



**BANGKO SENTRAL NG PILIPINAS**

**OFFICE OF THE GOVERNOR**

**MEMORANDUM NO. M-2013- 002**

**To : ALL BSP- Supervised Financial Institutions**

**Subject: Guidelines in Assessing the Quality of Corporate Governance in BSP- Supervised Financial Institutions**

The Monetary Board in its Resolution No. 2146 dated 20 December 2012 approved the attached guidelines in assessing the quality of corporate governance in BSP-supervised financial institutions. The said guidelines provide a framework for evaluating the quality of corporate governance and assigning the corresponding "Management" component rating in the CAMELS rating system.

The guidelines will be used in all examinations beginning 2013.

For information and guidance.

**FOR THE MONETARY BOARD:**

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

11 January 2013



**GUIDELINES IN ASSESSING THE QUALITY OF CORPORATE GOVERNANCE  
IN BSP SUPERVISED FINANCIAL INSTITUTIONS<sup>1</sup>**

**I. Purpose of the Guidelines**

- 1) The Supervision Guidelines (SG) aim to provide a framework for assessing the quality of corporate governance in BSP supervised financial institutions (FIs) and for assigning the corresponding “Management” component rating in the CAMELS rating system. Note that these guidelines are not substitutes for sound supervisory judgment; rather, they only provide a structure to assist in the thought process in evaluating the quality of corporate governance in FIs.
- 2) The SG is applicable to all types of FIs<sup>2</sup>. The supervisory expectations and standards set-out in this SG apply to the board of directors of FIs, unless stated otherwise. Moreover, the term “supervisors” shall refer to both on-site and off-site BSP supervision personnel.

**II. Overarching Principles**

- 3) In applying these guidelines, supervisors should keep in mind the following overarching principles to facilitate the integration of issues and come up with an overall rating for Management:
  - **Proportionality.** There is no “one size fits all” framework for governance. The approach to governance will vary from one FI to another depending on its size, risk profile, and complexity of operations. To illustrate, the governance framework of a rural/cooperative bank is not expected to be as intricate as that of a universal/commercial bank considering the size of the former and the type of transactions it engages in.
  - **Fair share for each stakeholder.** All transactions of the FI should be dealt with on an arm’s length basis to ensure that no party is unduly disadvantaged particularly the depositors, other creditors and minority shareholders. The FI should conduct its business with a deep sense of responsibility as a good corporate citizen.

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<sup>1</sup> Certain concepts/principles were drawn from the Assessment Criteria of the Office of the Superintendent of Financial Institutions Canada.

<sup>2</sup> In case of branches of foreign banks, supervisors will assess how the country manager/head of the branch oversees the implementation of governance principles in the branch and manages the operations of said entity.

- **Ultimate responsibility rests with the board.** The board is at the helm of the FI's strategic direction and operations. The FI's financial condition, results of operations, current and potential level of risk exposures and the quality of the control environment are the ultimate responsibility of the board. The board should be assessed on the quality of its leadership in ensuring the sound operations of the FI and in dealing decisively with issues that may emerge.

### III. Assessment Approach

- 4) Good corporate governance is the foundation of safe and sound banking operations. It embodies the principles of fairness, accountability and transparency hence, it promotes the protection of the rights of all stakeholders. This is critical particularly in the financial industry, where the public's trust is paramount to sustain its resiliency.
- 5) Good corporate governance is a reflection of the collective values and competence of the board of directors and senior management team. In this regard, complete documentation of policies and procedures, albeit preferred, does not automatically translate to good corporate governance as their effective implementation is largely dependent on the stewardship of the board and management. Considering this, the evaluation of the quality of governance should transcend the checklist approach or assessment of compliance with the provisions of existing regulations. Rather, supervisors should focus more on the effective implementation of the governance standards and principles by putting greater weight on the practices and performance of the board of directors and senior management.

### IV. Rating "Management"

- 6) The assignment of the "Management" rating shall be based on the evaluation of four (4) factors that characterizes the quality of governance in an FI as follows: **(a) Governance landscape; (b) Fitness and propriety of the Board and Management; (c) Risk Governance; and (d) Controls and Independent Oversight.** Each factor will be rated using a scale of 1 to 5 with 5 being the highest rating.
- 7) Section V of this SG describes the factors that should be considered in assessing a particular component. However, the four (4) factors should not be taken independently of each other. Instead, their relationships should be considered particularly on how they complement each other in terms of serving their purpose in enhancing the quality of governance in an organization.
- 8) The component rating for "Management" should not be based on the arithmetic average of the ratings assigned to the four factors. Judgment should be

exercised on how much weight should be given to a particular factor given the distinct circumstances in the FI. The relationship of the different factors should be evaluated as to the extent they shape the quality of governance in an FI. The challenge for supervisors therefore, is in identifying the issues that are of greatest supervisory concern and in synthesizing how these have affected the quality of governance in the FI.

- 9) Note that FIs are expected to meet the minimum requirements set forth under existing regulations. Hence, although the deficiencies noted (e.g., not meeting the minimum number of independent directors) do not affect the overall quality of governance in an FI, this precludes the assignment of the highest rating either for the Management component or factor rating.
- 10) The five point rating scale for the “Management” component rating is described as follows:
  - **“5” (Strong)** – The governance landscape, characteristics of the board and management, risk governance and governance over controls and independent oversight exceed what is considered necessary<sup>3</sup> given the size, risk profile and complexity of operations of the FI. Deficiencies/weaknesses are considered to be minor and insignificant.
  - **“4” (Satisfactory)** – The governance landscape, characteristics of the board and management, risk governance and governance over controls and independent oversight meet what is considered necessary given the size, risk profile and complexity of operations of the FI. Deficiencies/weaknesses may exist but these do not affect the overall quality of governance in an FI.
  - **“3” (Less than Satisfactory)** – The governance landscape, characteristics of the board and management, risk governance and governance over controls and independent oversight do not meet what is considered necessary given the size, risk profile and complexity of operations of the FI. However, the Board and Management are committed (with ability and willingness) to correct the situation in a timely manner.
  - **“2” (Deficient)** - The governance landscape, characteristics of the board and management, risk governance and governance over controls and independent oversight are deficient, in a material way, to meet what is considered necessary given the size, risk profile and complexity of operations

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<sup>3</sup> For this purpose, “what is considered necessary” shall be more than what is prescribed under existing regulations considering the size, risk profile and complexity of operations of the FI and considers planned expansionary activities or strategic direction of the FI

of the FI. Moreover, the ability of the Board and Management to correct the situation in a timely manner is doubtful.

- **“1” (Critically Deficient)** - The governance landscape, characteristics of the board and management, risk governance and governance over controls and independent oversight are critically deficient to meet what is considered necessary given the size, risk profile and complexity of operations of the FI. The deficiencies/weaknesses pose an imminent threat to the safety and soundness of the financial institution.

11) Supervisors should explain succinctly the basis for the rating assignments and what factors were considered specifically on case-by-case basis.

## **V. Components of “Management” Rating**

12) The four (4) factors to be considered in assessing the “Management” component rating namely, **(a) Governance landscape; (b) Fitness and propriety of the Board and Management; (c) Risk Governance; and (d) Controls and Independent Oversight** cover the entire spectrum of governance from the platform that sets the backdrop for good governance to the implementation of its principles, which is reflective of the performance of the board or management. These factors are discussed in detail below.

13) **Governance landscape.** This pertains to the corporate structure and organizational culture of the FI that sets the stage for good governance. This is seen in the propriety of the organizational structure and the general attitude of the board and management towards all stakeholders including regulators and customers. This factor also covers the level of risk consciousness of employees and how such manifests in the performance of their duties and responsibilities.

### **Corporate Structure**

14) An FI should have a board-approved organizational structure that is commensurate with its size and complexity of business model and activities. The organizational structure should clearly define the relationships between groups or divisions and the reporting line from the staff level to the board. It should also establish the scope of accountability of management or the extent of their authority and involvement over the affairs of the institution. Moreover, the organizational structure should also clearly reflect the independence of the control functions (i.e. internal audit, compliance and risk management).

15) Management is expected to periodically update the organizational structure to reflect significant changes in the FI’s operations or functions and regularly review the same to ensure that such remain appropriate given the size and complexity of operations of the FI. In this respect, any changes in the organizational

structure and the rationale for the change should be approved by the board of directors.

- 16) The assessment of the propriety of the organizational structure of an FI should not be limited to the evaluation of its organizational chart as the latter may not be reflective of the actual set-up; in which case supervisors must observe whether the indicated reporting lines are being followed and that the members of the management team or the positions identified to head particular area/s of operations are the ones who actually carry-out the corresponding functions. Albeit, management is expected to ensure that the organizational structure as reflected in the FI's documents and charts are reflective of the actual operating framework, supervisors should lend flexibility if there are certain deviations particularly if the pertinent control principles in the revised reporting lines were observed.
- 17) In the case of FIs belonging either to the large conglomerates or the small network type structure<sup>4</sup>, the organizational structure of the supervised FI should reflect all related entities in the group. The entities identified should not be confined to the definition of DOSRI under existing regulations. Rather, all entities that may pose material risk to the FI either through direct or indirect relationships (e.g., parent company, entities owned directly or indirectly by the parent company and/or its subsidiaries/affiliates including special purpose entities (SPEs), and other entities that the bank exerts control over or those that exert control over the bank, or those that are related to the bank and/or its subsidiaries/affiliates either through common ownership/ directorship/ officership) should be included.
- 18) The board and management of supervised FIs should know and understand the structure of the conglomerate group and the risks posed by entities in the group. This shall also include identifying the risks attendant to the use of opaque structures or special purpose vehicles that impede transparency.

*Attitude towards regulators*

- 19) The board and management should maintain a constructive working relationship with regulatory/supervisory agencies (e.g. BSP). This entails understanding the supervisory approach of the concerned agency in order to be able to fully utilize its assessment and recommendations.

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<sup>4</sup> 'Small Network Type Structure' consists of financial institutions within a group, which are connected through common ownership. This group is not systemic in nature but is likely to warrant significant supervisory attention and the extensive use of supervisory resources. Further, this group rapidly acquires different small financial institutions and employs simple business model.

- 20) The board and management should espouse a cooperative stance toward the regulator/supervisor. This may manifest in several ways such as by being transparent to the regulator/supervisors, by being cooperative during on-site examinations and in implementing supervisory actions, by showing willingness to discuss the issues concerning the FI and by promptly complying with all directives.

*Responsiveness to complaints/concerns*

- 21) Management should establish a system for resolving complaints and concerns of stakeholders within a defined timeframe and such system should be accorded with adequate independence from FI's operations. Serious allegations or complaints of stakeholders should be investigated expeditiously and appropriate actions should be undertaken to prevent recurrence. All complaints and concerns should be monitored and serious cases should be reported to the board. In this respect, what constitutes "serious cases" should be clearly defined by management and such definition should be approved by the board of directors.
- 22) Management is expected to maintain a database of the complaints/concerns received. Likewise a periodic analysis of the nature of the complaints gathered should be conducted to be able to institute measures to address the root cause of recurring concerns.

*Risk consciousness of employees*

- 23) Risk consciousness of employees results from an effective cascade of the overall objectives and strategies of the organization. This may be seen from the outcome of formal system of assessment such as compliance testing, internal audit and risk control self assessment. Risk consciousness reflects the level of employees' awareness of the impact of their specific function in achieving the overall goal of the FI and the extent to which they are aware of the specific risks arising from the processes they are involved in. To illustrate, a trader's repeated breach of limits may reflect a low level of risk consciousness and could also be a result of Management's tolerance of excessive risk-taking, which is a bigger (or more pervasive) issue.
- 24) Management's efforts to ensure risk consciousness of employees may be observed from the trainings and other initiatives mounted to cascade information and the manner by which compensation and incentives packages for personnel embody prudent risk taking. Likewise, Management should foster a culture that would encourage employees to discuss their risk concerns at their own levels and with members of the management team.

### Ethical culture

- 25) Ethics is an underpinning of good governance. An ethical culture does not emanate solely from having appropriate and adequate description of acceptable and unacceptable practices. The ethical culture develops out of the bearing of the board to implement the policies, which is reflected in its performance and decisions. It can also be seen on the actions done to chastise unethical practices. Supervisors should then look into how management handled unethical practices and the propriety of the sanctions imposed on the perpetrators.
- 26) Moreover, supervisors should also evaluate how management attends to instances of whistle-blowing. Relative to this, the officer who will receive the complaints should be specifically identified and there should be a defined process in investigating and handling whistle-blowing cases.

### Transparency practices

- 27) Transparency practices reflect board and management's recognition of their accountability to the different stakeholders. The more information is disclosed, to the extent allowed under applicable laws, the narrower the gap among stakeholders in terms of making informed decisions.
- 28) Disclosures either to the public or to the regulators should at all times be accurate, timely clear and comprehensible to facilitate the users' understanding of the information.
- 29) The quality of disclosures to the public may be assessed through the amount and accuracy of information reflected in the audited financial statements, income statements and published balance sheets annual reports and the FI's websites. The board and management should treat the required disclosures under existing regulations and accounting standards, as the minimum rather than an exhaustive list of disclosure requirements. More information should be disclosed on transactions that have material impact on the FI. The breadth and depth of the information disclosed would give indicators on the intention of the board and management for the disclosure, which is either to comply with existing regulations or to empower the user.
- 30) The assessment of the quality of disclosures to regulators will not be limited to the completeness and accuracy of information provided in the prudential reports. Management should periodically apprise regulators of significant transactions, business decisions or issues that may change the risk profile of the FI.
- 31) Supervisors may also take into account the results of the assessment of the corporate governance scorecard (CGS) for universal/commercial banks.

Supervisors should however, give due regard to the fact that the “man-on-the-street” approach was adopted in the assessment, which means that the assessor based its judgment on the extent of disclosures provided for each category without taking into account concerns of interest to supervisors.

32) The five (5) point rating scale for the factor “Governance landscape” is described as follows:

- **“5” (Strong)** – The governance landscape exceeds what is considered necessary given the size, risk profile and complexity of operations of the FI. Deficiencies/weaknesses are considered to be minor and insignificant.
- **“4” (Satisfactory)** – The governance landscape meets what is considered necessary given the size, risk profile and complexity of operations of the FI. Deficiencies/weaknesses may exist but these do not affect the overall quality of governance in an FI.
- **“3” (Less than Satisfactory)** – The governance landscape do not meet what is considered necessary given the size, risk profile and complexity of operations of the FI. However, the Board and Management are committed (with ability and willingness) to correct the situation in a timely manner.
- **“2” (Deficient)** - The governance landscape is deficient, in a material way, to meet what is considered necessary given the size, risk profile and complexity of operations of the FI. Moreover, the ability of the Board and Management to correct the situation in a timely manner is doubtful.
- **“1” (Critically Deficient)** - The governance landscape is critically deficient to meet what is considered necessary given the size, risk profile and complexity of operations of the FI. The deficiencies/weaknesses pose an imminent threat to the safety and soundness of the financial institution.

33) **Fitness and propriety of board and management.** This pertains to the characteristics and propriety of the composition of the board and management. Since the BSP has set minimum qualifications for the members of the board of directors, FIs are expected to meet the provisions of existing regulations and set its own specific qualifications and standards for the position. Supervisors on the other hand, should evaluate whether these qualifications as well as the policies and practices in the selection, election and re-election of the members of the board of directors, are appropriate for the size, risk profile and complexity of operations of the FI. Further, supervisors should also assess the comprehensiveness of the bank’s continuing education/training program for directors aimed at ensuring that they are kept up-to-date on the developments in the financial industry.

- 34) The selection, election and re-election processes for the members of the board of directors should be adequate and should allow the FI to select the members of the board from a broad pool of candidates with diverse background and experiences that are relevant in the performance of the corresponding duties and responsibilities of the position. The selection and appointment processes should be fair and reflective of the standards set by the board.
- 35) The roles, duties and responsibilities of the board should be clearly defined and documented. Supervisors should determine whether these are consistent with those provided under existing regulations. More importantly, supervisors should assess if the board actually performs its roles, duties and responsibilities as provided under existing regulations and internal policies.
- 36) The board should periodically review their roles, duties and responsibilities to ensure that these remain relevant amidst the changes in the business environment and are consistent with sound corporate governance practices.
- 37) The board should have a comprehensive appreciation of the risk exposures of the FI. The members of the board of directors should have business or financial acumen to be able to understand the impact of the exposure to the bank's financial condition and operations. The different background and experience of the members of the boards of directors should complement each other and this should surface in the decision-making process. Albeit it is not expected that all members of the board of directors will have the same level of understanding, some should be able to fully grasp the risk attendant to a particular exposure and explain the same to the other members. Nonetheless, all members of the board should exhibit interest in the affairs and exposures of the FI.
- 38) It is a continuing challenge to determine the propriety of the composition of the board given the size, risk profile and complexity of operations of the FI, but indicators will manifest in the process. For instance, the extent to which the board reviewed and challenged the assumptions presented by Management will signify the breadth and depth not only of its interest in the business but also of its understanding of the possible implications to the safety and soundness of the FI.
- 39) The richness of discussion in the board will reflect the interest and extent of appreciation of the board of the FI's operations. In which case, meetings of the board of directors should be duly minuted to reflect the thought process behind the decisions made. Supervisors reviewing the minutes should take note of the stance taken by the independent directors as these would reflect their state of "independence" at the time sensitive issues are being discussed. The scantiness of information reflected in the minutes of board meetings does not necessarily mean limited discussions in the board. In this regard, supervisors should adopt a

different approach in assessing the performance of the board in this respect such as by evaluating the results of the decisions the board has taken in the past.

- 40) In instances where the FI has not yet completed the required number of independent directors, supervisors should assess whether this has affected the quality of discussions during board meetings. Considering that “independent and objective” judgment is expected of the entire board at all times, the absence of the minimum required number of independent directors should not impede the board from deliberating key concerns involving a particular transaction or business line. All members of the board of directors are expected to consistently exercise fair, objective and independent judgment for the interest of all stakeholders.
- 41) Under existing regulations, the board of directors of complex banks should create the audit, risk oversight and corporate governance committees. On the other hand, non-complex banks (i.e., thrift, rural and cooperative banks) may avail of the reduced minimum requirement to create only the audit committee. Notwithstanding these, the board may create other committees that they deem necessary to allow them to focus on specific areas of operations. The mandate of these committees should be clearly defined and understood to ensure that discussions and assessments meet the objectives set.
- 42) Members of the different board-level committees should bring in their individual expertise to collectively reach independent and sound decisions. Existing regulations provide the minimum number of members and composition of certain board-level committees. In which case, supervisors should assess whether the directors who are members of a certain committee have the expertise and experience and have displayed the necessary “independence” in carrying-out the duties and responsibilities attendant to the position. Moreover, supervisors should determine whether there is no conflict of interest involving directors with concurrent membership in different board-level committees, particularly those involving committees with control or independent oversight functions (i.e., audit, risk oversight and corporate governance).
- 43) Although supervisors will assess the propriety of the composition and size of the board, the board should by itself, assess its performance as a collective body and the performance of its committees and individual members on a regular basis. The outcome of its decisions in the past and the effectiveness of management of the FI’s risk exposures should be taken into account in the evaluation. The board may also choose to hire an external facilitator to conduct said evaluation.
- 44) The board should approve and regularly review the compensation policies of the FI. Supervisors should determine the soundness of the compensation policies such that these do not promote excessive risk-taking. For instance, incentives based solely on short-term revenues generated (e.g. trading gains) may expose

the bank to excessive risks as the exposure may remain outstanding for a long period of time.

- 45) In this regard, compensation policies may include clauses that would protect the FI from any adverse long-term effects of the risk exposure. For example, the policies may have timing provisions such that the grant of incentives will coincide with the time when the FI realized the benefits from actions or decisions taken. In addition, a claw-back policy may also be introduced that will allow the FI to demand repayment of incentives earlier granted if the particular exposure had an adverse effect on the entity.
- 46) The compensation package granted to management should not be excessive given the size of the FI. In this case, supervisors should exercise judgment in determining what is excessive, which may vary from one FI to another. The compensation package given by peer banks may be used as benchmark. Likewise supervisors may also gauge the reasonableness of the compensation package by comparing the same to the FI's financial results. Supervisors should also be sensitive to incentives or benefits given to members of the board of directors such that these do not represent indirect declaration of dividends, which may be more common in the case of smaller banks.

#### Management

- 47) One of the critical duties and responsibilities of the board is the selection of the Chief Executive Officer (CEO) and the members of the management team. Supervisors should assess the qualifications for the critical positions in the FI as well as the selection process for appointment. The standards set by the FI should be consistent with the qualifications provided under existing regulations and at the same time meet the demands of the position given the size, risk profile and complexity of operations of the FI.
- 48) Members of the management team are primarily tasked to oversee the implementation of approved business plans and strategies and management of the FI's day to day operations. The fitness and propriety of management translate to their performance in effectively achieving the FI's objectives and in cascading the tone of governance and culture of control in the organization.
- 49) Apart from reviewing personnel profiles of the management team, supervisors should engage in discussions with the directors on their view on the performance of the management team. Reports and information package submitted by management to the board will also reflect the quality and extent of its performance. Moreover, the internal and external audit reports will also provide leads on the performance of management.

50) Supervisors should assess the extent to which management has been involved in the development of strategies and in monitoring achievement of the business plans, how it has effectively monitored adherence to policies and procedures and the promptness of its actions to address deficiencies and weaknesses noted, how it has retained competent staff and attracted new employees who believe and adhere to the values of the organization and how it informs the board on a timely basis of the FI's operating performance, its concern on the implementation of strategies and business plans as well as the developments in the business environment.

51) The five (5) point rating scale for the factor "Fitness and propriety" is described as follows:

- **"5" (Strong)** – The characteristics and performance of the board and management exceed what is considered necessary given the size, risk profile and complexity of operations of the FI. Deficiencies/weaknesses are considered to be minor and insignificant.
- **"4" (Satisfactory)** – The characteristics and performance of the board and management meet what is considered necessary given the size, risk profile and complexity of operations of the FI. Deficiencies/weaknesses may exist but these do not affect the overall quality of governance in an FI.
- **"3" (Less than Satisfactory)** – The characteristics and performance of the board and management do not meet what is considered necessary given the size, risk profile and complexity of operations of the FI. However, the Board and Management are committed (with ability and willingness) to correct the situation in a timely manner.
- **2" (Deficient)** - The characteristics and performance of the board and management are deficient, in a material way, to meet what is considered necessary given the size, risk profile and complexity of operations of the FI. Moreover, the ability of the board and management to correct the situation in a timely manner is doubtful.
- **"1" (Critically Deficient)** - The characteristics and performance of the board and management are critically deficient to meet what is considered necessary given the size, risk profile and complexity of operations of the FI. The deficiencies/weaknesses pose an imminent threat to the safety and soundness of the financial institution.

52) **Risk governance.** This pertains to the effectiveness and extent of board oversight over the FI's risk management system (RMS) from strategic goal setting to addressing the weaknesses/deficiencies noted. Under the existing CAMELS

rating system, supervisors assess the RMS of FIs per specific risk exposure (e.g., credit, market, liquidity), which assessment also feeds into the "Management" component rating. Albeit it is recognized that the components of the CAMELS rating system are interrelated such that RMS weaknesses manifested in the specific risk areas may be attributed to weak "Management", this SG provides a structure for evaluating the extent to which the deficiencies/weaknesses will feed into the Management rating.

- 53) The primary duty and responsibility of the board relative to risk governance is to identify and understand the types of risk that may affect the financial institution as well as the systems, tools and methodologies that the FI has to measure and manage the risks.
- 54) The board should set strategic goals for the FI and clearly define the level of the FI's risk tolerance given the scope and complexity of the FI's operations as well as its capability to manage risk. Supervisors, on the other hand should determine whether the level of risk tolerance set by the board is acceptable with due consideration of the FI's safe and sound operations. The business decisions of the board with respect to the transactions and exposures of the FI shall be assessed against these goals and level of risk tolerance. The board is also expected to be aware of any changes in the FIs strategies, risk tolerance levels and authorization limits for management and/or personnel.
- 55) Risk governance also reflects the extent to which board approval is required for policies, practices, methodologies and limits for managing risk exposures. This also includes the extent to which the board ensures that such policies, practices, methodologies and limits are commensurate given the FI's size and complexity of operations, and how these are aligned with the capital planning exercise of the FI. Hence, the board should not merely pass "rubberstamp" approval on these policies; rather it should be able to display understanding on how these policies shape the control environment. This may be gleaned from the discussions of the board in approving the policies or in discussions with the board during examination. In this regard, supervisors should be able to draw out from the members of the board of directors the thought process behind the approval of policies. Moreover, the board should also require regular updating of policies and procedures taking into account the developments in the business environment and in the risk appetite of the FI.
- 56) The board should require management to establish a process for determining the FI's desired level of capital given the quantified and unquantified risk exposures. For example, the board should require management to establish an effective loan review and provisioning system such that impairment losses are promptly and accurately reflected in the books of the bank and effected as capital adjustments. Cognizant of the challenges in quantifying certain types of risks (e.g., reputational), supervisors should assess how the board manages such risks

and whether these are considered in developing plans and strategies for the bank.

- 57) Supervisors should keep in mind that all banks, regardless of size or type should have a capital management process in place. The complexity of the said process however, would vary from one FI to another depending on its size, risk profile, and complexity of operations.
- 58) Supervisors should also assess the policies and practices on the regular reporting to the board on the risk exposures of the FI and the effectiveness of the RMS. The board's discussion and the extent to which it challenged the proposals, assumptions and recommendations of management would indicate the board's understanding of the risk exposures and how these affect the safety and soundness of the FI. Moreover, the board should be satisfied on how the issues raised by the risk management function are being handled.
- 59) The board should require the risk management function to include in its review new strategies or business initiatives and risk tolerance levels of the FI.
- 60) Risk governance also covers the assessment of the adequacy of resources of the risk management unit/function, which includes having sufficient number of personnel with collective qualifications and competencies necessary in carrying out its function. In this respect the board of directors should also ensure that there is an established system to assess whether the risk management function has adequate resources to perform its mandate.
- 61) Lastly, the board should ensure that there is a system that will assess the performance of the risk management function.
- 62) The five (5) point rating scale for the factor "Risk Governance" is described as follows:
- **"5" (Strong)** – Risk governance exceeds what is considered necessary given the size, risk profile and complexity of operations of the FI. Deficiencies/weaknesses are considered to be minor and insignificant.
  - **"4" (Satisfactory)** – Risk governance meets what is considered necessary given the size, risk profile and complexity of operations of the FI. Deficiencies/weaknesses may exist but these do not affect the overall quality of governance in an FI.
  - **"3" (Less than Satisfactory)** – Risk governance do not meet what is considered necessary given the size, risk profile and complexity of operations of the FI. However, the Board and Management are committed (with ability and willingness) to correct the situation in a timely manner.

- **"2" (Deficient)** - Risk governance is deficient, in a material way, to meet what is considered necessary given the size, risk profile and complexity of operations of the FI. Moreover, the ability of the board and management to correct the situation in a timely manner is doubtful.
- **"1" (Critically Deficient)** - Risk governance is critically deficient to meet what is considered necessary given the size, risk profile and complexity of operations of the FI. The deficiencies/weaknesses pose an imminent threat to the safety and soundness of the financial institution.

- 63) **Controls and Independent Oversight.** This pertains to the effectiveness of the oversight of the board of directors over internal controls and independent oversight bodies such as the compliance, internal audit, risk management and external audit functions. The role of the board of directors in this respect starts from ensuring that the internal independent oversight functions have clear mandates and reporting lines within the organization to ensure that follow-up actions are taken on the concerns raised.
- 64) Adequate and effective control environment sets the tone of control consciousness among personnel. The board of directors is responsible for ensuring that an FI has a strong internal control system and that such system is regularly assessed to determine whether it still meets its objectives and remain commensurate with the size and complexity of operations of the FI. The board may depend on the reports of the internal and external audit functions with respect to their assessment of the internal control system as well as the reports of the compliance and risk management functions with respect to the impact of the identified deficiencies/weaknesses on the FI's operations.
- 65) The roles of the board of directors with respect to the independent oversight functions start with the approval of the mandates of the different oversight units. The board is also expected to review the same on a regular basis and approve any changes thereto.
- 66) The board should ensure that said functions have appropriate stature in the organization. That is, they should be independent of operations under the scope of their review and free of any influence that could materially impair their judgment. Further, the heads of these functions should have direct access to the board of directors.
- 67) The controls and independent oversight functions should have access to the board of directors or the appropriate board-level committee without any impediment. Non-executive board members are also expected to meet regularly, other than in meetings of the audit and risk oversight committees, in the absence of senior management, with the external auditor and heads of the

internal audit, compliance and risk management functions to discuss issues that may warrant closer attention.

- 68) The board needs to provide adequate resources to the independent oversight functions including having sufficient number of personnel with collective qualifications and competencies necessary in carrying out the mandate of the respective functions. In this respect the board of directors should also ensure that there is an established system to assess the adequacy of resources of these independent oversight functions.
- 69) The board of directors or the appropriate board-level committee should appoint the heads of the internal audit, compliance and risk management units and select the external auditor. The criteria, process and practices for the selection of the heads of said units and the external auditor would display the extent to which the board is committed to establish strong checks and balances in the organization.
- 70) Moreover, the scope of review of the independent oversight functions should be evaluated by the board or the appropriate board-level committee to ensure that the coverage comprehensively covers the key risk areas of the FI.
- 71) Minutes of board meetings will indicate management's commitment to address the issues cited by the external audit, compliance, internal audit and risk management units. Decisions to disregard recommendations made by these units should be adequately supported, explained and documented. Timelines on the implementation of actions done by management should be clear and adequately communicated to the responsible units.
- 72) The extent of the board's deliberations and discussions regarding assessments made by the compliance, risk management unit and internal audit functions reflect the institution's perception on the value of its self-assessment functions. It also reflects the stature of the independent units within the organization. The degree of responsiveness by the board to the recommendations of auditors/compliance function/risk management office is critical. Management's laxity and lack of interest to address the issues noted will weaken the institutions check and balance system and defeats the purpose for which these independent functions were established. Further, the board should also adopt a follow-up mechanism to monitor how disagreements and other issues raised are resolved.
- 73) Finally, the board should regularly review the independence and effectiveness of the control functions. In this respect, the board should be satisfied that the compensation of the individuals performing these functions is reflective of the importance of the function and is consistent with the objectives of carrying-out their duties and responsibilities.

74) The five (5) point rating scale for the factor "Controls and Independent Oversight" is described as follows:

- **"5" (Strong)** – Governance over controls and independent oversight exceeds what is considered necessary given the size, risk profile and complexity of operations of the FI. Deficiencies/weaknesses are considered to be minor and insignificant.
- **"4" (Satisfactory)** – Governance over controls and independent oversight meets what is considered necessary given the size, risk profile and complexity of operations of the FI. Deficiencies/weaknesses may exist but these do not affect the overall quality of governance in an FI.
- **"3" (Less than Satisfactory)** – Governance over controls and independent oversight do not meet what is considered necessary given the size, risk profile and complexity of operations of the FI. However, the Board and Management are committed (with ability and willingness) to correct the situation in a timely manner.
- **"2" (Deficient)** - Governance over controls and independent oversight is deficient, in a material way, to meet what is considered necessary given the size, risk profile and complexity of operations of the FI. Moreover, the ability of the board and management to correct the situation in a timely manner is doubtful.
- **"1" (Critically Deficient)** - The board's risk governance is critically deficient to meet what is considered necessary given the size, risk profile and complexity of operations of the FI. The deficiencies/weaknesses pose an imminent threat to the safety and soundness of the financial institution.

#### **VI. Directives/Action Points**

75) Apart from assigning a rating, the supervisor should come up with specific applicable action recommendations commensurate with the supervisory issues identified and the resulting assessment on the quality of governance.