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MARKET RISK MANAGEMENT POLICY & PROCEDURES

Policy Owner : Chief Risk Officer
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1 Overview

Market risk refers to the risk of losses a company faces in its on-balance sheet and off-balance sheet positions resulting from movements in market prices, particularly changes in interest rates, foreign exchange rates, credit spreads, and commodity and equity prices. Financial institutions should establish market risk management practices depending on the nature, complexity, and diversity of their market activities. Lanka Credit and Finance PLC (LCBF) should also have robust governance arrangements, including a clear organizational structure with well-defined, transparent, and consistent lines of responsibility and effective processes to identify, measure, manage, monitor, and report the risks to which it might be exposed.

2 Risk Management Structure

The organization of the market risk management varies depending on the nature, size, and scope of business activities of the company. The structure should be aligned with the risk profile of the institution and the overall risk strategy set by the board, defining clear lines of authority and should be approved by the institution's board of directors. Individuals responsible for market risk management must be aware of their responsibilities and capable of performing their roles in overseeing and managing market risk. Depending on the size, complexity, and diversity of their activities, financial institutions should select various methods and methodologies, ranging from simple gap analysis to computerized modeling techniques.

LCBF Market Risk Management Structure is mainly complied by Treasury and Finance department through ALCO, BIRMC and Board of Directors.

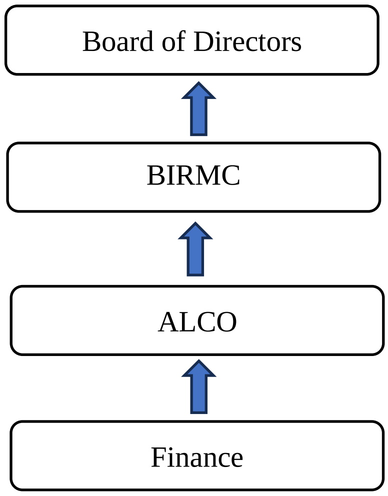

Figure 1- Market Risk Management Structure

3 Market Risk Management Strategy

LCBF should develop a sound and well-informed strategy to manage market risk based on its risk profile and the level of market risk. This strategy should be approved by the Board and clearly communicated throughout the organization. The following factors should be taken into account when setting its market risk strategy:

- Economic and market liquidity conditions and their impact on market risk.
- The company's knowledge required to take positions in specific markets and the ability to identify, measure, evaluate, monitor, report, and mitigate market risk in a timely manner in such markets.
- The company's portfolio mix and how it would be affected if more market risk was assumed.

4 Definition of Market Risk

Market risk refers to the potential for the company to experience losses due to factors that affect the overall performance of financial markets. These risks are inherent to investing and are largely unpredictable, stemming from changes in economic conditions, political events, and market sentiment. It is the risk that the company can only meet its cash and collateral obligations by suffering losses and uncertainty in the future value of a portfolio, either an investment portfolio or a trading portfolio, due to changes in market risk factors such as equity prices, market interest rates, foreign currency, commodity prices (e.g., gold), and country situations.

5 Key Market Risk Categories

5.1 Foreign Exchange Risk (FX Risk)

Foreign exchange risk arises from the possible adverse volatility of foreign exchange rates. The company currently offers the service of exchanging a few currencies only. The statutes require that LCBF shall, to the extent practicable, protect itself against the risk of exchange rate losses.

The potential loss to LCBF owing to the sharp shifts in the local currency (LKR) movement. The Company is exposed to two types of risks caused by currency volatility.

- **Transaction risk** arises whenever the Company has contractual cash flows (receivables and payables) whose values are subject to unanticipated changes in exchange rates due to contact being denominated in a foreign currency. This type of exposure is short-term to medium-term in nature.
- **Translation risk** arises from the effect of currency fluctuations on the Company's

consolidated financial statements, particularly when it has foreign subsidiaries. This type of exposure is medium-term to long-term.

5.1.1 How does the risk translate to the business:

Unexpected currency volatility affects the following aspects of the business:

- Foreign currency received and paid for money exchanging
- Indirect impact on the local gold prices
- Foreign currency denominated loans

5.1.2 Monitoring and Governance

- The ALCO monitors forex loss/gain position of Foreign Currency Operations regularly.
- The changes to the total investment limit of the Foreign Currency Operations need to be approved at both the ALCO and Board levels.

5.2 Equity Price Risk

Equity risk is the risk to earnings or capital that results from adverse changes in the value of equity-related portfolios of the company. The company does not deal in derivatives and has a very small appetite for trading book exposures. The fixed income investments are mostly for liquidity purposes and are generally restricted to government securities. Equity investments are made in quality stocks listed on the Colombo Stock Exchange (CSE). The company shall invest only in low-risk instruments while maintaining the highest possible return.

5.3 Interest Rate Risk (IRR)

Interest rate risk is the risk to which the company is exposed due to uncertain and adverse movements in future interest rates. This risk arises from the differences in the re-pricing of rate-sensitive assets (RSA) and rate-sensitive liabilities (RSL), which will have an impact on future income and expenses produced by relevant gap positions and an impact on the company's net interest income (NII) compared to the level of NII expected from current interest rate levels. Gap analysis on RSA and RSL is prepared and presented to ALCO monthly to decide on suitable strategies based on future interest rate forecasts.

The potential loss LCBF would have to bear owing to unexpected movements in interest rates. The Company's exposure to interest rate risk is primarily associated with factors such as;

- Re-pricing risk arising from a fixed rate borrowing portfolio where re-pricing frequency is different to that of the lending portfolio.
- Yield curve risk arising from unanticipated shifts of the market yield curve.

5.3.1 How does the risk translate to the business:

Interest rate volatility has a direct impact on LCBF's Net Interest Income (NII) and ultimately Net Interest Margins (NIMs). The fluctuations in market interest rates will result in either weakening or strengthening of NIMs depending on the rate structure (fixed/ variable) of rate sensitive assets and rate sensitive liabilities.

5.3.2 Key Risk Indicators:

- Rate structure of interest bearing borrowings
- Stress tests on NII

5.3.3 Interest Rate Risk Management Approach

LCBF's approach to Interest Rate Risk Management seeks to improve the alignment between interest rate sensitive assets and liabilities and in doing so ensure that the margin spreads are not unduly affected by adverse movements in interest rates. As part of its overall approach, LCBF also seeks to;

- Promote lending products with shorter re-pricing cycle to reduce interest rate sensitive gaps
- Explore hedging options such as interest swaps.
- Negotiate interest rate caps on new borrowings

5.3.4 Monitoring and Governance

- LCBF's ALCO provides oversight for the management of Interest Rate Risk. The ALCO closely monitors the interest rate movements and issues directions to lending and borrowing units on interest rate strategies.
- The Risk Management Department conducts regular stress testing to assess interest rate sensitivity on LCBF's asset and liability portfolios and gauge the likely financial impact under adverse scenarios.

5.3.5 Actions Taken by the Company to Manage the Interest Rate Risk

- Strategic repricing of assets to reflect the current market interest rates environment.
- Reduce the rate sensitivity of the funding base by shedding high cost deposits and increasing the share of savings deposits which by nature are less rate sensitive.

5.4 Commodity Price Risk

The potential loss to LCBF owing to the volatility in world gold prices.

5.4.1 How does the risk translate to the business:

Movements in world gold prices have a direct bearing on the prospects of the LCBF's Gold Loans business. Frequent fluctuations in gold prices will be reflected in earnings volatility in the Gold Loan operation.

5.4.2 Key Risk Indicators:

- Gold Market Price Vs. Maximum Advances Value
- Loan-to-value (LTV) ratio of new Gold Loans disbursements

5.4.3 Commodity Risk Management Approach

Commodity risk arising from movements in the world gold prices remained largely hedged owing to the fact that Gold Loans are a secured lending product. However, given that world gold prices are fluid and subject to frequent change, LCBF's Gold Loan offering is designed as a short term lending proposition (typically 1 or 3 months), which provides the flexibility to make necessary adjustments in line with world/local market prices. Moreover strict control is exercised to ensure the board approved safety margin limit is adhered to at all times.

5.4.4 Monitoring and Governance

The Risk Management Department uses the Value-at-Risk (VaR) method to compute (on a monthly basis) the potential losses the Company may have to incur in the event of a shift in world gold prices. The VaR calculation is based on the Exponential Weighted Moving Average (EWMA) where a greater weightage is assigned to recent price changes while a progressively lower weightage is allocated to price movements over the preceding 12 month period.

6 Key Responsibilities

The Board of Directors annually reviews and approves maximum limits for exposure to market risks. The Board receives reports on the company's market risk positions at its regular meetings. The Asset Liability and Risk (ALR) Committee oversees the activities that give rise to market risk exposure and establishes operating guidelines, including various levels of operational limits within the maximum limits set by the Board of Directors. The day-to-day management of market risks is conducted by the Finance Department. The Risk Management Department provides independent oversight of all significant market risks, supporting the ALR and Finance Departments with risk measurement, analysis, daily monitoring, and reporting.

7 Market Risk Management

ALM and market risks are managed by ALCO, mainly through the Treasury and Finance departments (1st line of defense) and monitored by the Treasury Middle Office (2nd line of defense). The role of the 2nd line functions (i.e., the Market Risk Unit/Risk Management Department) with regard to these risks is to review and propose (before final Board approval) all methodologies, assumptions, and policies concerning ALM and market risks. Furthermore, it shall independently monitor, report, and review exposures, including the generation of market risk reports.

8 Capital Charge for Market Risk

The company has adopted Basel II accords and allocates capital charges for market risk as per the standardized approach. The Finance Department quarterly prepares and compiles the capital adequacy report to EIRMC & BIRMC to monitor and review market risk.

9 Risk Specific Assessment and Measurement Guidelines

9.1 Market Risk (applicable to TB & FX positions)

The preferred measurement approach for market risk is Value at Risk (VaR). VaR is defined as the highest loss estimate the company may experience on a specific position or portfolio over a certain period and within a specified confidence level. All recognized VaR methodologies can be deployed by the company, but as a minimum, two methodologies shall be applied simultaneously:

- Historical VaR simulation, estimating the largest portfolio impact based on past volatility of underlying risk factors.
- Parametric VaR, estimating specific variances and covariances for all underlying risk factors, assuming a normal distribution to arrive at the VaR estimate.

9.2 Interest Rate Risk in Banking Book (IRRBB) – Advanced Book

Two perspectives are used by the company when measuring IRRBB:

- **Earnings Perspective**: The focus is on the impact of changes in interest rates on accrued or reported earnings, particularly net interest income (the difference between total interest income and total interest expense).
- **Economic Value Perspective**: The sensitivity of the company's economic value of equity (EVE) to fluctuations in interest rates is considered, reflecting the present value of expected net cash flows discounted at market rates.

10 Key Abbreviations

- **BOD** – Board of Directors
- **BIRMC** – Board Integrated Risk Management Committee
- **CEO** – Chief Executive Officer
- **CRO** – Chief Risk Officer
- **IRMC** – Integrated Risk Management Committee
- **EIRMC** – Executive Integrated Risk Management Committee
- **ALCO** – Asset and Liability Management Committee

- **TMO** – Treasury Middle Office
- **NII** – Net Interest Income
- **NIM** – Net Interest Margin
- **VaR** – Value at Risk
- **IRRBB** – Interest Rate Risk in Banking Book
- **ALM** – Asset and Liability Management
- **RSA** – Rate Sensitive Assets
- **RSL** – Rate Sensitive Liabilities

This policy outlines the structure and approach to managing market risk at LCB Finance PLC, ensuring that risks are identified, measured, managed, and reported effectively to protect the company's financial health and regulatory com

RECOMMENDATION

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Chief Risk Officer CEO/Chief Executive Officer