Risk report

Introduction

Risk-taking, in an appropriate manner, is a fundamental part of the group's business activity and an essential component of its planning process. This is achieved by keeping risk management at the centre of the executive agenda and by building a culture in which risk management is embedded in the everyday management of the business.

The risk appetite of the group is always monitored in managing the business. Risk appetite refers to the level of risk that the group is willing to accept in fulfilling business objectives. These risks are first understood on an inherent basis, which involves understanding the main drivers to such risks in the absence of any controls. Thereafter, there is an assessment of the residual level of risks, taking into account the controls that are in place to manage such risks. Where the residual level is outside the risk appetite, further controls and action are defined to bring these risks within the risk appetite. An important aspect of this approach is the recognition that risk management is not limited solely to the downside or risk avoidance, but is about taking risk knowingly.

The board acknowledges its overall responsibility for the process of risk management, as well as for reviewing its effectiveness. Executive management is accountable to the board for designing, implementing and monitoring the process of risk management, as well as integrating it with the day-to-day activities of the group. It should be noted that this process is designed to manage, rather than eliminate, the risk of failure to achieve the group's business objectives, and can only provide reasonable, and not absolute, assurance against material loss.

The group remains committed to the objective of increasing shareholder value by developing and growing business that is consistent with its risk appetite, and through building more effective risk management capabilities.

Responsibility for risk management resides at all levels within the group, from the executive down through the organisation to each manager. We are seeking an appropriate balance in our business, and continue to build the risk management capabilities that will help us to deliver our growth plans in a controlled environment.

Risk management principles

Risk management in the group is guided by several principles, the most important of which are:

- assignment of responsibility and accountability for all risks
- adoption of a framework for integrated risk management
- protection of our reputation
- risk governance

Responsibility and accountability

The responsibility for risk management resides with management at all levels, from members of the board to individuals throughout the group.

Overall risk management policies, risk appetite and tolerances are established on a group basis by senior management, reviewed and where appropriate, approved by the board of directors. These policies are clearly communicated throughout the group and apply to all businesses within the group.

Integrated Risk Management Framework

The Business Performance and Risk Management Framework as adopted by the group is effective, comprehensive and consistent for the purposes that it has been developed. Under this framework, responsibilities for risk management remain with line-management. Management allocates resources to support the framework.

Risks are appropriately identified, evaluated and managed, considering the interrelationships between risks. This process happens on a continuous basis. Under this framework, structured risk self-assessments take place on a recurring basis. Risk assessments consider both the likelihood of an event occurring, as well as the impact the risk would have, should the event in question occur.

Protection of our reputation

A strong corporate reputation is a valuable asset to a financial institution.

By managing and controlling the risks incurred in the course of conducting business, the group protects its reputation. This means avoiding large concentrations of exposures of all kinds, as well as transactions that are sensitive for tax, legal, regulatory, social, environmental or accounting reasons. A cautious approach is adopted to other risks that cannot be sensibly evaluated or priced.

Risk governance

Risk governance is the approach that balances the demands for entrepreneurship, control and transparency, while supporting the group's objectives with an efficient decision-making process.

The management of risk in the group is guided and monitored by a number of committees. The details regarding the composition and main responsibilities of our board of directors and board committees are contained in the corporate governance statement of the annual report.

Risk, policies and procedures

In our ordinary course of business, we are exposed to various risks, including credit, interest rate and liquidity, operational and reputational risks. Below is an overview.

Credit risk

Credit risk represents the risk of loss to the group as a result of a client or counterparty being unable or unwilling to meet its contractual obligations. Credit risk arises from two types of transactions:

- Lending transactions, giving rise to counterparty risk (the risk that a counterparty to a transaction will be unable or unwilling to repay capital and interest on advances and loans granted to it);
- Trading transactions, giving rise to issuer and settlement risk. Issuer risk is the risk that payments due from the issuer of a financial instrument will not be received.

Settlement risk is the risk that settlement of a transaction does not take place as expected, with one party effecting settlement as they fall due but not receiving settlements to which they are entitled.

Management and measurement of credit risk

The senior credit risk committee is responsible for managing credit risk. This committee operates under the bank board's approved discretionary limits, policies and procedures, and at least two bank board members in addition to the bank CEO participate in these meetings.

A centralised decision making structure with decentralised limits is the basis on which applications for credit are entertained. Decentralised limits tend to be relatively low to ensure a high degree of centralised involvement in all areas where credit risk is incurred.

The group applies the following fundamental principles to manage credit risk:

- a clear definition of our target market;
- a quantitative and qualitative assessment of the credit worthiness of our counterparties;
- appropriate credit granting criteria;
- an analysis of all related risks, including concentration risks (concentration risk includes asset class, industry and counterparty concentration);
- prudential limits;
- regular monitoring of existing and potential exposures once facilities have been approved; and
- a high level of executive involvement and non-executive awareness of decision-making and review.

Credit risk classification and impairment policy

It is policy to make provision for specific impairments and to ensure that calculations for portfolio impairment are promptly made on a consistent basis. The external auditors review these impairments during the annual audit. Two types of impairments are in place: specific and portfolio.

Specific impairments

The specific impairment represents the quantification of actual and inherent losses from individually identified exposures. Specific impairments are evaluated on a case-by-case basis for all non performing exposures. In determining specific impairments, the following factors are considered:

- our exposure to the customer;
- capability of the client to generate sufficient cashflow to service debt obligations;
- viability of the client's business;
- amount and timing of expected cash flows;
- realisable value of security held taking the time value of money into account; and
- deduction of any recovery related costs.

Portfolio impairments

The portfolio impairment supplements the specific impairment as outlined above and provides additional cover, based on prevailing market conditions and current default statistics.

Balance sheet risk management

This includes the financial risks relating to our asset and liability portfolios, comprising liquidity, funding concentration and interest rate risks on the balance sheet. The Treasury division manages the liquidity mismatch and interest rate risk arising from our asset and liability portfolios. It is required to exercise tight control on funding, liquidity, concentration and interest rate risk within defined parameters.

The asset and liability management committee (ALCO) manages the balance sheet risks on a consistent basis with pre-approved principles and policies. The balance sheet position is regularly reported to the executive committee as well as the board of directors.

Interest rate risk

Interest rate risk is the impact on the net interest earnings and sensitivity to economic value, as a result of increases or decreases in the absolute levels of interest rates. It is managed by ongoing measurement of the interest rate mismatch and basis risk, translated into sensitivity of interest income and economic value across varying interest rate scenarios.

The group bases its interest rate risk management processes on the following fundamental steps:

- measurement and assessment of interest rate mismatch gaps detailing the sources of interest rate exposure at a point in time, which forms the basis for:
- translations into interest income sensitivity analysis; and
- daily management of interest rate risk by Treasury subject to independent ALCO review.

Liquidity risk

Liquidity risk is the risk that the group is unable to meet its obligations when they fall due and to replace funds when they are withdrawn, with consequent failure to repay depositors and fulfil commitments to lend.

Sources of liquidity risk include unforeseen withdrawals of demand deposits, restricted access to new funding with appropriate maturity and interest rates characteristics, inability to liquidate a marketable asset timeously with minimal risk of capital loss, unpredicted customer non-payment of a loan obligation and a sudden increased demand for loans.

Liquidity management is vital to preserving market confidence, safeguarding our reputation and ensuring sustainable growth. The following elements form part of the liquidity management process:

- short and long-term cash flow management;
- maintaining a structurally sound balance sheet;
- ensuring the availability of sufficient contingency liquidity;
- preserving a diversified funding base;
- undertaking regular liquidity stress testing and
- maintaining liquidity contingency plans.

Operational risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Operational risk is inherent in the group's operations. The goal is to manage this risk to acceptable levels and to minimise unexpected events. Senior management is responsible for identifying and mitigating operational risks.

Operational risk includes amongst others the management of business continuity risk, information security risk, information risk management as well as our response to financial crime.

Business continuity risk

The group has a comprehensive programme to assess and enhance our capability to support the availability of systems, restore technology platforms, resume operations and deliver core business processes in the event of problems.

Information risk management

Changes to IT systems can introduce risk if not properly planned, assessed and implemented with care. Information security continues to receive attention so that the group can respond proactively to threats to data, systems and information.

Changes to line and business continuity environments are subject to a robust process to minimise disruptions.

Financial crime

The group has zero tolerance to financial crime, both internal and external. Incidents are fully investigated to understand source and cause, achieve recovery and initiate legal action, and implement appropriate mitigating action.

Reputational risk

Reputational risk is the risk caused by damage to an organisation's reputation, name or brand. Such damage may result from a breakdown of trust, confidence or business relationships, and can arise if other risks emerge and are not dealt with.

The group enforces polices and practices to manage reputational risk. Its strong values statement is regularly and proactively reinforced, as is its commitment to sound corporate governance practices. All activities, processes and decisions are bound by carefully considered principles.

It fosters an acute awareness at all levels of the impact of practices that may result in the breakdown of trust and confidence in the organisation.

Policies and practices are regularly enforced through transparent communication, accurate reporting, internal audit and regulatory compliance review and risk management practices.

Solvency risk

Insolvency is the chronic condition of being unable to pay one's debts in full. An insolvent company cannot discharge its debts. It must either be liquidated or rescued. A group's solvency may be threatened if other risks have been mismanaged.

Capital adequacy is an exclusive concept which bankers, insurance companies, analysts and regulators attempt to measure in various ways. For further reference to capital adequacy, refer to the chief financial officer's report.

Market risk

Market risk is defined as the risk of losses in on and off-balance sheet positions arising from movements in market prices. Exchange rate risks as well as Interest rate risk are the primary risks in this category. The bank operates within a risk management framework where principles of managing risks associated with trading positions are set.

Trading limits are approved by the board, with the day-to-day operations and utilisation thereof resting with the group treasurer. Accordingly, the risk of adverse movements arising from interest rates is managed in the dealing room within treasury, where operations take place within limits assigned to each dealer, based on his/her knowledge, expertise and experience.

The group treasurer and independent risk manager monitor the trading portfolio daily and report weekly to relevant risk monitoring structures in the group and to the chief executive officer of the bank.

Market risk related operational risk

All activities are authorised and conducted using operational systems that are adequate for the recording, valuation and settlement of all transactions.

Security measures are in place to prevent access of unauthorised persons. In line with generally accepted good risk management practices, the group has an adequate segregation of duties in respect if dealing, confirmation, settlement and risk exposure measurement.

Counterparty risk

This risk arises from a counterparty defaulting to a transaction failing to meet punctually a financial commitment. The risk is managed in the dealing room, by allotting counterparty trading limits on foreign exchange, capital market and the money market transactions. The risk manager monitors these limits daily and reports deviations to relevant executive management.

Insurance risk

Insurance risk is the risk that future risk claims and expenses will exceed the value placed on insurance liabilities. It occurs due to the uncertainty of the timing and amount of future cash flows arising under insurance contracts. The timing is specifically influenced by future mortality, longevity, morbidity, withdrawal and expenses about which assumptions are made in order to place a value on the liabilities. Deviations from assumptions will result in actual cash flows differing from those projected in the policyholder liability calculations. As such, each assumption represents a source of uncertainty.

The larger the portfolio of uncorrelated insurance risks, the smaller the relative variability around the expected outcome will be. In addition, a more diversified portfolio of risks is less likely to be affected across the board by a change in any subset of the risks.

In determining the value of insurance liabilities, assumptions need to be made regarding future rates of mortality, morbidity, termination rates, expenses and investment performance. The uncertainty of these rates may result in actual experience being different from that assumed and hence actual cash flows being different from those projected, and, in the extreme, that the actual claims and benefits exceed the liabilities.

Insurance events are by nature random and the actual number and amount of claims and benefits could be different from the number and amount of claims and benefits estimated. The larger the portfolio of contracts, the smaller the expected variation between actual and expected experience becomes. In addition, the more diversified a portfolio of risks, the smaller the impact of deviation of actual experience in a particular risk factor, compared to the assumption. The lack of diversification in respect of type and amount of risk can increase insurance risk.

Swabou Life is exposed to the following types of risks as a result of the insurance contracts it issues:

- Mortality, longevity and morbidity risk;
- Persistency risk;
- Expense risk; and
- Business volume risk.

The main insurance risks are set out below, as well as Swabou Life's approach to the management of these risks.

Mortality and morbidity risks

The risk that actual experience in respect of the rates of mortality and morbidity may be higher than what is assumed in pricing and valuation varies, depending on the terms of different products. The material classes of business most affected by these risks are as follows.

i. Individual insurance business

Products are sold directly to individuals providing benefits on death and disability, including impairment, or in the event of suffering a critical illness. The main insurance risk relates to the possibility that rates of death or disability may be higher than expected. This may be due to:

- Normal statistical variation due to the random nature of insurance events;
- Incorrect assumptions regarding future experience;
- Natural catastrophes such as floods or earthquakes, and unnatural catastrophes such as acts of terrorism;
- The impact of HIV/AIDS or epidemics such as bird or swine flu;
- Anti-selection such as where a client who has a pre-existing condition or disease purchases a product where a benefit will be paid on death or in the event of contracting such a disease;
- The effect of selective withdrawal which means policyholders are less likely to withdraw voluntarily if they are more likely to need the cover in the foreseeable future;
- Economic conditions resulting in more disability claims; and
- Concentration risk, which is the risk of a large number of claims from a single event or in a particular geographical area.

For contracts with fixed and guaranteed benefits and fixed future premiums there are no mitigating terms that reduce the risk accepted by Swabou Life. Therefore Swabou Life employs the following underwriting controls to ensure that only acceptable risks are accepted:

- Underwriting, which is the assessment of health risk, hazardous pursuits or financial risk, including the requirement of a negative HIV test as a condition for accepting risk, charging extra premiums or declining cover where applicable based on the outcome of the underwriting, and differentiating premiums for risk factors such as age and smoker status;
- Appropriate pricing including allowing for known risks based on actual claims experience, and making use of profit-testing techniques;
- Regular review of premium rates and approval of the approach to setting premium rates by the Statutory Actuary;
- A guarantee period shorter than the policy term applies to risk business, and enables Swabou Life to review premium rates on in-force contracts during the life of contracts. The guarantee period on whole-life products is generally within the range of 10 to 15 years; and
- Appropriate policy conditions, including setting appropriate maximum income replacement ratios in the case of products providing disability benefits, and approval of policy conditions by the Statutory Actuary.

The following additional controls and measures are in place in order to ensure that Swabou Life manages it's exposure to mortality and morbidity risk:

- Claims assessment processes to ensure only valid claims are paid;
- Reserving for AIDS risk in accordance with the guidelines issued by the Actuarial Society of South Africa as set out in Professional Guidance Note (“PGN”) 105; and
- Reinsurance to limit Swabou Life's liability on particularly large claims or substandard risks. On individual pure risk business, Swabou Life reinsures up to N$100 000 per life of the mortality risk and of the morbidity risk. The maximum retention on aggregate mortality and morbidity risks on any one life is N$100 000.

ii. Group risk business

Employee benefit products provide life and disability cover to members of a group, such as employees of companies or members of trade unions. Typical benefits are:

- Life insurance (mostly lump sum, but some children and spouse's annuities)
- Disability insurance (lump sum and income protection)
- Dread disease cover and
- Continuation of insurance option

The products are, as a rule, quite simple and mostly basic products with a one-year renewable term. In most cases the products are compulsory for all employees although it has become more common recently to provide members with a degree of choice when selecting risk benefits.

Underwriting on group business is much less stringent than for individual business as there is typically less scope for anti-selection. The main reason for this is that participation in Swabou Life's insurance programmes is normally compulsory, and as a rule members have limited choice in the level of benefits. Where choice in benefits and levels is offered, this is accompanied by an increase in the level of underwriting to combat anti-selection.

Groups are priced using standard mortality and morbidity tables plus an explicit AIDS loading. The price for an individual scheme is adjusted for the following risk factors:

- Region
- Salary structure
- Gender structure
- Industry

Swabou Life reinsures all lump sum benefits and disability income benefits.

iii. Individual annuity business

Annuity contracts provide a specified regular income in return for a lump sum consideration. The income is normally provided for the life of the annuitant. In the case of a joint-life annuity, the income is payable until the death of the last survivor. The income may furthermore be paid for a minimum guaranteed period and may be fixed or increased at a fixed rate or in line with inflation. The mortality risk in this case is that the annuitants may live longer than assumed in the pricing of the contract. This is known as the risk of longevity.

Swabou Life manages its risk by reinsuring guaranteed increases to ensure that it can match the risk profile with appropriate assets.

iv. Permanent health insurance business

Swabou Life also pays Permanent Health Insurance ("PHI") income to disabled employees, the bulk of which are from employee benefit insured schemes. The income payments continue to the earlier of death, recovery or retirement of the disabled employee. There is therefore the risk of lower recovery rates or lower mortality rates than assumed, resulting in claims being paid for longer periods. Claims in payment are reviewed annually to ensure claimants still qualify and rehabilitation is managed and encouraged.

Swabou Life reinsures all Permanent Health Insurance benefits.

Persistency risk

Persistency risk relates to the risk that policyholders may cease or reduce their contributions, or withdraw their benefits and terminate their contracts prior to the contractual maturity date of a contract.

Expenses such as commission and acquisition expenses are largely incurred at outset of the contract. These upfront costs are expected to be recouped over the term of a contract from fees and charges from the contract. Therefore, if the contract or premiums are terminated before the contractual date, expenses might not have been fully recovered, resulting in losses being incurred. As a result, the amount payable on withdrawal normally makes provision for recouping any outstanding expenses. However, losses may still occur if the expenses incurred exceed the value of a policy, which normally happens early on in the term of recurring premium policies, or where the withdrawal amount does not fully allow for the recovery of all unrecouped expenses. This may either be due to a regulatory minimum applying, or because of product design.

In addition to setting realistic assumptions with regards to termination rates (rates of withdrawal and lapse), based on Swabou Life's actual experience specific amounts are set aside to cover the expected cost of any lost charges when policyholders cease their premiums or terminate their contracts.

Expense risk

There is a risk that Swabou Life may experience a loss due to actual expenses being higher than those assumed when pricing and valuing policies. This may be due to inefficiencies, higher than expected inflation, lower than expected volumes of new business or higher than expected terminations resulting in a smaller in-force book size.

Swabou Life regularly performs expense investigations and sets pricing and valuation assumptions to be in line with actual experience, with allowance for inflation. The latest investigation was performed at 30 June 2009. The inflation assumption furthermore allows for the expected gradual shrinking of the number of policies arising from the run-off of books closed to new business arising from past acquisitions.

Business volume risk

There is a risk that Swabou Life may not sell sufficient volumes of new business to meet the expenses associated with distribution and administration. A significant portion of the new business acquisition costs are variable and relate directly to sales volumes. The fixed cost component can be scaled down if there is an indication of a permanent decline in business volumes.

Insurance risk sensitivity

Sensitivity testing determines that the assumptions regarding future mortality and morbidity experience have an impact on the actuarial liability. This is to be expected given the nature of the business (risk insurance). This implies future trends in mortality and morbidity experience, whether positive or negative, will impact on profits in the future. The sensitivity provided, in isolation, are not amounts that can be simply extrapolated to determine prospective earnings forecasts.

Reinsurance risk

Reinsurance risk is the risk of default from reinsurance companies contracted. The company only enters into reinsurance treaties with reinsurances within the FirstRand Company or subsidiaries of large international reinsurance companies and no instances of default have yet been encountered.

Claims risk

Pro-active training of staff takes place to ensure that fraudulent claims are identified and investigated timeously. The legitimacy of claims is verified by internal, financial and operating controls that are designed to contain and monitor claims risk.

The conduct of staff within the group is subject to the group's code of ethics, which is communicated to all concerned staff.

Capital management

The capital management information is set out in the CFO's report on pages 25 to 30 of the group annual financial statements.

Internal audit

The group's internal audit function performs an independent appraisal activity with the full cooperation of the board and management. It has the authority to independently determine the scope and extent of work to be performed. Its objective is to assist executive management with the effective discharge of their responsibilities by examining and evaluation of the group's activities, resultant business risks and systems of internal control. Its mandate requires it to bring any significant control weaknesses to the attention of management and the audit committee for remedial action. Based on the recommendations of executive management and review of the group audit committee, the board relies on the adoption of appropriate risk management and internal control. Internal audit reports functionally to the group audit committee and administratively to the CEO of the group.

Nothing has come to the attention of the directors or the external or internal auditors to indicate that any material breakdown in the functioning of internal controls and systems has occurred at a group level during the year under review.

Internal control

Internal control comprises methods and procedures implemented by management to safeguard assets, prevent and detect error and fraud, and ensure the accuracy and completeness of accounting records and the timely preparation of reliable financial information.

The directors are responsible for maintaining an adequate system of internal control. Such a system reduces, but cannot eliminate, the possibility of fraud and error. Shareholders, depositors, policyholders and regulatory authorities have a vested interest in the accuracy and integrity of the financial statements and in knowing that accountability of assets is adequately safeguarded, verified and maintained. These controls are based on established written policies and procedures and are implemented by skilled personnel with an appropriate segregation of duties.

To ensure that the group's business practices are beyond reproach, all employees are required to maintain the highest ethical standards. Nothing has come to the attention of the directors to indicate that any material breakdown in controls, procedures and systems has occurred during the year under review.

Audited quantitative risk management information, which forms an integral part of this Risk Report, is disclosed in note 43 of these annual financial statements.