Integrated Risk Management Policy Framework

Complying to the regulatory directions, The Board of Directors of Cargills Bank PLC has adopted an Integrated Risk Management Policy Framework (IRMF) which facilitates oversight and accountability for various risks at different levels of the Bank. Key elements of the IRMF are as follows.

Components of IRMF framework

- Risk Appetite
- Risk Management Tools
- A culture of risk awareness.

The IRMF of the Bank covers various potential risks, possible sources of such risks, effective measures to control and mitigate risks at prudent levels and relevant officers and committees responsible for mitigation. Through IRMF Board of Directors assess the integrated risk profile of the Bank and oversight the management of risks periodically. Board Integrated Risk Management Committee (BIRMC) has established and delegated by the Board of Directors of the Bank to govern the effective implementation of IRMF within the Bank. The Board of directors of Cargills Bank PLC has established policies covering credit risk, market risk, liquidity risk and operational risk in the objective of comprehensive risk management within the Bank. Executive level management committees in respective domain monitor the execution of the policies and procedures.

Credit Risk

Credit risk refers to the potential loss that may occur when a borrower or counterparty fails to meet their financial obligations, such as repaying a loan or fulfilling a contract. It's the risk that a borrower may default on their debt obligations or fail to make payments on time, leading to financial losses for the Bank. Credit risk is a significant consideration for banks, and we are exposed to risk from diverse financial instruments. The credit risk management framework stipulates the policies, guidelines, and organizational structure for credit risk management of the Bank.

1. Explicitly stipulate credit risk management policies and guidelines to be adhered by the Banks management and staff.
2. Establish an independent Credit Risk Management function as a part of the overall Integrated Risk Management Function of the Bank.
3. Define responsibilities of different parties involved in the credit risk management function.
4. Communicate the Banks credit risk management policies, practices, guidelines, and strategies to its relevant stakeholders.

Credit Risk Management

1. Recommend risk mitigation tools, techniques and approaches to the management that will be implemented by the business units. CRMU will monitor the effective implementation of risk mitigation techniques.
2. Perform annual rating reviews for large clients and for groups with large exposures.
3. Establish and review the credit risk related limits based on the changes in the business environment and monitor the same on periodic basis.
4. Carry out risk reporting to the senior management, executive committees, board integrated risk management committee (BIRMC) and the Board of Directors (BOD).
5. Watch list monitoring.

6. Monitoring of large nonperforming clients.

Risk Rating

The risk rating model will indicate diverse risk factors of the borrower and will guide to take credit decisions. Further, the model will reflect underlying credit risk of the loan book. These models are developed based on both quantitative (Financial ratios) and qualitative characteristics (Industry, payment history, credit reports, management, purpose of the loan, quality of financial information, facility characteristics etc.) and the models are documented together with the user guidelines. Currently we have different type of the risk rating scoring model for different business units.

Impairment Assessment

Bank is classifying all credit facilities for the purpose of impairment assessment, risk mitigation and monitoring into performing and non-performing loans and advances.

Model Validation and Governance.

To ensure the reliability of the impairment assessment, the Bank conducts periodic and independent validations in the iterative process used to verify and validate impairment assessments to ensure that they meet their intended business use and perform within design expectations through a series of tests of the critical elements of a model. Validation exercise establishes models' capability of generating accurate, consistent, and unbiased predictive estimates on an ongoing basis.

Write off of interest-bearing assets.

The Bank shall decide to write off a transaction when the Bank is unable to recover the financial value of that transaction despite its recovery efforts; or the cost of recovery being greater than the outstanding amount; and has exceeded time defined in the respective Directions.

Recognition of write offs shall be as per the write off policy, relevant accounting standards (LKASs & SLFRSs) and other regulations issued from time to time. The Bank shall ensure due approval is obtained for write-offs and waivers in accordance with the approved Delegated Authority (DA) limits.

Valuation and collateral management

The Bank generally extends credit based on the customer's ability to meet their obligations from cash flow, rather than relying primarily on collateral, though collateral remains a crucial part of managing credit risk. Depending on the customer's profile and the type of loan, some credit facilities may be unsecured. For other types of lending, collateral is required and influences the credit decision and pricing. In the event of default, the Bank may use the collateral to recover the outstanding amount. The nature of the collateral can greatly affect our capacity to mitigate credit risk.

Market Risk

Market risk is the potential loss in both On and Off-balance sheet positions, caused by movements in foreign exchange rates, interest rates, and equity and commodity prices. The portfolios significant demarcations are made on the basis of trading and no trading segments. Covering the entire portfolio, Market Risk Policies of the bank address the following:

i. Assessment of bank's exposure on a consolidated basis, considering issues related to interest rate, currency, equity price and liquidity risks; and
ii. Risk measurement systems capture all material sources of market risk and assess the effects on bank's capital.

Management of the market risk exposures

The bank through its Market risk Management Policy takes appropriate measures to mitigate the risk through fixing appropriate limits on open positions, gaps, adopting risk measurement methods and monitoring exposures. Such limits and measurement mechanism include,

i. Fix appropriate limits on overall risk profile.
ii. Fix appropriate limits on individual and aggregate gaps on major currencies, linked to capital.
iii. Adopt the Value at Risk (VaR) technique to measure the risk associated with exposures.
iv. Monitor Forex risk exposures with the preparation of the Related gap limit reports.
v. Ensure clear-cut and well-defined division of responsibility between front, middle and back offices.

The entire gamut of the exposures is covered by the Dealer Limits, Portfolio Limits, Portfolio Limits, Portfolio Limits, FIS Limits, Repo/Rev Repo Limits, FX Trading Limits, Gap Limits, Foreign currency liquidity, Broker and Counterparty Limits, Rate tolerance limits, Deposit rate exception limits

Liquidity Risk

Liquidity risk is the risk that the Bank will not be able to efficiently meet both expected and unexpected current and future cash flows and collateral needs without affecting either daily operations or the financial condition of the Bank.

Management of the liquidity risk exposures

Liquidity measurement is assessed through concentration of funding sources, stock, and flow approaches as advised in the CBSL guidelines as well.

Under the stock approach, liquidity is measured in terms of key ratios such as Net Loans to Total Assets, Total Loans to Total Deposits, Purchased Funds to Total Assets, Net Stable Funding Ratio, Liquidity Coverage Ratio etc. The same set of indicators will be used to monitor the Liquidity Risk of the Bank and relevant information will be extracted from the statement of financial position and statutory returns shared by the finance department.

Under the flow approach, maturity mismatch of assets and liabilities have been analyzed based on their behavioral pattern. Behaviors and assumptions depicted in the Bank's stress testing policy are used in deriving at the behavior-based Maturity Mismatch and Time to time changes will be adapted to the assumptions considering the remaining economic conditions at the time of reporting.

In running multi-currency balance sheets, and particularly when domestic currency assets are funded with foreign currency liabilities, banks are exposed to another layer of complexity to liquidity management. Market risk activities and procedures are covered in detail in Market Risk Management Policy

Operation Risk

Definition of Operational Risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal process, people and systems or external events. Operational risk includes legal risk but excludes strategic and reputation risk.

Operational risk management structure.

Executive Integrated Risk Management Committee (EIRMC) provide the management level oversight of the implementation of Operational risk control measures and Operation Risk Management Committee (ORMC) was established by the EIRMC to streamline the action the mitigation controls. Responsibilities of operations risk includes;

Objective of Operational Risk Management

•Ensuring that there is clear accountability and responsibility of senior management at the Bank with regard to operational risk.
• Developing a common understanding of operational risk across the Bank, so as to assess exposure of business and operation groups with respect to operational risk and take appropriate actions.
• Improving internal controls throughout the Bank thereby reducing the probability and potential impact of losses from operational risk incidents.
• Developing risk loss database to collect and monitor operational risk related losses.
• Meeting regulatory requirements of the Central Bank of Sri Lanka.

Each business and operational department is required to evaluate its own procedures to ensure compliance with the requirements of this policy. To achieve the effective establishment of operational risk management within the Bank, dedicated Business Operational Risk Manager was appointed from each department to identify and report the Risks and internal loss events. Each business unit is responsible of proactive and robust identification of operational risks through a Risk Control Self Attestation (RCSA) process. Through IRMF, Bank has established timely capture of Internal Loss Events (LER) and maintain a central repository on the actions taken along with the lessons learned.

Capital management.

The Bank shall calculate its operational risk capital requirement using Basic Indicator Approach as follows:

$\boldsymbol{KBIA} = [\Sigma(\boldsymbol{GI1} \ldots \boldsymbol{n} \times \boldsymbol{\alpha})]$

Where; KBIA = capital charge for operational risk under BIA GI = annual gross income, where positive, over the preceding three years. n = Number of years in the preceding three years when annual gross income is positive α = 15%, which is set by Basel Committee on Banking Supervision Banks shall calculate its gross income as the sum of net interest income and non-interest income taking into account the following adjustments:

i) gross of any provisions/impairments (including unpaid interest);

ii) gross of operating expenses, including fees paid to outsourcing service providers, in contrast to fees paid for services that are outsourced, fees received by banks that provide outsourcing services shall be included in the definition of gross income but excluding

a) Any realized profits/losses arising from the sale of securities in the banking book. Securities in the banking book shall be the securities that are classified as “held to maturity” or “available for sale”, in accordance with Sri Lanka Accounting Standard - LKAS 39.

b) Any income or expenses not derived from the ordinary activities of the bank and not expected to recur frequently or regularly, i.e., sale of fixed assets, income derived from insurance recoveries etc.

If the annual gross income/capital charge for any given year is negative or zero, it should be excluded from both the numerator and denominator when calculating the average capital charge. Banks shall calculate its annual gross income for the most recent year by aggregating the gross income of the last four financial quarters and follow same to calculate annual gross income for each of the two years preceding the most recent year.

Capital Adequacy

The bank’s capital management process includes quarterly Capital Adequacy Ratio (CAR) reporting to the Central Bank of Sri Lanka (CBSL) to meet regulatory requirements. Also, the Bank conducts annual comprehensive internal Capital Adequacy Assessment Process (ICAAP)with focusing more intently on Pillar 2. Pillar 2 of the Basel III guideline, which directs maintaining an economic capital buffer addressing risks, which are not, capture under Pillar 1. The bank uses a mix of quantitative and qualitative assessment methods to measure Pillar 2 risks. Further, the Bank conducts a detailed stress testing to gauge the impact of adverse scenarios on the Bank’s Capital Adequacy. Finally, the Bank derives the overall impact on CAR aggregating stress test results combining most likely scenarios.

Classification, Valuation and Controlling Framework of Fixed Income Securities

The classification, recognition, and measurement of financial assets other than credit facilities shall be in line with the CBSL Direction 14 of 2021, which aims to harmonize the reporting in line with the accounting standard SLFRS 9 – Financial Instruments. Reclassification of securities between portfolios will generally not be permitted, except under specified circumstances, under the provisions of Sri Lanka Accounting Standards. In line with the requirements under the Sri Lanka Accounting Standards, such changes in business models and reclassifications shall be approved by the Board of Directors and shall be notified to the Director of Bank Supervision within 7 working days of the date of such approval.

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