NRB Unified Directives for Class A, B and C Licensed Institutions

Directive 05

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Provisions Relating to Risk Management

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Directive No. 5/2082

Provisions Relating to Risk Management

In exercise of the authority conferred by Section 79 of the Nepal Rastra Bank Act, 2058, this Directive is issued for the management of credit, operational, liquidity, market, interest-rate, foreign-exchange and other risks inherent in the business of Class ‘A’, ‘B’ and ‘C’ licensed institutions.

१ 1. Risk Management

Controlled English translation

An institution shall establish and implement a sound framework for identifying, measuring, monitoring, managing, controlling and reporting the risks it faces. Effective risk management shall follow a comprehensive and integrated approach covering the entire institution. The institution shall demonstrate full commitment to risk management so that an effective relationship is established between corporate governance and sound risk management.

२ 2. Risk Management Program

Controlled English translation

(1) The risk-management framework shall at least include: (a) active oversight by the Board and senior management; (b) adequate policies and procedures; (c) an effective Risk Management Function; (d) an appropriate management information system; and (e) an effective internal-control system and limits.

(2) The Board shall identify the institution’s Risk Appetite and Tolerance Limit and set its risk strategy. The Board shall be responsible for the institution’s overall risk management.

(3) Policies and procedures addressing the institution’s material risks shall be approved by the Board, reviewed at least annually and updated as necessary. Senior management shall implement the risk policies, procedures and processes. The Board and senior management shall review and discuss risk reports at least quarterly and whenever otherwise necessary.

(4) An independent Risk Management Function headed by a Chief Risk Officer (CRO) or equivalent officer shall be maintained. Separate or combined units/divisions may be created for individual risks according to the institution’s size and business. The function shall at least: (a) manage the process for formulating and updating risk policies and procedures; (b) regularly monitor material risks in all functional units and promptly alert decision-makers to unexpected risks; (c) prepare risk reports and submit them to the Risk Management Committee and Board; and (d) support effective implementation of all aspects of risk management.

(5) The duties, responsibilities and authority of the CRO shall be specified in a manner commensurate with the institution’s size, nature and functions. The CRO shall report directly and periodically to the Board-level Risk Management Committee.

(6) Business functions and risk-management functions shall be separated so as to avoid conflicts of interest. Risk management shall not be treated solely as the responsibility of the risk department/unit; the business function shall serve

as the First Line of Defence. A Risk Culture shall be developed under which every employee remains alert to their own responsibilities.

(7) A sound Internal Control System shall be maintained to keep risks within the approved Risk Appetite and Tolerance Limit. The Board/Risk Management Committee shall ensure effective audit of the strength and adequacy of internal controls.

(8) An annual report covering policies and processes implemented for all material risks, the CRO's mandate and the Risk Governance Structure shall be submitted to the concerned Supervision Department within one month after the end of the financial year.

३ 3. Classification of Risks

Controlled English translation

For effective risk management, risks shall be classified as: (a) credit risk; (b) operational risk; (c) liquidity risk; (d) market risk; (e) interest-rate risk; (f) foreign-exchange risk; and (g) other risks.

४ 4. Credit-Risk Management

Controlled English translation

(1) Directive No. 2 on loan classification and loan-loss provisioning, Directive No. 3 on single-obligor and sectoral limits, and Directive No. 8 on investments shall serve as the basis for mitigating credit and investment risk.

(2) Appropriate policies and procedures capable of identifying, measuring, monitoring and controlling credit risk shall be adopted.

(3) The Board shall approve the overall credit-authority structure. Credit authority delegated to senior management shall be clearly defined according to the institution's size and business.

(4) Business solicitation, credit appraisal, credit approval, disbursement and borrower-relationship management shall be organised as separate functions.

(5) Adequate credit-analysis criteria shall be established for new lending, renewal and enhancement of existing facilities. Sufficient grounds shall be analysed to ensure that credit is and continues to be used for its approved purpose.

(6) Class 'A' commercial banks and national-level Class 'B' development banks shall develop a Credit Risk Rating System for evaluating credit proposals. It shall effectively capture customer and business creditworthiness and serve as a basis for borrower Due Diligence; international best practices may be followed.

(7) An appropriate Credit Administration Function shall be maintained for credit documentation, repayment monitoring, credit-file and security records, and updated personal information.

(8) All credits shall be reviewed periodically on both individual and sectoral bases, and such review shall form a basis for customer-relationship strategy.

(9) Institutions are encouraged to set their own sectoral, purpose-based, non-performing-loan and other limits, having regard to Board-approved Risk Appetite, Tolerance Limits and regulatory requirements.

(10) Appropriate policies and processes for the proper management of non-performing loans shall be implemented.

(11) For a consortium loan, the Lead Bank shall bear primary responsibility for risk analysis; participating banks may also perform their own analysis.

(12) A bank or financial institution shall accept only an audit report bearing a Unique Document Identification Number (UDIN). The credit file shall clearly record verification through the UDIN portal on the Institute of Chartered Accountants of Nepal's website that the submitted particulars are authentic.

५ 5. Operational-Risk Management

Controlled English translation

(a) Appropriate policies and procedures shall address operational risks arising from people, processes, systems and external events, including risks in accounting, IT, human resources, cash and banking operations and all operating units.

(b) Effective internal-control and information systems shall be developed. Internal-audit reports for each branch, department and office shall comment on the adequacy of measures for managing operational risk.

(c) A system shall provide regular monitoring of operational risks and systematic recording of material information on loss events, including their nature, severity and financial loss.

(d) Appropriate Disaster Recovery and Business Continuity Plans shall ensure continuity through disasters; they shall be tested through annual drills and updated.

(e) Posting and transfer practices shall mitigate staff-related risks arising from excessive dependence on one employee, prolonged posting in one location or collusion.

(f) A Continuity Management Framework shall be prepared and implemented to mitigate adverse effects of natural disasters and similar events on business continuity in the financial system.

(g) Only chip-based debit, credit, prepaid and similar cards shall be issued to reduce operational risk and assure customers of secure banking services.

६ 6. Liquidity-Risk Management

Controlled English translation

(1) An appropriate Liquidity Risk Management Policy, including procedures and guidelines commensurate with the nature, size and business of the institution, shall be implemented.

(2) Assets and liabilities shall be classified into Time Intervals by Maturity Period. The quarterly Liquidity Profile in Form No. 5.1 shall be submitted to the concerned Supervision Department within 15 days after the ends of Ashwin, Poush, Chaitra and Ashadh.

(3) Time intervals shall be: (a) up to 90 days; (b) over 90 days up to 180 days; (c) over 180 days up to 270 days; (d) over 270 days up to one year; and (e) over one year.

(4) Assets and liabilities with fixed maturity shall be placed in the corresponding intervals under sub-clause (3).

(5) Of current and savings deposits without fixed maturity, the estimated core-deposit/minimum-stable-balance portion shall be included in the over-one-year interval. The institution shall make a realistic estimate; ordinarily, the permanently stable portion of current deposits shall be treated as core deposits.

(6) The maximum Credit-Deposit Ratio (CD Ratio) shall be 90 percent.

Explanation—(a) Debentures other than those forming part of the capital fund, foreign-currency borrowings of one year or more, and refinance provided by Nepal Rastra Bank may be counted as deposits. Whether a debenture forms part of capital shall be specified at issuance. For debentures issued before 2078/05/08, 100 percent could be counted through Poush-end 2080 and 50 percent thereafter through Ashadh-end 2081.

(b) An institution exceeding the limit was required to reduce it gradually by Ashadh-end 2079, manage deposits and lending with monthly monitoring, and submit and implement a Board-approved action plan.

(c) Interbank deposits shall not be included in the CD Ratio. An 'interbank deposit' means an amount lent by one licensed institution to another and placed as a deposit with that same borrowing institution.

(7) CD Ratio monitoring and penalty: (a) daily monitoring; (b) a penalty based on the prevailing Bank Rate through the concerned Supervision Department where the monthly average exceeds the limit; (c) the monthly average based on every

working day of the month; and (d) the following formula where the limit is exceeded. From Poush 1, 2079, no such penalty applies where the Net Liquid Assets to Total Deposit Ratio is at least 22 percent.

Penalty = [(Monthly average outstanding credit monthly average amount corresponding to 90%) Bank Rate] (100
12)

(8) A specialised structure such as an Assets Liabilities Committee (ALCO) shall manage overall liquidity. It shall meet regularly, review liquidity and take measures to keep liquidity risk within the Tolerance Limit.

(9) A Contingency Funding Plan shall be maintained for raising funds during liquidity stress.

(10) The Board and senior management shall regularly review liquidity and liquidity-risk reports. ALCO agenda items and decisions shall be submitted quarterly to the Board for discussion.

(11) Institutions are encouraged to set liquidity limits—such as CRR, statutory liquidity and loan-to-resource-mobilisation limits—appropriate to their business size and nature, having regard to Board-approved Risk Appetite/Tolerance Limits and regulatory limits.

७ 7. Market-Risk Management

Controlled English translation

(1) Necessary policies and procedures shall manage material market risk arising from fluctuations in indicators such as prices and interest rates.

(2) Class ‘A’ commercial banks shall establish a Middle Office to monitor, measure and analyse Treasury Management risks. It shall be independent of Treasury Functions and shall also report to the risk-management department/unit.

८ 8. Interest-Rate-Risk Management

Controlled English translation

(1) Appropriate policies and procedures shall address risks arising from interest-rate fluctuations.

(2) (a) Only Interest-Sensitive Assets and Liabilities shall be included. (b) Cash Balance and Non-Interest-Bearing Accounts shall be excluded from Gap Analysis of Maturity Mismatch. (c) Form No. 5.2 shall be prepared quarterly and submitted to the concerned Supervision Department within 15 days after quarter-end.

(3) Time Intervals shall be classified in accordance with the Interest-Rate Risk Monitoring Table in Form No. 5.2.

(4) Assets/liabilities without fixed maturity: (a)(1) a periodically adjusted floating-rate loan shall be placed in its interest-reset interval; (2) a term loan linked to a specified rate such as the Treasury-bill rate shall be placed in the shortest interval; and (b) interest-sensitive floating-rate liabilities shall be placed in their interest-reset interval.

(5) Gap measurement: (a) determine each interval’s positive or negative Gap by subtracting total liabilities from total assets; (b) determine Cumulative Gap by adding the current and all preceding gaps; (c) estimate the possible interest-rate change—ordinarily one percentage point; (d) calculate the time-adjusted Interest Rate Change (IRC) as days in interval/365 estimated rate change (example: 90/365 0.01 = 0.0025); and (e) determine the impact on profit or loss as Cumulative Gap adjusted IRC.

(6) When designing a New Product, the impact of interest-rate fluctuations on the balance sheet shall be assessed. Institutions are encouraged to formulate and implement methods and strategies for Pricing, Repricing and Competitive Analysis.

९ 9. Foreign-Exchange-Risk Management

Controlled English translation

(1) Appropriate policies and procedures shall manage exchange-rate risk, and the potential impact on the institution's income and capital shall be assessed.

(2) The monthly return in Form No. 5.3 shall be submitted to the concerned Supervision Department within seven days after month-end.

(3) An Exchange Fluctuation Reserve shall be maintained under Directive No. 4.

(4) Foreign-exchange positions shall be classified by currency and short-/long-term maturity, showing the Net Position for each period. 'Short-term' means one month or less.

(5) The daily net foreign-exchange position shall not exceed 30 percent of Tier 1 Capital for the preceding quarter. An excess shall be brought within the limit within one month, failing which action shall be taken under the Nepal Rastra Bank Act, 2058. Foreign Currency Deposit Liabilities, forward foreign-exchange purchases/sales and other derivatives shall be adjusted in the calculation.

(6) The institution shall be capable of properly assessing, measuring and managing foreign-exchange risks arising from on- and off-balance-sheet transactions.

१० 10. Management of Other Risks

Controlled English translation

Other risks—including Reputation Risk, Strategic Risk, AML/CFT Risk, Legal Risk, and Environmental, Social and Climate Change Risk—shall be identified, and adequate policies and procedures shall be formulated for their management.

११ 11. Risk Management Guidelines

Controlled English translation

The Risk Management Guidelines issued by Nepal Rastra Bank shall also be used as a basis for strengthening risk management in licensed institutions.

१२ 12. Stress-Testing Guidelines

Controlled English translation

Regular stress tests shall be conducted under the prescribed Stress Testing Guidelines. Additionally: (a) tests shall be based on quarterly financial statements and results discussed by the Board and senior management; (b) the NRB-prepared spreadsheet may be obtained from the Off-site Division of the concerned Supervision Department; and (c) the spreadsheet's data and results shall be provided to the Off-site Unit within 30 days after each quarter-end.

१३ 13. Repeal and Saving

Controlled English translation

(1) Directive No. 5/2081 on risk management under the Unified Directives, 2081, and all related circulars issued thereafter up to Magh 2, 2082, are repealed.

(2) Acts and actions performed under the repealed directives and circulars shall be deemed to have been performed under this Directive.

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