ALLIANCE BANK

Alliance Bank Malaysia Berhad (88103-W)

RISK MANAGEMENT REPORT

(for the Financial Year Ended 31 March 2011)

Risk Management Philosophy

At Alliance Financial Group, we believe that sound risk management is key to ensuring commensurate returns for our financing and risk-taking activities. To this end, we regularly review our risk management approaches to better understand and manage our exposure to risks within our risk appetite.

The Group has established an Integrated Risk Management Framework (IRMF) that includes risk management and compliance components. The IRMF supports a programme of action that is consistent with industry's best practices to better position the Group to deal with economic and business challenges. Under the IRMF, we have established risk frameworks and governance structures as well as Board and Senior Management risk oversight.

Risk Governance Framework

The Board of Directors, through the Group Risk Management Committee (GRMC), is responsible for risk oversight. This includes reviewing and approving risk management policies, risk exposures and limits, whilst ensuring the necessary infrastructure and resources are in place.

GRMC is supported by specialised risk committees to manage credit, market, liquidity, operational risks and other key risks. These include the Group Assets and Liabilities Management Committee (GALCO) and Group Operational Risk Management Committee (GORMC). Credit risk policy formulation under the Group Credit Risk Working Group is separated from the loan approval functions undertaken by the Group Management

Credit Committee. For Islamic financing, Shariah matters/risk issues are deliberated and decided by the Shariah Committee, which serves as advisors to the Board.

Business units and risk management units are represented at the respective committees/working groups, to reflect the joint ownership of business and risk management responsibilities by both the risk takers and risk managers.

On a functional basis, business units and business risk units form the first line of defence against risks. The Business units manage the risk-reward trade-off contained within the policies and guidelines laid down by the Group. On the other hand, business risk units are principally responsible for monitoring and ensuring that the conduct of their business activities are carried out within the approved policies, product programme parameters and business models.

Group Risk Management forms the second line of defence. Group Risk Management consists of central units for credit risk management, market risk management and operational risk management and is responsible for assisting the Group in formulating the risk management framework and policies, developing tools and methodologies for risk identification and measurement, performing independent risk monitoring and reporting to the GRMC and Board of Directors.

Group Internal Audit forms the third line of defence by providing independent assessments of risk management processes and infrastructure, as well as the adequacy and effectiveness of risk policies and internal controls.

Board & Management Oversight	Board of Directors		
	Board Committees:		
	Group Risk Management Committee (GRMC)		Group Audit Committee (GAC)
	Management Committees:		
	GALCO	GORMC	Shariah Committee

3 Lines of Defence			
	3rd Line of Defence	Internal Audit	• Provide independent assurance to Senior Management/Board and Risk Management Committee on the effectiveness of internal control
	2nd Line of Defence	Group Compliance Department Group Risk Management Department	• The effectiveness and integrity of the Operational Risk Management (ORM) Framework by reviewing adequacy of ongoing monitoring by line management • Updating of standards and group level policies
	1st Line of Defence	Line Management Business/ Unit Risk Officers Business Managers	• Ensuring compliance to laws, regulations, standards, policies, procedures, etc. via timely and effective monitoring and management

Basel II

With effect from 1 January 2008, as required by Bank Negara Malaysia (BNM), the Group has adopted the following standards for capital requirements under Pillar 1 of Risk Weighted Capital Adequacy Framework (RWCAF) and BNM Capital Adequacy Framework for Islamic Banks (CAFIB):

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

The guidelines provide guidance on the amount of regulatory capital required in proportion to the risk profile arising from lending/financing, investment and trading activities.

In accordance with BNM's implementation of the Pillar 2 guidelines – Internal Capital Adequacy Assessment Process (ICAAP), the Group has embarked on the journey to prepare for assessment of capital requirement for risks not covered under Pillar 1.

Meanwhile, 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. Please refer to the ABMB Basel II Pillar 3 Disclosure on page 229 for the full report.

Basel III

At the turn of 2011, Bank for International Settlement (BIS) had issued the Basel III Framework with the aim of making banking institutions more resilient to financial stress by requiring amongst others, the following:

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

The regulators have given these additional requirements, in addition to Basel II, a phased-in transitional period of eight years from 2011. With regard to the proposed phased de-recognition of Hybrid Tier-1 capital instruments, the Group does not expect to be impacted as it does not have such instruments.

Stress Testing

The Group carries out stress testing 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 to a sector, customer or product segment.

The Group has a stress testing framework which is applied to identify:

- Potential vulnerable risk areas of the Bank's portfolio to stress events. It examines an alternative future that could cause problems to the Bank's portfolio, thus enabling the Bank to assess the potential worst case scenarios and to be prepared to face such challenges; and

- Possible events or future changes in financial and economic conditions that could have unfavourable effects on the Bank’s ability to withstand such changes (particularly in relation to the Bank’s capital and earnings capacity to absorb potentially significant losses), thus enabling the Bank to take steps to manage these risks and conserve capital.

The Stress Test Steering Group comprises representatives from Group Risk, Business Risk, Group Finance and the Lines of Business. 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 and parameters are presented to the Stress Test Working Group and to the GRMC for deliberation before being rolled out to the respective business units to run portfolio and segmental stress tests.

In collaboration with Group Finance, the results are then centrally consolidated by the Lines of Business at the banking entity and banking group levels, analysed and reported to the Stress Test Steering Group, GRMC/Board and the Central Bank. These results are not reviewed in isolation. Where appropriate, proactive action is taken to adjust our product programmes, lending guidelines and contingency plans.

Credit Risk Management

Credit risk arises from the risk of financial loss as a result of the failure of a customer or counter-party to discharge his or her contractual obligations. The Group’s credit risk exposures arise primarily from its lending, investment and trading activities.

The Credit Risk Management Framework (CRMF) defines core policies to be adopted by the credit granting programmes, products and business models. The core policies, together with business level policies, require that the Group underwrites risks that are within our risk appetite. Regular credit reviews and business-specific early warning frameworks ensure early detection of an imminent problem, thereby improving the chances of remedial action or recovery.

In the Group’s Standardised Approach for Credit Risk, internal credit rating scorecards/models or external credit rating as credit evaluation tools are used to underwrite loans and invest in debt securities as well as other credit processes. The scorecards and models are validated regularly to ensure robustness and relevancy.

Business Risk Units monitor and report credit portfolio quality to the Credit Risk Working Group and GRMC regularly. Such reporting enables the identification of adverse credit trends, allowing corrective measures, and realignment of risk strategies when necessary.

Functionally, Group Credit Risk Management is responsible for managing credit risk, involving the following roles:

- formulate group wide credit risk policies
- formulate risk control limits
- portfolio risk monitoring
- risk measurement methodology
- risk reporting

The Group has over the years invested in building risk management infrastructure, methodology and tools to improve the capability of managing risk. To date, the risk infrastructure is as follows:

Risk Infrastructure/Methodology/Tool

Prospecting & Account Planning	Risk Assessment & Credit Approval	Documentation/ Disbursement	Monitoring	Collection & Recovery
• Group Loans Origination System • Customer Relationship Management System	• Credit Risk Rating Systems • Product Programmes • Risk Acceptance Criteria	• Collateral Management & Limit Monitoring System	• Credit Review • Early Warning Frameworks	• Debt Management System • Collection Strategies • Tracking of Collection and Recoveries
• Retail Loans Origination System and Business Banking Loans Origination Systems have been implemented between 2009 and 2010 • Went live in March 2011	• Development of rating models/ scorecards for retail and business banking and hosting system • Development and periodic review of Product Programmes/Risk Acceptance Criteria	• Phase 3 of Collateral Management & Limit Monitoring System pertaining to straight-through processing with various origination/ transaction systems is in progress	• Low tolerance of late credit review • Early Warning Frameworks tailored to manage different customers in Business Unit	• Debt Management System went live in 2009

Market 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 takes two forms: funding liquidity risk and market liquidity risk. Funding liquidity risk could arise if the Bank/Group is unable to meet financial commitments when due. Market liquidity risk arises if the Bank/Group is unable to unwind or offset its position in the market within a short span of time, at or near the previous market price, because of inadequate market depth or disruptions to the marketplace.

The Market Risk Management Framework outlines the core policies 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 supplemented by product specific policies that define the risk limits and parameters for the product plus administrative procedures to handle and report exceptions, risk monitoring and reporting.

Market risk in the Banking Book is supervised primarily by the GALCO and executed through Financial Markets whereas market risk in the Trading Book is managed primarily by Financial Markets based on policies and limits approved by the GRMC/Board.

The bulk of the Group's treasury positions are held under the Banking Book, which predominantly consists of government bonds with a smaller proportion of corporate bonds. The Trading Book is relatively small, comprising mainly foreign exchange instruments, which are primarily entered into to meet the needs of our wealth management, commercial and corporate customers. The Bank also engages in proprietary trading of bonds and interest rate swaps. These activities are governed by risk limits such as cash limits, loss limits and Value-at-Risk.

While the Group offers share financing, stockbroking and unit trust management services to our retail customers, the treasury arm did not undertake proprietary trading of equities and commodities during the financial year ended 31 March 2011.

Group Market Risk Management undertakes the following support roles:

- Formulating and reviewing the Group's market risk and asset liability management frameworks and policies in accordance with the Group's business direction and revised regulatory requirements. This includes developing appropriate risk measures and associated risk limits to manage market and liquidity risks.
- Carrying out independent monitoring of treasury activities on a daily basis, including reporting and escalation of exceptions and scheduled reporting of market and liquidity exposures to senior management and Board of Directors.
- Providing independent market-to-market valuation of treasury positions and risk exposures, using rates obtained from various sources, such as independent market price/information providers.
- Reviewing new product proposal papers (in conjunction with other risk management units), to assess the market and liquidity risks prior to launching new products.
- Providing integrated risk management support activities in conjunction with other Risk Management functions and participating with other departments on joint assignments and projects involving market risk, liquidity risk and asset-liability management and stress testing exercises

To assist in the management of market and liquidity risks, the Group has invested and established the following risk infrastructure, systems and tool/methodology:

	Systems	Tools/Methodology
Trading Book	Middle Office Module, Treasury System	• Notional limits • Sensitivity limit (e.g. Price Value of a Basis Point) • Value-at-Risk • Stress Testing • Back Testing
Banking Book	Assets and Liabilities Management System	• Repricing gap analysis • Net interest income simulation • Liquidity gap analysis • Liquidity ratios and benchmarks • Liquidity stress test and contingency funding plan

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.

Management, escalation and reporting processes are instituted through various management committees such as the Group Operational Risk Management Committee and Group Risk Management Committee as well as the Board.

The responsibilities of the committees and Board include the following:

- Oversight and implementation of the Operational Risk Management Frameworks.
- Establishment of risk appetite and the provision of strategic and specific directions.
- Regular review of operational risks reports and profiles.
- Addressing operational risk issues.
- Ensuring compliance with regulatory and internal requirements including disclosures.

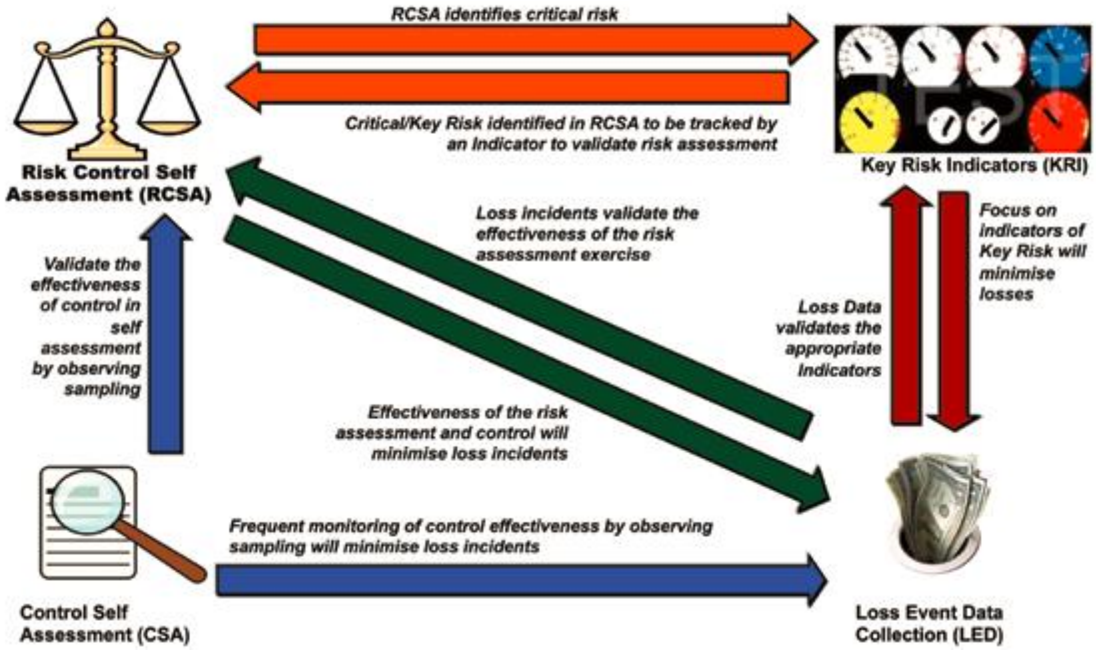
The Group has adopted the following guiding principles for operational risk management:

- Sound risk management practices as outlined in the ORM Framework, which is in accordance with Basel II and regulatory guidelines.
  (For Islamic Banking, a separate ORM Framework has been adopted to ensure compliance with the Islamic Financial Services Board (IFSB) and our regulatory bodies)
- Board and Senior Management oversight.
- Defined responsibilities for all staff.
- Established operational risk methodologies and processes applied in the identification, assessment, measurement, control and monitor of risks.
- Regular dashboard reports submitted to Senior Management and Risk Management Committee.
- Continuous cultivation of an organisational culture that places great emphasis on effective operational risk management and adherence to sound operating controls.

The tools employed in best practices for management of operational risks applicable across the Group are:

- Risk Control Self Assessment (RCSA)
- Key Risk Indicators (KRIs)
- Loss Event Data Collection (LED)
- Control Self Assessment (CSA)

The illustration below summarises how the operational risk tools complement one another:



The Group also ensures that the operational risk awareness programme is conducted on an ongoing basis. The training programme includes emphasis on business continuity planning. Meanwhile, scheduled business continuity and disaster recovery exercises are conducted at periodic intervals.

Internal audit plays its part in ensuring an independent assurance of the implementation of the Framework through their regular audit reviews and reports to the Group Audit Committee.

Islamic Risk Management

Islamic Risk Management focuses on managing Operational and Shariah Compliance Risk, besides managing the Credit and Market Risks in Islamic Banking operations.

Shariah Compliance risk arises from the risk of failure to comply with Shariah rules and principles determined by the relevant Shariah regulatory council. The Shariah compliance in the Islamic Banking business activities includes prohibition of Riba (interest), Gharar (uncertainty) and Masyir (gambling).

Under the Group's Islamic Operational Risk Management Framework (ORM-i), including Shariah Governance Framework, the Group applies several key measures, including:

- Adopting sound risk management practices in accordance with the Islamic Financial Services Board (IFSB), and other relevant regulatory guidelines.
- Providing continuous Board and Senior Management oversight.
- Emplacing qualified Shariah Committee members with capabilities to deliberate on Shariah issues and provide sound Shariah decisions.
- Ensuring at least one representative from the Shariah Committee in the Board of Directors.
- Ensuring that the Bank complies with Shariah principles in relation to existing and new products, services and business activities at all times, by having adequate mechanisms and processes.
- Establishing clear lines of roles and responsibilities.
- Providing timely management reports.
- Fostering a risk awareness culture through ongoing staff training.
- Deploying the Shariah Review Team to conduct independent Shariah reviews regularly at various business lines and reporting their findings to the Shariah Committee and Board. The functions cover amongst others, training, research and regular assessment on Shariah compliance in the activities and operations of the Bank.
- Reporting Shariah non-compliant incidents and issues to the Shariah Committee and the Board. Any rectification should only be carried out in consultation with the Shariah Committee and any non-compliant income discovered during the review exercise will be channeled to charities.