



BANGKO SENTRAL NG PILIPINAS

OFFICE OF THE GOVERNOR

MEMORANDUM NO. M-2013-023

To : ALL BANKS

Subject : BSP Compliance Rating System

The Monetary Board in its Resolution No. 809 dated 16 May 2013 approved the attached Compliance Rating System (CRS), which aims to provide a framework for assessing the quality of the compliance system and provide appropriate supervisory actions for weaknesses and violations of rules and regulations.

The assessment on the CRS will form part of the assessment of "controls and independent oversight" factor in the Corporate Governance assessment as articulated in Memorandum to All BSP Supervised Financial Institutions No. 2013-002 dated 11 January 2013. Overall assessment of corporate governance, in turn, shall be incorporated in the "Management" component of CAMELS¹ rating. On the other hand, for branches of foreign banks the assessment on the CRS shall be an input in the "Compliance" component of ROCA² rating.

The CRS will be used in assessing the quality of the compliance system in examinations starting September 2013.

FOR THE MONETARY BOARD:

AMANDO M. TETANGCO, JR.
Governor

28 May 2013

¹ Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity to Market Risk
² Risk Management, Operational Controls, Compliance, and Asset Quality



BANGKO SENTRAL NG PILIPINAS

BSP COMPLIANCE RATING SYSTEM

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BSP COMPLIANCE RATING SYSTEM

Policy Statement

The Bangko Sentral ng Pilipinas actively promotes the safety and soundness of the Philippine banking system through an enabling policy and oversight environment. Such environment is governed by the high standards and accepted practices of good corporate governance. Towards this end, the Revised Compliance Framework requires financial institutions to implement a robust, dynamically-responsive and distinctly-appropriate Compliance System as an integral component of an institution's internal controls and risk management system.

A responsive enforcement on the implementation of regulations on compliance system is premised on a holistic approach taken on supervision. Supervision is not centered on an enumeration of violations noted but rather on the nature and degree of the impact of these violations on the safety and soundness of the supervised entity, as determined through BSP's risk assessment process provided under Guidelines on Supervision by Risk, Section X173 of the Manual of Regulations for Banks (MORB). As such, in arriving at the appropriate enforcement action/s, there may not necessarily be a one to one correspondence between the violations noted and the enforcement actions deployed. BSP's supervisory action shall be directed to correct the cause of the violations and minimize the impact of these violations. This is consistent with BSP's Guidelines on Supervision by Risk which provides that BSP's risk assessment of the supervised entity drives supervisory strategies and activities¹. In order to achieve this, the BSP shall evaluate the overall effectiveness of financial institutions' compliance system in mitigating business risk. This shall aid BSP in assessing level of supervisory concern and apply enforcement actions accordingly.

Overview

The Compliance Rating System serves as a tool for the BSP to assess in a comprehensive and consistent manner the effectiveness of the institutions' compliance system and provide appropriate supervisory actions for weaknesses and violations of regulations pertaining to compliance. Furthermore, the Compliance Rating System supplements other supervisory tools such as the Anti-Money Laundering/Information Technology/Trust, ROCA² and CAMELS³ rating systems or such other tools that may be adopted by the BSP. Specifically, the assessment on compliance system will form part of assessment of "controls and independent oversight" factor in the Corporate Governance

¹ Section VI of Appendix 72, an appendix to Section X173 of the MORB.

² Risk Management, Operational Controls, Compliance, and Asset Quality

³ Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk

assessment as articulated under Memorandum to All BSP Supervised Financial Institutions No. 2013-002 dated 11 January 2013. Overall assessment of corporate governance, in turn, shall be incorporated in the “Management” component rating of CAMELS rating. On the other hand, for branches of foreign banks, the compliance assessment shall provide an input in the “C” component of the ROCA rating system.

On the basis of the over-all assessment of an institution’s compliance system, supervisory actions shall be taken. A compliance system found to be materially inadequate within the parameters of these guidelines indicates existence of unsafe and unsound practices⁴ and may subject the supervised entity to appropriate enforcement actions provided under existing laws, rules, and regulations.

Assessment Approach

The Compliance Rating System aims to provide a framework for assessing the quality of compliance system and corresponding supervisory actions for weaknesses and violations noted. This framework provides a structure to assist the supervisor in exercising sound judgment in assessing the compliance system.

In applying these guidelines, supervisors should keep in mind the principle of proportionality to facilitate the integration of issues to come up with an overall rating for the compliance system. As articulated in BSP’s Guidelines on Supervision by Risk (Section X173 of the MORB)⁵, market-driven, technological and legislative changes have allowed financial institutions to expand product offerings, geographic diversity, and delivery systems which in turn increased the complexity of financial institutions’ consolidated risk exposure. Thus, financial institutions must evaluate, control and manage risks according to its significance. Further, because market conditions and company structures vary, there is no single risk management system that works for all financial institutions. Thus, each financial institution should tailor its risk management system to its needs and circumstances⁶. Similarly, there is no “one size fits all” framework for compliance and the approach to compliance will vary from one financial institution to another depending on its risk profile. Correspondingly, BSP’s assessment shall be based on these underlying principles.

Overall assessment of the effectiveness of the institution’s compliance system is a reflection of the supervisor’s use of professional judgment within the parameters of existing regulations and guidelines; thus, the assessment of the compliance system requires understanding of the institution’s business model and strategy, as well as its risk profile. This is to ensure that evaluation of compliance system shall be proportionate to the nature, complexity and volume of the institution’s operations, consistent with risk-focused supervision provided under Section X173 of the MORB. Thus, the evaluation of the quality of compliance system should transcend the checklist approach in determining

⁴ As defined under existing laws, rules, and regulations.

⁵ Section I of Appendix 72 (Guidelines on Supervision by Risk), an appendix to Section X173 of the MORB.

⁶ Section IV of Appendix 72 (Guidelines on Supervision by Risk), an appendix to Section X173 of the MORB.

compliance with the provisions of existing regulations. This is particularly true especially when framing appropriate supervisory actions that aim to correct the underlying root cause(s) of violations and minimize impact of weaknesses on the safety and soundness of the institution.

Under the Compliance Rating System, each financial institution is assigned a composite rating based on an assessment of three components that address the following:

1. Board of Directors (BOD) and Senior Management (SM) oversight (“Management Oversight”);
2. Compliance Policy and Program; and
3. Internal controls and audit.

In addition to reviewing formal documents that describe the institution’s compliance system, the BSP shall supplement the same with on-site observation and verification of its implementation. Thereafter, a component rating shall be assigned ranging from 4 as the strongest and 1 as the weakest.

The overall or composite rating generally bears a close relationship to the component ratings assigned. However, the composite rating is not derived by computing an arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of that component and its interrelationship with the other components. The supervisor shall assess which areas place the greatest impact on the overall safety and soundness of the institution. In all cases, enforcement actions shall be based on underlying weaknesses/deficiencies and violations of laws, rules and regulations that support component and composite ratings.

The composite rating is assigned based on a 1 to 4 numerical scale. The highest rating of 4 indicates the strongest and most effective compliance system that entails minimal supervisory concern on compliance. The lowest rating of 1, on the other hand, signifies the weakest compliance system which requires the highest degree of supervisory concern.

COMPOSITE RATING

Description

The composite rating reflects the overall conclusion of the supervisor about the effectiveness of the institution's compliance system in mitigating business risk. The composite ratings are defined as follows:

Composite 4

The compliance system is strong relative to the institution's size, complexity and risk profile and has minimal cause for supervisory concern. Any identified weaknesses are minor, can be routinely handled by the Board and Senior Management and/or does not affect overall quality of compliance system. The compliance framework is clearly defined, effectively implemented, and fully compatible with the nature and complexity of the institution's activities. All or most of its component ratings are 4 with no component rating below 3. This institution is in substantial compliance with laws and regulations. The compliance system is most capable in identifying and mitigating reputation, compliance, market conduct, and legal risks that may erode the franchise value of the institution. Supervisory response is very limited. No administrative sanctions shall be imposed.

Composite 3

The compliance system is acceptable relative to the institution's size, complexity and risk profile with moderate supervisory concern. Moderate weaknesses may be present, exhibiting a compliance system that needs improvement. Nevertheless, these weaknesses do not pose significant threat to the safety and soundness of the institution and are being/will be addressed by the Board and Senior Management in a timely manner. The compliance framework is well-defined, adequately implemented, and sufficiently compatible with the nature and complexity of the institution's activities. All or most of its component ratings are 3 with no component rating below 2. This institution is in substantial compliance with laws and regulations. The compliance system is capable of identifying and mitigating reputation, compliance, market conduct and legal risks that may erode the franchise value of the institution. Supervisory response is limited and shall include corrective actions to improve or further strengthen the compliance system. No administrative sanctions shall be imposed.

Composite 2

The compliance system is weak relative to the institution's size, complexity and risk profile and requires enhanced supervision. Material weaknesses may be present, exhibiting a compliance system that needs significant improvement. The compliance framework is poorly defined, ineffectively implemented, and/or insufficiently compatible

with the nature and complexity of the institution's activities. All or most of its component ratings are 2. This institution may be in substantial non-compliance with laws and regulations. The compliance system is not capable of identifying and mitigating reputation, compliance, market conduct, and legal risks that may erode the franchise value of the institution. Supervisory actions include corrective actions, and/or administrative sanctions for violations of BSP rules and regulations.

Composite 1

The compliance system is deficient and materially inadequate relative to the institution's size, complexity and risk profile and needs drastic and/or immediate improvements that require close supervisory attention. Weaknesses are severe and threaten safety and soundness of the institution. The compliance framework is not defined or not compatible with the nature and complexity of the institution's activities. All or most of its component ratings are 1. This institution is in substantial non-compliance with laws and regulations. Business risks are high and the compliance system is not capable and failed to identify and mitigate reputation, compliance, market conduct and legal risks that may erode the franchise value of the institution. A composite rating of 1 indicates a compliance system that generally exhibits unsafe/unsound practices, as defined under existing laws, rules and regulations, or other supervisory concerns that place the institution at more-than-normal risk of failure. Supervisory actions include corrective actions, administrative sanctions for violations of BSP rules and regulations, and/or other formal enforcement actions as provided under BSP rules and regulations.

Supervisory Actions

The following shall apply in deploying supervisory actions:

1. A composite rating of 4 or 3 will require no imposition of administrative sanctions. Supervisory action is limited and may include corrective actions to improve or further strengthen the compliance system.
2. A composite rating of 2 will require, at a minimum, corrective actions to address underlying causes of weaknesses/deficiencies noted. This shall involve a directive for Management to develop and implement a BOD-approved action plan aimed at correcting and addressing weaknesses/deficiencies noted on the institution's compliance system within a reasonable period of time.

The appropriate supervision department shall assess the viability of the plan and shall monitor the institution's performance. In the event of non-submission of an acceptable plan within the deadline or failure to implement its action plan, the supervision department shall recommend appropriate enforcement actions on the institution and its responsible officers.

Notwithstanding the corrective actions required, administrative sanctions may be imposed for violations of BSP rules and regulations.

- Supervisory actions for an institution with a composite rating of 1 include a combination of corrective actions (see composite rating of 2), administrative sanctions for violations of laws, rules and regulations, and other formal enforcement actions as provided under BSP rules and regulations. A composite rating of 1 indicates a compliance system that may exhibit unsafe/unsound practices, as defined under existing laws, rules and regulations, and other supervisory concerns that place the institution at more-than-normal risk of failure. Prompt Corrective Action shall be initiated on the institution when the grounds as defined under BSP rules and regulations have been established.

SUMMARY OF COMPOSITE RATING

Composite Rating				
Numerical Rating	4	3	2	1
Adjectival Rating	Strong	Acceptable	Weak	Deficient
Over-all Compliance Framework	Strong compliance system with minimal cause for supervisory concern. The compliance framework is clearly defined, effectively implemented, and fully compatible with the nature and complexity of the institution's activities. There is substantial compliance with laws and regulations.	Acceptable compliance system with moderate supervisory concern. The compliance framework is well-defined ⁷ , adequately implemented, and sufficiently compatible with the nature and complexity of the institution's activities. There is substantial compliance with laws and regulations.	Weak compliance system and requires enhanced supervision. The compliance framework is poorly defined, ineffectively implemented, and/or insufficiently compatible with the nature and complexity of the institution's activities. There may be substantial non-compliance with laws and regulations.	Deficient compliance system that needs drastic and/or immediate improvement which requires close supervisory attention. Business risks are not or inadequately mitigated and poorly controlled. The compliance framework is poorly defined, ineffectively implemented, and/or incompatible with the nature and complexity of the institution's activities. There is substantial non-compliance with laws and regulations.

⁷ A rating of "3" may also be given even if the institution has a weak or not defined framework provided that it has a very efficient/effective compliance function practices. Similarly, a rating of "2" may also be given even if the Framework is well-defined and sufficiently compatible but ineffectively implemented.

Composite Rating				
Numerical Rating	4	3	2	1
Adjectival Rating	Strong	Acceptable	Weak	Deficient
Components⁸ Rating	All or mostly 4 with no component rating less than 3	All or mostly 3 with no component rating less than 2	All or mostly 2	All or mostly 1
Capacity to Identify and Mitigate business risk	Most capable in identifying and mitigating reputation, compliance, market conduct, and legal risks that may erode the franchise value of the institution.	Capable of identifying and mitigating reputation, compliance, market conduct, and legal risks that may erode the franchise value of the institution.	The compliance system is not capable of identifying and mitigating reputation, compliance, market conduct, and legal risks that may erode the franchise value of the institution.	The compliance system is not capable and failed to identify and mitigate significant reputation, compliance, market conduct and legal risks that may erode the franchise value of the institution.
Supervisory Action	Expected corrective actions to address minor weaknesses.	Required corrective actions to improve or further strengthen the compliance system	Required corrective actions to address deficiencies. Warning to written reprimand. Administrative sanctions for violation of laws, rules and regulations	Required corrective actions to address deficiencies. Warning to written reprimand Administrative sanctions for violations of laws, rules and regulations. Other formal enforcement actions such as initiation of PCA, as may be applicable under existing laws, rules and regulations.

⁸Consist of (i) Effective and Efficient BOD and SM Oversight ("Management Oversight"); (ii) Sound policies and procedures embodied in a Compliance Program duly approved by the Board of Directors and effectively implemented by Senior Management ("Compliance Policy and Program"); and (iii) Robust internal controls and audit ("Internal controls and audit").

**“MANAGEMENT OVERSIGHT” COMPONENT RATING:
EFFECTIVE AND EFFICIENT BOARD OF DIRECTORS AND SENIOR MANAGEMENT OVERSIGHT
ON COMPLIANCE**

The Management oversight component rating reflects the overall effectiveness and efficiency of the board of directors and senior management, of which the Chief Compliance Officer (CCO) is the lead operating officer on compliance, in designing, implementing, and monitoring a compliance system.

Assessment of the Management Oversight component rating takes into account the size, complexity and risk profile of the institution. Likewise, the assessment considers the other component ratings. Ultimately, Management oversight rating measures whether the Board and Senior Management have fulfilled their duties and responsibilities on compliance. A strong or acceptable Management oversight component rating exhibits the following characteristics:

1. Clear delineation of duties and responsibilities of the board of directors and senior management.
2. Independence of the compliance function as exhibited by four elements:
 - Formal status that provides appropriate standing, authority and independence of the compliance function;
 - Clearly-defined responsibilities of chief compliance officer;
 - Absence of conflict of interest between compliance responsibilities of compliance function staff and any other responsibilities that they may have; and
 - Ready access to information and personnel necessary to carry out compliance responsibilities.
3. Sufficient resources of compliance function to carry out its responsibilities effectively.
4. Cooperative and constructive working relationship of the compliance function with the BSP and units within the organization.

Sub-component 1: Clear delineation of duties and responsibilities of the board of directors and senior management.

Responsibilities of the BOD on compliance

The Board of Directors (BOD)⁹ is responsible for overseeing the management of the institution’s business risk and is ultimately responsible for ensuring the effective

⁹ In the case of branches of foreign banks, alternative arrangements (e.g. management committee) are acceptable, depending on branch organizational structure. Nevertheless, the Branch should be able to demonstrate the independence of the CCO from executive functions and business line responsibilities operations and revenue-generating functions.

implementation of the compliance system. Specifically, the BOD shall approve the compliance system, ensure that a compliance system is defined for the institution and that compliance issues are resolved expeditiously. For this purpose, a board-level committee, chaired by a non-executive Director, shall oversee the compliance system. Whether or not an exclusive/separate board-level compliance committee is needed depends on the size, complexity and nature of institution's operations. In most cases, the Risk Oversight Committee or Audit Committee may also be designated to discharge this oversight role concurrently. The BOD shall likewise be responsible in providing sufficient authority, independence, and resources to the compliance function, as headed by the CCO.

Responsibilities of Senior Management on compliance

The institution's senior management is responsible for the effective implementation of the compliance system. Compliance should be part of the culture of the organization; it is not just the responsibility of the specialist compliance staff or the chief compliance officer. Accordingly, ensuring that institution personnel and affiliated parties adhere to pre-defined compliance standards of the institution rests collectively with Senior Management, of which the CCO is the lead operating officer on compliance. Thus, any material breaches of the compliance program shall be promptly addressed by the CCO, including ensuring that documentary submissions to the BSP are accurate; this shall be conducted within the mechanisms defined by the Compliance Policy, as approved by the BOD, documented in the Compliance Manual and implemented through the Compliance Program. Such mechanisms shall, at a minimum, define responsibilities of senior management involved in operations and outline coordination arrangements across different functions. As such, the BOD should provide the CCO, as chief operating officer on compliance, sufficient authority and resources to ensure effective implementation of the compliance system. This includes the ability to hold officers/staff responsible for breaches of the compliance policy and ensure that appropriate remedial or disciplinary action is taken in a timely manner.

Institution's Senior Management, with the CCO as lead operating officer, shall:

- Design and implement an appropriate compliance system;
- Effectively communicate the compliance policy (as approved by the BOD) within the compliance system;
- Ensure a institution-wide compliance culture such that compliance standards are understood and observed by all institution personnel and units;
- Ensure the integrity and accuracy of all documentary submissions to the BSP and other regulators;
- Identify and assess material breaches of the compliance program and properly address the same (e.g. remedial or disciplinary actions) within the mechanisms defined by the Compliance Manual; and
- Periodically report to the BOD or its designated Committee, matters that affect the design and implementation of the compliance policy. This includes promptly reporting any material failures on compliance system (e.g. failures that may attract significant risk of legal or regulatory sanctions or enforcement actions, whether monetary or non-monetary; material financial loss, loss of reputation, or loss of market standing).

The CCO is the lead senior officer for purposes of administering the compliance system and interacting with the BSP on compliance-related issues, including quality of documentary and supervisory reports and timely submissions to the BSP. Given the importance of the compliance function, the CCO is a senior officer functionally reporting to the BOD. The CCO should meet BSP's fit and proper criteria such as integrity/probity, competence, education, diligence, and experience/training.

The CCO shall have commensurate skills and expertise to provide appropriate guidance and direction to the institution on the development, implementation and maintenance of the compliance system.

Sub-component 2: Independence of Compliance Function

The compliance function should be independent from the business activities of the institution. The concept of independence involves four related elements. First, the compliance function should have a formal status within the institution. Second, there should be a CCO with overall responsibility of leading the implementation of the compliance system and coordinating the management of the compliance system. The CCO's responsibilities and authority should be clearly defined. Third, compliance function staff, and in particular the chief compliance officer, should not be placed in a position where there is possible conflict of interest between their compliance responsibilities and any other responsibilities they may have. Finally, compliance function staff should have access to information and resources (including personnel) necessary to carry out their responsibilities.

Status and Authority of the Compliance Function

The compliance function shall have a formal status within the organization. It shall be established by a charter or other formal document (see "Compliance Program" component rating) approved by the Board of Directors that defines the compliance function's standing, authority, and independence. This document shall be communicated to all staff throughout the organization.

The following factors shall be considered in assessing whether the **compliance function** has sufficient status and authority:

- Organizational structure and scope of responsibilities of the unit or department administering the compliance program.
- Its formal reporting relationships to senior management, the Board of Directors, and the appropriate board-level committee.
- Its ability to be able to freely express and disclose its findings to senior management, the board of directors and appropriate board-level committee.
- Its ability to directly access the BOD and to the appropriate board-level committee. This may be demonstrated by direct functional reporting line of the CCO to the Board and/or access (e.g. as resource persons) to Board meetings in relation to compliance matters.
- Its ability to conduct investigations of possible breaches of the compliance policy.
- Its ability to hold officers/staff responsible for breaches of the compliance policy and ensure that appropriate remedial or disciplinary action is taken.

An appropriate organizational structure must be in place to manage the compliance function and execute the approved compliance program. How the institution organizes its compliance function, reporting line and other functional relationship between staff exercising compliance responsibilities and the CCO will depend on the nature, size and complexity of the institution's operations. The compliance function shall be manned by independent full-time officers/staff either embedded in operating departments, or in a department operating on its own, or a combination thereof. For example, in complex institutions, some of the compliance staff (who exclusively performs compliance responsibilities) may be located within operating business lines and internationally active institutions may also have group and local compliance officers. Separate units may be established for specialist areas such as the prevention of money laundering and terrorist financing.

It should be noted that exclusive compliance function staff who reside in operating business units or in local subsidiaries or in separate independent support units (e.g. financial control, risk management) may have administrative reporting lines to the management of the respective unit. However, such staff should have a reporting line through to the CCO as regards their compliance responsibilities. In certain cases, complex institutions may designate "deputy compliance officers" whose primary responsibilities remain with the business units. This is consistent with the principle that operating units are also responsible for ensuring compliance with internal policies and procedures pertaining to compliance matters. In such cases, the Board shall ensure that compliance oversight remains effective through robust monitoring and testing, and sufficient authority by compliance to address breaches in compliance policies and procedures. This includes having such "deputy compliance officers" reporting lines to the CCO as regards their compliance responsibilities.

In simple institutions, compliance function staff may be located in one unit. In certain cases for simple institutions, compliance staff may concurrently fulfill other independent control oversight functions (e.g. internal audit, risk management). In such cases, the Board shall ensure that overall control oversight functions remain effective and that any potential conflicts among the functions are monitored and controlled.

Conflicts of Interest

The independence of the CCO and any other staff having compliance responsibilities may be undermined if they are placed in a position where there is a real or potential conflict between their compliance responsibilities and their other responsibilities. Thus, the CCO shall be appointed on a full-time basis and should perform only compliance responsibilities. It is preferable that other compliance function staff also perform only compliance responsibilities. The compliance function shall be manned by full-time officers/staff either embedded in the operating departments, or in a department operating on its own. Coordination with the respective department heads shall be the responsibility of the CCO.

The independence of the compliance function staff may be undermined if their remuneration is related to the financial performance of the business line for which they exercise compliance responsibilities.

Access to Information and Personnel

The compliance function should have the right on its own initiative to communicate with any staff member and obtain access to any records or files necessary to enable it to carry out its responsibilities.

Sub-component 3: Sufficient Resources of Compliance Function

The resources to be provided for the compliance function should be both sufficient and appropriate. In particular, compliance staff should have the necessary qualifications, experience, and professional and personal qualities to enable them to carry out their compliance mandate. The professional skills of compliance function staff should be maintained through regular and systematic education and training.

Sub-component 4: Cooperative and Constructive Working Relationships with the BSP and other units within the organization.

The financial institution, through its CCO and/or other authorized compliance officers, may consult the BSP for clarifications on specific provisions of related laws and regulations. Similarly, BSP may initiate a dialogue with the institution to discuss the compliance program and its implementation.

The BSP recognizes that categories of risks are not mutually exclusive and that risks are interrelated and can be interdependent. Thus, various risks may appear to overlap with one another. For instance, certain aspects of operational risk which is usually covered by the risk management function, may give rise to conditions that will be detrimental to an institution's business model and erode its franchise value (business risk). An institution should therefore organize its compliance function and set priorities for the management of business risk in a way that is consistent with its risk management strategy and structures. In cases where the organization has separate risk management and compliance functions, the Board shall clearly identify the delineation of risk management responsibilities between the two functions, through the compliance and risk policies outlined in the compliance and risk programs. Further, there should be mechanisms that will facilitate close coordination between the two functions, as well as with the internal audit function. Finally, in cases where compliance responsibilities are carried out by staff in different departments, the compliance program should address how these responsibilities are to be allocated among the departments.

SUMMARY OF MANAGEMENT OVERSIGHT COMPONENT RATING

Component Rating ("Management Oversight")			
Numerical Rating	4	3	2
Over-all effectiveness and efficiency of the BOD and SM oversight relative to the size, complexity and risk profile	Strong and efficient oversight	Adequate oversight	Less than adequate oversight
Sub-components rating	All or mostly 4 with no sub-component rating less than 3	All or mostly 3 but no sub-component rating less than 2	All or mostly 2
			1
			Weak oversight
			All or mostly 1
SUB-COMPONENT RATING			
Numerical Rating	4	3	2
1. Clear Delineation of BOD and SM responsibilities	Clearly defined responsibilities appropriate to the nature, size and complexity of the institution's operations. Responsibilities are effectively communicated and undertaken by the BOD and SM.	Well-defined responsibilities that are appropriate to the nature, size and complexity of operations but may exhibit low to moderate weaknesses in the delineation and/or communication of responsibilities. Nevertheless, these weaknesses have no material impact on the soundness of the compliance system.	Inadequately-defined responsibilities that may not be appropriate to the nature, size and complexity of operations. Delineation is not clear. Responsibilities are not effectively communicated or the BOD or SM does not exhibit willingness to assume responsibilities.
			1
			No clear delineation of responsibilities or poorly-defined responsibilities which are not appropriate to the nature, size and complexity of operations. Responsibilities are not effectively communicated or the BOD or SM does not exhibit willingness to assume responsibilities.

MANAGEMENT OVERSIGHT COMPONENT

Numerical Rating	4	3	2	1
2. Independence of Compliance Function	<p>Compliance function is independent. It maintains formal status with appropriate standing and authority within the organization. Chief Compliance Officer is qualified to carry out clearly-defined responsibilities. There is no potential or actual conflict of interest between compliance responsibilities and other function staff may have. Compliance function has ready access to information and personnel to carry out responsibilities.</p>	<p>Compliance function maintains sufficient independence to carry out its responsibilities but may exhibit low to moderate weaknesses that can be addressed within the normal course of business. Such weaknesses may be exhibited in the following areas:</p> <ul style="list-style-type: none"> • Organizational structure of compliance function • Reporting relationships of compliance function with the BOD and SM • Ability to report breaches and enforce actions to correct breaches • Access to the BOD • Qualifications of CCO • Potential conflict of interest • Access to information and personnel to carry out responsibilities 	<p>Independence of compliance function is impaired which can negatively impact its ability to carry out its responsibilities. Significant weaknesses are present in the following areas:</p> <ul style="list-style-type: none"> • Organizational structure of compliance function • Reporting relationships of compliance function with the BOD and SM • Ability to report breaches and enforce actions to correct breaches • Access to the BOD • Qualifications of CCO • Potential and/or actual conflict of interest • Access to information and personnel to carry out responsibilities 	<p>Compliance function is not independent as characterized by actual conflicts of interest in carrying out the responsibilities of the CCO or compliance function staff. Compliance function has no formal status and insufficient authority within the organization. CCO lacks the basic qualifications to carry out their responsibilities. Compliance function has limited or no access to information and personnel to carry out its responsibilities.</p>
3. Sufficient Resources of Compliance Function	<p>Strong support by the BOD and SM. Compliance function has sufficient and appropriate resources. Compliance function staff has strong manpower complement and supported by high competence, experience and professional qualities to enable them to carry out compliance responsibilities.</p>	<p>Adequate support by the BOD and SM. Compliance function has sufficient and appropriate resources, supported by adequate manpower complement who possess adequate qualifications, competence, experience and professional qualities to enable them to carry out compliance responsibilities. Institution has adequate training/education provided for its personnel.</p>	<p>Compliance function has inadequate resources to carry out its responsibilities. Weaknesses range from moderate to significant such as lack of manpower complement; insufficient experience and qualifications of compliance staff, and irregular training/education to maintain professional skills.</p>	<p>Compliance function has grossly inadequate resources to carry out its responsibilities. Weaknesses range from significant to severe. Compliance function cannot be carried out effectively due to lack of manpower complement, lack of competence of compliance staff, and irregular and/or inadequate training/education.</p>

MANAGEMENT OVERSIGHT COMPONENT

Numerical Rating	4	3	2	1
4. Cooperative and Constructive Relationship with other units and the BSP	Professional skills are maintained through regular and systematic training/education. Compliance function has strong cooperation from other units as exhibited by strong constructive relationship with other units and the BSP while maintaining its independence. There is strong coordination resulting in effective implementation of the compliance program.	Compliance function has adequate cooperative and constructive relationship with other units and the BSP. Coordination is sufficient to effectively carry out its compliance responsibilities.	Conflicts may arise that affect the working relationship of the compliance function with other units within the organization. Further, communication with the BSP is less than satisfactory resulting in non-compliance with BSP directives. Nevertheless, conflicts are not severe enough to affect the overall implementation of the compliance program.	There is lack of cooperation and coordination between the compliance function and other units within the organization. As a result, there are material breaches in the compliance program. The institution does not consult with the BSP and persistently violates BSP directives.

“COMPLIANCE POLICY AND PROGRAM” COMPONENT RATING

This rating determines the soundness of compliance policies and procedures embodied in a Compliance Policy Manual duly approved by the Board of Directors and the effectiveness of implementation of compliance policy by Senior Management through a Compliance Program.

The compliance system shall be designed to specifically identify and mitigate business risks which may erode the franchise value of the institution. The BOD and SM should therefore design and implement sound policies and procedures that achieve this objective. The compliance policies and procedures should be formally documented in a Compliance Policy Manual, duly approved by the Board of Directors. These policies and procedures are carried out by Senior Management, through the compliance function, under a Compliance Program. The Compliance Program sets out the compliance function’s planned activities, such as the implementation and review of specific policies and procedures, risk assessment, compliance testing¹⁰, and educating staff on compliance matters. Compliance program may be risk-based and should be subject to oversight by the CCO to ensure appropriate coverage across businesses and coordination among risk management functions.

When effectively implementing sound compliance policies and procedures through the compliance program, the institution shall take into account the size and complexities of its operations. The compliance program must clearly identify the avenues through which business risks may occur for the institution, including risks from actions of the institution that are contrary to existing regulations. Correspondingly, compliance measures effectively suited to the operations to mitigate these risks shall be institutionalized and implemented through the compliance program.

Sub-component 1: Scope of Compliance Policy and Program – Identification, Measurement and Assessment of Business Risk

Business risk refers to conditions which may be detrimental to the institution’s business model and its ability to generate returns from operations, which in turn erodes its franchise value. The concept of business risk is broad. Nevertheless, the compliance policy and program shall take into account the size and complexity of operations of the institution. Further, it should clearly identify the scope of the compliance function.

For purposes of these guidelines, business risk includes reputation, compliance, market conduct, and legal risks that may erode the franchise value of the institution. Specifically, this includes:

- Reputation risk arising from internal decisions that may damage an institution’s market standing;

¹⁰ While BSP Circular No. 747 no longer includes specific provisions on periodic compliance testing based on prioritization of compliance risks, broader requirements were set to allow banks greater flexibility to effect compliance measures suited to the operations of the bank. Such measures may include risk-based compliance testing and other procedures to ensure the program is effective in achieving its objectives.

COMPLIANCE POLICY AND PROGRAM COMPONENT

- Reputation risk arising from internal decisions and practices that ultimately impinge on the public's trust of the institution;
- Risks from actions of an institution that are contrary to existing regulations;
- Risks from actions of an institution that are contrary to identified best practices;
- Risks from weaknesses in the implementation of codes of conduct and standards of good practice; and
- Legal risk to the extent that changes in the interpretation or provisions of regulations directly affect the institution's business model.

The scope of compliance may also include verifying that the institution's own internal policies, procedures and rules are being followed. In any case, the scope should be clearly defined and appropriate for the institution given the size, nature and complexity of its operations. The following areas shall be considered when identifying, measuring and assessing business risk:

- Accounting and auditing requirements;
- Prudential laws, regulations, or other regulatory requirements;
- Proper standards of market conduct, managing conflicts of interest, treating customers fairly, and ensuring suitability of advice to customers, where applicable;
- Prevention of money laundering and terrorist financing;
- Responsibilities of authorized agent banks (e.g. clean note policy);
- Agreements and/or commitments with industry associations and/or regulators; and
- Other laws relevant to banking (e.g. securities laws, tax laws, labor code).

In addition to identifying the scope of the compliance function, a comprehensive policy, as formally documented in the Compliance Policy Manual, shall include: delineation of responsibilities of the BOD and SM; role of the compliance function and the CCO, including organization structure and measures to ensure independence of the compliance function; resources to carry out compliance responsibilities effectively; nature of working relationship with other operating units, including the scope of responsibilities of operating units on compliance; and mechanisms through which compliance policy is communicated throughout the organization and compliance matters are reported to the board. Senior management, through the CCO, should periodically report to the Board of Directors or designated Committee matters that affect the design and implementation of the compliance program. Any changes, updates and amendments to the compliance program must be approved by the Board of Directors. In certain cases, board-level committee approval of operational amendments/updates on compliance program may be acceptable, provided there is an established and well-defined process of escalation for approval. In all cases, board-level committee actions shall be ratified by the full Board.

The compliance function should, on a pro-active basis, identify, document and assess the business risks associated with the institution's activities, including the development of new products and business practices, the proposed establishment of new types of business or customer relationships, or material changes in the nature of such relationships. If the institution has a new products committee, compliance function staff should be represented in the committee.

The compliance function should also consider ways to measure business risk (e.g. by using performance indicators) and use such measurements to enhance business risk assessment. Technology can be used as a tool in developing performance indicators by aggregating or filtering data that may be indicative of potential compliance problems (e.g. increasing number of customer complaints, irregular trading or payments activities, breaches in regulations or internal policies, etc.).

The compliance function should assess the appropriateness of the institution's compliance procedures and guidelines, promptly follow up any identified deficiencies, and where necessary, formulate proposals for amendments to the Board of Directors. Further, the compliance program shall be updated at least annually to incorporate changing responses to evolving internal and external conditions.

Sub-component 2: Monitoring, Testing, Reporting, and Mechanism to Address Compliance Matters

Robust compliance monitoring and testing play a key role in identifying weaknesses in existing compliance system controls and are, therefore, critical components of an effective compliance program. Risk assessments are the foundation of an effective compliance monitoring and testing program. The scope and frequency of compliance monitoring and testing activities should be a function of an assessment of the overall business risk associated with a particular business activity. Financial Institutions are expected to implement comprehensive risk assessment methodologies and to ensure that compliance monitoring and testing activities are based upon the resulting risk assessments. Monitoring and testing should therefore cover major business lines and other areas that pose material business risks to the institution. The results of the compliance testing should be reported at a minimum to the Board and business units through the compliance function reporting line in accordance with the institution's internal procedures.

It should be emphasized that operating business units are responsible for ensuring compliance with relevant internal policies and procedures pertaining to compliance matters. As articulated in Board and Senior Management Oversight component, the institution's senior management is responsible for the effective implementation of the compliance system. Compliance should be part of the culture of the organization; it is not just the responsibility of specialist compliance staff or the CCO. Accordingly, ensuring that institution personnel and affiliated parties adhere to pre-defined compliance standards of the institution rests collectively with Senior Management, of which the CCO is the lead operating officer on compliance.

While business units are responsible in ensuring compliance, independent monitoring and testing is important to ensure that lapses in controls that lead to breaches in compliance policies are identified, monitored, and addressed in a timely manner. In this regard, the compliance function should monitor and test implementation of policies and procedures by performing sufficient and representative compliance testing. Compliance testing is necessary to validate that key assumptions, data sources, and procedures utilized in measuring and monitoring compliance issues can be relied upon on an ongoing basis and, in the case of transaction testing, that controls are working as intended. The testing of controls

and remediation of deficiencies identified as a result of testing activities are essential to maintain an effective internal control framework. In certain cases, the Board may allow other independent units, such as internal or external audit, to conduct compliance testing. Such arrangements, however, should be governed by clear scope of engagement. Further, compliance function shall still be responsible for assessing reliability of third party testing and adequacy of compliance testing actually conducted, and for addressing lapses in compliance testing process/procedures. In cases where compliance testing is conducted by internal audit, the Board shall ensure that adequate resources are still available for internal audit function.

The scope and frequency of compliance testing activities shall be based upon the assessment of the specific business risks associated with a particular business activity. If, however, compliance testing is performed exclusively by the internal audit function, particular care should be taken to ensure that high-risk compliance elements are not otherwise obscured by a lower overall risk rating of a broadly defined audit entity. Otherwise, the scope and frequency of audit coverage of higher-risk compliance elements tends to be insufficient.

The CCO shall report on a regular basis to the BOD or appropriate board-level committee on compliance matters. The reports should (1) refer to the risk assessment that has taken place during the reporting period, including any changes in the risk profile based on relevant measurements such as performance indicators, (2) summarize any identified breaches and/or deficiencies and the corrective measures recommended to address them, and (3) report corrective measures already taken. The reporting format shall be commensurate with the institution's risk profile and activities.

Sub-component 3: Continuing Education/Training Program

The compliance function should assist Senior Management in educating officers and staff on compliance issues, and acting as a contact point within the institution for compliance queries from staff members. Guidance and education can be implemented through the written guidelines, policies and procedures on appropriate implementation of laws, rules, and standards and other documents such as compliance manuals, internal codes of conduct and practice guidelines. This shall be supplemented by trainings, seminars, and/or briefings.

The processes for imparting to personnel the necessary appreciation of the institution's compliance culture and training of staff with respect to identified business risks shall form part of the compliance policy and the implementation of the training shall form part of the compliance program.

COMPLIANCE POLICY AND PROGRAM COMPONENT

SUMMARY OF COMPLIANCE POLICY AND PROGRAM COMPONENT RATING

Component Rating ("Compliance Policy and Program")				
Numerical Rating	4	3	2	1
Over-all soundness of compliance policy and effectiveness of implementation.	Sound compliance policies and procedures that are strongly implemented throughout the organization.	Adequate compliance policies and procedures that are satisfactorily implemented throughout the organization.	Less than adequate compliance policies and procedures. The BOD may have formulated acceptable policies but these are not documented in the Compliance Policy Manual or are inadequately implemented.	Weak compliance policies and procedures or policies and procedures that are not implemented effectively.
Sub-components rating	All or mostly 4 with no sub-component rating less than 3	All or mostly 3 but no sub-component rating less than 2	All or mostly 2	All or mostly 1
SUB-COMPONENT RATING				
Numerical Rating	4	3	2	1
1. Scope of Compliance Policy and Program	Comprehensive and clearly-defined scope that enables the BOD and SM to proactively identify, measure and assess business risks. The compliance policy and program are regularly updated and are highly relevant to the institution's size, complexity and nature of operations.	Adequate coverage of compliance policies and procedures with well-defined scope that allows BOD and SM to identify, measure and assess business risks. The compliance policy and program are regularly updated and are relevant to the institution's size, complexity and nature of operations.	Inadequate coverage of compliance policies and procedures with inadequately defined scope that affects ability of BOD and SM to identify, measure and assess business risks. The compliance policy and program may not be updated and/or are not commensurate to the size, complexity and nature of operations.	Poorly-defined scope with inadequate coverage that result in failure to identify, measure and assess business risks. The compliance policy and program are not updated and/or are not commensurate to the size, complexity and nature of operations.
2. Monitoring, Reporting Mechanism to Address Compliance	Strong and highly reliable management information system that allows regular monitoring, and risk-based monitoring, and risk-based	Acceptable management information system that allows regular monitoring, and sufficient compliance testing. The BOD is	Inadequate management information system that does not provide appropriate mechanism to regularly monitor compliance	Weak management information system. There are no monitoring and compliance testing conducted. The BOD or SM are not aware of

COMPLIANCE POLICY AND PROGRAM COMPONENT

<p>Matters</p>	<p>compliance testing. The BOD is promptly informed about material breaches and corrective actions are undertaken in a timely manner.</p>	<p>informed about material breaches and corrective actions are undertaken in a timely manner.</p>	<p>matters, report breaches and take corrective actions. Compliance testing is inadequate. Compliance matters and/or breaches may be reported but insufficient or no actions are taken to address breaches or to improve compliance function or to take corrective actions.</p>	<p>compliance matters or do not take action to address compliance matters.</p>
<p>3. Education/Training Program</p>	<p>High level effectiveness of continuing education and training program.</p>	<p>Adequate level effectiveness of continuing education and training program.</p>	<p>Continuing education and training program needs improvement.</p>	<p>Weak continuing education and training program.</p>

“INTERNAL CONTROLS AND AUDIT” COMPONENT RATING

This component rating assesses the (1) adequacy and soundness of internal controls that support BOD and SM in identifying, measuring, monitoring and controlling business risks as provided in the compliance policy and program; and (2) effectiveness of the internal audit function in assessing the compliance function.

Business risk covered by the institution’s compliance function should be included in the risk assessment methodology of the internal audit function, which is headed by the Internal Auditor, who directly reports to the audit committee. An audit program should be established, including testing of controls commensurate with the perceived level of risk.

The internal audit function shall review the application and effectiveness of risk management procedures and risk assessment methodologies, which shall include business risk covered in the compliance policy. The IA should keep the CCO informed of any audit findings relating to compliance.

Board-approved written compliance policy of the institution should clearly define how risk assessment and transaction testing activities are to be divided and undertaken between the compliance and the internal audit functions, taking into account the size, complexity of operations and risk profile of the institution concerned. To cover the adequacy and effectiveness of the institution’s compliance function, the internal audit program shall provide for transaction testing commensurate to the perceived level of compliance risk. Generally, the internal audit report can be used as reference to assess the performance of the internal control and internal audit function.

The internal control and audit rating is based upon, but not limited to the assessment of the following:

Sub-component 1: Internal Controls

1. The framework of internal controls should, at a minimum, contain the following:
 - Adequate board and senior management oversight;
 - Comprehensive and updated policies and procedures communicated to affected personnel;
 - Adequate measurement and monitoring system;
 - Effective internal control system and audit function; and
 - Adequate staffing and continuing personnel development and training.

2. Other operational controls shall be evaluated based on the following:
 - Nature, scale and complexity of the institution’s business;
 - Diversity of the institution’s operations, including geographical diversity;
 - Institution’s customers, products and activity profile; and
 - Volume and size of core and non-core transactions.

Sub-component 2: Audit Function

1. Assessment by the internal audit unit/department of the institution's compliance function shall take into consideration the following:
 - Status of the internal audit function - the independence, frequency, quality and scope of the internal audit function relative to the volume, character and risk profile of the institution (written audit programs, periodic assessment of the applicability of audit programs; sufficiency of audit scope and intervals);
 - Compliance culture of the institution;
 - Policies and procedures on compliance risk management;
 - Control environment
 - Volume and/or severity of internal control and audit findings/exceptions.
 - Extent to which audit issues/findings are tracked, resolved, and monitored in terms of prompt and accurate reporting to the Audit Committee and the Board of Directors.
 - Regulatory environment, including BSP's enforcement actions; and
 - Manpower complement of the internal audit unit/department
 - Qualifications, experience, competence, skills, training and sufficiency in number of the audit staff.
 - Strong knowledge of applicable laws and regulations.
 - Understanding of compliance technologies.
 - Confidence to question senior management and board of director's commitment.

2. The internal audit function should be able to:
 - Attest to the overall integrity and effectiveness of the institution's controls over the compliance function;
 - Test transactions in all major areas of the institution with emphasis on high risk areas, products and services;
 - Analyze the compliance function's own identification and assessment of risks;
 - Risk assessment is current and comprehensive; methodology used is documented and understandable; and
 - Linkages between risk assessment and other elements of compliance program (i.e., monitoring and training) are identified.
 - Assess the following:
 - Frequency and quality of compliance information provided to senior management and the board of directors, as follows:
 - Results of self-monitoring and compliance audit;
 - Status of identified exceptions;
 - Briefings on new legislative issuances and regulatory requirements and their potential effect on the institution; and
 - Periodic reporting on the 'state of compliance'.
 - Adequacy of Board of directors and senior management oversight
 - Appointment of qualified and experienced key compliance personnel
 - Approval and implementation of compliance program;

- Compliance function's access to senior management and board of directors and participation in the preparation and distribution of new products and services; and
- Communication channels, including whistleblower hotline, to encourage reporting of compliance issues and concerns; and
- Adequacy and effectiveness of training efforts and the quality of training materials; extent to which the institution undertakes awareness initiatives.

INTERNAL CONTROLS AND AUDIT COMPONENT

SUMMARY OF "INTERNAL CONTROLS AND AUDIT" COMPONENT RATING

Composite Rating ("Internal Control and Audit")				
Numerical Rating	4	3	2	1
Over-all assessment of Internal Controls and Audit	Robust	Satisfactory	Less than satisfactory	Deficient
Sub-components rating	All or mostly 4 with no sub-component rating less than 3	All or mostly 3 but no sub-component rating less than 2	All or mostly 2	All or mostly 1
SUB-COMPONENTS RATING				
Numerical Rating	4	3	2	1
1. Internal Controls	Robust internal controls that support BOD and SM in identifying, measuring, monitoring and controlling business risks as provided in the compliance policy and program.	Satisfactory internal controls that support BOD and SM in identifying, measuring, monitoring and controlling business risks as provided in the compliance policy and program.	Less than satisfactory internal controls that do not support BOD and SM in identifying, measuring, monitoring and controlling business risks as provided in the compliance policy and program.	Deficient internal controls that led to failure of BOD and SM to identify, measure, monitor and control business risks as provided in the compliance policy and program.
2. Internal Audit	Internal audit is fully independent and has total support of BOD and SM. Scope comprehensively covers all areas of concern. Audit findings are promptly communicated to the BOD and Compliance Office, thus, corrective actions are taken in a timely manner.	Internal audit is sufficiently independent and has adequate support from BOD and SM. Audit scope significantly covers all areas of concern. Audit findings are communicated to the BOD and Compliance office, thus, corrective actions are undertaken within reasonable time.	Internal audit has less than satisfactory independence and/or support from the BOD and SM. Audit coverage needs improvement as it fails to cover some major concerns. Significant audit findings are not communicated to the BOD and Compliance Office, thus corrective actions are not undertaken in a timely manner	Internal audit is not independent and/or not supported by BOD and SM. Audit coverage is deficient as majority of the areas of concern are not covered. There is poor communication resulting in no corrective action or delayed actions.

Glossary of Terms

Compliance System - a group of interacting, interrelated, or interdependent elements forming a complex whole designed to identify and mitigate business risks which may erode the franchise value of the institution. These include the design and adoption of sound compliance policies and procedures embodied in a duly board-approved Compliance Manual and the implementation of the compliance policies and procedures through a Compliance Program.

Compliance Policy – is the principle or statement of intent set by the Board of Directors with regard to compliance matters. This shall guide management in crafting and implementing procedures that will achieve stated objectives.

Compliance Manual – a formal document that outlines duly board-approved compliance policies and procedures.

Compliance Program – sets out the compliance function’s planned activities, such as the implementation and review of specific policies and procedures, risk assessment, compliance testing, and educating staff on compliance matters.

Business Risk – Activities and actions that may negatively impact on the business model (and thus, the franchise value) of the institution. Business risk includes reputation, compliance, market conduct, and legal risks that may erode the franchise value of the institution.

Franchise Value – the long-run performance potential of a BSP-supervised institution. Franchise value may also refer to the popularity of a particular brand or product with consumers.

Market Conduct – Refers to firm’s behavior in pricing, promoting, marketing, selling and issuing products and services.

Prompt Corrective Action – refers to the framework adopted by the BSP on early intervention on banks demonstrating higher-than-normal risk of failure. It essentially includes, among others, directives to restore capital to within the regulatory minima, improve general business condition and institute corporate governance reforms to address the bank’s underlying problems to restore the bank to normal operating condition within a reasonable period, ideally within one year.

Board of Directors – A body or a group of individuals who are named as such in the Articles of Incorporation or are elected or appointed by the stockholders in the subsequent meetings primarily to oversee the activities of the institutions. They are the governing mechanism between the stockholders and executive management and their power, duties and responsibilities as Board of Directors are typically outlined in the institution’s By-laws.

Administrative reporting line – is an organizational structure wherein the actions of the officer/staff are subject to the direction and/or approval of the next higher level position that has the responsibility to administer matters such as but not limited to leave, attendance, and training requirements concerning the said officer/staff.

Functional reporting line – is an organizational structure wherein the reporting line is based on the specialized nature of the function for which it is a mutual and shared responsibility. The actions of the officer/staff are subject to the direction, guidance and/or approval of the next higher level position or senior position concerning the discharge/accomplishment of the assigned task and responsibilities.