Our approach to risk management and control continued to evolve during the year to reflect best practice. Sustainable profitability forms the core objective of the Group's risk management strategy.

Every risk assumed by the Group carries potential for gains as well as potential to erode shareholders' value. Risk management policy is designed to identify, capture and analyse these risks at an early stage, continuously measure and monitor these risks and to set limits, policies and procedures to control them to ensure sustainable risk-taking and sufficient returns. Seven types of risk identified are strategic, capital, credit, market, funding, operational and legal risks.

Managing Risks

The Risk Governing Bodies

Managing risks is the responsibility of every unit within the Group. Nevertheless, the Group has set up committees where risk issues are centrally reviewed for management attention and bank wide decisions. They comprise the Board of Directors, the Risk Management Committee of Directors and the Executive Risk Management Committees. As the Board of every licensed banking institution within the Group continues to be responsible for the management of risks in their respective entity, these key risk governing structures are set up in each of the three licensed banking institutions, i.e. AmBank Berhad, AmMerchant Bank Berhad and AmFinance Berhad (the term Bank hereinafter in this section shall refer to each licensed banking institution of the Group).

Board Overview

The focus on risk and risk management policies begins at the most senior level of the Bank, i.e the Board of Directors who:

- approves the risk management strategy of the Bank and sets the broad risk tolerance level for the Bank; and
- approves the engagement of new products or activities after taking into account the risk bearing capacity and readiness of the Bank.

The Risk Management Committee of Directors assists the Boards in discharging their functions and overseeing the executive body by having a more focused forum on risk issues. The Committee is independent from management and comprises only non-executive directors. The Committee:

- ensures that risks at all levels are managed effectively and the Board's risk tolerance level is effectively enforced; and
- reviews high-level risk exposures and management decisions to ensure that they are within the overall interests of the Bank.

Management

The Executive Risk Management Committee carries out the day-to-day management of risks and implements the Board's approved risk management policies. The Committees are chaired by senior level executives and participated by relevant senior executives of both the business and non-business units. The Committee:

- implements the risk strategy and capital allocation decision of the Board and Risk Management Committee of Directors;
- reviews risk exposures of the Bank and the environment, and sets appropriate risk positioning strategy;
- assesses Bank's ability to accommodate risks under normal and stress scenario;
- reviews compliance with limits or constraints set;
- monitors and assesses risk-return profile; and
- evaluates and approve recommendations made by the risk management and business units.

At the Group level, the consolidated risks of the three banking institutions within the Group are reviewed and discussed at the Group Risk Forum. The Forum is represented by the banks' chief executive officers, heads of risk management and other key senior executives of the three banking institutions.

- The Forum reviews all risks and sets uniform standards in risk measurement and risk tolerance for the Group. The Forum discusses and makes decisions on common risk issues for adoption across the Group.

Risk Management Department

The Risk Management Department is independent of business units and reports directly to the Managing Director. It serves to assist the Executive Risk Management Committees in discharging their duties and implementing the directives of the committees. The major role of the Risk Management Department is to:

- be a central platform for which risks throughout the Bank can be aggregated for overview on a portfolio basis;
- standardise risk measurement methodology to enable comparability;
- act as a central resource for evaluating risks to assist management, business and operating units; and
- recommend means to control or minimise risks on a portfolio basis.

The Risk Management Department is made up of several units to provide a comprehensive coverage of all risks in the Bank. Their functions encompass research and analysis, risk exposure reporting, limit compliance monitoring, formulation of risk assessment methodology and formulation of the Bank's risk strategies.

To achieve Group harmonisation, risk measurement and evaluation methodologies are being standardised across the Group. The resources of the research and development function within each entities' risk management department are mobilised as a central resource for the Group with each risk management department developing specific expertise in certain risk areas.

Internal Audit Department

Complementing the above risk machinery, the Internal Audit Department assists the Audit Committee and the Board by providing an independent assessment on the effectiveness of the risk management structure, control systems and methodologies used to manage risks.

THE BANKING GROUP'S RISK MANAGEMENT GOALS

- All significant risks in the Bank must be recognised and managed as far as possible.
- Centralised overview, accountability and management of risks in the Bank in order for risks to be considered and evaluated from a complete organisational perspective.
- A uniform risk language for quantifiable risks that permit comparability and risk aggregation.
- Better awareness, grading and development of risk indicators on non-quantifiable risks for assessing risks.
- The Bank only takes risks that it can accommodate.
- Risk taking activities must generate sufficient profits to cover the expected losses that can arise from their inherent risks in the long-run.
- A balance must be achieved between revenue expectations and risks involved in relation to any activity consideration.

The Risk Management Approach

The management approaches towards the significant risks of the Company are enumerated in the following paragraphs.

Market risk is the risk of loss from changes in the value of portfolios and financial instruments caused by movements in market variables, such as interest rates and foreign exchange rates, credit spreads and equity prices.

The primary objective of market risk management is to ensure that losses from market risk can be promptly arrested and risk positions are sufficiently liquid so as to enable the Company to reduce its position without incurring potential loss that is beyond its sustainability.

Market Risk Management Structure

Market risk management is the responsibility of the Executive Risk Management Committee in charge of market risk. Its members and invitees include senior management of business and support units, such as Treasury, Risk Management and Finance Departments.

Market risk policies as approved by the Committee are implemented by the appropriate business units and if necessary are monitored and reported back to Committee by Treasury and/or Risk Management Department(s). The Committee reports to the Risk Management Committee of Directors on a quarterly basis on the market risk position and highlights major issues discussed.

Risk Management Method

The market risk of the trading and non-trading portfolio is managed separately. The duration-weighted-gap value-at-risk (DWG VAR) approach to compute market risk exposure for non-trading portfolio and parametric value-at-risk (parametric VAR) as well as a 25 basis point movement sensitivity analysis for its trading portfolio.

Value-At-Risk: the potential loss a portfolio is expected to incur over a specified time period, within a specified probability under normal market conditions.

The market risk exposure of its trading and non-trading activities is primarily controlled through a series of limits. Stop loss, parametric VAR and position sensitivity limits govern the trading activities while the DWG VAR limits governs the non-trading positions. Each relevant business desk is assigned month-to-date, quarter-to-date and year-to-date stop loss limits based on the business profitability budget. VAR limits are used to control the size of risk positions to ensure they are within sustainable capacity of the Company. Approved by the Board of Directors, these limit structure aligns specific risk-taking activities with the overall risk appetite of the Company and of its individual business units.

All business units are expected to maintain their exposure within assigned limits. If a limit is exceeded, business units are responsible to reduce their exposure immediately to a level within the limit. Where this is not possible, senior management is consulted on the appropriate method to address the exposure. Together, these techniques reduce the likelihood that trading and non-trading losses will exceed the risk appetite of the Company. These limits are reviewed regularly in line with the Company's quarterly performance.

To complement VAR, the Company has a set of scenario analysis that serves as an indicator of the change in portfolio value under various potential market conditions such as shifts in currency rates, general equity prices and interest rates, and yield curve shifts.

Funding Risk Management Objectives

Funding risk is the risk that the organisation will not be able to fund its day-to-day operations at a reasonable cost.

The primary objective of funding risk management framework is to ensure the availability of sufficient funds at a reasonable cost to honour all financial commitments as it comes due.

The secondary objective is to ensure an optimal funding structure and to balance the key funding risk management objectives, which includes diversification of funding sources, customer base, and maturity period.

Funding Risk Management Structure

Funding risk management is the responsibility of the Executive Risk Management Committee in charge of funding risk. Its members and invitees include senior management of business and support units, such as Treasury, Risk Management and Finance Departments.

Funding risk policies approved by the Committee are implemented by the appropriate business units and if necessary monitored and reported back to the Committee by Treasury and/or Risk Management Departments. The Committee reports to the Risk Management Committee of Directors on a quarterly basis on the funding risk position of the bank and highlights major issues discussed.

Management Method

The ongoing funding risk management is based on the following key strategies:

- Management of cash-flow, through maintenance of adequate cash and liquefiable assets over and above what is required by BNM in their cash flow maturity mismatch framework.
- Scenario analysis, new business, changes in portfolio as well as stress scenarios based on historical experience of large withdrawals.
- Diversification and stabilisation of liabilities through management of funding sources, diversification of customer depositor base and inter-bank exposures.

The measures utilised for funding risk management is varied and ranges from daily to monthly monitoring and reporting. These include weekly cash flows, daily monitoring of depositors and relevant key ratios and monthly reporting to the Committee on the measures as well as any breaches of limits, if any.

Contingency Funding Plan

The Contingency Funding Plan provides a formal process to identify a funding crisis. Detailed responsibilities among the relevant departments are also specified to ensure orderly execution of procedures to restore the funding position and confidence in the Company during actual crisis.

Credit Risk Management Objectives

Credit risk is the risk of loss due to the inability or unwillingness of a counterparty to meet its payment obligations. Exposure to credit risk arises primarily from lending activities and, to a lesser extent, pre-settlement and settlement exposures of sales and trading activities.

The primary objective of credit risk management framework is to ensure that exposure to credit risk is always kept within its capability and financial capacity to withstand potential future losses.

Credit Risk Management Structure

Credit risk management comes within the purview of the Executive Risk Management Committee in charge of credit risk. Its members and invitees include senior management of business and support units, such as the lending relationship departments, Credit Risk Management, and Risk Management Departments.

The Business Managers perform credit assessment on new exposures, grade existing and new borrowers and ensure the compliance with all relevant guidelines and policies. However, this is subject to stringent vetting and review by an independent risk management department. To enhance the quality and consistency of credit evaluation for non-retail credits across the group, the Boards of AmMerchant, AmBank and AmFinance recently approved an exercise to centralise the credit evaluation function into specialised centres, one to undertake credit evaluation of large corporate exposures and the other for medium sized business banking exposures. Major loan approvals within approved policies are made by the Credit and Commitments Committee with exceptions escalated to the Executive Committee of Directors. These include the approval of new loans as well as revisions to the terms and conditions of existing loans.

Management Methods

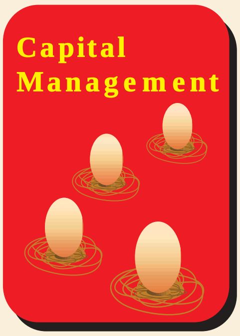
For non-retail credits, risk measurement begins with an assessment of the financial standing of the borrower or counterparty using an internally developed credit rating model. The model consists of quantitative and qualitative scores which are then translated into a rating grade, which ranges from 'AAA' (lowest risk) to 'C' (highest risk). The credit analysis not only highlights the key credit issues that need to be mitigated, but also reflects the overall level of risk for each new borrower. Notwithstanding this, the Board also sets the minimum credit acceptance criteria for new credits. The assigned credit rating forms a crucial part of the credit analysis undertaken for each credit exposure. A review of the credit rating assigned to each borrower is done once a year.

Credit risk is quantified based on expected default frequencies and expected losses on default from its portfolio of loans and off-balance sheet credit commitments. Expected default frequencies are calibrated to the internal rating model while loan loss estimates are based on past portfolio default experiences.

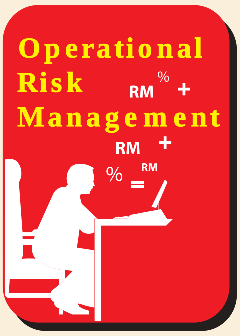
Apart from recommendations of the risk management units, lending activities are guided by internal credit policies and guidelines that are approved by the Board of Directors. Within these policies, name limits restrict total exposure allowed to corporate groups according to their level of creditworthiness, while sector limits ensure that total credit exposure to each economic sector is within prudent thresholds. These limits are monitored and reported to the senior management monthly. The pricing of non-retail exposure is also guided by benchmark return guidelines to ensure minimum returns that compensate for the risk taken, operating expenses and the cost of capital.

In order to further enhance the overall quality of loan exposures, the Board also endorsed a credit portfolio management strategy designed to achieve a desired ideal portfolio risk tolerance level and sector distribution over the next few years. These portfolio management strategies include minimum credit rating targets for new facilities, a more aggressive approach towards reducing existing high-risk exposures and exposures to certain sectors.

For retail credits, an in-house developed credit-scoring system to support the credit cards, housing and hire purchase applications is being used to complement the credit assessment process. Moving forward, the Company is in the midst of enhancing further the robustness of the credit scoring system to a level capable of performing credit based decision and automated approval in order to speed up the credit granting processes.



The Group continues to rely on retained earnings to enlarge its capital resources to drive the Group's businesses. Traditionally, the Group shall only employ rights issues only when the business expansion is expected to be strong to enable the shareholders to enjoy sustainable returns. The Group also believes in diversifying its sources of capital, and relying on qualifying hybrid instruments and long-dated subordinated debt instruments which contain, among others, interest deferral and loss absorption features. This is to ensure that optimum balance is maintained between the return on shareholders' investments and a prudent level of capitalisation.



Operational Risk Management Objectives

Operational risk is the risk arising from inadequate or failed internal processes, people and systems or from external events on the Company's day-to-day operations that are executed to attain its business objectives, which restrict or prevent such objectives from being achieved. It is increasingly recognised that operational risk is the single most widespread risk facing financial institutions today.

Operational risk management is the discipline of systematically identifying the critical potential points and causes of failure, assess the potential cost and to minimise the impact of such risk through the initiation of risks mitigating measures and policies.

Operational Risk Management Structure

Operational risk management is the responsibility of the Executive Risk Management Committee in charge of operational risk. Its members include senior management of the operational and support units.

Operational risk policies as approved by the Committee will be implemented by the various departments and monitored and reported back to the Committee by Risk Management Department. The Committee reviews the adequacy of controls to manage operational risks based on the assessment performed on each operating units. On a quarterly basis, the Committee will report to the Risk Management Committee of Directors.

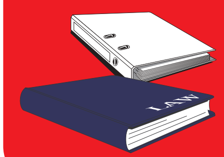
Management Method

Efforts are in progress to implement the internal framework on risk identification and assessment of the operational risk. This would assist the Company in prioritising the operational risk areas which require further enhancement.

The Company minimises operational risk by putting in place appropriate policies, internal controls and procedures as well as maintaining back-up procedures for key activities and undertaking contingency planning. These are supported by independent reviews by the Internal Audit Department.

The primary responsibility for managing operational risk rests with each operating department. Nevertheless, the execution of risk assessment methodology is supported and guided by a Risk Management Department whose function is to define minimum standards, policies and methodologies, monitor compliance, and identify as well as report on Company-wide risk exposures. The operating departments are responsible to assess their operational risks and review controls instituted on a periodical basis to ensure that the measures introduced continue to be relevant and appropriate.

Legal and Regulatory Risk



The Company manages legal and regulatory risks to its business. Legal risk arises from the potential that breaches of applicable laws and regulatory requirements, unenforceability of contracts, lawsuits, or adverse judgement, may lead to the incurrence of losses, disrupt or otherwise resulting in financial and reputational risk. Legal risk is managed by internal legal counsel and where necessary, in consultation with external legal counsel to ensure that legal risk is minimised.

The Compliance Unit manages regulatory risk which arises from the possibility of laws and regulatory rules being breached. Strategies and tasks implemented to manage these risks include monitoring and reporting, training, providing advisory service and disseminating information.

A compliance monitoring and reporting process has been implemented to monitor compliance to rules. The process requires the identification of risk areas, prioritisation of these risks and prescribing controls to minimize these risks. Monitoring is conducted through self-certification as well as monthly, quarterly and exception reporting. Efforts are underway to further enhance the entire process by enabling monitoring and reporting to be carried out on-line.

All staff undergo continuous Compliance Awareness Training, on banking and other relevant rules. Assessments are also conducted to gauge staff comprehension on topics covered. This is vital to make staff conversant with new rules, develop their skills to identify compliance issues as well as create an appreciation for good corporate ethics.

In its advisory role, the Unit provides advice on all areas of regulation applicable to the Company. This includes implementing measures and procedures within the organisation to facilitate compliance with new regulations. To further promote understanding, application and compliance with these regulations, the Unit conducts briefings, disseminates information as well as leads coordination efforts.

Compliance Repository, an e-Library that enables easy access to rules through various search modes, continues to serve staff as an important resource tool. Easy access to rules is vital to facilitate staff in their daily tasks as well as educate new staff joining the organisation.