

# RISK MANAGEMENT REPORT

## OUR NEW PATH...

Seylan Bank views Risk Management as an important element of the management control and business of the Bank. A renewed and re-emphasised approach is being taken under the new board for managing risks better.

We have recognised that risk is the existence of a range of possible outcomes where such outcomes and the potential range can be reasonably estimated. Where such estimation becomes difficult the situation is one of uncertainty. A Bank is faced with both uncertainty and risk. While attempting to avoid uncertainty as a business outcome, the Bank does accept risk within acceptable norms and limits, within our strategy set towards our new path.

We have categorised the key risks faced by us into three main risks viz. Credit Risk, Market Risk and Operational Risk. Apart from these three risks, several other risks such as liquidity risk, reputation risk, solvency risk and event risk, are some of the key risks faced by the Bank.

## THE RESPONSIBILITIES FOR MANAGING RISK

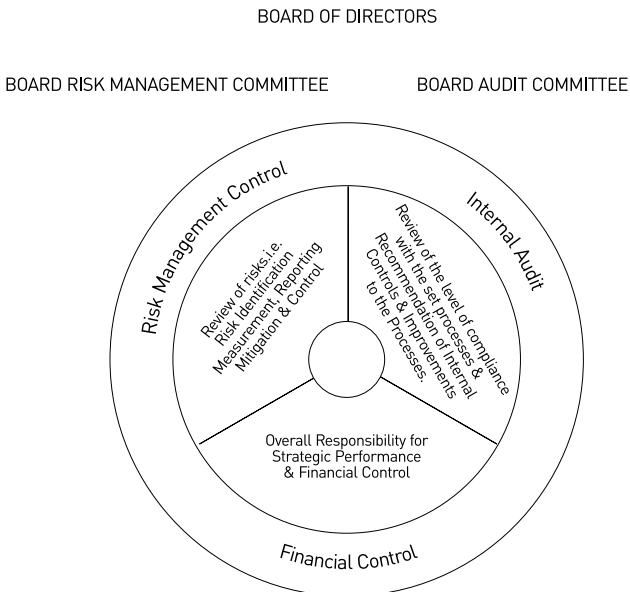
The board of directors assumes overall responsibility for managing risks in the Bank. For this purpose, the board has determined the organisational structure that should prevail to ensure a sound and adequate risk management framework. Further, the board has designated Key Management Personnel to manage risk and identify their areas of responsibilities. The board also reviews on a regular basis the risk exposures of the Bank and specifies and approves policies with regard to risk measurement and control.

The board delegates some of its duties to various risk management committees and officials of the Bank.

## THE RISK MANAGEMENT PROCESS AND THE INTEGRATED RISK MANAGEMENT COMMITTEE

The following is a schematic presentation of the multifaceted framework of Risk Management that encompasses three areas of controls viz. Financial Control, Risk Management Control and Internal Audit.

MULTIFACETED FRAMEWORK OF RISK MANAGEMENT



The key mechanism in discharging the board responsibilities of risk management is through the Integrated Risk Management Committee that comprises the undermentioned three directors with the participation of senior management personnel. The Committee meets at least on a quarterly basis.

The members of the Board Integrated Risk Management Committee are:

- Mr. Ajith Devasurendra - *Director, Chairman of the Committee*
- Mr. Naomal Goonawardene - *Director (Resigned w.e.f. 03/12/2009), Chairman of the Committee, till 3/12/2009*
- Mr. Lalith Withana - *Director*
- Mr. Pradeepa Kariyawasam - *Director*

Four meetings of the Risk Management Committee were held during the year 2009.

The responsibilities of the Integrated Risk Management Committee are designed to capture a wide range of potential risk-related issues that are dealt in a proactive and preventive manner. Some of the key functions include the following:

- Taking prompt corrective actions to mitigate effects of specific risks.
- Reviewing and recommending Risk Management policy, strategy and policy controls and systems for the Bank.
- Establishing risk tolerance for the Bank at enterprise and strategic business unit levels.

- Maintaining continued awareness of changes in the Bank's risk profile and with periodical review of the risk exposures of the Bank.
- Submission of risk assessment reports to the board pursuant to the discussions and observations at the Risk Management Committee meetings.

The new board places a very high emphasis on the risk management function and strengthened the committees as well as the organisational framework. Further, the effectiveness of the committees is being elaborated on, rather than mere functioning for the sake of formality. The structures of information dissemination and reporting formats have been improved.

A board approved Risk Management Policy covering multifaceted aspects has been put in place.

A new Risk Management Department enhancing the former Risk Management Department with wider scope and functions is set up to concentrate on the risk management function as a second line of defence for the Bank's Integrated Risk Management system. This Department will coordinate the activities of risk management and submit quarterly reports to the Integrated Risk Management Committee. These reports include risk identification, risk measurement, reporting on risk-based occurrences, trends in the risks undertaken, risk mitigation and control. The Risk Management Department will also maintain data relating to operational loss events for further evaluation and study.

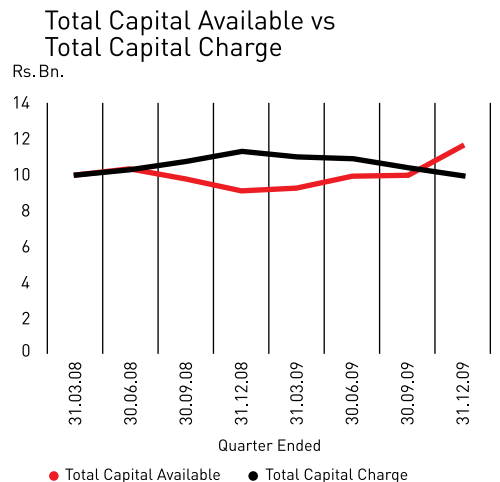
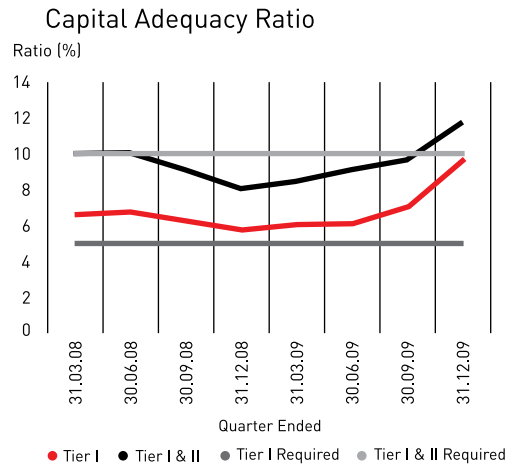
The Risk Management Department is designed to comprise three units namely, Credit Risk Monitoring Unit, Treasury Middle Office and Operational Risk Monitoring Unit. In addition, a separate unit carries out Quality Assurance, Business Continuity Planning and Information Systems Security.



**OUR APPROACH TO MONITORING RISK AND CAPITAL**

Availability of adequate capital in the business acts as a cushion against risk. Hence, minimum capital requirements have been stipulated by the authorities as a prudential means of regulation. The Bank had a deteriorating capital adequacy ratio in the early part of 2008.

The capital adequacy ratio that had fallen below the required level towards the end of the year 2008 got restored at 11.74% towards December 2009 which is above the statutory requirement of 10%. This was a result of several strategic moves and strategies adopted by the Bank including the issue of new shares to boost the capital base. The restoration of the capital adequacy requirement was a major achievement of the Bank during the year 2009.



## Risks arising from Financial Instruments

International Financial Reporting Standards require certain disclosures on the risks arising from various financial instruments. The Bank deals in financial assets and liabilities and also in financial instruments such as the fixed income securities mainly comprising of Government Securities viz. Treasury Bills and Treasury Bonds. The Bank held a trading portfolio of Treasury Bills and Bonds amounting to Rs. 14.37 Bn. as at 31st December 2009 and an investment portfolio of Rs. 14.73 Bn. The main risk arising from the trading portfolio is the interest rate risk as detailed elsewhere in this Annual Report. Bank quantifies and monitors this risk on a regular basis. Further, the instruments result in liquidity risk in a very insignificant manner as the instruments themselves are fairly liquid and can be converted into cash quite easily or can be used as collateral to borrow in the REPO market.

The Bank also deals in forward exchange contracts mainly to cover the requirements of the clients and usually the positions are covered by opposite contracts and the level of exposure is not significant. The Bank also enters into currency swaps in a minimal way.

Bank does not as a policy usually enter into various derivative transactions on a speculative basis.

## KEY RISKS AND RISK MANAGEMENT

### CREDIT RISK

Credit Risk is the risk of default of capital and interest by the borrowers of the Bank as a result of which the Bank will encounter loss of revenue and a reduction in the value of its assets leading to reduced profits.

### THE BOARD CREDIT SUBCOMMITTEE

The Board Credit Subcommittee is chaired by the Chairman of the Bank and has a minimum of two directors.

The Board Credit Subcommittee formulates credit policies for the Bank inclusive of maximum limits of exposure to each major sector of the economy. The Committee formulates credit strategies towards maintaining a healthy credit portfolio and maintains credit discipline within the Bank.

The areas of focus include:

- Approval of facilities within a range of specified limits and recommendation of credit facilities beyond such limits.
- Formulating credit policies and guidelines for the Bank from time to time and review of existing policies.
- Formulation of policies /review of existing policies on credit risk management.
- Monitoring recoveries and formulating recovery strategies.
- Ensuring that the credit portfolio does not exceed accepted levels of risk.
- Review of single borrower limits and sector limits where more stringent limits are in place for any sector and also review of other lending criteria.

The Board Credit Subcommittee meets on a regular basis at a frequency of at least twice a month. The Chief Executive Officer and Key Management Personnel in charge of credit areas are co-opted to the meetings.

### THE INTERNAL CREDIT COMMITTEE

This Committee comprises of Executive Management and deals with approval of facilities within a certain range of amounts. Further, this Committee deals with recommendation of credit policies and implementation and monitoring of the same through respective credit disbursement areas and branch outlets.

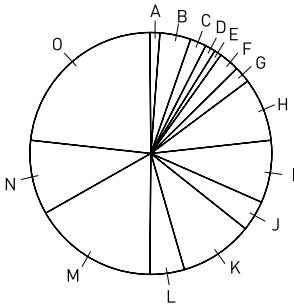
### Credit Policies

This Committee formulates and recommends Bank's credit risk policies based on the board's risk management strategy. It has also during the year, improved the process for the management of credit and quantification of risk by standardising reporting formats, following a more stringent policy towards collateral requirements for credit facilities, restricting the exposures to any single customer, scaling down the facilities where the clean exposure is excessive, and application of shorter repayment periods on term loans.

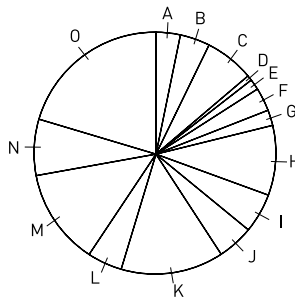
## SECTORAL EXPOSURE OF CREDIT PORTFOLIO

### Sectorwise Exposure

2009



2008

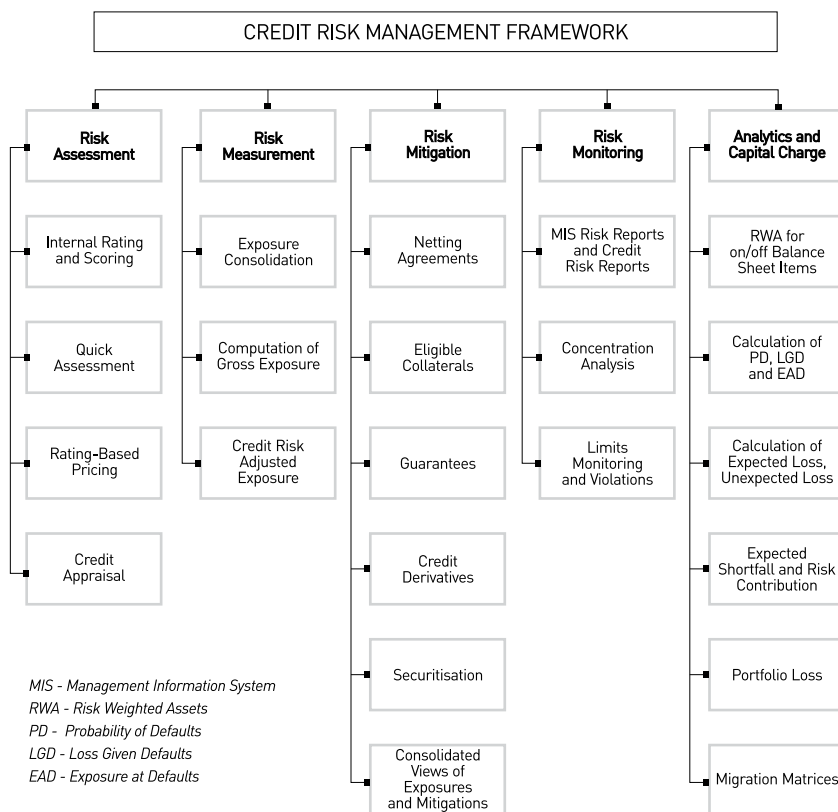


	2009 %	2008 %
○ A - Food, Beverage & Tobacco	1	3
○ B - Agriculture, Agro Business & Fisheries	4	4
○ C - Textile & Wearing Apparel	2	7
○ D - Wood & Paper Products	1	1
○ E - Rubber & Leather Products	1	1
○ F - Metals, Chemicals & Engineering	3	3
○ G - Hotels	2	2
○ H - Services	8	10
○ I - Exports	8	5
○ J - Imports	4	5
○ K - Trading	9	14
○ L - Financial	5	5
○ M - Housing	18	13
○ N - Consumption	10	8
○ O - Miscellaneous	24	19
	<u>100</u>	<u>100</u>

### Credit Rating

The Bank also uses a comprehensive credit rating system based on a package acquired from an international vendor. The rating engine acquired by the Bank is capable of developing different rating modules. Bank has developed seven credit rating modules covering the areas of Corporate, SME, SMI, Leasing, Housing, Credit Cards and Personal Loans. The rating system provides quantitative support to the very subjective area of credit where both qualitative and quantitative aspects are captured in a scientific approach to maintain consistency.

The largest risk exposure of the Bank is in the area of credit risk, as common to any banking institution. The total risk weight of the three different risks viz. Credit Risk, Market Risk and Operational Risk as per the capital adequacy computations based on BASEL II approach under the Central Bank Guidelines, as at 31st December 2009 was Rs. 98.9 Bn. whereas the component of credit risk within this was Rs. 79.3 Bn. representing 80% of the quantified risk.



Systemic Presentation of the Systems Framework considered in the Road-Map on Credit Risk Management

## MARKET RISK

Market Risk is the risk arising from fluctuations in the market price/value of tradable assets such as foreign exchange, fixed income securities and shares that are held for trading purposes where the Bank holds either long positions or short positions of such assets.

The two risk components of the market risk most applicable to the Bank are foreign exchange risk and interest rate risk.

**The Foreign Exchange Risk** arises from the foreign exchange positions maintained by the Bank where either the foreign currency denominated assets exceed such liabilities (long positions) or the foreign currency denominated liabilities exceed the assets (short positions). Such long or short positions could also be created through the purchase or sale

transactions both in spot and forward markets as well as through swap transactions. Bank is conservative and prudent in its management of foreign exchange exposures and has set out limits on its transactions and exposures including dealer limits, portfolio limits, daylight limits, overnight limits, long position limits, short position limits, counterparty limits etc. The Treasury Middle Office monitors the compliance with the set limits.

Seylan maintained a net oversold position of USD 3.85 Mn. as at 31st December 2009 where the risk arising from appreciation of foreign currency was Rs 3.85 Mn. for each one Rupee appreciation of USD against the Rupee or equivalent in other currencies; a level of risk considered to be low based on the capital and resources of the Bank.

**Interest Rate Risk** arises from the movement of interest rates affecting the value of tradable fixed income securities as well as the interest rate re-pricing gaps of the interest rate sensitive assets and liabilities. The Bank evaluates the risk level of the tradable fixed income securities portfolio by assessing the sensitivity of the market value towards a change of interest rates by one hundred basis points, which is one percentage point. The size and duration of the trading portfolio is capped based on the potential risk exposure as well as the board approved limits placed on absolute values. Banks also typically have mismatches in the re-pricing periods of assets and liabilities and an approach of minimising the gaps and limiting long-term fixed rates is followed by the Bank.

Seylan as a policy does not carry a significant exposure to the equity market whilst of course being an active investor within applicable prudential limits.

The different types of market risks and the Balance Sheet structure with a long-term focus are monitored by the Asset and Liability Management Committee (ALCO).

## **ASSET AND LIABILITY MANAGEMENT COMMITTEE (ALCO)**

This Committee comprises of senior management personnel representing Treasury and main business functions and also the Risk Management area. The Committee meets once a month and addresses matters relating to market risk and to some extent the business risk which is mainly dealt with at the board level. A comprehensive reporting system is available to provide detailed information to the ALCO. During the year the ALCO reporting system was streamlined and a standardised "ALCO Pack" has been introduced for better reporting towards more effective risk management.

Of the total risk weight of the three different risks amounting to Rs. 98.9 Bn. the component of market risk was Rs. 4.5 Bn. representing 5% of the quantified risk.

## **OPERATIONAL RISK**

Operational Risk refers to the losses arising from fraud, negligence, oversight, human error, process errors, system failures, external events etc. The Bank manages most elements of the Operational Risk through sound internal control systems and well-defined processes both technology driven and with human intervention.

The areas of risk include process risks where faulty processes or errors in the processes could trigger losses. Continuous review of the systems and the processes either on a regular review basis or pursuant to observed loss events and incidents addresses potential weaknesses of the processes.

In implementation of new products that invariably relies on technology as well as human involvement a risk review is an essential aspect that needs both the marketing objectives as well as the Risk Management requirements. Bank strives to subject such new product introductions to adequate review.

Bank also maintains its policies with regard to access control and data protection and necessary safeguards are constantly introduced and upgraded to ensure the integrity of the information and the data bases. Preventive measures such as firewalls and virus guards among other steps are put in place.

**Operational Risk Unit** - The operational risk is monitored by the Operational Risk Unit and the Operations Department.

The objective of operational risk assessment is to identify the areas of high risk based on the prevalence of occurrences as well as evaluation of potential dangers. The Bank is at an early stage of analysing loss events and loss data under different product and business categories. Any significant loss events are analysed in depth so as to strengthen the processes and close out any weak controls.

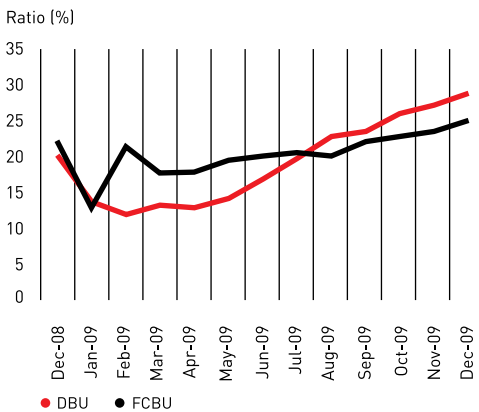
Of the total risk weight of the three different risks amounting to Rs. 98.9 Bn. the component of operational risk was Rs. 15.1 Bn. representing 15% of the quantified risk.

## LIQUIDITY RISK

Liquidity Risk is the risk that an entity may not be able to meet the payments as they fall due. It appears to be an insignificant risk that does not cause regular losses until such time a major event occurs resulting in even a threat to the mere existence of an organisation. Seylan views Liquidity Risk as an important aspect in managing risks and pays serious attention to the management of liquidity. The Bank underwent a potential liquidity crisis towards the end of year 2008 that was triggered by the external events, a situation referred to as 'event risk' that triggered potential crystallising of liquidity risk.

Bank always maintained its liquid assets in excess of the statutory requirement of 20% of liabilities; however as a result of the crisis the ratio fell to a range of 13%. Due to several measures taken by the Bank and the regulatory authority in meeting the challenges, the deposit base improved significantly and the ratio restored much above the statutory minimum of 20% to a level of 29% by the end of the year 2009.

### Liquid Assets Ratio



## ASSET AND LIABILITY MATURITY GAPS

Another tool used by the Bank in the management of long-term Balance Sheet Structure of the Bank is to monitor the gap between the maturity of assets and liabilities under different time bands. This analysis shows the potential risks of mismatches between maturity of assets and maturity of liabilities. Seylan uses this analysis in its risk management process and monitors the maturity ladder at the ALCO meetings

on a monthly basis. While it is typical for a bank to have mismatches based on contractual maturities, it is also appropriate to analyse the maturities based on behavioural patterns. Bank has set targets in reducing the mismatches over a time period.

## TREASURY MANAGEMENT COMMITTEE

This Committee chaired by the Chief Executive Officer, meets on a daily basis to deal with matters relating to liquidity management and market interest rates. In addition, foreign currency exposures are reviewed regularly. It is a strength of the Bank to have a focused approach through the Treasury Committee in its liquidity management and management of the day to day forex and money market exposures as well as monitoring of the market rates for competitive and current pricing of products.

## COMPLIANCE FUNCTION

Bank has set up a separate Compliance Department specialised in ensuring compliance with the regulatory and legal framework. The Department also has set in place necessary systems and processes to comply with the Anti-Money Laundering Regulations and Laws.

The Bank has taken a serious view that compliance with all regulations is an essential element of good governance and management of the Bank and therefore, emphasis is made on this aspect throughout the organisation.

**Information Technology Risk** - The technology teams and users meet regularly and review the information systems currently utilised by the Bank and analyse the future technology and systems needs of the organization to compete effectively and efficiently in the future. Additionally, key areas of focus include Information Security, Business Continuity Planning (BCP) and Data Security.

## BUSINESS CONTINUITY PLANNING (BCP)

BCP is a strategic and tactical approach of an organisation to plan for and respond to incidents and business disruptions in order to continue business operations at an acceptable pre-defined level.

BCP is a process designed to reduce the organisation's business risk arising from an unexpected disruption of the critical functions/operations (manual or automated) necessary for the survival of the organisation. This includes human/material resources supporting the critical functions/operations and the assurance of continuity of minimum level of service necessary for critical operations.

Bank has set in place a comprehensive Business Continuity Plan which has been developed with the assistance of external consultants. The plan addresses the criticality of different business functions and maintains contingency arrangements accordingly. Bank maintains an off-site Disaster Recovery Centre as part of the Business Continuity Plan. Further, data of all critical systems are updated on a real time basis in the backup machines at the Disaster Recovery Centre.

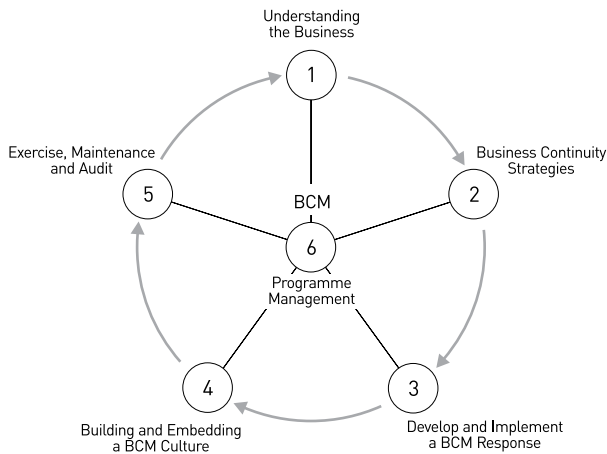
The initial task was to conduct a detailed Business Impact Analysis (BIA) and a Risk Assessment (RA) on 29 business units and a team was formed comprising of a business team leader, coordinator and support staff with the assistance of an external consultant who was given the task of formulating a comprehensive business continuity plan for each business unit. The Plan has been built considering the following areas that could be affected due to any disaster or crisis.

- Personnel
- Building structure
- Resources / Utilities and
- Access Routes

**BUSINESS CONTINUITY MANAGEMENT (BCM) STRUCTURE AND FRAMEWORK**

BCM structure and framework consists of six stages and components.

BUSINESS CONTINUITY MANAGEMENT (BCM) STRUCTURE AND FRAMEWORK

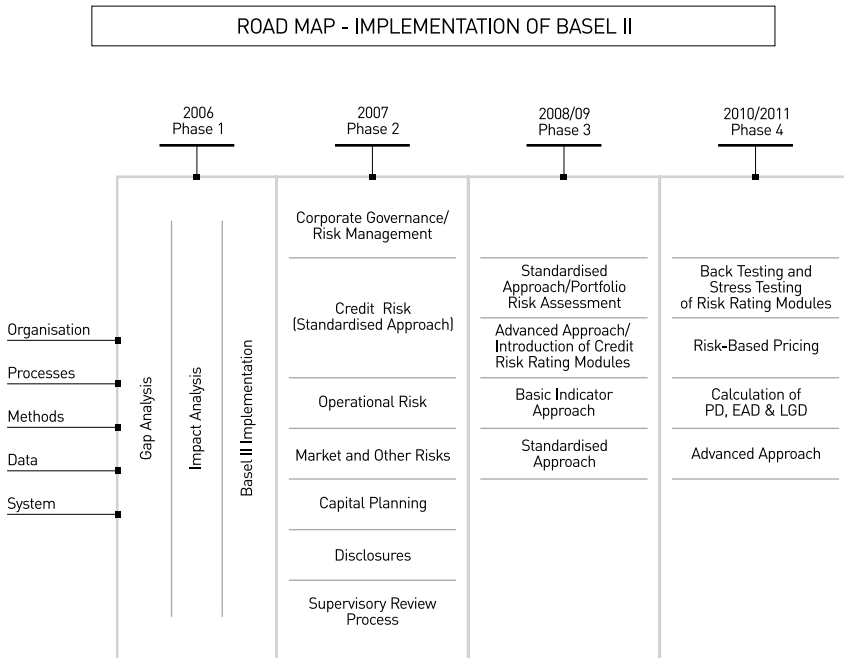


The Bank adopted a six phase approach to develop the BCP as shown below.

Phase I	Project planning
Phase II	Identify business activities
Phase III	Vulnerability and business impact analysis
Phase IV	Recovery strategy development
Phase V	Development of BCP
Phase VI	Training and implementation of BCP

### RISK MANAGEMENT RELATED SYSTEMS

The Bank has been developing its systems capabilities and infrastructure for the purpose of improved Risk Management. Accordingly, a comprehensive Credit Rating System was acquired in 2007. Bank also acquired a comprehensive Treasury Management software system way back in the year 2001 and this system provides several facilities of stress testing, scenario analysis, gap analysis and duration measurement that facilitates monitoring of Market and Liquidity Risk of Treasury products. Seylan also became one of the pioneering banks to acquire BASEL II related software that covers capital charge calculations for Market Risk, Credit Risk and Operational Risk. The software is capable of expansion from the Basic Indicator and Standardised Approaches towards Foundation and Advanced Internal Rating Based Approaches. With the support of these software systems, Seylan Bank would possess a comprehensive and sophisticated Risk Management framework.



PD - Probability of Defaults  
 EAD - Exposure at Defaults  
 LGD - Loss Given Defaults

## BASEL II IMPLEMENTATION PLAN

Seylan Bank was able to face its first stage of meeting the challenge of implementing the BASEL II for credit risk - standardised approach, operation risk - basic indicator approach, and market risk - standardised approach very successfully through the appointment of a dedicated committee which comprised several subcommittees for evaluation and implementation involving key officers representing the core banking areas of finance, credit, operations, branch banking, and treasury who worked tirelessly towards achieving the set goals.

The first stage, comprised three phases; that of assessing and planning where a GAP analysis was conducted on our processes, methods, and systems involving the core system of Kapiti, and other systems used by Treasury Operations, Pawning, Leasing, Credit Cards, etc, comparing the availability of data against the required data and thereafter developing a master plan involving short-term and long-term goals. The short-term goal was to initially achieve the CBSL stipulations of meeting the preliminary standards by 1st January 2008, a goal which was achieved successfully and on time.

After a careful evaluation process a reputed IT software developer was hired to design the system to integrate the main operational systems of the Bank in forming a common data platform and thereafter performing the following tasks ;

### Risk Measurement

- Credit Portfolio Exposure Calculation
- Upload of data
- Data Validation
- Calculation of gross exposure for on-Balance Sheet and off-Balance sheet items
- Calculation of credit risk exposure for regulatory purpose and
- Capital charge calculations.

### Risk Mitigation

- Setting up netting agreements and management
- Calculation of impact of netting on the exposures
- Collateral Management
- Collateral set up
- Calculation of impact of collateralisation on exposures using simple approach
- Guarantees Management and
- Calculation of impact of guarantees on exposures.

### Risk Reporting

- Capital charge computation
- Statutory reporting.

Parallel to the above, the second stage of gearing and preparing for the advanced approach in credit risk was launched by the introduction of internal credit scoring and rating modules for different types of facilities was rolled out throughout the branch network, and credit SBUs of the Bank. These rating modules are currently being fine tuned through stress testing, and back-testing with the view of ensuring that they reflect a realistic risk assessment of the counterparty and transaction, prior to linking them for credit decision making, risk-based pricing and the calculation of Probability of Default, Exposure at Default, and Loss Given Default.

## KEY ELEMENTS OF SUCCESSFUL BASEL II RISK MANAGEMENT SYSTEM

- Sponsorship from top management.
- Project implementation team who can collaborate between systems experts and risk experts.
- Bank-wide cross-functional Taskforce, established to identify and prioritise data quality issues, evaluate solutions and initiate process changes. Implementing tools that detect data errors and omissions.
- Discipline needed to maintain "clean" data. Reports generated regularly to ensure that errors are not creeping back into database.

## **WAY FORWARD ON RISK MANAGEMENT - KEY FOCUS AREAS OF THE BANK**

The following is a summary of the key areas focused by the Bank for implementation during the year 2010 onwards:

- Further development of internal risk rating frameworks.
- Integration of frameworks through credit redesign initiatives.
- Ongoing testing and validation of risk rating systems.
- Calibration of probability of default.
- Development of portfolio management information system.
- Building database of default data, loss data and recovery data.
- Measuring credit exposures accurately.
- Analytics Engines that support BASEL II capital requirements and economic capital attribution.

Each is a major project requiring cross-functional expertise and deep skill sets. Projects driven via Steering Committee and project leaders are held accountable for project delivery.

## **CONCLUSION**

Risk Management is an important function of any organisation and more so in the case of a financial institution because the ability to expand the exposures is much more significant compared to most other business entities. Seylan Bank recognises the need for a sound and comprehensive risk management framework and therefore has introduced a risk management framework that is being continuously improved and developed.