# RISK MANAGEMENT AND COMPLIANCE

## Due to the nature of its activities, the Bank may be exposed to certain risks, both currently and in the future.

Such risks are monitored and managed through the Bank's Risk Management Group, whose tasks include managing a range of risks, as well as ensuring compliance with the requirements of the Saudi Arabian Monetary Authority (SAMA) and the Basel Committee. A full description of the mentioned risks is found in the representations attached to the Consolidated Financial Statements notes 29 to 34, which forms part of the Board of Directors' report. Below is a short summary of these risks:

Throughout 2019, the Risk Management Group continued to focus on improving the effectiveness of its risk management system, while implementing best practices to ensure that the Bank's activities maintain the right balance between achieved returns and projected risks.

The Group's framework is based on three key pillars, namely the sound principles of risk management, the integrity of the organizational structure, and risk measurement and monitoring. These practices should align with the banking activities to ensure that risks are maintained at an acceptable level. The Risk Management Group operates separately and independently from the Bank's other business groups and sectors, in line with SAMA's guidelines and Basel Committee's requirements.

The Bank implements frameworks to identify, measure, monitor and manage risks, covering credit risk, liquidity risk, operating risk and market risk. The Bank regularly reviews the policies and systems of risk management, and keeps up with market and product changes, in order to adopt and implement best international banking practices.

1. **Credit Risk:**
   Credit risk is one of the key risks to which the Bank is exposed, mainly through financing and investment activities. Managing credit risks involves multiple units that operate under a unified system in accordance with approved credit policies and procedures.

   a. **Measurement of Credit Risk Degree:**
   The Bank measures the degree of credit risk to identify the maximum qualitative and quantitative amounts of risk to which it might be exposed, and to determine the degree of credit risks to which the Bank is actually exposed. The Bank employs an advanced system for the internal assessment of the degree of credit risk to which corporate banking, retail banking and financial institution clients may present. This assessment helps measure the probability of default, the volume of projected default and the likely or possible amount of losses resulting from such default. To ensure a more accurate and fair assessment of risk degree, the Bank continues to improve its assessment methods and applies a different assessment methodology for each client category, such as SME and high solvency clients, as well as corporate clients. Additionally, the Bank has put in place a system to measure the level of risk for retail banking clients.

   b. **Credit Risk Mitigation and Control:**
   The Bank employs several methods of assessment aimed at mitigating the degree of credit risk within reasonable levels. Such methods include analyzing future data in order to measure the client's ability to meet financing obligations. Credit approvals in such cases are issued by several credit committees composed of Bank executives, or by Board-level committees. The approval depends on the degree of credit risk, potential credit loss and the total volume of credit facilities provided to the client. In addition to these measures, the Bank requires clients to provide such collateral as is deemed necessary against the facilities to be provided, preferably in a form that can be quickly liquidated and applied. There are many types of collateral against facilities, such as cash coverage, mortgage against investments and assets for the Bank, mortgage/reservation of commercial and residential real estate assets, waiving project returns in certain instances of project financing, as well as requiring financial, personal or third-party guarantees against the facilities. Guarantees under a sponsor guarantee program for the financing of small and medium enterprises (SMEs) should be collected as long as the program's terms are met. However, financing for individuals is granted on the basis of conditions that involve specific credit standards to be met and require the transfer of the client's salary to the Bank. This type of financing also requires that the credit portfolio involves no concentration of credit risk, as well as the conformity of credit exposure levels with relevant established controls, be it exposure to a certain entity or a specific sector or activity.

   c. **Monitoring and Reporting:**
   The Bank conducts a comprehensive annual credit review of the financial and credit positions of all clients who are financed through corporate and retail banking services. This review ensures that the client's status, and their financing needs, is sustainable and that the smooth functioning of credit relations with them remain viable. The Bank also conducts reviews that involve regular visits to financed clients throughout the year.

   High credit risk corporate clients are categorized as clients who require special supervision. Their credit exposure is closely and carefully monitored and reviewed bi-annually in order to properly mitigate the risk exposure. On the other hand, the Bank conducts comprehensive monitoring of the portfolio of retail banking clients who have obtained credit facilities for consumer purposes and credit cards. This involves the evaluation of established standards for each segment in the portfolio independently.

   The Bank calculates the appropriate level of credit provisions in its records and financial statements in accordance with recognized international financial standards for accounts that may incur losses. This measure is adopted when there are indications that circumstances exist which may affect the expected cash flow of these assets or investments and that such provisions are required. The Bank also prepares a comprehensive monthly status report for its portfolio, analyzing the concentration of credit exposure, and comparing it with approved percentages. This report is submitted for the Bank's Senior Management's review and supervision.

2. **Market Risk:**
Market risks are among the key risks to which bank activities are exposed, where fluctuations in profit margin rates and foreign exchange rates lead to negative or positive outcomes and may consequently result in losses or profits for the Bank. Additionally, the sudden and significant change in these rates may affect the Bank's liquidity position as well as its financing ability. Market risk involves several main risks to which the Bank is exposed, including: Return rate risk or profit rate risk: Known as the potential impact on the Bank's profitability due to fluctuations in market return rates. These changes often occur as a result of overall market activity, or due to specific reasons affecting the borrower. Foreign exchange risk: The risk resulting from share price fluctuations, which impacts both the Bank's profitability and shareholder rights and exposes to the Bank to increased risk. Managing the Bank's market risk is generally based on monitoring market conditions and seeking to increase return within the limits of approved market risk policies, as well as within the Bank's acceptable risk levels. **The Bank is exposed to market risks from the following sources:** Trading portfolios: Risk exposure in the case of foreign exchange trading portfolios arising from meeting the Bank's and clients' requirements for foreign exchange. Non-trading portfolios: Risk exposure in the case of non-trading portfolios mainly occurs due to non-conformity of assets and their maturity dates with the maturity dates of liabilities. It also occurs due to the impact of rate fluctuations upon re-investment.

3. **Liquidity risk:**
Considered one of the most critical risks to which the banking sector in general as well as individual banks could be exposed, liquidity risk takes into consideration the Bank's potential inability to meet financing requirements at reasonable cost (liquidity financing risk) or its inability to liquidate its position reasonably quickly while maintaining an appropriate price level (market liquidity risk).

**Market and Liquidity Risk Governance:**
Managing market risks helps to place limits as well as monitor compliance by implementing policies and controls that are approved and adopted by the Board of Directors. The Assets and Liabilities Committee is responsible for managing market risks on a strategic level in accordance with its delegated duties and responsibilities. Additionally, portfolio and product limitations, as well as risk types, are identified based on the levels of market liquidity and associated credit risks, and on an analysis of the extent to which the limitations are used.

**The Market Risk Management sector is categorized as an independent supervisory function, responsible for a range of activities. These include:**

the effective implementation of market risk policies; the development of the Bank's market risk management techniques and methods; the development of measurement mechanisms and behavioral assumptions of liquidity and investment; the immediate reporting to Senior Management of any violation of established limits and controls in accordance with the strict procedure approved and adopted by the Board; regular reporting to the Assets and Liabilities Committee and the Board, of any exposure to market risks and limit violations.

In order to limit exposure to liquidity risk, the Bank seeks to diversify financing sources to help reduce the degree of concentration and maintain an acceptable level of liquid assets. The Bank also puts in place policies and standards aimed at managing liquidity risks, and develops an emergency plan in accordance with the Basel Committee's best practices regarding liquidity risk management. A regular review of liquidity risk management policies and measures is subject to the approval of the Assets and Liabilities Committee and the Board of Directors. Moreover, additional control measures often help market risk exposure within an acceptable level of readiness in the case of adverse events. These measures include stress tests and procedures to obtain approval for new products. Receiving stress test results on a regular basis helps identify the impact of fluctuating profit rates and foreign exchange rates, as well as other risk factors that affect the Bank's profitability, capital adequacy and liquidity. These results are periodically sent to the Executive Management and the Board of Directors for their assessment of the potential financial impact on the Bank's profitability of exceptional circumstances. Over the course of 2019, the Risk Management Group successfully improved the performance of IT systems that help measure liquidity risks and manage assets and liabilities, as well carried out relevant studies, reports and stress tests as part of a comprehensive system developed to measure all types of financial risks.

4. **Operating Risk:**
Operating risk is the risk of losses arising from the inadequacy or failure of internal operations, individuals,

technical systems or external incidents. This definition of operating risks includes legal risk – but excludes strategic risk and reputation risk. To this end, operating risk is an inherent risk in all the Bank's products, activities, operations and technical systems, resulting from internal factors, unlike credit and market risks, which arise from external factors. Taking these aspects into consideration, the Bank adopts a strategy based on the active and effective involvement of its Executive Management in managing this type of risk, which can potentially affect the Bank's various activities. As part of its continuous efforts to limit the effects of operating risk, and consequently help achieve its strategic objectives, the Bank adopts the following practices:

i) Analysis and evaluation of secondary objectives and activities, in order to better limit exposure to operating risk
ii) Identification of potential operating risk in existing and new products, as well as in IT activities, operations and systems. This is achieved primarily through calculating operating losses in order to identify the monitory gaps that led to such losses, and developing corrective measures to prevent future occurrences. It also involves evaluating risks inherent in the Bank's various activities, as well as monitoring elements in place to manage these risks. Collecting indicator data about key risks to monitor exposure levels to operating risks is also part of this process. The following indicators act as an initial warning before the risk occurs:
iii) A proactive approach to operating risk management.
iv) Continuous and independent assessment of policies, procedures and Bank performance.
v) Compliance with the guidelines and regulations issued by regulatory bodies as well as international standards of risk management.
vi) Regular reporting to the Bank's Executive Management and Board of Directors about risk assessment and operating losses, as well as corrective measures put in place to manage the risks.

5. **Fraud Risk:**
Fraud risks are among the operating risks to which organizations, including banking organizations, are often exposed. To this end, the Bank focuses on implementing best practices and meeting the requirements of relevant regulatory and supervisory bodies in order to limit exposure to such risks. The Bank has developed relevant policies and procedures focused on raising awareness among its employees and clients about ways to detect fraud, and has implemented techniques to measure and limit fraud risk by evaluating such risks and implementing controls covering any vulnerabilities to avoid isolated or repeated exposure to risk. Fraud risk evaluation is applied to existing and new products. The Bank has developed further monitoring mechanisms applied to its operations, as well as indicators that examine such operations based on approved standards. It continues to improve on existing systems to increase the efficiency of monitoring and fraud detection efforts, offering improved channels through which employees and clients can report fraud or suspected fraud, in accordance with the rules and standards of regulatory and supervisory bodies, and in line with the Bank's strategy aiming towards keeping fraud risk within acceptable levels.

6. **Information Security Risk:**
In view of the increased reliance on information and telecommunication technologies, there is an increased risk, both emerging and potential, that could critically threaten companies' networks and information security. The Bank's Information Security Department is responsible for supporting the growth of the Bank's IT capability by mitigating information technology risks. This is achieved by applying information security standards within the organization, which include Availability, Integration and Confidentiality. These efforts go hand in hand with a continuous evaluation of risks to ensure that they cover all tech-related weaknesses within services and technologies adopted by the Bank in order to service its client base. Evaluating information security risks includes the following steps:

i) Taking part in the process of evaluating any new services or changes adopted by the Bank in its efforts to improve e-services.
ii) Evaluating and detecting security gaps within the Bank's offering, by looking for any vulnerabilities existing in highly sensitive data systems, which may occur due to the digital transformation within the organization.
iii) Overseeing implementation of compliance with relevant regulations, making sure cyber security controls are properly and adequately implemented.

## BUSINESS CONTINUITY

The Bank recognizes the criticality of business continuity and has a robust Business Continuity Plan (BCP) to enable it to respond to any serious and/or disruptive incident in a timely and appropriate manner. During 2019, two comprehensive tests were carried out to ensure the effectiveness of the Plan. In addition, a continuous ten-day recovery test was conducted on all mission-critical IT operations by switching them over to the Bank's Disaster Recovery Centre (DRC). The Bank will continue to upgrade its disaster recovery capabilities, as well as provide ongoing training specific to business continuity, to ensure its optimum response capability in the event of a major incident. The Bank has already begun establishing a new DRC which will be completed in 2020.

## COMPLIANCE

Compliance is an independent function that identifies, assesses and provides advice, monitors and reports on risks of a bank's non-compliance related to its exposure to legal and administrative penalties, financial loss, or what may undermine the bank's reputation due to its failure to abide by the regulations and controls or sound standards of conduct and professional practice.

### COMPLIANCE AND ANTI-MONEY LAUNDRY ROLE

The Compliance and Anti-Money Laundering division plays an essential role in maintaining the reputation, credibility, and interest of shareholders and depositors, and protecting them from penalties. Compliance and AML division has a number of broad roles and responsibilities. Some of the specific functions under this are:

- Prevention of risks, especially systematic, reputation and financial penalties risks
- Consolidate relations with regulatory entities
- Establish mechanisms and frameworks to ensure preventing any banking channels from being used to commit crimes such as money laundering and terrorist financing
- Reviewing and monitoring all the Bank's procedures, products, services, forms, contracts and agreements, to ensure they comply with all relevant laws and regulations
- Reporting on non-compliance issues and recommending processes to resolve the identified issues

### MONITORING AND ASSESSMENT OF COMPLIANCE RISK

The Compliance and AML division responsible for the assessment and monitoring on the effectiveness of implementing all regulations, policies and rules issued by the regulatory and legislative authorities on the Bank's polices, manuals, procedures, products, and services.

### COMPLIANCE INITIATIVES

Bank Albilad aims to enhance the culture of compliance and AML in its employees and the community.

One of the compliance functions is to organize the education and awareness of staff on compliance and AML subjects. The Bank continuously conducts training on compliance, including AML & CTF training to all employees to enhance their knowledge of all relevant compliance regulations, and to upgrade their skills and capabilities in the compliance area, such as professional certified training to compliance employees, online courses to the Bank's employees, and training for new hires which emphasizes compliance and AML. Further, our Compliance and AML training extends to the Board of Directors where we train relevant knowledge on Bank Albilad's compliance rules.

In addition, the Compliance and Anti-Money Laundering Division educates the community through cooperation with universities to provide awareness lectures to students. Bank Albilad is committed to follow the rules and regulations to protect the Bank and its customers from risks. Documents have been prepared for the Bank's employees on the appropriate implementation of compliance regulations, rules, and standards through policies and procedures and other documents such as compliance manual and internal rules.

### HUMAN RESOURCES POLICY

The Bank's commitment to rules, regulations, instructions and policies is one of the most important bases and factors of success, excellence and maintenance of its reputation and credibility. It is obligatory, therefore, that all the Bank's staff shall know and adhere to the regulations, instructions and polices related to the work and tasks assigned thereto, and apply them without any violation, breach or negligence.