MESSAGE FROM THE BOARD ICAAP STEERING COMMITTEE CHAIRMAN

MICHAEL G. TAN
DIRECTOR

INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS

PNB's ICAAP (Internal Capital Adequacy Assessment Plan) has come a long way from its inception in 2009 in compliance to Bangko Sentral's issuance of Circular 639. PNB has always maintained a policy of "beyond compliance" and has embedded the capital adequacy requirement with its long term strategic objectives. With the annual submission of the bank's ICAAP document, the approach and processes have continually improved over the years.

The annual strategic planning exercise becomes an interactive process among the Bank's various business and support groups, including subsidiaries that culminated with the crafting of the 3-year Business Plan aimed at achieving the corporate goal of becoming a BIGGER, BETTER and STRONGER bank.

On the other hand, the risk assessment implementation which already includes all business and support units, as well as the subsidiaries, was cascaded down to the branch and unit levels in the Bank's desire to appreciate and understand the ICAAP at the grassroots level. Impact to the Bank's Capital Adequacy Ratio (CAR) is now a standard computation for all major risk exposure which the various business units of the bank propose to embark. Terms such as Quantified Potential Loss (QPL) and Risk-weighted Assets (RWA) are common points of discussion for major policy decisions. The bank's journey to go 'beyond compliance" is apparent in the objectives set to ensure capital allocation will be the end goal for the ICAAP.

Further, to adapt to the changing business and regulatory environment and to ensure continued high standards of board oversight for the bank, board level committees were refined for a more robust governance structure. One of which, the Board ICAAP Steering Committee (BISC) functions has been subsumed into the Board Policy Committee (BPC) to ensure regular reporting on the capital assessment and planning policies and procedures. The revised charter for the BPC includes review and endorses and/or approves the bank's strategic plan, risk appetite and set limits on risk taking activities; policies, procedures and manuals of products and services to be offered to the Bank's domestic and overseas market. In addition to this, the Capital Management Sub-Committee of the Asset/Liability Committee (ALCO) was created to specifically handle policies and procedures pertaining to the capital planning and assessment as well as possible equity investments of the Bank.

The risks that the banks are facing today are far more complex than that of years ago with emerging risks such as technology and cyber security. With these, Basel III remains at the forefront with guidelines to strengthen global capital, liquidity and risk management rules to ensure a more resilient banking sector. Just recently, BSP released respective Circulars on: (1) guidelines on Sound Credit Risk Management; (2) guidelines on Operational Risk Management; (3) Leverage Ratio Framework; (4) additional capital buffer for Domestic Systemically Important Banks (DSIB); (5) Liquidity Coverage Ratio (LCR) and; (6) Recovery Plan of a DSIB, which are to be considered and incorporated in the ICAAP Document.

The Bank's capital fund stood at P97.6 billion as of end-December 2015, up by 4% from year-ago level of P94.2 billion which was boosted by a Stock Rights offering of 162,931,262 common shares in 2014, equivalent to an offer size of P11.568 billion. The Bank's Capital Adequacy Ratio (CAR) on consolidated basis remained solid at 19.2%, well above the minimum 10% required by the BSP. The Bank's CET1 ratio of 16.2% was almost twice the BSP minimum Core ratio of 8. 5%.

The Bank's ICAAP challenge is to continue to improve on the process towards fulfilling a wish list of actions and blueprint for the future, and to ensure that this is done consciously and involves the whole enterprise. It is only with the use of planning and risk management, as strategic tools and embedding these with operations that will bring effective results.

MICHAEL G. TAN
Board ICAAP Steering Committee Chairman

CAPITAL STRUCTURE AND ADEQUACY

PNB CAPITAL MANAGEMENT AND RISK MANAGEMENT DISCLOSURES

PNB is committed to maintaining public transparency with regard to its business, financial performance and risks. Extensive information is provided in financial reports, including in this PNB's Annual Report, quarterly reports to the SEC and the discussions with investors, third parties. In this report – Capital Adequacy and Risk Management Report (under the Pillar 3 Framework) – PNB provides additional detailed information on its risk management and capital adequacy.

ABOUT PILLAR 3

The aim of Pillar 3 is to allow for market discipline to supplement the regulation of banks. The Basel Committee on Banking Supervision (BCBS) set out, in its Basel II framework (2004), a concept of three pillars for banking regulation:

Pillar 1 – Minimum capital requirements to meet credit, market and operational risk;

Pillar 2 – Supervisory review process, and the bank's internal process for assessing overall capital and liquidity adequacy in accordance with its risks; and

Pillar 3 – Market discipline enabled by disclosures.

Pillar 3 entails extended disclosures by banks with regard to capital adequacy and risk management, in order to allow investors and other market participants to understand the risk profiles of individual banks.

BASIS FOR PILLAR 3 DISCLOSURES

The Capital & Risk Management Disclosure Sections incorporate regulatory disclosure requirements enforced by Compliance and Appendix 63b of the MORB-Disclosures in the Annual Reports and Published Statement of Condition, Risk Exposures and Assessments (for each separate risk area – credit, market, operational, interest rate risk in the banking book) and additional disclosure requirements for specific types of risks (namely: Credit, Market, Operational and Interest Rate risks in the banking books)

In June 2006, BSP approved major revisions to the risk-based capital adequacy framework. Together with the revised guidelines on minimum capital requirements, BSP also outlined changes in the list of items that banks need to disclose in their Annual Reports and in their quarterly published statement of condition. The BSP further laid down the groundwork for the implementation of Basel III through the issuance of Circular No. 709, Circular No. 716 in 2011, and M-2012-002.

The expanded disclosure requirements relate to banks' (a) capital structure and adequacy, and (b) risk management policies and processes and risk exposures, specifically on credit risk, market risk, operational risk, and interest rate risk in the banking book.

PILLAR 3 DISCLOSURES

For assessment of the appropriateness of its disclosures, the following units / stakeholders are involved:

- Board of Directors & its delegated Board Sub-Committees – approve the information on adequacy and stakeholders' interests;
- Chief Financial Officer / Financial Accounting Division – prepare the financial reporting;
- Risk Management Group – prepare information following from its role of managing the risks associated with the banking operations;
- Internal Audit Group – check on reliability and consistency with financial statements;
- Compliance – check on compliancy with applicable regulations.

The Pillar 3 – Capital Adequacy & Risk Management Sections complement the Annual Report with additional information. Corporate Governance in PNB and Related Party Transactions are included in separate sections of the Annual Report.

Pillar 3 Disclosures on Capital Adequacy & Risk Management provide comprehensive information related to capital adequacy, capital management and risk management. This is composed of the following chapters:

A. Capital Structure & Capital Adequacy: Provides disclosure information pertaining to the bank's solo and consolidated capital structure and capital adequacy. Further, this chapter also discusses the bank's compliance to the BSP implementation of Basel Committee on Banking Supervision (BCBS) guidelines on Basel III.

B. Risk Management: Provides extensive information of the bank's risk management framework, continuing improvement in the implementation of the said framework to include specific highlights on the 2015 risk management activities.