SMALL BUSINESS CORPORATION
TRANSFORMING THE MSME LANDSCAPE

dti PHILIPPINES BAGONG PILIPINAS

RISK MANAGEMENT

I. Risk Management Policy

The Small Business Corporation (SB Corporation) pursues adequate and effective risk management systems commensurate to its risk-taking activities. Towards this end, SB Corporation aims to implement best practices in Enterprise Risk Management (ERM) acrossits systems and processes.

II. Enterprise Risk Management Framework

The ERM Framework of SB Corporation was formally established with the approval by the Governing Board of the ERM Manual through Board Resolution No. 2282, s. 2016 dated 10March 2016. The ERM framework is updated through continuing issuances of relevant guidelines and tools prescribed by the BSP, such as, Information Technology Risk Management Framework per Board Resolution No. 2019-04-2734, s. 2019 dated 11 April 2019, Operational Risk Management Framework per Board Resolution No. 2023-3401, s. 2023 dated 24 March 2023, and Information Security Strategic Plan per Board Resolution No. 2023-08-3490, s. 2023 dated 4 September 2023.

Financial institutions are in the business of taking risks. SB Corporation – as the organization charged primarily with the responsibility of implementing comprehensive policies and programs to assist micro, small and medium enterprises (MSMEs) by way of providing access to finance, among others – has risk taking as an integral part of its business. Its ability to manage risks thus allows the institution to live up to its mandate as provided for under Republic Act No. 9501, otherwise known as the Magna Carta for Micro,Small and Medium Enterprises.

As a government-owned and controlled corporation (GOCC) administratively attached to the Department of Trade and Industry (DTI), SB Corporation aligns itself to national goalsand objectives for MSME development as outlined in the MSME Development Plan 2023-2028. This provides the context by which the Corporation's ERM Framework operates.

SB Corporation's Governing Board and Senior Management effectively drives its ERM, withthe former being charged with approving and overseeing the implementation of the institution's strategic objectives, risk strategies and corporate governance while the lattermanages day-to-day affairs. Together, they set the tone for managing risks across its systems and processes which is shared at all levels of the institution.

The engine driving SB Corporation's ERM vehicle is the linkage between its Strategic Planning, Risk Management and Capital Management Processes. This is anchored on four (4) key components, namely: 1) Risk Organization and Governance; 2) Processes and Policies; 3) Data and System Infrastructure; and, 4) Risk Measurements.

These components undergo a continuous cycle of improvement where design translates to implementation and is regularly monitored for enhancement. Thus, ERM is subject of an iterative process and takes on a dynamic form that adjusts to the dynamic risk environment and responds to both internal and external factors and changes in its business model.

III. Enterprise Risk Management Roles and Responsibilities

The following key principles guide SB Corporation's approach to ERM:

Finance and Risk Oversight Committee (Board-level)

The role of the Finance and Risk Oversight Committee (FROC) is to set the direction and overall risk strategies. It provides oversight to the Management of SB Corporation ensuring that risks are effectively managed across the Corporation in a timely and appropriate manner.

President and CEO

The President and CEO maintains ultimate accountability for the management of the institution's risks, including issuing directives for their management. The P/CEO likewise authorizes and owns the ERM Policy and issues final approval of the ERM risk appetite statements.

Management Committee (Management-level)

The Management Committee (MC) is a senior management-level committee chaired by the P/CEO. It shall be responsible for ensuring that the risk-taking activities of SB Corporation are aligned with the strategy approved by the Board of Directors. It shall also be responsible for developing and implementing policies and procedures that lay down the conditions and guidelines for an effective risk management process, as well as proper channels of communication to ensure that these policies are clearly communicated and adhered to by all levels of the organization.

The risks include the typical risks faced by a financial institution (e.g., credit, market, operational and information security risks), along with emerging risks that could impede SB Corporation's ability to achieve its strategic objectives. The MC is broadly responsible for ensuring that risks are managed to create value and, in a manner, consistent with established risk appetite and risk tolerance levels.

Group Heads

Group Heads (GHs), collectively called as Middle Management, serves as the ultimate risk owners. Groups will adopt and follow the ERM Framework and the ERM Policy and participate in enterprise-wide risk management efforts and perform risk management activities within their respective offices. GHs are responsible for implementing consistentrisk management practices in alignment with this policy.

It is the responsibility of the GHs to disaggregate the enterprise-level risk appetite statements into unit-specific risk limits, where applicable. They will also assist the ERM Group in creating ad hoc risk analysis teams to serve as subject matter experts during the risk identification and analysis process.

Chief Risk Officer (CRO)

The Chief Risk Officer serves as the principal advisor to the P/CEO on all risk matters that could impact the institution's ability to perform its mission. The CRO is responsible for the design, development, and implementation of the ERM program of SB Corporation. The CRO, inconjunction with the ERM Unit, will lead the institution in conducting regular enterprise risk assessments of business processes or programs at least annually and will oversee the identification, assessment, response, and monitoring of enterprise risks. The CRO will take an active role in strategic planning and integration of risk management principles across the enterprise.

ERM Unit

This refers to the existing Enterprise Risk Management Group. The Unit leads ERM activities under the supervision of the CRO. Such activities include developing and maintaining ERM policies, processes, procedures, tools, and information systems; leading efforts to perform enterprise risk identification, assessment, prioritization, reporting, and monitoring; and, establishing ERM communication at all levels and for gathering data and developing risk reports.

To further strengthen enterprise risk management and internal controls and inform risk management approach by enhancing the Corporation's ability to timely identify and assess all material risks, including new and emerging risks, as well as hard to quantify risks, the CRO or his next in line were included as a permanent resource person to the various Management-Level committees of SB Corporation.

IV. Management of Material Financial Risks

Risk identification and assessment is the fundamental element of an effective risk management system. It allows SB Corporation to better understand its risk profile and allocate risk management resources and strategies more effectively.

SB Corporation is exposed to a variety of financial risks such as market risk (including, interest rate risk and price risk), credit risk, and liquidity risk. The financial risks are identified, measured, and monitored through various control mechanisms. This is to adequately assess market circumstances, thereby helping avoid adverse financial consequences for the institution.

This is to likewise ensure that SB Corporation performs its developmental mandate as a Non-Bank Financial Institution (NBFI) and not merely duplicates what the mainstream players in MSME finance (e.g., private banks and financial institutions, government financial institution, etc.) are already doing. SB Corporation develops and operates its financing programs along these lines, to optimize the utilization of National Government investments by not contributing to the cycle of poverty and debt for small business owners.

Over the years, SB Corporation's understanding of the nature of our unique role in MSME finance has deepened, which can be seen in its innovative and countercyclical product offerings as well as in how it evaluates risks and allocates limited resources.

The Corporation's risk management policies for each financial risk factor are summarized below:

a. FINANCIAL RISK

SB Corporation is exposed to a variety of financial risks such as market risk (including currency risk, interest rate risk and price risk), credit risk and liquidity risk. The financial risks are identified, measured, and monitored through various control mechanisms to assess adequately the market circumstances to avoid adverse financial consequences. This is to ensure that SB Corporation performs its mandate as a government-owned and controlled corporation (GOCC) and not merely duplicates what the private sector and other GOCCs are already doing. This is to likewise optimize the utilization of NG investments by not contributing to the cycle of poverty and debt for small business owners.

SB Corporation's risk management policies for each financial risk factors are summarized below:

i. Market Risk

Market risk is the risk to earnings or capital arising from adverse movements in factors that affect the market value of financial instruments, products, and transactions in the institution's overall investment portfolio. The market risk of SB Corporation as at December 31, 2022 is primarily interest rate risk.

SB Corporation anticipates, measures, and manages its interest rate sensitivity position to ensure its long run earning power, buildup of its investment portfolio and avoid economic losses. Special emphasis is placed on the change in net interest income/expense that will result from possible fluctuations in interest rates, changes in portfolio mix and tenor.

ii. Liquidity Risk

SB Corporation seeks to manage its liquidity profile to be able to finance operating and capital expenditures and service maturing debts. To cover its financing requirements, corporate and P3 funds shall be intended to utilize.

As part of its liquidity risk management, the Corporation regularly evaluates its projected and actual cash flows and institutes liquidity risk controls. It also continuously assesses conditions in the financial markets for opportunities to pursue fund raising activities in case any requirements may arise. Fundraising activities may include stand-by credit lines from government banks.

iii. Credit Risk

Credit risk is the risk of financial loss to SB Corporation if a counterparty to a financial instrument fails to meet its contractual obligations.

In view of its mandate to safeguard the interest of the public and contribute to the promotion of stability in the economy, SB Corporation manages credit risk at all relevant levels of the organization. It defines credit risk as the risk that the loans granted to borrowers and/or other financial institutions will not be paid when due, that causes incurrence and financial losses. Credit risk is found in all activities where success depends on counterparty, issuer, or borrower performance. It arises any time when SB Corporation's funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreements, whether reflected on or off the statements of financial position.

Credit Risk Management aims to adequately manage the risk of financial loss arising from the failure of borrowers or counterparties to settle their obligations in accordance with the terms and conditions of the duly approved contractual agreement.

This involves the identification, measurement, and monitoring of actual or potential losses and the implementation of appropriate measures, including the setting up of applicable limits to keep credit risk exposures within the Corporation's risk appetite or the acceptable level of credit risk that is willing to accept in pursuit of its lending plans and programs.

Credit risk is not limited to the loan portfolio. SB Corporation therefore exercises prudence in the grant of loans over its exposures to credit risk, taking into consideration the developmental objectives of the Corporation as mandated by the Magna Carta for MSMEs. This is managed through the implementation of the borrower risk rating and monitoring of loan covenants in the loan agreements. The borrower risk rating is being used, among others, as a basis for determining credit worthiness of loan applicants. The Corporation uses credit evaluation criteria dependent on the lending programs when initially considering a prospect. When the prospect passes and meets these criteria, the Corporation performs qualitative and quantitative analyses to determine creditworthiness of the prospect. The qualitative analysis includes evaluation of the borrower's ownership, business operations, collateral, and others. The quantitative analysis includes review of past and present financial condition and future expectations based on assumptions and projections. Accordingly, approval of loan application goes through prescribed loan approving levels depending on the transaction or amount of loan applied and based in SBC CASA. Further, the Corporation mitigates such credit risks through the acceptance of eligible collateral as a secondary form of payment.

SB Corporation performs it mandate of implementing comprehensive policies and programs to assist MSMEs in all areas, including but not limited to finance and information services, training and marketing and collateral is not the primary factor in granting of credit. The required amount and type of collateral and other credit enhancements to mitigate credit exposures depend primarily on the results of the holistic and prudent credit assessment based on the lending program's requirements. When needed, the Corporation evaluates the enforceability, realizable value, and marketability of offered collaterals and other credit enhancement.

Credit Risk Assessment

The company's credit risk assessment is performed based on the different segments of the financial asset portfolio.

Loans, regardless of if the accounts have been fully paid, extended or renewed in a subsequent year or period, are subjected to evaluation for possible losses. SB Corp's estimation of credit exposure for risk management purposes is complex and requires the use of models, as the exposure varies with changes in loan characteristics, payment behavior and credit risk. The assessment of credit risk of a portfolio of assets requires further estimations as to the PDs occurring, of the associated loss ratios and of default correlations between counterparties; accordingly, such credit risk is measured using PD, LGD and EAD for the purposes of measuring ECL.

The SB Corporation adopted an ECL model that consider the estimated timing of loss and the three major factor in calculation of ECL as probability of default (PD), exposure at default (EAD) and loss given default (LGD). The model is on a per borrower basis whereas each borrower is assigned its own PD and EAD which are calculated through a Machine-Learning (ML) regression and classification model.

The PD predicts the likelihood of default given the borrower's profile and payment behavior over a specified time horizon (12-month or lifetime). It was predicted through a machine learning modeling of historical loan data. Through model selection and validation, two (2) separate regressor models were developed for the calculation of 12-month PD and lifetime PD. Both models employed a Random Forest Classification Algorithm. The regressor model allows the prediction of the probability of default of the current portfolio of the borrower within 12 months and within its entire loan term.

The EAD predicts the amount that may not be recovered at the predicted time of default. It is a function of the current outstanding balance (OB) and the proportion of the unrecoverable amount relative to the current OB. It is predicted based on a machine learning-aided analysis of historical data.

The LGD is a function that describes the monetary loss when a borrower defaults, taking into account the value of collaterals and other securities submitted to SB Corp. It is the inverse of the recovery rate (1-R), where R is the percent recovery from the total exposure at a point in time. Most of the SB Corp's current portfolio are unsecured loans and a value of 1 was assigned to the LGD. This conservative assumption means the recovery rate is 0 and that no collaterals are factored in the ECL Model.

The SB Corp has adapted a time series analysis that is able to capture trends and seasonality to predict future default rates. This was used to adjust 12-month and lifetime PD generated by the classification model. The SB Corp adapted this approach in recognition of the reliability and availability of the SB Corp's data on the default rate of MSMEs. A similar time series analysis of GDP and other macroeconomic factors entails errors that could be carried over into the prediction of default rates. A time series analysis of default rates is a straightforward incorporation of forward-looking data, which factors in trends and seasonality in borrower behaviors.

b. OPERATIONAL RISK

Operational risk management is at the core of every financing operation - integrating risk management practices into processes, systems, and culture. As a pro-active partner to senior management, ORM's value lies in supporting and challenging them to align the business control environment with the corporation's strategy by measuring and mitigating risk exposure, contributing to optimal return for stakeholders.

i. Risk Control Self-Assessment

Cognizant that operational risk is inherent in all activities, products, and services, and is closely tied in with other types of risks, SB Corporation monitors risks arising from inadequate or failed internal processes, people, and systems or from external events suchas natural and man-made disasters. Towards this end, the Corporation conducts a Risk Control Self-Assessment (RCSA) to assess inherent operational risks and the design and effectiveness of mitigating controls, and residual risk.

ERMG validates the RCSA exercise to determine, among others, the completeness and appropriateness of the identified risk events and its potential impact to operations as wellas to identify and understand risk triggers.

ii. Risk Event Reporting

Likewise, in recognition of the importance of timely and accurate reporting of risk events to immediately address issues especially losses that may be incurred by SB Corporation and assign authority, responsibility, and reporting relationships in identifying, reporting, and addressing risk incidents and events, the Risk Event Reporting guidelines was established and currently being operationalized.

iii. Internal Loss Data Collection and Analysis

The risk event/incidents shall be collected into an Internal loss database which can be fed back into the operational risk management process to accumulate history of operational risk losses. This allows a quantified view of incurred risks turning them into valuable source of informationfor assessing exposure to operational risk and the effectiveness of internal controls.

iv. Information Security Risk Management

SBCorp recognizes that information is a critical asset and that how information is managed, controlled, and protected has a significant impact on the delivery of services. Information assets must be protected from unauthorized use, disclosure, and loss. Information assets must be available when needed, particularly during emergencies and crises.

The Information Security Strategic Plan (ISSP), aligned with its business plan, has been established to clearly articulate the Management's direction on Information Security. The ISSP shall provide a roadmap that would guide SBCorp in transforming the current state of security to the desired state considering business goals and strategies. The ISSP is being operationalized through the implementation of an Information Security Program (ISP). The ISP is presented as a set of goals for program implementation and oversight across all business units.

The ISP Implementation Cycle involves establishing Information Security requirements, educating people about their responsibilities, building governance structures to ensure program compliance, and monitoring and reporting of progress for an informed decision-making process. These initiatives will allow data owners, data users and administrators to be more aware of the security risks that their information assets are vulnerable to. It can identify controls to reduce those risks, and understand what risks remain after any identified controls have been implemented.

v. Business Continuity Risk Management

Given SB Corporation’s developmental mandate and crucial role in the

Philippine financial system particularly during a crisis, it is important to ensure that its operations can withstand the effects of major disruptions. The Corporation therefore delivers its message of commitment, service and integrity towards its mandate as defined under the Magna Carta for MSME.

Guided by its vision, mission, service philosophy and core values, SB Corporation acknowledges the need to establish, implement and maintain appropriate procedures for managing the immediate consequences of disruptive incidents with due regard to the welfare of employees, clients, and guests, operational options for responding to incidents,prevention of further loss or unavailability of prioritized activities, and recovery and resumption of business critical and mission essential functions.

At the onset of the COVID-19 pandemic, SB Corporation immediately puts in motion itsbusiness continuity plans which revolves around its countercyclical role during a crisis, when private financial institutions become risk-averse and private financing contracts. Nevertheless, the Corporation commits to the attainment of the following business continuity objectives as it delivers its mandate:

a. To safeguard human life;
b. To enable effective decision-making and communication during incidents;
c. To implement a plan to adjust and adapt even if resources are constrained;
d. To ensure that workplace policies are responsive, equitable, compliant, andadaptable;
e. To reduce dependency on a specific business critical or mission essential function-holder;
f. To develop a clear, measurable, fair, and practicable Performance Management System specifically designed for remote work to align with the crisis or pandemic situations and ensure that individual and team performance dovetails into organizational goals; and,
g. To ensure continuous improvement of the organization through public servicecontinuity management.

SB Corp's business continuity plan now evolves into a Public Service Continuity Plan (PSCP). The PSCP is an all-hazard plan that aims to ensure continuous delivery of services to micro, small and medium enterprises amidst any disruption. The PSCP highlights the internal capacities, recovery requirements strategies to minimize damage and loss to essential processes, ensure succession of leadership and improve continuity capabilities of SB Corporation (BR No. 2021-3186).