

## **GUIDELINES ON THE BANGKO SENTRAL'S SUPERVISORY REVIEW PROCESS**

### ***(Appendix to Sec. 130)***

#### **A. Introduction**

1. The Bangko Sentral 's supervisory review process (SRP) in the context of this document involves (1) an evaluation of banks' internal capital adequacy assessment processes (ICAAP) and their output, (2) a dialogue with banks with regard to their ICAAP, and (3) the prudential measures that may be taken to address issues identified. These guidelines should be observed mainly by the appropriate Central Point of Contact Department (CPCD) within the Bangko Sentral and, where appropriate for on-site validation during regular examination, by the examination personnel. This therefore supplements the existing guidelines set out in the Manual of Examinations, the CAMELS Rating, and the Risk Assessment System (RAS). The CPCD may draft, for its own use, detailed guidelines on the conduct of the assessment of banks' ICAAP and of the Bangko Sentral - bank dialogue.
2. Although these guidelines are directed mainly at Bangko Sentral supervision and examination personnel, banks will have a clear interest in knowing the approach the Bangko Sentral intends to take in assessing their capital adequacy.

#### **B. Guiding principles in assessing banks' ICAAP**

1. As a first step, the Bangko Sentral should evaluate banks' compliance with the minimum regulatory capital requirements as prescribed under the Framework. This would involve the verification of banks' calculation of their risk weighted assets (RWA) and capital adequacy ratio (CAR). The minimum regulatory capital requirements should always be the starting point in the assessment of banks' capital adequacy. The validated CAR should then be compared with the required capital resulting from the ICAAP.
2. Next, the assessment of banks' ICAAP should include an evaluation of their assumptions, components, methodologies, coverage and outcome. This review should cover both banks' risk management processes and their assessment of adequate capital. The Bangko Sentral should review how banks assess the other risks they are exposed to, especially Elements 2 to 4 listed in Item "C.4" hereof, the controls they have in place to mitigate these risks, as well as the adequacy and composition of capital held against those risks.
3. The Bangko Sentral should then identify existing or potential problems and key risks faced by banks, the deficiencies in their control and risk management frameworks, and the degree of reliance that can be placed on the outputs of their ICAAP. This process will enable the Bangko

Sentral to tailor its approach for each individual bank and will provide the foundation for the Bangko Sentral 's general approach for each bank and its actions.

4. The Bangko Sentral 's evaluation of the adequacy of banks' capital in relation to their risk profile would serve as the basis for assigning a rating for the Capital component of the bank's CAMELS rating. It would also serve as the basis for identifying any prudential measures or other supervisory actions required. For example, where there is an imbalance between business and risk controls, the Bangko Sentral should consider the range of remedial supervisory actions that may be needed to rectify a deficiency in controls and/or perceived shortfalls in capital, either as a long-term requirement(s) or as a short-term action(s).
5. The results of the SRP will be communicated to the board and senior management of banks together with any action that is required of them and any significant action planned by the Bangko Sentral . This may be done as part of the dialogue between the Bangko Sentral and each bank on the ICAAP.
6. In evaluating the ICAAP of branches of foreign banks in the Philippines, the Bangko Sentral will refer to the home supervisor's consolidated assessment of the ICAAP of the head office/parent bank. The Bangko Sentral will also take into account the strength and availability of parental support.

### **C. Guiding principles on Bangko Sentral -bank dialogue**

1. A key element of the SRP is the dialogue between the Bangko Sentral and each bank. The dialogue will inform the Bangko Sentral about the way each bank's ICAAP is structured, and the assumptions and methodologies which are used to assess its risk exposures.
2. The ICAAP document, which banks are required to submit to the Bangko Sentral every January of each year (suggested format is in Annex A of Appendix 90), will be the basis for the Bangko Sentral -bank (specifically, BSP-CPCD) dialogue. This dialogue may feed into the regular examination, and the findings of the regular examination may in turn feed into the dialogue. The Bangko Sentral will determine the nature and depth of the dialogue, based on the type and complexity of the bank.
3. Banks should be able to justify their processes for identifying and measuring their risks as well as how much capital, if any, they allocate against them, taking into account other qualitative mitigants of risk. Banks should be able to explain any differences between their own assessment of capital needs and targets under the ICAAP and the minimum regulatory capital requirements prescribed under the Framework.

4. The dialogue should embrace the following four main elements:
  - a. Element 1: Risks covered under the Framework (i.e., credit risk, market risk, and operational risk);
  - b. Element 2: Risks not fully covered under the Framework (for example, credit concentration risk, risk posed by non-performing assets, risk posed by contingent exposures, etc.);
  - c. Element 3: Risks not covered under the Framework (other risks identified under Circular No. 510 dated 3 February 2006); and
  - d. Element 4: External factors, which include risks which may arise from the regulatory, economic or business environment.
5. Aside from these four main elements, the dialogue should also cover the quality of internal governance of banks, including risk controls, compliance and internal audit, as well as operational and organizational structure.
6. For the SRP to be effective, the Bangko Sentral will need to develop a sufficiently thorough understanding of how the ICAAP is determined and the differences between it and the minimum regulatory capital requirement under the Framework. This would help in evaluating the ICAAP outcome. The SRP emphasizes the importance of analyzing the main elements, and understanding the differences between ICAAP assumptions and minimum regulatory capital requirement assumptions.
7. Once the process has begun, the dialogue will provide the opportunity for iteration between the ICAAP and SRP, with each informing the other, i.e., banks may make changes to the ICAAP in the course of the dialogue, in response to challenge and feedback from the Bangko Sentral, and vice versa. Following the dialogue, the Bangko Sentral will reach an assessment.

#### **D. Guidelines on prudential measures**

If the Bangko Sentral considers that a bank's ICAAP does not adequately reflect its overall risk profile, or does not result in the bank having adequate capital, then consideration should be given to applying prudential measures.

1. The measures available to the Bangko Sentral include:
  - a. Requiring the bank to improve its internal control and risk management frameworks;
  - b. Requiring the bank to reduce the risk inherent in its activities, products and systems;
  - c. Restricting or limiting the business, operations or network of the bank;
  - d. Limiting or prohibiting the distribution of net profits and requiring that part or all of the net

profits be used to increase the capital accounts of the bank; and  
e. Requiring the bank to increase its capital.

2. The choice of prudential measures should be determined according to the severity and underlying causes of the situation and the range of measures and sanctions available to the Bangko Sentral . Measures can be used individually or in combination. The requirement to increase capital should, however, be imposed on any bank which exhibits an imbalance between its business risks and its internal control and risk frameworks, if that imbalance cannot be remedied by other prudential measures or supervisory actions within an appropriate timeframe.
3. The requirement to increase capital may also be set where the Bangko Sentral judges the existing capital held by a bank to be inherently inadequate for its overall risk profile. It must be acknowledged that there is no 'scientific' method for determining the amount, and that capital is not a long-run substitute for remedying deficiencies in systems and controls. In practice, the process relies heavily on subjective judgment and peer-group consistency to ensure a level playing field and a defense to possible challenge that may be posed by banks.
4. Prudential measures should be communicated promptly and in sufficient detail. In communicating its decision on prudential measures, the Bangko Sentral should:
  - a. Explain in sufficient detail the factors which have led to the risk assessment conclusions;
  - b. Indicate areas of weakness and the timeframe for remedial action;
  - c. Explain the reasons for any additional capital requirement; and
  - d. Indicate what improvements could be made to systems and controls to make them adequate for the risks and activities of the bank, and for this improvement to be reflected in the bank's capital requirements.