## Credit Risk

Credit risk is the primary concern of PhilEXIM as it is inherent to its core business of providing credit and guarantee to exporters and priority development projects of the government. It is an inevitable risk that occurs when a guaranteed obligor or direct lending client of PhilEXIM will fail to meet its obligations in accordance with the agreed terms.

For its developmental mandate, PhilEXIM adopts the regulatory view that the role of capital is to absorb "unexpected loss". To be sustainable, expected loss should be covered by the premium earned for taking on credit risk (in the form of guarantee fees) and collateral. Unlike banks, which may be able to subsidize any differential between expected credit loss and credit spread (over cost of funds and servicing cost ) from other businesses (e.g., spread income from their liabilities business), PhilEXIM does not enjoy such flexibility. In this regard, it is recognized that, given PhilEXIM's socio-economic and developmental mandate, the objective to cover expected loss with core business revenue may not necessarily be achievable for PhilEXIM. It is possible that the "gap" in the credit market that PhilEXIM is supposed to fill would necessarily (perhaps almost by definition) imply that it is not compensated for the credit risks it is taking[i]. In this case, capital would need to serve two purposes: to absorb unexpected loss as well as to effectively subsidize the expected shortfall of premium received vis-à-vis expected losses. Although this is certainly a valid and important line of deeper analysis and reflection for PhilEXIM, however, this would potentially be a complex and time-consuming undertaking that the institution must continuously prioritize in its annual business planning.

To further mitigate risks, management adopts strict evaluation process which include but not limited to comprehensive financial statement validation, project viability analysis and putting heavy weights on the 5C's(Character, Capital, Collateral, Condition and Capacity) of Credit and Risk Rating System in granting loan and/or guarantee. This is further reinforced by imposing safeguards by way of standard terms and conditions before loan release or issuance of guarantee is effected to protect PhilEXIM's interest as well as close monitoring of projects financed including submission of post release requirements to be thoroughly verified such as sufficient and up-to-date collateral insurance, borrower's observance of standard credit stipulations and financial indicators at all times while the loan or guarantee is outstanding.

## Market Risk

Market risk is the risk that the fair value or future cash flows of financial instruments will fluctuate due to changes in market variables such as interest rates, foreign exchange and equity prices.

PhilEXIM's activity of selling/trading of government securities exposes it to market risk, which is essentially the risk of loss on PhilEXIM's balance sheet positions and asset/liability structure arising from the volatility of market prices or interest rates. In particular, it is the potential loss of market value of PhilEXIM's holdings of government securities due to price or interest rate fluctuations.

In order to address this, Management requires the weekly meetings of the Asset Liability Committee (ALCO) wherein it discusses the behavior of the market in terms of prevailing interest rates and mark-to-market valuation of PhilEXIM's available-for-sale government securities. In this light, the ALCO establishes guidelines for the investment mix of the

Corporation. Likewise, it establishes limits for financial risk-taking and confirmation of lending rates to existing clients. The projected foreign exchange level is also tackled to address risks related to its existing FX assets and liabilities.

To ensure that exposure to fluctuations in price or interest rate is kept within acceptable limits, the Management Action Trigger(MAT) was established to take corrective action in a timely manner and to prevent further losses. MAT is a trigger level to warn of a persistently loss-making position. It defines management maximum tolerance for accepting market risk related losses. When MAT is breached, the risk taking unit, which is Fund Management Department(FMD) must consult top management like the President(ALCO Chairman) for urgent decision required and Asset Liability Committee(ALCO), who meets weekly, for discussion of a course of action moving forward. A board notification procedure was also put in place to further mitigate risk. Aside from the weekly report, a monthly and quarterly reports are being submitted and presented to the Board and Risk Oversight Committee, respectively for information and instruction.

**Operational Risk**

Operational risk is the risk of loss arising from systems failure, human error, fraud or external events. When controls fail to perform, operational risks can cause damage to the reputation, have legal or regulatory implications, or lead to financial loss. PhilEXIM cannot expect to eliminate all operational risks, but through a control framework and monitoring, PhilEXIM is able to manage the risks. Controls include effective segregation of duties, access, authorization and reconciliation procedures, staff education and assessment processes, updated review of all Manuals of Operational Procedures, including the conduct of regular and special internal risk based operations audit.

Although PhilEXIM has previously requested to be exempted from operational risk capital charge because of its simple and straightforward operations, i.e. variety of processes is quite low and internal controls are easily implementable given the volume of transactions, PhilEXIM, nevertheless has been adopting the basic indicator approach under BSP Circular 538 in determining the operational risk capital charge.

The Agency continue to update its Manual of Operations through its Operations Committee to prevent and/or minimize operational lapses. More importantly is the regular conduct of risk-based operations audit by the Internal Audit Office wherein major audit observations are reported to the Board Audit Committee and necessary instructions are issued for appropriate action by the management.

**Liquidity Risk.**

- Liquidity risk is the risk that the Corporation will be unable to meet its payment obligations when they fall due under normal and stress circumstances. It is also represents the current and prospective risk to earnings and capital arising from an institution's inability to meet its obligations when they fall due without incurring losses or costs. It includes the inability to manage unplanned decrease or changes in funding sources. Liquidity risk also arises from the failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value.

- To mitigate this risk, Management can arrange diversified funding sources in addition to its core revenue base, must manage assets with liquidity in mind, and monitor future cash flows and liquidity position on a daily basis.

The Agency also adopted a liquidity management strategy as embodied in a Board approved Liquidity Policy with the following salient objectives

- Cash operating expenses would be met by revenues earned from risk-free investments.
- A fund will be built up for expected loss provisioning to satisfy claims within the expected loss rate.
- The Corporation maintains a portfolio of Available-for-Sale securities that can be easily liquidated in the event of unforeseen interruption on cash flows.
- The Corporation shall build up over a period of five(5) years a Guarantee Fund equivalent to 1% of total risk weighted assets.
- The Corporation may have maximum funding mix or leverage ratio of 20% equity and 80% borrowing.
- The Corporation shall maintain a 70:30 ratio of earning assets vis-a-vis non-earning assets. Of the 70% earning assets, 60% shall represent liquid assets.
- Loans, if any, will be funded by equity.
- A weekly cashflows report is presented to the ALCO to ensure prudent liquidity risk management. Moreover, the same report including the financial performance of the Agency is being reported to the Audit Committee and Board of Director
- There is an existing contingency funding plan.
- If the Guarantee Reserve Fund is insufficient to cover the servicing of default guaranteed loans, the Corporation shall access the capital markets via borrowings subject to the necessary clearances. If borrowings are still insufficient, not feasible or unavailable, the Corporation shall access the net lending windows of the National Government through the Department of Finance, as a last resort, pursuant to AO 10.