level with comprehensive policies that guide Risk Management.
The Bank has in place properly constituted Board and Management Committees to oversee key areas such as Credit, Market and Operational Risks.
Diversification in terms of sources of income, geography and business units is proactively pursued by the Bank.

OVERVIEW

Based on the many views expressed in the aftermath of the recent turmoil affecting the credit markets and their constituent financial institutions, there is absolutely no doubt in the value of prudent risk management policies and processes. It remains an essential building block for longer term stability for both the individual Financial Institutions (FIs) as well as the financial systems. Today, given the intense competition and commoditised banking products, risk management plays another more important role as a strategic differentiator between the many FIs that look and feel the same. Viewed as a business limiter and a cost burden, some FIs engage in its exercise and application only as a response to regulatory censure while others do so for not only regulatory reasons but also to obtain competitive advantage enabling them to undertake more and new business in a measured and controlled environment. The need for risk management is also rooted in the scarcity of capital and difficulty of capital accumulation via the earnings stream. The capacity to capture and measure risks, to monitor their impact and manage their outcome in real time, to avoid concentrations be they customers, industries, currencies, tenors, rates, etc., provides tangible safeguards in the preservation of capital and hence a basis to grow and expand.

Our risk management strategy encapsulates all of the above and strives to ensure that only well-calculated conservative risks are undertaken while the integrity and reputation of the institution remains paramount. The systematic identification of risks and a structured process for managing them, which includes well-defined responsibilities and demarcated areas of accountability, are cornerstones of the process. The aim is to optimise stakeholder value by achieving an appropriate balance between risk and return with a clear focus of encouraging and inculcating an organisation with a wide risk management culture.

RISK GOVERNANCE

The NTB Board identifies the optimal risk - return profile for the business at the strategic planning level while establishing the appropriate risk governance structure both at the Board and at the Management Level. Also the Board puts in place comprehensive risk management policies and processes on the recommendation of Management and Board Committees which are frequently reviewed in tandem with local and international best practices. In discharging its governance responsibility for overall risk management and control, the Board has established two key Committees, the Integrated Risk Management Committee (IRMC) and the Board Audit Review Committee (BARC).

The IRMC assists the Board in fulfilling its responsibilities relating to the oversight and review of risk management strategies, policies, processes and establishing mechanisms to identify sources of risk, methods for risk assessment and measurement and introduction of appropriate controls and monitoring. It also sets and monitors a variety of numerical risk goals and limits that capture the entirety of the Bank's operations. The BARC assists the Board in overseeing Management compliance with set policies, procedures and relevant regulations and ensures the effectiveness of the system of internal controls.

Management for their part continues to oversee and update the systems, policies and procedures in all dimensions of operations within the broad guidelines and policies set by the Board. These policies and procedures are integrated into the day-to-day operations and decision making process of all business and support units.

Graphically the Risk Management Framework at NTB can be expressed as follows:

Establish Risk Appetite and Policy
- Chairman and Board of Directors
- Integrated Risk Management Committee
- Board Credit Committee
- Board Supervisory Committee

Ensure Implementation of Risk Policy including Compliance
- **Dedicated Institutional Committees**
  - Assets and Liabilities Management Committee
  - Head Office Credit Committee
  - Operational Risk Committee (Being formed)
- **Independent Risk Management and Control**
  - Credit Risk Division
  - Treasury Middle Office
  - Operational Risk Unit
  - Compliance Unit

Implement and Comply with Policy
- **Strategic Business Units**
  - Consumer Banking
  - Corporate and Wholesale Banking
  - Card and Consumer Assets
  - Small and Medium Enterprise Banking
  - Treasury and Capital Market Operations

Board Audit Review Committee

CREDIT RISK

Credit Risk is the possibility of losses resulting from the failure or unwillingness of a borrower or counterparty to meet the contractual obligations to the Bank and the risk that collateral will not cover such claim. Being the largest source of risk, the Bank attaches a greater emphasis and importance to its management.

Our credit risk management policies and guidelines are approved by the Board of Directors with a comprehensive mechanism to evaluate and approve credit exposure through delegated powers entrusted with the Head Office Credit Committee. In turn, the Committee recommends to the Board Credit Committee proposals and transactions beyond its delegated authority.

Responsibilities for credit risk are clearly demarcated between:

- Marketing and relationship management
- Credit risk management
- Documentation and administration and
- Recovery and management of distressed loans

The Credit Risk Management Division closely monitors changes in economic and market conditions, identifying trends and concentrations. It guides business units in their responsibilities for managing their customer portfolios while focusing on the quality of the entire loan portfolio.

It independently evaluates all credit proposals above specified limits and monitors industry and sector exposures while also ensuring that regulatory guidelines pertaining to the Single Borrower Limit and maximum aggregate limits to large 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.

Another Board committee, the Board Supervisory Committee, reviews amongst others detailed analysis of non-performing loans and advances, sector-wise NPL statistics and high risk exposures on a monthly basis, all of which are submitted to the Board for discussion. It also undertakes a comprehensive review of all large exposures on a quarterly basis to gauge and understand the quality of the loan portfolio and recommends suitable action to management.

Our internal risk identification and monitoring system which is consistent with the nature, size and complexity of the Bank's activities together with tools and control procedures plays a pivotal role identifying emerging trends and taking proactive steps to minimise losses. Further, 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 has enabled reassessment of the overall credit quality of the loan portfolio relating to the Corporate and Wholesale banking sector. An Internal Rating System is currently being used for a range of purposes. At one end it is primarily used to determine and identify risk level of borrowers, while at the other it is also an integral element of credit portfolio monitoring and management, capital allocation and pricing of risk.

The asset writing strategy for the consumer lending area consisting of consumer loans and credit cards comes under the scrutiny of a separate Consumer Credit Risk Committee. It reviews market developments and weakening disposable income levels of average consumers during the year for appropriate risk control measures. Further, steps have been taken to develop a scoring mechanism to underwrite Credit Cards and Personal Loans, which will be implemented during the 1st quarter 2010.

We adopt a conservative policy towards specific provisioning and commence provisioning on facilities that are in arrears for more than 90 days, a more stringent requirement than that set by the Central Bank of Sri Lanka (CBSL). In the case of the Lease Portfolio, the provisioning is in line with CBSL guidelines.

MARKET RISK

Arising in the normal course of business of any financial institution, market risk incorporates liquidity risk and price risk. Liquidity risk is the possibility that an entity may be unable to meet a financial commitment to a customer, creditor or investor or another market participant when contractually due. On the other hand, price risk is the potential threat to earnings arising from fluctuations in interest rates, foreign exchange rates, equities and commodity prices and may be incurred in both non-trading and trading portfolios.

At the Bank, market risk has received significant additional management attention during 2009 as a result of not only the operational lapses that occurred during the year but also as a result of directives issued by CBSL to the banking industry.

Management of market risk at the Bank is supervised by the Assets and Liabilities Committee (ALCO) headed by the CEO with the participation of the Executive Director and heads of key business divisions together with the Head of Credit and Market Risk Management and Chief Financial Officer who meets at least once a month. ALCO formulates the market risk management policies to appropriately manage the assets and liabilities and relevant exposures within set limits. Key market and operational risk indicators with liquidity and interest rate gap reports are monitored and discussed at ALCO. It also reviews the potential impact of concentrations and various scenarios on the Treasury business and other business units to mitigate and manage the related risks.

We have now clearly defined the division of responsibility for day-to-day management of market risks. The Head of Treasury who manages the overall Treasury business and market risks reports to CEO, while the Back Office which processes the Treasury transactions reports to the Chief Operating Officer. The Treasury Middle Office (TMO) independently monitors, measures and analyses the transactions booked on a real time basis. It reports to the Head of Credit and Market Risk Management via key market risk indicator reports that are compiled, reviewed and circulated to the CEO on a daily basis.

Through the internally developed Funds Transfer Pricing System, the interest rate risk and other types of market risks are managed under the Treasury. It in turn assists in ensuring that the various capital, liquidity and pricing issues are well understood by business managers and that they remain adequately motivated by the profitability of the various products coming under their purview.

LIQUIDITY RISK

As mentioned earlier, liquidity risk is the insufficiency of cash flows to meet all financial obligations of the Bank as and when they fall due. Thus the overall funding strategy is planned annually taking into consideration both timing and size of business and investment together with the various sources of funding.

Considerable importance is placed on maintaining the stability of current, savings and other core deposits which are diversified by type and maturity, representing a stable source of funds. Stability depends on maintaining high levels of depositor confidence that we have achieved through fair, competitive and transparent deposit pricing policies. The Bank also maintains active participation in the wholesale and inter-bank money market with established lines of credit. The Bank has appropriate levels of unencumbered marketable securities, principally government securities, which can be realised, repurchased or used as collateral in the event of stress or need for liquidity.

The balance and mix of these two essential sources of funds i.e. deposits and money market funds, play a key role in strategic liquidity management at the Bank.

The ALCO reviews local and foreign currency maturity gaps of assets and liabilities separately and analyses the various stress scenarios which could cause the Bank specific or market-wide liquidity shortfall taking into account forecast for deposit withdrawals and drawdown of committed lending facilities. It also reviews liquidity contingency plans to manage serious disruptions to the liquidity profile. 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 emerge to monitor and map out strategies to address liquidity concerns. Additionally, the Bank continuously complies with a statutory requirement to maintain a minimum 20% Statutory Liquid Asset Ratio on a daily basis within both the Domestic Banking Unit and the Foreign Currency Banking Unit.

INTEREST RATE RISK

As the repricing of assets and liabilities is not identically matched, Interest Rate Risk is unavoidable in any financial institution. The Treasury manages the potential impact which may be caused by the volatility of changes in market interest rates and yield curves in order to optimise net interest income. The ALCO reviews interest rate gap reports with various market scenarios and considers the impact on capital. This assists the ALCO to decide timely re-pricing of products and to device strategies to manage and ensure the financial stability of the Bank in the event of noticeable changes in market conditions and sentiment. Also the TMO monitors the mark to market profitability of the trading portfolio together with the profitability of the investment portfolio.

FOREIGN EXCHANGE RISK

The foreign exchange exposure is derived from many sources. In the main, they result from trade and remittance flows, treasury trading activities and structural foreign currency translation exposures. The Bank has established Risk Tolerance Limits in tandem with CBSL directives and guidelines to ensure that adverse exchange rate movements due to un-hedged foreign exchange positions are restrained within acceptable parameters. The most significant limits in place are -

- Foreign currency position limits for individual currencies and on an aggregate basis;
- Individual dealer limits and Intra-day transaction limits;
- Counterparty Spot, Forward and Placement limits;
- Trading Stop-loss limits; and
- Off-market trades.

While the Treasury is primarily responsible for maintaining these limits, the TMO independently monitors all of them. Details of cash flows and open positions are maintained by both the Treasury Front Office and Treasury Back Office. They are independently reconciled with the books on a daily basis.

OPERATIONAL RISK

Operational risk is the risk of loss arising from failed or inadequate internal processes, people and systems or from external events. Operational Risk Management is an integral part of the duties of the Heads of each business and support units. They are responsible for maintaining an appropriate internal control environment commensurate with the nature of the operations within the framework of the Bank's wide policies and procedures, which are regularly updated in response to changing conditions. Each of the business and support units also has their own risk grids that identify risk events and related impact on their respective units.

Extensive on-going training is provided to ensure that the staff are fully aware of their responsibility for complying with the correct operational procedures in order to optimise operational efficiency and individual accountability at all levels of the Bank. Some of the Internal Controls which are in place for mitigating Operational Risk are:

- Setting of appropriate risk limits and controls and monitor the risks and adherence to limits on a regular basis
- Regular MIS reports to capture exceptional transactions and other risk events for management investigation
- Clear management reporting lines, empowerment and accountability
- Appropriate segregation of duties to prevent any single person being allowed to carry out a process from beginning to end without independent review and to prevent conflicts of interest
- Regular staff rotation and compulsory availment of annual leave
- Maintaining the right MIS infrastructure and upgrading where necessary
- On-going staff training and development

The Bank's Compliance Department also monitors all regulatory activities and ensures that the Bank complies with all laws, regulatory directives and drives the compliance culture across the Bank. Key business processes, procedures and products are regularly reviewed by the Business Process Re-engineering Unit to find any gaps in controls and improve efficiency. Regular staff training programmes on Compliance, Know Your Customer and Anti-Money Laundering as well as Financing of Terrorism Activities are conducted with the participation of industry experts to reinforce staff awareness. We expect to implement an annual self-certification programme for all customer-facing staff covering these aspects of compliance.

The control environment in each business, department and branch is subject to an independent periodic audit by the Internal Audit Department. Major or high-risk observations made during these inspections and corrective action are brought to the attention of the Board Audit Review Committee.

A documented Business Continuity Plan (BCP) is in place to ensure banking operations are carried out without disruption in the event of any external disasters or severe system breakdown. Risk mitigation including insurance for potential low frequency high severity losses is obtained where it is available and cost-effective.

CAPITAL RESOURCES

The capital management framework of the Bank is designed to ensure that it maintains adequate capital resources in relation to its risk profile as both market and public confidence is obtained and retained by such self-regulation and attention to all applicable legislation, regulatory supervision and external rating agency recommendations. The process is interactive and subject to continuous review. As commonly appreciated capital is generated principally via retained earnings, issuance of stock and subordinated debt. Excess capital, alternatively, is used to pay dividends or restructure the business. Capital targets for both the Bank and its subsidiaries are set at levels that exceed regulatory standards.

NTB in common with other banks in Sri Lanka is subject to risk-based capital ratios issued by CBSL. Basically, capital adequacy is measured under two risk-based ratios, namely Tier I and Total Capital (Tier I + Tier II Capital). Tier I capital is considered core capital while Total Capital includes other items such as subordinated debt and loan loss provisions. Both measures are stated as a percentage of risk-adjusted assets, which are measured in terms of their perceived credit risk and include selected off-balance sheet items such as unfunded loan commitments, Letters of Credit and FX contracts.

REGULATORY CAPITAL RATIOS

The Regulatory Capital Ratios of the Group are disclosed in some detail below. In the interest of fuller disclosure on this important aspect, ratios for years 2008 and 2009 are given below:

	2009 Rs. mn	2008 Rs. mn
Tier I Capital	**4,687.21**	4,253.55
Tier II Capital	**1,720.38**	2,222.66
Total Capital	**6,407.60**	6,476.21
Risk-Weighted Amount for Credit Risk	**32,282.69**	36,791.23
Risk-Weighted Amount for Market Risk	**2,143.26**	632.62
Risk-Weighted Amount for Operational Risk	**5,352.68**	3,832.64
Total Risk-Weighted Amount	**39,778.63**	41,256.49
Risk-Adjusted Capital Ratio against Tier I Capital*		
(Tier I Capital/Total Risk-Weighted Amount)	**11.79%**	10.31%
Risk-Adjusted Capital Ratio against Total Capital**		
(Total Capital/Total Risk-Weighted Amount)	**16.11%**	15.70%

**Statutory minimum 5%*
***Statutory minimum 10%*

The decrease of Rs. 4.5 bn in Risk-Weighted Assets for credit risk was mainly due to the contraction of loans and advances evidenced industry-wide during the year. In contrast, Risk-Weighted Assets for Market risk increased by Rs. 1.5 bn with the expanded trading activity in 2009. Growth in business volumes contributed to the increase in operational risk by another Rs. 1.5 bn. As a result, the overall Risk-Weighted assets of the Group reduced by Rs. 1.5 bn.

Due to the combined effect of 2009 earnings and depreciation of subordinate debt during the year, total capital declined by Rs. 68 mn.

However, the significant decrease in Risk Weighted Assets in comparison to the decrease in capital, resulted in appreciation of Total Capital Adequacy Ratio by 0.41%.

The Bank constantly reviews its risk management process and every year takes steps to refine it further. For the years ahead in response to the new Risk Management Guidelines issued by the Central Bank of Sri Lanka (CBSL), we propose to introduce some new risk management processes and structures.

Currently risk management processes operate independently of the revenue-generating business units but have two reporting lines instead of the recommended single reporting line to a Chief Risk Officer (CRO). Under the existing process both credit and market risk is handled by the Head of Credit and Market Risk Management while both Operational Risk and Compliance report to another Head. It is our intention in the fullness of time but as early as possible to combine them in a single role. For the time being, however, we believe that the risks although reported via two channels is well covered and independently managed thereby fulfilling the CBSL guidelines in spirit.