# MESSAGE FROM THE RISK OVERSIGHT COMMITTEE CHAIRMAN

**FLORIDO P. CASUELA**
DIRECTOR

## RISK MANAGEMENT DISCLOSURE

The board Risk Oversight Committee (comprising of 5 directors) meets once a month and discusses the bank's risk exposures from the identified material risks against the overall bank's strategy. Together with the other designated board level sub-committees, a comprehensive risk management process is put in place vis a vis the bank's risk appetite. The PNB Board of Directors approves the bank's risk appetite and sets broad parameters relating to the board's expectations around performance, business stability and risk management. The board ensures that there are appropriate resources to manage the risk arising from running our businesses.

Our enterprise risk management process involve identifying, quantifying, managing and mitigating the risks associated with each the lines of business of the parent bank, as well as those of its subsidiaries. Risk awareness, control and compliance are embedded in all our day-to-day activities. We seek to achieve an appropriate balance between risk and reward, mindful of our stakeholders' interests. A strong risk and capital management culture is embedded into our values.

The current regulatory and economic environment continues to prove challenging to our business, however, we are comfortable that we have robust risk management processes and systems in place which provide a strong foundation to manage and mitigate risks within our risk appetite tolerance framework.

Our shareholders and stakeholders require expertise to identify issues and find creative solutions to resolve these issues and challenges. They require creative solutions and broader, more up-to-date financial services across the bank's global network. They require professional and operational expertise to set up solutions to the changing economic capital markets environment and ensure that they work. They require quality communication skills to ensure that operations are kept tight, that controls are in place and that no opportunities are lost. The mission of Risk Management is to maintain a tight rein on the increasing risks as a consequence of these new solutions, products and services.

It is worth mentioning that emerging trends on risks have been a topic of numerous discussions at the Committee meetings. The onset of cybersecurity risks raises new challenges as new policies have to be drafted and risk mitigation tools need to be identified and implemented. The risks have gone from a physical one to the digital world. The Philippine financial service industry is not immune to the global risks as advanced threats of hacking, phishing, and the wide range of cyber fraud has cost the industry millions of pesos. The year 2015 is characterized by increased diligence in identifying risks, changing regulatory environment and emerging of cyber security as a primary focus of awareness and risk mitigation.

As risk management continues to be embedded within the lines of business, it is expected that a continued proactive stance be in place and that the implementation of a consistent and comprehensive risk management framework is at par with international standards and best practices. The bank's risk management team remains to be in the forefront of the Bank programs to support its mission, vision and objectives of optimal use of the Bank's domestic and international footprint to deliver innovative products and services to all our stakeholders/clients.

FLORIDO P. CASUELA
Risk Management Chairman



### INTRODUCTION

The Bank places a high priority on risk management and has taken concrete steps to refine its framework for risk management, including the identification and control of the risks associated with its operational activities.

A sound, robust and effective enterprise risk management system coupled with global best practices were recognized as a necessity and are the prime responsibility of the Board and senior management. The approach to risk is founded on strong corporate governance practices that are intended to strengthen the enterprise risk management of PNB, while positioning PNB Group to manage the changing regulatory environment in an effective and efficient manner.

Strong independent oversight has been established at all levels within the group. The bank's Board of Directors has delegated specific responsibilities to various board committees which are integral to the PNB's risk governance framework and allow executive management, through management committees, to evaluate the risks inherent in the business and to manage them effectively.

The Board and its Risk Oversight Committee operate as the highest level of PNB's risk governance. Risk governance is undertaken by a structured hierarchy of committees (both at board level and at the executive / management level) each with specified accountabilities. The continuous flow of information between the board and board-level committees and the corresponding management committees; allow for consistent evaluation of the risks inherent in the business, raise the alarms, if any, and manage the business effectively with strong adherence to process management guidelines and controls. Figure 1 below provides a list of the board level committees and management committees. Their corresponding functions, roles and responsibilities are highlighted in the Corporate Governance discussion in this annual report.

Members of the senior management team play a pivotal role in the day-to-day running of the bank. Executive officers are assigned to various management committees that provide the leadership and execution of the vision and policies approved by the bank's board of directors. The bank's business objectives are driven for most part by the day-to-day directions decided by these management committees with approvals and notation by the various board level committees as follows (see Figure 1):

**BOARD OF DIRECTORS**

- Corporate Governance Committee
- Board Audit and Compliance Committee
- Risk Oversight Committee
- Board Oversight Committee - Domestic and Foreign Offices/Subsidiaries
- Board Oversight RPT Committee
- Board Policy Committee
- Executive Committee
- Trust Committee
- Board Information Technology Governance Committee

**PRESIDENT & CEO**

- Senior Management Credit Committee
- Senior Management Team Committee
- Acquired Assets Disposal Committee
- Operations Committee
- Administrative Investigation Committee
- Bids and Awards Committee
- IT Evaluation Committee
- Asset Liability Committee (with sub committee on Capital Management)
- Anti-Money Laundering Review Committee
- IT Management Committee
- Product Committee
- PNB Retirement Fund Board
- Promotions Committee
- Branch Site Selection Committees
- Asset Disposal Committee
- Selection Committee for Expatriate Personnel
- Committee on Accreditation of Overseas Remittance Agent (CAORA)
- Committee on Decorum and Investigation

**Figure 1: Board & Management Committees**

## ENTERPRISE RISK MANAGEMENT FRAMEWORK (ERM)

The Bank's philosophy is that responsibility for risk management resides at all levels within the Bank and therefore uses the three lines of defense model:

- The *first line of defense* rests with business units that are responsible for risk management. Assessment, evaluation and measurement of risk are ongoing processes and are integrated in the day to day activities of the business units. The process includes the setting up of a proper system of internal control, identifying issues and taking remedial actions where required.
- The *second line of defense* comes from the risk management function of the Bank, which is independent of business operations. The risk management unit implements the risk management framework, provides independent oversight over specific board directives and is responsible for regular reporting to the Risk Oversight Committee
- The *third line of defense* is the internal audit function & the compliance testing function which provides an independent assessment(s) of the adequacy and effectiveness of the overall risk management framework and governance structures. The internal audit function & compliance testing function report directly to the Board Audit Committee & Compliance Committee.

The PNB Board Risk Oversight Committee (ROC) is mandated to set risk appetite, approve frameworks, policies and processes for managing risk, and accept risks beyond the approval discretion provided to management.

The risk management policy includes:

- a comprehensive risk management approach;
- a detailed structure of limits, guidelines and other parameters used to govern risk-taking;
- a clear delineation of lines of responsibilities for managing risk;
- an adequate system for measuring risk; and
- effective internal controls and a comprehensive monitoring & risk-reporting process

While the first line of defense in risk management lies primarily on the bank's risk taking units as well as the bank's support units, the Risk Management Group is responsible for the monitoring of bank's overall risk management functions to ensure that a robust risk-oriented organization is maintained. The Risk Management Group (RMG) is independent from the business lines and is organized in 7 divisions: Credit Risk Division, ICAAP & BASEL Implementation Division, Market & ALM Division, Operational Risk Division, Information Security and Technology Risk Division, Trust Risk Division and Business Intelligence & Data Warehouse Division.

Each division monitors the implementation of the processes and procedures that support the policies for risk management applicable to the organization. These policies clearly define the kinds of risks to be managed, set forth the organizational structure and provide appropriate training necessary to manage and control risks. The policies also provide for the validation, audits & compliance testing, to measure the effectiveness and suitability of the risk management structure. RMG also functions as the Secretariat to the Risk Oversight Committee which meets monthly to discuss the immediate previous month's total risk profile according to the material risks defined by the bank in its ICAAP document. Further, each risk division engages with all levels of the organization among its business and support groups, including domestic/overseas branches and domestic/foreign subsidiaries. This ensures that the risk management and monitoring is embedded at the moment of origination.

## THE BANK'S RISK APPETITE, THRESHOLD & TOLERANCE

The Bank's principle on risk appetite is expressed as Risk Threshold (as defined in the bank's ICAAP document), and is embedded in the business units. Risk Threshold emphasizes that ***"the risk appetite should not go beyond the Bank's capacity to manage risk, thus risk management is the responsibility of everybody"***.

The bank expressed its overall **risk appetite** through the quantitative statement on materiality defined as our **Risk Threshold**. This is the guiding principle behind the execution of our business objectives and is closely monitored alongside the set limits by the various revenue generating groups.

**Risk tolerance** is expressed in limits (internal & regulatory) for each of the determined material risks, which are more conservative than regulatory limits to provide cushion/buffer.

The following major limits (among others) are set:

1. Earnings At Risk
2. Value At Risk
3. Capital Adequacy Ratio Threshold Level
4. Credit Concentration Limits
5. Single Borrower's Limit

The Board of Directors and Senior Management are responsible in ensuring that the Group maintains at all times the desired level and quality of capital commensurate with the inherent risks (credit, market and operational risks) and with the material risks such as Legal, Compliance, Information Technology/ Security, Strategic Business, Customer Franchise/Reputational that the Group is exposed to.

The Board Risk Oversight Committee (ROC), as delegated by the Board, supported by Risk Management Group, oversees the risk profile and approves the risk management framework of PNB and its related allied subsidiaries.

The Board Policy Committee (BPC) reviews, evaluates, approves and/or endorses for Board approval policies, procedures and manuals of products and services to be offered to the Bank's domestic and overseas market, as well as, Annual Strategic Forecasts, Plans and Budget. They are also responsible in determining the Bank's risk appetite and set limits on risk taking activities and the periodic review of the Bank's ICAAP program.

The Executive Committee (ExCom) reviews, discusses, notes, endorses and/or approves management proposals on credit facilities; investment in financial assets; and borrowings and capital raising, updates and reports on credit, transactional, administrative and other matters.

The Capital Management Sub-Committee of the Asset/Liability Committee (ALCO) is tasked to specifically handle policies and procedures pertaining to the capital planning and assessment as well as possible equity investments of the Bank.

The Senior Management Team and the Business Units agree on the target risk profiles defined by the Bank's strategic plan, and allocate capital based on the risk/return profile. Corporate Planning Group (CorPlan) and RMG monitor this jointly.

### RISK CATEGORIES AND DEFINITIONS

Under the Bank's ERM framework, all the risk taking Business Units of the Bank, including its domestic and foreign subsidiaries, shall perform comprehensive assessment of all material risks.

The identification of risks revolves around the monitoring of the risk categories as defined by BSP for supervision purposes. These key risks, namely, credit, market, interest rate, liquidity, operational, compliance, strategic, and reputational risks, are not only monitored under their separate and distinct components, but also monitored across all interrelated business risks. In addition, the various business units identify, measure, monitor and control additional risk categories that may be relevant to their specific areas and correspondingly identify the priorities in the roll up of the bank's Risk & Control Self-Assessment (RCSA) Process.

During the Bank's conduct of the Risk Assessment and Quantification for the last semester of 2015, all risk taking business units undertook to identify and assess the risks applicable to them. The assessments made are based on three (3) factors, namely; (a) probability, (b) control effectiveness and, (c) significance.

The risk owners provided a quantitative assessment of the identified risks by means of computing for estimated loss, which can be based on foregone income, opportunity loss, portfolio size, transaction amount, historical loss, additional cost and others.

Further, stress tests were employed to capture potential losses under extreme scenarios.

**Material Risks**

The Group defines material risks (at group level) as those risks from any business activity large enough to threaten the Bank's capital position to drop below its desired level; resulting in either an P8 billion increase in risk weighted assets or a P1 billion reduction in earnings and/or qualifying capital which translate into a reduction in CAR by 20 bps.

On the other hand, risks not significant enough to impact the CAR by 20 bps will also be considered "material" by the Group if they fall under the following:

- Pillar 1 risks i.e. Credit, Market, and Operational Risks;
- Other risks under BSP Circular no. 510 i.e. Interest Rate Risk in the Banking Book (IRRBB), Liquidity Risk, Reputational Risk and Strategic Risk;
- Information Technology Risk (BSP Cir. No. 808);
- Other risks identified by the Senior Management, i.e. Credit Concentration Risk, New Regulations Risk;
- Any top significant risk defined as "Material" based on group-wide consolidated ICAAP RCSA results

Resulting from the assessments based on the premise identified above, the Bank agrees and reviews on a regular basis the material risks that need particular focus from all 3 lines of defense. For 2015, these are based on the following ten (10) material risks, which are grouped under Pillar 1 and Pillar 2 risks, and shall be covered in the ICAAP Document and required for monitoring.

Types and definition of each of these risks are discussed hereunder:

Pillar 1 Risks:

1. Credit Risk (includes Counterparty and Country Risks)
2. Market Risk
3. Operational Risk

Pillar 2 Risks:

4. Credit Concentration Risk
5. Interest Rate Risk in Banking Book (IRRBB)
6. Liquidity Risk
7. Reputational / Customer Franchise Risk
8. Strategic Business Risk
9. Information Technology Risk (includes Information Security risk)
10. New Regulations Risk

We broadly classify and define risks into the following categories, and manage the risks according to their characteristics. These are monitored accordingly under the enterprise ICAAP program:

| Risk Category | Risk Definition | Risk Monitoring Process | Risk Management Tools |
|---|---|---|---|
| Credit Risk (including Credit Concentration Risks and Counterparty Risks) | Credit risk is the risk to earnings or capital that arises from an obligor/s, customer/s or counterparty's failure to perform and meet the terms of its contract. | ▪ Loan Portfolio Analysis<br>▪ Credit Dashboards | ▪ Trend Analysis (Portfolio / Past Due and NPL Levels<br>▪ Regulatory and Internal Limits<br>▪ Stress Testing<br>▪ Rapid Portfolio Review<br>▪ CRR Migration<br>▪ Movement of Portfolio<br>▪ Concentrations and Demographics Review<br>▪ Large Exposure Report<br>▪ Counterparty Limits Monitoring<br>▪ Adequacy of Loan Loss Reserves Review |
| Market Risk | Market risk is the risk to earnings or capital arising from adverse movements in factors that affect the market value of financial instruments, products and transactions in an institution's overall portfolio, both on or off balance sheet and contingent financial contracts. Market risk arises from market-making, dealing and position taking in interest rate, foreign exchange, equity, and commodities market. | ▪ Value at Risk Utilization<br>▪ Results of Marking to Market<br>▪ Risks Sensitivity/Duration Report<br>▪ Exposure to Derivative/ Structured Products | ▪ VAR Limits<br>▪ Stop Loss Limits<br>▪ Management Triggers<br>▪ Duration Report<br>▪ ROP Exposure Limit<br>▪ Limit to Structured Products<br>▪ 30-day AFS Holding Period<br>▪ Exception Report on Traders' Limit<br>▪ Exception Report on Rate Tolerance |
| Liquidity Risk | Liquidity risk is generally defined as the current and prospective risk to earnings or capital arising from an FI's inability to meet its obligations when they come due. | ▪ Funding Liquidity Plan<br>▪ Liquidity Ratios<br>▪ Large Fund Providers<br>▪ MCO<br>▪ Liquid Gap Analysis | ▪ MCO Limits<br>▪ Liquid Assets Monitoring<br>▪ Stress testing<br>▪ Large Fund Provider Analysis<br>▪ Contingency Planning |
| Interest Rate Risk in the Banking Books (IRBB) | Interest rate risk is the current and prospective risk to earnings or capital arising from movements in interest rates. The amount at risk is a function of the magnitude and direction of interest rate changes and the size and maturity structure of the mismatch position. (BSP Circ 510, dated 03 Feb 2006) | ▪ Interest Rate Gap Analysis<br>▪ Earnings at Risk Measurement<br>▪ Duration based Economic Value of Equity | ▪ EAR Limits<br>▪ Balance Sheet Profiling<br>▪ Repricing Gap Analysis<br>▪ Duration based Economic Value of Equity<br>▪ Stress Testing |
| Operational Risk | Operational Risk refers to the risk of loss resulting from inadequate or failed internal processes, people and systems; or from external events. This definition includes Legal Risk, but excludes Strategic and Reputational Risk. Operational Risk is inherent in all activities, products and services, and cuts across multiple activities and business lines within the financial institution and across the different entities in a banking group or conglomerate where the financial institution belongs. | ▪ Risk Identification<br>▪ Risk Measurement<br>▪ Risk Evaluation (i.e. Analysis of Risk)<br>▪ Risk Management ( i.e. Monitor, Control or Mitigate Risk)<br><br>Monitoring of Pillar II Risks fall under the purview of Operational Risk Management:<br>Risk Identification – Risk Maps<br>Risk Measurement and Analysis – ICAAP Risk Assessment | ▪ Internal Control<br>▪ Board Approved Operating Policies and Procedures Manuals<br>▪ Board Approved Product Manuals<br>▪ Loss Events Report (LER)<br>▪ Risk and Control Self-Assessment (RCSA)<br>▪ Key Risk Indicators (KRI)<br>▪ Business Continuity Management (BCM)<br>▪ Statistical Analysis |