



# BANGKO SENTRAL NG PILIPINAS

OFFICE OF THE GOVERNOR

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**Subject: Guidelines on Sound Credit Risk Management Practices;  
Amendments to the Manual of Regulations for Banks and Non-Bank  
Financial Institutions**

The Monetary Board in its Resolution No. 1606 dated 9 October 2014, approved the following guidelines on sound credit risk management practices as well as the amendments/deletions of certain provisions in the Manual of Regulations for Banks (MORB) and Manual of Regulations for Non-Bank Financial Institutions (MORNBFI).

**Section 1.** Section X178/4178Q/4197N on credit risk management statement of policy is hereby added to the MORB/MORNBFI to read as follows:

**“Sec. X178/4178Q/4197N Credit Risk Management; Statement of Policy.** It is the policy of the BSP to ensure that financial institutions (FIs) under its supervision have adequate and effective credit risk management systems commensurate to their credit risk-taking activities. Towards this end, the following guidelines on credit risk management set forth the expectations of the BSP with respect to the comprehensive management of credit risk. The guidelines further articulate sound principles and practices that shall be embedded in the credit risk management framework of FIs and shall cover the following areas: a) establishing an appropriate credit risk environment; b) operating under a sound credit granting process; and c) maintaining appropriate credit administration, measurement, monitoring and control processes over credit risk. While FIs may employ different approaches in the management of their credit risk, the BSP expects that all these areas are effectively addressed.

For purposes of these guidelines, FIs refer to universal, commercial, thrift, rural and cooperative banks and their respective credit-granting financial subsidiaries (if any) as well as stand-alone quasi-banks (QBs).

**§X178.1/§4178Q.1/4197N.1 Evaluation of credit risk management system.** The BSP shall evaluate the FI’s credit risk management system not only at the level of individual legal entities but also across the subsidiaries within the consolidated banking organization. It will not restrict the scope of the credit risk-taking activities of an FI, so long as the FI is authorized to engage in such activities and:

- Understands, measures, monitors and controls the risk assumed;
- Adopts risk management practices whose sophistication and effectiveness are commensurate to the risk being taken; and
- Maintains capital commensurate with the risk exposure assumed.

If the BSP determines that an FI’s risk exposures are excessive relative to the FI’s capital, or that the risk assumed is not well-managed, the BSP will direct the FI to reduce its exposure to an appropriate level and/or to strengthen its risk management systems. In evaluating the above parameters, the BSP expects FIs to have sufficient

knowledge, skills and appropriate system and technology necessary to understand and effectively manage their credit risk exposures.

The principles set forth in the credit risk management guidelines shall be used in determining the adequacy and effectiveness of an FI's credit risk management process and adequacy of capital relative to exposure. The BSP shall consider the following factors:

1. The FI's business strategies, operating environment, and the competencies of its officers and personnel; and
2. The major sources of credit risk exposure and the complexity and level of risk posed by the assets, liabilities, and off-balance sheet activities.

**A. Establishing an Appropriate Credit Risk Environment**

***§X178.2/§4178Q.2/4197N.2 Role of the Board and Senior Management***

- a. *Board of directors.* The board of directors shall be responsible for the approval and regular review of credit risk strategy and credit policy, as well as the oversight of the implementation of a comprehensive and effective credit risk management system appropriate for the size, complexity and scope of operations of an FI. The board shall ensure that the system provides for adequate policies, procedures and processes to identify, measure, monitor and control all credit risks inherent in an FI's products and activities, both at the individual and portfolio levels on a consistent and continuing basis; and that an independent assessment of the system is periodically performed, the results of which shall be reported to it or to a board-level committee for appropriate action.
- b. *Senior management.* Senior management shall be responsible for ensuring that the credit risk-taking activities of an FI are aligned with the credit risk strategy approved by the board of directors. It shall also be responsible for developing and implementing an FI's credit policies and procedures that lay down the conditions and guidelines for an effective credit risk management process, as well as proper channels of communication to ensure that these policies are clearly communicated and adhered to by all levels of the organization.

***§X178.3/§4178Q.3/4197N.3 Credit risk management structure***

- a. Senior management or an appropriate level of management shall implement a board-approved credit risk management structure that clearly delineates lines of authority, establish accountabilities and responsibilities of individuals involved in the different phases of the credit risk management process.
- b. Depending on the size, complexity and scope of credit activities, and in addition to the roles and responsibilities of the board and senior management, an FI's credit risk management organization may be broadly classified into three functional lines of activities: the front, back and middle offices, to properly segregate accountabilities, ensure that no individual is assigned conflicting responsibilities, and effectively monitor and control the risks being taken.
- c. The front office function performs credit originating; recommends internal credit ratings, classifications and allowances for losses including changes thereon, when necessary; and the on-going monitoring of credit exposures of borrowers on a day-to-day basis.

- d. The back office provides support in the overall credit administration, including, among others: ensuring complete documentation, credit disbursement and recording of payments received; maintenance of credit and collateral files; and compilation of management information reports.
- e. The middle office performs risk management and control functions that are independent from the credit originating and administration functions. The risk management function provides meaningful inputs in policy formulation and limits setting; designs and implements the FI's internal credit risk rating system; and performs periodic exposure and exception monitoring. The risk management function shall report directly to the Risk Management Committee (RMC) or appropriate board-level committee or the board.
- f. An independent credit review is a function within the middle office that performs an unbiased assessment of the quality of individual credits and the aggregate credit portfolio, including appropriateness of credit risk rating, classification and adequacy of allowance for loan losses. In the case of simple FIs, such independent credit review function may be concurrently performed by qualified personnel fulfilling other independent control oversight functions (e.g. compliance, internal audit).
- g. The workout or problem loan management is another function within the middle office that is independent from the credit originating function to ensure that problem loans are managed effectively to minimize potential losses. For simple FIs, however, the function may still be performed by the credit originating function and/or unit responsible for monitoring the quality of such credit.
- h. The structure shall likewise provide for independent audits, i.e., internal audit and compliance, to conduct independent credit and compliance audits of the credit risk management system of the FI. The scope of internal audit shall include the evaluation of the independence and overall effectiveness of the credit review function.
- i. Regardless of the organizational structure that an FI adopts, the board shall ensure that the aforementioned key functions are considered and independence and control oversight functions are effective to avoid or address any potential conflict of interest.
- j. Personnel or staff involved in all phases of the credit risk management process shall be qualified, competent and have the necessary training and experience to exercise prudent judgment in assessing, managing and/or controlling credit risk, and a solid understanding of an FI's strategic direction, policies, procedures, risk tolerance and limits. Their qualification standards, roles and responsibilities shall be clearly defined in the credit operating policies and procedures manual of the FI. The board and senior management shall ensure that adequate resources and appropriate level of staffing are allocated to execute all kinds of credit activities.

**§X178.4/§4178Q.4/4197N.4 Credit risk strategy.** The credit risk strategy must reflect the FI's profitability and portfolio growth targets, and must be consistent with the credit risk tolerance and overall corporate strategy and business goals of the FI.

- a. In formulating the credit risk strategy, the FI shall articulate the desired market segments and types of credit exposures (i.e., commercial credits, retail credits, real

estate, investments, trading products, credit commitments and/or guarantees); specific characteristics of clients, economic sector, geographical location; the portfolio mix that reflects the acceptable level of diversification and concentration; and consider the risk/reward trade-off by factoring in, to the greatest extent possible, price and non-price (e.g. collateral, restrictive covenants, etc.) terms as well as likely downside scenarios and their possible impact on the obligors.

The FI shall likewise define acceptable and unacceptable types of credits, clients, activities, transactions and behaviors that could result or potentially result in conflict of interest, personal gain at the expense of the FI, or unethical conduct.

- b. The credit risk strategy shall consider the cyclical aspects of the economy and the varying effects of the economic cycle on the credit portfolio of the FI.

**§X178.5/§4178Q.5/4197N.5 Credit policies, processes and procedures.** FIs shall have in place a sound, comprehensive and clearly defined credit policies, processes and procedures consistent with prudent standards, practices, and relevant regulatory requirements adequate for the size, complexity and scope of an FI's operations. The board-approved policies, processes and procedures shall cover all phases of the credit risk management system.

- a. FIs shall establish appropriate processes and procedures to implement the credit policy and strategy. These processes and procedures, as well as the credit policy, shall be documented in sufficient detail, effectively communicated throughout the organization to provide guidance to staff, and periodically reviewed and updated to take into account new activities and products, as well as new lending approaches. Subsequent major changes must be approved by the board.
- b. The credit policy shall likewise provide for the maintenance of an audit trail documenting that the credit risk management process was properly observed and identifying the unit, individual(s) and/or committee(s) providing input into the process.
- c. The credit culture, which reflects the FI's credit values, beliefs and behaviors, shall likewise be articulated in the credit policy and communicated to credit officers and staff at all levels through the strategic plan. The credit practices shall be assessed periodically to ensure that the officers and staff conform to the desired standard and value.

## **B. Operating Under a Sound Credit Granting Process**

**§X178.6/§4178Q.6/4197N.6 Credit approval process.** The approval process for new credits as well as the amendment, renewal and refinancing of existing credit exposures shall be aligned with the credit risk management structure and clearly articulated in an FI's written credit policy. The process shall include the different levels of appropriate approving authority and the corresponding approving authority limits, which shall be commensurate with the risks of the credit exposures, as well as expertise of the approving individuals involved. It shall also include an escalation process where approval for restructuring of credits, policy exceptions or excesses in internal limits is escalated to units/officer with higher authorities. Further, there shall be proper coordination of relevant units and individuals and sufficient controls to ensure acceptable credit quality at origination.

**§X178.7/§4178Q.7/4197N.7 Credit granting and loan evaluation/analysis process and underwriting standards.** Consistent with safe and sound banking practice, an FI shall grant credits only in amounts and for the periods of time essential for the effective completion of the activity to be financed and after ascertaining that the obligor<sup>1</sup> is capable of fulfilling his commitments to the FI. Towards this end, an FI shall establish well-defined credit-granting criteria and underwriting standards, which shall include a clear indication of the FI's target market and a thorough understanding of the obligor or counterparty, as well as the purpose and structure of the credit and its source of repayment.

- a. FIs shall conduct comprehensive assessments of the creditworthiness of their obligors, and shall not put undue reliance on external credit assessments. Credit shall be granted on the basis of the primary source of loan repayment or cash flow, integrity and reputation of the obligor or counterparty as well as their legal capacity to assume the liability.
- b. Depending on the type of credit exposure and the nature of the credit relationship, the factors to be considered and documented in approving credits shall include, but are not limited to, the following:
  - 1) The purpose of the credit which shall be clearly stated in the credit application and in the contract between the FI and the obligor;
  - 2) The current risk profile (including the nature and aggregate amounts of risks, risk rating or credit score, pricing information) of the borrower, collateral, other credit enhancements and its sensitivity to economic and market developments;
  - 3) The sources of repayment, repayment history and current capacity to repay based on financial analysis from historical financial trends and indicators such as equity, profitability, turnover, leverage, and debt servicing ability via cash flow projections, under various scenarios;
  - 4) For commercial credits, the borrower's business expertise, its credit relationships including its shareholders and company directors, as applicable, and the status of the borrower's economic sector and its track record vis-à-vis industry peers;
  - 5) The proposed terms and conditions of the credit (i.e., type of financing, tenor, repayment structure, acceptable collateral) including covenants designed to limit changes in the future risk profile of the obligor;
  - 6) Use of credit reports; and
  - 7) Where applicable, the adequacy, valuation and enforceability of collateral or guarantees.
- c. In performing the financial analysis, FIs shall use, to the extent available, credible audited financial statements and other relevant documents and sources. FIs may opt to use financial information/data from other sources provided that the process for arriving at such disposition and an evaluation of how much reliance or value was attached into the financial information used is clearly articulated and documented.

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<sup>1</sup> Obligor refers to an individual or entity that owes another person or entity a certain debt or duty. For purposes of these guidelines, obligor can also be used interchangeably with borrower or debtor

- d. When participating in loan syndications, an FI shall not place undue reliance on the credit analysis done by the lead underwriter and shall perform its own analysis and review of syndicate terms. It shall analyze the risk and return on syndicated loans in the same manner as directly sourced loans and ensure that the loan is consistent with its credit risk strategy.
- e. When an FI purchases securities issued by an obligor that is different from the counterparty (e.g. asset swaps), it shall also analyze issuer risk. For treasury and capital market activities, the structure of products and transactions shall be analyzed to determine the source and volatility of credit exposure.
- f. When granting consumer credits, an FI shall conduct its credit assessment in a holistic and prudent manner, taking into account all relevant factors that could influence the prospect for the loan to be repaid according to its terms and conditions. This shall include an appropriate consideration of the potential obligor's other debt obligations and repayment history and an assessment of whether the loan can be expected to be repaid from the potential obligor's own resources without causing undue hardship and over-indebtedness. Adequate checkings, including with relevant credit bureaus, shall be made to verify the obligor's credit applications and repayment records.
- g. FIs shall factor into their credit-granting decisions, the likelihood of providing allowance for identified and expected losses and holding adequate capital to absorb unexpected losses for credits with apparent weaknesses.
- h. FIs may utilize physical collateral (like real estate), financial guarantees and other instruments to help mitigate risk in credit exposures. However, these shall not substitute for a comprehensive assessment of the obligor or fully compensate for insufficient information.
- i. FIs shall establish adequate policies in determining the acceptability of various forms of credit mitigants and appropriate collateral value limits; procedures for regularly assessing the value of physical collaterals and availability of financial guarantees; and a process to ensure that these are, and continue to be, enforceable, realizable and marketable. Finally, FIs need to consider that the realizable value of the physical collateral or the quality of financial guarantees and other credit mitigants may be impaired by the same factors that have led to the diminished recoverability of the credit.

In the case of guarantees, the level of coverage being provided in relation to the credit quality, financial and legal capacity of the guarantor shall be evaluated.

For credit exposures secured by deposits, FIs shall likewise require obligors to provide a written waiver of his rights under existing law to the confidentiality of his deposits, and make this available for inspection and/or examination by the appropriate department of the SES.
- j. Netting arrangements also mitigate risks, especially in interbank and off-balance sheet transactions. In order to actually reduce risk, such agreements need to be sound and legally enforceable in all relevant jurisdictions.
- k. For more complex credit risk exposures, (e.g., asset securitization, credit derivatives, credit-linked notes, credit granted internationally, etc.), a more sophisticated tool shall be used for identifying, measuring, monitoring and controlling credit, country and transfer risks. Each complex credit risk product or activity, especially those that are

new to banking, shall be subject to a thorough analysis in addition to the regular assessment that is done with traditional credit-granting activities.

- I. For new products and activities, the credit risk shall be appropriately identified and managed through a formal risk assessment program. FIs shall ensure that they fully understand the risk involved in new products and activities and put in place adequate policies, procedures and controls before being introduced or undertaken.

**§X178.8/§4178Q.8/4197N.8 *Renewal or Extension of maturity date of credits.*** FIs shall adopt and adhere to the following explicit standards that control the use of renewals and extensions of maturity date of credits:

- a. Credits and other accommodations shall only be renewed or its maturity date extended:
  - i. Upon re-establishment of the creditworthiness of the obligor using the same credit-granting criteria for the evaluation and approval of new loans; and
  - ii. When the corresponding accrued interest receivable has been paid.
- b. A policy on clean-up of principal, either partial or full, shall be established and appropriate controls put in place to prevent continuous renewal or extension over a long period of time without reduction in principal; otherwise, such credits and other accommodations shall be subject to classification and allowance for credit losses.
- c. Specific and reasonable standards shall be provided for renewals or extensions of certain types of credit exposures that take into consideration the following factors:
  - i. Borrower's normal operating, trade or production cycle, in the case of credit exposures for working capital, trade financing, production, and/or other similar purposes to ensure a realistic repayment schedule;
  - ii. Transaction history such as frequency of renewal or extension, rate of utilization of facilities granted, and business requirements;
  - iii. Status of collateral and other guarantees in the case of secured credit exposures, including requiring the FI to re-appraise the property especially when there is a material change in market conditions or in the physical aspects of the property that threatens the collateral protection; and
  - iv. Age of the account, utilization rate, average balance carried, delinquency status, payment history, and account profitability (if available) in the case of retail credits.

**§X178.9/§4178Q.9/4197N.9 *Credit limits, large exposures, and credit risk concentrations.*** An FI is exposed to various forms of credit risk concentration which if not properly managed, monitored and controlled may cause significant losses that could threaten its financial strength and undermine public confidence in the FI. Concentration risk can arise from excessive exposures to individual obligors, groups of connected counterparties and groups of counterparties with similar characteristics (e.g., counterparties in specific geographical locations, economic or industry sectors) or entities in a foreign country or a group of countries with strongly interrelated economies.

While concentration of credit risks is inherent in banking and cannot be totally eliminated, this can be mitigated by adopting policies and processes that would limit

and control credit exposures and employing portfolio diversification strategies. Policies and procedures may include, but are not limited to the following:

- a. Policies and procedures for identifying, reviewing, managing and reporting large exposures and concentration risks of the FI.
- b. Segmenting its portfolio into the following diverse categories or such other segmentations consistent with the FI's credit strategy.
  - Various types of borrowers/counterparties or loan category (e.g., government, banks and other FIs, corporate and individual borrowers, including exchanges, electronic communication networks or ECNs and clearing houses);
  - A group of connected borrowers/counterparties (includes aggregating exposures to groups of accounts exhibiting financial or economic interdependence, including corporate or non-corporate, where they are under common ownership or control or with strong connecting links, e.g. common management, familial ties);
  - Individual industry sectors;
  - Geographic regions or countries;
  - Loan structure, collateral, and tenor; and
  - Various types of investments, including other credit instruments in the trading books and off-balance sheet transactions.
- c. Defining limit structure on each of the foregoing categories. Limits shall meaningfully aggregate credit exposures, both in the banking, trading book and on and off the balance sheet and shall be reasonable in relation to the FI's level of risk tolerance, historical loss experience, capital and resources. Such limits can be based in part on the internal risk rating assigned to the obligor or counterparty.
- d. Procedures shall ensure that limits are not exceeded and are clearly communicated, periodically reviewed and modified, as appropriate. Shall exceptions to policy be allowed, the circumstances under which limits may be exceeded and the party authorized to approve such excesses shall be clearly articulated in the credit policy.

**§X178.10/§4178Q.10 Country and Transfer Risks.** Country risk refers to uncertainties arising from economic, social and political conditions of a country which may cause obligors in that country to be unable or unwilling to fulfill their obligations. Transfer risk exists when an obligor is unable to secure foreign exchange to service external obligations due to restrictions imposed by the country on foreign exchange remittance or repayment on foreign-currency denominated assets to a foreign lender. FIs that have cross-border credit risk exposures shall have adequate internal capacity for identifying, measuring, monitoring and controlling country and transfer risks in its international lending and investment activities, and shall not place undue reliance on external ratings. An FI shall consider the following:

- a. Establishing credit-granting criteria taking into consideration country risk factors that shall include the potential for default of foreign private sector obligors arising from country-specific economic, social and political factors, the enforceability of loan agreements, and the timing and ability to realize collateral under the national legal framework. The results of the country risk analysis shall be integrated into the internal credit risk rating of the obligor. These country risk factors shall be



- regularly monitored. An FI shall also assess an obligor's ability to obtain foreign exchange to service cross-currency debt and honor contracts across jurisdictions.
- b. Country risk limits shall be put in place and regularly reviewed to determine that approved limits still reflect the FI's business strategy in line with the changing market conditions. FIs shall ensure that country exposures are reported and monitored against these limits. Significant country risks shall be assessed and highlighted in credit proposals submitted to management for approval.
  - c. Credit policy shall clearly articulate appropriate countermeasures that an FI shall take in the event of an adverse development in a particular country where it has exposures. These measures shall include closer analysis of the obligor's capacity to repay, provisioning and preparation of contingency plans if country risk continues to deteriorate. It shall consider in its monitoring and evaluation of country and transfer risks, the internal and external country risk rating transitions and economic social and political developments of the relevant countries. Any significant changes to the conditions of a country shall also be elevated to the BOD promptly particularly if the FI has substantial exposure to that country.

**§X178.11/§4178Q.11/4197N.10 Credits granted to related parties.** Consistent with sound corporate governance practices, the board and senior management shall articulate and implement clear policies in handling transactions with directors, officers, stockholders, their related interests (DOSRI), the FI's subsidiaries and affiliates, and other related parties, ensuring that there is effective compliance with existing laws, rules, and regulations at all times and that no stakeholder is unduly disadvantaged.

- a. All extensions of credit must be made on an arm's-length basis, in accordance with the FI's credit-granting criteria and in the regular course of business, and upon terms not less favorable to the FI than those offered to non-related borrowers.
- b. FI policies shall cover standards that require directors and/or officers to avoid placing themselves in a position that creates conflict of interest or the appearance of conflict of interest. The board and management shall likewise establish and implement policies that require full disclosure of personal interests that they may have in credit transactions. Directors and officers with personal interest in a transaction shall not participate in any deliberation, approval, or voting on the matter.

**C. Maintaining an Appropriate Credit Administration, Measurement, and Monitoring Process**

**§X178.12/§4178Q.12/4197N.11 Credit Administration.** FIs shall have in place a system for the ongoing administration of their various credit portfolios. Credit administration refers to the back office activities that support and control extension and maintenance of credit. FIs shall ensure the efficiency and effectiveness of the following credit administration functions:

- a. Credit documentation. Procedures shall be put in place to ensure completeness of documentation in accordance with policy including a file documentation tickler system;
- b. Disbursement. Proper approval shall be obtained and complete documentation ensured prior to disbursement. Exceptions, if any, shall be duly approved;

- c. Billing and repayment. Payments received shall be properly recorded. Measures shall be in place to ensure that late payments are tracked and collected; and
- d. Maintenance of credit files. Credit files shall include sufficient and updated information necessary to ascertain the financial condition of the obligor or counterparty and include documents covering the history of an FI's relationship with the obligor. All loan and collateral documents shall be kept in a secured area under joint custody.

**§X178.13/§4178Q.13/4197N.12 Credit Risk Measurement, Validation and Stress Testing.** FIs shall adopt sound and appropriate risk measurement methodologies which shall provide a framework to control and monitor the quality of credit as well as total loan portfolio.

- a. *Internal credit risk rating system.* FIs shall develop and utilize an internal risk rating system appropriate to the nature, size and complexity of the FI's activities in order to help the board and senior management differentiate risks across the individual credits and groups and to facilitate informed decision making.

FIs shall have sophisticated rating systems involving sufficiently granular rating grades. Simple FIs may adopt simpler systems. In all cases, however, FIs shall demonstrate the influence of the internal risk rating system in the following important functions: i) credit approval and underwriting; ii) loan pricing; iii) relationship management and credit administration; iv) allowance for credit losses and capital adequacy; and v) portfolio management and board reporting.

Internal risk rating systems shall generally observe the following standards:

- 1) It must be operationally integrated into the FI's internal credit risk management process. Its output shall accordingly be an integral part of the process of evaluation and review of prospective and existing exposures. Credit underwriting criteria shall become progressively more stringent as credit rating declines;
- 2) It must be fully documented and shall address topics such as coverage, rating criteria, responsibilities of parties involved in the ratings process, definition of what constitutes a rating exception, parties that have authority to approve exceptions, frequency of rating reviews, and management oversight of the rating process. In addition, FIs must document the rationale for its choice of rating criteria and must be able to provide analyses demonstrating that the rating criteria and procedures are likely to result in ratings that meaningfully differentiate risk;
- 3) All credit exposures shall be rated for risk. Where individual credit risk ratings are not assigned, e.g., small-denomination performing loans, FIs shall assign the portfolio of such exposures a composite credit risk rating that adequately defines its risk, i.e., repayment capacity and/or loss potential;
- 4) The board shall receive sufficient information to oversee management's implementation of the process. Migration analysis/transition matrix of ratings shall be regularly reported to show the actual performance of the rating system over time;
- 5) The risk rating system shall encompass an adequate number of ratings. FIs shall ensure that "pass" credits are sufficiently differentiated and more precisely defined. There shall be a proper process to map the internal rating system to

regulatory classification. The FI shall readjust the mapping after every review of its internal risk rating methodology. For FIs whose internal rating systems have several pass grades, special mention loans may pertain to several risk ratings while substandard, doubtful and loss generally correspond to the lowest three risk ratings;

- 6) Risk ratings must be reasonable, timely and dynamic. Ratings shall be reviewed at least annually and shall be modified whenever the borrower's creditworthiness changes;
- 7) The rating criteria shall reflect an established blend of qualitative (e.g., the quality of management, willingness to repay, etc.) and quantitative (e.g., cash flow, profitability, and leverage) factors. The criteria for assigning each rating shall be clearly defined;
- 8) The rating policy shall indicate a time horizon for the risk rating. Generally, the time horizon used for probability of default estimation is one year. However, FIs may use a different time horizon to cover one business cycle;
- 9) Ratings shall reflect the risks posed by both the borrower's expected performance and the transaction's structure. The ratings output of internal credit risk rating systems must contain both a borrower and a facility dimension. The borrower dimension shall focus on factors that affect the inherent credit quality of each borrower. The facility dimension, on the other hand, shall focus on security/collateral arrangements and other similar risk influencing factors of each transaction;
- 10) The rating assigned to a credit shall be well supported and documented in the credit file; and
- 11) Rating histories on individual accounts shall be maintained, which shall include the ratings of the account, the dates the ratings were assigned, the methodology and key data used to derive the ratings and the analyst who gave the ratings. The identity of borrowers and facilities that default, and the timing and circumstances of such defaults, must be retained. FIs must also retain data on the realized default rates associated with rating grades and ratings migration in order to eventually track the predictive power of the risk rating system.

As used in these standards, a default is considered to have occurred in the following cases:

- (a) If a credit obligation is considered non-performing under existing rules and regulations;
- (b) If a borrower/obligor has sought or has been placed in bankruptcy, has been found insolvent, or has ceased operations in the case of businesses;
- (c) If the bank sells a credit obligation at a material credit-related loss, i.e., excluding gains and losses due to interest rate movements. Banks' board-approved internal policies that govern the use of their internal rating systems must specifically define when a material credit-related loss<sup>2</sup> occurs; and

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<sup>2</sup> This refers to economic loss, thus shall include discount effects, as well as direct and indirect costs associated with collecting on the credit obligation. The FIs' board-approved internal policies that govern the use of their internal rating systems must include specific policies and procedures that shall be followed in the determination of economic loss.

- (d) If a credit obligation of a borrower/obligor is considered to be in default, all credit obligations of the borrower/obligor with the same bank shall also be considered to be in default.
- b. *Credit Scoring Model.* FIs may use a credit scoring model in measuring credit risk for pools of loans that are similar in purpose, risk characteristics and/or general exposure to groups, industries or geographical locations granted in small denomination; provided, that the FI ensures that the credit scoring model sufficiently captures the credit behavior and other characteristics of the targeted borrowers. These loans include retail loans, loans to micro and small enterprises, microfinance loans and unsecured small business loans, and consumer loans (i.e., housing loans, car or auto loans, loans for the purchase of appliance and furniture and fixtures, loans for payment of educational and hospital bills, salary loans and loans for personal consumption, including credit card loans). Risks for these types of portfolio are generally measured at portfolio level.
- c. *Other credit risk measurement/methodologies.* FIs may likewise adopt other appropriate credit risk measurement methodologies/models to estimate expected losses from credit portfolio.
- d. *Validation of internal rating systems.* Validation is a process to assess the performance of risk component measurement systems consistently and meaningfully, to ensure that the realized risk measures are within an expected range. It not only increases the reliability of a model, but also promotes improvements and a clearer understanding of a model's strengths and weaknesses among management and user groups.

FIs shall establish comprehensive policies and procedures on effective validation of the rating system (i.e. review of model design/developmental evidence, backtesting, benchmarking and assessment of the discriminatory power of the ratings) and rating process (i.e. review of data quality, internal reporting, problem handling and how the rating system issued by the credit officers). This shall be adequately documented and results reported to appropriate levels of the FI. The process shall likewise be subject to periodic review by qualified, independent individuals.

Moreover, FIs shall periodically conduct back-testing in evaluating the quality of their credit risk assessment models and establish internal tolerance limits for differences between expected and actual outcomes and processes for updating limits as conditions warrant. The policy shall also include remedial actions to be taken when risk tolerances are exceeded.

- e. *Stress testing.* When appropriate, an FI shall conduct stress testing and scenario analysis of its credit portfolio including off-balance sheet exposures, both at an individual and group levels to assess the impact of market dislocations and changes in economic conditions or key risk factors on its profile and earnings.
- i. Whether stress tests are performed manually, or through automated modeling techniques, FIs shall ensure that:
  - 1) Policies and processes –

- a) Are adequate and clearly documented, rational, easily understood and approved by the board and senior management; and
  - b) Includes methodology for constructing appropriate and plausible single and multi-factor stress tests, and possible events, scenarios, or future changes in economic conditions that could have adverse impact on credit exposures, and assess the FI's ability to withstand such changes;
  - 2) The inputs are reliable and relate directly to the subject portfolios;
  - 3) The process includes frequency of test and procedures for convening periodic meetings to identify the principal risk factors affecting the portfolio, setting loss limits and the authority for setting these limits, and monitoring stress loss limits;
  - 4) Assumptions are well documented and conservative;
  - 5) Models (if any) are subject to a comprehensive validation process;
  - 6) Exceptions to limits and stress testing results are reported to the senior management and board of directors for appropriate remedial actions; and
  - 7) Results are discussed and actions and resolutions made arising from the discussion.
- ii. The linkages between different categories of risk that are likely to emerge in times of crisis shall be fully identified. In case of adverse circumstances, there may be a substantial correlation of various risks, especially credit, liquidity, and market risk.
- f. FIs shall develop a contingency plan for scenarios and outcomes that involve credit risk in excess of the FI's established risk tolerances. This plan may include increasing monitoring, limiting portfolio growth, and hedging or exit strategies for both significant individual transactions and key portfolio segments.

**§X178.14/§4178Q.14/4197N.13 Credit Risk Management Information and Reporting Systems.** FIs shall render accurate, reliable and timely information and reports. Thus, adequate management information and reporting systems shall be in place to identify and measure credit risk inherent in all on- and off-balance sheet activities and ensure the overall effectiveness of the risk management process. The information generated from such systems shall enable the board and all levels of management to fulfill their respective oversight roles, including determining the level of capital commensurate to the credit risk exposure of the FI.

- a. At a minimum, an effective management information system (MIS) shall enable FIs to:
  - (1) Provide adequate information on the quality and composition of the credit portfolio (including off-balance sheet accounts);
  - (2) Determine accurately the level of credit risk exposures of an FI through its various activities (e.g. renewal and extension of loans, collection process, status of delinquent accounts, write-offs, provisioning, among others);
  - (3) Timely identify and monitor credit risk concentrations, exposures approaching risk limits, exceptions to credit risk limits and overrides to ensure that policy and underwriting deviations as well as breaches and other potential problems are promptly reported to the board and management for appropriate corrective action;

- (4) Aggregate credit exposures to individual borrowers and counterparties as well as to a group of accounts under common ownership or control;
  - (5) Permit additional analysis of the credit portfolio, including stress testing; and
  - (6) Maintain a database for research and use of analytical techniques, report exposures, track quality and account performances, and maintain limits.
- b. The credit policy shall clearly define the types of information and reports to be generated, frequency of reporting, deadline of submission, and the users/ recipients of and personnel responsible for the preparation of such information and reports.
  - c. FIs shall provide sufficient controls to ensure integrity of the MIS. Reports shall be periodically reviewed to ensure adequacy of scope and reliability and accuracy of the information generated. Internal audit shall also periodically assess the controls over MIS.

**§X178.15/§4178Q.15/4197N.14 Credit Monitoring.** FIs shall develop and implement comprehensive processes, procedures and information systems to effectively monitor the condition and quality of individual credits and group of credits across the FIs' various portfolios. These shall include criteria that identify and report problem credits to reasonably assure that they are appropriately monitored as well as administered and provided for.

- a. The system shall be able to, among others, provide measures to ensure that the board and management are kept informed of the current financial condition of the borrower and the various credit portfolios; loan covenants are consistently adhered to; cash flow projections meet repayment requirements; prudential and internal limits are not exceeded; portfolios are stress-tested; and potential problem credits and other transactions are identified. Exceptions, breaches and potential problems noted shall be promptly reported to management for corrective action, possible classification and/or provisioning and more frequent monitoring.
- b. Personnel or unit assigned to monitor, on an ongoing basis, credit quality and underlying physical collateral and financial guarantees shall ensure that relevant information is communicated to those personnel or unit assigned to provide internal credit risk ratings.
- c. FIs shall perform post-validation of the actual use of funds to determine that credits were drawn down for their intended purposes. Shall funds be diverted for purposes other than what has been applied for and approved, the FI shall immediately re-evaluate its approval or if necessary terminate the credit accommodation and demand immediate repayment of the obligation.
- d. FIs shall monitor individual and aggregate exposures against prudential and internal limits on a regular basis. Large exposures shall be subject to more intensive monitoring.
- e. FIs shall develop a system that allows monitoring of asset quality indicators (e.g. non-performing loans, collateral values, etc.) and trends in loan growth to identify potential weaknesses in the portfolio.

#### **D. Maintaining an Appropriate Credit Control Process**

##### **§ X178.16/§4178Q.16/4197N.15 Credit Review Process**

- a. FIs shall implement an independent and objective credit review process to determine that credits are granted in accordance with the FI's policies; assess the overall asset quality, including appropriateness of classification and adequacy of loan-loss provisioning; determine trends; and identify problems (e.g., risk concentration, risk migration, deficiencies in credit administration and monitoring processes).
- b. FIs may employ an appropriate sampling methodology to determine the scope of credit review. At a minimum, credit review shall be conducted on all individual obligors with substantial exposures, and on a consolidated group basis to factor in the business connections among related entities in a borrowing group. Credit review for credits that are similar in purpose or risk characteristics may be performed on a portfolio basis. The portfolio sample selected for review shall provide reasonable assurance that all major credit risk issues have been assessed and valid conclusions can be drawn. Moreover, sampling methodology shall be documented and periodically reviewed to ensure its quality and minimize bias.
- c. Credit review shall also evaluate credit administration function and ensure that credit files are complete and updated, and all loan approvals and other necessary documents have been obtained.
- d. Credit reviews shall be performed at least annually, and more frequently for substantial exposures, new accounts and classified accounts. Assessments shall be promptly discussed with the officers responsible for the credit activities and escalated to senior management.
- e. Results of the credit review shall be promptly reported to the board of directors or the appropriate board-level committee for their appropriate action. The board shall mandate and track the implementation of corrective action in instances of unresolved deficiencies and breaches in policies and procedures. Deficiencies shall be addressed in a timely manner and monitored until resolved/corrected.

##### **§X178.17/§4178Q.17/4197N.16 Credit Classification and Provisioning**

- a. *Classification of Loans and Other Credit Accommodations*<sup>3</sup>. FIs shall have in place a reliable credit classification system to promptly identify deteriorating credit exposures and determine appropriate allowance for credit losses. Classification can be done on the basis of internal credit risk rating system, including payment delinquency status. All credit classifications, not only those reflecting severe credit deterioration, shall be considered in determining the appropriate allowance for credit losses.
  - i. All FIs shall map their classification of loans and other credit accommodations against the regulatory classification criteria provided below. However, FIs are encouraged and not precluded from using additional criteria appropriate to

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<sup>3</sup> Other credit accommodations include other credits such as accounts receivables, sales contract receivables, accrued interest receivables and advances

their internal credit risk rating system provided they are consistent with the regulatory classification as follows:

- 1) *Pass*. These are loans and other credit accommodations that do not have a greater-than-normal credit risk. The borrower has the apparent ability and willingness to satisfy his obligations in full and therefore no loss in ultimate collection is anticipated.
- 2) *Especially Mentioned (EM)*. These are loans and other credit accommodations that have potential weaknesses that deserve management's close attention. If left uncorrected, these weaknesses may affect the repayment of the loan. Some degree of structural weakness may be found in virtually any aspect of the loan arrangement or type of loan, and the presence of one (or more) need not be indicative of an overall credit weakness deserving criticism. Instead, the FI must evaluate the relative importance of such factors in the context of the borrower's overall financial strength, the condition of the borrower's industry or market, and the borrower's total relationship with the FI. Basic characteristics include, but are not limited to, any of the following:
  - a) Deficiencies in underwriting, documentation, structure and/or credit administration that can compromise an FI's ability to control credit relationship if economic or other events adversely affect the borrower;
  - b) Continuous renewal/extension without reduction in principal, except when the capacity to pay of the borrower has been clearly re-established;
  - c) Adverse economic or market conditions, that in the future may affect the borrower's ability to meet scheduled repayments. Loans and other credit accommodations affected by these characteristics may retain the EM classification in the next examination shall the same adverse conditions persist, provided that the loans remain current; or
  - d) Intermittent delays or inadequate repayment of principal, interest or periodic amortizations of loans and other credit accommodations granted by the FI or by other FIs, where such information is available.
- 3) *Substandard*. These are loans and other credit accommodations that have well-defined weakness/(es), that may jeopardize repayment/liquidation in full, either in respect of the business, cash flow or financial position, which may include adverse trends or developments that affect willingness or repayment ability of the borrower. Basic characteristics include any of the following:
  - a) Weak financial condition and results of operation that leads to the borrower's inability to generate sufficient cash flow for debt servicing, except for start-up firms which shall be evaluated on a case-to-case basis;
  - b) Past due secured loans and other credit accommodations where properties offered as collateral have been found with defects as to ownership or with other adverse information;
  - c) Breach of any key financial covenants/agreements that will adversely affect the capacity to pay of the borrower; or



- d) Classified "Especially Mentioned" as of the last credit review without adequate corrective action.
- 4) *Doubtful*. These are loans and other credit accommodations that exhibit more severe weaknesses than those classified as "Substandard", whose characteristics on the basis of currently known facts, conditions and values make collection or liquidation highly improbable, however the exact amount remains undeterminable as yet. Classification as "Loss" is deferred because of specific pending factors which may strengthen the assets. Some basic characteristics include any of the following:
- a) Secured loans and other credit accommodations where properties offered as collateral are either subject to an adverse claim rendering settlement of the loan through foreclosure doubtful or whose values have materially declined without the borrower offering additional collateral for the loan/s to cover the deficiency; or
  - b) Loans and other credit accommodations wherein the possibility of loss is extremely high but because of certain important and reasonable pending factors (i.e., merger, acquisition, or liquidation procedures, capital infusion, perfecting liens on additional collateral, and refinancing plans) that may work to the advantage and strengthening of the asset, its classification as an estimated loss is deferred until the next credit review.
- 5) *Loss*. These are loans and other credit accommodations which are considered uncollectible or worthless and of such little value that their continuance as bankable assets is not warranted although the loans may have some recovery or salvage value. This shall be viewed as a transitional category for loans and other credit accommodations which have been identified as requiring write-off during the current reporting period even though partial recovery may be obtained in the future. Their basic characteristics include any of the following:
- a) When the borrower's and co-makers'/guarantors' whereabouts are unknown, or they are insolvent, or their earning power is permanently impaired; or
  - b) Where the collaterals securing the loans are without recoverable values.
- ii. Split classification may apply for non-performing secured loans and other credit accommodations, depending on the recoverability and liquidity of the collateral. The secured portion may be classified as "substandard" or "doubtful", as appropriate, while the unsecured portion shall be classified "loss" if there is no other source of payment other than the collateral.
  - iii. In the case of syndicated loans, each participating FI shall maintain credit information on the borrower, and grade and make provision for its portion of the syndicated loan in accordance with the requirements of these guidelines. The lead FI shall provide participating FIs with the credit information on the borrower upon request by the participating FI and inform the latter if the loan will be classified so as to achieve uniform classification of the syndicated loan.

- iv. FIs may upgrade a classified loan or restore it to a pass rating provided that it does so on the basis of a written policy on the upgrading of classification or rating and the credit review function is reliable and effective. Such policy shall include a comprehensive analysis of the repayment capability/financial strength of the borrower and the corrective actions made on the weaknesses noted to support the upgrade in classification. Upgrading may be supported by the following developments:
- 1) When all arrears or missed payments on principal and interests including penalties have been cleared rendering the account to be fully compliant with the original terms of the loan;
  - 2) Upon establishing that the weaknesses were substantially addressed and that the borrower has exhibited a sustained trend of improvement and willingness and capability to fully pay its loans and advances in a timely manner to justify the upgrade;
  - 3) Offering of new or additional collateral security; or
  - 4) In the case of restructured loans, the classification shall only be upgraded after establishing a satisfactory track record of at least six (6) consecutive payments of the required amortization of principal and interest, or until the borrower has sufficiently exhibited that the loan will be fully repaid (continued collection in accordance with the terms of the loans is expected) and the loan meets the criteria of lower loan classification.

*b. Loan Loss Estimation Methodology, Provisioning and Allowance for Credit Losses*

- i. All FIs shall develop and document a sound loan loss methodology that can reasonably estimate provisions for loans and other credit accommodations and risk assets in a timely manner, using their experience and research and this guidance to ensure that the specific and collective allowance for credit losses<sup>4</sup> (ACL) are adequate and approximates the expected losses in their credit portfolio.

An FI's loan loss methodology shall consider the following:

- 1) Written policies and procedures for the credit risk systems and controls inherent in the methodology, including roles and responsibilities of the FI's board of directors and senior management;
- 2) A detailed analysis of the entire loan portfolio, including off-balance sheet facilities, performed on a regular basis;
- 3) A realistic view of its lending activities and adequately consider uncertainty and risks inherent in those activities in preparing accounting information. Loan accounting policies and practices shall be selected and applied in a consistent way that reasonably assures that loan and loan loss provision information is reliable and verifiable;
- 4) Identification of loans to be evaluated individually and segmentation of the remaining portfolio into groups of loans with similar credit risk characteristics for collective assessment.

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<sup>4</sup> ACL represents the aggregate amount of individual and collectively assessed probable credit losses.

- a) *Individually assessed loans.* FIs shall establish a materiality threshold for significant credit exposures that will warrant an individual assessment, which threshold shall be regularly reviewed.

The loan loss estimates shall reflect consideration of the facts and circumstances that affect the repayment of each individual loan as of the evaluation date. The following factors are relevant in estimating loan losses for individually assessed loans:

- 1) Significant financial difficulty of the borrower;
- 2) Probable bankruptcy or other financial reorganization of the borrower;
- 3) Breach of contract, such as a default or delinquency in interest or principal payments; or
- 4) Concession granted by the FI, for economic or legal reasons relating to the borrower's financial difficulty, which would not otherwise be considered.

The methodology shall include procedures describing the determination and measurement of the amount of any impairment, the impairment measurement techniques available and steps performed to determine which technique is most appropriate in a given situation.

- b) *Collectively assessed loans.* FIs may use different methods to group loans for the purpose of assessing credit risk and valuation. More sophisticated credit risk assessment models or methodologies for estimating expected future cash flows, including credit risk grading processes, may combine several of the following characteristics: loan type, product type, market segment, estimated default probabilities or credit risk grading and classification, collateral type, geographical location and past-due status.

Estimated credit losses shall reflect consideration of the FI's historical net charge-off rate<sup>5</sup> of the groups, adjusted for changes in trends, conditions and other relevant factors that affect repayment of the loans in these groups as of the evaluation date, and applied consistently over time;

- 5) Methods used to determine whether and how loans individually evaluated, but not considered to be individually impaired, shall be grouped with other loan (excluding individually assessed loans that are impaired) that share similar credit risk characteristics for collective impairment evaluation;
- 6) The quality and net realizable values of physical collateral and other financial guarantees and credit risk mitigants incorporated in the loan agreement, where applicable;
- 7) Address the methods used to validate models for credit risk assessment;
- 8) The analyses, estimates, reviews and other provisioning methodology functions shall be performed by competent and well-trained personnel and

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<sup>5</sup> The historical net charge-off rate is generally based on the annualized historical gross loan charge-offs, less recoveries, recorded by the FI.

be well documented, with clear explanations of the supporting analyses and rationale; and

9) *Use experienced credit judgment.* Assessment of expected losses shall not be based solely on prescriptive rules or formula but must be enhanced with experienced credit judgment by the appropriate levels of management<sup>6</sup> inasmuch as historical loss experience or observable data may be limited or not fully relevant to current circumstances. However, the scope for actual discretion shall be prudently within the following constraints:

- a) Experienced credit judgments shall be subject to established policies and procedures;
- b) With approved and documented analytical framework for assessing loan quality applied consistently over time;
- c) Estimates shall be based on reasonable and verifiable assumptions and supported by adequate documentation; and
- d) Assumptions concerning the impact on borrowers of changes in general economic activity, both favorable and unfavorable, shall be made with sufficient prudence.

The method of determining loan loss provisions shall reasonably assure the timely recognition of loan losses. While historical loss experience and recent economic conditions are a reasonable starting point for the institution's analysis, these factors are not, by themselves, sufficient basis to determine the appropriate level of aggregate loan loss provisions. Management shall also consider any current factors that are likely to cause loan losses to differ from historical loss experience, including changes in the following:

- Lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices;
- International, national and local economic and business conditions and developments, including the condition of various market segments;
- Trend, volume and severity of past due loans and loans graded as low quality, as well as trends in the volume of impaired loans, troubled debt restructurings and other loan modifications;
- The experience, ability, and depth of lending management and staff;
- Changes related to new market segments and products;
- Quality of the FI's loan review system and the degree of oversight by senior management and board of directors;
- The existence and effect of any concentrations of credit, and changes in the level of such concentrations; and
- Credit risk profile of the loan portfolio as a whole as well as the effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the FI's current portfolio.

Experienced credit judgment shall also be used to determine an acceptable period that will yield reliable historical loss rates as loss rate periods shall

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<sup>6</sup> There may be instances when no adjustments are needed to the data in the recognition and measurement of loan losses because the data are consistent with current conditions.

not be restricted to a fixed time period to determine the average historical loss experience for any group of loans with similar credit risk characteristics. An FI shall maintain sufficient historical loss data over a full credit cycle to provide robust and meaningful statistical loan loss estimates for establishing the level of collective impairment losses for each group of loans with similar credit risk characteristics. When applying experienced credit judgment, an FI shall provide a sound rationale for excluding any historical loss data that is deemed not representative of the performance of the portfolio.

- ii. FIs with credit operations that may not economically justify a more sophisticated loan loss estimation methodology or whose practices fell short of expected standards shall, at a minimum, be subject to the regulatory guidelines in setting up allowance for credit losses prescribed in Appendix 18/Q-10, provided that the FIs notify the BSP, through their respective Central Points of Contact, of this preference. Nevertheless, such FIs shall still use experienced credit judgment, subject to the criteria prescribed in this Subsection, in determining the ACL.
- iii. FIs shall set up general loan loss provision equivalent to one percent (1%) of the outstanding balance of individually and collectively assessed loans for which no specific provisions are made and/or for which the estimated loan losses are less than one percent (<1%), less loans which are considered non-risk under existing laws, rules and regulations.
- iv. FIs shall ensure the adequacy of the individual and collective ACL for the entire loan portfolio. They shall have a policy for the regular review of the ACL, which shall be conducted at least semi-annually after considering results of the credit review, level of classified loans, delinquency reports, historical losses and market conditions. Failure to make adequate provisions for estimated future losses results in material misrepresentation of an FI's financial condition.

***§X178.18/§4178Q.18/4197N.17 Credit Workout and Remedial Management of Problem Credits*** FIs shall develop and maintain a disciplined and vigorous process for the early identification and intervention for potential or existing problem credits. The process shall ensure that timely and adequate management action is taken to maintain the quality of the credit portfolio, prevent further deterioration, and minimize the likelihood of future losses.

- a. Problem credits refer to credits that display signs of potential problems and/or well-defined weaknesses such as those not performing according to the terms of the contract, or with credit quality impairment, or deficiencies relating to their approval and/or conduct that are not in keeping with sound and prudent credit policies. These shall include past due loans, non-performing loans and restructured loans.
- b. FIs shall adopt appropriate and cost effective workout, restructuring or remedial management policies, processes and strategies to revive and recover problem credits. The strategies shall take into account the specific condition of the obligor and the FI's interest, and shall be approved by the board of directors or management, in accordance with internal policy.

- c. At a minimum, the policies and strategies shall cover the following areas:
- i. authority and responsibilities of officers and staff in managing problem credits;
  - ii. collection strategy to be adopted for different types of loans;
  - iii. restructuring and handling of restructured accounts and/or loans for workout;
  - iv. supervision and monitoring of loan recovery performance;
  - v. management and disposal of real and other properties acquired (ROPA), including appraisal process;
  - vi. management information system to support the reporting, monitoring and decision making processes;
  - vii. defined timelines and provision for regular monitoring; and
  - viii. other strategies, such as the use of collection agencies, and criteria for hiring a consultant on problem credits.
- d. Restructuring strategies
- 1) Restructuring may be resorted to for the purpose of lessening the financial difficulty of the obligor towards full settlement of his obligation, and restructuring agreements shall always take into account the borrower's capacity to pay his obligation and available credit enhancements such as financial guarantees and physical collateral. Thus, except in special cases which also require approval by the Monetary Board, such as loans funded by foreign currency obligations, FIs shall have full discretion on whether to restructure loans in order to provide flexibility in arranging the repayment of such loans without impairing or endangering the FI's interest.
  - 2) Accounts shall not be restructured unless the financial capacity of the obligor to repay has been re-established, the events or crises that triggered the financial stress had been identified, and the nature and extent of protection of the FI's exposure had been determined, to justify the need for restructuring.
  - 3) At a minimum, the classification and provisioning of a loan, prior to the execution of the restructuring agreement shall be retained until the borrower has sufficiently exhibited that the loan will be fully repaid.
  - 4) A second restructuring of a loan shall be allowed only if there are reasonable justifications: *Provided*, That it shall be considered a non-performing loan and classified, at least, "*Substandard*". The restoration to a performing loan status and/or upgrading of loan classification, e.g., from "*Substandard*" to "*Especially Mentioned*", may be allowed if circumstances warrant an upgrading in accordance with this Subsection.
  - 5) When restructuring of exposures to DOSRI and other related parties is pursued, this shall be upon terms not less favorable to the FI than those offered to others and shall be approved by the board, excluding the concerned director.
  - 6) Physical collaterals offered, such as real estate, shall be appraised by an independent appraisal company (not a subsidiary or an affiliate of the FI) acceptable to the BSP at the time of restructuring and every year thereafter to ensure that current market values are being used. A credit exposure benchmark of P1.0 million for simple FIs and P5.0 million for all other FIs shall be observed, such that physical collaterals for credit exposures beyond this amount will require an independent appraisal.

- e. Problem credits, including restructured accounts, shall be subjected to more frequent review and monitoring. Regular reports on the status of loan accounts and progress of any remedial plan shall be submitted to senior management to facilitate an informed decision whether escalated remedial actions are called for.

**§X178.19/§4178Q.19/4197N.18 Writing off problem credits.** Policies for writing off problem credits must be approved by the board of directors in accordance with defined policies, and shall incorporate, at a minimum, well-defined criteria (i.e., circumstances, conditions and historical write-off experience) under which credit exposures may be written off. Procedures shall explicitly narrate and document the necessary operational steps and processes to execute the policies.

Policies and procedures shall be periodically reviewed and if necessary, revised in a timely manner to address material internal changes (e.g., change in business focus) or external circumstances (e.g., changes in economic conditions).

FIs shall write off problem credits, regardless of amount, against ACL or current operations within a reasonable period as soon as such problem credits are determined to be worthless as defined in the FIs' written policies. However, problem credits to DOSRI shall be written off only upon prior approval of the Monetary Board.

Policies shall define and establish the reasonable period of time within which to write off loans already classified as "Loss". There shall be no undue delay in implementing write-offs. Notice of write-off of problem credits shall be submitted in the prescribed form to the BSP through the appropriate Central Point of Contact within thirty (30) business days after every write-off with a sworn statement signed by the President of the FI or officer of equivalent rank that write-off did not include transactions with DOSRI and was undertaken in accordance with board-approved internal credit policy.

An effective monitoring and reporting system shall be in place to monitor debts written off and future recoveries. Progress on recovery shall be periodically reported to the board and senior management. A database of loan accounts written off shall be maintained and must be periodically reviewed for updates on individual loan obligor's information.

**§X178.20/§4178Q.20/4197N.19 Enforcement Actions.** The BSP reserves the right to deploy its range of supervisory tools to promote adherence to standards and principles set forth in these guidelines, bring about timely corrective actions and compliance with BSP directives and ensure that FIs continuously observe the said standards. Persistent non-observance of the provisions of Section X178/4178Q/4197N and its subsections, which may lead to material misstatement of the financial condition or illiquidity of the FI, may be a ground for declaration of unsafe or unsound practices under Section 56 of R. A. No. 8791 and subject the FI to appropriate sanctions.

Enforcement actions shall be based on a holistic assessment to determine if FIs adopt appropriate risk management practices and maintain capital commensurate with the risk assumed based on existing rules and regulations. These may include, but are not limited to, the following:

- a. *Corrective Actions.* These are measures intended to primarily require FIs to rectify any deviations from the standards and principles expected in the conduct of its credit risk-taking activities to address the negative impact of such deviation.

Corrective actions generally include issuance of specific directives to address supervisory concerns within a reasonable timeframe.

- b. *Sanctions.* The Monetary Board (MB) may impose sanctions on an FI and/or its Board, directors and officers, as provided under existing laws, BSP rules and regulations proportionate to the gravity/seriousness of offense.
- c. *Other Enforcement Actions.* Subject to prior MB approval, the BSP, when warranted, may deploy other enforcement actions such as:
  - i. Initiation into the prompt corrective action (PCA) framework whenever grounds for PCA exist;
  - ii. Issuance of cease and desist order (CDO) in case of persistence of unsafe/unsound banking practices and/or violation of any banking law or any order, instruction or regulation issued by the Monetary Board or any order, instruction or ruling issued by the Governor;
  - iii. Additional capital infusion in case hazardous lending practices resulted in excessive provisions for credit losses leading to capital deficiency;
  - iv. Requiring the FI to gross up the amount of required allowance for credit losses based on the examination of a representative sample of loans, if in the course of the BSP examination, a high incidence of non-reporting/concealment of past due and/or problem loans is noted; or
  - v. Other appropriate non-monetary enforcement actions that the MB may impose.

**Section 2.** Subsection X301.6/4301Q.6 on large exposures and credit risk concentrations is hereby amended to read as follows:

***“§X301.6/§4301Q.6 Large exposures and credit risk concentrations***

- a. *Definition.* “Large exposures” shall refer to exposures to counterparty or a group of connected counterparties equal or greater than five percent (5%) of the FI’s qualifying capital as defined under Sec. X116/4115Q.

“Connected counterparties” refer to a group of counterparties that are connected through (a) direct or indirect control of one of the counterparties over the other(s) or (b) economic interdependencies, and must be treated as a single counterparty. Control shall be determined in accordance with Subsection X303.1(g) of the Manual of Regulations for Banks.

“Economic interdependence”, on the other hand, refers to a situation where counterparties are reliant on each other, such that if one of the counterparties experiences financial problems in repaying its obligations, the creditworthiness of the other(s) would also likely deteriorate. FIs shall define in their credit policy criteria in determining connectedness based on economic interdependence, which shall consider, among others, significant dealings or transactions of one or more counterpart(y/ies) that impact the financial capacity or ability to repay the obligations of the other counterpart(y/ies).

In cases where the criteria do not automatically imply an economic dependence that results in two or more counterparties being connected, the FI shall provide evidence to BSP that a counterparty which is economically connected to another, still can pay its liabilities even if the latter’s financial condition weakens.



- b. *Scope of Application.* Large exposures of FIs and their subsidiaries and affiliates to third parties across the relevant regulatory consolidation group shall be aggregated and compared with the group's qualifying capital.
- c. *Exclusions.* Loans, other credit accommodations and guarantees that are excluded from the single borrower's limit (SBL) under Sections X303/4303Q and Subsections X303.4/4303Q.1 of the Manual of Regulations for Banks/Non-Bank Financial Institutions, as well as intraday and end-of-day interbank exposures arising from interbank payment and settlement processes shall be excluded from large exposures.
- d. *Notification requirements.* An FI must immediately inform the BSP when it has concerns that its large exposures or credit risk concentrations have the potential to impact materially upon its capital adequacy, along with proposed measures to address these concerns.
- e. *Reporting.* FI's records on monitoring of large exposures shall be made available to the BSP examiners for verification at any given time. When warranted, the BSP may impose additional reporting requirements on the FI in relation to its large exposures and credit risk concentrations.
- f. *Sanction.* Any failure or delay in complying with the requirements under Items "d" and "e" of this Subsection shall be subject to penalty applicable to those involving major reports."

**Section 3.** The following provision is added as last paragraph of Section X303/4303Q on credit exposure limits to a single borrower:

"It is expected that FIs would generally observe a lower internal single borrower's limit than the prescribed limit of twenty-five percent (25%) as a matter of sound practice."

**Section 4.** Section X304/4304Q/4312N and Subsection X304.1/4304Q.1/4312N.1 on the grant of loans and other credit accommodations are hereby amended to read as follows:

**"Sec. X304/4304Q/4312N Grant of Loans and Other Credit Accommodations.** In addition to the principles and standards provided under Section X178/4178Q/4197N, the following regulations shall be observed in the grant of loans and other credit accommodations."

**"§X304.1/§4304Q.14312N.1 Additional Requirements.** FIs shall require submission and maintain on file updated ITRs of the borrower, and his co-maker, if applicable, duly stamped as received by the BIR together with supporting financial statements, as applicable. FIs shall likewise require borrowers to execute a waiver of confidentiality of client information and/or an authority of the FI to conduct random verification with the BIR in order to establish authenticity of these documents.

Shall the document(s) submitted prove to be incorrect in any material detail, the FI may terminate any loan or other credit accommodation granted on the basis of said document(s) and shall have the right to demand immediate repayment or liquidation of the obligation.

The required submission of such documents shall not cover the following credit exposures:

- (1) Microfinance loans as defined under Subsec X361.1(a);
- (2) X x x;

- (7) Loans and other credit accommodations not exceeding P3.0 million; or
- (8) Loans to start up enterprise borrowers during the first three (3) years of their operations or banking relationship.”

**Section 5.** Subsection X305.4/4305Q.4 on accrual of interest earned on loans is hereby amended, and Subsection 4312N.6 is added, to read as follows:

**“§X305.4/§4305Q.4/4312N.6 Accrual of interest earned on loans.** Accrual of interest earned on loans shall only be allowed if the loans and other credit accommodations are current and performing (i.e., no condition of financial difficulties or inability to meet financial obligations as they mature). However, interest income on past due loans arising from discount amortization (not from the contractual interest of the accounts) shall be accrued in accordance with PAS 39.

Accrued interest receivable shall be classified in accordance with their respective loan accounts and provided with *Allowance for Uncollected Interest on Loans.*”

**Section 6.** Item i of Subsection X306.1/4306Q.1 on accounts considered as past due is hereby added to read as follows:

**“§ X306.1/4306Q.1 Accounts considered past due**

- i. Restructured loans shall be considered past due in case of delay of any of its principal or interest payments.

*Restructured loans* are loans the principal terms and conditions of which have been modified in accordance with a restructuring agreement setting forth a new plan of payment or a schedule of payment on a periodic basis. The modification may include, but is not limited to, change in maturity, interest rate, collateral or increase in the face amount of the debt resulting from the capitalization of accrued interest/accumulated charges. Items in litigation and loans subject of judicially approved compromise, as well as those covered by petitions for suspension or for new plans of payment approved by the court or the SEC, shall not be classified as restructured loans.

**Section 7.** Item d of Subsection X309.1/4309Q.1 on restructured loans considered as non-performing is hereby amended to read as follows:

**“§ X309.1/4309Q.1 Accounts considered non-performing; definitions**

- d. Restructured loans shall be considered non-performing except when as of restructuring date: (i) the principal and interest payments have been updated and (ii) the loan is yielding a rate of interest that fully compensates the FI for its cost of funds and credit risk.

The restoration to a performing loan shall only be effective after a *satisfactory track record* of at least three (3) consecutive payments of the required amortizations of principal and/or interest.

A restructured loan which has been restored to a performing loan status shall be immediately considered non-performing in case of default of any principal or interest payment.”

**Section 8.** The provisions of Section X311 on loans secured by real estate mortgages are hereby amended and the same provisions are added as Section 4311Q/4311N to read as follows:

**"Sec. X311/4311Q/4311N Secured Loans and Other Credit Accommodations.** "A loan may be considered secured by collateral to the extent the estimated value of net proceeds at disposition of such collateral can be used without legal impediment to settle the principal and accrued interest of such loan, provided that such collateral must have an established market and the valuation methodology used is sound, and provided further that in the case of real estate collateral the maximum collateral value shall be 60% of its value as appraised by an appraiser acceptable to the BSP.

A loan may also be considered as secured to the extent covered by a third party financial guarantee or surety arrangement where the credit enhancement provider is itself considered to be of high credit quality (credit rating of at least AA or equivalent) or is considered to be such by the BSP.

Finally, a loan may be secured by a combination of acceptable collateral and guarantee arrangements as defined above, provided such arrangements are independent of one another for credit enhancement purposes."

**Section 9.** The following Sections/Subsections are hereby deleted and the applicable provisions are incorporated in the guidelines under Section 1 hereof:

Section/Subsection	Title/Description	Covered By
X301/4301Q	Lending Policies	X178.5/4178Q.5/4197N.5
1301.1	Rules and regulations to govern the development and implementation of the internal credit risk rating system	X178.13
X302/4302Q/4302N	Loan Portfolio and Other Risk Assets Review System	X178.16/4178Q.16/4197N.15
X302.1/4302Q.1	Provisions for losses; booking	X178.17/4178Q.17
X302.2/4302Q.2	Sanctions	X178.20/4178Q.20
X304.2/4304Q.2/ 4312N.2	Purpose of loans and other credit accommodations	X178.7/4178Q.7/4197N.7
X306.3/4306Q.3	Renewals/extensions	X178.8/4178Q.8
X306.4/4306Q.4	Restructured loans (past due)	X306.1/4306Q.1
X306.5/4306Q.5	Write-off of loans as bad debts	X178.19/4178Q.19 X178.19
X306.6	Writing-off microfinance loans as bad debts	
X311.1	Loans secured by junior mortgage on real estate	Section X311/ 4311Q
3311.2	Eligible real estate collaterals on rural/cooperative bank loans	
X311.3	Insurance on real estate improvements	
X312	Loans and other credit accommodations secured by chattels and intangible properties	
X313	Loans secured by personal properties	
X314	Increased loan values and terms of loans for home building	
X315	Loans secured by certificates of time deposit	
X319/4319Q/4314N	Loans Against Personal Security	X304.4/4304Q.4/4312N.4
X322/4322Q	Restructured Loans; General Policy	X178.18/4178Q.18
X322.2/4322Q.2	Procedural Requirements	
X322.1/4322Q.1	Definition; when to consider performing/non-	X309.1/4309Q.1
X322.3	performing Restructured loans considered past due	X306.1/4306Q.1
X322.4/4322Q.4	Classification of Restructured loans	X178.17/4178Q.17

**Section 10. Transitory Provision.** FIs shall be given six (6) months from the effectivity of this Circular to: (1) perform a gap analysis of their current practices vis-à-vis this Circular and (2) propose an action plan duly approved by the board of directors to achieve full compliance within a reasonable period of time but in no case longer than two (2) years from effectivity of this Circular.

All action plans shall be subject to acceptance by the BSP through the Deputy Governor, Supervision and Examination Sector. All requests for regulatory relief shall be subject to prior Monetary Board approval.

Any FI that fails to comply with the obligations prescribed during this transition period shall be subject to the imposition of appropriate monetary and/or non-monetary sanctions.

**Section 10. Effectivity.** This Circular shall take effect fifteen (15) calendar days following its publication either in the Official Gazette or in a newspaper of general circulation.

**FOR THE MONETARY BOARD:**

  
**AMANDO M. TETANGCO, JR.**  
Governor

29 October 2014

## BASIC GUIDELINES IN SETTING UP OF ALLOWANCE FOR CREDIT LOSSES

FIs with credit operations that may not economically justify a more sophisticated loan loss estimation methodology or where practices fell short of expected standards shall, at a minimum, be subject to the following guidelines:

### I. Individually Assessed Loans and Other Credit Accommodations<sup>1</sup>

- Loans and other credit accommodations with unpaid principal and/or interest shall be classified and provided with allowance for credit losses (ACL) based on the number of days of missed payments as follows:

For unsecured loans and other credit accommodations:

No. of Days Unpaid/with Missed Payment	Classification	ACL
31 - 90 days	Substandard	10%
91 - 120 days	Substandard	25%
121 - 180 days	Doubtful	50%
181 days and over	Loss	100%

For secured loans and other credit accommodations:

No. of Days Unpaid/with Missed Payment	Classification	ACL
31 - 180 days*	Substandard	10%
181 - 365 days	Substandard	25%
Over 1 year - 5 years	Doubtful	50%
Over 5 years	Loss	100%

*\* When there is imminent possibility of foreclosure and expectation of loss, ACL shall be increased to 25%*

Provided, that where the quality of physical collaterals or financial guarantees securing the loans and advances are determined to be insufficient, weak or without recoverable values, such loans and advances shall be treated as if these are unsecured.

- Loans and other credit accommodations that exhibit the characteristics for classified accounts described under Subsection X178.17/ 4178Q.17 shall be provided with allowance for credit losses as follows:

Classification	ACL
Especially Mentioned	5%
Substandard - Secured	10%
Substandard - Unsecured	25%
Doubtful	50%
Loss	100%

- Unsecured loans and other credit accommodations classified as "Substandard" in the last two (2) internal credit reviews which have been continuously renewed/extended without reduction in principal and is not in process of collection, shall be downgraded to "Doubtful" classification and provided with a 50% allowance for credit losses;

<sup>1</sup> Other credit accommodations include other credits such as accounts receivables, sales contract receivables, accrued interest receivables and advances

4. Loans and other credit accommodations under litigation which have been classified as "Pass" prior to the litigation process shall be classified as "Substandard" and provided with 25% allowance for credit losses.
5. Loans and other credit accommodations that were previously classified as "Pass" but were subsequently restructured shall have a minimum classification of EM and provided with a 5% allowance for credit losses, except for loans which are considered non-risk under existing laws, rules and regulations.
6. Classified loans and other credit accommodations that were subsequently restructured shall retain their classification and provisioning until the borrower has sufficiently exhibited that the loan will be fully repaid.

## II. Collectively Assessed Loans<sup>2</sup> and Other Credit Accommodations

1. Current "Pass" loans and other credit accommodations should be provided with a reasonable level of collective allowance, using historical loss experience adjusted for current conditions.
2. Loans and other credit accommodations with unpaid principal and/or interest shall be classified and provided with ACL based on the number of days of missed payments as follows:

For unsecured loans and other credit accommodations:

No. of Days Unpaid/with Missed Payment*	Classification	ACL
1 – 30 days	EM	2%
31 – 60 days/1 <sup>st</sup> restructuring	Substandard	25%
61 – 90 days	Doubtful	50%
91 days and over/2 <sup>nd</sup> restructuring	Loss	100%

\* PAR for microfinance loans

For secured loans and other credit accommodations<sup>3</sup>:

No. of Days Unpaid/with Missed Payment	Classification	ACL (%)	
		Other types of collateral	Secured by real estate
31 – 90	Substandard	10	10
91 – 120	Substandard	25	15
121 – 360 days	Doubtful	50	25
361 days – 5 years	Loss	100	50
Over 5 years	Loss		100

Provided, that where the quality of physical collaterals or financial guarantees securing the loans and advances are determined to be insufficient, weak or without recoverable values, such loans and advances shall be treated as if these are unsecured.

<sup>2</sup> This includes microfinance loans, micro enterprises and small business loans and consumer loans such as salary loans, credit card receivables, auto loans, housing loans and other consumption loans, and other loan types which fall below the FI's materiality threshold for individual assessment;

<sup>3</sup> As defined under Section X311 of the Manual of Regulations for Banks