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GUIDELINES ON SUPERVISION BY RISK

The Monetary Board in its Resolution No. 68 dated 19 January 2006 approved the attached guidelines on supervision by risk to provide guidance on how financial institutions (FIs) should identify, measure, monitor and control risks.

The guidelines set forth the expectations of the Bangko Sentral ng Pilipinas (BSP) with respect to the management of risks and are intended to provide more consistency in how the risk-focused supervision function is applied to these risks. The BSP will review the risks to ensure that an FI's internal risk management processes are integrated and comprehensive. All FIs should follow the guidance in their risk management efforts.

This Circular shall take effect fifteen (15) calendar days after publication in the Official Gazette or in a newspaper of general circulation.

Adopted: 3 Feb. 2006

(SGD.) AMANDO M. TETANGCO, JR.
Governor

Guidelines on Supervision by Risk

I. Background

It must be recognized that banking is a business of taking risks in order to earn profits. While banking risks historically have been concentrated in traditional banking activities, the financial services industry has evolved in response to market-driven, technological, and legislative changes. These changes have allowed financial institutions (FIs) to expand product offerings, geographic diversity, and delivery systems. They have also increased the complexity of the FI's consolidated risk exposure. Because of this complexity, FIs must evaluate, control, and manage risk according to its significance. The FIs evaluation of risk must take into account how nonbank activities within a banking organization affect the FI. Consolidated risk assessments should be a fundamental part of managing the FI. Large FIs assume varied and complex risks that warrant a risk-oriented supervisory approach.

II. Statement of Policy

The existence of risk is not necessarily reason for concern. Likewise, the existence of high risk in any area is not necessarily a concern, so long as management exhibits the ability to effectively manage the level of risk. Under this approach, the Bangko Sentral ng Pilipinas (BSP) will not necessarily attempt to restrict risk-taking but rather to ensure that FIs identify, understand, and control the risks they assume. As an organization grows more diverse and complex, the FIs risk management processes must keep pace. When risk is not properly managed, BSP will direct FI management to take corrective action such as reducing exposures, increasing capital, strengthening risk management processes or a combination of these actions. In all cases, the primary concern of the BSP is that the FI operates in a safe and sound manner and maintains capital commensurate with its risks. Further guidance on risk management issues will be addressed in subsequent issuances that are part of the overall risk assessment program.

III. Guidelines for Risk Management

For purposes of the discussion of risk, the BSP will evaluate banking risk relative to its impact on capital and earnings. From a supervisory perspective, risk is the potential that events, expected or unanticipated, may have an adverse impact on the FI's capital or earnings.

The BSP-Supervision and Examination Sector has defined eight categories of risk for FI supervision purposes. These risks are: credit, market, interest rate, liquidity, operational, compliance, strategic, and reputation. These categories are not mutually exclusive; any product or service may expose the FI to multiple risks. In addition, they can be interdependent. Increased risk in one category can increase risk in other categories.

Types and Definitions of Risk

1. Credit risk arises from a counterparty's failure to meet the terms of any contract with the FI or otherwise perform as agreed. Credit risk is found in all activities where success depends on counterparty, issuer, or borrower performance. It arises any time FI funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreements, whether reflected on or off the balance sheet. Credit risk is not limited to the loan portfolio.

2. Market risk is the risk to earnings or capital arising from changes in the value of traded portfolios of financial instruments. This risk arises from market-making, dealing, and position-taking in interest rate, foreign exchange, equity and commodities markets.

3. Interest rate risk is the current and prospective risk to earnings or capital arising from movements in interest rates. Interest rate risk arises from differences between the timing of rate changes and the timing of cash flows (repricing risk); from changing rate relationships among different yield curves affecting FI activities (basis risk); from changing rate relationships across the spectrum of maturities (yield curve risk): and from interest-related options embedded in FI products (options risk).

4. Liquidity risk is the current and prospective risk to earnings or capital arising from an FI's inability to meet its obligations when they come due without incurring unacceptable losses. Liquidity risk includes the inability to manage unplanned decreases or changes in funding sources. Liquidity risk also arises from the failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value.

5. Operational risk is the current and prospective risk to earnings or capital arising from fraud, error, and the inability to deliver products or services, maintain a

competitive position, and manage information. Risk is inherent in efforts to gain strategic advantage, and in the failure to keep pace with changes in the financial services marketplace. Operational risk is evident in each product and service offered. Operational risk encompasses: product development and delivery, operational processing, systems development, computing systems, complexity of products and services, and the internal control environment.

6. Compliance risk is the current and prospective risk to earnings or capital arising from violations of, or nonconformance with, laws, rules, regulations, prescribed practices, internal policies and procedures, or ethical standards. Compliance risk also arises in situations where the laws or rules governing certain FI products or activities of the FI's clients may be ambiguous or untested. This risk exposes the FI to fines, payment of damages, and the voiding of contracts. Compliance risk can lead to diminished reputation, reduced franchise value, limited business opportunities, reduced expansion potential, and lack of contract enforceability.

7. strategic risk is the current and prospective impact on earnings or capital arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes. This risk is a function of the compatibility of an organization's strategic goals, the business strategies developed to achieve those goals, the resources deployed against these goals, and the quality of implementation. The resources needed to carry out business strategies are both tangible and intangible. They include communication channels, operating systems, delivery networks, and managerial capacities and capabilities. The organization's internal characteristics must be evaluated against the impact of economic, technological, competitive, regulatory, and other environmental changes.

8. reputation risk is the current and prospective impact on earnings or capital arising from negative public opinion. This affects the FIs ability to establish new relationships or services or continue servicing existing relationships. This risk may expose the FI to litigation, financial loss, or a decline in its customer base. In extreme cases, FIs that lose their reputation may suffer a run on deposits. Reputation risk exposure is present throughout the organization and requires the responsibility to exercise an abundance of caution in dealing with customers and the community.

IV. FI Management of risk.

Because market conditions and company structures vary, there is no single risk management system that works for all FIs. Each FI should tailor its risk management program to its needs and circumstances. Sound risk management systems, however, have several things in common; for example, they are independent of risk-taking activities. Regardless of the risk management program's design, each program should:

1. Identify risk: To properly identify risks, an FI must recognize and understand existing risks or risks that may arise from new business initiatives, including risks that originate in nonbank subsidiaries and affiliates. Risk identification should be a continuing process, and should occur at both the transaction and portfolio level.

2. Measure risk: Accurate and timely measurement of risk is essential to effective risk management systems. An FI that does not have a risk measurement system has limited ability to control or monitor risk levels. Further, the more complex the risk, the more sophisticated should be the tools that measure it. An FI should