



Bangko Sentral ng Pilipinas

OFFICE OF THE DEPUTY GOVERNOR SUPERVISION AND EXAMINATION SECTOR

MEMORANDUM TO ALL UNIVERSAL BANKS AND COMMERCIAL BANKS

To facilitate effective implementation of Circular No. 439 dated 5 July 2004, the following clarifications are hereby issued:

1. On whether the required accreditation of external auditors is to be conducted by the Securities and Exchange Commission (SEC) or by the BSP, the process for accreditation, and the responsibility of the banks in the accreditation process.

Response: Banks must ensure that external auditors of clients are accredited by the SEC. The SEC accreditation process can be viewed on the SEC website (www.sec.gov.ph). It is important to note that SEC accreditation requires prior Professional Regulatory Commission (PRC)/ Board of Accountancy (BOA) accreditation.

2. On the requirement to have bank clients' financial statements audited only by accredited auditors vs. affordability by/accessibility of bank clients.

Response: Both the SEC and the BOA have confirmed that they have regional centers which are readily accessible by even provincial external auditors intending to be accredited. The process is quite straightforward. The BOA accreditation costs only P1,000 for a 3-year accreditation and the SEC accreditation cost is likewise very affordable. Banks may access the Philippine Institute for Certified Public Accountants (PICPA) website (www.picpa.com.ph) for more information on BOA accreditation.

3. Is the development of an accreditation process for external auditors to be used by corporate clients included in the new requirements of BSP? Is this included in the December deadline?

Response: Circular No. 439 does not require banks to have their own accreditation process for external auditors. The Circular simply requires that corporate clients, which are subject to banks' internal credit risk rating systems, use SEC-accredited external auditors by 2005.

4. When will the SEC come up with its list of accredited auditors? Will these include provincial auditors?

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Response: Please see responses to Items 1 to 3 above.

5. Circular No. 439 specifies that in rating corporate borrowers, only financial statements audited by SEC-accredited external auditors shall be used starting with 2005 financial statements. Does this mean that any SEC accreditation will be sufficient, or does the auditor have to be accredited for the specific industry?

Response: The SEC has specific accreditation criteria for auditors for various sectors such as publicly listed companies, finance companies, or general corporates. Therefore, publicly listed companies must be audited by auditors accredited to audit publicly listed companies, finance companies by auditors accredited to audit finance companies, and so on.

6. Will the BSP come up with a list of suggested software/vendor considered compliant with the Circular?

Response: No, the BSP will not and will leave this matter to individual banks to address.

7. Will the internal credit risk rating system adopted by a bank form part of its CAMELS rating criteria? If so, what weight will it be given? Will banks adopting the BAP model and currently under a "3" rating be stuck at this rating level? Apparently, the BSP letter to the Bankers Association of the Philippines (BAP) indicates that banks aspiring for a better CAMELS rating should adopt a more sophisticated "internal credit rating model" to obtain a better score. Is this correct?

Response: The internal credit risk rating system used by the banks will form part of the CAMELS rating system. In the context of Deputy Governor Reyes' letter to the BAP, a better than "3" CAMELS rating may be obtained by banks if their internal rating systems have comprehensive coverage of all their significant credit exposures, not just exposures to corporates with asset sizes of P15 million and above.

8. A bank uses a scorecard system for evaluating small business clients (defined as those with facilities of up to P10 million, regardless of asset size). Because clients are defined differently, there would be cases where a small business client, which is evaluated using a scorecard, has assets of more than P15 million. However, under Circular No. 439, this client should be evaluated using the bank's internal risk rating system. Would the BSP consider this as having substantial compliance inasmuch as the small business exposure also undergo a comprehensive scorecard-type of evaluation?

Response: Substantial compliance would mean that the scorecard system uses a 10-grade rating system; if substantially different from the BAP model this would need to be justified to the BSP. However, the BSP intends to come out with guidelines on the use of credit scoring models for SME exposures.

9. On what the BSP auditors expect at the time of audit in 2005

Response: Circular No. 439 states that a fully documented internal credit risk rating system duly approved by the Board of Directors must be submitted to the BSP not later than 31 December 2004, and that upon submission, all prospective and existing corporate accounts must be evaluated and monitored according to such a system.

10. Will there be new reserves allocation structure for accounts rated 1 to 6?

Response: At present, reserves will remain applicable only for the accounts rated from 7 to 10.

11. What is meant by a "meaningful or excessive concentration of exposures" across grades? Is there any quantitative criteria for such concentration? Will banks having a skewed concentration of their outstanding portfolio be considered as not using an appropriate internal rating model?

Response: Each bank under its portfolio management function must determine the proper levels of concentration of exposures across grades. The BSP, however, may note exceptional cases of skewed concentration limits.

12. Does rating migration in the Circular refer to a "transition matrix"? If so, how often should the ratings be updated for purposes of constructing the matrix?

Response: Yes, rating migration refers to a transition matrix. The risk ratings must be updated as often as deemed necessary by each bank's approving body to ensure their accuracy and timeliness.

13. The independence of credit review function from the business origination unit is a minimum operational requirement. It is suggested that the Circular should explicitly define the reporting lines of the credit department to strictly enforce objective and independent risk assessment process.

Response: Circular No. 439 states that the function that is responsible for the design, implementation and performance of banks' credit risk rating systems should be independent from the business functions responsible for originating exposures (i.e., those responsible for giving out loans). In testing this independence, BSP examiners will expectedly look into the reporting lines of the credit risk control function.

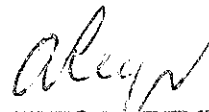
14. What is meant by "meaningful" risk differentiation on Section 4, Paragraph 1. Are there any quantitative/objective criteria for this? In defining what constitutes a rating exception, should the banks not be given guidelines/benchmarks?

Response: The BSP expects banks to eventually be able to show that their rating criteria are statistically significant determinants of borrower default. Rating exceptions obviously refer to instances when banks disregard the result of their internal rating system due to additional information not captured by the system. Banks are expected to come up with their own policies and procedures in dealing with rating exceptions (especially their implication on the integrity of default measures). The BSP, however, expects that rating exceptions will be minimal.

15. Please provide an explicit definition of "default" for comparability across banks as there are a variety of existing (technical, economic, etc.) definitions of what constitutes default.

Response: The BSP is currently conducting a study that aims to come up with a uniform definition of default to be used across all BSP regulations.

For guidance.


ALBERTO V. REYES
Deputy Governor

1 December 2004