ALLIANCE BANK

Alliance Bank Malaysia Berhad (88103-W)

RISK MANAGEMENT REPORT FOR THE FINANCIAL YEAR ENDED 31 MARCH 2017

In the course of our daily operations, the Group/Bank takes on a wide variety of risks. Briefly, key risks arise from:

- Economic factors that impact our country, commodity prices, financial markets, retail trade, etc., which ultimately impacts on the economic well-being of our customers;
- Products/services that we offer and the business activities that the Bank is engaged in;
- Changing pace of technology, in particular, changes that affect the way our society performs banking and transacts in cash and cashless/electronic payments; and
- New/revised financial regulations and compliance requirements.

The role of risk management is to help maintain the safety of the Bank and achieve sustainable growth, while managing these risks.

INTEGRATED RISK MANAGEMENT FRAMEWORK

The Group adopts an Integrated Risk Management Framework ("IRMF") to manage business and financial risks on a Group-wide basis. It provides a structured approach for the Group to form a consolidated view of all risks and to manage these risks in a holistic manner, alongside business and compliance requirements.

Risk Appetite and Strategy

The Group's Risk Appetite Statement, which has been approved by the Board, serves as an expression of the boundaries for managing business and risk concerns.

Overall, the Group strives for balanced, sustainable growth by:
- Performing the Group's business activities in accordance with approved strategic plans, policies and limits;
- Balancing between risks and rewards; and
- Balancing the interest of the Group's various stakeholders.

Underpinning the above, the Group is committed towards ensuring strong risk management practices, active liquidity management and a healthy capital position. Parameters include:

- Maintaining sufficient capital buffer under normal business conditions and projected stress scenarios;
- Maintaining sufficient liquidity buffer to fund daily operations and holding sufficient levels of high quality liquid assets to handle contingencies;
- Generating an equitable level of returns while controlling/managing business activities that would otherwise give rise to volatile swings in earnings; and
- Maintaining good asset quality through active monitoring and management of financing activities.

These parameters are monitored regularly to ensure that the Group operates within established risk boundaries.

Risk Governance and Organisation

The Group adopts three (3) lines of defence in managing risks, and each line of defence has clear areas of responsibility.

1ST LINE

Frontline Units

The Business Units own the risks within the business segments that they serve and the products/services that they offer. They are aided by Business Support functions, including Business Risk and Credit Underwriting functions, which report to the Group Chief Credit Officer. All of these form the first line of defence against risk by managing the risk-reward trade-off within the scope of the Group's business model, risk tolerance levels, lending and governance policies.

2ND LINE

Risk Control Functions

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:

- Formulating, reviewing and enhancing risk management, compliance and Shariah compliance frameworks;
- Recommending risk management/compliance/Shariah policies, methodologies, limits and parameters; and
- Reviewing the adequacy of control measures.

Group Risk Management and Group Compliance report to the Group Risk Management Committee ("GRMC"). The Shariah Review Team reports to the Alliance Islamic Bank Board.

3RD LINE

Internal Audit

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.

Group Internal Audit reports to the Group Audit Committee.

Governance Structure

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

Board of Directors

- Provides oversight on business strategies and significant policies.
- Sets the Bank's risk appetite.

Board Level

Group Risk Management Committee ("GRMC")

- Provides oversight on risk management strategies, policies and risk tolerance limits.
- Reviews compliance reports/issues.
- Ensures infrastructure and resources are in place to manage risk.

Executive Committee

- Provides oversight on business issues.
- Reviews large credit exposures.

Group Audit Committee

Oversees the adequacy and effectiveness of the Group's internal controls.

Shariah Committee

Oversees Shariah governance/ compliance matters.

Management Level

Group Management Committee ("MANCO")

Tracks/monitors plans to address governance, risk and control ("GRC") issues.

Group Assets & Liabilities Management Committee ("GALCO")

Governs:

- Capital and Balance Sheet management
- Liquidity risk management
- Interest/profit rate risk management
- Trading and investment risk management

Group Management Credit Committee

Evaluates/approves credit proposals for large exposures.

Credit Portfolio Review Committees
- **Consumer Banking**
- **SME Banking**
- **Corporate & Commercial Banking**

- Monitors the health of the respective financing portfolio segments.
- Reviews early warning cases, collection and recovery efforts.

Group Operational Risk Management Committee

Reviews issues that affect the Group's operational risk profile.

Product Review Group

Governs the introduction of new products, covering in-house developed products and third party products (bancassurance and wealth management).

Role 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; and
- 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 deeper consideration. The Board may delegate certain duties to these Board Committees, but remains accountable for the policies/decisions approved by these committees.

Roles and Responsibilities of the GRMC

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

- Providing risk oversight over Senior Management's handling of various risks, across the Group;
- Endorsing/approving risk frameworks and policies; risk management strategies, risk exposures, risk tolerance limits and thresholds;
- Reviewing and assessing the adequacy of risk management policies and frameworks for identifying, measuring, monitoring and controlling risks;
- Ensuring that the risk management frameworks and processes are functioning effectively, as intended;
- Ensuring that infrastructure, resources and systems are in place for managing risks;
- Ensuring that the staff responsible for implementing risk management systems perform their duties independently of the Group's risk-taking activities; and
- Reviewing management reports on risk exposures, compositions/concentrations and trends.

The GRMC held seventeen (17) meetings during the financial year ended 31 March 2017. The attendance of the GRMC members are as follows:

Committee Member	Attendance
Kuah Hun Liang (Chairman)	17/17
Ho Hon Cheong	17/17
Majid Bin Mohamed	16/17
Lee Boon Huat	13/17
Premod P. Thomas[1]	N/A

[1] Resigned on 13 April 2016

Risk Methodology, Tools and Communication

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 & Policies	Methodologies, Tools Used
Credit Risk The risk of loss due to failure by customers/counterparties to fulfil their financial obligations/contractual, when due.	• Credit Risk Management Framework • Credit Programmes/Product Programmes • Risk Acceptance Criteria	• Key Risk Indicators • Tripwires, limits and thresholds • Credit ratings/scorecards • Risk-based pricing • Stress testing
Market Risk The risk of loss arising from market volatility and adverse price changes in interest rates, profit rates, foreign exchange rates, equity prices and commodity prices.	• Market Risk Management Framework • Trading Book Policy Statement • Valuation Policy • Hedging Policy • Value-at-Risk & Back testing • Treasury Product Programmes	• Limits and thresholds • Revaluation, marking-to-market and marking-to-model • Stress testing and back testing • Hedging

Risk Universe	Frameworks & Policies	Methodologies, Tools Used
Liquidity Risk The risks include: • Inability to fund financial commitments when due; • Risk of incurring losses when attempting to liquidate assets, due to market disruptions and/or illiquid market situations.	• Liquidity Risk Management Policy • Contingency Funding Plan	• Liquidity gap analysis • Liquidity stress testing • Diversification of funding sources, instruments and maturities • 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 & 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 Governance Framework	• Shariah reviews and rating • Shariah non-compliance monitoring and reporting
Strategic Risk The risk of loss arising from adopting the wrong business strategy, failure to properly execute business strategies, or failure to effectively respond to changes in the industry/economy.	• 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
Reputational Risk The risk of loss arising from negative perception by customers, counter-parties, shareholders, and other relevant key stakeholders. This can adversely affect the Group's existing and new business relationships; and access to funding sources.	• 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 inappropriate reliance on risk models.	• Independent Risk Rating Model Validation Framework	• Quantitative statistical tools/ratios, used to test the models ability to discriminate between potentially "good" versus "bad" credits •

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, limits and controls; guided by the Group's risk appetite, and direction.
- We use a combination of various 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 purely statistical models. Instead, we combine 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;
  - Engaging and training our employees;
  - Tracking and reporting our progress, performance and activities;
  - Highlighting exceptions and key developments to Senior Management and the Board; and
  - Communicating/engaging with 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 and 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 and Disclosure
- Furnish periodic risk reports/dashboards to Senior Management and the Board.
- Provide disclosure to investors/regulators via statutory/regulatory reporting.

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 Key Behaviours from a risk management perspective are as follows:

Collaborate
- Working together with all 3 Lines of Defence, to meet the Group's strategic initiatives and ongoing mission.

Innovate and Simplify
- Providing solutions that are responsive and innovative.
- Working towards reducing complexity whenever possible.

Understand and Act
- Understanding how our products/services meet our customer's needs.
- Understanding the inherent risks within our products/services.
- Implementing controls to mitigate these risks, based on accepted risk-control trade-offs.

Commit to Excellence
- Enabling the Group to provide products and services that are in the best interests of our customers.

Take Ownership
- Holding ourselves accountable for achieving the Group's Mission.
- Honouring our commitments to our partners/stakeholders to address/resolve issues that arise.

CAPITAL MANAGEMENT

The Group and its entities strive to maintain a healthy capital position, to fuel growth and act as a risk buffer. Towards this end, the following frameworks are in place:

- Internal Capital Adequacy Assessment Process ("ICAAP"): This serves to identify and quantify all material risks; and to continually re-assess the adequacy of the Group's capital buffer.
- Capital Management Framework: This sets out the policies and guidelines for managing the Group's/Bank's capital structure, with an appropriate mix of Core Equity, Tier-1 and Tier-2 capital instruments; and contingency plans to raise more capital when needed.

Bank Negara Malaysia requires banking institutions to have a minimum total capital ratio plus conservation buffer of 9.25% by 2017, with annual stepped increases, to reach 10.5% by 2019. The Group has maintained strong Total Capital Ratios, in line with the industry average.

The Group continuously monitors its capital levels via the ICAAP process, to maintain a strong capital base and buffer against stress losses.

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, we conduct thematic stress tests, scenario analyses and 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 and any other emerging risks 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 into our long 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:

Higher Cost of Compliance and Operational Controls

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.

To strengthen our operational controls and to avoid incurring compliance penalties, the Bank has taken several tasks, including the following:

- Group Compliance undertakes to perform gap analyses when new/revised regulations are issued, together with the affected business and support units.
- Group Management Committee regularly monitors the progress of addressing governance, risk and control issues.
- The Bank strengthened risk awareness among staff, via e-learnings, classroom training and refresher courses.
- The Bank formed a work group to look into process optimisation and streamlining, to improve operational efficiency.

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, job cuts across business sectors, a weaker currency and volatile commodity prices. The Group uses various approaches to mitigate these risk concerns, such as conducting policy reviews, reviewing customer vetting criteria, regular portfolio reviews, conducting thematic reviews to assess our potential exposures; and close monitoring of our collection/remedial efforts.

Cyber Risk

The Bank uses technology as an enabler to conduct business transactions, to make payments, to process, store and retrieve data, etc.

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, including engaging external expertise to assist us in areas such as Security and Network Surveillance and establishing threat intelligence through a global network.

The Bank carries out periodic reviews/reassessment of security measures to counter cyber risks. In addition to software tools, hardware controls, independent reviews and verification checks, the Bank has also taken steps to raise risk awareness among our staff and customers, on the basis that prevention is the best cure.

During the year:

- We performed benchmarking against regulatory requirements and industry standards, including e-payment systems and cyber risk resilience.
- We collaborated with other business and support units to build security measures into the Bank's strategic initiatives and digitalisation projects.

As part of our fraud prevention measures, we continuously post security reminders on our allianceonline sign-on page and corporate websites to educate customers on online banking security.

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.