[BSP CIRCULAR NO. 1222, January 19, 1990]

RISK ASSETS

The Monetary Board, in its Resolution No. 1093 dated December 22, 1989, approved the following amendments to Books I, II, III, IV of the Manual of Regulations for Banks and Other Financial Intermediaries:

SECTION 1. The following are hereby added to Part I of Books I, II, III and IV of the Manual of Regulations to read as follows:

> "___________ [1] Management of Risk Assets. It shall be the responsibility of the board of directors of a bank/NBQB to formulate written policies on the extension of credit and risk diversification and to set the guidelines for evaluation of risk assets. Well-defined lending policies and sound lending practices are essential if a bank/NBQB is to perform its credit-creation function effectively and minimize the risk inherent in any extension of credit. The responsibility should be approached in a way that will provide assurance to the public, thru stock holders and supervisory authorities that timely and adequate action will be taken to maintain the quality of the loan portfolio and other risk assets on the extension of credit and risk diversification and to set the guidelines for evaluation of risk assets."

SECTION 2. The following are hereby added to Part III Books I, II, III and IV of the Manual of Regulations to read as follows:

> "___________ [2] Loan Portfolio and Other Risk Assets Review System — To ensure that timely and adequate management action is taken to maintain the quality of the loan portfolio and other risk assets and that adequate loss reserves are set up and maintained at a level sufficient to absorb the loss inherent in the loan portfolio and other risk assets, each bank/NBQB shall establish a system of identifying and monitoring existing or potential problem loans and other risk assets and of evaluating credit policies vis-a-vis prevailing circumstances and emerging portfolio trends. Management must also recognize that loss reserve is a stabilizing factor and that failure to account appropriately for losses or make adequate provisions for estimated future losses may result in misrepresentation of the bank's/NBQB's financial condition.
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> "The system of identifying and monitoring problem loans and other risk assets and setting up of allowance for probable losses may include but is not limited to the following criteria:
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> "Subsec. _______ [3] Classification of loans — In addition to classifying loans as either current or past due the same should be qualitatively

appraised and grouped as Unclassified or Classified.

"Subsec. ________ [4] Unclassified loans — These are loans that do not have a greater-than-normal risk and do not possess the characteristics of classified loans as defined in the succeeding subsection. The borrower has the apparent ability to satisfy his obligations in full and therefore no loss in ultimate collection is anticipated.

"Subsec. _________ [5] Classified Loans — These are loans which possess the characteristics outlined hereunder. Classified loans are subdivided into (a) Loans especially mentioned; (b) Substandard; (c) Doubtful; (d) Loss.

"a. Loans especially mentioned. These are loans or portions thereof which are superior in quality to those classified Substandard, but which are potentially weak e.g., where there is lack of collateral, credit information or documentation and thus require closer management supervision. These loans do not have sufficient adverse information to warrant Substandard classification.

"This Category may include the following:

1. Loans with technical defects and collateral exceptions, such as:

   a. Unlocated collateral folders and documents including but not limited to title papers, mortgage instruments and promissory notes;

   b. Improper execution of the supporting deed of assignment/pledge agreement/chattel mortgage/real estate mortgage;

   c. Unregistered and/or unnotarized mortgage instruments as required in the loan approval;

   d. Collaterals not covered by appraisal reports or appraisal reports of which are unlocated;

   e. Collaterals not insured or with inadequate/expired insurance policies; and

   f. Loans to firms not covered by board resolutions authorizing the borrowings.

2. Loans not supported by up-to-date and adequate financial statements or adequate credit information. Regardless of the size of the financial intermediary, it is important that available credit information on its borrowers be complied in the credit folders/files for effective credit supervision. Included in this group are:

   a. Loans — renewed without updated financial statements, income tax returns and/or statements of assets and liabilities; and

   b. Loans without credit investigation reports or updated credit information.

3. Loans which need the attention of management for special and/or corrective action. Common to this group of loans are:

a. Loan accounts wherein effort to collect is not evident or is deemed inadequate;

b. Loans granted beyond the limits of approving authority;

c. Availments against expired credit line; availments in excess of credit line; or availments against credit line without prior approval by appropriate authority;

d. Demand loans outstanding for an unreasonable length of time;

e. Loans granted without compliance with conditions set forth in the approval;

f. Loans with promissory notes signed by unauthorized officers of the borrowing firm;

g. Loans secured by property the title to which bears an uncancelled annotation of lien or encumbrance; and

h. Loans to firms with profitable operations but belonging to a distressed industry.

4. Loans the repayment of which may be endangered by economic or market conditions that in the future may affect the borrower's ability to meet scheduled repayments such as declining or fluctuating operation, illiquidity, or increasing leverage trend in the borrower's financial statements.

"b. Substandard loans — These are loans or portions thereof which appear to involve a substantial and unreasonable degree of risk to the institution because of unfavorable record or unsatisfactory characteristics. There exists in such loans the possibility of future loss to the institution unless given closer supervision. No loan should be classified Substandard if repayment seems reasonably assured. Loans classified as Substandard must have a well-defined weakness or weaknesses that jeopardize their liquidation. Such well-defined weakness may include adverse trends or development of financial, managerial, economic or political nature, or a significant weakness in collateral.

"The basic characteristics of loan accounts subject to Substandard classification are as follows:

1. Secured loans

a. Loans under litigation;

b. Past due and circumstances are such that there is an imminent possibility of foreclosure or acquisition of the collateral because of failure of all collection efforts;

c. Past due for more than six (6) months without reduction in principal but in process of collection; and

d. Current loans to borrowers with inadequate net worth, poor earnings, or whose properties securing the loan have declined in value materially or have been found with defects as to ownership or other adverse information.

"Loans possessing any of the above characteristics should be classified Substandard at the full amount except portions thereof secured by hold-outs on deposits, margin deposits or government-supported securities. The portions so secured are not subject to classification.

2. Unsecured Loans

a. Items under litigation;

b. Loans past due for more than ninety (90) days;

c. Renewed/extended loans without at least twenty per cent (20%) repayment of the principal before renewal or extension;

d. Unmatured loans which have become unsound due to unfavorable results of operations of the borrower, minimal capitalization of the borrower in relation to the loan and/or project financed, weaknesses inherent to conduit loans or loans availed of for the benefit of another party, or absence of favorable track record showing borrower's financial responsibility; and

e. Loans to distressed industries repayments of which are imperiled.

c. Doubtful loans — These are loans or portions thereof which have the weaknesses inherent in those classified as Substandard, with the added characteristics that existing facts, conditions, and values make collection or liquidation in full highly improbable and in which substantial loss is probable.

"The basic characteristics of loan accounts subject to Doubtful classification are as follows:

1. All past due clean loans classified as Substandard in the last Central Bank examination without at least twenty per cent (20%) repayment of principal during the succeeding twelve (12) months or with current unfavorable credit information;

2. Past due loans secured by collaterals which have declined in value materially such as inventories, receivables, equipment, and other chattels without the borrower offering additional collateral for the loans coupled by the weakened financial condition of the borrower;

3. Past due loans secured by real estate mortgage title to which is subject to an adverse claim rendering settlement of the loan through foreclosure doubtful;

4. Loans the possibility of loss of which is extremely high but because of certain important and reasonably specific pending factors that may work to the advantage and strengthening of the asset, its classification as an

estimated loss is deferred until a more exact status may be determined.

d. Loss — These are loans or portions thereof 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. The amount of loss is difficult to measure and it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be obtained in the future. Also included under this category are statutory bad debts as defined under Subsection ____ [6].

"The basic characteristics of loan accounts subject to Loss classification are as follows:

1. Past due clean loans and advances the interest of which is unpaid for a period of six (6) months;

2. Past due well secured loans and advances not in process of collection, interest of which is unpaid for a period of six (6) months;

3. Loans payable in installments where amortization applicable to interest is past due for a period of six (6)months, unless the loan is well secured and in process of collection;

4. When the borrower's whereabouts is unknown, or he is insolvent, or his earning power is permanently impaired and his co-makers or guarantors are insolvent or that their guaranty is not financially supported;

5. Where the collateral securing the loan is considered worthless and the borrower and/or his co-makers are insolvent;

6. Loans considered as absolutely uncollectible; and

7. Loans classified as Doubtful in the last Central Bank examination and without any payment of interest or substantial reduction of principal during the succeeding twelve (12) months or has current unfavorable credit information which renders collection of the loan highly improbable.

Subsec. _________ [7] Investments and other risk assets.

1. Temporary investments in stocks and bonds should be valued at lower of cost or market. The lower of cost or market should be applied to the portfolio in its entirety. A valuation reserve account should be set up to reflect a material or major market decline equivalent to at least ten per cent (10%) of the book value.

2. Equity investment in affiliates shall be booked at cost or book value whichever is lower on the date of acquisition. If cost is greater than book value, the excess shall be charged in full to operations or booked as deferred charges and amortized as expense over a period not exceeding five years. Subsequent to acquisition, if there is an impairment in the recorded value, the impairment should adequately be provided with allowance for probable losses.