National Bank of Malawi

# BASEL II PILLAR III (MARKET DISCLOSURE) REPORT

June 2018

## TABLE OF CONTENTS

# 1. OVERVIEW

## 1.1. Report Scope

This report is in compliance with Pillar III Disclosures under Basel II which complements the minimum capital requirements and the supervisory review process. It discloses the scope of application of Basel II, capital, particular risk exposures and risk assessment processes, and hence the capital adequacy of National Bank of Malawi. Disclosures consist of both quantitative and qualitative information and are provided at the consolidated level.

National Bank of Malawi plc hereby presents this report Market Disclosure report at 30th June 2018 in line with Guidelines on Market Disclosures under Basel II Pillar III issued by the Reserve Bank of Malawi.

## 1.2. Risk Governance

In line with the corporate governance structure adopted by National Bank of Malawi plc, the Board has the ultimate responsibility of ensuring that risks are adequately identified, measured, monitored and managed.

The Board is committed to good corporate governance which it achieves by following principles of openness, integrity and accountability. The Board monitors compliance with policies and achievement of objectives by holding management accountable for its activities through quarterly Board meetings at which performance is reported.

## 1.3. Risk Management Oversight

The Bank's approach to risk management is based on a well-established governance process and relies both on individual responsibility and collective oversight, supported by comprehensive reporting. This approach balances stringent corporate oversight with independent risk management structures within the business units. Below is the governance structure of the bank;

The Board has overall responsibility for the establishment and oversight of the Bank's risk management framework. The Board develops the risk appetite and risk tolerance limits appropriate to the Bank's strategy and requires that management maintains an appropriate system of internal controls to ensure that these risks are managed within the agreed parameters. The Board delegates risk related responsibilities to five Board subcommittees namely; the Risk Committee, the Credit Committee, the Audit Committee, the Appointments, Remuneration and Governance Committee, and the Related Parties Committee. The Board Committees comprise of a non-executive membership only and they report regularly to the Board on their activities.

The mandate of the Board subcommittees is as follows:

i. **The Board Risk Committee** has responsibility for the risk management in the Bank as delegated by the Board. Its main responsibility is to have the overall oversight in the credit, market, liquidity and operational risks management as well as any other risks that the Bank may be exposed to in its course of business. It is also responsible for reviewing management performance in implementing the Bank's strategic plan and ensures that the Bank's activities are consistent with the policies agreed by the Bank's Board and Directives of the RBM and other regulatory requirements.

ii. **The Board Audit Committee** is responsible for conducting an independent check to ensure compliance with the Bank's risk management policies, procedures and controls, and for reviewing the adequacy of the risk management framework in relation to the risks faced by the Bank.

iii. **The Board Credit Committee** is responsible for oversight of the Bank's overall credit risk management issues. The committee is responsible for reviewing and approving the Bank's credit policies including provisioning, large loan exposures, counter-party lending and dealing lines.

iv. **The Appointments, Remuneration and Governance Committee** is responsible for nominations and vetting of director appointments, good governance practices, ensuring that the Bank has a robust succession plan, that the Bank's human resources are best utilized, and that members of staff are remunerated commensurately with their responsibilities and effectiveness.

v. **The Related Party Committee** is responsible for overseeing the implementation of the transactions with related parties by all entities falling under the control of the Bank's Board.

At a management level, the Bank has the Enterprise Risk Committee (ERCO) which provides a holistic oversight of the risks affecting the Bank and the control measures that should be put in place to mitigate the risks and thereby reduce the potential losses. Capital Management report is discussed at both ERCO and Asset and Liability Committee (ALCO). Other management committee include Credit Management Committee and IT Policy Committee which are all responsible for developing and monitoring the Bank's risk management policies in their specified areas.

## 2. BACKGROUND

### 2.1. Shareholding structure

The authorized share capital of the Bank is K500m divided into 500,000,000 Ordinary Shares of K1 each. The issued capital is K467m divided into 466,931,738 fully paid Ordinary Shares of K1 each.

The shareholding structure as at 30 June, 2018 was as follows:

| | 2018 |
|---|---|
| **Press Corporation Limited** | 51.5% |
| **Old Mutual Group** | 24.9% |
| **Members of the public** | 23.2% |
| **Employees (ESOS)** | 0.4% |
| **Total** | 100% |

## 2.2. Subsidiaries, associates and Service Centres

National Bank of Malawi Group provides retail, corporate and investment banking as well as stock broking, insurance and pension administration services in Malawi. It has a network of 31 Service Centres in Malawi.

The subsidiaries and associate companies of the Group are shown below:

| Subsidiaries | Percentage of control | Nature of operations |
|---|---|---|
| **NBM Capital Markets Limited** | 100% | Investments and fund management |
| **NBM Securities Limited** | 100% | Dormant |
| **NBM Nominees Limited** | 100% | Holding of investments as nominee |
| **Stockbrokers Malawi Limited** | 75% | Registered stockbroker |
| **NBM Bureau de Change Limited** | 100% | Dormant |
| **NBM Pension Administration Limited** | 100% | Pension administration |
| **Indebank Limited** | 100% | Commercial banking(up to 30 April 2016) |

## 2.3. Performance and Financial Position

The Bank registered a 10% decrease in the Group after tax profit to K8.5b (2017: K9.5b) but registered growths of 17% and 19% in the loan book and customer deposits respectively, contributing to overall growth in the Statement of Financial Position of 19% to K409b (2017: K343b). The results were impacted by reduction in growth of other banking products due to the subdued business environment.

Total capital increased by 5.56% from K65.98bn to K69.65bn as at 30th June 2018. This increase in capital was attributed to a 17.31% increase in revaluation reserves from K15.48 billion to K18.16 billion and a 13.56% increase in retained earnings from K44.39 billion to K50.41 billion.

Total Risk Weighted assets increased by 35.73% from K245.43bn to K333.11bn. This change was attributed to an increase in credit risk component.

The Tier I ratio decreased from 16.78% to 13.92% as at 30th June 2018. The Tier II ratio decreased from 21.93% to 18.33%. The decrease arose from proper alignment of the computation of the Operational Risk Capital charge in line with Reserve Bank of Malawi Operational Risk Guidelines in terms of the computation of Gross Income. Both capital ratios were within regulatory limits and Bank's risk appetite limits.

# 3. CAPITAL MANAGEMENT

The Bank's capital management strategy is designed to ensure that regulatory capital requirements are met at all times, and that the Bank and its principal subsidiaries are capitalised in line with the group's risk appetite and target ratios, both of which are approved by the board.

## 3.1. Approach to Capital Management

The Bank deploys a capital management strategy aimed at ensuring capital adequacy by considering the resources necessary to cover unexpected losses arising from discretionary risks, being those which it chooses to accept (such as credit risk and market risk), and from non-discretionary and inherent risks, being those which arise by virtue of its operations (such as operational risk and business risk). The Bank's capital management and allocation policy is underpinned in the Capital Management Policy. The Board and Senior Management examine the risk profile of the Bank from both regulatory and economic capital viewpoints to ensure that the Bank's level of capital achieves the following:

i. Remain sufficient to support its risk profile and outstanding commitments;
ii. Is adequate to implement its growth plans embedded in the Strategic plan
iii. Exceeds the formal minimum regulatory capital required
iv. Is capable of withstanding severe economic shocks; and
v. Remains consistent with the group's strategic and operational goals, and shareholder expectations.

## 3.2. Regulatory capital

The main regulatory requirements to be complied with are those specified in the Financial Services Act 26 of 2010, The Reserve Bank of Malawi Directive on Capital Adequacy and related regulations, which are aligned with Basel II.

Regulatory capital adequacy is measured through the following two risk-based ratios:

- **Tier 1 (core capital) ratio:** the sum of share capital, paid-up, share premium, retained profits (prior years), 60% of after tax profit (current year-to-date) and in case of a loss, 100% and Other eligible core capital (Tier 1) capital elements as prescribed by the Registrar, less: investment in unconsolidated financial institutions.

- **Tier II (supplementary capital) ratio:** the sum of revaluation reserves, subordinated debt; and the general provisions, which have received prior approval of the Registrar.

The table below shows the capital position of the Bank as at 30th June 2018 compared to a similar period last year.

| **Capital adequacy** | **Jun-18** | **Jun-17** |
|---|---:|---:|
| Core Capital | 46,366,876 | 41,033,103 |
| Total Capital | 61,049,481 | 53,829,938 |
| Credit Risk Weighted Assets | 229,109,533 | 203,590,436 |
| Operational Risk Weighted Assets | 95,463,263 | 37,906,619 |
| Market Risk Weighted Assets | 8,540,359 | 3,919,375 |
| Total Risk Weighted Assets | 333,113,155 | 245,416,430 |
| Risk Based capital ratio I (Basel II approach) | 13.92% | 16.72% |
| Risk Based capital ratio II (Basel II approach) | 18.33% | 21.93% |

Total Risk Weighted assets increased by 35.73% from K245.42bn to K333.11bn. This change was largely attributed to an increase in the operational risk and market risk components.

## 4. RISK APPETITE

Risk appetite is the amount and type of risk that the Bank is able and willing to accept in pursuit of its business objectives. It reflects the tolerance and willingness to accept risk. The Bank's risk appetite includes qualitative statements as well as quantitative measures expressed relative to earnings, capital, risk measures, liquidity and other relevant measures. Qualitatively, the Bank expresses risk appetite in terms of policies, processes, procedures, statements and controls meant to limit risks that may or may not be quantified.

Risk appetite across all risk types for the Bank is determined by the risk appetite statement and is apportioned to the various business units. Each business unit sub allocates its apportionment to various risk types in accordance with its business strategy. In developing the Risk Appetite Statement, the Bank's strategy and the desired balance between risk and return is taken into consideration.

The overall responsibility for the establishment and oversight of the Bank's risk appetite rests with the Board. Senior Management maintains an appropriate system of internal controls to ensure that these risks are managed within the agreed parameters. The Board Risk Committee reviews the group's risk profile in relation to the approved risk appetite on a quarterly basis

During the review period, the Bank was generally within the approved risk appetite limits. However the Bank failed to achieve the approved growth targets in a number of portfolio sectors due to increased demand in the agriculture, electricity, wholesale and retail and personal sectors. Further, the Non-Performing Loan ratio was at 7.52% which was outside the risk appetite range of 3-5%.

## 5. STRESS TESTING

The Bank has a comprehensive Stress and Scenario Testing Framework which is used to assess the Bank's vulnerability to shocks of the different financial parameters. The aim of the stress test is to prepare the Bank for the worst case scenario in the financial system as it provides the Bank with a forward-looking assessment of risks and facilitates development of mitigation or contingency plans.

The Bank conducts stress tests on a quarterly basis and the results of the stress tests are submitted to the ALCO, ERCO and BRC to ensure that appropriate strategies are formulated to address the needs revealed by the stress testing.

The stress testing results for the combination of macro-economic shocks show a decline in the Tier I ratio from 13.92% to 7.91% in the mild scenario and 3.49% in the extreme scenario. The default of the top five borrowers reduced the Tier 1 ratio to 12.25%, 10.71%, 9.65%, 8.66% and 7.74% respectively.

The liquidity shock test revealed that the Bank would remain liquid for 2 days which is less than 5 days recommended by the Reserve Bank of Malawi.

In order to mitigate the impact of capital risk the adoption of Advanced Measurement approach will be key as the Standardized measures for measuring the Risk Weighted Assets are punitive given the rudimentary approach to the calculation. On liquidity the Bank continues to mobilize cheap deposits so as to improve the liquidity base and the number of days in which the Bank would be liquid in the event of a run on deposits.

## 6. CREDIT RISK

Credit Risk means the likelihood that a debtor or financial instrument issuer is unwilling or unable to pay interest and/or repay the principal according to the terms specified in a credit agreement resulting in economic loss to the Bank. The risk arises from direct lending, trade finance and leasing business, but also from off-balance sheet activities such as guarantees, letters of credits and from holding of debt securities.

### 6.1. Approach to Managing Credit Risk

The group's credit risk arises mainly from wholesale and retail loans and advances. The Board of Directors has the responsibility for approving and periodically reviewing the credit risk strategy and significant credit risk policies or departures there from of the Bank as well as sanctioning facilities beyond Management's delegated limits. The Board of Directors delegates this responsibility to its Board Credit Committee.

Additionally, there is a Management Credit Committee which is comprised of some members of senior management. The Management Credit Committee has the responsibility of implementing the credit risk strategy approved by the Board and for formulating and developing policies and procedures for identifying, measuring, monitoring and controlling credit risk in existing as well as new products, activities and procedures in order to ascertain quality of the Bank's credit portfolio.

The Committee oversees development, maintenance and review of the Group's risk grades in order to categorize exposures according to the degree of risk of potential financial loss and focus management on the attendant risk. The risk grading system helps in determining where impairment provisions may be required against specific credit exposures. The current risk grading framework consists of ten grades reflecting varying degrees of risk of default and the availability of collateral or other credit risk mitigation. Risk grades are subject to regular reviews.

The committee reviews credit concentrations vis-à-vis the Bank's capital in the form of single borrowers or counter parties, group of connected counter parties, sectors and products to ensure aggregate credit commitments to arrest widespread losses that can arise out of close linkages and correlated factors.

A separate Credit Management Division reporting to the Chief Executive and the Board Credit Committee is responsible for oversight of the Group's overall credit risk management issues.

Each Business Unit (BU) is required to implement the Bank's credit policies and procedures, within delegated credit approval authorities. Each business unit has a Head or Manager who is accountable for all credit related matters and reports as appropriate to Credit Management Division or the Credit Committee through Credit Management Division. Regular audits of business units and Credit processes are undertaken by the Internal Audit Division.

## 6.2. Credit Risk Measurement

The Bank measures the credit risk capital requirements by applying appropriate risk weights to both on-balance sheet and off-balance sheet exposures in line with Basel II and the Guidelines on Standardized Approach to Credit Risk issued by the Reserve Bank of Malawi (RBM). The capital adequacy and return on capital levels for the individual risk categories of the Bank's portfolio are regularly monitored against the overall risk-bearing capacity of the Bank, in order to ensure that the Bank is, at all times, maintaining adequate capital to provide for its growth and to support a reasonable measure of unexpected losses.

The Bank follows IFRS 9 "expected loss model" for all financial instruments that are subject to impairment accounting. It recognises a loss allowance for expected credit losses on a financial asset measured at amortised cost or at fair value through other comprehensive income, a lease receivable, a contract asset or a loan commitment and a financial guarantee contract to which the impairment requirements of the Standard apply. Expected credit losses shall be an estimate of losses that the Bank expect to result from a credit event, such as a payment default. For risk management reporting purposes, the Bank considers and consolidates all elements of credit risk exposure (such as individual obligor default risk, country and sector risk). In adopting IFRS 9 the Bank has re-aligned all definitions of default and cure given by IFRS 9 to those of Basel II.

### Expected Credit Loss Model and Provisioning Categories

The adoption of IFRS 9 has necessitated implementation of its classification standards which maps the credit book into three stages to reflect the general pattern of the deterioration of a financial instrument that ultimately defaults as follows:

**i. Stage 1**

12-month expected credit losses shall be recognised in profit or loss and a loss allowance shall be established as soon as a financial instrument has been originated or purchased. For financial instruments that have not deteriorated significantly in credit quality since initial recognition or that have low credit risk at the reporting date, the loss allowance for 12month expected credit losses is maintained but updated for changes in amount. For financial assets, interest revenue is calculated on the gross carrying amount of the asset (i.e. without reduction for expected credit losses);

**ii. Stage 2**

If the credit risk increases significantly and the resulting credit quality is not considered to be low credit risk, full lifetime expected losses are recognised. Lifetime expected credit losses are only recognised if the credit risk increases significantly from when the entity originates or purchases the financial instruments but that do not have objective evidence of a credit loss event. Expected credit losses may be individually and/or collectively assessed. For a financial asset, interest revenue is still calculated on the gross carrying amount of the asset (same as for Stage 1).

**iii. Stage 3**

If the credit risk of a financial asset increases to the point that it is considered credit impaired (that have objective evidence of impairment at the reporting date), lifetime expected credit losses continue to be recognised. For financial assets in this stage, lifetime expected credit losses will generally be individually assessed. However, interest revenue shall be calculated on the amortized cost net carrying amount (i.e. reduced for expected credit losses).

The Bank's Credit Division in collaboration with the Business Units regularly analyses default trends. These enable identification of the underlying root causes and subsequently channels recommendations to Senior Management allowing the fine-tuning of the appropriate credit scoring parameters. Similarly, risk grades of major corporate customers are used to set tolerance limits to enhance the management of excesses.

## 6.3. Credit Risk Mitigation

As a fundamental credit principle, the Group generally does not grant credit facilities solely on the basis of the collateral provided. All credit facilities are granted based on the credit standing, source of repayment and debt servicing ability of the borrower. Collateral is taken whenever possible to mitigate the credit risk assumed. The value of the collateral is monitored periodically, with the frequency of valuation depending on the type, liquidity and volatility of the collateral value. On the whole, the main credit risk mitigation techniques applied by the Bank include security/collateral, netting and guarantees, all of which contribute to a reduction in the Bank's credit risk exposures.

## 6.4. Credit Risk Exposures

Overall credit risk was rated moderate.

| Indicators | Jun-18 | Jun-17 |
|---|---|---|
| | K'm | K'm |
| **Net Loans and Advances** | 156,533 | 139,006 |
| **Non-Performing loans** | 12,614 | 8,090 |
| **Specific Provisions** | 0 | 3,164 |
| **IFRS9 Provision** | 8,984 | 0 |
| **Non-Performing loans to total loans and advances** | 7.52% | 5.82% |

Total loans and advances increased by 12.60% from K139.01bn to K156.53bn as at 30th June 2018. This increase was attributed to an increase in loans mainly in the Construction sector which increased by 33.64% from K1.07bn to K2.50m.

Total non-performing loans increased by 55.87% from K8.09bn to K12.61bn which increased the ratio of NPLs therefore increased from 5.82% to 7.52%. This was outside the Bank's risk appetite of 3%-5%. The increased NPLs is attributed to subdued economic activity due to low productivity levels which is resulting from power supply challenges and reduced demand for goods and services. These resulted in reduced demand for some banking products and increased the level of NPLS. The Bank is implementing strategies to minimize the NPL ratio to be within 5% as stated in the risk appetite.

## 7. LIQUIDITY RISK

The Bank defines Liquidity Risk as the potential for loss to the Bank arising from either its inability to meet obligations as they fall due or to fund increases in assets without incurring unacceptable cost or losses (funding or market liquidity risk).

### 7.1. Approach to Managing Liquidity Risk

The Group's approach to managing liquidity is to ensure that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Group's reputation. The Group has a Liquidity and Funds Management Policy that provides guidance in the management of liquidity.

The daily management of liquidity is entrusted to the Treasury and Investment Banking Division (TIBD) at Head Office. The TIBD receives information from other business units regarding the liquidity profile of their financial assets and liabilities and details of other projected cash flows arising from projected future business. The TIBD then maintains a portfolio of short-term liquid assets, largely made up of short-term liquid investment securities, loans and advances to banks and other inter-bank facilities, to ensure that sufficient liquidity is maintained within the Group as a whole. The liquidity requirements of business units are funded through deposits from customers. Any short-term fluctuations are funded through treasury activities such as inter-bank facilities, repurchase agreements and others.

The TIBD monitors compliance of all operating units of the Group with local regulatory limits on a daily basis.

The daily liquidity position is monitored and regular liquidity stress testing is conducted under a variety of scenarios covering both normal and more severe market conditions. All liquidity policies and procedures are subject to review and approval by ALCO. Daily reports cover the liquidity position of both the Group and operating units. A summary report, including any exceptions and remedial action taken, is submitted regularly to ALCO.

### 7.2. Regulatory Liquidity Limits

The Bank experienced a steady increase in liquidity ratios during the first half of 2018. Liquidity ratio I increased from 57.64% in Jun 2017 to 61.99% in Jun 2018. Liquidity ratio II increased from 57.72% to 61.90%.

The Table below shows that the Liquidity ratios were within regulatory limit and risk appetite.

| | Jun-18 | Jun-17 |
|---|---|---|
| **Liquidity Ratio I** | 61.99% | 57.64% |
| **RBM Limit** | 25.00% | 30.00% |
| **NBM Limit** | 45.00% | 40.00% |
| **Liquidity Ratio II** | 61.90% | 57.72% |
| **RBM Limit** | 25.00% | 20.00% |
| **NBM Limit** | 35.00% | 30.00% |

### 7.3. Deposit Concentration

Total deposits increased by 15.10% from K227.72bn in June 2017 to K262.11bn in June 2018. The increase in total deposits was mainly attributed to an increase in time deposits by 39.63% from K16.16bn to K22.57bn and demand deposits by 28.66% from K86.29bn to K111.02bn. The ratio of top 10 depositors to total deposits decreased from 16.23% to 14.59%. The ratio was within the 25% threshold limit.

## 8. MARKET RISK

The Bank defines Market Risk as Market risk is the risk of a change in the market value, actual earnings, or future cash flows of a portfolio of financial instruments, including commodities, caused by adverse movements in market variables such as equity, bond and commodity prices, currency exchange and interest rates and implied volatilities in all of these variables.

### 8.1. Approach to Managing Market Risk

The Group separates its exposure to market risk between trading and non-trading portfolios. Basel II's market risk standardized approach has pre-specified and standardized methods for all the four types of risks covered: Interest rate risk, equity risk, exchange rate risk and commodity risk. The Group's trading portfolios mainly are held by the Treasury and Investment Banking Division, and include positions arising from market making and proprietary position taking, together with financial assets and liabilities that are managed on a fair value basis.

Overall authority for market risk is vested in ALCO. TIBD is responsible for the development of detailed risk management policies (subject to review and approval by ALCO) and for the day-to day review of their implementation. The total capital set aside for market risk under the Standardized Approach was as follows;

| Capital Charge | Jun 2018 (K'm) | Jun 2017 (K'm) |
|---|---|---|
| **Interest Rate Risk** | - | - |
| **Foreign Exchange Risk** | 4 | 13 |
| **Equity Risk** | 8,536 | 3,906 |
| **Total** | **8,540** | **3,919** |

The Bank has a comprehensive framework of limits that is used to control market risk exposures for different levels of reporting. The limits are reviewed at least annually or more frequently and adjusted when conditions of risk tolerances change. A summary of all breaches is reported to ALCO, ERCO and BRC.

## 9. OPERATIONAL RISK

Operational risk is the risk of direct or indirect loss arising from a wide variety of causes associated with the Group's processes, personnel, technology and infrastructure, and from external factors other than credit, market and liquidity risks such as those arising from legal and regulatory requirements and generally accepted standards of corporate behaviour. Operational risks arise from all of the Group's operations and are faced by all business entities.

The Group has an Operational Risk Management Framework that guides the management of operational risk.

### 9.1. Approach to Managing Operational Risk

The Group's objectives is to manage operational risk so as to balance the avoidance of financial losses and damage to the Group's reputation with overall cost effectiveness and avoid control procedures that restrict initiative and creativity.

The Bank measures operational risk using the Basic Indicator Approach. In using this approach the Bank determines the gross income for 3 years and then multiplies it by a capital charge factor of 15% to determine the total operational risk capital charge.

The total capital set aside for operational risk under the Basic Indicator Approach was as follows;

| Capital Charge | June 2018 (K'm) | June 2017 (K'm) |
|---|---|---|
| **Operational Risk** | 95.463 | 37,906 |

## 10. CONCLUSION

This report has comprehensively presented the level of risks in the Bank and also how they are being closely monitored and mitigated. Supported by the sustained growth in retained earnings, exposures across risk types are generally assigned comfortable capital levels. Looking ahead, some fundamental changes that could potentially occur on the regulatory front over the course of the next few years would heighten prudential standards for capital requirements, leverage, liquidity and contingent capital applicable for the banking industry as a whole. Besides, the ramifications of the weakened economic and financial environments both domestically and internationally would invariably impact the market potential of banks over the foreseeable future.