



# ALLIANCE BANK

**Alliance Bank Malaysia Berhad** (88103-W)

## **RISK MANAGEMENT REPORT**

(for the Financial Year Ended 31 March 2013)

### **Risk Management Philosophy**

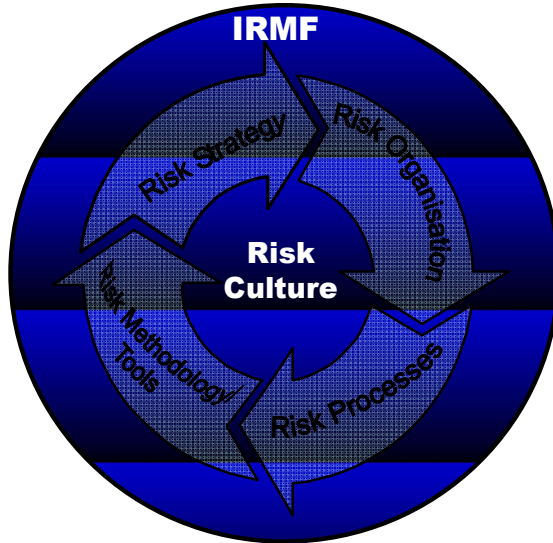
- *To continuously uphold strong risk management culture and practices within the Group, to generate returns that commensurate with our financing and risk taking activities.*
- *To proactively manage risk exposures within our risk appetite, by constantly fine-tuning our risk management approaches in line with the changing financial landscape.*

### **Integrated Risk Management Framework**

In line with this philosophy, the Group has adopted an Integrated Risk Management Framework (IRMF) to govern our businesses and operations. This enables the Bank to carry out systematic and proactive management of the various risks faced on an ongoing basis. These include credit risk, market risk, operational risk, Shariah non-compliance risk, strategic risk and reputational risk.

During the year, the Group also continued to build on the IRMF and risk governance structure. The ongoing risk management efforts included initiatives covering liquidity and capital management under the Basel II and Basel III guidelines, fine-tuning of lending guidelines and credit scorecards, operations and internal control reviews, stress testing and sensitivity analysis, and risk awareness training.

The IRMF supports a programme of actions that is consistent with the industry's best practices, to better position the Group to deal with economic and business challenges. The main thrusts of the IRMF are:



**Risk Strategy** - encompasses risk objectives, risk appetite and risk tolerance limits, and covers alternative approaches to manage the risks.

**Risk Organization** - relates to risk governance, organizational infrastructure and system architectures required for risk management.

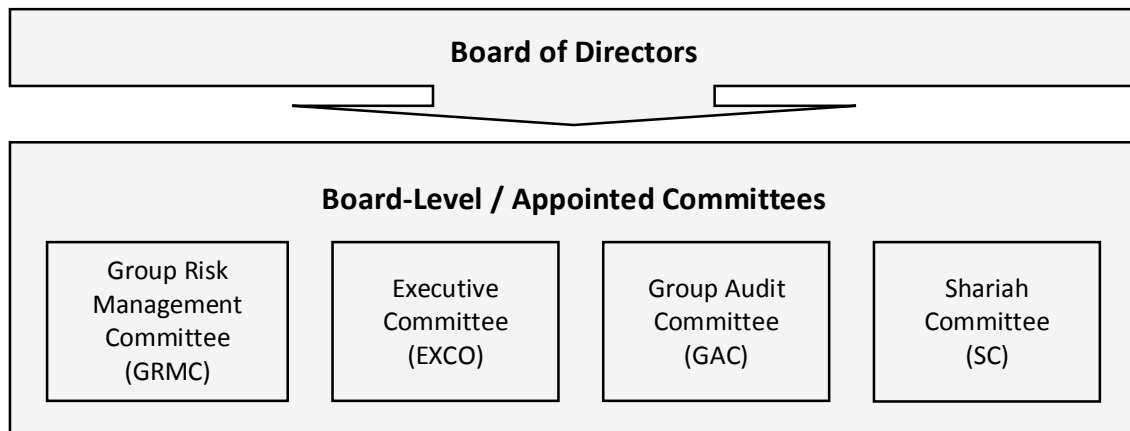
**Risk Processes** - associated with risk identification, risk assessment, risk mitigation, risk monitoring and risk reporting.

**Risk Methodology / Tools** - articulates the methods and tools to support continuous risk management.

The IRMF represents an integration of risk strategies, risk organisation, risk processes, risk methodologies and tools to enable sound risk management. Emphasis is given to the implementation of a strong risk awareness culture, coupled with comprehensive risk frameworks, policies and guidelines; and risk mitigation measures.

### Risk Governance Structure

The following diagrams summarise the risk governance structure of the Banking Group.



The Board of Directors (Board), through the GRMC, is responsible for the overall risk oversight within the Group. This includes reviewing and approving risk management frameworks, risk appetite, risk exposures and limits, whilst ensuring the necessary infrastructure and resources are in place. In support of its risk oversight function, the Board is also assisted by the following committees:

- EXCO – covers business matters
- GAC – covers audit issues
- SC – governs Shariah compliance issues



The PRCs, GALCO and GORMC represent Management Committees that were established to support GRMC in managing credit, market, liquidity, operational and non-compliance risks. In addition, the PRG assists the GRMC in reviewing new products prior to the introduction of such products.

Business and risk management units are represented at the respective committees and work groups, to reflect the joint ownership of business and risk management responsibilities. To strengthen the effectiveness of the risk management function, the Group is functionally segregated into three Lines of Defence, with oversight from the Board and Board-Level Committees.

## Three Lines of Defence Concept

Functional Segregation	Key Responsibilities
<b>1<sup>st</sup> Line of Defence</b> <ul style="list-style-type: none"> <li>Business and Support Units</li> <li>Business Risk Officers / Support Risk Officers</li> </ul>	Business and Support units execute and manage the risk-reward trade-off. Business / Support Risk Officers are embedded within the business and support units, and have the primary responsibility of monitoring and ensuring that the conduct of their activities are carried out within the approved policies and procedures.
<b>2<sup>nd</sup> Line of Defence</b> <ul style="list-style-type: none"> <li>Group Risk Management function</li> <li>Group Compliance function</li> <li>Shariah Compliance and Secretariat Department</li> </ul>	Responsible for: <ul style="list-style-type: none"> <li>Formulating and enhancing risk management and compliance frameworks;</li> <li>Recommending risk management policies, parameters, methodologies and tools;</li> <li>Reviewing the adequacy of controls measures;</li> <li>Performing independent risk monitoring and compliance reporting.</li> </ul>
<b>3<sup>rd</sup> Line of Defence</b> <ul style="list-style-type: none"> <li>Internal Audit</li> </ul>	Internal Audit provides independent assessment of the adequacy and effectiveness of risk policies and internal controls.

## Credit Risk Management

*Credit risk is the risk of financial loss resulting from the failure of the Bank's borrowers or counterparties to fulfil their contractual obligations to repay their loans or settle financial commitments. The Group's credit risk exposures arise primarily from its lending, investment and trading activities.*

The Credit Risk Management Framework defines core policies to be adopted by the Bank's lending activities, financing products and credit models. The core policies, together with business segment policies, require the Group to underwrite risks within the scope of our risk appetite. Regular credit reviews and business-specific early warning frameworks facilitate early detection of imminent problems to improve effectiveness of remedial / recovery actions.

Internal credit rating scorecards / models and external credit ratings are used as credit evaluation tools to underwrite loans and invest in debt securities. The scorecards and models are back-tested / validated for robustness and relevancy.

Business Risk Units monitor and report credit portfolio quality to the respective Portfolio Review Committees and GRMC regularly. Such monitoring enables the identification of adverse credit trends, allowing corrective measures and re-alignment of risk strategies to be implemented, when necessary. Close engagement is also practiced between business units, business risk managers and credit underwriters to foster better alignment of credit policy and execution.

## Market and Liquidity Risk Management

*Market Risk is the risk of loss of earnings arising from changes in interest rates, foreign exchange rates, equity prices, commodity prices and in their implied volatilities.*

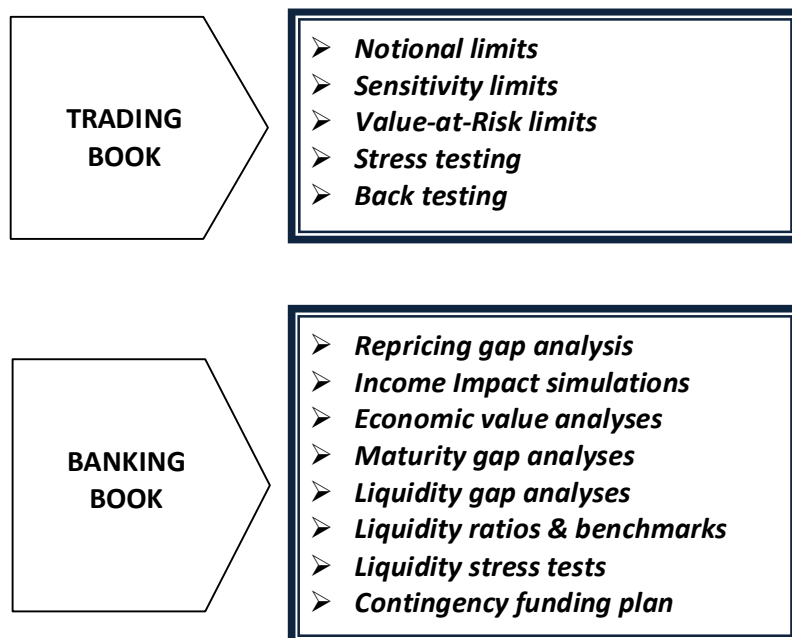
*Liquidity risk refers to inability to:*

- *cover financial commitments when due;*
- *liquidate assets in an orderly manner, due to market disruptions, inadequate market depth and/or wider bid-ask spreads.*

Market and Liquidity risks are governed by the Market Risk Management Framework, which outlines the core policies, principles and methodologies in managing market and liquidity risks. The framework integrates the Group's internal policies with best practices and relevant regulatory requirements. It is complemented by supplementary policies such as the Liquidity Risk Management Policy and Interest Rate Risk Management Policy. In addition, we also have product-specific and portfolio-specific policies that define the risk limits, parameters, monitoring and reporting processes. Trading activities are governed by prescribed risk limits such as cash limits, sensitivity limits, loss limits and Value-at-Risk limits.

Independent monitoring of treasury activities is performed on a daily basis, including reporting and escalation of exceptions, and scheduled reporting of market and liquidity exposures to Senior Management and the GRMC / Board. Furthermore, independent mark-to-market valuation of treasury positions and risk exposures are carried out using rates obtained from various sources.

Market and liquidity risks are managed via the Treasury system and the Asset Liability Management (ALM) system respectively. Various types of limits and tools employed to manage trading and banking book exposures include:



## Operational Risk Management

*Operational Risk is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems, or from external events.*

The Group's strategy for operational risk management is governed by the Operational Risk Management framework as well as:

- Operational policies and procedures
- Risk and control self assessments
- Key risk indicators
- Loss data tracking

We conduct Operational Risk Awareness programmes periodically to inculcate and reinforce risk awareness amongst the staff.

In line with the best practices, the Group employs the following tools for the management of operational risks:

No	Tool	Purpose
1	Risk and Control Self Assessment (RCSA)	To identify and assess operational risks as well as to identify the controls and assess their effectiveness.
2	Control Self Assessment (CSA)	To test / validate the effectiveness of the controls as stated in the RCSA.
3	Key Risk Indicator (KRI)	To monitor and manage operational risk exposures over time.
4	Loss Event Data Collection (LED)	To collect and report loss incidents involving actual losses and 'near misses'.

### Shariah Non-Compliance Risk Management

*Shariah Non-Compliance Risk arises from the risk of failure to comply with Shariah rules and principles, as determined by the relevant Shariah advisory councils. Shariah compliance issues in Islamic financing activities, inter-alia, includes prohibition of Riba (interest), Gharar (uncertainty) and Maisir (gambling).*

Shariah compliance considerations are taken into account in the daily operations of our Islamic financing activities. Our Shariah Governance Framework and Islamic Operational Risk Management Framework have been established to manage Shariah non-compliance risks.

The Group has engaged qualified persons within our Shariah Committee to deliberate on Shariah issues and provide sound Shariah decisions. At least one member of the Shariah Committee sits on the Board of Alliance Islamic Bank to serve as a bridge between the Shariah Committee and Board. Independent Shariah reviews are carried out by the Shariah Review team and are reported to the Shariah Committee. The Shariah Review team also conducts training and research on Shariah compliance covering the activities and operations of the Group.

## Strategic Risk Management

*Strategic risk is the risk of current or prospective impact on a bank's earnings, capital, reputation or standing, arising from changes in the environment the bank operates in and from adverse strategic decisions, improper implementation of decisions, or lack of responsiveness to industry, economy or technological changes.*

The Strategic Risk Management Framework serves as a blueprint that outlines the principles and policies employed by the Group to identify, assess, measure, manage and report on strategic risk issues. Emphasis is given to the implementation of strategic plans, which is aligned with the Group's corporate mission, vision, core values, Risk Appetite Statement and Shariah principles (for Islamic Banking).

## Reputational Risk Management

*Reputational risk is the risk arising from negative perception on the part of customers, counterparties, shareholders, investors, debt-holders, market analysts, other relevant key stakeholders or regulators that can adversely affect a bank's ability to maintain existing, or establish new, business relationships and continued access to sources of funding (e.g. through the interbank markets and / or capital markets).*

The Reputational Risk Management Framework was formalised to manage reputational risk, policies and procedures to ensure that all disclosures to stakeholders are clear, accurate, complete, relevant, consistent and timely. The staff are also guided by our corporate vision, mission and core values.

## Capital Management

### Basel II, Pillar 1 - Capital Computation

The Group has adopted the following respective approaches for capital requirements under Pillar 1 of BNM's guidelines:

- Capital Adequacy Framework (Basel II – Risk-Weighted Assets) for conventional banks; and
- Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets).

Risk Category	Approach
Credit Risk	Standardised Approach
Market Risk	Standardised Approach
Operational Risk	Basic Indicator Approach

**Basel II, Pillar 2 - Internal Capital Adequacy Assessment Process (ICAAP)**

In accordance with our ICAAP implementation, the Group had reviewed the capital management process set out in our Capital Management Framework, covering three dimensions i.e. strategy, process and infrastructure.

The Group performs periodic assessments of all of its exposures in the areas prescribed by ICAAP. We have also carried out estimates of our Internal Minimum Required Capital (IMRR) at entity level, to determine if additional capital is required to support business growth. This includes an annual capital planning exercise covering the projected business plan for the financial year and the next three years' horizon, to ensure that the Group is adequately capitalised.

The Group has also formalised its Risk Appetite statement for each banking entity, which strives for consistent and sustainable growth whilst balancing the risk-reward trade-off. The Group's Risk Appetite statements set out the nature and level of risks that the Group is willing to take to pursue its articulated business strategy.

Capital stress testing is performed regularly, whereby its results form an integral component of the ICAAP, to assess our capital adequacy under stress conditions. The impact of the stress test will be taken into account when assessing the Group's capital requirements during the budgeting and business planning cycle.

The overall responsibility for oversight and governance on ICAAP resides with the Board, while GRMC and GALCO assist the Board in supervising and implementing the process respectively. The ICAAP is reviewed on an annual basis to ensure that the Group maintains adequate capital levels to meet its risk exposures.

**Basel II, Pillar 3 – Disclosure Requirements**

Pillar 3 of Basel II requires banks to provide consistent and comprehensive disclosures for risk management practices, to improve transparency in the financial markets and enhance market discipline. This has been in place since March 2011. Please refer to the Basel II Pillar 3 Disclosure in the Notes to the Financial Statements for further details.

### **Basel III**

BNM has issued the Capital Adequacy Framework which includes the components and the requirement outlined under Basel III. Generally, the implementation of the Basel III guidelines aims to strengthen the capital components of banking institutions in order to be more resilient to financial stress. The main requirements under Basel III include:

- Higher minimum common equity and Tier-1 capital,
- Capital conservation and counter-cyclical buffer,
- Leverage ratio, and
- Phasing out of certain types of capital instruments.

BNM has announced that these additional requirements (in addition to Basel II) shall be implemented in phases, starting from 2013, with full adoption scheduled in 2019. The Group has included regulatory capital de-recognition of our existing Subordinated Debt under the Basel III requirements; and this is reflected in our RWCR computations. From January 2013 onwards, the Group has been reporting the Bank's regulatory capital position based on Basel III requirements. The Group has also put in place processes to monitor the Basel III liquidity ratios to ensure smooth transition when these ratios are subsequently enforced by BNM.

### **Stress Testing**

The Group carries out stress tests to estimate the potential impact of extreme events on the Group's earnings, balance sheet and capital. These stress tests also aim to gauge our sensitivity and vulnerability of specific sectors, product segments or customer segments.

A stress testing framework is applied to identify:

- Vulnerability of the Group's balance sheet to stress events. It examines situations that could pose problems to the Group's balance sheet, thus enabling the Group to assess the potential worst case scenarios and be prepared to face such challenges; and
- Possible events or future changes in financial and economic conditions that could have unfavourable effects on the Group's ability to withstand such changes (particularly in relation to the Group's capital and earnings capacity to absorb significant losses), thus enabling the Group to take steps to conserve capital and manage the risks.

The Stress Test Working Group comprises representatives from relevant functions. The stress test parameters are formulated internally, taking into account the economic scenario, plus current and forecasted key indicators over a rolling one-year period. The scenario, parameters and eventual stress test results are presented to the Stress Test Working Group and GALCO for concurrence and GRMC for approval.

Stress tests are conducted on specific areas, lines of business, entity and group level to identify potential vulnerabilities brought about by the events / scenarios identified. The results, including impact on earnings and capital of the respective entities and group are analysed and reported to the Stress Test Working Group, GRMC / Board and BNM. Where necessary, proactive measures are taken to address potential areas of vulnerability.

The Group has taken relevant measures to ensure that identified key risks are addressed and mitigated, and that its initiatives are in line with regulatory requirements and business growth strategies.