Superintendencia de Bancos de Panamá

GUIDE FOR MICROPRUDENTIAL SUPERVISION AND OPERATION OF THE UNIFORM RISK-BASED SUPERVISION MANUAL (MUSBER)

FIRST EDITION

FOREWORD

The Superintendency of Banks of Panama (hereinafter referred to as SBP) is the regulator and supervisor of the banks and banking groups authorized to operate in Panama, as well as the supervisor of the trust companies to which the SBP has granted a license.

The main objective of the SBP is to ensure the soundness and efficiency of the banking system. To achieve this goal, the SBP conducts bank examinations required by the Banking Law and the Board of Directors of the SBP, and those it deems necessary or prudent.

In July 2012, the Board of Directors of the SBP approved the use of the Uniform Risk-Based Supervision Manual (MUSBER, for its acronym in Spanish), which introduced a significant change in the supervisory model of the SBP.

From that moment on, the SBP has applied, calibrated and adjusted the risk-based supervision methodology and procedures according to internal assessments and new international procedures for banking supervision.

The MUSBER is an internal document for use by the SBP staff, describing the processes, procedures and methodology for supervising banks and banking groups. This document is fundamental for guaranteeing the application of the same supervisory rules to all regulated entities, without bypassing the supervisor’s professional criteria.

This “Guide for Microprudential Supervision and Operation of the Uniform Risk-based Supervision Manual (MUSBER)” is a document that explains the general functions of the MUSBER in a simple way and provides a general perspective on the main supervisory processes, procedures and methodologies applied to regulated entities. The purpose of the guide is to help the regulated entities better understand the basic MUSBER supervisory processes and permit them to know what the SBP expects from them to improve their performance. It will be updated as needed.

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I INTRODUCTION

Conceptual considerations

There is consensus on what the banking supervisory model must be (along with effective and prudent regulatory framework and a disciplinary regime)[1]:

- An ongoing banking supervisory system, consisting of the input of regular information, offsite analysis and examinations;
- A set of corrective supervisory measures that the supervisor can determine based on the situation of the banks (requirements and recommendations, authorization of remedial action plans, receivership and replacement of administrators).

The ongoing supervisory process must be designed to maintain an updated and comparative understanding of the supervised banks situation and risk profile, using the risk-based approach for action planning as well as for development and assessment. According to this model, increasingly widespread in the international arena, a frequent onsite examination schedule reinforces and secures the system.

Within this framework, the supervision must be continuous and oriented towards the banks' areas of risk, identifying potential control deficiencies and developing a plan to ascertain whether these deficiencies exist. The following risks should be considered during the supervisory process:

- Inherent: the susceptibility of a balance or type of operation to contain indications of significant errors, regardless of the internal control structure of the banks;
- Control: the risk that the internal control structure will fail to prevent or detect significant mistakes;
- Detection: the risk that banking supervisory procedures will fail to detect significant mistakes in accounting records and in the control structure.

[1] Banks of Spain, SABER Methodology Document

The supervisor may identify and assess the inherent risk (quantity of risk) and assess control risk (quality of risk management) but cannot directly reduce either of them.

However, the supervisor may reduce the detection risk by defining and implementing a framework for banking supervision that includes appropriate strategies, policies, procedures, organizational structure and information systems that permit establishing supervisory standards to make sure that different supervisors will adopt the same remedial actions in the same situation. It is not prudent to rely only on the supervisors' experience; it is necessary to have tools and procedures in place to follow during the onsite and offsite examinations that permit the "mitigation" of detection risks

Considering the topics mentioned above, the MUSBER, provides the SBP a bank rating system (called GREN) and a banking supervision system focusing on the assessment of the quality of corporate governance and the quality of risk management, in order to determine the risk provide "at all times" and to adopt the best supervisory strategy based on that profile.

It also includes the Risk Assessment System (RAS). The RAS permits supervisors to assess bank residual risk (the quantity of risk minus the quality of risk management) and is the foundation on which the approach of supervisory processes is determined. In assessing the bank's risk profile, the greatest risk to be found is in those activities in the risk profile that have inappropriate risk management or rudimentary internal controls. Therefore, the supervisor must examine and assess them rigorously.

The architecture of the unique banking supervisory process described in the Uniform Risk-based Approach Supervision Manual (MUSBER) is based on the most advanced conceptual developments for conducting effective banking supervision (especially those of the Basel Committee on Banking Supervision) and the best practices and experiences of the countries of the region and of other countries (the Bank of Spain, the Federal Reserve and the Office of the Comptroller of the Currency of the United States, the Office of the Superintendent of Financial Institutions of Canada, the Superintendency of Financial Intermediation Entities of Uruguay, the Superintendency of Financial and Exchange Entities of Argentina, the Superintendency of Banks and Insurance of Peru and the Superintendency of Banks and Insurance of Ecuador, among others). what is proposed is a rating system which, in compiling the most recent developments on supervisory approaches, takes into account four large areas: Corporate Governance, Risk, Financial – economic condition, and Regulatory Compliance. Additionally, it takes into account previous developments in the SBP and the strategic determinations and situation of Panama.

MUSBER and the principles for effective banking supervision

In 2006, the Basel Committee on Banking Supervision (the "Basel Committee") published the latest version of its 25 Core Principles for Effective Banking Supervision ("Basel Core Principles" – BCP) (the September 2012 version is being analyzed for inclusion in the MUSBER).

If a supervisory body complies with these principles, it should have better control over its banks and, therefore, the country's banking system should be less vulnerable in a crisis. In 1999, the Basel Committee issued the methodology to conduct the BCP assessment: a list of (key and additional) criteria to assess compliance of each principle. The BCP and the methodology have been used by over 130 countries and are the undisputed banking regulatory and supervisory standard. The last version of this methodology is also from 2006 (Basel Committee's "Core Principles Evaluation Methodology").

In that framework, the contents of the MUSBER are developed taking into consideration the Basel Committee's "Core Principles of Effective Banking Supervision," focusing on the key and additional criteria for the principles defined by the Core Principles Evaluation Methodology.

For example, the assessment objectives the supervisor must satisfy and on which he must make a judgment when assessing the risk management process of banks are based on the key and additional criteria defined by the Basel Committee for the BCP's Principle 7 "Risk Management Process."

MUSBER and the principles for corporate governance

In October 2010 the Basel Committee issued a new version of its principles for enhancing corporate governance in banks[2]. The first version was published on February 2006. The July 2015 revised version is being analyzed for inclusion in the MUSBER.

The Principles address basic deficiencies in bank corporate governance that were evident during the financial crisis. The principles include:

- The role of the Board of Directors, including the approval and supervision of the bank's risk strategy;
- The suitability of the Board of Directors. For example, the Board of Directors must have the suitable knowledge and experience for each of the significant activities of the bank, the bank management and supervision;
- The importance of risk management (including the Chief Risk Officer, CRO or its equivalent for big banks and internationally active banks), compliance and internal auditing, each with sufficient authority, independence, resources and access to the Board of Directors;
- The need for identifying, measuring, mitigating/controlling and monitoring individual and consolidated risks. This must be based on risk management systems and internal control infrastructures appropriate to the bank's risk profile;
- Active supervision by the Board of Directors for the design and operation of a compensation system, including the careful alignment of employee compensation for prudent risk-taking.

Furthermore, the principles emphasize the importance of the Board of Directors and Top Management clearly knowing and understanding the bank's operational structure and risks. This includes the risks derived from the bank's own activities as well as from other related structures (e.g. subsidiaries or branch offices).

[2] Basel Committee on Banking Supervision, *Principles for enhancing Corporate Governance*, 2010.

The supervisors also have a critical role in ensuring the best practices of banks related to corporate governance. According to the Committee's principles, the supervisors must establish guidelines to require sound bank corporate governance strategies, policies and procedures. The supervisors should regularly evaluate the corporate governance policies according to the bank's size, complexity of operations, structure and risk profile. The SBP issued Rule 5-2011 whereby the rules on corporate governance were updated; this Rule is used by supervisors, along with the Basel Committee's principles, to assess this area.

Margin for technical criteria

The MUSBER is an objective guide to frame the supervisory process, but it provides a margin for the supervisors' technical criteria (it does not replace the supervisor's opinion or skills).

This means that the MUSBER is a guide to conducting effective baking supervision and, therefore, cannot replace the judgment and professional experience of the SBP's supervisors in deciding the relevant contents for onsite and offsite examinations. To that end, the supervisor must take into account the activities, size and complexity of the banks, in addition to the necessary processes for a cost-effective supervision in accordance with the supervisory standards and the SBP's own policies and principles.

II MUSBER OBJECTIVES

The objective of the MUSBER is to establish the methodology the SBP will apply during the risk-based approach to bank supervision following the guiding principles developed below.

The MUSBER seeks, through defined policies, processes and procedure guidelines, "to diminish the supervisor's detection risk," i.e. the possibility that the processes conducted by the supervisors (control and/or substantive tests) will fail to identify failures in risk management quality and/or errors in the bank's financial statements.

Similarly, the MUSBER provides the SBP a scheme for the timely and appropriate assessment of the banking groups' ability to take and require the necessary measures to foster the stability of the financial system.

III BANKING SUPERVISION FRAMEWORK

Guiding principles of the SBP's banking supervision

The Uniform Risk-Based Supervision Manual (MUSBER) focuses on the following guiding principles:

- The framework of international standards;
- Risk-based supervision;
- Ongoing supervision;
- Comprehensive supervision;
- Effective preventive and corrective actions;
- Corporate governance relevance;
- Consideration of the points of view of the sector's analysts;
- Consolidated and cross-border supervision.

The Framework of International Standards

The exclusive supervisory process is framed on the current international standards related to this matter developed by the Basel Committee on Banking Supervision and other supervisory and regulatory bodies worldwide.

In that sense, this principle permits complying with the strategies of the SBP's Strategic Plan for updating the regulatory and supervisory framework according to the latest trends in the IFRS, Basel and FATF, among others, to guarantee the transparency, efficiency, reliability and security of the Banking Center's operation.

Risk-based supervision

The supervisory strategy will vary according to the particular risks to which the supervised bank is exposed, the operation of the risk management system adopted and, especially, on control effectiveness. In this sense, the rating the bank receives from the SBP will determine the supervisory strategy to be applied. In addition, this definition has a strong impact on the allocation of supervisory resources, which must be consistent with the adopted approach.

Finally, in other dimension of the "risk approach," the SBP will take into account the bank's systemic risk resulting from considering the bank's "condition" and its "size" relative to the financial system, when allocating supervisory resources.

Ongoing supervision

The SBP should have "at all times" an understanding and opinion on the bank's condition, risk profile and rating. The ongoing supervision will use tools such as examinations, follow-up visits, special visits, offsite processes, meetings with the Board/Management, memoranda, official contacts, telephone calls, e-mails, etc. There will always be a current examination rating of the bank that will be complemented and updated with punctual visits or offsite reports.

Comprehensive supervision

There must be an overall, comprehensive assessment of the bank's condition by means of offsite analysis and onsite examination, including the assessments and evaluations of specialized areas, in order to identify the relevant supervisory strategy. The MUSBER integrates the opinions and points of view of the different sections of the SBP that are relevant to rating the bank, as well as the planning and execution of offsite examinations and reporting.

Effective preventive and corrective actions

The supervisory process must seek to foresee problems that may affect the bank's stability in the future and could eventually deteriorate its current solvency. For that, the bank's financial – economic condition and management quality will be assessed continuously to promote the adoption of corrective actions by the supervised bank's top management as early as possible in the case of weaknesses found during supervision.

Relevance of the bank’s corporate governance

The supervision will be conducted based on the strong responsibility banks have for corporate governance according to the SBP’s regulations and taking into consideration beset practices. Corporate governance is the system by means of which banks are directed, monitored and controlled and includes the shareholders, board of directors, top management and the different control mechanisms, such as internal auditing, external auditing and the Auditing Committee.

The way in which each of the corporate governance members meets its role in the comprehensive risk management adopted by the bank will be evaluated to identify, measure, control/mitigate and monitor the risk exposures the bank is taking.

The bank is responsible for implementing a comprehensive risk management system, defined as the set of policies, procedures and control mechanisms implemented by such to foster the appropriate identification, measurement, control and monitoring of risks to which it is exposed.

Consideration of the points of view of the sector’s analysts

The SBP, as in all financial systems in the world, is not the only entity analyzing the banks in Panama. There are other players in the sector that, with different sources of information, approaches and objectives, also evaluate banks. Among these are external auditors, internal auditors, rating agencies and economic analysts. It is considered that the different points of view enrich SBP’s point of view for the work it does directly and, therefore, it includes them as input of the supervisory process.

It seeks to make the participation of other players in the industry permanent and consistent with the regulations. In some cases, the supervisors will use their work as an input in the supervision, to minimize duplication, while, in other situations, it will be complementary. In the latter case, the duplication is used to obtain two different points of view on the same matter. For example, rating agencies and the SBP will both rate banks, but their views are from different perspectives and their responsibilities are dissimilar.

Consolidated and cross-border supervision

Supervision will be conducted on a consolidated basis for banks that belong to a banking group, considering the relationships and risks with the related financial and nonfinancial companies, both in Panama and abroad. This will require designing supervisory processes that permit the appropriate execution of this task, coordinating with other supervisors in the country and abroad and agreeing on mechanisms for the exchange of information that will permit ascertaining the condition of the entire banking group to which the supervised bank belongs.

Consolidated supervision includes cross-border supervision when a bank has branch offices or subsidiaries abroad; i.e. consolidated supervision is necessarily cross-border if the bank has subsidiaries or branch offices abroad. In these cases, there cannot be a consolidated supervision without cross-border supervision. The cross-border supervision is an "input" for the consolidated supervision.

Risk Assessment System (RAS)

The RAS is a methodology that permits determining the residual risk based on the measurement of a bank's risks and the assessment of the quality of the bank's risk. It is the foundation on which the supervisory process approach is determined. This assessment shows both the current valuation and the outlook of the bank's risk profile.

The purpose of the RAS is to determine and assess the risks to which the bank is exposed in its activities and how Top Management manages/controls these risks. The RAS has been designed to evaluate prospectively, i.e. that supervisors consider both the current condition of the bank as well as factors that may indicate risks that are growing. It is very important that supervisors be attentive to early signs suggesting increasing risk levels.

In the RAS, the risk profile of the bank consists of five items:

- Risk quantity;
- Risk management quality;

- Residual risk;
- Residual risk direction;
- Banking group risk.

The first four items (risk quantity, management quality, residual risk and residual risk direction) are the RAS dimensions.

Finally, for the purpose of focusing on the "residual risk," the RAS, having its starting point the identified risks, assesses how these are mitigated by risk management through internal controls and processes, management of each of them, compliance with internal, regulatory and legal procedures, and corporate governance, among others, as visualized below:

Risk quantity - Risk management quality = Residual risk

The results obtained from the risk assessment are summarized in the Risk Matrix described later in this section.

The supervisors must update the Risk Matrix at the end of each supervisory activity, both in planned offsite monitoring activities as well as after onsite inspection visits.

The Risk Matrix is a tool for aggregating and documenting the RAS results. It is one of the foundations for preparing the individual follow-up GREN report and the inspection GREN report. At the same time, we get to the banking group's risk line (which is documented in the consolidated follow-up GREN report) by means of consolidated supervisory processes.

There are two types of risk matrixes: the onsite risk matrix and the offsite risk matrix. The former is based on the business lines and the latter by risk categories. This comes from the characteristics of each type of supervision, as the onsite supervision focuses on the activities/business lines/products and/or services the bank has defined in its business strategy and management while the offsite examination does not have information by business line but by type of risk.

The Onsite Risk Matrix is by business line as shown below:

Business lines	**Risk Quantity** (high, medium-high, medium-low, low)	**Risk Management Quality** (strong, acceptable, improvable, weak)	**Residual Risk** (high, medium-high, medium-low, low)	**Risk Trend** (decreasing, stable or increasing)
Corporate finance				
Treasury				
Retail banking				
Microfinance				
Private banking				
Cards				
Corporate banking				
Collections, payments and settlements				
Trust funds				
Other financial services				
Global risk				
Banking group risk				

The Offsite Risk Matrix is by risk as shown below:

Risk Categories	**Risk Quantity** (high, medium-high, medium-low, low)	**Risk Management Quality** (strong, acceptable, improvable, weak)	**Residual Risk** (high, medium-high, medium-low, low)	**Risk Trend** (decreasing, stable or increasing)
Credit risk				
Liquidity risk				
Market risk (Price)				
Interest rate risk (Banking Book)				
Exchange rate risk				
Operational risk (processes, persons and external events)				
Legal risk				
Information technology risk				
Reputational risk	N/A			
Money Laundering/Terrorism Financing Risk				
Global risk				
Banking group risk				

N/A: Not applicable

Bank ratings and supervisory strategies

The MUSBER anticipates the use of a bank rating methodology called GREN.

As a result of a comprehensive supervisory process, banks are rated according to the GREN methodology. This methodology has a strong emphasis on qualitative aspects, focusing on the banks' corporate governance and risk management. The **GREN** rating includes the following components:

***G**obierno corporativo*	(Corporate governance)
***R**iesgos*	(Risks)
***E**valuación económico-financiera*	(Financial – economic assessment)
***N**ormatividad*	(Regulatory compliance)

The first two components (G and R) are related principally to the bank's management (related to risk-based approach supervision), while the last two components are related to financial – economic condition and compliance (related to traditional supervision). The GREN seeks to collect elements from the modern supervisory approach while keeping those from the traditional approach considered appropriate.

The GREN components are applied to the supervisory process for the individual bank (onsite and offsite), as well as the consolidated supervisory process (offsite). The sub-components for the individual bank examination are different from those for the consolidated supervision.

The GREN is only a rating system for banks but a way of focusing and conducting supervision.

The GREN has a one-to-five scale, "1" being the best possible rating and "5" the worst possible rating. The same rating scale is applied to each of the GREN's components. The Appendix has the guidelines for rating the four components.

To obtain the GREN rating, each component is rated (first analyzing the sub-components of each component) and then the bank is rated. The GREN rating is not an average result or the worst component grade; it will depend on the weighting made by the supervisor on a case-by-case basis. For example, the GREN rating cannot be better than the best of components or worse than the worst component. However, it must be consistent with the rating assigned to the components. This rating also has a 1 to 5 scale, with the same criteria. The GREN rating summarizes the diagnosis and the supervisor's degree of concern and is closely related to the supervisory strategies.

The GREN serves various functions and provides certain advantages. These are listed below:

- It is an opinion or diagnosis of the bank. The rating is the best summarized expression on the situation of a bank. The rating summarizes, on a 1 to 5 scale, the opinion the SBP has on the corporate governance, risk management, financial – economic condition and regulatory compliance of a bank, determined from the onsite and offsite supervisory processes (behind that simple number are many months of work);
- It can be disaggregated into its components and sub-components, permitting an understanding of the main aspects that originated the assigned rating;
- It permits an objective analysis of the bank's situation over time;
- It is an element that defines the supervisory strategy;
- It facilitates coordination among all participants involved in the supervisory process;
- It permits the bank to be ranked according to risk, based on the rating obtained.

Description of supervisory strategies

The strategies are a guide, not a rigid system in which all situations must necessarily be treated the same. The strategies must be used as guides for what generally must be done; if any measure is not met, there must be a justification. Without prejudice of the above, there are measures applicable to a strategy that are applied in subsequent strategies, as well as measures that are taken earlier than foreseen in the guide.

The Appendix describes the supervisory strategies related to the rating determined.

IV SUPERVISORY PROCESS

Onsite individual supervisory process

The purpose of the onsite examination is to verify and assess on site the different GREN components: corporate governance and risk management quality, the quality of the bank's financial-economic information (and condition) and the degree of regulatory compliance, in order to assign an Examination GREN Rating.

The onsite supervisory process consists of three stages:

- Examination planning;
- Examination execution;
- Examination assessment and closing.

Examination planning

The examination schedule must be based on understanding the bank's business, the nature of transactions and the information, accounting and control systems. The schedule must be documented as part of the working papers and must be amended, when necessary, during the examination process.

According to the different businesses they operate, banks are exposed to different risks and have different information, accounting and control systems. For the purpose of meeting the supervisory objectives, an examination strategy must be defined to focus attention on the bank's riskiest areas.

The planning phase has three sub-stages:

- Preliminary assessment of the bank and its business;
- Preliminary risk management quality assessment;
- Definition of examination strategy and scope.

Examination planning stage

Preliminary assessment of the bank and its busiess

- Bank's profile development or updating
- Identification of business lines
- Determination of relevant business lines
- Identification and evaluation of inherent risks
- Coordination meeting
- Preliminary visit planning
- Drafting letter for the first day of the preliminary visit

Preliminary risk management quality assessment

- Preliminary assessment of corporate governance quality
- Preliminary assessment of the risk management process
- Assessment of support areas
- Assessment of specific control environment of business lines defined as relevant
- Communication of preliminary visit results
- Consolidation of the findings and recommendtions matrix
- Coordination meeting
- Preliminary assessmnet of risk management quality

Definition of examination strategy and approach

- Determination of residual risk by business line
- Drafting of the examination planning memorandum
- Approval of the examination strategy and scope
- Drafting letter for the first day of the examination

Examination execution

During this stage the procedures included in the working schedule (examination micro-planning) are conducted in order to assess each of the components and sub-components of the GREN rating methodology and assign ratings to each one of them.

The conclusions obtained from the risk matrix and examination strategy adopted may determine that it is necessary to go into greater detail in the assessment of the relevant business lines associated with risk measurement (e.g. model validation or evaluation of other tools or methodologies of measurement or management) and the verification of compliance with the processes, sub-processes and operational and control procedures of each. Finally, the impact on the risk matrix and GREN rating of the different procedures conducted by each business line defined as relevant will be assessed during the preliminary visit of the inspection and those conducted during the examination.

The examination execution phase will be conducted as follows:

- Assessment of relevant business lines;
- Assessment of models, mathematical methodologies and other tools for risk measurement;
- Draft of preliminary GREN report;
- Draft of the minutes for presenting the examination results;
- Updating the Findings and Recommendations Matrix.

The procedures of this stage consist of the execution of compliance and/or substantive tests, according to the defined strategy.

In order to obtain valid and sufficient judgment elements necessary to support the ratings on the GREN components and sub-components, certain procedures or tests must be conducted to gather or collect them. Considering the impossibility of examining the documentation for all operations or transactions conducted by the bank during the analyzed period, the supervisor must employ selective tests as a means of supporting his/her conclusions and ratings.

Tests can be grouped into compliance and substantive procedures according to the evidence they provide. As a practical matter, they are difficult to classify because may meet a dual purpose. The procedures providing control evidence may also provide substantive evidence on the balance or operations. Similarly, the procedures providing substantive evidence usually permit inferring the existence and effectiveness of related controls.

Examination evaluation and conclusion

The examination evaluation and conclusion has the following sub-phases:

- Coordination meeting of the Divisions;
- Onsite Risk Matrix update;
- GREN examination reporting;
- Draft Rating proposal and supervisory strategy summary;

- GREN examination rating approval;
- GREN report submittal to the bank;
- Closing procedures

The GREN Rating Committee will be responsible for approving the GREN ratings proposed by the Banking Supervision Departments. The Committee will require all seven of the following members for a quorum:

- The Director of Supervision, who will chair the committee;
- The Director of Risk Management;
- The Director of Prevention and Control of Illicit Operations;
- The Deputy Director of Supervision, Team I or Deputy Director of Supervision, Team II;
- Three banking supervision Managers (in rotation);
- The Supervisory Policy, Coordination and Quality Manager;
- The banking supervision Manager responsible for the bank being rated.

When the GREN rating proposed is 3, 4 or 5 the participation of the Superintendent in the GREN Committee meeting will be required. In this case and other cases in which the Superintendent decides to participate, his/her attendance will be considered part of the quorum.

Offsite individual supervisory process

The offsite activities must permit maintaining an updated risk profile of each bank at all times. The supervision must be made on an ongoing basis, integrating the onsite and offsite processes.

The purpose of the offsite individual supervision is to assess — at the SBP's headquarters — the bank's situation and determine whether its risk profile should be updated.

The main aspects evaluated offsite are the bank's financial – economic condition, regulatory compliance and compliance with SBP recommendations (whether made as a result of onsite examinations or offsite requirements).

The offsite activities must permit the supervisors to make a determination of:

- The bank's solvency and its ability to meet the requirements derived from the expiration of contract terms as well as the unusual requests made during the regular course of business;
- The use of best and secure banking practices;
- Compliance with legal frameworks and regulations;
- The bank's permanent viability.

It is essential to have an updated offsite risk profile to detect changes in the bank's condition in a timely manner and to establish the relevant actions. This activity is conducted by updating the risk matrix and GREN rating. As mentioned above, the individual bank's offsite GREN rating is called its "individual follow-up GREN."

The offsite supervisory process consists of three phases:

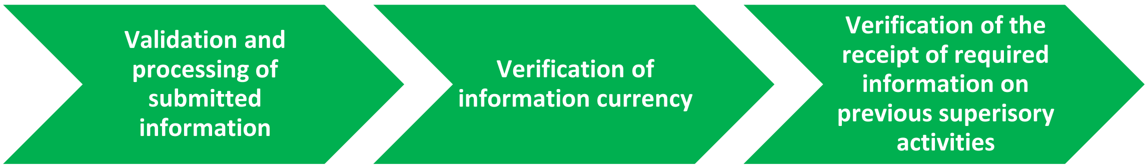
- Receiving and processing information;
- Analyzing and monitoring the risk profile;
- Updating the individual follow-up GREN rating.

All of these phases are conducted at the SBP headquarters and are conducted throughout the supervisory process.

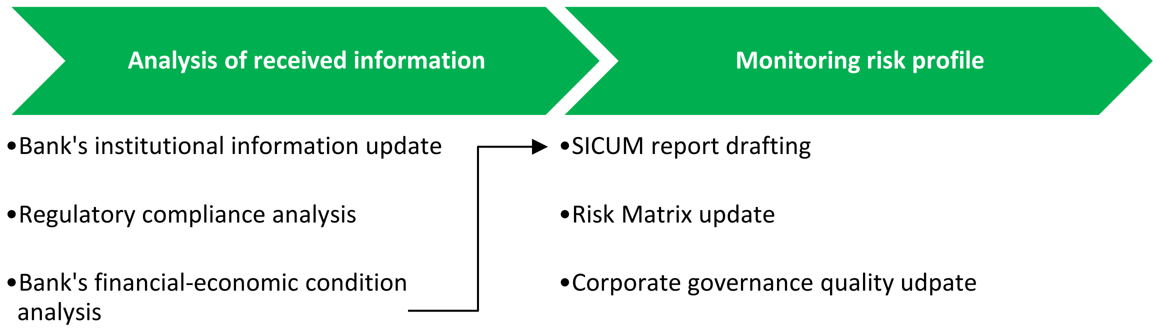
The first two phases are conducted on a monthly basis, while the individual follow-up GREN rating will depend on the supervisory strategy, which could be every 2, 3 or 6 months.

The process phases and sub-phases are explained below.

Receiving and processing information



Analysis and monitoring the risk profile



Updating the individual follow-up GREN rating

Onsite consolidated supervisory process

Article 1 of Decree Law 52 (Banking Law) provides the scope of application; Paragraph 2 includes banking groups as defined in the Banking Law.

In that sense, paragraph 26 of Article 3 defines the banking group as: "one constituted by a bank holding company and its subsidiaries at any level, whose activities consist, predominantly, of providing services in the banking or financial sectors, including nonbanking subsidiaries of the latter which, in the opinion of the Superintendency, operate under common management, either through the bank holding company or through different holdings or agreements."

Subparagraph 12, paragraph I of Article 16 provides that "conducting the consolidated supervision of banking groups in accordance with the provisions of this Decree Law and the Board of Directors" is a duty of the Superintendent.

The consolidated supervision of banking groups is part of the MUSBER and supplements the individual supervision of banks holding general or international licenses that is conducted on a regular basis.

The onsite consolidated supervision is framed within the supervisory process conducted by the SBP, performing activities in two approaches: the group-level supervision and the cross-border supervision, according to the supervised banking group's size and the complexity of its operations.

- The onsite group consolidated supervision consists of examination visits or actions conducted at the entity's main management office (in Panama or abroad), especially in the local bank, the Panamanian holding company or the entity's main management offices abroad. Without prejudice to the above, the examination visits or actions to be conducted on the entities in the insurance and/or securities sector or nonfinancial subsidiaries in the same country will be part of this approach and will be coordinated with the respective domestic supervisors;

- Onsite cross-border consolidated supervision — simply known as consolidated cross-border supervision — consists of examination visits or actions to foreign entities (outside Panama) that are part of the banking group, especially banks and/or other financial, insurance and/or securities entities or nonfinancial subsidiaries in other countries in coordination with the respective domestic and foreign supervisors.

An appropriate consolidated banking supervision is based on the assessment of eight (group-level, cross-border and offsite) sub-components:

- Banking group's corporate governance;
- Banking group's structure;

- Banking group's comprehensive risk management;
- Banking group's capital adequacy and solvency;
- Banking group's consolidated financial situation;
- Group-level transactions, banking group's concentration exposures with related parties and third parties;
- Banking group's consolidation of financial information, drafting and issuance of nonfinancial information;
- Compliance with regulatory requirements and limits.

The purpose of the MUSBER in consolidated supervision is to obtain an assessment of each of these sub-components for the banking groups whose home supervisor is the SBP.

The group's onsite consolidated supervision process consists of three phases:

- Examination planning;
- Examination execution;
- Examination closing.

These phases are not different from those already defined for onsite individual supervision, but the supervision is focused on the banking group's management instead of the bank's or entity's management.

Ideally, the onsite consolidated supervision phases are conducted at the same time or as part of the relevant individual supervision, complementing each other. The simultaneous individual and consolidated onsite measures generate synergies on the quality and flow of information between member entities of the banking group. Since the holding company may be located in the same place as the bank in Panama, one or two of the supervisors conducting the individual examination can be assigned the onsite consolidated supervision forms to evaluate the holding company.

Offsite consolidated supervisory process

The consolidated supervision has a strong offsite supervision component, which is being continuously conducted with the analysis of financial and nonfinancial consolidated information on the bank (consolidated financial statements, reports, surveys) from both the offsite process and examination visits conducted to the entities that are part of the banking group, from other relevant and involved supervisors and any other may provide more information on the banking group's financial condition, business and risk profile.

The purpose of the offsite consolidated supervision is to maintain continuous information on the banking group's profile and, specifically, on everything related to the group's management, its corporate governance quality, its solvency condition, the financial consolidation process and risk concentration, among others.

The main aspects to be evaluated during the offsite inspection are the banking group's financial-economic condition, the compliance of regulations and recommendations made by the SBP to any of the banks that are part of the group (whether as a result of the onsite examinations or offsite requirements).

Corporate governance quality and risk management must be updated when information is obtained from other supervisors or information submitted by the group itself and, of course, information obtained from cross-border onsite visits.

However, the most important point of all is the banking group's solvency, an assessment that no other supervisor can have as long as the extent of his scope of supervision does not extend beyond his jurisdiction. Only the home supervisor has the power to issue a judgment on the banking group's or banking conglomerate's solvency.

Just as with the individual banks, the banking groups are rated according to the GREN rating, but one adapted to the consolidated supervision objectives.

The consolidated GREN rating is assigned during the offsite process in the consolidated follow-up GREN report, which is issued every 6 months.

The consolidated cross-border onsite supervision does not finish when assigning the supervised banking group or foreign bank GREN rating, but the assessment result will impact the next consolidated follow-up or updated GREN (which may be done during the group's consolidated or cross-border supervision visit if any finding requires it).

The product that results from the consolidated cross-border onsite supervision is the cross-border visit report with the findings and specific recommendations that will result from the assessment of the eight sub-components of the consolidated supervision. Below is a guide to establish the relationship between the GREN components and the sub-components.

GREN Component	Sub-component
***G**obierno corporativo* (Corporate governance)	Banking group's corporate governance
	Banking group's structure
***R**iesgos* (Risk)	Banking group's comprehensive risk management
***E**valuación económico-financiera* (Financial-economic condition)	Banking group's capital adequacy and solvency
	Banking group's consolidated financial condition
	Banking group's intergroup transactions and exposure concentration with related parties and third parties
***N**ormatividad* (Regulatory compliance)	Consolidation of the banking group's financial information and development of nonfinancial information
	Compliance with the regulatory requirements and limits

Documentation of the supervisory process

The work conducted by the professional team assigned to the different onsite and offsite examinations is electronically documented by means of the international auditing software known as TeamMate®, installed in the personal computers of each supervisor under strict security measures. The paperwork is transmitted to the SBP's server with the necessary security measures for safeguarding the information and maintaining the highest degree of confidentiality.

All procedures are automated in this tool, which permits maintaining a standardized process ensuring a high level of quality.

V CORRECTIVE MEASURES

Corrective measures are not part of the regular supervisory process. They are rare. However, the regular supervisory process may raise the need for requiring and adopting corrective measures.

The corrective measures foreseen in the current legislation are listed below (in order of seriousness):

- Requirement to appoint an advisor and applying corrective measures (Chapter XV of the Banking Law)
- Seizure of administrative and operating control of the bank (Chapter XVI of the Banking Law)
- Reorganization of the bank (Chapter XVII of the Banking Law)
- Compulsory liquidation (Chapter XVIII of the Banking Law).

The main characteristics of the corrective measures are summarized below.

Appointment of advisor and application of corrective measures

If the Superintendent determines that there exists or may exist a deterioration or operating, administrative or financial weakness in a bank, he may require the bank to appoint one or several persons that meet the required background and experience to advise the bank on specific or general measures that must be taken to remedy the deficiency(ies), in accordance to Article 124 of the Banking Law.

The advisor will have the powers determined by the Superintendent. The advisor will have unrestricted access to all documents, minutes, correspondence and records of the bank, so that he/she may carry out a proper evaluation of the irregularities. The advisor will also have access to all information held by the SBP and will be required to maintain its confidentiality.

The advisor will be appointed for a period of up to 30 days. The Superintendent may extend this term for exceptional reasons.

The advisor will submit reports to the Superintendent, with a copy to the bank, with the frequency that the Superintendent deems necessary.

Seizure of Administrative and Operating Control of the Bank

According to the provisions of Article 131 of the Banking Law and in order to defend the best interests of a bank's depositors and creditors, the SBP may take over administrative and operating control of a bank, including the possession of its assets and seizure of its management, by means of a substantiated resolution in conformity with the grounds described below (and established in Article 132).

The Superintendent may seize administrative and operating control of a bank based on any of the following grounds:

- Upon a substantiated request from the bank itself, if the bank cannot continue operations without jeopardizing the interests of the depositors.
- As a consequence of the evaluation of the report submitted by the appointed advisor.
- Noncompliance with the measures ordered by the SBP resulting from the appointment of the advisor described above.
- If the bank carries out its operations in an illegal, negligent or fraudulent manner.
- If the bank has suspended payment on its obligations.
- If the SBP confirms that the capital adequacy, solvency or liquidity of the bank has deteriorated to the point of requiring the Superintendency's action.

At the moment of seizure of administrative and operating control of the bank, the Superintendent will appoint a competent interim administrator to exercise exclusive legal representation of the bank on behalf of the SBP. The term of the interim administration will not be longer than 30 days, except when, due to exceptional reasons and a prior substantiated request from the administrator, the Superintendent decides to extend it. In this case, the extension shall not be longer than thirty days. The interim administrator may be an employee of the seized bank.

The interim administrator will have the powers determined by the Superintendent at the time he/she is appointed or at a later date, as well as those that are inherent in the tasks assigned to him/her. In any case, it is understood that the interim administrator will have access to all documents, minutes, correspondence and records of the bank.

Among the powers that the interim administrator shall have are the following:

- To stop or limit payment of the bank's obligations, during a period that will not in any case exceed the period of seizure of control.
- To employ any additional personnel necessary and to dismiss those employees whose fraudulent or negligent actions have motivated the seizure of control.
- To attend to the bank's correspondence.
- Any other powers requested by the interim administrator and approved by the Superintendent.
- Any additional powers that the Superintendent considers necessary.

Reorganization of the bank

According to the provisions of Article 142 of the Banking Law: "The Superintendent will decide if a bank should be reorganized based on the measures and changes necessary to protect the best interests of the depositors and creditors."

In the resolution ordering the reorganization, the Superintendent will determine the following:

- The appointment of a reorganizer or a reorganization committee made up of up to three members who shall not have direct or indirect relationships among themselves up to the fourth degree of consanguinity or with the bank or the bank holding company. The reorganizer or the reorganization committee will have exclusive responsibility over the administration and control of the bank while the reorganization lasts and will be accountable to the SBP.

  In the case of a reorganization committee, at least one of its members must have a minimum of five years of experienced in the banking or financial sector. In the case of a reorganizer, he/she must have a minimum of five years of experience in the banking or financial sector. The SBP will designate the person who will preside over the reorganization committee.
- The instructions for the removal of any director, officer, executive, manager or other employee considered necessary.
- The time period within which the reorganization shall be completed. This deadline may be extended or curtailed by the SBP based on a substantiated request from the reorganizer or the reorganization committee.

The reorganizer or reorganization committee shall have the broadest powers to conduct the reorganization. Among these powers are the following:

- To amortize all losses against tier-one and tier-two capital, as well as to determine the value of the stock at that point in time.
- To appoint new managers.
- To authorize the issuance of new stock, as well as its sale to third parties at a price determined by the reorganizer or the reorganization committee.
- To negotiate and execute the merger or consolidation of the bank with one or more banks, obtain loans for the bank, sell or partially liquidate the bank’s assets or accept liens on these assets, according to criteria developed by the SBP.
- To recommend the compulsory liquidation of the bank to the Superintendency.
- Any other powers needed for specific purposes, when requested and justified by the reorganizer or reorganization committee and approved by the Superintendent.

- Any additional powers which the SBP considers necessary.

Compulsory liquidation

According to the provisions of Article 154 of the Banking Law: "If the Superintendent considers that the compulsory liquidation of a bank is necessary, he/she will issue a substantiated resolution by means of which the administrative liquidation of the bank is ordered and which designates one or more liquidators that must comply with the same requirements necessary to act as interim administrators of the bank."

VI SUPERVISOR / REGULATED ENTITY RELATIONSHIP

When conducting its duties, the SBP expects regulated entities to comply with the provisions of the applicable legislation (Banking Law, Trust Law, Prevention Law, etc.) as well as the regulations issued by the SBP (rules, resolutions, circulars, etc.).

In addition, the SBP emphasizes the importance of regulated entities adopting the best practices issued by the Basel Committee, principally those related to Corporate Governance and Risk Management.

Other, no less important expectations include the following: regulated entities must conduct their business with responsibility, prudence, integrity, professionalism and care. They must have adequate financial resources at all times. They should maintain effective risk strategies, risk control systems and internal control systems.

The SBP hopes that regulated entities will interact with the SBP in an open, honest and cooperative manner and disclose any matter on which the SBP may reasonably expect to be informed to the supervisor in a timely manner. The SBP expects total cooperation during its visits to regulated entities for the timely preparation of requested information and response to its inquiries. The SBP is always at the disposal of regulated entities to clarify questions related to the application of laws and regulations.

Maintaining an appropriate supervisor / regulated entity relationship will result in the effective supervisory process necessary for maintaining the soundness, efficiency and reliability of the Panamanian banking system.

APPENDIX

GUIDELINES FOR RATING GREN COMPONENTS AND SUPERVISORY STRATEGIES

G – *Gobierno Corporativo* (Corporate Governance)

Corporate governance is the set of principles and rules that govern the design, integration and functions of the bank's governance bodies. It consists of the bank's direction (the Board of Directors or its equivalent), the management (Top Management), control (Auditing Committee, Internal Audit, External Audit, Compliance Officer, among others) and owners (shareholders). It also encompasses the practices used to conduct the daily management, monitor and control of the business under the applicable laws and regulations. It is the established policies to achieve institutional objectives and to supervise its regulatory compliance. Good corporate governance seeks to ensure that actions are taken in the best interest of the bank, its shareholders and creditors and to respect the rights of consumers and other groups of interest.

The Board of Directors of the bank meets its fundamental role of overseeing the bank's activities, for which they must know the bank's risk profile. Compliance with its role has a critical impact on the bank's viability and solvency.

Supervisors must assess corporate governance when conducting the analysis, because its deficiency can result in important losses for banks, even bankruptcy. The bank's establishment and application of policies to govern their activities and the Board of Directors' and Top Management's verification of their compliance are important for the control functions of the supervisors. The SBP issued Rule 5-2011, which updates corporate governance provisions and is used by supervisors, along with the Basel Committee's Principles for enhancing corporate governance, to assess this area.

The sub-components of Corporate Governance are:

- Practices of the Board of Directors
- Practices of Top Management
- Quality of shareholders
- Control and risk management environment
- Settlement system
- Information and transparency
- Customer service

To assess G – *Gobierno Corporativo* (Corporate Governance) the results of the rating of its 7 sub-components will be considered, without prejudice to taking into consideration other elements the supervisor deems necessary.

Guidelines for rating Corporate Governance

- A **1 rating** is applied to banks whose Board of Directors and Top Management have good mechanisms for planning, implementing and controlling their strategic, business, budgetary and risk strategies plans. There is an active supervision of the bank's functioning. The Board of Directors and Top Management have a smooth relationship with the supervisor and are open to the supervisor's recommendations. They show a proactive problem-solving attitude; the members of the board of directors are suitable, have enough experience and have the appropriate capacity to respond to the market's changing conditions. Their shareholders are responsible and are strongly committed to the bank with regard to capital support. They have an efficient internal control system and a risk management function with sufficient authority, prestige, independence, resources and access to the Board of Directors and Top Management. They have appropriate settlement systems. The bank has adopted good financial information disclosure practices. They have an appropriate customer service framework.

- A **2 rating** is applied to banks whose Board of Directors and Top Management have reasonable mechanisms for planning, implementing and controlling their strategic, business, budgetary and risk strategies plans. There is supervision of the bank's functioning. The Board of Directors and Top management maintain a proper relationship with the supervisor and are open to the supervisor's recommendations. They show a good attitude to problem-solving, have enough experienced and their capacity to respond to the market's changing conditions is appropriate. Their shareholders are responsible and are committed to the bank with regard to capital support. They have an effective internal control system and an adequate risk management function. The bank has adopted financial information disclosure practices. If in fact any of the aforementioned elements require improvement, these situations can be easily resolved by the Board of Directors and Top Management.

- A **3 rating** is applied to banks in which the mechanisms for planning, implementing and controlling their strategic, business, budgetary and risk strategies are weak. The Board of Directors and Top Management do not have a close relationship with the supervisor. There could be doubts on the Board of Directors' and Top Management's experience and capacity to respond to the market's changing conditions. Their shareholders are trustworthy, but there is no visible willingness or ability to provide capital support or support for management. The internal control system and risk management function are weak. There are weaknesses in the design and functioning of the settlement system, information disclosure practices or customer service. Banks receiving this rating evince one or more of the situations described above.

- A **4 rating** is applied to banks in which mechanisms for planning, implementing and controlling their strategic, business, budgetary and risk strategies plans have markedly significant weaknesses. The Board of Directors and Top Management do not understand or are not committed to solving identified problems. The capability or experience of the members of the Board of Directors is not sufficient for the bank's type, size or condition. The type of support the shareholders provide to the controlled bank raises concerns; their reliability and financial – economic condition are weak, making it difficult to expect their support in solving problems. The internal control system and the risk management function have very significant weaknesses. Their settlement system does not conform to the types of risks assumed. There are very significant customer service weaknesses. Banks receiving this rating evince one or more of the situations described above.

- A **5 rating** is applied to banks lacking mechanisms for planning, implementing and/or controlling their strategic, business, budgetary and risk strategies. The Board of Directors and Top Management do not demonstrate the capacity to solve problems. The shareholders have very significant weaknesses in terms of their reliability, financial – economic condition and/or ethical issues, which are an impediment to solving problems or may create problems for a solvent bank. There are strong imbalances between risks and settlement. The bank has not adopted financial disclosure practices. There are no customer service procedures. Significant risks have been detected from inadequate processes, threatening the future viability of the bank. Banks receiving this rating evince one or more of the situations described above.

R - *Riesgos* (Risks)

The assessment of a bank's risk management is a basic aspect of appropriate banking supervision. In that sense, following the provisions of the Basel Core Principles' Principle 7, banking supervisors must be satisfied that banks and banking groups establish a comprehensive risk management process (including the appropriate supervision by the Board of Directors and Top Management) to identify, measure, mitigate/control and monitor (IMMM process) risk exposures they are assuming. They should also analyze whether the bank's capital is adequate for their risk profile.[3]

The following risks will be assessed:

- Credit risk
- Liquidity risk
- Market (price) risk
- Interest rate risk (banking book)
- Exchange risk
- Operating risk
- Legal risk

[3] Capital adequacy will be assessed with the following component E – *Evaluación económica-financiera* (Financial-economic evaluation).

- Information technology risk
- Reputational risk
- Money laundering/financing of terrorism/financing the proliferation of weapons of mass destruction risk

To assess the above risks, supervisors must take into account Basel Committee standards as well as the following rules, among others, issued by the SBP:

Rule 8-2010 on comprehensive risk management
Rule 4-2008 on legal liquidity index
Rule 5-2001 on market risk
Rule 4-2013 on credit risk
Rule 7-2011 on operating risk
Rule 3-2012 on information technology risk
Rule 10-2015 on the prevention of the misuse of banking and trust services

To assess R – *Riesgos* (Risks) the results of the rating of its 10 sub-components will be considered, without prejudice to taking into consideration other elements the supervisor deems necessary.

Guidelines for rating Risks

- A **1 rating** is applied to banks with a strong risk culture and an effective risk management framework. The Board of Directors understands the risks taken and has established clear definitions regarding its risk tolerance level, as well as its nature. The risk levels are conservative, showing a balance between risk and return. They have defined guidelines not only for the management of the most important individual risks but for the holistic level as well. These guidelines are understood and adhered to within the organization without exceptions. The bank has appropriate risk strategies, policies, processes, procedures, limits, organizational structure, models and tools, internal control system and information systems to manage all its risks. The anti-money laundering and counter terrorism financing management is appropriate.

- A **2 rating** is applied to banks with an appropriate risk culture and an effective risk management framework. The Board of Directors understands the risks taken and has established clear definitions regarding its risk tolerance level, as well as its nature, although there could be areas where greater attention or clarity from the Board of Directors or Top Management is required. The risk levels are conservative to moderate and generally show a balance between risk and return. They have defined guidelines not only for the management of the most important individual risks but for the holistic level as well. In general, these guidelines are understood and adhered to within the organization, but with some exceptions. The bank has “reasonable” risk strategies, policies, processes, procedures, limits, organizational structure, models and tools, internal control system and information systems to manage important risks. Although some of the elements mentioned above require some improvement, weaknesses are not significant and can be easily resolved by the Board of Directors and Top Management. The anti-money laundering and counter terrorism financing management shows areas that can be improved and/or minor important weaknesses or non-compliances that can be rapidly remedied by the Board of Directors of Top Management.

- A **3 rating** is applied to banks without a risk culture and with weaknesses in their risk management framework. The Board of Directors has not taken a leadership role in understanding risks and establishing the nature and level of risk tolerance, delegating these decisions to Top Management. The bank has weaknesses in its risk strategies, policies, processes, procedures, limits, organizational structure, models and tools, internal control system, information systems to comprehensively manage risks or in some particular type of risk. There is an imbalance within the organization favoring the commercial departments. The anti-money laundering and counter terrorism financing management shows important weaknesses or non-compliances that require the application of immediate measures by the Board of Directors or Top Management. Banks that receive this rating evince one or more of the situations described above.

- A **4 rating** is applied to banks that show weaknesses in the established comprehensive risk management framework or, particularly, in any of their risks that, if not solved immediately, can affect the bank's viability. The nature and risk tolerance levels the bank is willing to accept are not defined; individual decisions are made without reference to framework. The bank may or may not have very significant weaknesses in risk strategies, policies, processes, procedures, limits, organizational structure, models and tools, internal risk management control or comprehensive risk management systems or in particular for some specific risk. There is an imbalance within the organization favoring the commercial departments. The bank's anti-money laundering and terrorism financing management shows serious weaknesses and non-compliances that require the attention and implementation of immediate measures by the Board of Directors or Top Management. Banks receiving this rating evince one or more of the situations described above.

- A **5 rating** is applied to banks showing very significant weaknesses in the established comprehensive risk management framework. The data provided by the bank cannot be trusted and it must be assumed that the financial-economic condition is worse than that presented in the financial statements. There is a strong imbalance within the organization favoring the commercial departments. There is no (or almost negligible) anti-money laundering and terrorism financing management, which represents a high risk for the viability of the bank in terms of reputational risk. Banks receiving this rating evince one or more of the situations described above.

E- *Evaluación económico-financiera* (Financial - economic assessment)

The banks' financial-economic assessment permits establishing their degree of soundness in facing adverse situations.

The sub-components of the financial-economic assessment are:

- Profitability
- Assets
- Liabilities and liquidity

- Equity

To assess E – *Evaluación económico-financiera* (Financial – economic assessment) the results of the rating of its 4 sub-components will be considered, without prejudice to taking into consideration other elements the supervisor deems necessary.

Guidelines for rating the Financial-economic assessment

- A **1 rating** is applied to banks with good results sufficient to support operations and equity growth. It shows a low risk of overvaluation of assets. The asset structure does not cause any concern to supervisors and there are no significant concentrations. The weaknesses detected are minimal in relation to the protection the bank provides to equity and the ability of the Board of Directors and Top Management to handle these situations. There is very low risk of facing funding problems and the funding structure does not cause any concern to supervisors. The bank has appropriate liquidity levels, possesses alternative sources of funding and shows appropriate levels of concentration of funding sources. The bank has a very good capacity to face adverse market situations. Capital adequacy is met comfortably.

- A **2 rating** is applied to banks with satisfactory results sufficient to support operations and equity growth. It shows a moderate risk of overvaluation of assets. The assets structure and assets concentration levels may require some improvement. The bank has reasonable liquidity levels; it can access alternative sources of funding and shows appropriate levels of concentration of funding sources. The bank has an appropriate equity level compared to its risk profile. The bank has a good capacity to face adverse market situations. It complies satisfactorily with capital adequacy. The weaknesses detected are minimal compared to the protection provided by equity and the capacity of the Board of Directors and Top Management to handle these situations.

- A **3 rating** is applied to banks that need to improve results and whose operating results are not sufficient to support operations and maintain equity growth. The bank shows a risk of overvaluation of assets, and the impact of eventual adjustments on its capital adequacy may be significant. The asset structure and assets concentration levels are not appropriate. It shows a moderate risk of facing funding problems. The funding structure may be of concern to supervisors. The bank's liquidity levels are exposed to changes in conditions which could present weaknesses. The bank has few alternate sources of funding and has a concentration in sources of funding. The bank has an equity level that does not adequately support its risk profile. The bank needs to improve its equity, regardless of whether or not it is complying with capital adequacy. There may be temporary deficiencies in capital adequacy, but it appears that the situation can be resolved in the short term. Banks receiving this rating evince one or more of the situations above.

- A **4 rating** is applied to banks with deficient results. It shows important fluctuations in the results components in terms of quantity, trend and stability. Operating results do not support operations to maintain an appropriate equity level. It shows a high risk of overvaluation of assets and the impact of the resulting adjustments on equity capacity may be significant. The economic value of its assets is far below their accounting value. The assets structure and assets concentration levels are of concern. They show a high risk of facing funding problems. The funding structure is of concern to supervisors. The bank's liquidity levels are very exposed to changes in conditions, having presented some deficiencies. The bank needs equity improvement. There are no clear indications that this situation can be solved in the short term. Bearing in mind its risk profile, the weaknesses evident in asset and/or profit structure, the bank's viability may be threatened. Shareholder help is required. Banks receiving this rating evince one or more of the situations above.

- A **5 rating** is applied to banks with critically deficient results. The bank's viability may be threatened by the impact of recurrent adverse results which deteriorate its solvency level more and more. It has a high risk of overvaluation of assets and the equity capacity could not absorb the adjustments derived from resulting adjustments. The economic value of assets is far below their accounting value. It is very vulnerable to funding problems. The funding structure is of serious concern to supervisors. The bank's liquidity level is deficient. It shows important equity insufficiency or may show it in the short term. The bank needs major equity improvement. There are no expectations that it can overcome this situation in the short term. Bearing in mind its risk profile, the significant weaknesses that derive from the asset and/or profit structure, there are definite doubts about the bank's viability. Immediate shareholder help is required. Banks receiving this rating evince one or more of the situations above.

N- *Normatividad* (Regulatory compliance)

This component focuses strictly on the bank's regulatory compliance.

The regulatory compliance assessment covers not only regulations (prudential and others) but the SBP's requirements in observations resulting from the onsite and offsite examinations, as well as from control plans.

The sub-components of regulatory compliance are:

- Technical standards (liquidity and solvency – Rule 4-2008 on liquidity and Rule 5-2008 on capital adequacy that will be rescinded on January 1, 2016 by Rule 1-2015)
- Other regulations
- Compliance with observations resulting from onsite and offsite examinations
- Compliance with capital adequacy programs

In assessing N – *Normatividad* (Regulatory compliance), the results of the rating of its 4 sub-components will be considered, without prejudice to taking into consideration other elements the supervisor deems necessary.

Guidelines for rating Regulatory Compliance

- A **1 rating** is applied to banks that have complied with all technical standards and all other regulations during the last twelve months. The bank has complied with or implemented all action plans — in both time and form — to remedy findings, recommendations and non-compliances identified during onsite and offsite examinations. The bank has not been required to have an adequacy program in the last two years.

- A **2 rating** is applied to banks that have generally complied with all technical standards and all other regulations during the last twelve months. Although the bank may have presented a particular non-compliance (in any month, but not repeatedly), it is not considered relevant. Although the bank has not complied with or implemented all action plans to remedy the findings, recommendations and non-compliances identified during onsite and offsite examinations, those pending are not significant.

- A **3 rating** is applied to banks that have not complied with various technical standards or other regulations repeatedly in the last twelve months, but which can correct the situation in the short term[4]. The bank does not show difficulties in complying with the technical standards associated with solvency. It has not complied with or implemented the corrective actions to remedy the findings, recommendations and non-compliances identified during onsite and offsite examinations. The Board of Directors and Top Management understand the importance of solving the identified findings, recommendations and non-compliances, which translates into having drafted a concrete action plan with the deadlines for solving each problem. The bank is under an "Appointment of Advisor and Application of corrective measures" requirement (Chapter XV of the Banking Law), which is being complied with to date. Banks receiving this rating evince one or more of the situations above.

- A **4 rating** is applied to banks that have not complied with various technical standards or other regulations repeatedly in the last twelve months and have been unable to correct the problem in the short term, but will in the medium term[5]. Regarding its solvency, the bank may show a temporary minor equity deficiency, but there are clear expectations for solving it in the short term. The bank has not complied with or implemented corrective actions to remedy the findings, recommendations or non-compliances identified during onsite and offsite examinations. The Board of Directors and Top Management do not show evidence of fully understanding the importance of solving detected weaknesses or do not show any commitment to solving the problems.

[4] The short term refers to three months.
[5] The medium term refers to six months.

This lack of commitment is reflected in the fact that the bank has not drafted a convincing plan or has not met the established deadlines. The bank is under an "Appointment of Advisor and Application of corrective measures" requirement (Chapter XV of the Banking Law), which has not been complied with to date. Banks receiving this rating evince one or more of the situations above.

- A **5 rating** is applied to banks that have failed to comply with various technical standards or with other regulations repeatedly in the past twelve months, without correcting the situation in the medium term[6]. Regarding its solvency, the bank shows equity deficiencies compared to the required capital funds and there is no clear expectation of a solution in the short term. The bank has not complied with or implemented corrective actions to remedy the findings, recommendations or non-compliances identified during onsite and offsite examinations. The Board of Directors and Top Management do not show evidence of fully understanding the importance of solving detected weaknesses or do not show any commitment to solving the problems. If the problems are not solved or faced, the bank's viability may be questioned. The bank is under an "Appointment of Advisor and Application of corrective measures" requirement (Chapter XV of the Banking Law), which is not being complied with to date or shows significant non-compliance. Banks receiving this rating evince one or more of the situations above.

Individual GREN Rating and Supervisory Profile

For the individual GREN rating, the results of the rating of the 4 components will be considered, without prejudice to taking into consideration other elements the supervisor deems necessary. Similarly, the rating should be based on whether or not problems raising concerns for the supervisor exist. If problems raising concern for the supervisor are identified, the capacity and willingness of the Board of Directors, Top Management and shareholders to solve them, and last but not least, the bank's solvency, should be considered.

The supervisory risk profile resulting from the rating of the 4 components is:

[6] The medium term refers to six months.

GREN	Supervisor's Risk Profile
1	There are no concerns for the Superintendency of Banks. Within the findings, there is no regulatory non-compliance; the report will include only recommendations.
2	There are no important red flags for the Superintendency of Banks and the general recommendations are minor. Within the findings, there may be regulatory non-compliances in matters the bank is able to solve immediately; the findings are mainly recommendations.
3	There are concerns for the Superintendency of Banks in one or more components. Within the findings, there is regulatory non-compliance and the recommendations are significant and require a greater commitment by the Board of Directors and Top Management. A timetable for solving all of these findings is established.
4	There are significant concerns for the Superintendency of Banks. The findings include a significant number of regulatory non-compliances; there are weaknesses in most of the bank's areas. The bank has defined target dates for definitively solving all non-compliances.
5	There is the major concern for the Superintendency of Banks. Within the findings, there are legal and regulatory non-compliances; the Superintendency of Banks will take over the administration.

Supervisory Strategy

The supervisory strategy will vary depending on the particular risks to which the bank is exposed, the functions of the comprehensive risk management system adopted and, particularly, the effectiveness of the controls. In this sense, the rating a bank receives from the SBP will determine the supervisory strategy to be applied. In addition, this determination has a strong impact on the allocation of supervisory resources, which must be consistent with the approach adopted.

For individual rating, a supervisory strategy will be determined for the bank for the next supervisory cycle. The criteria for the determination of the strategy are:

Examination GREN and individual follow-up GREN	Supervisory Strategy
1 or 2	Normal
3	Intensive
4	Warning and remedial action
5	Resolution

The description of supervisory strategies is as follows:

Normal Strategy: To be applied to banks holding a 1 or 2 GREN rating. The SBP has determined that corporate governance, the risk management system, financial – economic condition, and compliance with regulations, policies and procedures are generally appropriate and there are no significant problems or control deficiencies. There could be minor recommendations to the bank to solve matters that do not indicate significant concern for the supervisory.

The activities included in this strategy are:

- Emphasizing the offsite examination to assess the financial-economic condition and risk profile.
- Making risk assessments and conducting individual follow-up GREN ratings on a semi-annual basis, as a minimum, to determine whether risk levels remain low.
- Conducting interviews with the bank's Top Management to understand the managerial view on its own performance.
- Running examination GREN ratings focused on internal control systems and corporate governance quality to confirm that they are still trusted by the supervisor.
- Informing the bank of detected weaknesses on a timely basis.
- Continuous follow-up on the recommendations made.

Intensive Strategy: To be applied to banks holding a 3 GREN rating. The SBP has determined that corporate governance, the risk management system, financial – economic condition, and compliance with regulations, policies and procedures have deficiencies which may create greater problems if they are not solved. There is a low risk of non-compliance with the equity requirements provided in the regulations.

The activities included in this strategy are:

- Increasing the periodicity and intensity of the offsite monitoring for assessing the financial-economic condition and risk profile and, if necessary, asking for additional information.
- Requiring the bank to submit a corrective action plan to solve weaknesses.
- Following up on the recommendations made and compliance with the corrective action plan.
- Meeting with the Board of Directors or Top Management to discuss concerns and solutions. Engaging the shareholder(s) in solving problems. The relationship with the authorities must change, making clear that weaknesses exist and the bank is responsible for solving them.
- Conducting risk assessments and making individual follow-up GREN ratings on a quarterly basis, as a minimum.
- Making inspection GREN ratings more frequently and/or conducting special visits to supervise areas of concern.
- Informing the bank of detected weaknesses on a timely basis.
- Preparing a contingency plan in case the results expected are not produced (e.g. restrictions to their operations).

In this case, adopting this strategy may trigger the appointment of an advisor and the application of corrective measures (Chapter XV of the Banking Law) at the Superintendent's discretion.

Warning and Remedial Action Strategy: To be applied to banks holding a 4 GREN rating. The SBP has determined that there as substantial deficiencies in corporate governance, the risk management system, financial – economic condition, and compliance with regulations, policies and procedures that may create major problems if they are not solved. The Board of Directors, Top Management and shareholders (corporate governance) do not show the necessary ability or willingness to solve the problem. There is no non-compliance with the capital requirements provided in the regulations.

The activities included in this strategy are:

- Conducting special visits by specialists in the areas of concern.
- Conducting individual follow-up GREN ratings on quarterly basis, as a minimum.
- Imposing restrictions on business lines in order to maintain or reduce risks taken and/or increase the information submitted to the SBP.
- Having a greater presence of supervisors in the bank in order to monitor the condition with “first hand” information.
- Designing a contingency plan that covers a scenario producing rapid deterioration of the bank’s situation. If the bank’s solvency or liquidity were threatened and there were a lack of appropriate management, consider the relevant measures, such as changing management, as well as assessing other alternatives.
- Meeting the Top Management and Board of Directors to discuss concerns and solutions. Engaging the shareholder(s) in solving problems. The relationship with the authorities must change, making clear that weaknesses exist and the bank is responsible for solving them.
- Strictly following up on the recommendations made and compliance with the action plan. Complement such with follow-up visits.
- Making onsite visits to verify the quality of the information handled.

In this case, adopting this strategy may trigger the appointment of an advisor and the application of corrective measures (Chapter XV of the Banking Law) at the Superintendent’s discretion. However, this strategy can also trigger the seizure of administrative and operating control of the bank (Chapter XVI of the Banking Law) at the Superintendent’s discretion.

When a bank is assigned a Warning and Remedial Action Strategy, the Director of Banking Supervision must follow up on the actions and inform the Superintendent and the Board of Directors of the SBP of the situation.

Resolution Strategy: To be applied to banks holding a 5 GREN rating. The SBP has determined that there are severe deficiencies in which there are already non-compliances with the minimum capital required by the regulations based on the risks taken by the bank and there are no clear expectations of this situation being resolved in the short term.

The activities included in this strategy are:

- Strictly monitoring the situation and reporting the actions taken and the expectations to the Director of Banking Supervision, the Superintendent and the Board of Directors of the SBP.
- Designing a contingency plan that covers a scenario producing rapid deterioration of the bank's situation. If the bank's solvency or liquidity is threatened and management does not take appropriate action, consider the relevant measures, such as changing management, as well as assessing other alternatives.
- Conducting individual follow-up GREN ratings on a bi-monthly basis, as a minimum.
- The measures must be oriented to recovering the bank's capital support. Without prejudice to the requirement in this stage for the supervisor to develop a Contingency Plan according to the evolution of the bank's capital condition that can be applied at any point, if capital falls below 50% of the regulatory capital required according to the risks taken, the supervisor is required to evaluate adopting precautionary special measures under the existing legal framework.

In this case, adopting this strategy may trigger the seizure of administrative and operating control of the bank (Chapter XVI of the Banking Law) at the Superintendent's discretion.