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1. INTRODUCTION

Purpose and scope

The purpose of this document is to set out the high-level principles for the company's management of its key risks. The risks covered are credit risk, market risk, liquidity risk, operational risk, and compliance risk. The high-level principles for the company's risk management are subject to regular update and amendment, as required. Amendments to the document are approved by the Board of Directors. The high-level principles shall be affirmed by the Board at least annually in connection with the review of the maximum limits for risk exposure.

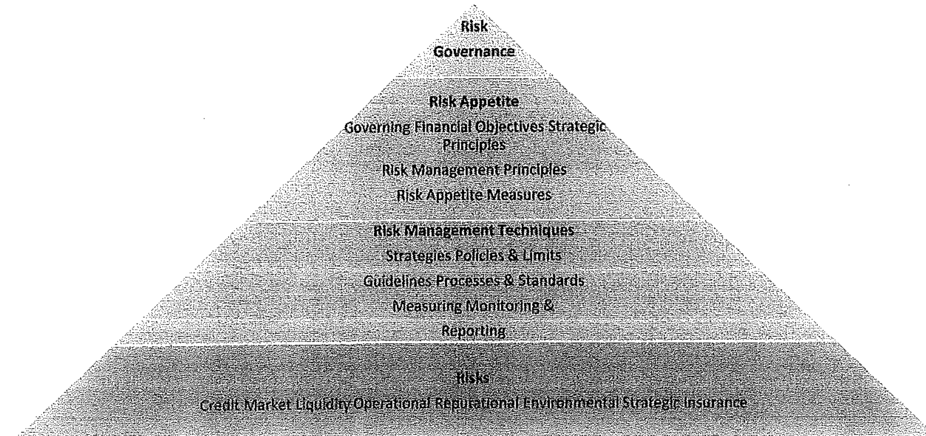
The document is structured to set the company's risk-taking into the context of its mission and strategy as well as to its risk-bearing capacity and willingness to take various risks. The comapny's risk governance structure is described with focus on key risk responsibilities. The main risks are described as follows:

1. Definition of the risk;
2. Sources of the risk for AFC;
3. Key risk management responsibilities;
4. Risk management principles including risk mitigation.

The high-level principles for risk management are implemented through policies, limits, operational guidelines as well as methodologies and tools for risk measuring, monitoring and reporting. Together these form the company's risk management framework.

Risk Management Framework

The primary goals of risk management are to ensure that the outcomes of risk-taking activities are consistent with the company's strategies and risk appetite, and that there is an appropriate balance between risk and reward in order to maximize shareholder returns. The company's enterprise wide risk management framework provides the foundation for achieving these goals.

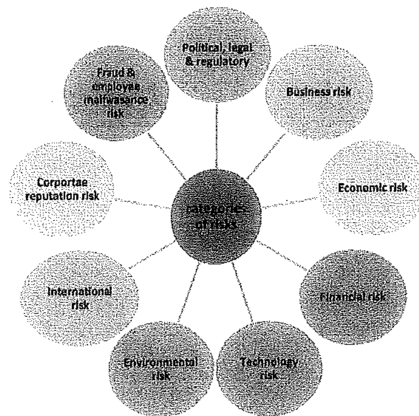


2. INTRODUCTION TO RISK

Risk in business is the chance that the future events or results may not be as expected. Risk is often thought of as purely bad (pure or downside risk), but it must be considered that risk can also be good – the result s may be better than expected as well as worse (speculative or upside risk).

Types and sources of risk

Some of the commonly used risk categories are shown below which have an impact on the company's risk profile.



Political, legal & regulatory

These are the risks that the company faces because of the regulatory regime that they operate in.

Political risk	Risk due to the political instability. Generally considered to be the external to the business.
Legal risk	Risk that litigation will be brought against the business.
Regulatory risk	Risk of changes in regulation affecting the business.
Compliance risk	Risk of non-compliance with the laws & regulations resulting in fines/penalties.

Business risk

Business risk is the risk, the company face due to the nature of their operations and products.

Strategic risk	Risk that the business strategies will fail.
Product risk	Risk of failure of new product launches/ loss of interest in existing products.
Operational risk	Risk that business operations may be inefficient or business process may fail.
Contractual inadequacy risk	Risk that the terms of a contract do not fully cover a business against all potential outcomes.

Economic risk

Risk that changes in the economy might affect the business. Those changes could be inflation, unemployment rates, international trade relations or fiscal policy decisions by government. Again, this risk is considered to be external to the business.

Financial risk
This is a major risk that affects the business and it is the risk of a change in a financial condition such as an exchange rate, interest rate, credit rating and etc.

Environmental risk
This is the risk that arises from changes in the environment such as climate change or natural disaster.

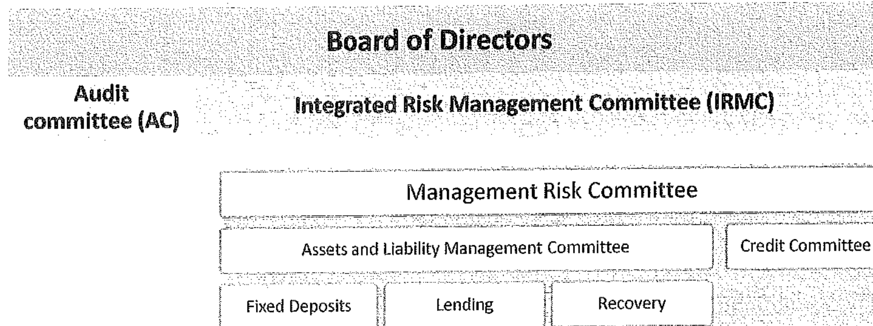
Technology risk
Risk that technology will occur that either present new opportunities to the business, or on the down-side make their existing processes obsolete and inefficient.

Fraud & employee malfeasance risk
Fraud risk is the vulnerability of an organisation to fraud. Malfeasance means doing or committing an offence or crime (other than fraud). This, like fraud risk, a type of operational business risk.

Corporate reputational risk
Reputation risk is for many organisations a downside risk as the better the reputation of the business the more risk there is of losing that reputation. A good reputation can be very quickly eroded if companies suffer adverse media comments or perceived to be untrustworthy.

3. RISK GOVERNANCE STRUCTURE

The Board is responsible for setting the risk appetite for the business and the implementation thereon comes under the purview of the senior management. Integrated Risk Management Committee (IRMC), delegated authority of the Board, is responsible to establish an effective risk appetite framework within the Company. The risk appetite is determined on the level of risk that the Company is willing to accept in reaching for its business objectives.



The foundation of our Risk Management framework is built on the 'Three Lines of Defence' model, which promotes transparency, accountability and consistency, the building blocks for a strong relationship with stakeholders.

The Board of Directors has ultimate responsibility for managing risk and has delegated oversight responsibility to the IRMC which reports on risk at regular meetings of the Board. Risk is accepted, monitored and managed by the business units which report to the CEO forming the first line of defense. The risk management function independently monitors risk on an aggregate basis and promulgates policies and guidelines for effective management of risk. Reporting directly to the IRMC, the risk management function constitutes the second line of defense. Assurance over the first and second lines of defense is provided by Internal Audit which report directly to the AC forming the third line of defense, together with external audit. This structure facilitates constructive challenge of the balance between risk and reward which is necessary for effective risk management.

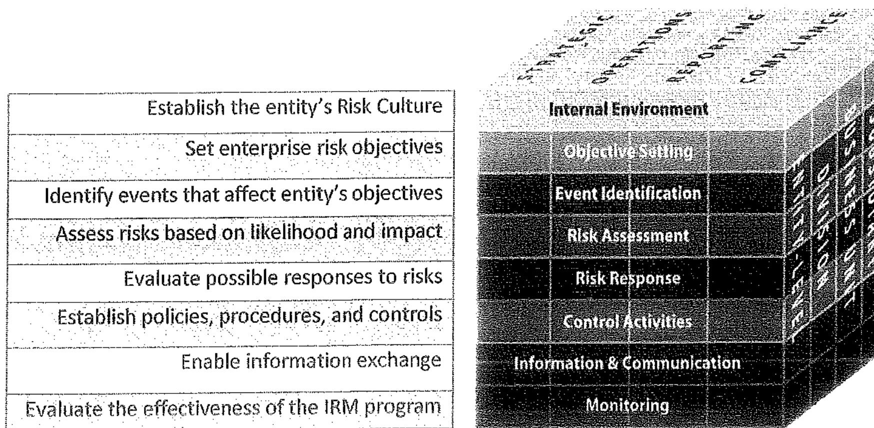
4. INTEGRATED RISK MANAGEMENT

This is the overarching pillar through amalgamation of all identified risks in company operations. IRM function of the risk unit facilitates a structured and disciplined approach to aggregated risk management. Further, IRM approach aligns to business strategy, processes, people, technology, and knowledge within all risk pillars and Integrate in all levels of decision-making. Main scope under IRM pillar is to carry out inter-linked stress tests across risk verticals.

The establishment of IRM framework adopts its core structure and values from the CoSo framework which is depicted below, ensuring appropriate internal controls are in place to optimize strategic vision of the company and risk return formula.

Integrated risk management enables the company to pragmatically deal with uncertainty and associated risks and opportunities thus enhancing the brand value and profitability. Integrated risk management helps in identifying, selecting among alternative risk responses, risk avoidance, reduction, transfer and acceptance. It also helps to ensure effective reporting and compliance with laws and regulations and avoid damage to the entity's reputation and associated consequences.

In summary, IRM framework helps AFC to achieve its business objectives and avoid pitfalls and surprises along the way. The company has understood the challenges, various risk domains and risk areas relevant to its business and various risk activities, which need to be carried out to successfully implement an IRM framework.



5. RISK MANAGEMENT APPROACH OF AFC

The company is exposed to risks which have the potential to impact the company's ability to achieve agreed strategic goals including the financial performance. While some risks can be managed by the company, there are other key risks that need to be monitored to assess their impacts as described below.

Risks	
Risks that are monitored but cannot be managed by the company	Risks that are managed by the company
Macroeconomic Risk	Credit Risk
Macro prudential, Regulatory and Legal Risk	Market Risk
	Concentration Risk
	Liquidity Risk
	Operational Risk
	Strategic Risk

Macroeconomic Risks

The economic and market conditions of the countries we operate in have a direct impact on our performance but such risks cannot be managed by the company. These include global economic growth particularly in principal import/export markets for Sri Lanka, geo-political risks impacting principal trading partners, commodities markets which impact sovereign corporate earnings and external trade and structural reforms to regulate or stimulate economic activity including Fiscal and Monetary Policy.

Macro-Prudential, Regulatory and Legal Risks

The Risk Management Committees receive regular reports on trends and analysis of these risks to support decision making at operational and strategic levels. Key risks monitored include developments in the financial services sector both locally and globally that give rise to increased regulation in Finance Leasing sector, increased regulation of the financial services sector and tax-related risks.

RISK CULTURE

A sound risk culture is a core element of the IRM framework and is deemed to be vital in building resilience and creating a scalable platform for future growth for AFC.

Risk Management is seen as the responsibility of every employee. In this regard, the company seeks to promote a culture where employees are aware of potential threats related to their actions and work towards minimizing them by exercising the right controls at the right time.

RISK APPETITE

An integral component of the overall strategy formulation process, the company's Risk Appetite provides measurable targets and tolerance thresholds across all material risk categories. This creates a framework where optimal growth options can be evaluated alongside the risks involved in order to drive sustainable performance.

RISK MEASUREMENT THROUGH STRESS TESTING

Stress testing is carried out at individual risk level and at entity level to estimate the potential impact on income, capital and liquidity position as a result of changes in market conditions and other risk factors. Results of stress testing are used for decision making processes for credit risk appetite, market risk limits, capital and funding and are also integrated into the strategic and financial planning processes. Development, approval and review of stress tests are the responsibility of the IRMC and the ERMC.

CREDIT RISK

Credit Risk is the risk of potential loss resulting from the failure of a customer/ borrower or counterparty to honour its financial or contractual obligations to the company. It arises mainly from direct lending activities which are reflected On-Balance Sheet. Credit risk is composed of counterparty risk, concentration risk and settlement risk. Credit risk may result in the loss of the principal amount and interest with adverse implications on profits due to the impairment provisions or write-offs of non-performing facilities. At AFC, the credit risk is applicable for leases, hire purchases and loan receivables, which in effect account for major percentage percent of the total assets.

MARKET RISK

Market Risk is the risk of loss arising from movements in interest rates, foreign exchange rates, commodity prices, equity and debt prices and their correlations. Most of the company's operations are subject to at least one or more elements of market risk.

STRATEGIC RISK

Strategic risk arises from adverse business decisions, improper implementation of decisions or lack of responsiveness to changes in the business environment.
Therefore, it is important to be mindful in formulating the corporate strategy as a wrong strategy will have an adverse impact on the operations. Even if it is the right strategy, improper implementation will also lead to unfavourable results to the Company. Accordingly, the strategic risk impacts earnings as well as the capital base. This is more pronounced in a highly competitive environment; pragmatic strategy and effective implementation are essential to ensure the sustainability of profits. The key drivers of strategic risk are competition, customer changes, industry trends, technological innovation and regulatory changes.

STRESS TESTING

Stress testing is carried out at individual risk level and at entity level to estimate the potential impact on income, capital and liquidity position as a result of changes in market conditions and other risk factors. Results of stress testing are used for decision making processes for credit risk appetite, market risk limits, capital and funding and are also integrated into the strategic and financial planning processes. Development, approval and review of stress tests are the responsibility of the IRMC.