Risk report

> Globalisation, rapid digitalisation and technological advances are fundamentally transforming economies and ways of doing business. This, together with increased demands from our clients, regulators and shareholders, means that the risks we face evolve continuously. Identifying, monitoring and mitigating these emerging risks, across geographies, is increasingly complex. In addition to analysing historical data, we will continue to apply a forward-looking approach to better understand the unique risks of each country we operate in, to not only manage them, but to realise the growth opportunities they present.

Neil Surgey / Chief risk officer

The full group risk and capital management report can be accessed online.

Overview

The global economy continues to be characterised by uncertainty, driving volatility in financial markets. This has impacted negatively on many emerging markets, including sub-Saharan Africa. The downturn in commodity prices and the tightening of monetary policy in the US has led to substantial capital outflows and steep depreciation of emerging market currencies against the US dollar.

Risks associated with a challenging economic environment, falling commodity prices and potential sovereign credit rating downgrades have featured highly in risk committee discussions over the past two years, at both board and management committee levels. Many of these risks materialised in the last year, and will continue to remain a focus in 2016. In 2015, South Africa experienced the lowest annual rainfall since 1904, which will have a wide ranging impact on both the agriculture sector and broader economy.

The challenges inherent in our external environment include changing customer expectations driven by rapid digitalisation and advances in technology, subdued economic conditions, a highly competitive environment, continued regulatory change and socioeconomic instability. The need to understand and mitigate the potential impact of these challenges on the group, and on our ability to successfully reorientate the group around our clients, is driving increased collaboration between the risk management function, and the group's business units and other enabling functions.

This integration is informing improved decision-making, management and oversight across the group, within the parameters of our risk appetite. A key responsibility of risk management is to assist business units and our enabling functions to effectively plan for, manage and mitigate the most material risks facing the group, and to leverage the opportunities inherent in addressing these risks.

The group's strategic reorientation around its clients serves improved risk management by enabling a clearer understanding of who our clients are, what they do and their unique circumstances. It allows for proactive action to help mitigate credit risk during difficult times, and for products and services to be structured in the best interests of our clients.

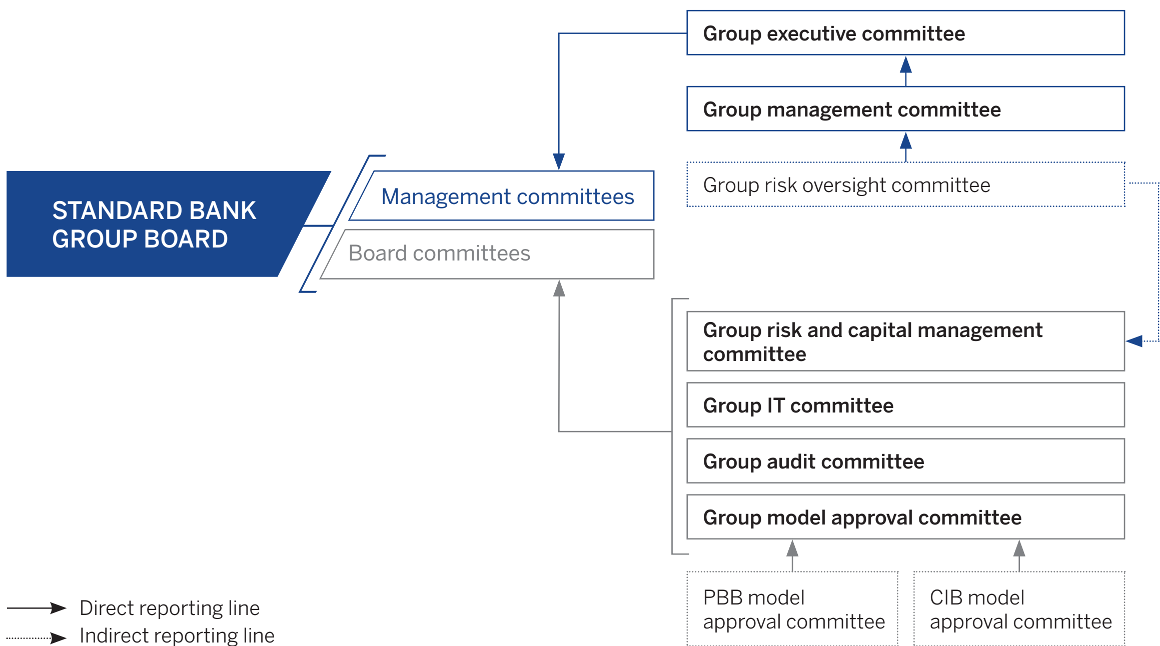
Embedding risk skills deeper into our business units and functions across our operations in the rest of Africa places pressure on the availability of specialist risk skills in the group. Although risk skills are generally scarce on the continent, we have been successful in allocating skilled risk practitioners to different business areas and jurisdictions, as required. Attracting and developing specialist risk practitioners is an ongoing focus, and improved systems capabilities in terms of gaining a single view of our clients and risk data aggregation enable more efficient allocation of risk resources.

Risk governance

The group's approach to managing risk and capital is set out in the group's risk, compliance and capital management governance framework, which is approved by the group risk and capital management committee. The framework has two components:

- Governance committees; and
- Governance documents such as standards, frameworks and policies.

RISK GOVERNANCE STRUCTURE



Building a risk and compliance culture

Continued resilience requires that we entrench a culture in which our people are aware of risk in executing our business activities, and in which compliance with laws and regulations, and acting ethically and fairly in everything we do, is second nature. This culture needs to be consistent across the group while being sufficiently flexible to new risks that arise in different jurisdictions.

Building a risk-aware and compliance-focused culture mitigates conduct risk, which is the risk that the group itself poses to our clients, and to the effective functioning of financial markets through behaviour that is dishonest, unethical or unfair. Conduct covers a range of activities, from how we design products and how we market these products, to how we communicate with our clients and meet their expectations.

Thus, risks to ethical and fair conduct arise from many aspects of our day-to-day activities. Effectively managing conduct risk supports the group in delivering on its strategy, meeting regulatory requirements, and working to ensure we keep the promises we make to our clients. The proposed Twin Peaks system of financial sector regulation in South Africa will place specific and enhanced emphasis on conduct.

The three lines of defence model is crucial to building this culture. It promotes transparency, accountability and consistency, which are key to building trust and maintaining our legitimacy among our stakeholders, and enables sufficient coverage of the risk landscape. Going forward, we will focus on greater collaboration between the group's risk, compliance and internal audit functions to support operational management in identifying and managing risks in their day-to-day business activities. This also serves our intention to bring risk identification and awareness closer to the client interface, supporting early identification of potential risks and providing deeper insight into our clients.

More detail on the three lines of defence model is provided in the risk and capital management report.

Improving risk data aggregation and reporting

The group continued to make progress in developing mechanisms to comply with the Basel Committee on Banking Supervision (BCBS) principles for effective risk data aggregation and risk reporting (BCBS 239), which were published in January 2013. These principles are intended to improve the quality of information that banks use in decision-making, particularly with regard to risk management.

In 2015, the governance framework, policies, scope definition and minimum requirements were agreed on, and an integrated implementation plan was finalised. In 2016, the group will continue to develop the people, process and technology required to ensure data accuracy and integrity, in line with BCBS 239. We are on track to meet the requirements of these principles.

Stress testing and risk appetite

The materialisation of global, regional and domestic external risks, many of which were anticipated and subsequently monitored, reinforced the importance of stress testing as an integrated component of our risk management framework, providing a forward-looking risk management tool to proactively manage risks to which the group is exposed.

During 2015, the group ran several stress tests on a groupwide, business unit, regional and risk-type basis to understand the impact these potential stress events could have on various portfolios. The group also participated in an industry-wide stress testing exercise initiated by the SARB's financial stability committee.

Risk appetite is formally reviewed and updated annually to ensure alignment with, and relevance to, the group's strategy. The group benchmarked itself in 2015 to external risk appetite practices to ensure that its risk appetite framework and implementation remains relevant and in line with leading international standards. Risk appetite was determined and cascaded on a groupwide, business unit, regional and risk-type basis.

Capital management

The group remains adequately capitalised above minimum regulatory capital adequacy requirements. Net proceeds from the disposal of the group's controlling interest in SB Plc were repatriated to South Africa as part of the repositioning of capital allocation in line with our Africa focus.

The SARB adopted the leverage framework that was issued by the BCBS in January 2014, with final calibrations and adjustments expected by 2017. Formal disclosure requirements commenced from 1 January 2015 and the capital adequacy ratio is expected to transition to a pillar 1 requirement by 2018. During the year, the group raised R32,1 billion senior and subordinated debt and syndicated loans.

A key focus for the year ahead will be to ensure that the group remains adequately capitalised and positioned to respond to higher capital requirements prescribed by regulatory authorities in the countries in which we operate. The volatility in capital markets, particularly in emerging markets, will require ongoing assessment of our capital buffers. The year ahead could see continued risk aversion in global markets and stress in a number of credit segments given tightening of monetary policy in key markets.

Formal disclosures relating to the BCBS leverage framework are set out in the risk and capital management report.

Looking ahead

The group's risk management framework has proven effective in navigating an increasingly complex risk environment. In line with our Africa strategy, we will continue to strengthen our risk management skills, capabilities and governance in the countries in which we operate, and further embed a client-focused, risk-based mindset.

There is an increased awareness of developing risks that are addressed in our risk management framework, relating to liquidity risk, cyber risk and the financial impact arising from the persisting drought conditions in sub-Saharan Africa, the potential downgrade of the South African sovereign credit risk rating to sub-investment grade and weaker commodity prices. A key challenge in the year ahead will be managing the business in a turning credit cycle given the tightening of monetary policy in key markets.

In line with our focus on improving group economic profit and ROE, we will optimise financial resource allocation, including capital and liquidity between product lines, trading desks, industry sectors and legal entities.

Key developments and performance

The risk and capital management report provides detailed discussion of each risk type, the group's risk performance and focus areas for 2016.

Credit risk

- The group's banking activities' credit loss ratio for 2015 was 0.87%, improving from 1% in 2014.
- In South Africa, credit extension grew steadily in the corporate sector but was subdued in the consumer sector due to higher household debt to disposable income.
- In the rest of Africa, growth in loans and advances remained strong year-on-year, despite the decline in demand for and price of commodities.
- Weaker economic growth prospects, increasing lending rates and lower business confidence continued to put downward pressure on demand for credit in a tightening credit cycle.

Compliance risk

- Enhanced our compliance skills and focused our allocation of our resources, which included expanding our Africa compliance teams.
- Implemented advanced anti-money laundering and anti-terrorism financing systems.
- Implemented structures and processes for market integrity and business conduct.
- Worked to remediate administrative sanctions and directives imposed by the SARB in respect of anti-money laundering and anti-terrorism financing controls.

Country risk

- Concentration of cross-border exposure to sub-Saharan Africa continued to increase, consistent with the group's strategic focus.
- Adverse macroeconomic conditions in several of the group's markets in the rest of Africa underpinned a negative risk tendency, requiring judicious management of cross-border exposure and implementation of additional mechanisms to manage risk exposure.

Funding and liquidity risk

- Maintained liquidity positions within approved risk appetite and tolerance limits, with total contingent liquidity amounting to R300,8 billion.
- Held appropriate liquidity buffers in line with regulatory, prudential and internal stress-testing requirements. Achieved average liquidity coverage ratio of 93.7%, comfortably above the 60% minimum regulatory requirement.
- Further advanced asset-liability management capabilities and liquidity risk management approach.
- Enhanced liquidity risk management and technology frameworks.
- Continued to evaluate the impact of Basel III net stable funding ratio.

Market risk

- Maintained trading and banking book positions within approved risk appetite and tolerance limits.
- Continued to advance interest rate risk management and enhanced global markets and market risk technology.
- Commented on proposed changes to regulations impacting trading and banking book positions.

Insurance risk

- Made significant progress in implementing a number of emerging regulations, with specific focus on embedding the solvency assessment and management programme, assessing the retail distribution review proposals and preparing for Twin Peaks regulations in the group's short- and long-term insurance operations.

Operational risk

- Continued to mature the integrated operational risk approach, with a focus on enhancing resourcing through combining appropriate skills with a deep understanding of business and risk management.
- Implemented a 24/7 cybersecurity capability, which continues to address cyber threats and unauthorised access to systems.
- Hosted a number of crisis simulation exercises and implemented a business continuity management automation tool, and undertook fraud and information risk awareness initiatives.

Legal risk

- Following the group's self-reporting of a suspicious transaction, Standard Bank Plc was party to the UK's first DPA and related settlement agreement.
- Successfully invoked legal rights to recover from insurers a material amount of the losses suffered from fraud relating to aluminium reverse repurchase agreements in Qingdao Port, China.