Risk Management & Corporate Governance

Risk Management

Bank Danamon's risk architecture has proven effective during challenging times.

Introduction

There are many risks in the markets in which Bank Danamon operates. A range of factors, some of which are beyond the bank's control, can influence performance.

Bank Danamon believes in Enterprise Risk Management as an approach to manage all risks. This requires a proactive, systematic, and disciplined risk management process covering all risks - Credit Risk, Market Risk, Liquidity Risk, and Operational Risk. Risks such as Reputation Risk, Legal Risk, Strategic Risk, and Compliance Risk are managed as part of Operational Risk.

An Integrated or Enterprise Risk Management culture is firmly entrenched throughout the bank. The bank's management takes a holistic approach to risk management based upon sound principles and values, encompassing a well defined risk strategy, proper board structures, and active working committees with clear roles, responsibilities, authorities and levels of delegation. Risk management is assessed in terms of key performance indicators. It is disseminated through detailed policy manuals and documentation and is independently audited and assessed.

Risks and Methods Defined

The risks inherent in the day-to-day operations of the bank are summarised under a number of different categories:

Credit risk is defined by a borrower's ability to meet repayment, interest or other obligations due to the bank. Credit risk is managed using established policies and procedures covering the origination, underwriting, maintenance, and collection of all credits to ensure the risk profile is within an acceptable range. Such ranges are defined by portfolio limits for the bank as a whole and separately for each business line. Portfolio limits take into account individual business plans and capabilities, industry or other concentrations and trends, economic conditions, product profitability and expected credit losses.

A credit risk management function within each line of business ensures there is proper segregation of duties between management authorised to grant credit up to a limit based on an individual's experience and track record and the nature of business requirements, and the Integrated Risk Group who independently assess and regularly review individual credits. A further independent review is undertaken by Internal Audit.

Management benchmarks itself against commonly understood "international best practices" in the field of Credit Risk Management. Compliance with Bank Indonesia regulations is of the highest priority, as is compliance with all other laws and regulations. In anticipation of the introduction of Basel II guidelines in Indonesia, we are currently working towards compliance with Basel II principles, which we expect to reach within timelines defined by Bank Indonesia.

The Market Risk framework enables the bank to correctly measure and manage risk arising from movements in market factors, e.g. interest rate, foreign exchange, etc. This includes instruments in the trading book as well as balance sheet interest rate gaps.

Market risks in the trading book are monitored and measured daily through DV01 and Option Greek limits. The limit framework enables management to monitor risk through the underlying risk factors (different currencies and interest rates) and decide on the appropriate level of hedging, if any.

In addition, Value-at-Risk (VaR) is calculated on a daily basis to quantify the overall risk level of the trading book.

Similarly, balance sheet interest rate gap limits are used to manage the interest rate risk arising out of balance sheet gaps more efficiently.

The Liquidity Risk framework measures and manages the ability of the bank to fund its liabilities on a day-to-day basis.

To enable the bank to effectively manage the liquidity risk inherent in the balance sheet, a comprehensive liquidity limit framework has been set up. The framework enables the treasury to manage short-term liquidity mismatches, while the Asset Liability Committee (ALCO) manages the structural balance sheet composition through an array of balance sheet ratio targets. As the senior management is ultimately responsible for the asset liability composition of the bank, ALCO is convened every month with participants from all business divisions.

Furthermore, in order to ensure we have the necessary capacity to manage liquidity stress situations, we conduct monthly stress testing.

Operational risk is the risk of direct or indirect loss resulting from inadequate or failed internal processes, and generally refers to physical or technology driven events, human error or deliberate action, legal risk or the occurrence of fraud. There were no material cases of fraud outstanding as of December 31, 2006. A systematic operational risk management framework is in place to ensure all operational risks are properly identified and controlled in a timely manner, and regular comprehensive self-assessment checks are in place in all key areas of the bank. Further independent reviews of the effectiveness and integrity of controls are carried out with a brief to make improvements at every step.

Bank Danamon manages operational risk following rules and regulations issued by Bank Indonesia and benchmarks itself against international best practice.

Business Continuity Planning

In 2006, a specific continuity plan was formulated regarding the possibility of an influenza pandemic. The plan included raising education and awareness of the problem, devising crisis management strategies for all units, and organizing a command centre.

A non-specific comprehensive business continuity plan was also devised, which saw the allocation of roles and responsibilities to parties in the event of a disaster, and the establishment of a central command office. Following a business impact analysis, a Business Continuity Management (BCM) manual has been designed expounding BCM philosophies and policies, as well as practical procedures to be followed in the event of a disaster.

Managing of Risk

The improvements and changes effected in 2006

All risk positions are carefully reviewed, on a regular basis including daily and intraday examinations. In addition monthly comprehensive reviews are undertaken of all likely risks and of the risk parameters themselves to ensure they are still relevant. External factors and trends in markets, in business sectors, and the economy as a whole are also evaluated. Risk assets are identified and measured (portfolio stress-test) in regular portfolio meetings, which are attended by senior risk management officers. The results are reviewed by the Risk Management Committee in monthly meetings.

New policy manuals and procedures are established for all businesses and activities, such as: a Risk Management Policy Manual which is issued by Credit Risk Management as part of the Good Corporate Governance framework, anti money laundering procedures, KYC policies & procedures which are revised to strengthen anti money laundering, and policies on Product Transparency. Clearly defined product approval processes have been established. Any new product or activity requires prior approval by all relevant authorities in Bank Danamon, including Risk Management, Legal, Compliance and Accounting to ensure compliance with all relevant laws, external regulations and Bank Danamon's internal standards and procedures. Existing processes are reviewed periodically. As in the past, processes and methodologies of affiliated companies will be reviewed, evaluated and amended if necessary.

Risk Management Committees

Frequent and robust testing of the overall risk management architecture is a central function of management committees in their role to assess the quality and effectiveness of the bank's risk management. Their duties, composition and frequency of meeting are described below:

Risk Monitoring Committee of the Board of Commissioners
See page 72 of the Corporate Governance section.

Risk Management Committee (RMC)

The Risk Management Committee met 11 times in 2006, and was established to implement an effective risk management framework and to ensure the application of risk supervision through the determination of risk tolerance, limits, and the overall risk management strategy.

Members of the Risk Management Committee comprise of the Integrated Risk Head as Chairman, the President Director, the Compliance Director, members of the Board of Management, and other executives as nominated.

Business Credit Committee (BCC)
The BCC is responsible for the approval of credit proposals and quality of the underwriting standards within any business. BCC members are delegated discretionary limits, based upon their skills and experience. All credits must be approved by at least 2 members of the BCC, one of whom must have a limit to approve the credit.

Asset and Liability Committee (ALCO)
See page 76 of the Corporate Governance section.

Operational Risk Committee (ORC)
Reviewing operational issues arising in the course of normal business, the ORC initiates corrective action where warranted and disseminates adjustments and changes to policy throughout the bank. Two meetings were conducted in 2006 to discuss and solve major operational issues.

Members of the Operational Risk Committee comprise of the Integrated Risk Head as Chairman, Operational Director, Head of Operations, Head of Internal Control Unit, Head of Operational Risk, Head of Mass Market Operations, Head of Credit Support Administration, Head of Legal Division and Head of SKAI.