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**TRENDS AND DEVELOPMENTS IN INSOLVENCY AND RISK
MANAGEMENT IN THE PHILIPPINES**

by

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TRENDS AND DEVELOPMENTS IN INSOLVENCY AND RISK MANAGEMENT IN THE PHILIPPINES

A. Trends and developments in insolvency and creditor rights

I. Insolvency

a. Legal Infrastructure

The legal framework for insolvency in the Philippines is characterized by few and far-between landmarks, starting with the 1909 antiquated and outmoded Insolvency Law. This law dealt simply with suspension of payments and the liquidation process. This was followed by a Presidential Decree issued in 1980 vesting the Securities and Exchange Commission with authority to act on petitions for rehabilitation. Subsequently, in the Securities Regulation Code enacted in 2000, such jurisdiction was transferred to the regular courts. This Code was complemented by the Interim Rules of Procedure on Corporate Rehabilitation issued by the Supreme Court in 2001 to govern rehabilitation proceedings.

Notwithstanding the foregoing enactments and issuances, grey areas have remained such as those on restructuring, rehabilitation, the stay of proceedings, and the treatment of the rights of creditors, both clean and secured. Available substantive law has not provided adequate rules and standards by which insolvency-related issues may be resolved, thereby prolonging almost interminably actual proceedings which have arisen in the meantime.

Realizing the need to consolidate, nationalize and upgrade the insolvency infrastructure, the Legislative-Executive joint council have agreed to include among the priority measures of the Philippine Congress the passage of the Corporate Recovery Act. It was agreed that this measure is an integral element for the restructuring and reform of the financial sector. Draft bills have been filed in both Houses of Congress and they are common in these objectives:

1. To modernize and clarify the rules for rehabilitation and insolvency in the Philippines;
2. To define the rights of debtors and creditors in these proceedings and facilitate the adjudication of issues between them;
3. To provide fair treatment to all parties while maximizing the chances for the survival of an enterprise; and
4. To inject speed and efficiency in the conduct and termination of the proceedings.

More specifically, the proposed Corporate Recovery Act would provide these reliefs and remedies:

1. Pre-negotiated rehabilitation. This would allow a debtor that has worked out a rehabilitation plan with its creditors to go to court for official approval. In the meantime, claims and lawsuits are suspended. When the court approves the plan, all creditors are bound thereby.
2. Fast-track rehabilitation. This would allow the creation of a new, debt-free enterprise based on the assets of the debtor. There will be a transfer of the shares of the new enterprise to the debtor in exchange of the debtor's assets; there may be an auctioning of the shares of the new enterprise to maximize revenues. This mode will keep the enterprise together with the possibility of significantly reducing its debt within a short period of time.
3. Court-supervised rehabilitation. This will put the onus on the shareholders in drafting and selling a rehabilitation plan. They may hire a rehabilitation planner to prepare the plan. The court may approve the plan

notwithstanding unresolved claims as long as the plan accommodate payment of the claims regardless of the outcome of the disputes.

4. Dissolution-liquidation. This is the relief of last resort. The proposed liquidation proceedings are straightforward and involve simple and clearer prioritization of creditors.

b. Related developments

(1) In June 2004, the Philippine Congress enacted Republic Act No. 9302 which amended the Charter of the Philippine Deposit Insurance Corporation (PDIC). Among other provisions, the amendments authorizes the PDIC to: (a) issue cease-and-desist orders; (b) to issue directives for corrective actions; and (c) to make loans to, purchase assets of, assume liabilities of, or make deposits in a bank to prevent the same from closing. There are also provisions which would expedite payment of insured deposits upon closure. Moreover, actions of the PDIC can be restrained only by the Court of Appeals. These amendments seek to have preventive measures to avert, if possible, bank closures and, in the event it happens, to permit an expedient receivership and liquidation process for the closed bank.

(2) In September 2004, the Bangko Sentral ng Pilipinas initiated efforts for the amendment of its charter. Insolvency-related proposals would include an authority for the receiver of a closed bank to sell, transfer or dispose of the assets of the closed bank or to pursue its merger or consolidation with another institution, so as to effect rehabilitation. Under the present law, the receiver does not have such authority. Aside from banks and quasi-banks, the authority of the Bangko Sentral to place an institution under receivership would include trust entities and non-stock savings and loan associations thereby providing clear insolvency rules relative to said entities.

II. Creditor rights

Creditor rights in the Philippines arising from promissory notes, loan documents, mortgages, pledges and deeds of assignment are substantially similar as those in other jurisdictions except on two (2) features which are peculiar to the Philippine legal system, namely:

1. The right of redemption after foreclosure of real estate mortgages; and
2. The rule on “pactum commisorium” which disallows the creditor to appropriate to himself the property of the debtor for the purpose of satisfying the debt.

Under the Philippine mortgage law, the mortgagor of real property to a banking institution has a one-year period after foreclosure to redeem the foreclosed property. This period has been shortened to three months in some instances as provided in the General Banking Law. This law impairs the capability of the creditor bank to liquidate, put to use, or dispose the foreclosed assets, or benefit therefrom for the duration of the redemption period. Moreover, since before the creditor files the foreclosure proceedings it had already exhausted all efforts to collect and failed, there is really no likelihood that the debtor would have the resources to repay. There were proposals several years ago to have the right of redemption repealed but there was no favorable response to it.

On the rule on “pactum commisorium”, it would technically require all proceedings for the involuntary settlement of debt against the assets of the debtor to be subject to public auction, thereby making collection cumbersome and costly. Private sales by the creditor of mortgaged and pledged assets are not allowed in the event of default. This rule should be subject to review.

B. Current risk assessment and management systems and policies

I. Risk Assessment and Management Systems

Credit risk in its most basic form is the risk that a customer or counterparty will be unable or unwilling to pay obligations on time or in full as expected or previously contracted, subjecting a bank to a financial loss. In the Philippines, credit risk management - although the most basic risk that characterize the banking business - is still at its nascent stage. The first line of defense for such risk – loan origination standards - is still vulnerable and needs to be improved. The second line of defense - credit risk rating systems - is still generally crude. Although crude credit risk rating systems are better than having nothing, the reliability of the output of such systems may be in question since unaudited financial statements are still in use. This problem, however, is not a monopoly of the Philippines. As Mr. McDonough remarked in his speech before the Bond Market Association in New York on 21 January 1999: “Let me be a bit more specific about some of the weaknesses found in credit risk management techniques. For example, some institutions routinely performed credit assessments using sparse, often unaudited financial information from valued customers.” The Bangko Sentral ng Pilipinas (BSP) has already addressed this problem by requiring banks to use only financial statements audited by accredited external auditors starting 2005.

To improve banks’ credit risk management practices, the BSP has issued a number of regulations that include the following:

1. Circular No. 389, which sets out the basic guidelines for the granting of loans and other credit accommodations;
2. Circular No. 414, which sets out the principles for the management of large exposures and credit risk concentrations;
3. Circular No. 423, which sets out specific guidelines regarding banks’ dealings with any of its Directors, Officers, Stockholders and their Related Interests (DOSRI);
4. Circular No. 425, which sets a limit to loans to a single borrower; and
5. Circular No. 439, which requires banks to put in place internal credit risk rating systems for their corporate exposures.

Circular No. 439, in particular, emphasized the role of banks’ board of directors in risk management. It requires, among others, that banks’ internal credit risk rating systems be approved by the bank’s board of directors, and designed and implemented by an independent credit risk control function.

The involvement of banks’ board of directors in the risk management process is further emphasized in a recent issuance by the BSP which prescribes the creation of a Risk Management Committee (RMC) composed of at least 3 members of the Board of Directors. The RMC shall be responsible for the development and oversight of the bank’s risk management program. Specifically, the RMC shall identify and evaluate risk exposures, develop risk management strategies, implement a risk management plan, and review and revise the said plan as needed.

The BSP has also worked with the industry through the Bankers Association of the Philippines (BAP) to improve risk management practices in the banking sector. Together, they came up with the Financial Markets Risk Reference Manual. The Manual serves as a basis for commercial banks’ risk management policies and practices. For credit risk, it prescribes the ideal structure of a bank’s Credit Risk Management Organization, the establishment and operation of a sound credit granting process, the establishment of credit monitoring systems which will track the composition and quality of the credit portfolio, as well as compliance with the banks’ internal credit limit and concentration policies.

To encourage banks to further improve their risk management practices and to prevent them from taking on excessive risks, the BSP has issued Circular No. 212 which sets out the types of information that banks should publicly disclose. The said Circular adopts the core public disclosure requirements as prescribed in the 1998 Basel Committee on Banking Supervision (BCBS) paper – “Enhancing Bank Transparency.” Aside from the usual information on banks’ financials and accounting practices, the said paper also prescribed the disclosure of information regarding banks’ risk management philosophy, risk management systems and structures, as well as

qualitative and quantitative information on their risk exposures. Unfortunately, Philippine domestic banks are still getting used to the idea of risk-focused disclosures.

II. Credit Information Systems

To improve credit risk management in the financial markets, there has to be a source of reliable public information on the creditworthiness of corporate entities. To address this, the BSP has supported the development of two key market infrastructures: credit information bureaus and credit rating agencies.

Credit Information Bureau

The BSP is supporting the creation of a central credit bureau in order to improve the credit information systems in the domestic financial markets. This central credit bureau brings together the various small credit information bureaus throughout the industry. As such, it will compile credible and reliable information on credit transactions, payment history, and other indicators of creditworthiness of a wide range of consumers and businesses. The proposed central credit bureau is therefore seen to protect the financial system from fraud, improve credit decision-making and promote credit discipline.

The BSP has engaged a comprehensive legal study on how it can put together a central credit bureau at the earliest possible time. Based on the legal study's recommendations, the BSP has the legal authority to establish and operate a credit information bureau as an internal unit within its organization. Thus in the interim, BSP will operate a credit bureau while an appropriate enabling law is being worked out with Congress. Once the law is in place, BSP will seek to divest to allow the private sector to take over.

Credit Rating Agencies

Credit ratings are important for risk management purposes since ratings are perceived to be a major variable that factors into the risk-pricing function. The BSP therefore sees it fit to support the development of domestic credit rating agencies. Toward this end, the BSP issued Circular No. 404 containing the guidelines for the recognition and derecognition process of credit rating agencies.

Currently, there is only one credit rating agency in the Philippines recognized by the BSP. There is, however, a pending application from a foreign rating agency that expressed intention to devise a national rating scale for the country.

III. Credit Risk Transfer and New Financial Instruments

The desire of financial institutions to manage and mitigate credit risks has led to new and more complex credit risk transfer mechanisms, two of which are credit derivatives and securitization structures.

Credit Derivatives

Credit derivatives is a way of transferring the credit risk of a reference asset from a party (protection buyer) to one or more other parties (protection seller). Theoretically, credit derivatives offer protection buyers a means of diffusing risk, and thus achieving capital relief because the reference asset is virtually no longer in their books. For the protection sellers, credit derivatives offer an opportunity for diversifying investments since they can already take positions in certain debts even if the cash market for these debts no longer exist.

In the Philippines, however, a different scenario is taking shape. Offshore banks utilize credit derivatives to reduce their exposures to the Philippine sovereign by synthetically transferring these exposures to the domestic banks. The domestic banks, on the other hand, are more than willing to accept these exposures because, aside from the enhanced yield, exposures to the Philippine sovereign (even those that are dollar-denominated) are considered

by the BSP as risk-free. This resulted in a growing concentration of exposure of the domestic banking system to Philippine sovereign dollar debt.

To provide a regulatory framework for credit derivatives transactions in the Philippines, the BSP issued Circular No. 417 specifying the capital requirements for credit-linked notes. The BSP is now in the process of drafting regulations for unfunded credit derivatives.

Securitization

On 19 March 2004, the President has signed into law R.A. No. 9267, otherwise known as the Securitization Act of 2004. This sets the legal and regulatory framework for the sale of financial assets like loans, mortgages, receivables, etc., and transform them into marketable securities. Securitization is a device of structured financing where an entity seeks to pool together its interest in identifiable cash flows over time, and create securities against these for sale to investors. As such, securitization presents banks yet another means of raising funds other than the traditional borrowing, as well as managing credit exposures. However, there are risks inherent to securitization that have implications on individual entities, as well as the macroeconomy as a whole (i.e., the possibility of more sub prime lending to feed into securitization, banks may be carrying excessive risks which are not reflected on the face of their balance sheets, sterilization of monetary policy, etc.). The challenge is to design an appropriate regulatory environment to minimize these risks.

Currently, the BSP has already exposed to the banking industry a draft Circular prescribing the rules for banks' investments in securitization structures, including CDO structures.

References:

Bangko Sentral ng Pilipinas and Bankers Association of the Philippines. 2004 version. *Financial Markets Risk Reference Manual*.

Basel Committee on Banking Supervision. 1998. *Enhancing Bank Transparency*. BIS.

McDonough, W. *Importance of Risk Management Techniques and the Enhancement of Market Discipline*. Speech delivered before the Bond Market Association in New York on 21 January 1999.

Prenio, J. 2004. *A Survey of the Disclosure Practices of Philippine Universal Banks*. Bangko Sentral Review, July 2004 issue (to be released).

Non-Performing Assets

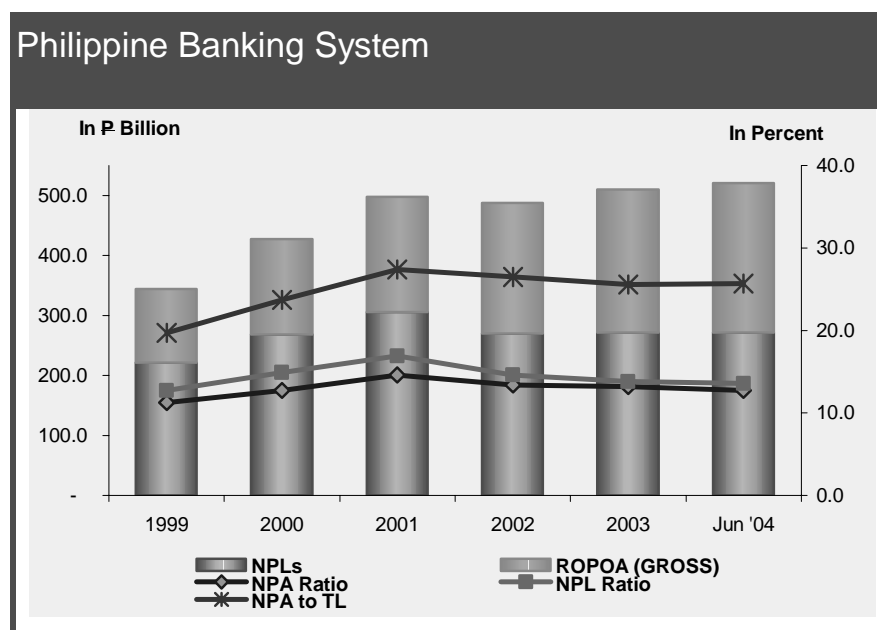
While non-performing assets (NPAs) still remain a problem of the Philippine banking system, positive development was the easing of ratios on NPAs and non-performing loans (NPLs). At end-June 2004 NPA and NPL ratios stood at 12.7 and 13.6 percent, respectively. Likewise, NPAs as a percentage of total loans slightly improved to 25.7 percent as of end-June 2004 from a peak of 27.4 percent at end-year 2001. It may be noted, however, that the level of NPAs continue to climb as banks were foreclosing on collaterals in settlement of loans. Higher growth rates in gross assets accounted for the reduction in the NPA ratio. (Table 1 and Chart 1)

Table 1. Philippine Banking System: Selected Indicators

Philippine Banking System: Selected Indicators ^{1/}						
	1999	2000	2001	2002	2003	June 2004 ^{P/}
Major Asset Quality Accounts						
Levels (P Billion)						
Gross Assets ^{2/}	3057.5	3,356.5	3,406.3	3,622.5	3,816.3	4,030.1
Total Loan Portfolio (TLP)	1752.6	1804.8	1,812.2	1,840.8	1,961.4	1,996.3
Non-performing Loans (NPL)	222.0	268.7	305.8	269.6	271.4	271.5
Loan Loss Reserves (LLR)	100.4	117.4	138.6	135.4	139.9	140.8
ROPOA, gross ^{3/}	122.4	158.5	191.4	217.6	238.8	249.6
Non-performing Assets (NPAs) ^{4/}	344.4	427.1	497.2	487.2	502.1	512.7
Allowance for Probable Losses on NPAs	102.7	122.1	147.0	146.8	155.2	156.8
Selected Ratios						
Asset Quality						
NPL to TLP	12.7 %	14.9 %	16.9 %	14.6 %	13.8 %	13.6 %
NPL Coverage ^{5/}	45.2 %	43.7 %	45.3 %	50.2 %	51.5 %	51.9 %
NPA to Gross Assets	11.3 %	12.7 %	14.6 %	13.4 %	13.2 %	12.7 %
NPA Coverage ^{6/}	29.8 %	28.6 %	29.6 %	30.1 %	30.9 %	30.6 %
NPA to Total Loans	19.7 %	23.7 %	27.4 %	26.5 %	25.6 %	25.7 %

^{1/} Asset Quality Indicators defined per BSP Circular No. 202 dated 27 May 1999 amended by BSP Circular No. 351 dated 19 September 2002
^{2/} Gross Assets refers to Total Assets, net of reserves plus Loan Loss Reserves (LLR) plus provision for ROPOA
^{3/} ROPOA refers to Real and Other Properties Owned or Acquired
^{4/} NPA refers to NPLs plus ROPOA, gross excluding performing sales contracts receivable per BSP Circular No. 380 dated 28 March 2003
^{5/} NPL Coverage refers to the ratio of LLR to NPL
^{6/} NPA Coverage refers to the ratio of valuation reserves (for Loans and ROPOA) to NPAs
^{P/} Preliminary

Chart 1. Philippine Banking System: Asset Quality Indicators



The SPV law (which primarily seeks to encourage private sector investments in NPAs, eliminate existing barriers to the acquisition of NPAs and improve liquidity of the financial system) was enacted in January 2003. The law became operational in April 2003, but bulk transactions big enough to start a real turnaround in balance sheet quality have yet to materialize.

The greatest obstacle to wholesale disposal of NPAs under the SPV law continues to be the gap between bank's target prices and bid prices of NPAs. The BSP has tried to play the role of a catalyst by providing measured regulatory relief but market forces need to be the main driver of these transactions.

Unresolved bad debts dampen economic growth since capital, which could have otherwise supported the expansion of businesses and their attendant multiplier effect, is tied up in defaulted borrowers. Mounting NPLs affects bank profitability and eat up on capital. In addition, banks become risk-averse, preferring to invest in government securities and foreign markets instead of lending to local businesses thus, dragging down national productivity.

While banks have resorted to restructuring arrangements, "dacion en pago" (payment in kind), debt-to-equity conversion, securitization, write-offs, and direct sale to resolve NPAs, improvement in asset quality is still limited because our debt resolution process is tedious and costly. Existing legal system makes it hard for creditors to obtain and enforce their claims on debtors. The need to provide order and process to rehabilitate or wind-up affected businesses was highlighted during the Asian financial crisis. The out-dated insolvency law needs to be replaced by more contemporary and efficient process.

Definitions:

1. *Non-performing loans (NPL) refer to past due loan accounts whose principal and/or interest is unpaid for thirty (30) days or more after due date (applicable to loans payable in lump sum and loans payable in quarterly, semi-annual or annual installments), including the outstanding balance of loans payable in monthly installments when three (3) or more installments are in arrears, the outstanding balance of loans payable daily, weekly or semi-monthly instalments when the total amount of arrearages reaches ten percent (10%) of the total loan receivable balance, restructured loans which do not meet the requirements to be treated as performing loans under existing rules and regulations, and all items in litigation. Effective September 2002, NPLs exclude loans classified as Loss in the latest BSP examination which are fully covered by allowance for probable losses and applicable to a bank with no unbooked valuation reserves and other capital adjustments required by the BSP (Circular No. 351).*
2. *Non-performing assets (NPA) refer to the sum of non-performing loans (NPL and real and other properties owned and acquired (ROPOA). Effective March 2003, NPAs exclude performing sales contract receivable which met certain requirements under Circular No. 380.*
3. *NPL ratio refers to the ratio of non-performing loans (NPL) to total loans (gross of allowance for probable losses), inclusive of interbank loans.*
4. *NPA ratio refers to the ratio of NPA to total assets, gross of allowance for probable losses.*

Financial Sector

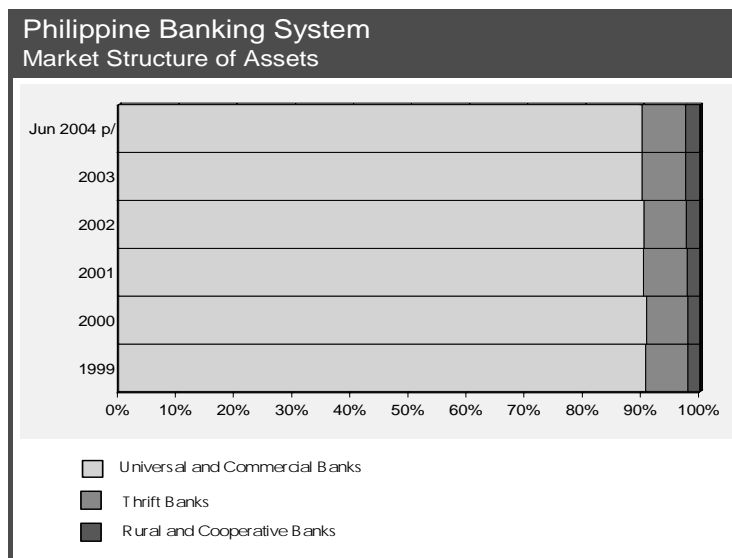
As of end-June 2004, there were 6,552 operating financial institutions under the supervision of the Bangko Sentral ng Pilipinas (BSP), as shown below. Except for 3 banks which are owned and controlled by the government, the rest of the financial institutions are privately owned. Meanwhile, of the 89 operating thrift banks, 17 are controlled by other banks/non-bank financial institutions (NBFIs). There were 2 bank closures in 2004. A rural bank was closed in January and a thrift bank in September.

**Banking and Non-Bank Financial Institutions (NBFIs)
as of end-June 2004**

Financial Institution	Head Offices
Banks	896
• Universal/Commercial Banks	42
• Thrift Banks	89
• Rural/Cooperative Banks	765
NBFIs	5,647
• With Quasi-Banking Function	11
• Without Quasi-Banking Function	5,636
• Offshore Banking Units	9
Total	6,552

Banking System - Universal and commercial banks consistently accounted for the largest share of the banking system's aggregate resources which at end-June 2004 was at 90.1 percent. Thrift banks held 7.5 percent and rural and cooperative banks held the remaining 2.4 percent. (Chart 1)

Chart 1. Philippine Banking System: Market structure of assets



Financial Health - Universal and Commercial Banks

Universal and commercial banks, the dominant players in the Philippine banking system remained stable and resilient as shown by favorable trends in selected indicators. (Table 1)

Table 1. Universal and Commercial Banks – Selected Indicators

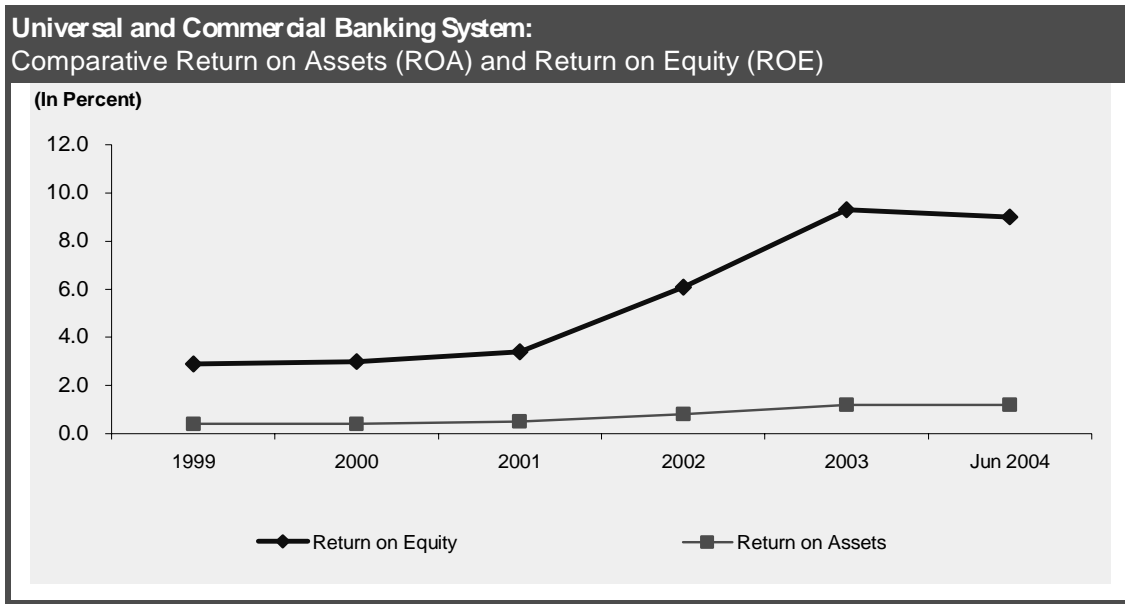
Universal and Commercial Banking System: Selected Indicators ^{1/}						
Major Asset Quality Accounts	1999	2000	2001	2002	2003	June 2004
Levels (P Billion)						
Gross Assets ^{2/}	2771.7	3,046.9	3,077.6	3,277.0	3,441.2	3,634.9
Total Loan Portfolio (TLP)	1582.9	1628.2	1,625.1	1,639.4	1,747.2	1,778.7
Non-performing Loans (NPL)	195.4	245.8	281.9	245.1	245.5	244.9
Loan Loss Reserves (LLR)	90.6	107.2	127.4	125.5	130.0	130.9
ROPOA, gross ^{3/}	99.9	131.9	158.6	183.0	202.3	207.5
Non-performing Assets (NPAs) ^{4/}	295.3	377.7	440.5	428.1	442.3	446.8
Allowance for Probable Losses on NPAs	92.1	110.9	134.9	135.6	144.0	145.5
Selected Ratios						
Asset Quality						
NPL to TLP	12.3 %	15.1 %	17.3 %	15.0 %	14.1 %	13.8 %
NPL Coverage ^{5/}	46.3 %	43.6 %	45.2 %	51.2 %	53.0 %	53.5 %
NPA to Gross Assets	10.7 %	12.4 %	14.3 %	13.1 %	12.9 %	12.3 %
NPA Coverage ^{6/}	31.2 %	29.4 %	30.6 %	31.7 %	32.6 %	32.6 %
Liquidity						
Liquid Assets to Deposits	41.3%	45.7 %	45.6 %	49.3 %	49.5 %	54.0%
Solvency						
CAR - solo basis	n.a.	n.a.	14.2 %	15.0 %	15.7 %	n.a.
Profitability						
Return on Equity	2.9 %	3.0 %	3.4 %	6.1 %	9.3 %	9.0 %
Return on Assets	0.4 %	0.4 %	0.5 %	0.8 %	1.2 %	1.2 %

^{1/} Asset Quality Indicators defined per BSP Circular No. 202 dated 27 May 1999 amended by BSP Circular No. 351 dated 19 September 2002
^{2/} Gross Assets refers to Total Assets, net of reserves plus Loan Loss Reserves (LLR) plus provision for ROPOA
^{3/} ROPOA refers to Real and Other Properties Owned or Acquired
^{4/} NPA refers to NPLs plus ROPOA, gross excluding performing sales contracts receivable per BSP Circular No. 380 dated 28 March 2003
^{5/} NPL Coverage refers to the ratio of LLR to NPL
^{6/} NPA Coverage refers to the ratio of valuation reserves (for Loans and ROPOA) to NPAs
n.a. Not Available

ASSET QUALITY – Resolute efforts to improve asset quality (intensified collection efforts, restructuring, foreclosures, “dacion en pago” and sale of NPAs) reflected in the easing of the NPL and NPA ratios as of end-June 2004 to 13.8 percent and 12.3 percent (from their highest at 17.3 percent and 14.3 percent at end-year 2003), respectively. Banks continued to address vulnerability concern by raising loss provisioning on NPAs as shown by the rising NPL and NPA coverage ratios.

PROFITABILITY – Improved asset quality, increased level of lending and investments, together with cost-reduction measures, propelled enhanced profitability as shown by the improved return on assets and return on equity. (Chart 2)

Chart 2. Universal and Commercial Banking System: Comparative Return on Assets and Return on Equity



LIQUIDITY – Universal and commercial banks continued to maintain adequate liquidity as shown by the increasing liquid assets to deposits ratio from 41.3 percent in 1999 to 54.0 percent as of end-June 2004 which grew at an average rate of 2.5 percent. Liquid assets rose as banks sustained investments in government securities.

SOLVENCY – Under the new risk-based framework, the capital adequacy ratio of universal and commercial banks for end-years 2001, 2002 and 2003 at 14.2 percent, 15.0 percent and 15.7 percent, respectively, exceeded the 10 percent benchmark. So far, only universal banks have issued unsecured subordinated debts to beef up their tier 2 (supplementary) capital.

Prudential Supervision and Regulatory Capacity

The BSP is committed to ensure the safety and soundness of the Philippine banking system by continuously enhancing its supervisory and regulatory capabilities to align prudential standards with international norms and to enforce risk-focused and consolidated supervision.

In 2004, new regulations have been issued that prescribe tighter rules on large exposures, credit concentrations and connected-party lending, as well as minimum operational requirements and technical standards on banks' internal credit risk rating systems.