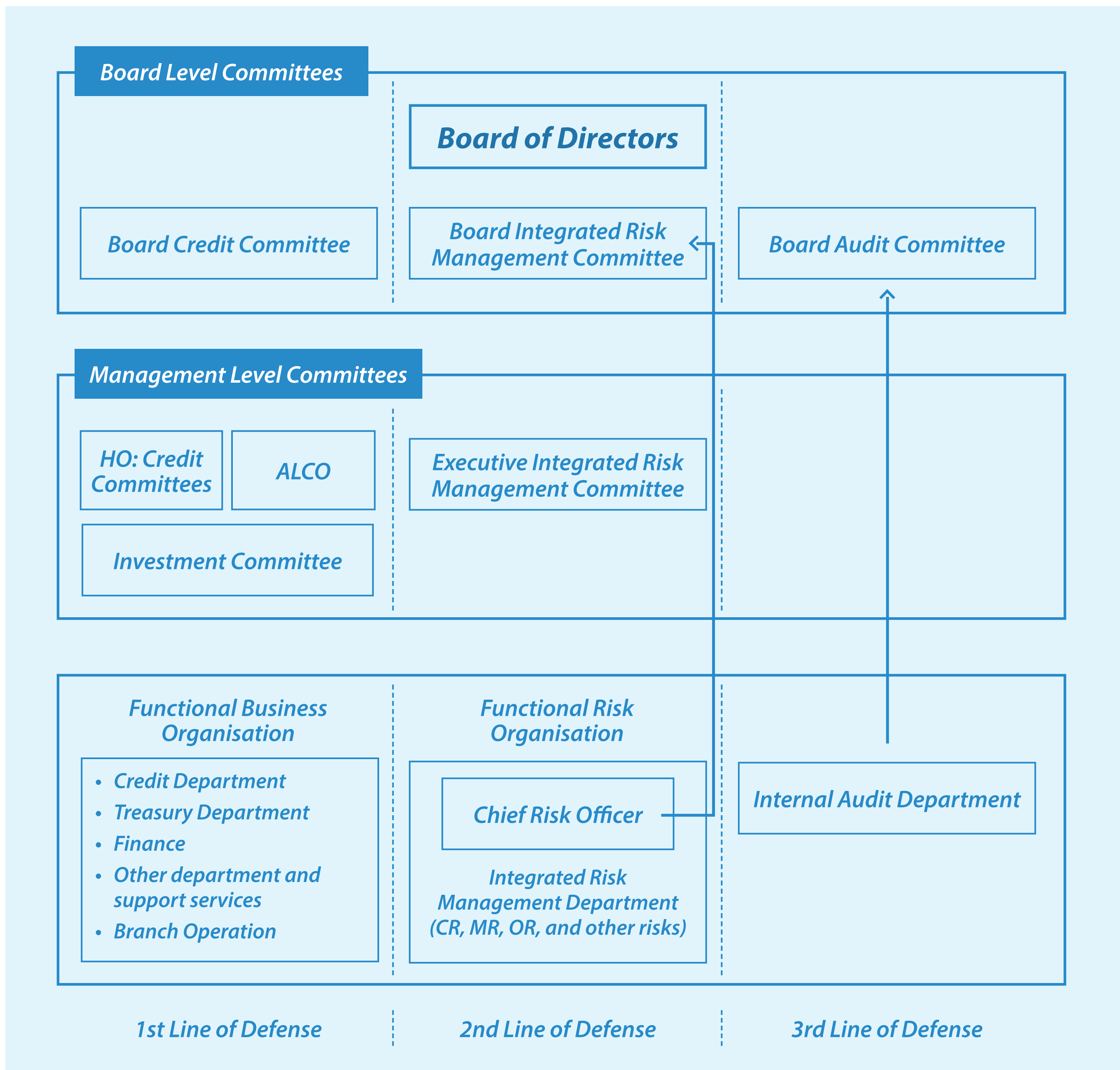
Managing Our
Risks

SANASA Development Bank's approach to risk management is based on policy frameworks approved by the Board of Directors, governance structures, and tools and techniques to identify, measure, mitigate and manage all risk exposures.

The Board of Directors has the ultimate responsibility to manage risk. It formulates policy and sets the risk parameters. The Board Integrated Risk Management Committee (BIRMC) assists the Board of Directors in this regard.

The responsibility for implementing the risk management framework lies with the Executive Integrated Risk Management Committee (EIRMC) who review the Bank's credit, market, liquidity and operational risk indicators as well as its internal capital adequacy levels.

The Chief Risk Officer has a triple reporting responsibility to the EIRMC, the Operational Risk Management Committee and the BIRMC.



The above Committees and Organisation Structure is limited only to Risk and related areas.

Approach to risk management

Having recognised the importance of risk management to the effective running of the Bank, the Board of Directors has developed a risk management policy that is designed to help identify, measure, manage and report all material risks.

Relevant procedures have been built around these policies which are communicated throughout the Bank to assist business units in the discharge of their duties and in dealing with customers.

The Bank adopts the internationally recognised Three Lines of Defence governance model where transparency and accountability are practised through clear segregation of duties.

The 1st Line of Defence (functions own and manage risks) consists of identifying, managing, and reporting of risks at all levels. The intention is to manage specific risks at the source as effectively as possible.

The 2nd Line of Defence (functions oversee risk) is the centralised oversight of the 1st Line of Defence by the risk management, compliance, finance and other support functions.

The 3rd Line of Defence (independent assurance) comprises Internal and External audit who provide unaffiliated opinions on the strength and effectiveness of controls.

In order to embed a risk awareness culture across the organisation, ongoing training programmes are conducted and various communiques are issued continuously. During the year 33 training programmes were conducted. Risk consciousness is an integral part of the Bank's induction programme and consists of several mandatory training modules for all employees. In addition, a risk reporting process at multiple levels in the organisation, lends weight to its importance in the functions of the Bank.

Risk appetite

The risk appetite of the Bank is articulated through a clear set of indicators, with limits and triggers, relating to the key risks the Bank is exposed to. This set of guidelines is reviewed and updated regularly by the Board of Directors in keeping with the strategic objectives and corporate plan for the year.

The following are the Bank's key risk appetite indicators, along with actual performance results for the year.

Key Risk Indicator	As at 31 December	Internal limit
Credit risk		
Gross non-performing loans ratio	2.6%	3%
Top twenty exposures/total loans	4.5%	20%
Market risk		
Single counterparty exposure (fixed income)	27%	30%
Single counterparty exposure (public equity)	0%	10%
Single counterparty exposure (private equity)	1%	10%
Liquidity		
SLAR	23.2%	20%
LCR	142.2%	90%

Risk reporting

An integral part of risk management is regular reporting of those factors relating to the exposures that have been identified. These reports are sent to the Board of Directors, the relevant department head, Operational Risk Management Committee and the EIRMC by the Chief Risk Officer.

Risk exposure	Risk reports
Credit risk	Number of NPL accounts by sector, geography, and product relative to the provision coverage
Market risk	Impact of rate shifts on the Bank's economic value of equity and earnings Trading book value and return against limits
Liquidity risk	Liquidity allocation Cash flow forecasts Analysis of regulatory and internal cash flow maturities Stressed cash flow analysis
Operational risk	Summary of operational loss events by business unit
Strategic and reputational risk	Key Budgetary ratios Scorecard based questionnaires to assess reputation risk across the Bank

Stress testing

The Bank conducts regular stress testing to identify potential impacts that fluctuations in market variables and other risk factors could have on the Bank's risk profile. Stresses in the Bank's credit, market, liquidity, interest rate and equity risks are evaluated with reference to capital and earnings positions.

The Board Integrated Risk Management Committee (BIRMC) conducts regular reviews of the stress testing outcomes, including the major assumptions that underpin them.

The following table shows examples of stress factors that need to be tested to determine their impact on the Capital Adequacy Ratio (CAR), Net Interest Margin (NIM) and profitability.

	Credit risk	Concentration risk	Interest rate risk	Liquidity risk
Stress scenario	Increase in NPL ratio Shifts in NPL categories	Increase in HHI (Herfindahl-Hirschman index) values across lending counterparties and sector	Movement in interest rates	Liquidity stress scenarios

External drivers of risk

While risk exposures shown above are to a great degree controllable by the Bank, there are external factors, the outcomes of which, the Bank is unable to influence. Given the environment in which a bank operates, economic conditions in the country, government policy, regulatory changes and climate change are some of those aspects which can have an effect on the Bank's profitability and ability to comply with laws and regulations.

During the year under review, the following external drivers had an impact on the Bank's overall risk profile.

Macroeconomic conditions

- While the economy recovered slowly in the first half of the year due to more favourable weather conditions, the political uncertainties in the latter half resulted in a subdued performance overall. The inactivity of the Government sector in the second half of the year brought hardship to many of the Bank's customers who either suffered from a lack of government contracts or were not able to receive payment for jobs that were already completed. This in turn, had a negative effect on the Bank's performance.
- The Government's intent is to spread the economy throughout the country and disperse the concentration of economic activity in the Western Province. This feeds well into SDB Bank's market strategy of concentrating their energies on the rural and SME sectors. The realisation of this intent is yet to be seen and the question remains as to whether the Government will be allowed to pursue this agenda without political interference.

Regulatory changes

The introduction of more stringent provisioning requirements on non-performing loans and advances as specified by the accounting standard SLFRS 9, imposes greater pressure on the profitability of the Bank.

- Basel III is a set of international banking regulations developed by the "Bank for International Settlements" in order to promote stability in the international financial system. The purpose of Basel III is to reduce the ability of banks to damage the economy by taking on excess risk.
- Basel III introduced a set of reforms designed to improve the regulation, supervision and risk management within the banking sector. Banks are required to maintain proper leverage ratios and meet certain minimum capital requirements.
- Under Basel III, the minimum capital adequacy ratio that banks must maintain is 11.88%. The capital adequacy ratio measures a bank's capital in relation to its risk-weighted assets. The capital-to-risk-weighted-assets ratio promotes financial stability and efficiency in economic systems throughout the world.

- The Liquidity Coverage Ratio (LCR) requirements are designed to ensure banks maintain an adequate level of readily available, high-quality liquid assets (HQLA), that can quickly and easily be converted into cash to meet any liquidity needs that might arise during a 30-day period of liquidity.

  The Basel III guidelines to prudent banking practices come into full effect from January 2019.

  Its gradual implementation has enabled the Bank to progressively improve its capital ratios which are now comfortably above the minimum standards set. This of course means that there is less capital that can be used to generate a return and it creates its own challenges to the Bank in raising additional capital to service the needs of the market.
- The new Income Tax Act was introduced and resulted in higher tax contributions from SDB Bank to the Government. In addition to the increased doubtful debt provisions, these tax payments were another impost on the Bank that contributed to a curtailment of the profit for the year. There is conjecture that further taxes may be introduced and the Bank will need to be in a position to meet those obligations and yet generate a satisfactory return to the shareholders.

Political environment

- Political instability in the last quarter of 2018 which brought the country to almost a standstill, had a profound effect on the business climate in the country. The subsequent breakdown in relationship between the President and the Prime Minister, brings on further uncertainty to the effective functioning of Government. The flow-on result is the ambiguity that pervades economic activity, which in turn poses more difficult questions for the Bank to deal with in running a profitable operation.
- The slowdown in Government activity has prevailed past the political events of the last quarter of 2018, into the new year. The Bank has to find ways to circumvent this situation and find ways to generate a sufficient quantum of business.

Climate change

- Drought and floods have become regular occurrences over the recent past. Since these unfortunate events generally take place in rural areas, the Bank is aware of the need to take adequate precautions to prevent losses.

The Bank's relationships within the banking industry, particularly in Sri Lanka, must be nurtured and matured to gain an increasingly influential voice. The closer the Bank is to the regulators, other major banks and to the political environment, the more likely it will be able to influence and/or be prepared to respond to future challenges.

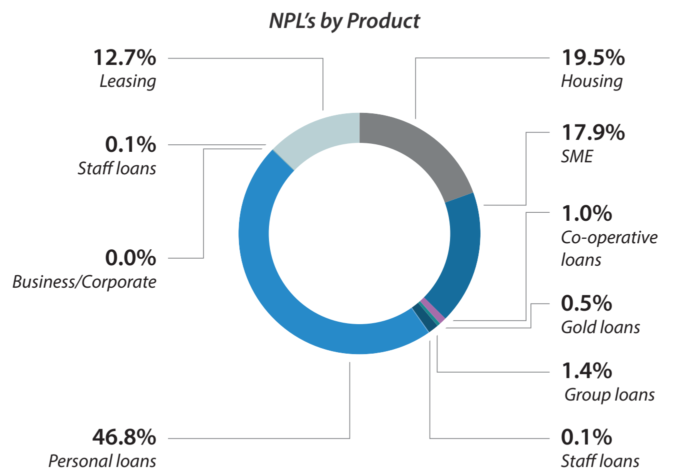
SDB Bank continues to grow its voice in the banking industry by being a niche player catering almost exclusively to the rural sector in a developmental role.

Credit risk

The Bank's underlying business model requires the extension of credit to individuals and businesses to enable them to fund their occupations and other personal needs. Credit risk relates to the potential losses than can arise by customers being unable to discharge their obligations in the repayment of loans and advances taken by them.

SDB Bank has in place the Board Credit Committee which is charged with the responsibility of implementing the Bank's credit risk management framework. A Board approved Credit Risk Management Policy outlines the responsibilities, tools and techniques for credit risk identification, measurement, mitigation, and management. Key aspects, amongst others, of the Bank's credit policy include pre-credit sanctioning criteria, delegated approval authority, due diligence, collateral management and post-credit monitoring. The framework is reviewed and updated regularly based on evolving best practices as well as emerging risks and opportunities.

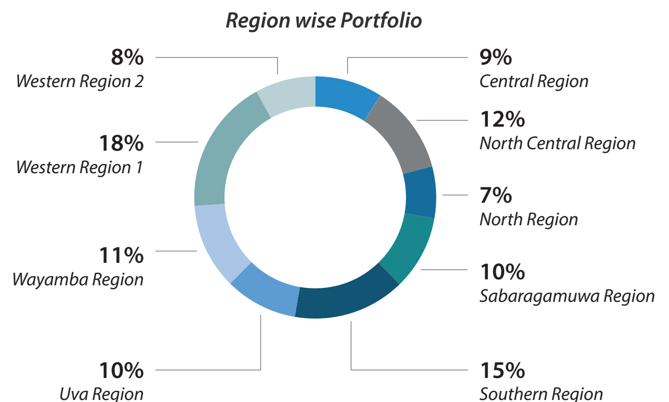
NPL's by Product



Concentration risk

Concentration risk is the potential for a loss in value of the loan portfolio when an individual or group of exposures move together in an unfavourable direction. The implication of concentration risk is that it generates such a significant loss that recovery is unlikely. The exposures can be geographical or sector wide. The goal of credit risk management is to maximise a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters.

Region wise Portfolio



Market risk

Market risk refers to the risk of losses in the Bank's trading book due to changes in equity prices, interest rates, credit spreads, foreign-exchange rates, commodity prices, and other indicators whose values are set in a public market.

How SDB Bank manages market risk

The Bank's main market risk exposure relates to interest rate risk. Fluctuations in interest rates affect the cost of funds and consequently the Bank's profitability.

The Assets and Liabilities Committee (ALCO) is responsible for monitoring the Bank's market risk exposure. It reviews the impact of interest rate risk on the banking book as well as net interest margin, funding mismatches and the cumulative rate sensitive gap. The Committee also undertakes stress tests on the Net Interest Margin (NIM) and equity, under different interest rate scenarios.

A comprehensive set of policies is in place to govern all aspects of market risk. These policies are reviewed and updated regularly in view of emerging market risks.

The term structure of the Bank's interest rate sensitive instruments is given below:

	Less than 7 day	7-30 days	1-3 months	3-6 months	6-12 months	1-3 years	3-5 years	>5 years
Interest bearing assets (%)	3	10	18	16	30	9	10	5
Interest bearing liabilities (%)	7	5	15	26	25	13	8	0

Its exposure, to SME and consumption driven loans which fall into the short to medium-term categories relates well to the Bank's ability to source mid to long-term debt and equity financing respectively.

Equity risk

Equity risk relates to potential losses in earnings resulting in adverse fluctuations of the share price. SDB Bank had zero investments in shares and consequently this does not pose a risk.

Liquidity risk

Liquidity risk relates to the possibility that the Bank will be unable to meet its financial obligations by settling them in cash or being able to convert a security or hard asset to cash without a loss of capital and/or income in the process.

The ALCO is responsible for managing the Bank's liquidity risks. The Committee regularly reviews the Bank's cash flow positions, projections, funding capabilities and pricing decisions to ensure internal targets and regulatory liquidity requirements are met.

Liquidity risk performance in 2018

During the year the Bank maintained its liquidity ratios well within the internal limits and above regulatory minimums specified by the Central Bank of Sri Lanka (CBSL).

An analysis of the funding profile of the Bank, shows that the deposits are distributed amongst a range of customers and other sources where a few do not control a large percentage of the total.

The Bank also has in place a contingency plan to bridge unexpected liquidity shortfalls. In the event of liquidity stress, Treasury is able to borrow 80% against Treasury Securities as repco borrowings through bank approved primary dealers.

	2018			
Liquidity ratios	**March**	**June**	**September**	**December**
SLAR* (%)	**21.02**	**21.15**	**21.32**	**23.22**
LD ratio** (%)	**118**	**117**	**121**	**122**
LCR*** (%)	**94**	**126.49**	**167.66**	**142.15**

**Statutory Liquid Asset Ratio*
***Gross Loan to Deposit*
****Liquid Coverage Ratio*

Operational risk

Operational risk is the potential loss resulting from inadequate or failed internal processes, people and systems, or from external events.

The Operational Risk Management Unit (ORMU) is responsible for administering the evaluation, to defined operational risk parameters, of all key business units on their exposure. This is a mechanism that enables business units to identify and assess their own risks and introduce measures to improve risk control. The Bank also maintains an Operational Risk Loss Data Base in line with Basel guidelines. Processes are also in place to capture all operational loss events which are then categorised in accordance with the guidelines.

Exposure to IT/Cyber risk is a significant threat for all businesses. So far, SDB Bank has been protected from these risks due to the Bank's minimal exposure to digitalised processes. However, the Bank is now venturing increasingly into these electronic processes and is actively strengthening processes to mitigate cyber risk.

Operational risk performance in 2018

Indicators showed that operational risks were contained within the defined parameters and no significant breaches were recorded during the year. The total value and volume of operational losses by category are shown below.

Category	Events
External fraud	0
Internal fraud	12
Employment practices and workplace safety	11
Client, products, and business practices	7
Damage to physical assets	2
Business disruption and system failure and power failure	275
Execution, delivery and process management	19

Legal risk

"Legal risk is the risk of financial or reputational loss that can result from lack of awareness or misunderstanding of, ambiguity in, or reckless indifference to, the way law and regulation apply to your business, its relationships, processes, products and services."

– Whalley, M. 2016.

Added to these is the risk of arrest and prosecution.

All legal documents executed on behalf of the Bank are vetted by the Legal Department of the Bank. Services of external lawyers are obtained whenever required. Internal processes described in previous sections, relating to compliance with regulatory provisions, are in place to mitigate potential losses and harm to the Organisation.

Strategic risk

Strategic risk relates to the possibility that the strategic direction the Bank is taking does not lead to the desired outcome or results in losses. This may be due to external or internal factors which are responded to inadequately or ineffectively.

SDB Bank in formulating their medium-term strategic plan have put in place performance indicators and set milestones in terms of achieving the required outcomes. The Board of Directors plays an active role through adopting relevant policies, monitoring progress through a number of reporting formats and helping the Bank maintain its focus on the end goals.

Capital management

The Internal Capital Adequacy Assessment Process (ICAAP) which complies with Basel requirements, outlines the process for assessing overall capital adequacy in relation to the Bank's risk profile.
The implementation of this framework ensures that the Bank possesses sufficient capital to cover its material risk exposures.

	Regulatory requirement	2018
Tier 1 (%)	7.87	11
Total Capital (%)	11.88	12.55

The implementation of a state-of-the-art loan originating system, centralised credit approvals and the move to concentrate more on the SME sector, paves the way to reducing the Bank's credit risk exposure.

During the year the Bank undertook several measures to improve its operational risk reporting and measurement process. A system for Loss event reporting and measurement was implemented which enables the Bank to accurately track operational loss incidents. Bank-wide training initiatives was conducted to strengthen staff competency on accurate loss data capture and reporting. The risk and control self-assessment process was further refined to enable departments and branches to evaluate their own risk.