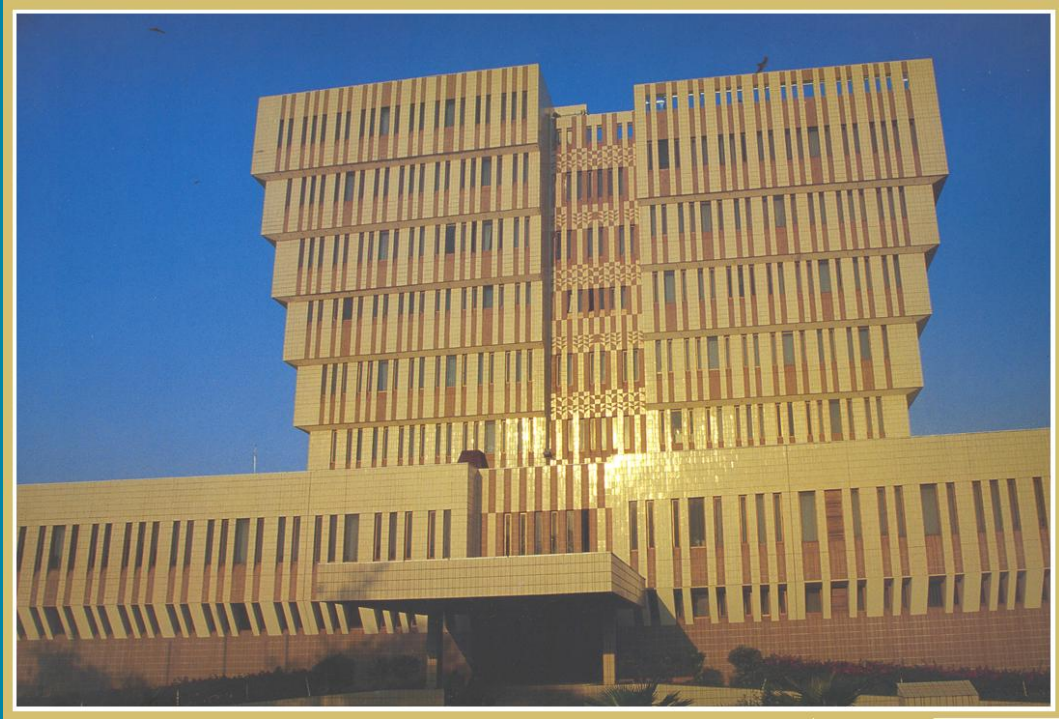




RESERVE BANK OF MALAWI



RISK MANAGEMENT SURVEY RESULTS

SEPTEMBER 2007

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Foreword

In early 2007 the Reserve Bank of Malawi (RBM) approved a policy to move towards risk-based approach to supervision of banks and other financial institutions in the country. This has been necessitated by the need to obtain a very good understanding of how financial institutions are managing their dynamic risk profiles in view of the major changes in the financial landscape brought about by globalization, technological advances and product innovation. Moreover, developments in Malawi such as financial liberalization and the entry into the financial market of new players including international banks changed the financial sector environment in the country and with it the risk profiles of all players. To manage risks emanating from these changes and developments, there is an urgent need for financial institutions to cultivate a risk management culture in their approach to doing business and for the RBM to support such initiative.

This proactive role of the RBM is very much in line with international best practice embodied in the Basel Committee's Core Principles for Effective Banking Supervision (especially Principles 7, 9 -16), as revised in 2006. These Core Principles require that the supervisory authority should satisfy itself that banks have in place a comprehensive risk management process to identify, measure, monitor and control risks (country & transfer risk, market risk, liquidity risk, operational risk and interest rate risk) and, where appropriate, to hold capital against these risks.

The establishment of comprehensive risk management systems is also a pre-requisite for the capital adequacy assessment process enshrined in the New Capital Framework, more popularly known as Basel II. Implementation of Basel II in future will necessitate putting in place robust risk management systems in financial institutions as early as possible.

In order to determine the risk management practices of financial institutions in Malawi, the RBM conducted a survey in March 2007 on the structure of risk management function, the types of risks faced by these institutions, the risk management tools and

monitoring systems they use and their risk management philosophies. The survey revealed that not all institutions have a high level of awareness on the importance of employing systematic methods of identifying, measuring, monitoring and controlling/mitigating risks. In addition, few institutions have committed adequate resources to build capacity on risk management, generate effective reports, apply risk management tools, and ensure independent review of their risk management functions. Indeed, substantial efforts have to be taken to manage risks other than financial risks in the financial institutions.

The gaps identified in this survey have prompted the RBM to develop a comprehensive set of risk management guidelines that will be issued to financial institutions to provide guidance on minimum requirements for sound risk management practices on specific risks. These guidelines will form the basis for institutions to prepare risk management programmes.

The 100% response that we received from this survey is a good beginning and we look forward to working with all financial institutions to promote sound risk management practices with a view to encourage healthy competition and promote greater stability in the financial system which are preconditions to sustained economic growth in the country.

Tobias Chinkhwangwa

Executive Director, Supervision of Financial Institutions

September, 2007

Executive Summary

The survey on risk management practices in financial institutions explored the extent to which the financial sector in Malawi has adapted to the demands for new approaches to managing banking/financial business that lay emphasis on risk identification, measurement, monitoring, and control/mitigation.

The survey covered the following aspects:

1. Existence of clearly defined risk management guidelines;
2. Spectrum of risk categories covered;
3. Type of risk management structures adopted;
4. Risk management systems employed;
5. Nature of independent review of risk management activities conducted;
6. Size of budgetary allocations to the risk management function; and
7. Basel II awareness and preparedness.

All twelve institutions responded to the questionnaire. The responses highlighted a number of gaps that demonstrate the need for enhancing risk management in financial institutions. These include:

- Inadequate risk management policies and procedures, particularly foreign exchange rate and price risks; and for non-financial risks such as operational risk, reputation risk and strategic risk.
- Not all institutions have clearly defined functions and personnel dedicated for risk management.
- Some institutions have not developed their own comprehensive risk management reports and are relying on the RBM prudential returns to monitor some risks.
- Risk management tools in use are very limited.
- Not all institutions have put in place independent review of their risk management functions.

- Even though some institutions reported having set aside specific budgetary allocations to fund risk management activities, the reported percentages seem to indicate that there is no conscious efforts to quantify and monitor the costs associated with the risk management function.
- Most financial institutions are not that ready to move towards a more risk-sensitive capital adequacy framework.

To foster sound risk management systems among financial institutions in Malawi, the RBM is in the process of shifting its supervisory approach from the traditional methods to Risk Based Supervision (RBS). This new approach places strong emphasis on understanding and assessing the adequacy of each institution's risk management systems in place to identify, measure, monitor and control risk in an appropriate and timely manner. The ultimate objective is to take prompt and focused supervisory response that corresponds to an institution's risk profile and emerging risks.

Introduction

Economic reforms and financial liberalization have transformed the financial sector in Malawi. The last decade has seen foreign banks acquiring local banks as well as entry of new banks altogether. This has increased competition and risk taking among banks. As a result, new financial products are continuously being launched and new computer-based services are being introduced. Globalisation and technological innovation have also affected the risk profiles of financial institutions. In light of this, the need for sound risk management policies and procedures has become more important than ever. It is important that the supervisory process not only move in tandem with but also promote such risk management culture.

These changes and developments called for a review of the supervisory approach applied by the Reserve Bank of Malawi. In early 2007, the RBM adopted a policy to move towards risk-based approach to supervision of financial institutions. This approach focuses on evaluating risk management in financial institutions and on tailoring supervisory activities according to the risk profile of a particular financial institution. As a starting point RBM launched this survey on risk management practices of financial institutions operating in Malawi. To underline the need for all financial institutions to have effective risk management systems the RBM will issue comprehensive Risk Management Guidelines to all financial institutions and to require financial institutions to draw-up comprehensive risk management programmes for each of the major types of risk that they face.

Coverage of Questionnaire

The questionnaire sought financial institutions' self assessment on the following issues:

- Whether they have clearly defined risk management guidelines;
- Which of the generic risks are covered in the guidelines;
- Whether institutions have formal risk management structures, and if they do, whether the risk management functions are centralised or decentralised;
- Whether institutions operate risk management information systems, and what reports they generate;
- Whether they conduct independent review of their risk management activities;
- Whether they set aside specific budgets for the risk management function;
- Whether they are prepared to move towards a more risk-sensitive capital adequacy requirement.

All 12 financial institutions in Malawi responded to the questionnaire. The survey questionnaire was released in the first week of March, 2007 and institutions were asked to complete the questionnaire by 30th March, 2007. Some institutions responded long after the set deadline. Finally, the results of the survey have been tabulated and summarised to provide an overall feedback to the respondents and other stakeholders in the financial system.

Survey Results:

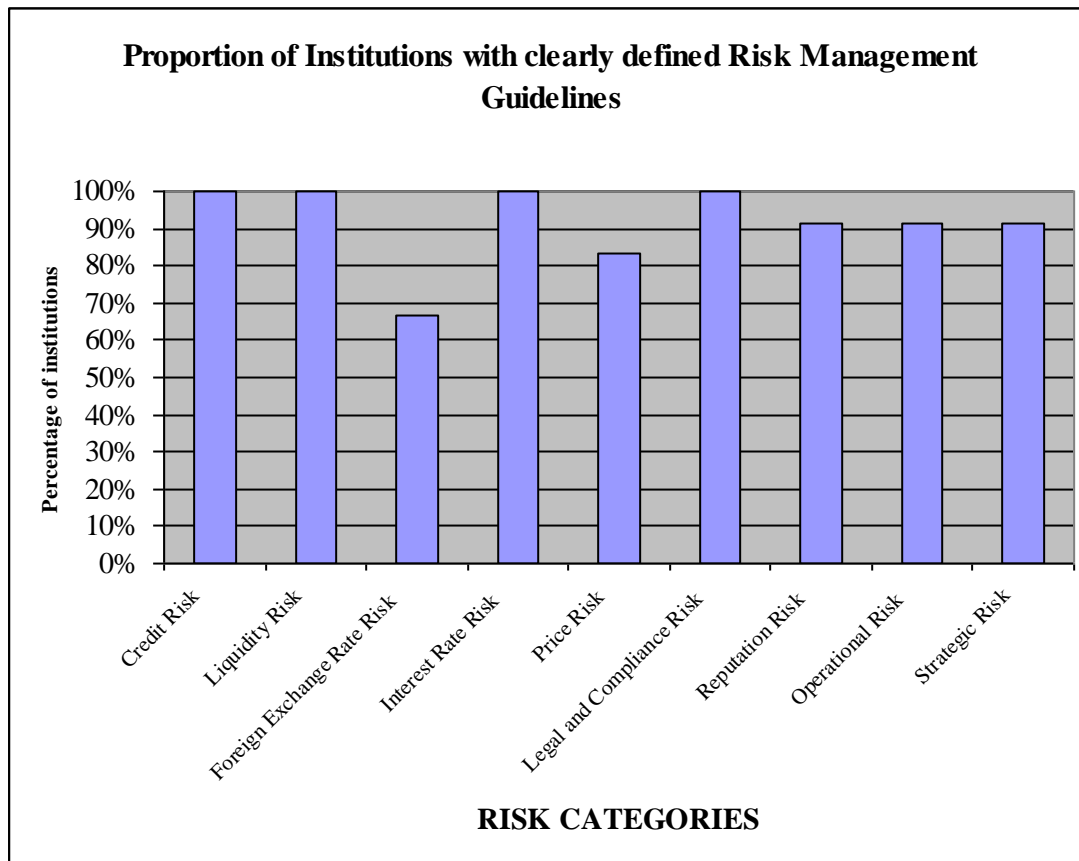
Risk Management Policies and Procedures and Risk Categories

All institutions reported having in place clearly defined risk management policies and procedures that cover credit risk, liquidity risk, interest rate risk and legal/compliance risk. A few small institutions did not cover foreign exchange risk and price risk.

It is quite noticeable, however, that not all financial institutions have clearly defined risk management policies and procedures for other non-financial risks namely: reputation risk, operational risk and strategic risk. Two financial institutions reported as having additional specific risk management policies and procedures for other types of risks such as anti-money laundering and external risks.

Table 1 below summarises the types of risks that are covered by the various financial institutions in Malawi.

TABLE 1



Risk Management Structure

All institutions reported having a well-constituted risk management structure. Half of the respondents reported as having centralised risk management structure, the other half as having decentralised structure and one financial institution as having a combination of the two set-ups.

For those having centralised structure, the risk management responsibility lies mostly with the risk manager, risk committee or the Asset-Liability Committee. For those reporting decentralised structure, the risk management responsibility lies invariably with the different committees and various line departments.

The survey disclosed that the risk management function in several institutions are not clearly defined with some institutions indicating the responsibility for risk management as falling under internal audit function or specific department head in charge of operational risk.

Management Information System

All institutions except one reported having comprehensive risk management information system. Examples of risk management reports being used as: reports on risk limits, exception reports, large exposures, top depositors, liquidity and interest rate mismatches, deposit and credit concentration reports, and asset maturity/gap analysis.

Independent Risk Review Function

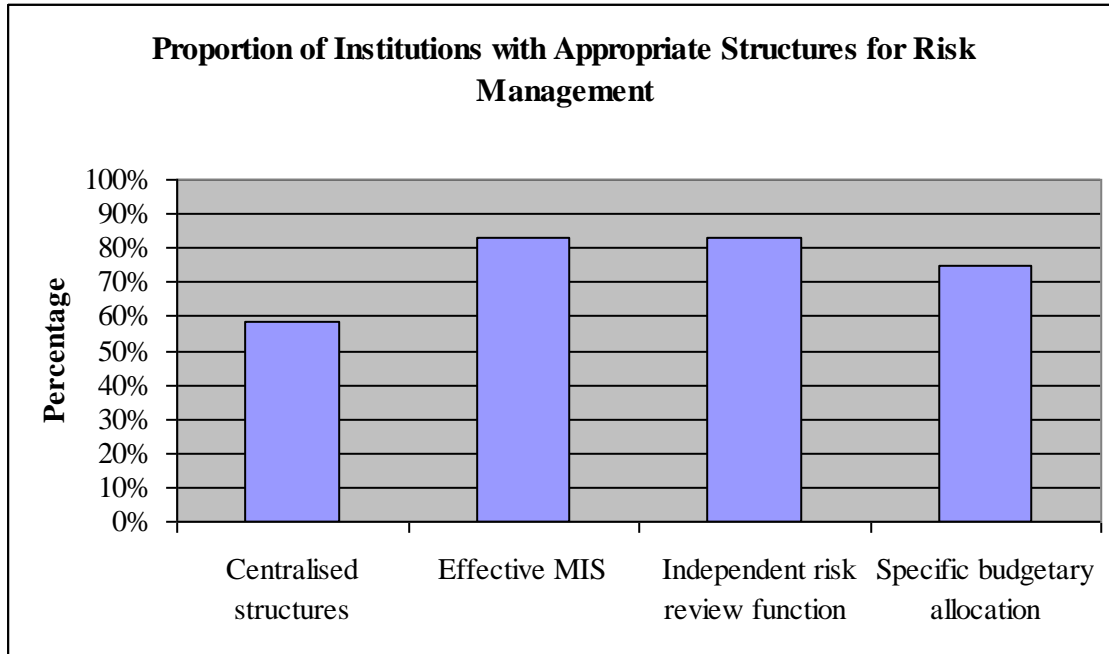
Most institutions reported as having independent risk review function done by internal audit, quality assurance officers or by Board Audit Committees. However, one institution admitted that no independent review of the risk management function is done and at least five institutions incorrectly placed the independent review under the mandate of the credit committee, the ALCO, or the Operational Risk Department.

Proportion of Budgetary Allocation on Risk Management Function

Budgetary allocations for risk management ranged from 0 to 15%, with two institutions reporting very high allocations of 35% and 60%. These wide variations in budgetary allocations seem to indicate that for some institutions no conscious efforts are being made to clearly quantify the cost associated with the risk management function.

Table 2 below is a summary of proportions of institutions with appropriate structures for risk management function.

TABLE 2



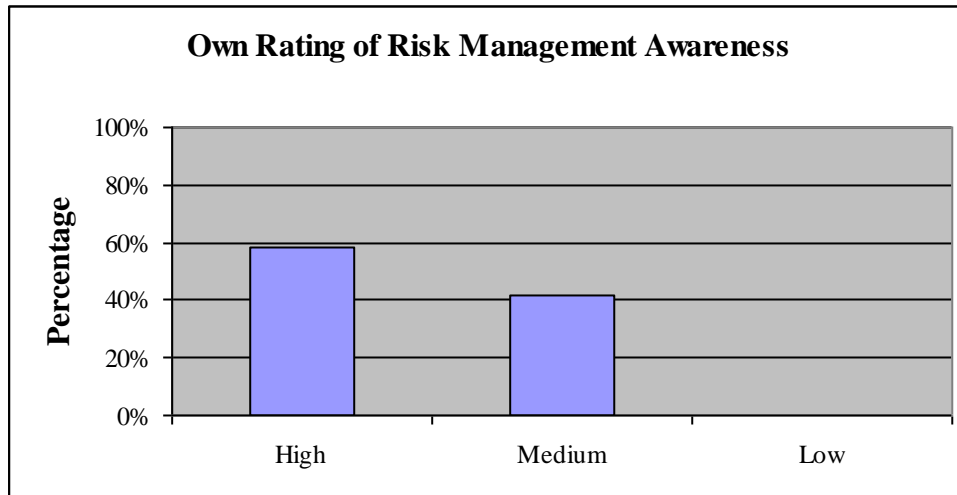
Risk Management Awareness

When asked about their own assessment of the level of risk management awareness in their organisation, more than half of the respondents rated themselves as having high risk management awareness, while five of them rated their risk management awareness as medium.

A few institutions were able to enunciate a clean risk management philosophy e.g. “to take only those risks that have been fully understood and are manageable” “risk management is integrated into every facet of the bank’s operation”. However, the rest of the respondents have either not defined their risk management philosophy yet or have stated their philosophy in very general terms.

Table 3 below is a summary of financial institutions own rating of risk management awareness.

TABLE 3



Tools for Measuring Risk

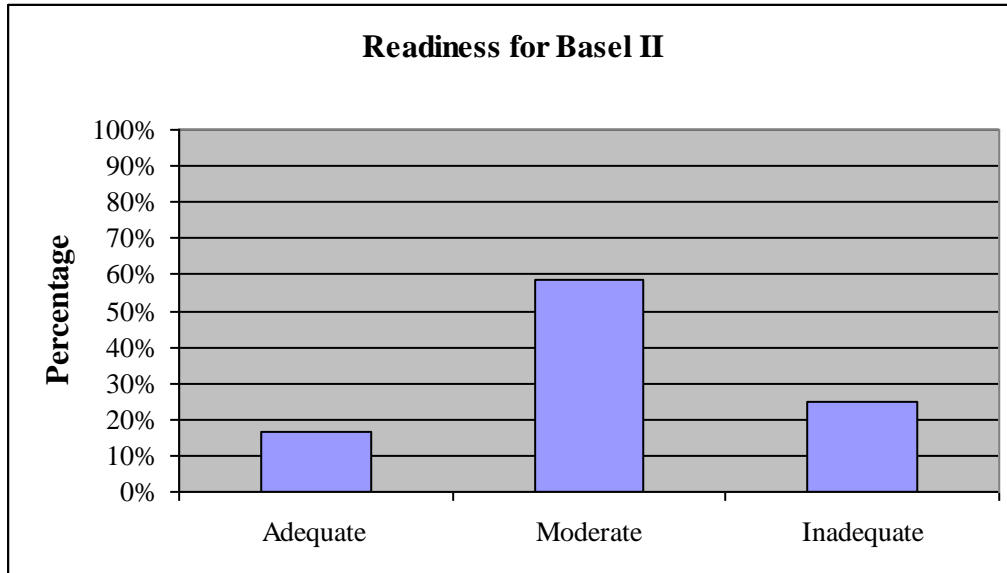
The most common tool used by financial institutions for measuring risks is the value at risk (VaR) followed by internal risk models. The smaller institutions reported as placing reliance on RBM's prudential returns for monitoring risks.

Basel II Awareness and Preparedness

The survey included a few questions to assess the institutions' awareness and preparedness to move towards a more risk sensitive capital adequacy framework. Only one institution reported as adequately prepared for implementing Basel II and the rest as only moderately prepared or not prepared at all. The preferred options gravitate towards the simpler approaches and only one expressed preference for the advanced approach of internal ratings based method for calculating capital requirements. Currently, most financial institutions have not adopted their own internal capital adequacy measurement and rely mainly on RBM Capital Requirement for assessing adequacy of their capital levels.

Table 4 below is a summary of financial institutions own rating of preparedness for Basel II.

TABLE 4



Summary and Conclusion

The survey identified a number of gaps that demonstrate the need for enhancing risk management in financial institutions. These include:

- Inadequate risk management policies and procedures, particularly for foreign exchange rate and price risks; and non-financial risks such as operational risk, reputation risk and strategic risk.
- Not all institutions have clearly defined functions and personnel dedicated for risk management.
- Some institutions have not developed their own comprehensive risk management reports and are relying on the RBM prudential returns to monitor some risks.
- Risk management tools in use are very limited.
- Not all institutions have in place independent review of their risk management functions.
- Even though some institutions reported having set aside specific budgetary allocations to fund risk management activities, the reported percentages seem to indicate that there is no conscious efforts to quantify and monitor the costs associated with the risk management function.
- Most financial institutions are not that ready to move towards a more risk-sensitive capital adequacy framework.

In an effort to address the above gaps revealed in the survey, the RBM will issue risk management guidelines to all financial institutions. These guidelines will provide institutions with a framework for management of each type of the principal risks facing institutions in our market. The guidelines contain the four key elements of sound risk management for each of these risks:

- Active board and senior management oversight;
- Adequate policies, procedures and limits;
- Adequate risk monitoring and management information system;

- Comprehensive internal control systems.

Financial institutions will be required to submit their risk management programmes containing, at a minimum, the key elements of sound risk management as presented in the Risk Management Guidelines. The programmes will be reviewed by the RBM, and will form the basis of continued discussions in a bid to ensure that they are comprehensive and are implemented. It is anticipated that, following the adoption of RBS, financial institutions will appreciate the need to enhance risk management practices to encourage healthy competition and promote greater stability in the financial system which are preconditions to sustained economic growth in the country.