# Amando M Tetangco, Jr: Central Bank of the Philippines' initiatives to strengthen risk management practices in banks

Keynote address by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the Quarterly Risk Management Forum, Makati City, 6 December 2006.

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Good afternoon, and thank you for inviting me to speak in this quarter's risk management forum organized by the Gov. Jose B. Fernandez, Jr. Center for Banking and Finance (JBF Center), in cooperation with the Professional Risk Managers' International Association (PRMIA).

My remarks this afternoon will focus on BSP's initiatives to strengthen risk management practices in banks under our supervision. Since banks still dominate the financial landscape in our country, the BSP as the banking supervisor has to be at the forefront of the development of better risk management practices in the country. Although this is a very challenging role to play given the pace of development in the field of risk management, I do believe that the BSP is up to the challenge and has been proactive judging by the number of initiatives we have put in place starting in the mid-90s.

It is my pleasure to share with you our experience on the implementation of these initiatives, but before that let me highlight the risk profile of the Philippine banking system, which dictated the direction and pace of these regulatory actions.

## Risk profile of the Philippine banking system

As of end-June 2006, total on-balance sheet assets of the banking industry amounted to P4.5 trillion, of which about 89 percent are accounted for by the dominant commercial banking segment. Additionally, off-balance sheet notional accounts – consisting of derivatives, trust and trade-related contingent exposures – amounted to P2.3 trillion. In terms of risk-weighted assets or RWA – which is a supervisory measure of banks' risk exposures to credit risk and market risk only – commercial banks' exposures are made up of 90 percent credit risk and 10 percent market risk. With the addition of operational risk in the risk-based capital adequacy framework of the BSP on 1 July 2007, our simulations show that commercial banks' RWA will be made up of 77 percent credit risk, 8 percent market risk, and 15 percent operational risk.

As primary buffer against these risk exposures, Tier 1 capitalization of the banking system, which includes hybrid Tier 1 capital stood at P433 billion as of end-March 2006. Our banks have also issued P79 billion in Tier 2 capital as allowed under our regulations consistent with international practices.

CAR (capital adequacy ratio) stood at 19.4 percent as of end-March 2006[1] while loss provisions, which serve as cushion for expected losses have been significantly boosted from just 1.44 percent of total assets in end-December 1997, to 2.72 percent as of end-June 2006.

## BSP's risk management initiatives

Now, let me guide you through the important historical highlights of BSP's risk management initiatives.

In 1995, the BSP recognized the greater risk exposure in the system brought about by derivatives activities. To mitigate this, the BSP issued Circular No. 102 prescribing the minimum standards for risk management of derivatives. This was probably the first BSP regulation that specifically focused on banks' market risk taking activities and risk management practices. Prior to this, risk management regulations were largely confined to basic credit risk management and to internal control issues.

In 1997, the thrust of bank supervision started to shift its focus towards a more forward-looking view of risk management and whether a bank has the infrastructure to manage its own risks, instead of just mainly performing financial audit and compliance review. The objective was to address weaknesses in management and internal controls before financial performance suffers rather than being satisfied with identifying what went wrong after the fact.

The BSP's effort to focus on risk management is ultimately intended to give banks greater flexibility to respond to changing opportunities and challenges in the face of global competition under a more deregulated environment and at a time of rapid technological advances.

Traditional bank supervision tended to micromanage banks to avoid risks that seem too high. The new approach to supervision is now more focused on the assessment of the quality of risk-management practices and generally allows banks to take on greater risks so long as the banks demonstrate the ability to identify, measure, manage and price for those risks.

This more liberal approach to supervision, which allows banks more opportunities for success, entails that the BSP emphasize the responsibility of the banks' board of directors and senior management to ensure the soundness and stability of their respective banks. The regulators' role is primarily to evaluate the quality of oversight and management provided by these critical actors – that is, the quality of corporate governance.

Strengthening banks' corporate governance has thus been the theme of a number of BSP regulations. In June 1997, Circular No. 130 requiring the board of directors of banks to, among others, adopt and maintain adequate risk management policy was issued. A few months after, or in October 1997, the BSP also issued Circular No. 145 requiring banks to develop and implement a compliance system and to appoint/designate a compliance officer to oversee its implementation. In September 2001, the BSP issued Circular No. 296 which implemented the fit and proper standards for directors and officers of banks and non-banks as mandated by the General Banking Law (GBL) of 2000. The same Circular also prescribed a mandatory orientation program on corporate governance for banks' board of directors. Moreover, the BSP issued in October 2003 Circular No. 410 which provided the accreditation guidelines for banks' external auditors.

In 2004, the BSP continued to issue a number of guidelines that aimed to further enhance governance practices in banks. Earlier that year, the BSP issued the guidelines for the management of banks' large exposures (Circular No. 414). This was followed by the strengthening of rules on connected party transactions or DOSRI by expanding both the coverage of transactions and the definition of related interests (Circular No. 423). The BSP also issued Circular No. 429 that year which aimed to further strengthen banks' compliance function. The BSP also issued that year the guidelines for the development and implementation of banks' internal credit risk rating systems (Circular No. 439) in anticipation of Basel II. The guidelines strongly emphasize the oversight function of the board of directors over these systems. Before 2004 ended, BSP issued Circular No. 456 amending the provisions on the specific duties and responsibilities of the board of directors in the Manual of Regulations for Banks. The said Circular created three board-of-director-level committees, namely; audit committee, corporate governance committee, and risk management committee.

This year, the BSP pushed forward with its shift to risk-based supervision by issuing the guidelines on the supervision by risk, setting forth the expectations of the BSP with respect to the conduct of risk management by financial institutions under its jurisdiction. This was followed closely by the issuance of the guidelines on technology risk management, which is aimed at ensuring effective management of technology-related risks by financial institutions. Just recently, the BSP issued broad guidelines on market risk management and liquidity risk management, which set forth BSP's expectations on the management of these risks by banks.

## BSP's risk-based capital initiatives

While the BSP has been trying to enhance banks' risk management practices, it is also simultaneously working on improving the risk-based capital adequacy framework as empowered under the GBL of 2000. We responded swiftly once the legal framework was put in place. In March 2001, the BSP adopted Basel I-type framework through Circular No. 280. This Circular provided the guidelines for the computation of risk-based capital for credit risk. The BSP's risk-based capital adequacy framework was further enhanced with the issuance of Circular No. 360 in December 2002. Circular No. 360 incorporated market risk into the framework.

In 2005, the focus was on preparing the implementing regulations for the eventual implementation of Basel II in the Philippines. At the time, preparatory works on Basel II implementation were already at an advanced stage globally. The discussions during international fora had already become complex and rather extended. For our part, the approach to implementation has been more calculated. Certain elements of the Basel II approaches such as those pertaining to risk weights for corporates and NPLs, were gradually incorporated in existing regulations to pave the way for a smoother implementation of

the whole new framework in 2007. Meanwhile, in response to heightened appetite and growing exposure of banks to structured products and in preparation for the envisaged take-off of the domestic securitization market following the approval of the Securitization Act of 2004, the BSP pre-emptively issued in 2005 the risk-based capital treatment of banks' exposures to structured products and securitization structures. In support of major policy objectives of enhancing credit access and expediting the clean-up of bad assets from the system, the BSP likewise advanced lower credit risk weightings for high grade corporate debt exposures and micro and SME exposures, but also increased the risk weighting on non-performing loans.

This year, the BSP has issued the much-awaited Basel II implementing guidelines for the Philippines. The BSP's Task Force on the Implementation of Basel II has just concluded their series of briefings both within and outside of the BSP in preparation for the parallel run that will be conducted starting end this year until mid next year. Unlike the existing BSP risk-based capital adequacy framework, the new Basel II-based framework does not only focus on the computation of the appropriate level of capital given a certain level of risk exposure, but it also highlights the need for more market disclosures by banks on their risk management exposures and practices. This is fully consistent with Basel II Pillar 3 recommendations, as well as the new International Financial Reporting Standards or IFRS which we fully adopted since 2005. The rationale is that the market itself contains disciplinary mechanisms that can reinforce the efforts of supervisors by rewarding banks that manage risk effectively and penalizing those whose risk management is inept or imprudent through their patronage or non-patronage.

### Basel II and risk management

As we move into implementation of Basel II, industry reaction is both revealing and interesting. On one hand, the commotion it is causing with banks doubling their efforts in improving their risk management systems to meet the requirements of the advanced approaches is a very positive development as far as the BSP is concerned. On the other hand, it is rather disappointing that it takes regulatory pressure for many banks to finally start investing in a sound risk management system.

I understand that there are certain problems that now face banks as they aim to improve their own risk management systems. . A survey of emerging market central banks conducted by the BIS reveals the three main difficulties faced not just by you, but by banks in emerging markets in general, in implementing more sophisticated risk assessment techniques. These are:

1. Data problems. Modern techniques of risk assessment in Basle II involve estimation of probabilities of default on the lenders' portfolio, as well as of loss-given-default. Foreign banks get around by relying on data from their home country operations, but these data may not be applicable in the emerging markets they operate in. Many emerging markets are however taking steps to improve data availability. For example, Malaysia and Thailand have respectively established centralized credit registry for households and corporations and a credit information bureau.
2. Lack of suitable techniques for designing and calibrating models to evaluate alternative scenarios.
3. Large human resources and infrastructure (IT and other) costs of implementing advanced techniques for risk assessment.

But improvements in risk management have inherent value to banks by avoiding major costs, including potentially catastrophic costs that can break a bank. Thus they should be pursued with or without regulatory requirements. Those of you who are sports fans can relate to this. As you know, success in many sports today relies on a solid defense that is always there whether the breaks are with you or not.

Sophisticated risk management systems should be put in place because the bank sees the need to, and not just to impress, or perhaps intimidate the supervisors. The latter I guarantee is highly unlikely to happen because our supervisory personnel have also been doing their homework. Indeed, we have not just strengthened the regulatory framework. No less important, the BSP has invested heavily in the last few years in enhancing our supervisory capacity in line with the new demands. These efforts have ranged from individual skills enhancement through world class in-house structured training program to acquisition of relevant international certification, to creation of highly trained special teams, and

currently a wholesale re-engineering and reorganization of the whole supervision and examination set-up. I assure you, we will be up to the task. We practice what we preach.

Wrong motivations for improving banks' risk management systems may obscure the ultimate aim for such actions – i.e., to make banks' shareholders and other stakeholders, NOT the regulators, happy by safeguarding and enhancing the value of their investments. On our part, BSP's interest in promoting better risk management is motivated more by macro considerations – that is, a safe and sound banking system is crucial to economic growth and to the stability of financial markets.

## Concluding remarks

Let me now sum up. If you notice, the BSP initiatives I have mentioned are geared towards simultaneously promoting sound risk management practices in banks, and strengthening the risk-based capital adequacy framework. This is because both robust risk management and strong capital positions are critical in ensuring that individual banks operate in a safe and sound manner, which in turn enhances the stability of the financial system. In addition, strong capital helps banks absorb unexpected shocks and reduces moral hazard associated with the regulatory safety nets.

Finally, let me reiterate BSP's commitment to the identification, assessment, and promotion of sound risk management practices in the financial system, which it considers as central elements of good supervisory practice. But of course the BSP can only do this with the invaluable help of our allies from the academe and the industry, such as the JBF Center and PRMIA.

Before I end, let me just quote Captain James Kirk of the Star Trek Enterprise: "Risk is our business. That's what this starship is all about. That's why we're aboard her." Indeed, the same can be said of banking.

Thank you very much and good day to all of you.