Risk Management

Banking by its very nature involves exposure to a multitude of risks. In order to avoid their negative impact, risks must be identified at the earliest possible stage and managed effectively. At People's Bank, factors such as continuous macro economic changes in the environment, evolving technological developments, growing competitive pressures and changing policies and needs of the Government form the basic framework for Risk Management. In order to achieve success, the Bank constantly strives to discover the perfect balance that will ensure value enhancement and creation for its customers and shareholders while at the same time maintaining key measures in place to manage risks effectively.

All activities of the Bank revolve around analysis, evaluation and the management of some degree of risk or a combination of risks. The Bank's capacity to make profits and sustain such profits, depend to a great extent on how well it can identify and manage these risks. The Risk Management process is being continuously developed to reach a standard of high quality with the ultimate objective of securing the survival of the Bank. It also aims at contributing to increased and sustainable profitability in the long run, thereby achieving a lasting and durable increase in shareholder value.

Risk Management Process

In order to achieve success, risk must be managed in a manner that ensures that all necessary measures are taken to minimise and eliminate risk where possible. In order to enhance such risk mitigating factors, the Bank took some new initiatives during the course of the year. Chief among these was the setting up of an Integrated Risk Management function.

The Board of People's Bank approves the Bank's risk appetite through the Board Risk Management Committee. One of the main objectives of the Board Risk Management Committee established in 2004 was to have an integrated review throughout the Bank of the necessity to put in place a risk management profile, risk issues and necessary managerial action. The Committee will also review the measures that have to be taken to gear the Bank to meet the stringent new requirements proposed in BASEL II.

The Board Executive Credit Committee consisting of Directors and Members of the Management team appointed by the Board of Directors, formulates the Credit Risk Management Policy, monitors risk and regularly reviews the effectiveness of the Bank's Credit Risk Management Policies. The Asset and Liability Committee (ALCO) comprising Senior and Corporate Management appointed by the Board of Directors undertakes the same role with regard to other financial risks.

The Bank's senior management formulates policies, procedures and controls to achieve the Bank's overall financial goals within the set risk appetite. The Management has defined risk as being the volatility of future income and the economic value of our shareholders funds that result from changing environmental and market conditions.

The Audit Department reviews and reports on the adequacy of controls and procedures on a systematic basis. This ensures that an internal system is in place to constantly monitor potential risks and identify them early. This enables the Bank to take necessary measures to mitigate or prevent their impact on the operations of the Bank.

All staff are trained and provided incentives to manage risks in their respective business activities. In an endeavour to further enhance knowledge and focus on risk management, the Bank formulated risk based training programmes as part of its future improvement initiatives.

Strategic Approach to Risk Management

People's Bank continues its strategic approach to Risk Management with a combined commitment to further enhance and strengthen the Bank's Risk Management capabilities, processes and procedures across all operations. This is particularly important in the

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context of past experience where historical problems relating to an immense portfolio of non-performing loan balances and the consequent result of capital erosion occurred.

The Bank's focus on resolving the capital deficit currently supported by a Letter of Comfort by the Ministry of Finance has been communicated to all levels within the management. In line with this, the Bank has developed a Risk Mitigation Vision and Strategy which focuses on cushioning and protecting the required capital adequacy level from unacceptable losses or further erosion of the Bank's capital.

We continued to strengthen the comprehensive management framework that has been established in the Bank. This has created a solid base to work upon and marked the Bank's rejuvenation, leading to long-term financial success, growth and sustainable performance. The second Strategic Plan begun in 2004 will be completed in 2008 and continues with a similar model to that already implemented in progressive Risk Management platforms.

Assets & Liability Management

Assets and liability management, defined as the continuous process of balancing risk and return in structural positions, result from the role played by the Bank as an intermediary in financial markets. This specifically relates to a framework that involves developing a co-ordinated approach to the management of assets, liabilities and Off-Balance Sheet items. It also involves mapping out a structured approach to positioning the Balance Sheet of the Bank, mapping out a structured approach to strategically manage all market related risks of the Bank and providing a framework for senior management towards an effective strategic decision making process.

The Assets & Liability Management Committee (ALCO) coordinates Assets & Liability Management and carries out the following processes to achieve its objectives:

- Protecting the Bank's required capital adequacy level from extraordinary losses.
- Stabilising the earnings of the Bank by managing potential volatile positions.
- Quantifying and developing mechanisms to further quantify the impact of risks.
- Meeting regulatory reporting and capital management related requirements.
- Articulating strategies for overall Balance Sheet management.
- Formulating and executing business strategies
- Engaging in product development, pricing and promotional strategies.
- Developing processes to measure risk adjusted performances of the various business segments within the Bank.

The Bank has identified the necessity for Risk Management in the main areas of credit risk, liquidity risk, interest rate risk, market risk, operational risk and legal and regulatory risk. To mitigate or nullify these risk areas, we have introduced strong Risk Management mechanisms, which permeate all management levels of the organisation. The primary objective of ALCO is to control the levels and volatility of income, while managing capital adequacy levels. To achieve this objective, ALCO focuses primarily on liquidity Risk Management, interest rate risk management and market risk management.

The core issues that effect strategic Risk Management are capital investment competition and political changes that impact the economic environment. To address the problem of declining business lines and the competition created by new market entrants, the Bank is focusing on new products and repackaging existing products. In keeping with environmental changes and implications, the Bank geared itself to face changes in the regulatory framework.

Exposure to Risk

The Bank is exposed to several risks. The Bank's Risk Management policy is designed to identify and analyse credit risk, liquidity and market risk as well as other risks, setting suitable risk limits and continuously monitoring these risks and limits via appropriate information systems. Continuous modification, revision and adaptation of Risk Management policies and systems reflect changes in markets and products.

Risk	Impact
Legal Compliance Reputation	Minimal
Operational Market Liquidity	Moderate
Credit	High

Credit Risk

Credit Risk is the risk of counterparties of the Bank failing to fulfill their agreed obligations to the People's Bank. Factors that contribute to this risk include market recession, high loan concentration and poor initial appraisal of credit proposals. As a full service commercial & development bank serving a wide range of clients, the Bank's exposure to credit risk is high.

The credit risk process involves an independent Credit Controller reporting to the Board Executive Credit Committee through the CEO/General Manager, thus providing a high level centralised management of credit risk. Strategies are then initiated and designed to improve credit risk management. These strategies reflect the Bank's limited appetite for risk in consonance with capital restraints, level of profitability the Bank expects to achieve for incurring such risks and the imperative of improving the quality of our loan portfolio. Obtaining the approval of the Management and the Board Executive Credit Committee for these strategies, the Committee Members then ensure that such strategies yield the desired results.

The Bank took several measures to manage risk during the course of the year. These included the following:

- The Bank continued to provide training on credit risk analysis to staff whose work purview include credit risk management and credit evaluation. This enabled staff to develop their understanding of credit risk and the means by which to manage such risk.
- The establishment of individual limits of authority for initiating and approving credit, together with accountabilities for recovery of such credit led to better management of risks.
- A hierarchy of approvals to review potential risks at several levels, enabled large exposures to be reviewed at the highest levels.
- Portfolio management including sectoral and large exposure caps enabling the review and maintenance of portfolio quality.
- Monitoring and post disbursement reviews.
- A number of risk measurement systems were adopted by the Bank.
- Early identification of impairment and remedial action including adequate provisioning.

As part of further improvement in the future, the Bank has plans to refine and develop the ability to measure credit risk and to streamline the credit risk approval process.

Operational Risk

Operational risk is inherent to every organisation and covers a wide spectrum of issues. This risk arises from economic loss arising through fraud, unauthorised activities, error, omission, inefficiency, systems failure or due to external events. The Bank's exposure to operational risk is moderate.

Operational risk cannot be completely eliminated but the Bank tries to minimise these through a set of procedures which include the following:

- Clearly written procedures and controls enable the Bank to manage this risk through a controls based environment in which processes are documented, authorisation is independent and transactions are monitored.
- Regular reconciliations.

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- Adequate segregation of duties. In each area of operations, the line management is held responsible for establishing an effective and efficient operational control environment to ensure that the Bank's assets are adequately protected and the operational risks have been identified and adequate risk management. procedures maintained to control those risks.
- Periodic audits are undertaken by internal audit under the guidance of the Board Audit Committee.
- Through a method of transferring risk wherever possible.
- Contingency planning is an important aspect of operational risk management and the Bank has drawn up disaster recovery plans for all the business units. Further, back-up copies of important data are made daily for all important business units. Insurance policies such as computer crime and bankers blanket are obtained to cover natural disasters such as major floods or storms and man made disasters.

As part of future improvements under operational risk, the Bank will implement a system for self assessment of operational risks across the Bank.

Market Risks

Market risks are risks that arise due to regular changes in the market. These translate into potential losses that may result from changes in market value of tradable assets due to adverse variances in interest rates, exchange rates, bond prices or stock prices. At People's Bank, we are very conscious of such potential losses and take various measures to mitigate them.

- Providing training to ensure adequate skills are in place,
- Imposing limits on exposures, gaps and losses,
- Conducting regular valuations,
- Stress testing of positions.

The Assets & Liability Committee sets in place a framework of Risk Management measures designed to minimise the risk of unfavourable changes in market conditions which adversely effect the prices of our trading and investment portfolio of Government and other securities with strict limits on, exposure, holding period, maturities and maximum level of loss.

The Bank is currently taking measures to further strengthen market risk management systems.

Liquidity Risk

Liquidity Risk occurs when the Bank is unable to meet obligations that are due, owing to an inability to liquidate assets or obtain funding. This means that funding liquidity risk can be redefined as the risk to the Bank's earnings and capital adequacy arising from its inability to meet obligations that become due on a timely basis, without incurring unacceptable losses. The Bank is also taking steps to further develop the liquidity management process through the following measures:

- Monitoring future cash flows to ensure requirements can be met and stress testing these positions.
- Maintaining a pool of liquid assets.
- Managing the advances to deposit ratio within set parameters.
- Diversification of funding sources.
- Ensuring availability of credit lines.
- Actively matching funding horizons of liabilities to liquidity.
- Maintaining a stable retail deposit base.

Legal Risk

The Bank as a corporate entity and a commercial bank engages in a large number of legally binding transactions and contracts with counterparties including its customers, suppliers, service providers and employees. The risks associated with management of laws relating to the proper documentation, execution and enforcement of these transactions and management of changes in the regulatory laws that can affect the Bank adversely can be classified as legal risk.

The Bank employs internal and external legal advisors to help in the management of this process. The other measures employed include:

1. Using standard documentation for routine transactions.
2. Implementing policies and procedures to ensure effective use of its internal and external counsel.
3. Keeping abreast of changes in laws relating to business of the Bank and other relevant areas and taking measures to adhere.

4. Keeping abreast of developments in regulatory laws.
5. Ensuring that proper action is taken to comply with orders of courts, tribunals and authorities whenever necessary.

Reputation

An organisation's reputation is one of its most valuable assets. A negative impact on the reputation of an organisation can have a disastrous impact on its financial performance and will affect its license to operate. We are very much aware of the need to manage and maintain our image and values by avoiding and preventing unfavourable episodes which if subject to public scrutiny would reflect badly on our reputation and status. The Bank has taken several measures to preserve the confidence of shareholders:

- Investing in brand
- CSR activities to connect with the community and give back
- Code of conduct for all staff to ensure the highest ethical behaviour at all times
- Training to enhance the performance of the workforce

Compliance

Compliance risk is about ascertaining whether relevant policies, procedures and controls are in place to mitigate risk and verifying whether the Bank's operations are in compliance with relevant laws and regulations. A Chief Compliance Officer has been appointed to co-ordinate these efforts. The Bank has also made the following endeavours in this regard:

- Submission of compliance status reports to the Central Bank of Sri Lanka and the Board of Directors.
- Instilling a compliance culture across the Bank.
- Intensive training in KYC/Anti-Money Laundering (AML) and CDD procedures.

Implementation of BASEL II

People's Bank is strongly committed to achieving full compliance with each of the progressive initiatives that have been and will continue to be initiated by the Central Bank of Sri Lanka (CBSL) in relation to the implementation of the above in Sri Lanka. Preparatory arrangements were made to implement BASEL II in line with CBSL guidelines. People's Bank is also laying the foundation to move into the more advanced versions of BASEL II.

The Bank has set up a unit in the Finance Division to co-ordinate the Bank wide preparation for full implementation of the changes required in relation to Risk Management and Capital Adequacy computation under the BASEL II regulations.

The Bank is preparing for BASEL II primarily in the following manner:

- Training of selected staff in Finance, Credit, Credit Control, Treasury and Treasury Operations Divisions *inter alia,* on the requirements of BASEL II.
- Issuing of educational newsletters and circulars from the Finance Division to all staff of the Bank on Risk Management and BASEL II.
- Selected staff being provided with local and overseas specialised training in Risk Management and BASEL II implications.
- Initiating 'parallel run' computations of Capital Adequacy under BASEL I & II since March 2007.
- Commencing a process to procure a Risk Management and ALCO System and a Credit Scoring and Evaluation System to facilitate compatibility with BASEL II requirements at the Bank.
- Participation of Bank Representatives in Central Bank of Sri Lanka Steering Committee relating to implementation of BASEL II in Sri Lanka.

The Management of People's Bank is confident that the measures initiated on an on-going basis will facilitate the Bank's full compliance with all Regulatory Requirements relating in particular to all 'new aspects' underlying the BASEL II Capital Adequacy computation framework and related risk management implications.