INTRODUCTION

This policy shall be called the Risk Management Policy of First national Bank Modaraba ('Modaraba'). It is established for identification, measurement, monitoring and controlling risks to ensure that

- The individuals who take or manage risks clearly understand it.
- The Modaraba's Risk exposure is within the limits established by Board of Directors.
- Risk taking Decisions are in line with the business strategy and objectives set by BOD.
- The expected payoffs compensate for the risks taken
- Risk taking decisions are explicit and clear.
- Sufficient capital as a buffer is available to take risk

DEFINATIONS

1. **Credit Risk:** Credit risk arises from the potential that an obligor is either unwilling to perform on an obligation or its ability to perform such obligation is impaired resulting in economic loss to the Modaraba.
2. **Liquidity Risk:** Liquidity risk is the potential for loss to Modaraba from either its inability to meet its obligations or to fund increases in assets as they fall due without incurring unacceptable cost or losses.
3. **Market Risk:** It is the risk that the value of on and off-balance sheet positions of Modaraba will be adversely affected by movements in market rates or prices such as interest rates, foreign exchange rates, equity prices, credit spreads and/or commodity prices resulting in a loss to earnings and capital.
4. **Operational Risk:** Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and system or from external events.
5. **Currency/Foreign Exchange Rates Risk** It is the market risk resulting from adverse movement of foreign exchange rates.
6. **Equity price Risk:** It is the market risk which arises from changes in value of equity investments and their measurement at fair value.
7. **Interest (Mark-up) Rate Risk:** It is the market risk stemming from changes in market (Mark-up) interest rates (like KIBOR or discount rates) effects in a loss of earnings and capital.
8. **Credit Spread Risk:** It is the market risk of loss in earnings stemming from the scenario that the mark-up spreads over benchmark rate of the potential clients fall to a level that does not cover the sum of cost of funds, factor of administrative/operational expenses and targeted return on equity.
9. **Commodity Price Risk:** It is the market risk of adverse movement in the price of commodities results in a loss on investments in the commodities.

10. **Risk of Fraud:** It is the operational risk and includes misappropriation of assets, tax evasion, bribery, theft of information, hacking damage, third-party theft and forgery
11. **Risk of Damage to Data/Physical Assets:** It is the operational risk resulting from natural disasters, terrorism, vandalism, cyber attack, etc.
12. **Risk of Business Disruption & Systems Failures:** It is the operational risk due to utility disruptions, software/hardware failures, loss of human resource etc.
13. **Legal Risk**: It is the operational risk of loss resulting from: non compliance with the laws and regulations; disputes for or against the company; and failure to correctly document, enforce or adhere to contractual arrangements.
14. **Reputation Risk**: It is the operational risk of loss resulting from damages to Modaraba's reputation, in the form of lost revenue or destruction of shareholder value.

ROLES AND RESPONSIBILITIES FOR RISK MANAGEMENT

- **Board of Directors**

  The Board of Directors of National Bank Modaraba Management Company Ltd (the management company) "the Board" shall have the overall responsibility for the establishment and oversight of the Modaraba's risk management framework. The Board is responsible for approving the Modaraba's risk management policies developed by the management, and the management is responsible for implementing the same.
- **Audit Committee the Board**

  The Modaraba's Audit Committee shall oversee how the management monitors compliance with the Modaraba's risk management policies and procedures and reviews the adequacy of the risk management framework in relation to the risks faced by the Modaraba. The Audit Committee is assisted in its oversight role by the Internal Audit Department, which will have the responsibility to submit the quarterly report.
- **CEO and Risk & Compliance Manager**

  The CEO shall be responsible for ensuring compliance with the risk management policies and procedures. The Risk and Compliance Manager shall ensure compliance at the transaction level and identify weaknesses and loopholes in the procedures and make suggestions for improvements.
- **Functional Heads**

Functional/Departmental Heads shall be responsible for managing the risks associated with their respective function/department according to the laid down policies and procedures.

MODARABA's EXPOSURE TO VARIOUS FORMS OF RISKS AND RELATED MANAGEMENT STRATEGIES:

CREDIT RISK:

The Modaraba is exposed to credit risk from its business activities, primarily from investments in ijarah, murabaha and musharakah contracts, deposits/placements with banks and financial institutions.

Risk Management strategies

- The Modaraba will only deal with creditworthy counterparties with good financial track record and to obtain sufficient collateral, where considered appropriate.
- Proper credit administration procedures are implemented that include credit approval procedures, documentation, disbursement, monitoring, repayments, maintenance of files, and safe custody collateral and security documents.
- The Modaraba shall have a proper credit risk measurement and internal risk rating mechanism. (The detailed credit administration procedures and internal risk rating mechanism are laid out in the relevant credit policy manuals).
- The Modaraba shall strictly adhere to limits set by the SECP Prudential Regulations for Modarabas regarding credit exposures.
- The calculation of quantification of credit risk and detailed credit administration procedures and internal risk rating mechanism shall be stated in the credit policy and manuals document.

Credit risk related to financial instruments and cash deposits

- The Modaraba would limit its exposure to credit risk by only investing in liquid securities and only with counterparties that have at least investment grade rating.

The management of credit related risks shall be the responsibility of credit department. The CEO would report any exceptions to the BOD on half yearly basis.

LIQUIDITY RISK

Being a financial institution Modaraba is faced with the liquidity risk from maturity and re-pricing mismatch of its borrowing and advances.

Risk Management strategies

- The Modaraba's approach to managing liquidity will be to ensure, as far as possible, that it always has sufficient liquidity in the form of cash reserves, marketable securities, or readily-available-for-drawdown credit/overdraft lines in order to meet its obligations/liabilities as and when fall due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Modaraba's reputation.
- The liquidity position shall continuously be monitored by the finance function/department, through regular and frequent generation of the cash flow projections, reports of composition/maturity profiles of assets and liabilities, and gap schedules.
- The liquidity ratios and their future projections shall be regularly monitored.

The management of liquidity risk shall be the responsibility of finance department. The CEO would report any exceptions to the BOD on half yearly basis.

MARKET RISK

Modaraba is exposed to various forms of market risk due to its holdings of financial, leased, and other assets. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while optimizing the return on risk.

Risk Management strategies and procedures

- Exposure to currency/foreign exchange rates risk: The Modaraba would not take any material exposure to any foreign currency.
- Exposure to (Mark-up)/interest rate risk: The Modaraba is exposed to movements in market benchmark interest rates like KIBOR. Changes in KIBOR can effect in a loss to earnings and capital. In order to minimize this risk the prices of all asset and liability side products (bank borrowings COMs and credit advances like Leases, Morahaba, Musharika) would be linked to KIBOR, and the gap between the durations of re-pricing of assets and liabilities would be kept at the minimum.

- For monitoring of interest rate risk a static gap report, the cash flow projections, composition and maturity profiles of assets and liabilities, and gap schedules shall be regularly prepared at frequent intervals by the finance function/department.
- A re-pricing gap schedules to measure and monitor interest rate risk shall be generated on half yearly intervals by the finance function/department.

- Equity price risk: The Modaraba would not invest in equity securities. In case such investments are undertaken in future the procedures for the quantification and management of risk shall be dealt with in an exclusive policy and manual for equity Investments.

- To manage credit spread risk only those clients will be selected for sanction of financing facilities where the spreads over benchmark rate (e.g. KIBOR) could be set at a level to cover the cost of funds plus the factor of administrative/operational expenses plus the factor of targeted return on equity plus a premium for the risk associated with the particular Credit case. The quantification of risk associated with individual credit cases are dealt with in the Credit Policy and related manuals.

- To manage commodity price risk the Modaraba would not directly invest in commodities, and any commodities purchased under morahaba arrangement shall be immediately sold to the client.

The management of market related risks shall be the responsibility of both credit and finance department under the supervision of the CEO.

OPERATIONAL RISK

Operational risk is associated with human error, system failures and inadequate procedures and controls. Operational risk exists in all products and business activities of Modaraba. Some major categories of operational risk Modaraba is faced with are:

- Risk of Fraud,
- Risk of Damage to Data/Physical Assets,
- Risk of Business Disruption & Systems Failures,
- Legal non-compliance Risk, and
- Reputation Risk.

Risk Management strategies and procedures

Given the broader scope of operational risk it would be managed by having proper systems and operating procedures in place like

- Code of Conduct/Ethics,
- Proper delegation of authority,
- Adequate segregation of duties,
- Effective audit coverage,
- Culture of strict compliance with laws and regulations,
- Proper succession planning,
- Comprehensive HR policy for staff compensation, recruitment and training,
- Procedures for dealing with customers, complaint handling, record keeping, MIS, physical controls, etc.

Furthermore to manage various operational risks following policies/plans shall be developed and implemented:

- IT Policy
- Disaster Recovery Plan
- Business Continuity Plan
- Policy for Procurement of Goods and Services

The management of operations related risks shall be the responsibility of all relevant departments under the supervision of the CEO.

CAPITAL RISK MANAGEMENT

In addition to the aforementioned risks there is an important aspect of capital risk management related to the capital structure of Modaraba

Definitions:

Capital Risk: It is the risk of loss of earnings and capital the Modaraba faces due to the composition of its capital.

Capital: means total of Equity and Debt.

Equity: includes Certificate Capital and Reserves.

Debt: includes Bank Borrowings under Islamic modes of Financing and deposit raised through issuance of Certificates of Musharaka.

Gering/Leveraging ratio: means net debt divided by total capital.

Objectives:

The primary objective of the Modaraba's capital risk management shall be:

- To maximize Certificate holders' value
- To ensure that it maintains a Strong credit rating and healthy capital ratios in order to support Modaraba's business.
- To enhance/maximize Certificate holders' wealth and to meet other stakeholders' expectations.
- To maintain sustainable growth by maintaining optimal capital structure.
- To ensure that the Modaraba continues to meet the going concern assumption
- To keep profit payable on debt (finance cost) minimum.

Risk Management strategies and procedures

The Modaraba shall manage its capital structure on the basis of leveraging ratio and make adjustments to it, in light of changes in economic conditions. To maintain or adjust the capital structure, the Company may adjust its leveraging/gearing ratio by decreasing Debt or issuing (right issue) new certificate capital (Adjusting cash dividend payment would not be an option since SECP PRs require modarabas to pay out alteast 90% of their profits as cash dividends).

The management of capital risk shall be the responsibility of finance department in liaison with the credit department under the supervision of the CEO.

RENEWAL /REVISIONS:

The policy will become eligible for revision after one year and shall be revised atleast once in three years, with the exception of an early revision called for by any change in laws or regulation or as required.

APPROVAL AND EFFECTIVE DATE

The Risk Management Policy was approved by the Board of Directors of National Bank Modaraba Management Company Ltd in its meeting held on April 24, 2014.