ALLIANCE BANK

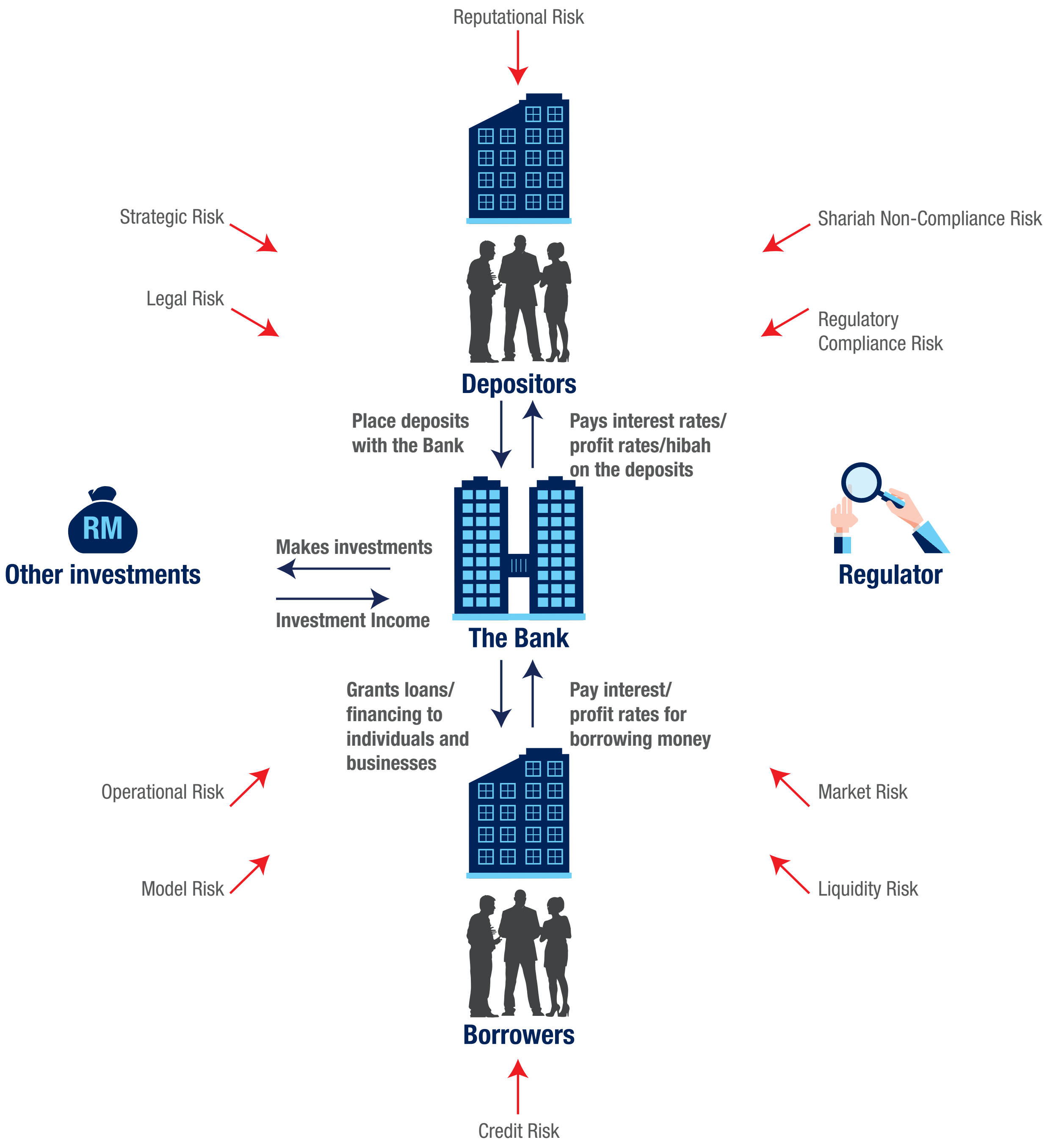
Alliance Bank Malaysia Berhad (88103-W)

RISK MANAGEMENT REPORT FOR THE FINANCIAL YEAR ENDED 31 MARCH 2016

RISK MANAGEMENT

In the course of our daily operations, the Group/Bank takes on a wide variety of risks. These risks arise from the products/services we offer and the business activities that the Bank is engaged in. The Bank faces additional challenges arising from external factors such as changes that impact our economic situation and the economic well being of our customers. Furthermore, the Bank must keep up with changes in the banking environment, industry regulations and compliance requirements. The role of risk management is to assist the Bank to stay safe and achieve sustainable growth, while managing these risks.

The following diagram summarises the Group's main business activities and the key risks we face.



Integrated Risk Management Framework

The Group adopts an Integrated Risk Management Framework (“IRMF”) to manage business and financial risks on a group-wide basis. The IRMF approach enables the Group to have a consolidated view/assessment of all risks and to manage these risks in a holistic manner, alongside business and compliance requirements. The IRMF defines the Group’s key risk activities according to risk categories and identifies the methodologies and tools to manage them, as follows:

Risk Universe	Frameworks and Policies	Methodologies, Tools Used
Credit Risk The risk of loss due to failure by customers/ counterparties to fulfil their contractual obligations to repay their loans/financing or to settle their commitments.	• Credit Risk Management Framework • Credit Programmes/Product Programmes • Risk Acceptance Criteria	• Key Risk Indicators • Tripwires, limits and thresholds • Credit ratings/scorecards • Stress testing
Market Risk The risk of loss arising from adverse changes in market variables such as interest/profit rates, foreign exchange rates, equity prices, commodity prices and/or due to volatile market conditions.	• Market Risk Management Framework • Trading Book Policy Statement • Valuation Policy • Hedging Policy • Value-at-Risk and Back testing • Treasury Product Programmes	• Limits and thresholds • Revaluation, marking-to-market and marking-to-model • Stress testing and back testing • Hedging
Liquidity Risk The risk related to the Bank’s: • Inability to fund financial commitments when due; • Incurring losses when attempting to liquidate assets due to market disruptions and/or illiquid market situations.	• Liquidity Risk Management Framework • Contingency Funding Plan	• Liquidity gap analysis • Liquidity stress testing • Diversification of funding by source, type of depositor, and instrument • Deposit concentration • Liquidity ratios, triggers and thresholds
Operational Risk The risk of loss resulting from failures of processes, people and systems; or from external events which are neither market-related nor credit-related. **Legal and Regulatory Risk** The risk of loss or imposition of penalties, fines, or other liabilities arising from breaches of applicable laws, regulations, or contractual obligations.	• Operational Risk Management Framework • IT Risk Management Framework • Business Continuity Plan • Compliance Framework • Legal Manual • Anti-Money Laundering and Counter Financing of Terrorism Policy	• Risk and Control Self-Assessment • Control Self-Assessment • Key Risk Indicators • Loss Event Data Collection • Heat maps • Operational risk and compliance reviews • New product assessment • Compliance and risk awareness programmes
Shariah Non-Compliance Risk The risk of loss arising from failure to comply with Shariah rules and principles. Shariah-compliant investments may be disposed at a loss.	• Shariah Governance Framework	• Shariah reviews and rating • Shariah non-compliance monitoring and reporting
Strategic Risk The risk of loss arising from the Group adopting the wrong business strategy, failure to properly execute business strategy, or respond to industry/economy or technological changes.	• Strategic Risk Management Framework	• Integrated business strategy, risk appetite and capital planning process • Tracking of strategic initiatives and deliverables • Regular reviews by Management and Board

Risk Universe	Frameworks & Policies	Methodologies, Tools Used
Reputational Risk The risk of loss arising from negative perception by customers, counter-parties, shareholders, investors, debt-holders, market analysts, other relevant key stakeholders or regulators that can adversely affect the Group's existing, or new business relationships and access to sources of funding.	• Reputational Risk Management Framework • Code of Conduct	• Stakeholder and media analysis • Monitoring of corporate risk rating • Regular industry and market benchmarking • Investor relations • Transparent disclosures and communications
Model Risk The risk of loss arising from the failure or inappropriate adoption of risk models.	• Independent Risk Rating Model Validation Framework	• Discriminatory power • Stability • Characteristic Analysis • Migration Analysis • Review of model design, data quality, modelling methodology and use of scorecard

We use a combination of the following components, techniques and tools to monitor and manage risks:

Risk Frameworks, Policies and Limits

- We establish risk frameworks to cover each key risk area.
- We set supplementary policies to govern individual products, business segments and entities.
- We factor in regulatory requirements as well as best practices.
- We set risk parameters and limits, guided by the Group's risk appetite, and add on operational controls.
- We use a combination of limits and controls, to suit different products and businesses.
- We use a combination of quantitative measures and qualitative/judgmental assessments to govern our risk-taking activities.
- We engage the relevant Business and Control functions, to seek input on the proposed policies, limits and controls.
- We review/revise these risk frameworks and policies periodically to adjust to changing market conditions and new regulations.

Risk Methodologies & Tools

- We strive to use statistical tools to quantify and aggregate risks across products, business segments and business entities.
- These quantitative techniques/tools include credit scorecards, risk-rating templates, expected loss models, stress testing and scenario analyses.
- Measurement of risks enables us to gauge the risk levels against risk limits. These are reported to the Senior Management/Board Committees.
- To ensure that these tools continue to function as intended, we employ other techniques to back test and independently validate their reliability.
- Where warranted, our risk models are recalibrated and fine-tuned.
- We avoid over-reliance on statistical models by combining the use of these tools alongside sound judgmental controls.

Risk Communication and Disclosures

- We promote active communication of risks by:
  - Documenting our policies, limits and procedures, and disseminating such information to relevant staff;
  - Training our employees;
  - Tracking and reporting our progress, performance and activities;
  - Highlighting exceptions and key developments to Senior Management and the Board; and
  - Communicating to employees, customers, regulators and other stakeholders.

Risk Management Process

The Group's risk management process starts with risk identification, risk assessment, followed by risk mitigation and control, risk monitoring, risk reporting, escalation, and disclosure. The process is illustrated in the following diagram:

Identify	• Identify the various risks inherent to each product or activity.
Assess	• Adopt quantitative and qualitative approaches to measure and assess these risks, in terms of quantum, severity of impact and likelihood of occurrence.
Mitigation & Control	• Examine various measures to mitigate and monitor these risks. • Implement an appropriate set of risk mitigating and control measures.
Monitoring	• Monitor the risks and control indicators. • Monitor areas of significant risks more closely/frequently. • Identify adverse trends. • Take corrective measures. Revise business/risk strategies where necessary.
Reporting, Escalation & Disclosure	• Furnish periodic risk reports/dashboards to Senior Management and the Board. • Provide disclosure to investors/regulators via statutory/regulatory reporting.

Risk Appetite and Risk Strategy

The Group seeks to achieve sustainable business growth by:

- Balancing business growth and risk-taking;
- Balancing the expectations of the Group's various stakeholders; and
- Managing the Group's Business Risks and Strategic Risks.

The Risk Appetite Framework defines how much risk is taken by the Group. The Group's Risk Appetite Statement, which has been approved by the Board, includes several key metrics:

- Maintaining sufficient capital buffer under business-as-usual operations and projected stress scenarios;
- Maintaining sufficient liquidity buffer to fund daily operations and contingencies;
- Generating equitable level of returns while controlling/managing business activities; and
- Maintaining good quality assets in the Group's loan/financing books through active management of loans/financing, investments and trading activities.

These are monitored regularly to ensure that the Group stays within appropriate risk boundaries.

Risk Culture

Risk management is not merely confined to policies, procedures, limits, and models. Effective risk management also requires a strong risk culture. Risk culture is the system of values and behaviours within the Group that shapes our day-to-day functions.

The Group's Core Values are:

- Respect
- Integrity
- Teamwork
- Excellence
- Ownership

Across the Bank, managing risk is everyone's responsibility, from the top to the front-line staff. The Bank has used various communication channels, ranging from staff communication bulletins, town halls, to staff training/induction courses to cascade and reinforce key messages.

Risk Governance

The Group adopts three lines of defence in managing risks, and each line of defence has clear areas of responsibility.

1st Line of Defence	**Business Units** Business Strategy/Performance and Risk Business Units and Business Risk functions own the risk associated with business. They form the first line of defence against risk by managing the risk-reward trade-off within the scope of the Group's risk tolerance and policies. Business Risk Units and Credit Underwriting Units under the Group Chief Credit Officer's Office are responsible for monitoring business activities and ensuring that they are carried out within the approved policies/product programmes, and business models. Loan/Financing portfolio management, early warning and recovery issues are deliberated at the monthly Portfolio Review Committee ("PRC") meetings, chaired by the respective Business Heads. Members of the PRCs comprise Group Credit and Group Risk personnel to ensure a balance of risk taking and risk control activities across the respective lines of business.
2nd Line of Defence	**Oversight Function** Governance and Risk Oversight Group Risk Management, Group Compliance and Shariah Review Team form the second line of defence, known as Independent Risk Control Units. The responsibilities of these departments include: • Formulate and enhance risk management, compliance and Shariah frameworks; • Recommend risk management/compliance/Shariah policies, methodologies, limits and parameters; • Review adequacy of control measures; and • Independent risk review, monitoring and reporting to the Group Risk Management Committee ("GRMC") and Board.
3rd Line of Defence	**Internal Audit** Independent Assurance As the third line of defence, Group Internal Audit provides independent assessment and assurance to the Audit Committee on the robustness, adequacy and effectiveness of our internal controls related to processes, risks and governance functions.

Governance Structure

The chart below illustrates the governance structure and committees that are mainly responsible for key governance and risk-related functions.

<table>
<tr><th colspan="5">Board of Directors</th></tr>
<tr><td colspan="5">Provides oversight on business strategies and significant policies.
Sets the Bank’s risk appetite.</td></tr>
<tr><th rowspan="2">Board Level</th><th>Group Risk Management Committee (“GRMC”)</th><th>Executive Committee</th><th>Group Audit Committee</th><th>Shariah Committee</th></tr>
<tr><td>Reviews risk management strategies, policies and risk tolerance limits.
Reviews compliance reports/issues.
Ensures infrastructure and resources are in place to manage risk.</td><td>Provides oversight on business issues.
Reviews large credit exposures.</td><td>Oversees the adequacy and effectiveness of the Group’s internal controls.</td><td>Oversees Shariah governance/compliance matters.</td></tr>
<tr><th rowspan="10">Management Level</th><th colspan="4">Group Assets and Liabilities Management Committee (“GALCO”)</th></tr>
<tr><td colspan="4">Governs:
Balance sheet and capital management
Liquidity risk management
Interest/profit rate risk management</td></tr>
<tr><th colspan="4">Group Management Credit Committee</th></tr>
<tr><td colspan="4">Evaluates/approves credit proposals and limits.</td></tr>
<tr><th colspan="4">Credit Portfolio Review Committees
Consumer Banking
SME Banking
Corporate and Commercial Banking</th></tr>
<tr><td colspan="4">Monitors the credit quality of the credit portfolios of the respective business segments. Chaired by the Business Segment Heads. Check-and-balance maintained with participation from Group Credit and Group Risk Management.</td></tr>
<tr><th colspan="4">Group Operational Risk Management Committee</th></tr>
<tr><td colspan="4">Reviews the Group’s operational risk issues/profile.</td></tr>
<tr><th colspan="4">Product Review Group</th></tr>
<tr><td colspan="4">Governs the introduction of new products, covering in-house developed products and third party (bancassurance and wealth management) products.</td></tr>
</table>

Roles and Responsibilities of the Board

- The Board is ultimately responsible for risk oversight within the Group, aided by the GRMC;
- The Board ensures that the Group establishes comprehensive risk management policies, processes and infrastructure to manage the various types of risk;
- The Board is collectively responsible and accountable for the accuracy of disclosures and management of risk;
- For this purpose, the Board has established specialised board committees to oversee critical or major functional areas and to address matters which require detailed review or in-depth consideration. Although the Board may delegate certain duties to the Board Committees, it remains responsible for the policies/decisions approved by these committees.

Roles and Responsibilities of GRMC

The GRMC is a Board-level committee that is responsible for assisting the Board to exercise its risk oversight responsibilities. These include:

- Overseeing Senior Management's activities in managing risks across the Group;
- Endorsing/approving risk frameworks and policies; risk management strategies, risk exposures, risk tolerance limits and thresholds;
- Reviewing and assessing adequacy of risk management policies and frameworks in identifying, measuring, monitoring and controlling risks; and the extent to which these are operating effectively;
- Ensuring that infrastructure, resources and systems are in place for managing risks; i.e. ensuring that the staff responsible for implementing risk management systems perform their duties independently of the Group's risk-taking activities;
- Reviewing management reports on risk exposures, compositions/concentrations and trends;
- Ensuring that the risk management process is functioning as intended.

The GRMC held thirteen (13) meetings during the financial year ended 31 March 2016. The attendance of the GRMC members are as follows:

Committee Members	Attendance
Kuah Hun Liang (Chairman)	13/13
Dato' Majid bin Mohamad *(appointed on 1 July 2015)*	9/9
Lee Boon Huat *(appointed on 1 July 2015)*	9/9
Premod Paul Thomas[1] *(appointed on 1 July 2015)*	8/9
Ho Hon Cheong *(appointed on 26 August 2015)*	7/7
Tan Yuen Fah[2]	4/4
Kung Beng Hong[3]	4/4

1 *Resigned on 13 April 2016*
2 *Chairman of GRMC up to 30 June 2015*
3 *A Member of GRMC up to 30 June 2015*

Capital Management

The Group and its entities strive to maintain a healthy capital position as a risk buffer. Towards this end, we have implemented an Internal Capital Adequacy Assessment Process ("ICAAP") and capital management framework. ICAAP aims to identify and quantify all material risks to assess the Group's capital adequacy buffer. The capital management framework outlines the broad policies and guidelines on capital management.

Bank Negara Malaysia requires banking institutions to have a minimum total capital ratio plus conservation buffer of 8.625% by 2016, with annual stepped increases, to reach 10.5% by 2019. To ensure that the Group has sufficient capital to meet regulatory requirements, the Bank issued RM1.2 billion subordinated debt in December 2015. This raised the Group's Total Capital Ratio to 17.1%, which was the highest in the industry for December 2015.

The Group will continuously monitor its capital levels via the ICAAP process to safeguard and maintain a strong capital base. The strong capital base will enable future business developments that could potentially enhance shareholders' value.

Stress Testing and Contingency Planning

The Group regularly performs stress testing to estimate the potential impact of extreme events on the Group's earnings, balance sheet and capital. These stress tests also provide a gauge of our sensitivity/ vulnerability to inherent and emerging risks to various business sectors, product segments or customer segments.

We identify possible events that could adversely impact the Group. For example, we conduct stress tests to gauge the potential impact of an economic downturn. These 'what-if' simulations enable the Group to assess potential worst-case scenarios, for us to prepare contingency plans to manage the risks and conserve capital.

These stress test parameters are formulated in consultation with various stakeholders, taking into account the current economic climate and plausible scenarios. The results are analysed and reported to the Stress Test Working Group, GALCO, GRMC and the respective Boards. Proactive actions are taken to address areas of potential vulnerability, where warranted.

In addition to conducting stress testing for regulatory reporting purposes, the Senior Management also conducts mini stress tests/scenario analyses/simulations, to:

- Ensure that we have sufficient cash and liquid assets to face a liquidity crunch;
- Ensure that we have sufficient capital to fund business growth for the current financial year as well as the next few years;
- Assess the impact of worsening market conditions affecting the equities, bonds and foreign exchange markets; and
- Assess the impact of operational loss events.

The Group's ICAAP process includes incorporating the results of our stress tests for longer term capital planning projections.

Early warning risk triggers have been established to monitor leading indicators of stress. Our contingency plans are not confined to desktop exercises. We carry out periodic exercises including physical simulations of systems failures; business resumption plans, activation of 'buddy branches' and alternate work-sites; plus fire-drill/ evacuation procedures.

Emerging Risks

The Group has identified several emerging risks, as listed below in alphabetical order:

Credit Risk

The global and domestic economic slowdown has led to a tougher operating environment for the banking industry. Risk concerns include high levels of household debts in Malaysia, a squeeze in disposable incomes, increased job cuts across business sectors, a weaker currency and lower commodity prices. The Group uses various approaches to mitigate these risk concerns, including customer vetting/selection, account monitoring and proactive collection and remedial processes.

Commodity prices especially oil & gas and steel have been declining since 2014. We conducted thematic reviews of credit portfolios related to these commodities, coupled with close monitoring of these portfolios. Credit concentrations are also monitored. For example, the Group's exposure to the oil & gas sector constitutes less than 1% of the Group's total portfolio.

Cyber Risk

Cyber attacks can have severe reputational consequences because banking relies heavily on information technology and communication channels. Cyber risk covers a wide spectrum of threats, ranging from malicious software, denial-of-service attacks, hacking to other criminal acts. Attacks that materialise may result in financial losses, data loss/theft; and loss of public confidence in the banking institution.

The Group uses an array of physical and system controls to protect our customers and our data. We strive to continuously upgrade and improve our security controls and surveillance tools, including engaging external experts to assist us.

As part of our fraud prevention measures, we had posted security reminders on our allianceonline sign-on page and corporate websites to educate customer on internet banking security as follows:

Security Reminder:

- Always ensure your SECURE PHRASE is correct before login
- Always type the allianceonline URL (www.allianceonline.com.my)
- Never click on links in emails/SMS

Liquidity Risk

Liquidity risk is managed on both the Group and entity basis. The primary objective of liquidity risk management is to ensure that the Bank has sufficient access to funding, to support business-as-usual activities and to meet contingencies. The Group uses several liquidity risk indicators/ratios for monitoring purposes. We review our liquidity ratios and deposit gathering activities regularly and maintain a good level of High Quality Liquid Assets, to provide sufficient liquidity buffer. Furthermore, we are exploring alternative funding sources which would provide us with additional avenues to manage costs, volumes and maturities.

Market Risk

The Group adopts various approaches and controls to mitigate market risks, as follows:

- Risk policies and risk limits are set for the various products and portfolios. These policies and limits are periodically reviewed and revised.
- We use a combination of risk limits for different products and portfolios. These include position limits, loss tolerance limits, risk sensitivity thresholds, Value at Risk ("VaR") limits, etc.
- Positions/portfolios are tracked closely and are revalued/ marked-to-market positions for comparison against approved limits.
- We conduct periodic stress testing to gauge the potential risk impact of a market downturn.

In the event that a risk limit is triggered, there is an escalation process in place to notify Senior Management/Board members and action plans are made to address the issue.

Regulatory Compliance

The regulatory landscape for the banking sector continues to evolve, with greater emphasis on governance, good market conduct, capital management, liquidity management, anti-money laundering, anti-financing of terrorism and Shariah compliance. In addition, the Group is also focusing efforts to incorporate new accounting and disclosure standards.

The Group strives to incorporate new/revised guidelines into our activities and processes in a manner that complies with the regulatory requirements and is conducive for business.