OPPORTUNITY BANK MALAWI

BASEL II DISCLOSURES 2012/2013

Contents

1.0 Introduction

Opportunity International Bank of Malawi is an implementing member of the Opportunity International Network (OIN). Established in 1971, Opportunity International Network (Opportunity) is a global leader in providing a full spectrum of financial services to individuals in the poorest and most hard-to-reach areas of the developing world. Opportunity International operates 33 microfinance institutions (MFIs) in urban and rural areas of 20 developing countries. Globally, Opportunity is reaching more than 1 million voluntary depositors, 1.4 million active loan clients and 2.5 million people with a range of products.

In Malawi, Opportunity Bank is focused towards providing financial services to economically marginalised Malawians and has presence in all the 28 districts in the country through various delivery channels. Opportunity bank has products and services tailored towards the needs of this targeted market, hence offers micro loans and micro savings products with features that are easily met by the low income people in Malawi.

The nature of the business that Opportunity Bank is involved in exposes the bank to various risks mostly due to the nature of the customers that the bank deals with. The bank is therefore exposed to a significant amount of credit risk, operational risk and also market related risks. By being highly concentrated in the low income segment of the market the bank is also significantly exposed to any unfavourable trends in the macroeconomic conditions since the majority of the people affected by any unfavourable trends, which are the key target customer base for the bank, do not have alternative means of survival in case of erosion of their disposable incomes due to tough economic conditions

In order to mitigate the above risks, the bank operates under the framework of which is tailored towards reducing the potential impact of these risks. The framework include an active board and senior management oversight, adequate policies, procedures and limits, adequate risk measurement, monitoring and management information system and comprehensive internal controls

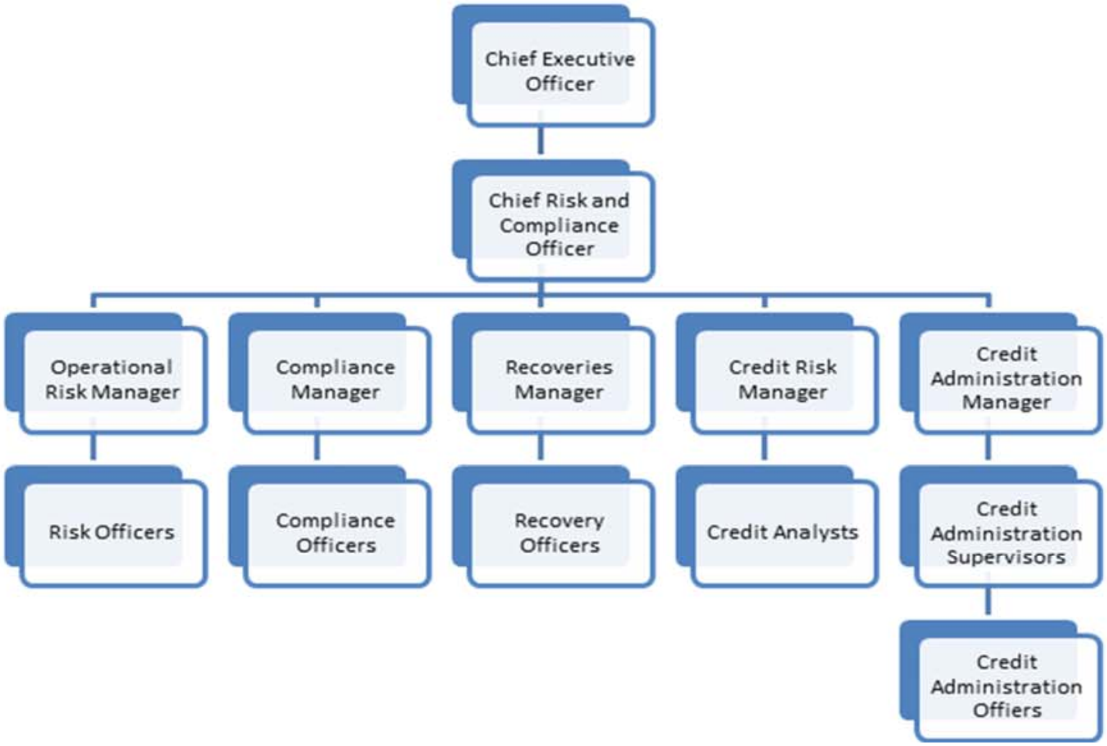
The overall risk management of the bank is the responsibility of the Risk and Compliance department. The Department is responsible for:

- Identification of current and emerging risks
- Development of risk assessment and measurement systems

- Establishment of policies, practices and other control mechanisms to manage risk
- Development of risk tolerance limits for senior management and Board Approval
- Monitoring of positions against approved limits
- Reporting results of risk monitoring to senior management and the Board.

1.1 Structure of the Risk Function

The Structure of the Risk Department is as outlined below:



The risk management function is divided into five key functions which focus on different risk areas:

1.1.1 Operation Risk Function

Tasked with the role of monitoring and controlling all operational risks in the bank. The function works with all functional heads and branch managers to address and minimise losses arising from processes, people and other operational events i.e. frauds.

1.1.2 Credit Risk Function

This function is tasked with the monitoring of the quality of the bank's loan book through the implementation of sound credit approval and management policies. The function therefore works with branches in addressing and minimising any losses arising from credit underwriting and monitoring lapses.

1.1.3. Recoveries Function

This function is focused on recovering all non-performing loans and also all written off loans. With representation in all branches with significant loan book values and low quality loan books, the function works with branches in spearheading the necessary actions required to minimise the migration of bad loans and also in collecting all non-performing loans.

1.1.4 Compliance Function

This function is focused on ensuring that all departments are operating within the stipulated policies and procedures as approved by the board. The function is also involved in resolving all audit queries in liaison with departmental heads and all branch managers.

1.1.5 Credit Administration Function

This function is aimed at undertaking various backend processes for credit ensuring that all loan disbursements have been done in line with policy and is also tasked with perfecting the collaterals offered by customers. The unit is also tasked with ensuring that that the credit archiving and retrieval of files is efficient and in line with procedure.

While the overall risk management is the responsibility of the Risk function, business units are equally responsible for the risks they undertake. The bank considers that the first line of defence against losses is the business unit and has put in place limits and risk monitoring mechanisms within the business Unit.:

1.1.6 Active Board and Senior Management Oversight

Banking as a business is inherently risky and the bank has in place an oversight structure to ensure that risks are properly managed. It has an active Board Committee which is responsible for approving its risk appetite. The Board approves Policies and procedures, approves the strategic plan and responsible for overseeing the implementation of policies and plans by senior management of the bank. The Board oversees risk management through the Risk and Finance Committee, The Audit Committee and the Human Resources, Transformation and Information Technology Committees.

Senior management is responsible for implementation of strategies, policies and procedures. The senior management receive reports from departments showing developments in implementation of strategies and adherence to policies and procedures.

1.1.7 Adequate policies, procedures and limits

The bank has adequate policies, procedures and limits that are consistent with its operations. The bank has policies and procedures in all major areas of activity which include Customer Accounts, Lending, Finance and Treasury, Human Resources and Information Technology (IT). The policies and procedures are reviewed and modified where necessary to respond to significant changes in business conditions.

1.1.8 Adequate risk measurement, monitoring and management information system

Risk measurement is core to the risk management of the bank. This first level measure is done by the business unit which will ensure the set limits are complied with. The second level is by the risk function which will advise business/department units in cases where the set limits are violated. The management information system is the main source of the information for measuring risk. There are several reports in the system that measure risk.

1.1.9 Comprehensive internal controls

The bank Comprehensive internal controls have been put in place. This is a clear line of authority and separation of duties. Clear reporting lines are incorporated in the organization chart. The bank's information system enforces the separation of duties through a system of origination of transactions and approval.

The Internal audit function in the bank reviews the effectiveness of internal controls. The department takes a risk based approach to audit to ensure that the areas with high risk are audited and any corrective action taken.

While the overall risk management is the responsibility of the Risk function, business units are equally responsible for the risks they undertake. The bank considers that the first line of defence against losses is the business unit and has put in place limits and risk monitoring mechanisms within the business unit.

1.1.10 Treatment of newly identified risk

When a new risk is identified, a discussion of the risk with the department from which the risk has arisen will take place. The Internal Audit department is also be part of the discussion. The discussion is aimed at establishing how the risk will be measured monitored and mitigated. The discussion will result in a change in policy or procedures.

1.1.11 New product development process

In order to meet the needs of clients the bank usually comes up with new products. The new product will undergo a new product development process involving the specification of the product. The risks arising from offering the product are discussed and controls and mitigation mechanism put in place.

2.0 Corporate Structure

Opportunity International Bank of Malawi Limited is a registered commercial Bank, which targets the entrepreneurial poor and disadvantaged people of Malawi in underserved areas including peri-urban and rural areas providing them broader access to financial services, particularly deposit and credit services. Opportunity Bank, Malawi is an implementing member of the Opportunity International Network (OIN). Established in 1971, Opportunity International Network (Opportunity) is a global leader in providing a full spectrum of financial services to individuals in the poorest and most hard-to-reach areas of the developing world. Opportunity International operates 33 microfinance institutions (MFIs) in urban and rural areas of 20 developing countries. Globally, Opportunity is reaching more than 1 million voluntary depositors, 1.4 million active loan clients and 2.5 million people with a range of products

2.1 Shareholding

The shareholders and their respective holdings as of December 2012 are:

	2012	2011	**2012 Class A Shares**	2011 Class A Shares	**2012 Class B Shares**	2011 Class B Shares
Opportunity Transformation Investment	**53.50%**	51.2%	**56,480**	56,480	**318,590**	174,640
Opportunity Micro-Finance Investment	**42.00%**	45.4%	**21,358**	21,358	**273,111**	183,448
Trust for Transformation	**0.53%**	0.8%	**3,700**	3,700	**-**	-
Africap Microfinance Fund	**1.67%**	2.6%	**11,707**	11,707	**-**	-
Opportunity International Canada	**2.3%**	-	-	-	**16,135**	-
	100.0%	100.0%	**93,245**	93,245	**607,836**	358,088

2.1. Directors

The particulars of the directors who served office during the year 2012 are as follows:

Francis Pelekamoyo	-	Full Year
Dyborn Chibonga	-	Full year
John Ford	-	Full year
Colin McCormack	-	Full year
Anne-Marie Chidzero	-	Up to 16 April 2012
David Smith	-	From 31 August 2012
Keith Flintham	-	From 23 July 2012
Innocentia Ottober	-	Full year
Christina Chithila	-	Full year
Evelyn Itimu	-	Full year

2.2 Services and products

The Bank offers the following services through different types of channels:

- 4 Main Branches
- 10 Satellite Branches
- 17 Kiosk Branches
- 11 Mobile Van Branch
- Cell phone Banking (Banki M'manja): Funds transfers, Balance enquiry, Third-party bill payment, and Information services.

The Bank offers a wide array of products and services to its clients through its branch outlets, including:-

Lending products:

- Group and Individual loans to micro businesses, smallholder farmers and youth, as well as Small-Medium Enterprise and Consumer loans (housing, school proprietor, payroll).

Deposit products:

- Ordinary savings, Fixed deposit, Premium Investment Account, School fee savings, Youth savings, Business savings, Group Savings- Foreign currency denominated accounts (FCDA), Foreign exchange drafts, Insurance products (as agent of Nico Limited and Old Mutual Limited): Life insurance, non-life insurance, weather-index crop insurance.

3.0 Capital

At all times the bank maintain adequate records, including daily balance sheets and periodic statements of income and expense in order to enable proper computation of its capital adequacy in line with regulatory requirements. As of December 2012 the bank's was using the Basel I framework for calculating its capital adequacy position in line with minimum ratios as outlined in the directive for minimum capital requirements for banks in Malawi. The table below is a composition of the bank's capital as of December 2012**:**

Share Capital (Paid Up)	1,540,287,294.12
Share premium	1,208,149,322.64
General Reserve	-
Retained earnings- Prior years	(688,602,411.70)
Net income (loss) - Current period (60%)	(437,012,193.51)
Less: Investment in unconsolidated subsidiaries	-
Tier 1 Core Capital	1,622,822,011.55
Add: Revaluation reserves (fixed assets)	522,858,875.35
Provisions for loan losses (general only)	104,412,028.33
Total Capital (Tier 1 & Tier 2)	2,250,092,915.23

In line with the prudential guidelines for computation of capital adequacy for banks, Opportunity Bank's capital adequacy position as of 2012 was as outlined below:

RISK BASED ASSETS	Book Amount	Risk Conver %	Risk Adjusted Amount
Currency & coin (domestic and foreign)	947,729,097.06	0%	-
Balances with Reserve Bank of Malawi	103,813,619.11	0%	-
Balances with other banks (excl. resid. maturity > 1 yr)	1,734,822,866.15	20%	346,964,573.23
Cheques in the course of collection	17,967,994.00	20%	3,593,598.80
Malawi Government securities	-	0%	-
Malawi Government treasury bills	-	0%	-
Reserve Bank of Malawi day bills	-	0%	-
Other securities	-	100%	-
Loans to or guaranteed by Malawi Government	-	0%	-
Loans secured by cash deposits	28,179,889.11	0%	-
Loans guaranteed by OECD incorporated banks	-	20%	-
All other loans	3,916,226,737.08	100%	3,916,226,737.08
Fixed assets	3,684,096,264.29	100%	3,684,096,264.29
All other assets	329,677,769.64	100%	329,677,769.64
Contingent Claims	-		
Claims to or guaranteed by Government	-	-	-
Claims with cash collateral	-	-	-
Direct credit substitutes (guarantees, acceptances, etc.)	-	100%	-
Transaction related contingency (perf. bonds, standbys)	-	50%	-
Documentary credits etc (trade related & self liquidating)	-	20%	-
Other commitments with maturity of over 1 year	-	50%	-
Similar commitments of up to 1 year or which can be conditionally cancelled		-	-
TOTAL RISK-BASED ASSETS	**10,762,514,236.44**		**8,280,558,943.04**
TIER 1 Risk-Based Capital Ratio			**20%**
TOTAL (T1&2) Risk-Based Ratio			**27%**

The bank has been making progress towards the implementation of Basel II, including the risk management frameworks for managing credit, operational and markets risks. As part of the requirements under Basel II pillar II the banks undertakes some internal capital adequacy assessment processes whereby the bank runs projections of its capital adequacy positions in line with business growth and projections and also in line with expected stressed scenarios. As part of its capital adequacy assessment under Pillar one the bank has adopted the following approaches for calculating its capital adequacy positions:

Risk Area	Approach Adopted
Credit Risk	Standardised approach
Operational Risk	Basic Indicator approach
Market Risk	Standardised Measurement approach

The capital adequacy position is reviewed every quarter by the board and appropriate action is undertaken in roder to ensure that the bank remains within the required minimum ratios at all times. For the year 2013, the bank undertook the capital adequacy assessment process through a consultative process between all business functions. The results of the assessment processes shows that the bank will be adequately capitalised in line with Basel II minimum ratios for both 2013 and 2014. This assumes that the bank remains profitable and achieves its annual targets for 2013 and 2014. Under assumed stressed scenarios, the bank will need to increase its capital injections and the board is committed to undertaking any further capital injections in line with the needs.

The table below is a summary of the projected capital adequacy positions or December 2013 and December 2014 under Basel II:

Projected Capital Adequacy Ratios (Basel II)		
	2013	2014
Share Capital (Paid-Up)	1,981,887,882	1,981,887,882
Paid-Up Non-Cumulative Perpetual Preference Shares		
Share Premium	2,179,667,688	2,179,667,688
Retained Profits/(accumulated losses)	- 889,344,457	- 820,130,656
Current Year Profits /losses	69,213,801	134,848,174
Current Year Profits (60%)	41,528,281	80,908,904
NET-TOTAL TIER 1 CAPITAL	**3,313,739,393**	**3,422,333,818**
Hybrid (debt/equity) Capital Instruments		
Eligible Subordinated Term Debt (limited to 50% of total Tier 1)		
Asset Revaluation Reserves	510,328,511	510,328,511
General Provisions (limited to 1.25% of risk-weighted assets)	107,121,164	263,663,279
TOTAL TIER 2 CAPITAL	**617,449,675**	**773,991,790**
Total Risk-weighted Amount for Credit Risk	12,568,326,267	12,666,197,444
Calibrated Risk-weighted Amount for Operational Risk	5,711,883,609	8,246,864,914
Calibrated Risk-weighted Amount for Market Risk	180,000,000	180,000,000
AGGREGATE RISK-WEIGHTED ASSETS	**18,460,209,876**	**21,093,062,358**
TOTAL RISK-WEIGHTED CAPITAL RATIO (Minimum 15%)	**21.30%**	**19.89%**
TIER 1 RISK-BASED CAPITAL RATIO (Minimum 10%)	**17.95%**	**16.22%**

4.0 Credit risk

Credit risk is the risk that a financial obligation will not be honored by counterparty, and exists in lending and other trading activities. It arises principally from the Bank's loans and advances to customers and other Banks, cash and cash equivalents, staff loans and advances and other receivables.

The Bank mitigates credit risk by proactively managing it. Lending and other facilities are granted only if the level of risk is acceptable. This is achieved by thoroughly evaluating customers' credit worthiness before facilities are granted. Even after the facilities are granted, the Bank continues to monitor customers' performance so that timely corrective action can be taken should circumstances demand. Various committees and structures are in place for sanctioning large facilities and monitoring customers' performances.

4.1 Management of credit risk

The Board of Directors has delegated the responsibility of the management of credit risk to its Risk and Finance Committee. The This committee of the board is responsible for oversight of the credit risk, including:

- **Formulating credit policies** in consultation with business units, covering collateral requirements, credit assessment, risk grading and reporting, documentary and legal procedures, and compliance with regulatory and statutory requirements.
- **Establishing the authorisation structure:** This includes a structure for approvals and renewals of credit facilities. Authorisation limits are provided to credit officers and credit committees. Large credit limits require approval by the Board.
- **Reviewing and assessing credit risk**. The Credit Department assesses all credit exposures and prepares a watch list which includes all those clients which have exceeded their limits or repayments are in arrears.
- **Limit concentration of exposure** to counterparts' location and type of customer in relation to the Banks loans and advances to customers by carrying a balanced portfolio.
- **Reviewing compliance by the risk department** so that exposure limits remain within the acceptable range.
- **Providing advice, guidance and specialist skills** to business units to promote best practice throughout the Bank in the management of credit risk.

In addition the bank has full time Credit Risk Manager who monitors credit risk across the bank and takes appropriate action to minimise the risk, through follow ups with business areas where credit risk is high and by the formulation of polices that will address and minimise credit risk for board consideration and approval. Regular audits of business units and credit processes are further undertaken by the Internal Audit department.

4.1.1 Delinquency Management

In addition the board has set the following policies with respect to management of past due and impaired loans as part of its delinquency management process:

Number of Days in Areas	Action Taken/Notice Given	Responsible Position
2 Days	Establish Reason for Arrear	Relationship Officer
7 Days	1st Notice of late payment	Relationship Officer
14 Days	2nd Notice of Late payment	Relationship Officer and Relationship Supervisor
30 Days	3rd and Final Notice of Late Payment	Relationship Officer and Branch Manager
45 Days	Demand Letter	Relationship Officer and Recoveries Officer
60 Days	Seizure Warrant	Recoveries Officer and External Debt Collector

4.1.2 Loan Loss Provisioning

The bank ensures adequate provision of all past due exposures in accordance with applicable accounting standards. The bank's loans loss provisioning guideline for Macro and Micro loans is as follows:

4.1.2.1 Macro credits

Classification Category	Number of days	Amount prov---ided for	Remarks

Standard	Current	2 % for all loans except for overdraft facilities which should be provisioned at 4%	Debtor is complying and expected to continue to comply with all terms and there is no reason to suspect risk of loss. This is a general provision which is made on net unsecured credit balance less specific provision and interest in suspense.
Special Mention	31-89 days PD	10%	Debts whose potential weaknesses if unaddressed could result in deterioration of the repayment prospects. This is specific provision.
Substandard	=>90 days to 179 days PD	20%	Repayment capacity is unfavourable and deteriorating; pledged collateral is deteriorating or is insufficient; contract is actually breached. These assets shall be placed on nonaccrual status. The bank shall cease reflecting in its net income the accrual of interest; uncollected interest which has previously been accrued shall be reversed and interest shall no longer be accounted for as income except as received in cash. Restoration to accrual status will only happen if all payments in PD + IN have been paid and debt is current or if debtor has resumed paying full amount of P+IN for at least 6 months. This is a specific provision.

Doubtful	50%	=>180 days to 364 days	Repayment of debt in full is highly questionable; probability of loss is very high based on currently existing circumstances (classification can be deferred if circumstances change for the better). This is a specific provision.
Loss	100%	=>365 days	Uncollectible asset. Should be written off but bank should continue chasing it.

4.1.2.2 Micro credits:

Classification Category	Number of days	Amount to provide for to be in line with OIN Policies	Remarks
Standard	1-29	5%	This is general provision which is made on outstanding credit balances less specific provision and interest in suspense
Special Mention	30-59	20%	Debts whose potential weaknesses if unaddressed could result in deterioration of the repayment prospects. This is specific provision
Substandard	60-89	40%	Repayment capacity is unfavourable and deteriorating; pledged collateral is deteriorating or is insufficient; contract is actually breached. These assets shall be placed on nonaccrual status. The bank shall cease reflecting in its net income

			the accrual of interest; uncollected interest which has previously been accrued shall be reversed and interest shall no longer be accounted for as income except as received in cash. Restoration to accrual status will only happen if all payments in PD + IN have been paid and debt is current or if debtor has resumed paying full amount of P+IN for at least 6 months. This is a specific provision.
Doubtful	90-119	60%	Repayment of debt in full is highly questionable; probability of loss is very high based on currently existing circumstances (classification can be deferred if circumstances change for the better). This is a specific provision.
Loss	=>120	100%	Uncollectible asset. Should be written off but bank should continue chasing it.

The Bank reserves the right to apply a subjective standard or criteria to any loan when it is more conservative than the objective criteria. For example, a loan that has no payment activity at all for 60 days may be classified as substandard rather than special mention and may be placed on NAB rather than wait until the loan reaches 90 days late.

At NAB status, all previously accrued and posted interest and charges not yet paid will be reversed out and placed into a suspense account.

The decision to place an asset on non-accrual status shall be made regardless of any collateral held against it.

Every quarter loans that are delinquent for more than 365 days or subjectively considered uncollectible are to be written off against the provisions earlier created. Where shortfalls exist the balances shall be written off against the bank's Profit and Loss. A Write-off register shall be maintained.

All attempts will be made to collect written-off loans, although they are removed from the portfolio. In the event that payment is received on a loan that is written off, it will be recorded appropriately in the bank's records Loan recoveries and entries marked in the Write-off register shall be maintained.

4.2 Exposure to credit risk

The carrying amount of financial assets represents the maximum credit exposure. The maximum exposure to credit risk as of December 2012 was as follows:

In thousands of Malawi Kwacha	**2012**	2011
Cash and cash equivalents	3,329,794	4,612,169
Loans and advances to customers	3,751,425	3,226,527
Staff loans and advances	54,741	88,218
Other receivables	326,951	290,171
TOTAL	7,462,911	8,217,085

The customer's loans and advances of the Bank and its exposure to credit risk comprise:

	2012	2011
Standard (fully performing)	**3,732,431**	3,396,411
Past due but not impaired	**68,536**	145,553
Impaired	**259,921**	551,388
	4,060,888	3,993,637
Past due but not impaired loans and advances comprise:		
30 – 60 days	**32,846**	48,932
60 – 90 days	**35,690**	96,621
	68,536	145,553

The Bank follows the guidelines of Reserve Bank of Malawi on asset classification. When a loan is not serviced for more than 30 days from the date it is due, it is classified as special mention (past due) and when it is not serviced for more than 90 days, it is classified as impaired.

The Bank holds collateral against loans and advances to customers in the form of mortgage interests over property, charges over moveable assets and guarantees. Estimates of fair value of collateral are based on the value assessed at the time of borrowing and generally not updated except when an individual loan becomes impaired.

An estimate of the fair value of collateral held against leases and loans and advances to customers is shown below:

Against individually impaired		
Guarantees	**17,736**	9,033
Property	**147,828**	252,937
Bill of sales and Power of Attorney	**130,070**	189,703
	295,634	451,673
Against past due but not impaired		
Guarantees	**1,368**	6,050
Property	**18,232**	80,793
Bill of sales and Power of Attorney	**13,248**	58,710
	32,848	145,553
Against neither past due nor impaired		
Guarantees	**706,877**	511,812
Cash	**458,666**	361,335
Property	**1,225,799**	1,057,227
Bill of sales and Power of Attorney	**1,341,086**	1,466,037
	3,732,431	3,396,411

Analysis of gross loans and advances by sector

	2012	2011
Community, Social and personal services	**510,858**	511,812
Wholesale and retail trade	**2,384,520**	2,618,674
Agriculture	**624,841**	37,374
Other (Payroll and Mphamvu**)**	**540,669**	925,492
TOTAL	**4,060,888**	4,093,352

5.0 Market Risk

Market risk is the risk that changes in market prices, such as interest rates and foreign exchange rates, will affect the Bank's income or the value of its holding of financial instruments. The objective of the Bank's market risk management policy is to manage and control market risk exposures within acceptable parameters while optimizing the return on risk.

5.1 Interest Rate Risk

Interest rate risk is the exposure of the bank's financial condition to adverse movements in interest rates. Accepting this risk is a normal part of banking and can be an important source of profitability and shareholder value. However, excessive interest rate risk can pose a significant threat to the bank's earnings and capital base.

Changes in interest rates affect the bank's earnings by changing its net interest income and the level of other interest sensitive income and operating expenses. Changes in interest rates also affect the underlying value of the bank's assets, liabilities and off-balance sheet instruments because they present value of future cash flows (and in some cases, the cash flows themselves) change when interest rates change. Accordingly, an effective risk management process that maintains interest rate risk within prudent levels is essential to the safety and soundness of the bank

The key sources of Interest Rate Risk within the bank include the following:

- **Re-pricing risk:** As a financial intermediary the bank encounters interest rate risk in several ways. The primary and most often form of interest rate risk arises from timing differences in the maturity (for fixed rate) and re-pricing (for floating rate) of bank assets, liabilities and off-balance-sheet (OBS) positions. While such re-pricing mismatches are fundamental to the business of banking, they can expose the bank's income and underlying economic value to unanticipated fluctuations as interest rates vary.
- **Basis risk:** Another important source of interest rate risk (commonly referred to as basis risk) arises from imperfect correlation in the adjustment of the rates earned and paid on different instruments with otherwise similar re-pricing characteristics. When interest rates change, these differences can give rise to unexpected changes in the cash flows and earnings spread between assets, liabilities and OBS instruments of similar maturities or re-pricing frequencies.

5.1.1 Management of Interest Rate Risk

The bank manages its interest rate exposures in line with the key indicators and assumptions made by ALCO regarding interest rate movements that may take place in the market. Certain reporting tools are used by the bank to ensure that the potential risk is identified. The tools include:

5.1.1.1 Gap Analysis:

The bank prepares maturity *gap analysis* reports or duration gap reports weekly. This tool measures the bank's interest rate risk exposure by distributing interest-sensitive assets (RSA), liabilities (RSL) and OBS positions into "time bands" according to their maturity (if fixed rate) or time remaining to their next re-pricing (if floating rate). This generates simple indicators of the interest rate risk sensitivity of both earnings and economic value to changing interest rates. The size of the gap for a given time band - that is, assets minus liabilities plus OBS exposures that re-price or mature within that time band - gives an indication of the bank's re-pricing risk exposure.

Gap Ratio (RSAs-RSLs)/total assets should be between +10% and -10%. A ratio within this range indicates low exposure to interest rate risk.

The *gap* is stress tested by measuring changes in interest rates that can affect profitability of the bank. The results of the "what if" analysis are considered as a general indication of magnitude and direction; they are not exact.

5.1.1.2 Interest Rate Spread

This is the difference between the interest rate paid on deposits and interest rate charged on loans. Spread is managed by loan pricing, deposit pricing, and investing. The Bank strives to have neither the lowest nor the highest loan or deposit rates in the market. Loans are priced in order to achieve a fair return on shareholder investment. Deposits are priced to provide fair treatment for the clients and to be reasonably competitive without increasing the Bank's cost of funds.

The Bank's spread management goal is to price loans and deposits in order to obtain an average interest **spread of 12%.** That goal is based on the following components

- **Yield on Earning Assets**: The yield on earning assets is the Bank's interest income (including loan fees) divided by its average earning assets.
- **Cost to Fund Earning Assets**: The cost to fund earning assets is the Bank's interest expense divided by its earning assets.
- **Interest Spread:** The interest spread is the yield on earning assets less the cost to fund earning assets.

  Interest rates are set by ALCO in accordance with the prevailing and expected macro-economic environment, competition, the liquidity position, as well as with the aim of achieving set objectives, plans, and the annual budget.

5.1.1.3 Interest Flexibility

The interest rate structure allows for flexibility to take into account important corporate clients as well as the liquidity of the Bank. As a basic rule, lending rates shall not be less than the base lending rate. The Chief Executive and Chief Relationship Officer and Chief Credit Officer under special circumstances approves lending rates below the base lending rate, of which the reduction does not exceed 2 percentage points.

The Chief Finance Officer also approves higher deposit rates on one off basis to big amounts for corporate customers if there is a perceived threat to the Banks liquidity provided that the cost of doing so is not higher than that which would be obtained from other sources of funding.

The overriding strategy will be to increase our deposits in the long term by not having higher deposit rates than the market but by the improvement of the Bank's image, reputation and service to customers.

The effective interest rates for the principal interest-bearing financial assets and financial liabilities at 31 December 2012 and 2011 were in the following ranges:-

	2012	2011
	%	%
Assets:		
Government securities	**20.1-26.4**	6-9
Deposits with Banking institution	**24.3-25.5**	5-8
Loans and advances to customers	**37-48**	23.5-39
(Flat interest rates on microcredit products)		
Liabilities:		
Customer deposits	**5-25**	5-14

Interest rate sensitivity analyses as on the reporting date are set out below:-

	Floating rate	Fixed rate 0-6 months	6-12 months	Over 12 months	Total
As at 31 December 2012					
Total rate sensitive assets	115,877	4,376,748	1,506,424	1,117,352	7,116,401
Total rate sensitive liabilities	(0)	(6,566,317)	(194,757)	(1,173,675)	(7,934,749)
Asset Liability Gap	**115,877**	**(2,189,569)**	**1,311,667**	**(56,323)**	**(818,348)**
Cumulative Gap	**115,877**	**(2,073,692)**	**(762,025)**	**(818,348)**	**(818,348)**
Impact of increase in interest rate					
5%	5,794	(109,478)	65,583	(2,816)	(40,917)
10%	11,588	(218,957)	131,166	(5,632)	(81,835)
15%	17,382	(328,435)	196,750	(8,449)	(122,752)
Impact of decrease in interest rate					
-5%	(5,794)	109,478	(65,583)	2,816	40,917
-10%	(11,588)	8,9572	(131,166)	5,632	81,835
-15%	(17,382)	328,435	(196,750)	8,449	122,752

5.2 Foreign exchange risk

Foreign exchange risk relates to the exposure of the Bank's foreign exchange position to adverse movements in foreign exchange rates. These movements may impact on the Bank's future cash flows. The Bank manages this risk by adhering to the exposure limits set internally and those set by the Reserve Bank of Malawi.

The responsibilities of the Treasury Department include monitoring of foreign exchange risk. Foreign exchange rate risk is the potential impact of adverse currency rates movements on earnings and economic value. This involves the risks of the Bank incurring financial loss on settlement of foreign exchange positions taken in both the trading and banking books. The foreign exchange positions arise from the following activities:-

- Trading in foreign currencies through spot, forward and option transactions as a market maker or position taker, arising from customer driven foreign exchange transactions.
- Holding foreign currency position in the bank books (e.g. in the form of loans, deposits, etc.)

5.2.1 Management of Foreign Exchange Risk:

The management of foreign exchange risk is coordinated by the Risk department in liaison with the Treasury department by undertaking the following

- Setting the foreign exchange risk management strategy and tolerance levels.
- Ensuring that effective risk management systems and internal controls are in place.
- Monitoring significant foreign exchange exposure.
- Ensuring that foreign exchange operations are supported by adequate management information systems which complement the risk management strategy
- Reviewing the policies, procedures and currency limits regularly in line with changes in the economic environment.

The ALCO regularly monitors the controls put in place by the treasury department, which are approved and reviewed by the board from time to time. The bank has also adopted various exposure limits to foreign currency. The aggregate exposure to foreign currency shall not at any time exceed 35% of the bank's total qualifying capital base. Intraday exposures, both in single currencies and overall, are maintained within the following prudential limits:

- USD limit 15% of capital
- GBP limit 15% of capital
- EUR limit 10% of capital
- ZAR limit 10% of capital

The Chief Finance Officer ensures that excess foreign exchange risk exposures are corrected immediately and no later than close of business the following day.

The Bank further calculates its individual currency and overall foreign exchange risk exposure on a daily basis using the Reserve Bank of Malawi prescribed forms.

As of December 2012, the financial instruments denominated in foreign currencies for the Bank were as follows:

	2012	2011
Financial assets		
Cash and cash equivalents		
United States Dollars	**1,289,458**	2,111,588
Great Britain Pounds	**399,267**	113,859
Euro	**1,680**	14,991
South African Rands	**46,927**	947
	1,737,332	2,241,385

	2012	2011
Financial liabilities		
Balance due to other banks	-	
Long term loans	**1,074,321**	2,012,552
	1,074,321	2,012,552
Net exposure to currency risk	**663,011**	228,833

5.3 Liquidity risk

Liquidity risk arises where the operations of the Bank cannot be funded due to mismatches in the cash flows of assets and liabilities within the statement of financial position. It includes both the risk of being unable to fund assets at appropriate maturities and rates and the risk of being unable to liquidate an asset at a reasonable price and in an appropriate time frame. The Bank's Assets and Liabilities Committee (ALCO) reviews the potential for these mismatches and takes measures to alter certain maturity profiles where necessary with a view to minimizing the impact of such mismatches.

5.3.1 Management of liquidity risk

The Bank's approach to managing liquidity is to ensure as far as possible that it will always have sufficient liquidity to meet its liabilities when due, both under stressed and normal conditions, without causing damage to the Bank's reputation.

The daily liquidity position is monitored and regular stress testing is done under normal and severe, market conditions. However, it is assumed that under normal circumstances customer demand deposits will remain stable or increase in value and unrecognised loan/ overdraft commitments are not expected to be immediately drawn down in their entirety.

All liquidity policies and procedures are subject to review and approval by the Asset Liability Committees (ALCO). These are management committees which meet once a month or more often if necessary. The daily monitoring of liquidity is the responsibility of an integrated treasury department which monitors the level of mismatches in the maturity positions of assets and liabilities

5.3.1.1 Asset and Liability Management Committee (ALCO)

The primary objective of the ALCO is to ensure a proper balance in terms of maturity profile, cost and yield, risk exposure etc. between funds mobilized and funds deployed. The ALCO seeks to manage risks in order to minimize the volatility of net interest income and protect the long term economic value of the Bank. The committee also monitors the capital adequacy of the Bank.

Key functions of the ALCO include setting pricing guidelines for assets and liabilities, setting limits and managing liquidity risk and interest rate risk and ensuring that contingency funding plans are in place to avert funding crises.

5.3.1.2 Liquidity requirement Reserve Requirement (LRR)

In accordance with central bank regulations each depository institution is required to maintain minimum cash balances in relation to the preceding week's total currency deposit liabilities, including government deposits. As at year end, the Liquidity Reserve Requirement (LRR) was at 15.50%. The Bank complied with this requirement throughout the year as evidenced by lack of violations or breaches of the same throughout the year.

The Reserve Bank has issued guidelines on the management of liquidity and how the Bank's liquidity will be monitored from time to time.

5.3.1.3 Net Liquidity

In line with the central bank's requirement that the Net Liquidity (total liquid assets less suspense accounts in foreign currency and cheques in the course of collection) divided by total deposits must be at least 20%, at the end of the year the Bank's Liquidity Ratio was 39% (2011: 40.9%).

The daily monitoring of liquidity is the responsibility of the treasury department which monitors the level of mismatches in the maturity positions of assets and liabilities.

The contractual maturity profile of the financial liabilities as at the reporting date was as follows:

	Carrying amount	Up to 3 month	3-12 months	1-5 years
As at 31 December 2012				
Non-derivative financial liabilities				
Customer deposits	6,749,707	4,704,339	1,906,693	138,675
Balances due to other banks	-	-	-	-
Other payables	743,854	743,854	-	-
Loans and Borrowings	1,074,321	-	39,322	1,035,000
Total financial liabilities	8,567,882	5,448,193	1,946,015	1,173,675
As at 31 December 2011				
Non-derivative financial liabilities				
Customer deposits	6,342,760	2,001,453	3,073,360	1,267,947
Balances due to other Banks	995,000	995,000	-	-
Other payables	482,057	482,057	-	-
Long-term loans	2,012,553	-	1,033,867	489,342
Total financial liabilities	9,832,370	3,478,510	4,107,227	1,757,289

6.0 Operational risk

This is the risk of losses arising from the operations of the Bank. Losses can occur due to system malfunctioning or failure to follow procedures. Operational risk manifests itself in losses, customer complaints and claims. To reduce risk, management continuously reviews the controls and procedures in place. Branch and Head Office departments employ risk officers in addition to internal auditing performed by the internal audit and Risk and Standard departments, which, periodically, determine whether the controls in place are commensurate with the risk involved. The results of Internal Audit reviews are discussed with the management of the business unit to which they relate, with summaries submitted to the Audit Committee and senior management of the Bank. Disaster recovery arrangements are also in place so that business can continue should major disruptions occur.

The objective of the Bank is to manage operational risks so as to balance the avoidance of financial losses and damages to the Bank's reputation with overall cost effectiveness and to avoid control procedures that restrict initiative and creativity.

The primary responsibility for the development and implementation of controls to address operational risk is assigned to senior management within each branch. The responsibility is supported by the development of overall standards in the group for the management of operational risks in the following areas:-

- Requirements for appropriate segregation of duties, including the independent authorisation of transactions
- Requirements for the reconciliation and monitoring of transactions
- Compliance with regulatory and other legal requirements
- Documentation of controls and procedures
- Requirements for the periodic assessment of operational risks faced through the identification of Key Risk Indicators, and the adequacy of controls and procedures to address the risks identified through Risk Self-Assessment templates
- Requirements for the reporting of Operational Loss Data and proposed remedial action
- Development of contingency plans
- Training and professional development
- Ethical and business standards.

Compliance with the Bank standards is supported by a programme of periodic reviews undertaken by Internal Audit. The results of Internal Audit reviews are discussed with the management of the business unit to which they relate, with summaries submitted to the relevant Audit Committee.

For purposes of capital calculations under Basel II, the bank has adopted the Basic Indicator approach for determining the risk weighted capital charge for operational risk. Under this method the bank aggregates the gross income for the bank for the past three years and multiplies the same by a capital charge of 15%.