RISK REVIEW

The Bank is operating in a highly competitive and dynamic environment. From a risk management perspective, year 2017 was characterised by changes in regulatory frameworks and reporting guidelines with the phased in implementation of Basel III Framework and SLFRS 9, worldwide spread of ransom ware to unprecedented levels targeting financial institutions in particular, significant investments for enhancing system and process capabilities arising from the above, and ripple effects of natural disasters throughout the year. Banks were seen approaching shareholders by way of rights issue of shares and capital markets by way of Basel III compliant debentures for augmenting increased levels of capital requirements. Further, competition for stable funding intensified with the implementation of new liquidity regulations in terms of Basel III and aggressive pricing for deposits is expected in the near future.

Credit growth continued at an accelerated phase in the first half of the year, but tightening of the monetary policy saw it slow down during the second half of the year. Despite a growth in non-performing loans and receivables by Rs. 19 Bn. during the year, banking sector asset quality remained more or less at the same levels of those reported at end 2016. Liquidity too remained at levels above optimum throughout the year. Interest margins continued to be under pressure.

Nevertheless, as evident from the risk profile (refer Table 05 below) and the operating results posted for the year, the rigorous risk management framework in place enabled the Bank to successfully manage its risk exposures, strengthen its stability and enhance profitability during the year. Overall risk profile did not undergo any significant changes during the year.

Progress in 2017

Key initiatives during the year in this regard include:

- Obtaining validation of the VaR model from an external consultant.
- Setting up and applying limits in VaR model to control market risk related portfolios.
- Significantly strengthened the Bank's Social and Environmental Management System (SEMS) by recruiting experts on the subject and impanelling consultants from the market thereby enhancing the level of its acceptance within the Bank.
- Successful rights issue of shares during the year strengthened the Common Equity Tier 1 and total Tier 1 capital by Rs. 10 Bn.
- Continued overseas expansion by incorporating a fully owned subsidiary for microfinance lending in Myanmar which will help geographical diversification of risk further.
- The Bank continued to evaluate options available for implementing an Enterprise Risk Management system.

Risk profile compared to risk appetite Table – 05

Risk category and parameter	Description	Policy parameter	Actual position 31.12.2017	Actual position 31.12.2016
Credit risk				
Quality of lending portfolio	Gross NPA Ratio	4% – 5%	1.88%	2.18%
	Net NPA Ratio	2.5% – 3.5%	0.92%	1.09%
	Provision Cover	30% – 40%	51.02%	50.11%
	Weighted Average Rating Score of the overall lending portfolios to be above	35% – 40%	57.63%	56.84%
Concentration	Loans and Advances by Product – Highest exposure to be maintained as a percentage of the total loan portfolio	30% – 40%	21.46	40.39%
	Advances by Economic sub-sector (using HHI)	0.015 – 0.025	0.016	0.0158
	Exposures exceeding 5% of the Eligible Capital (using HHI)	0.05 – 0.10	0.0071	0.0061
	Exposures exceeding 15% of the Eligible Capital (using HHI)	0.10 – 0.20	0.0095	0.0075
	Exposure to any sub-sector to be maintained at	4% – 5%	4.04%	3.97%
	Aggregate of exposures exceeding 15% of the Eligible Capital	20% – 30%	24.71%	20.55%
Cross border exposure	Rating of the highest exposure of the portfolio on S&P Investment Grade – AAA to BBB-	AA	AAA	AAA

Risk category and parameter	Description	Policy parameter	Actual position	
			31.12.2017	31.12.2016
Market risk				
Interest rate risk	Interest Rate Shock: (Impact to NII as a result of 100bps parallel rate shock for LKR and 25bps for FCY)	Maximum of Rs. 1,300 Mn.	Rs. 1,243.61 Mn.	Rs. 670.86 Mn.
	Re-pricing Gaps (RSA/RSL in each maturity bucket – upto one year period)	< 1.5 Times (Exemption < 2.5 times for 1 Month bucket)	0.89 Times (2.34 times for 1 Month bucket)	0.96 Times (2.03 times for 1 Month bucket)
Strategic risk				
	Capital Adequacy Ratio			
	CET1	Over 10%	12.11%	10.37%
	Total Capital	Over 14%	15.75%	14.87%
	ROE	Over 20%	17.88%	19.52%
	Creditworthiness – Fitch Rating	AA (lka)	AA (lka)	AA (lka)

Besides the conventional risks the Bank is faced with, it paid attention to several emerging risks and uncertainties with potential to disrupt banking business models in the future, arising from certain global developments and deliberated on the strategic responses thereto. A detailed review of these risks and mitigation measures is given in the Section on "Managing Risk: An Overview" on page 154 to 158.

Other developments and outcomes in relation to the risk profile and risk management initiatives during the year included:

- Increased foreign currency borrowings after a careful analysis of cost of funds and maturity profile of assets and liabilities.
- Stress tested the assets portfolio for Credit, Market and Operational risk under different stress scenarios which revealed that the risks associated therewith were well within the risk tolerance levels even under severe stress levels.
- Gearing in terms of on balance sheet assets as well as risk weighted assets improved from 12.92 (times) and 6.72 (times) in 2016 to 10.68 (times) and 6.35 (times) respectively in 2017.
- Both gross and net NPL ratios improved to 1.88% and 0.92% in 2017 from 2.18% and 1.09% respectively in 2016
- Both Provision Cover and Open Credit Exposure ratios improved to 51.05% and 7.60% in 2017 from 50.11% and 9.53% respectively in 2016.

Plans for 2018 and beyond

The Bank will continue to strengthen the Risk Management Framework further by taking into account the evolving regulatory requirements and conventional as well as emerging risks and uncertainties. Specific initiatives in this regard will include:

- Having the rating systems externally validated with the critical mass of information now in place,
- Implementing a new Assets and Liabilities Management System with an embedded risk based Funds Transfer Pricing mechanism and risk adjusted return calculations, enabling the Bank to better align the cost of capital to the risk profile of the borrowers.
- Gradual shifting of the maturity profile of assets from long term to medium term to improve maturity profile of assets and liabilities
- Furthering the success experienced in Bangladesh, Maldives, and Italy, continuing to explore opportunities for regional expansion to other geographies which will diversify the risk profile
- Maintaining a persistent focus on emerging risks and continuing to invest in improving protection against cyber security capabilities.
- Further integrating systems for effective risk management
- Intensifying the mobilization of stable funding