RISK MANAGEMENT

2015/2016

Part 1: risk management structure; compliance with resolutions 3380, 3464, 3721, 4090 and circular 3678 of the Brazilian Central Bank (qualitative part)

Contents

Corporate Risk

Objectives

Banco ABC Brasil and its affiliates understand risk management to be a process that seeks to create and preserve the institutions' value, providing reasonable guarantees that any events which might affect it are identified and immediately managed according to its risk appetite.

To that end, it has dedicated risk management structures which assess, monitor and provide information about both the risk assumed and the organization's risk appetite, suggesting measures that strengthen processes, correct failures and restrain practices that are not conducive with the standards required. Thus it also aims to comply with Resolutions 3380, 3464, 3721 and 4090 of the Brazilian Central Bank which govern the activities of the operational, market, credit and liquidity risk management structures, respectively.

The framework developed by Banco ABC is intended to achieve the objectives through actions that enable it to:

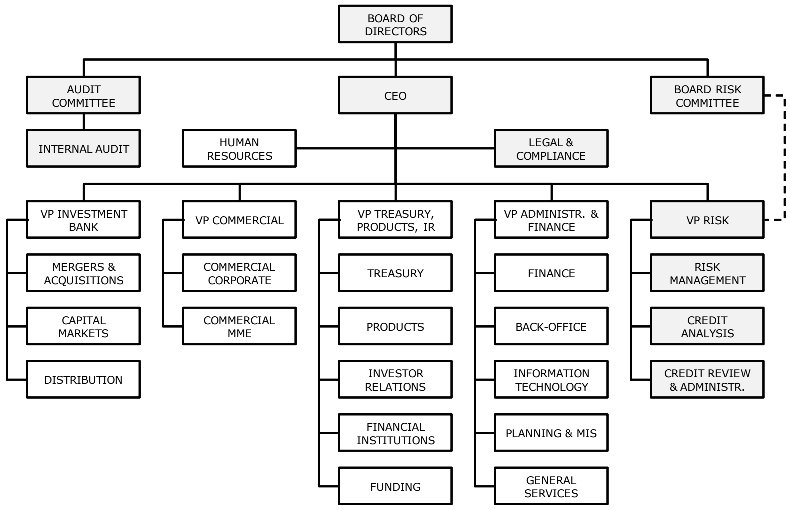
- align the risk appetite with the adopted strategy;
- take decisions in response to risks;
- reduce surprises and operational losses;
- identify and manage risks inherent to the business;
- provide integrated responses to the different risks;
- take advantage of the opportunities;
- improve capital allocation.

Corporate Risk Management is the responsibility of all departments and employees, who must carry out their activities in the best possible manner, timely communicating risks, faults and control deficiencies to the departments in position to deal with them. Yet, it is centralized in the Credit and Risk Management division (commanded by the Chief Risk Officer) and in the Audit. They are accountable to the President and the Board Risk Committee and to the Audit Committee, respectively.

Governance

ABC Brasil, a publicly quoted company whose shares are traded on level two of the São Paulo Stock Exchange, believes that the company should be managed with the main focus on generating shareholder value without adversely affecting the rights of stakeholders, while respecting the laws governing the markets within accepted and recommended standards of ethics.

The bank's governance structure is founded on the regulations of the São Paulo Stock Exchange, the Brazilian Securities Commission (CVM) and the Brazilian Central Bank, and relies on bodies such as the Board of Directors, the Audit Committee, the Fiscal Council and the Executive Board, in addition to internal collegiate bodies such as the Board Risk Committee and other operational committees.



The Board of Directors is charged with defining the institution's risk appetite, approving the business strategies and maintaining high standards of governance. It must ensure the effectiveness of the risk management framework, affording the independence and the resources required for this to function properly. It receives support from the bodies and committees created for that purpose.

The Executive Board is in charge of carrying out the resolutions from the Board of Directors and managing the institution's activities.

Policy Disclosure

The risk management policies are disclosed on the company's intranet, where the norms are published and access is available to all bank employees.

Operational Risk

Description

The bank acknowledges that operational risk represents a specific category of risk and must be managed as such. It must extend to the entire institution, involving to that end all employees while taking into account the bank's processes, activities, systems, products and physical structure. The operational risk management considers legal risks and relies on the support of the legal department, which manages the support of hired law offices. Yet it excludes strategic and reputation risks.

Resolution 3380 of the Brazilian Central Bank, in line with the recommendations of the Basel Committee, requires financial institutions to create and maintain an operational risk management structure. This must be capable of ensuring that events which might have a material effect on the organization are identified, assessed, monitored and, at the same time, controlled or mitigated according to the organisation's risk appetite.

Management is based on continuous identification, assessment, monitoring, control and mitigation of the risks using specific tools. It is routinely monitored within the corporate environment by internal and external auditors and by the Operational Risk and Compliance Committee created for this purpose. The effectiveness of these actions is backed up by timely notification to the management, the involvement of employees and by the efforts to disseminate a risk management culture.

The purpose of operational risk management is the balanced and constant assessment of the exposure to risk, consequently defining the attitude to be adopted in regard to each one: acceptance; reduction, sharing or elimination of the risk.

Management of operational risks is structured along three lines of defense. Primary responsibility rests with the manager of the departments responsible for processes, systems or products. Secondly, the risks are mapped together with their controls and mitigating factors, and monitored by the Risk Management Department. Lastly, Audit Department is the last instance of monitoring, both of the operating, business or support departments, and of the other risk control and management departments.

Responsibilities of the Committees

- *The Board Risk Committee:* approves the operational risk management structure; it comprises four members of the Board of Directors, including the Chairman and Deputy Chairman and grants access to the remaining members.
- *Executive Board:* ensures that the structure approved by the *Board Risk Committee* functions independently, relying on sufficient own resources; approval of the issues raised by the *Operational Risk and Compliance Committee* that require institutional support; comprises the President and the Executive Vice-Presidents;
- *Operational Risk and Compliance Committee*:
  - fostering the risk management culture;
  - risk management and compliance policies;
  - monitoring of the points raised by the auditors, Compliance, Risk Management or the affected area itself, and the respective corrective actions and/or action plans;
  - arbitrating matters involving more than one department or conflict of interests;
  - comprises the Operations and the Credit and Risk Executive Vice-Presidents, managers of Risk Management, Compliance, Operations, Accounts, Technology and Legal departments and invited managers.

Methodology

The Operational Risk management model envisages:

- The identification, assessment, monitoring, control and mitigation of operational risk using management instruments and systems.
- Mapping of processes in a standardized and organized manner based on the organization's structure;
- Systematic structured mapping of risk and controls for each process mapped (Risk and Control Matrix);
- Assessment of risks and controls according to the institution's internal methodology and supported by a dedicated electronic system;
- Key risk indicators;
- Loss and incident bases involving operational risk;
- Tests of Control;
- Notification of operational risk using management instruments, systems or specific forums;
- Universal and specific training.

Capital Allocation	The bank has opted for the "Alternative Standardized Approach" when calculating the operational risk charge (Resolution 4193 and Circular 3640).

Tools

Risk and controls matrix

- Mapping of the processes in all departments, identifying activities, risks and associated mitigating factors;
- Mapping of the risks inherent to the processes;
- Initial assessment of the risks in terms of impact and the probability of occurrence in the absence of controls (inherent risks) and afterwards by applying the control (residual risk);
- Individual assessment of the controls in regard to the degree of mitigation using two concepts: design and performance;
- Analysis of the coherence between the control effectiveness, the inherent risks and the residual risks;
- Incorporation of all data into the electronic operational risk system, enabling the largest risks or deficient controls to be identified, reports to be prepared and action plans defined;

Key risk indicators

- Indicators are captured and registered on the operational risk management system and associated with the various risks on a monthly basis;
- When analyzed in a time series or when compared against operational limits (for example, the capacity to process a given type of transaction), the indicators enable timely identification of operational problems and the preparation of action plans.
- The indicators are also used for assessing the efficacy of the controls and the frequency and impact of the risks, and therefore can be used to check the risk matrix data.

Tools (continuation)	Operational losses data base ◦ The base consists of operational losses classified by operational risk category and business line, and are registered on the electronic operational risk management system after reconciliation with the accounting data; ◦ The loss data base assists in assessing the risks and controls registered on the risk matrix, so that these can be checked and action plans defined; Operational failure data base ◦ Failures not resulting in operational losses are also captured; ◦ They are registered on a dedicated data base and used to check the risk matrix and to identify the need for action plans; Test of controls ◦ The controls associated with critical processes are tested by the Risk Management Department throughout the year; ◦ The test enable the quality of the controls registered on the risks and controls matrix to be checked; ◦ Furthermore, audit work also tests the controls and collects evidence; ◦ The test may lead to action plans where the controls are identified as insufficient or badly applied.
Communication	This occurs through meetings, reports and training sessions. There are specific reports prepared for the Board of Directors, Audit Committee, members of the Executive Committee and Management, besides the participants of the Operational Risk and Compliance Committee.

Market Risk

Description

Market risk is defined as the possibility of losses occurring as a result of fluctuations in the market values of positions held. This concept covers risks of transactions subject to variations in exchange rates, interest rates and share and commodity prices.

Market risk is managed by using internal information which the Risk Management Department, where portfolio exposure control and monitoring are centralized, provides on a daily basis to the Management, Treasury and the members of the Finance Committee.

The Risk Management Department also prepares specific reports for the Board of Directors and the Audit Committee, in addition to also disclosing the risk appetite to those departments involved in managing market risk and participating in the process of approving new products or activities.

Treasury acts on the decisions of the Finance Committee and manages the positions of the trading and banking books within its stipulated operating limits. The Finance Committee formally discusses exposure at weekly meetings and draws up the strategy for the next period, always ensuring that the limits are appropriate for the risk appetite and the market scenario, taking immediate action in cases of nonconformity.

Risk appetite is expressed as limits which are approved for each calendar year or for shorter periods if necessary; Finance Committee and the Board Risk Committee of ABC Brasil are the approval instances.

The market risk management structure adheres to the bank’s standards of governance. Treasury department’s reporting line ensures independence in relation to other business areas. The same applies to the Risk Management Department, which reports directly to the Credit and Risk Vice-President (Chief Risk Officer).

Responsibilities of the Committees

- *The Board Risk Committee:* approves the market risk management structure; approves risk exposure limits;
- *Executive Board:* ensures that the structure approved by the *Board Risk Committee* functions independently, relying on sufficient own resources;
- *Finance Committee:*
  - preapproval of the risk exposure limits;
  - monitoring of treasury positions and defining the strategy for the next period;
  - evaluation of the economic and financial scenario;
  - comprises the President, the Executive Vice-Presidents and the management of Treasury, Risk, Funding and Management Information departments

Tools

The principal tools used by the bank to manage market risk are:

- *Value at Risk (VaR)*: An indicator that measures the value in monetary units of the greatest loss a portfolio may experience in a given period, for a predetermined statistical confidence level. It can be calculated in different ways, but they all take into account the distribution of the return on the portfolios. The advantage of this indicator is that it enables aggregation of the risk of different asset classes, taking into account the correlation between their returns, in addition to being a simple measure for defining exposure limits. The daily reports generated show the VaR calculation for different risk factors, helping to identify concentration of risk in the portfolios and providing guidance regarding the most effective actions for reducing exposure. The calculation is based on an historical VaR model with an observation window of one year, a one-day retention period and a confidence level of 99%. The historical VaR, however, as mentioned in the "stress testing" section below is slow to take into account the initial impact of extreme events resulting from strong shocks that lead to sharp changes in prices and in correlation of returns.

Tools (continuation)

- *Sensitivity analysis (DV01)*: A fixed-income indicator showing earnings or losses resulting from the parallel shift of 1 b.p. (basis point – one-hundredth of one percent) on the forward structure of interest rates. It also serves to indicate risk concentration, taking into account that the effect of changes in interest rates is sharpest at longer tenors.
- *Stress testing:* The result of applying crisis scenarios to the portfolios. These can be historical scenarios representing the effects of crises that already occurred, or hypothetical scenarios. These scenarios must take into account the price variations in an appropriate time frame in order to consider both the accumulated effect of the shocks, and the reversal of the hedge of risk positions. It enables the taking into account of more feasible extreme events which would be found in the tail of the returns distribution curves, which are disregarded in VaR calculations.
- *Back-testing*: Tests that compare daily portfolio returns with the maximum loss predicted by the VaR at a given confidence level. For example, if the VaR has a confidence level of 99%, in the remaining 1% of the times the loss that occurred must be statistically greater than the VaR calculated. The purpose is to verify the adherence of the model used for VaR calculations.

Trading and Banking Books

According to the concepts of the Basel Committee and to comply with the Central Bank resolution, financial transactions are classified as part of the “Trading Book” or the “Banking Book” on account of the purpose for which they have been constituted.

The “Trading Book” comprises a series of positions in financial instruments and commodities traded for the purpose of obtaining gains arising from changes in market prices or as hedge for other positions in the same portfolio. All remaining positions are classified in the “Banking Book”.

Trading and Banking Books	Requisites for trading book transactions: ◦ Daily pricing; ◦ No contractual or legal restrictions on liquidating the position; ◦ High liquidity of the instrument or instruments capable of hedging it; ◦ Responsibility rests with the local or international treasury desks which are free to take positions within stipulated limits and the approved strategy.
Limits Structure	◦ Total book: VaR limit; ◦ Trading book: VaR limits for the book for each risk factor; exposure to risk factors; trading book stop-loss; ◦ Investment portfolio (securities classified in the accounts as available for sale): limits on volume and tenor on account of the indexation agent.
Hedge Accounting	Institutional transactions locked in using derivatives may be marked to market in such a manner that the combined effects on the income cancel each other out within the effectiveness limits established by regulatory resolution. These transactions are approved by the Audit Committee and are subject to special daily monitoring by the Accounting Department so as to ensure that the effectiveness of between 80% and 125% is always observed within the standards of Circular 3082 of the Brazilian Central Bank.
Interest Rate Risk in the Banking Book	Interest rate exposure gaps in the banking book are checked daily on account of the VaR established for the entire portfolio and monitored by specific reports. In addition, the bank allocates economic capital according to Brazilian Central Bank Circular 3365 (Rban calculation) and Pillar II of the Basel Agreement based on the VaR extrapolated for a one-year retention period and a confidence level of 99%.

Liquidity Risk

Description

Liquidity risk appears basically in two ways:

- *Funding risk:* involves access to funds for meeting obligations or expanding the business; contains a time component defined by the occurrence of imbalances between incoming and outgoing funds which might affect payment capacity, taking into account the currencies and tenors for liquidating assets and liabilities;
- *Market liquidity risk*: involves the ability to operate in the markets without causing large displacements of prices or rates.

Liquidity risk is managed by the Finance Committee and executed by Treasury within the operating limits allocated to it by raising and investing cash and by managing imbalances between incoming and outgoing funds over time. It relies on the support of the Risk Management department, which monitors the current and future acceptable levels of liquidity, and the Financial Planning department which centralizes the information for controlling the cash position. The daily reports generated are sent to Treasury, the Executive Board and Internal Audit department. The Finance Committee reassesses the strategy for the subsequent period once a week.

The bank basically raises funds on the wholesale market. That is why diversification is essential for ensuring stable funds that enable financing both of existing portfolios, and for future growth. Therefore, it invests in relationships with corporate clients, institutional clients (such as foundations, pension funds, mutual funds, insurance companies, etc...), private bankers and other Brazilian and international banks. Furthermore, the volume of funding from each client is subject to rules for avoiding excessive concentration in names and maturity dates.

Responsibilities of the Committees

- *Board Risk Committee:* approval of the liquidity risk management structure;
- *Executive Committee:* approval of the liquidity risk management structure, ensuring that this structure functions independently and with its own sufficient resources;
- *Finance Committee:*
  - approval of liquidity limits and setting the minimum cash position;
  - monitoring of liquidity and defining the strategy for the subsequent period;
  - evaluation of the economic and financial scenario and deployment of the liquidity contingency plan.

Tools

- *Liquidity Cushion:* the cash position must be enough to withstand a severe stress scenario for the time needed to implement due actions and guarantee that these show their effects; such scenarios take into account maturing liabilities, redemption of deposits, loss of value on government securities, margin calls and asset renewal rates, among others;
- *Cash flow maps:* indicates the evolution of the cash position in time buckets, serving to assess the behavior by product or client type and the adequacy of the time profile of funding in order to finance the bank's asset portfolios;
- *Liquidity contingency plan*: plan indicating the steps to be taken in managing the portfolios, in the activities of Treasury, in preparing reports and in managing crisis and other situations; it takes into account different scenarios and, in each one, several degrees of severity.

Credit Risk

Description

Because it operates with both large and mid-size corporate clients, the bank opted to create specialized structures for analyzing and granting credit, with the objective of being more efficient and precise in the analysis, in establishing limits and in defining the collateral required.

The Credit Committees are in charge of approving facilities for clients up to the limits of their responsibilities. Above this, approval lies exclusively with the Board Risk Committee.

Management rests with the Credit Department, where individual facilities to clients and economic groups are concerned. They rely on the support of the Operations Departments to ensure that the risks are within the stipulated limits and that collateral meets the required standards in terms of coverage and quality.

The Risk Management Department supervises the loans from the point of view of the portfolio, monitoring concentration and evaluating the impacts of adverse scenarios. The reports generated are sent on a regular basis to the Board Risk Committee, the Audit Committee and the Executive Board.

Banco ABC Brasil's business model, focused on loans, financing, guarantees and derivative instruments with large and mid-cap clients, relies on a structure whose purpose is to ensure:

- an appropriate credit risk management environment;
- an operation with robust processes for granting credit;
- maintenance of proper processes for managing, measuring and monitoring credit;
- proper credit risk controls.

Description (continuation)

This structure takes upon itself the entire credit management cycle, including but not limited to:

- evaluation of new clients;
- review of loans already granted;
- evaluation of new products;
- adequacy of the products to new target clients;
- monitoring of concentrations;
- release of transactions within the approved conditions;
- timely identification of deterioration in the economic and financial situation of clients;
- analysis of the impact of changing scenarios on the quality of the portfolio;
- sufficiency of the collateral provided by clients;
- collection of the amounts owed;
- collection actions;
- management of collateral collected.

Credit Management Criteria

Credit risk management brings together all activities arising from it, ranging from the approval of credit facilities, through to settlement, including the bookkeeping, the allocation of economic and regulatory capital and issuing periodic management reports for the Executive Board and the Board of Directors.

- Credit risk is managed both from the point of view of processes and products;
- The process of approving credit for new or existing clients depends on the authority and responsibility defined for the persons, departments and committees involved;
- The process of granting credit is governed by internal rules for the Corporate and Middle market portfolios and takes into account market conditions, the macroeconomic outlook, changes to products and concentrations in terms of industry sectors or geography;
- Credit risk is assessed on its own merits, considering additionally the mitigating effects of collaterals;
- The effectiveness of credit risk transfer is assessed in the event of acquisition and sale of portfolios, or in the use of instruments such as insurance or guarantees;

Credit Management Criteria (continuation)

- Limits are established on a per-client and per-financial group basis for all exposure to credit risk, including counterparty, settlement and issuer risk for both the trading and the banking books;
- Processes and specific tools exist for managing the credit portfolios and for monitoring clients individually, including proper setting up of provisions and reserves, in addition to processes for attributing and monitoring ratings;
- There are mechanisms for monitoring risks, the quality and concentration of the portfolios, and these are used in preparing stress scenarios and specific reports;
- Counterparty risk arising from alterations to market risk variables is identified and is subject to periodic analysis;
- There are formalized processes for dealing with problem loans, according to their classification and collection stage;
- All positions subject to credit risk are monitored, including off-balance items, which are recorded at the risk attributed to them, taking into account the probability and the impact of the bank's entitlement to receive them;
- Large credit facilities are approved by the Board Risk Committee, which defines the responsibilities of the local management as well;
- New products are analyzed, taking into account both the risk they bring to the bank and to the client, according to their requirements and sophistication;
- The departments involved in managing and monitoring credit risk are independent from the business departments, and they have the structure they require for carrying out their activities;
- Loans are independently verified on a regular basis by audit work, which is forwarded to the Board of Directors and the Executive Board.

Approval Flow	Credit approval begins with the Commercial Departments visiting the company/client. If the client has the profile the bank is looking for, the relationship manager prepares a proposal for analysis by the Credit Department and collects the information required. In possession of the proposal, the Credit Department contacts or visits the company, issuing a credit recommendation. This is discussed and, if considered to be in line with the bank's risk appetite, submitted to the Credit Committee. Approval by the Committee must be unanimous and documented. Thereafter, the approved limits are registered on the credit control system.
Rating	Banco ABC Brasil uses a rating scale applied to clients, supplemented by a rating for each individual transaction. The former is derived from client-related quantitative and qualitative factors and takes into account the industry sector, the quality of the management, the market position, and support from the controlling shareholders, the quality of the information available and the figures in the financial statements. The transaction rating takes into account the additional effect of the associated collateral.
Monitoring of Loans and Collateral	The adequacy of loan exposures is constantly monitored by dedicated systems. The same applies to the collateral which, in addition to this, has a specialist team that monitors the degree of coverage. The Collateral Committee convenes for the purpose of discussing, reporting and solving problems involving the sufficiency or quality of the collateral provided.
Credit Review	The credit reviews are performed by an area that is functionally and formally segregated. The objective is twofold: not only the creditworthiness of the clients are reassessed still during the validity period of the credit lines, but also the quality and the efficacy of the credit analysis process are checked.

Attributed Risk

Derivative transactions make use of the credit facilities specifically approved for them in amounts that take into account a proportion of the notional value. This derives from the tenor of the transaction and the volatility of the risk factors involved. Daily recalculations ensure that volatility shocks, amounts paid and reductions in tenors are taken into consideration.

Credit Recovery Process

Banco ABC Brasil uses specific processes for the rapid recovery of past due loans, for which it also has a dedicated structure. The Credit, Commercial and Legal departments, in addition to the Credit Committees and the Commercial Vice-Presidents, become directly involved, while the solution of problems is monitored on a case-by-case basis.

Responsibilities of the Committees

- *Board Risk Committee*: in charge of approving the credit risk management structure and the facilities that exceed the responsibilities of the local credit committees;
- *Executive Committee:* approval of the credit risk management structure, ensuring that this structure functions independently and with its own sufficient resources;
- *Credit Committee – Corporate*: charged with approving loans to corporate clients up to the limit of its authority and with ratifying the rating attributed to the clients and to the transactions – all approvals must be unanimous among its voting members, including the President, the Executive Vice-Presidents and the manager of the Credit department;
- *Credit Committee – Enterprises:* charged with approving loans to middle-market clients up to the limit of its authority and with ratifying the rating attributed to the clients and to the transactions - all approvals must be unanimous among its voting members, including the President, the Executive Vice-Presidents and the manager of the Credit department;
- *Finance Committee – Financial Institutions:* equal to the Corporate Credit Committee, but dedicated to credit for financial institutions;
- *Syndicated Transactions Committee*: responsible for approving limits for underwriting transactions;

Responsibilities of the Committees (continuation)

- *Collaterals Committee:* discusses and defines solutions for cases where collateral is deficient or there are quality problems.
- *PDD Committee:* discusses and validates the allocation of the amounts of provisions for all the bank's transactions, reassessing the rating on account of the arrears band, the collateral provided or relevant facts that impact the client's ability to repay;
- *BNDU (Assets not Intended for Use) Committee:* discusses the fate of assets recovered in problem loans and defines the criteria for their sale.

Conclusion

Conclusion	The Operational, Market, Liquidity and Credit Risk Management structures are in accordance with the size and degree of complexity of the bank's operations, and enjoy the independence and support required for carrying out their functions.
Approval of the Report	This report was approved by the Board of Directors, following the previous approval at the meeting of the Executive Board, in accordance with resolutions 3380, 3464, 3721 and 4090 of the Brazilian Central Bank.

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