



BANGKO SENTRAL NG PILIPINAS

OFFICE OF THE GOVERNOR

CIRCULAR NO. 1149 Series of 2022

**Subject: Guidelines on the Integration of Sustainability Principles
in Investment Activities of Banks**

The Monetary Board, in its Resolution No. 1180 dated 11 August 2022, approved the supervisory expectations on the integration of sustainability principles in the investment activities of banks.

This regulatory issuance covers banks' investments in the banking book. The Guidelines on the Integration of Sustainability Principles in Investment Activities of Banks is part of the series of guidelines implementing the Sustainable Finance Framework issued in April 2020.

Section 1. Section 153 of the Manual of Regulations for Banks (MORB), as amended by Circular No. 1128 dated 26 October 2021 is hereby amended as follows:

153 SUSTAINABLE FINANCE FRAMEWORK

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Environmental and Social Risk Management System (ESRMS). The ESRMS shall be articulated in a separate document solely relating to the management of E&S risk or embedded in existing documents related to the management of specific risk areas, (e.g., credit risk management system). xxx:

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Credit Risk Management System. Banks shall consider environmental and social (E&S) risks in defining credit risk appetite. xxx

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Investment Activities of Banks. The requirements governing the integration of sustainability principles in the investment activities of banks are provided under Sec. 614.

Investments in equities of allied or non-allied undertakings are provided under Sec. 371 to 376-A. Banks shall take into account their sustainability objectives and risk appetite in their investment activities as well as ensure that such investment does not contribute to sectors considered to have harmful effects to the environment or society.

Operational Risk Management System. E&S risk events, in the context of operational risk, can cause severe disruption to a bank's operations. xxx

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Section 2. Section 614 of the MORB on Investment Activities of BSP-Supervised Financial Institutions is hereby amended as follows:

614 INVESTMENT ACTIVITIES OF BANKS

Policy statement. The Bangko Sentral recognizes that the effective management of risks associated with a bank's investment activities is essential in ensuring its continued safety and soundness. The Bangko Sentral likewise recognizes the potential of banks' investment activities to contribute to the pursuit of sustainable and resilient growth of the Philippines. These guidelines set expectations on the prudent conduct of investment activities and the minimum practices that a bank should establish for the management and control of risks associated with investments. These guidelines likewise set expectations on the integration of sustainability principles in investment processes of banks.

Scope of Application. These guidelines cover all of a bank's investments in the trading and banking books.¹ These guidelines do not apply to bank's (a) investments that grant control over an enterprise and are accounted for using the equity method, (b) transactions in derivatives involving stand-alone contracts, and (c) receivables arising from repurchase agreements.

Risk Management Framework. A bank shall have systems to manage the risks arising from its investment activities. xxx

a. Board² and senior management oversight

As investment activities comprise a major area of a bank's operations, the board of directors shall perform the following, in accordance with Sec. 132 (*Specific duties and responsibilities of the board of directors*).

- (1) Approve portfolio objectives, overall investment strategies, general investment policies, and limits that are consistent with the bank's financial condition and risk tolerance. xxx
- (2) xxx
- (3) xxx
- (4) Oversee the integration of sustainability principles and objectives in the bank's investment activities and monitor the progress in attaining such objectives through the relevant committee it designated pursuant to Sec. 153.

As senior management is responsible for implementing board-approved strategic objectives, it shall therefore:

- (1) Develop portfolio objectives that set out the acceptable instruments, expected business returns, desired asset allocation and diversification parameters, and other elements of sound investment management. The portfolio objectives should likewise provide how the investment activities will be aligned with the sustainability objectives of the bank. Portfolios managed for the purpose of generating short term profits must be

¹ The provisions applicable to the integration of sustainability principles shall only apply to investments in the banking book.

² Or its equivalent body in the case of branches of foreign banks

distinct from those utilized to maintain ample balance sheet liquidity, generate accrual income or modify and manage risk profiles.

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b. Policies, Procedures, and Limits

A bank shall institute policies, procedures, and limits that provide a framework for managing investment activities. The framework shall be consistent with the organization's broader business strategies, including its sustainability objectives pursuant to Sec. 153; capital adequacy; technical expertise; and risk tolerance. In setting policies, procedures, and limits, a bank shall be guided by the following:

(1) Policies and procedures should clearly articulate guidelines for the acquisition and accounting of investments. Xxx

(2) Policies should promote the development of a comprehensive understanding of the risks associated with investments prior to acquisition and on an ongoing basis. In particular, these should require the following:

(a) xxx;

(b) xxx;

(c) the due diligence review to cover:

(i) an analysis of the risks and cash flow characteristic of the specific investments, especially for products that have unusual, leveraged, or highly variable cash flows;

(ii) xxx

(iii) the assessment of material E&S risk exposures of the investment as well as the issuing company;

(iv) an analysis of assumed and actual investment exit strategies, particularly for securities that are illiquid, not readily marketable, or those found to have high E&S risks, and the resulting effect on earnings; and

(v) the identification of appropriate methodologies for the allocation of capital based on the risk inherent in the bank's investment activities, and the identification of all material risks, and their potential impact on the safety and soundness of the institution;

(d) xxx;

(e) the due diligence and ongoing reviews to be performed by qualified personnel or a unit independent from the risk-taking function. Any third-party analysis independent of the seller or counterparty (e.g., reports prepared by investment managers, credit rating agencies, ESG rating organizations or external review providers) may only be used to complement a bank's own evaluation. The bank should only rely on third-party organizations with recognized expertise for their

analysis. Notwithstanding any responsibility, legal or otherwise, assumed by a dealer, counterparty, or financial advisor regarding a transaction, the investing bank is ultimately responsible for understanding and managing the risks of the transaction; and

(f) xxx

The conduct of due diligence reviews for new plain vanilla instruments xxx.

(3) Policies and procedures should provide the bank's approach for implementing the sustainability objectives of investment strategies. For this purpose, a bank may adopt any or a combination of the following approaches:

(a) *Integration* - This approach involves an explicit and systematic inclusion of material E&S factors in investment analysis and decisions to better manage risks and improve returns. This approach does not require ex-ante criteria for inclusion or exclusion.

(b) *Screening* - This approach involves the application of filters to lists of potential investments to rule companies in or out of contention for investment, based on the bank's risk profile or appetite, preferences, values, or ethics. Screening can be categorized as follows:

(i) *Exclusionary screening* - refers to avoiding securities of companies or countries based on traditional moral values (e.g., issuers belonging to the gambling or military weapons industries) or standards and norms (e.g., those pertaining to human and animal rights, working conditions; or environmental protection). The exclusionary screening may include filters on companies whose economic activities do not comply with Philippine laws, including environmental laws and regulations.

(ii) *Best-in-class selection* - refers to preferring companies or countries with better or improving E&S performance relative to sector peers. This is also referred to as positive selection or positive alignment. This approach may be implemented on either the level of E&S performance or the change in E&S performance. A bank that adopts this approach is expected to conduct due diligence on E&S concerns involving the company or country to avoid potentially misleading claims.

(c) *Thematic approach* - refers to investing that is based on trends, such as social, industrial, and demographic trends. This approach seeks to combine attractive risk return profiles with an intention to contribute to a specific environmental or social outcome. It likewise includes impact investing. For this purpose, impact investing refers to investing with the disclosed intention to generate and measure social and environmental benefits alongside a financial return.

The bank may adopt other approaches and global best practices it deems appropriate depending on its investment policy and sustainability objectives and goals, the nature of its investments, volume of transactions, and existing risk management system and resources:

Provided, That the related sustainability risk factors, including AML/CTF risk that arise from E&S issues, are sufficiently captured.

The bank shall adopt measures to ensure that investments are channeled to companies that comply with sustainability-related standards, laws and regulations as well as companies that do not engage in *greenwashing*.

For this purpose, *greenwashing* refers to the deceptive marketing used to persuade the public that an organization's products, aims, and policies are environmentally friendly.³ It also covers the dissemination of misleading information, whether intentional or not, regarding a company's environmental strategies, goals, motivations, and actions that can induce false positive perception of a company's E&S performance. The term *greenwashing* is often used in the broader sustainability context.⁴

- (4) The limits for investment activities shall be consistent with the bank's institution-wide risk limits. The limit structure may apply at the institutional, portfolio, sub-portfolio, or individual instrument levels, or a combination thereof. The bank's determination of the appropriate limit structure shall be guided by the diversity, complexity, and purpose of its portfolios (e.g., a bank with substantial holdings of non-resident issued instruments should establish country risk limits).
- (5) The limit structure should reflect the amount of exposure that the bank is willing to accept, taking into consideration the impact of such exposure to earnings and capital in both normal and stressed conditions.
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c. Risk Measurement, Monitoring and Management Information systems (MIS)

Given the impact of investments on the risk profile of an institution, banks shall ensure that they possess the capability to measure and monitor the risks associated with their investments prior to acquisition and periodically thereafter. In doing so, a bank shall be guided by the following:

- (1) A bank shall have the capability to value its positions and measure exposures to each type of risk arising from such positions under both normal and stressed market conditions. xxx Banks whose investments are limited to plain vanilla instruments in the banking book, should, at a minimum, have the capability to periodically mark the positions to market or obtain the market values of their positions.

A bank whose investments are exposed to material E&S risks shall adopt appropriate tools and metrics to assess, measure, and monitor these risks in accordance with the requirements under Sec. 153.

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(3) xxx

³ <https://www.imf.org/-/media/Files/Publications/GFSR/2021/October/English/ch3.ashx>

⁴ <https://www.bis.org/publ/bppdf/bispap118.pdf>

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d. **Internal Controls and Audit**

In addition to complying with the supervisory expectations set out in Secs. 162 and 163, a bank shall:

- (1) xxx
- (2) xxx
- (3) Ensure the integrity of investment valuations, risk measurement methodologies, and controls that address model risk. xxx Model validation processes of a bank shall meet the minimum expectations set forth under Sec. 144 (*Market Risk Management*) and Sec. 143 (*Credit Risk Measurement, Validation and Stress Testing*).

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Risks of Investment Activities. The management of risks arising from a bank's investment activities shall be integrated into the bank's overall risk management system, as required under Secs. 141 (*Supervision by Risk*), 143 (*Credit Risk Management*), 144 (*Market Risk Management*), 146 (*Operational Risk Management*), and 153 (*Sustainable Finance Framework*).

The guidelines below set out the supervisory expectations on the management of major risks that are inherent to investment activities. xxx

a. **Market Risk**

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b. **Interest rate risk in the banking book**

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c. **Credit risk**

- (1) A bank's investment policies and objectives shall be consistent with its overall credit risk strategy, as set out under Sec. 143 (*Role of the Board and Senior Management and Credit Risk Strategy*) and Sec. 153 (*Credit Risk Strategy*).
- (2) In accordance with Sec. 143 (*Credit granting and loan evaluation/analysis process and underwriting standards*), which requires the conduct of a comprehensive assessment of the creditworthiness of obligors, a bank shall not acquire an investment without conducting an independent assessment of the creditworthiness of the issuer. The latter shall form part of the due diligence review to be conducted in accordance with Item "b(2)" (*Policies, procedures, and limits*) of this Section.
- (3) xxx The following are examples of factors that a bank may consider as part of its credit risk due diligence review:

(a) xxx

(b) xxx

(c) Material E&S risks to which the issuer is exposed to based on criteria such as the level of greenhouse gas (GHG) emissions, vulnerability to extreme weather events, or linkages to unsustainable energy practices; or the analysis of key metrics and targets that the issuer has set for the management of its key E&S risks. Where the instrument is used to finance a specific project, the E&S profile of the project;

(d) The value of an instrument with a prepayment option compared to a plain vanilla security of similar credit quality;

(e) Potential impact to an instrument's value of specific product features such as credit-related triggers; and

(f) For an investment in a securitization structure, the class or tranche, loss allocation rules, specific definition of default, support provided by credit and/or liquidity enhancements, and the impact of collateral deterioration and potential credit losses under adverse economic conditions.

(4) xxx

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d. Market liquidity risk

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e. Operational risk

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Application of the guidelines.

a. General rule. These guidelines shall apply to all banks and non-bank financial institutions performing quasi-banking functions (QBs) and their financial subsidiaries. The guidelines pertaining to integration of sustainability principles in investment activities shall apply only to banks, consistent with Sec. 153.

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d. xxx

Supervisory enforcement actions. xxx

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Section 3. Section 246 of the MORB on the Issuance of Bonds and Commercial Papers is hereby amended as follows:

246 ISSUANCE OF BONDS AND COMMERCIAL PAPERS

All banks with quasi-banking authority issuing bonds or commercial papers to counterparties that meet the definition of lenders under Sec. 241 shall comply with Republic Act No. 8799 or the Securities Regulation Code (SRC) and its Implementing Rules and Regulation, and other applicable rules and regulations issued by the Securities and Exchange Commission (SEC). A bank may issue bonds and/or commercial papers without prior Bangko Sentral approval: *Provided*, That it meets the prudential criteria as described in Sec. 111 (*Prudential Criteria*).

Provided, further, That bonds issued are enrolled and/or traded in a market which is organized in accordance with the SEC rules and regulations.

In the case of issuance of green, social, or sustainability bonds, including other sustainable bonds falling within their acceptable definition, the issuing bank shall comply with the pertinent guidelines of the SEC as well as the disclosure requirements in Sec. 153. In addition, the issuing bank shall not engage in "greenwashing", as defined in Sec. 614.

Notice to the Bangko Sentral ng Pilipinas. xxx

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Section 4. This Circular shall take effect fifteen (15) calendar days following its publication either in the Official Gazette or in a newspaper of general circulation.

FOR THE MONETARY BOARD:



FELIPE M. MEDALLA
Governor

23 August 2022