DBP and the Economic Environment

Despite the incessant political noise, frequent oil spikes, dry spell, and the EVAT, the year 2005 managed to post a 5% growth in the domestic economy, thanks to the exceptional recovery in Finance, the resurgence in Mining, and the resumed Government Expenditure sub-sectors. This was further bolstered by the strong overseas Filipino workers' (OFW) remittances to post a 5.6% growth in the national economy. It could have been more had the multi-billion peso revenue generated by the business process outsourcing (BPO) sector been reflected.

The slowdown, when compared to 2004, was expected as everyone anticipated risk factors like budget deficit and debt burden, oil price spikes, and the slowing down of the export market.

SUPPLY-DRIVEN GROWTH

Services, while easing somewhat to a 6.4% growth from a high of 7.6% in 2004, still provided the drive in the economy. It is Finance's 13.6% rise that took the cudgels this time for the Service Sector as all its other sub-sectors slowed down including Transportation, Communication, & Storage (TCS) from 11.2% to 7.2%. Agriculture eked out a 1.8% growth as it took its toll from the prolonged mild dry spell in the first half of 2005. Industry's 4.9% mirrors the 5.6% momentum in Manufacturing and a 9.3% resurgence in Mining.

The growth driver on the expenditure accounts, Private Consumption, also slowed down to 4.9% from 5.8% in 2004. This was compensated by the 4% increase in Government Consumption, an improvement from its stagnant performance a year ago. Investment remained weak, as it contracted by 6%. The drop was on account of the significant depletion of stocks by 54% and the weak demand for durable equipment by 7%. Exports were up 4.2% while imports grew by 2.4%, both driven by the increase in trade of non-factor services such as tourism.

THE BANKING ENVIRONMENT

Despite the various reforms the banks had to contend with in 2005, coupled with an economic backdrop of high oil prices, rising global interest rates, lower farm output, and to some extent, political concerns, the Philippine commercial banking system ended the year on an upbeat note, showing signs of improvement in asset quality, lending and deposit base. This creditable performance by the banks was supported mainly by the continued economic expansion manifested by the easing inflation environment, improving fiscal performance, and surging peso, which resulted to an average GDP growth rate of 5% for the whole of 2005.

Resources of commercial banks grew by more than 7% to P4.141 trillion fueled by increases in bank borrowings of more than 14% to P471.4 billion, as well as deposit liabilities of more than 8% to P2.783 trillion. Growth in deposits, the system's main source of funding, carried consistent growth marks for the past three years, averaging at 8.4%. Although NPL ratio registered a single-digit level of 8.51% from 12.72% in end 2004, growth in net bank lending, meanwhile, continued to be modest at almost 3% to P1.518 trillion total loans in end 2005.

Asset quality of banks improved as indicated by the single digit NPL ratio of 8.51% and reflected in the marked decline in NPLs which decreased by 32.36%.

Banks' ROPAs and NPAs likewise showed decreases of 2.49% and 18.31%, respectively, reflecting Banks' ability to dispose not only of NPLs but foreclosed assets as well. Banks may find their non-performing assets significantly reduced further after the BSP approved lately a new regulation allowing joint ventures with real estate firms using real and other properties acquired (ROPAs).

Under the Special Purpose Vehicle, banks unloaded a total of P96.7 billion worth of NPAs through SPVs as of end-2005, or just a fifth of what banks promised lawmakers when the law offering perks to such deals was being formulated. Banks were estimated to have P520 billion worth of bad assets and have unloaded P103 billion during the SPV Law's first two years of implementation starting 2003. The law has been extended to give way to the financial community's projection of reaching the P200-billion target bad asset disposal, given another two years.

Initial figures reported by banks listed in the Philippine Stock Exchange indicate they were among the better performers in the equities markets in 2005, with bottom lines reporting earnings performance of over 20%. However, on an industry level, banks' average return on equity (ROE) reflected a lower 12% but still considered as creditable showing in 2005.

Last year, the BSP issued policy guidelines to signal the start of two of the most important banking reforms: (1) the adoption of banking standards under Basel II accord and (2) the aligning of local accounting with international standards.

The Basel II accord hopes to prevent bank failures by making sure that banks put up adequate capital. This requires banks to compute their capital adequacy ratio (CAR) in a way that would reflect all the risks that they are taking.

On the other hand, in shifting to the International Financial Reporting Standards or IFRS, the BSP approved the provisions of the Philippine Financial Reporting Standards and the Philippine Accounting Standards effective 2005. Among others, the rules require amendments to the booking of investments in debt equities and securities and recognition of sale of non-performing assets to SPVs.

Obviously, the poorly capitalized banks are the ones which will have problems complying with the new set of accounting standards and the Basel II accord as both are expected to erode the capital base. Already, 5 of the top ten KBs reported declines in total capital as of end 2005 as they begin to adjust to these standards.

With the new regulation calling for high capitalization, this might spawn a new wave of consolidation in the banking industry, similar to the ones that happened in previous years.

As of January 2006, BSP came out with its amendments to its regulations on the "fit and proper rule" centering on (1) persons disqualified to become directors; and (2) effects of non-possession of qualifications or possession of disqualifications. This is to ensure that officials tasked to manage banks and other financial institutions possess the required integrity and competence. To further ensure continued growth and promote healthy competition, BSP has liberalized certain aspects of banking. Among them is the lifting of the moratorium on bank branching except in 7 cities and one municipality in Metro Manila as well as allowing banks to outsource some of its operations to make them more cost efficient.

In early 2006, credit rating agency FitchRatings recognized the banks' performance in 2005 by revising its outlook particularly on four Philippine banks from negative to stable and at the same time affirmed all its ratings on the banks ranging from BB to D/E on their long and short term foreign currency, long-term local currency, individual and support ratings.

For DBP, Fitch gave the following credit ratings update published in May 2006: Individual, C/D and Support, 3. DBP's individual rating reflects its sound balance sheet strength and good profitability.

On July 13, 2005, Moody's Investors Service changed the outlooks for DBP's foreign currency B1 long-term deposit rating and local currency Ba2 long-term deposit rating to negative from stable together with other Moody's-rated Philippine banks.

This rating action followed the change in outlook to negative from stable for the Philippines' sovereign rating on foreign currency debt/deposit ceilings as well as foreign and local government bond ratings. The weaker outlook for the sovereign ratings reflects Moody's concern that the political turmoil which has beset the Arroyo administration may negatively affect the budget and external payments position.

DBP's constrained B1 rating essentially reflects its standalone financial fundamentals. In view of its 100% state ownership and status as the policy bank financing the country's long-term infrastructure projects, regulatory support can also be expected, if needed. But we are mindful that the government's pressured fiscal position and the political instability could constrain future assistance.

The recent change in outlook does not relate to bank-specific issues. Therefore, DBP's Bank Financial Strength Rating remains stable at D. At D, it is rated at the same level as the Philippines' stronger banks – Metropolitan Bank & Trust Co., Banco de Oro Universal Bank and Unionbank of the Philippines. Only the Bank of the Philippine Islands is rated higher.

GUARDED 2006 OUTLOOK

Philippine prospect for higher growth in 2006 is hinged on a rebound in the agriculture and export sectors. However, a Democles' sword hangs before most economies, i.e., the rising world oil prices – an external and uncontrollable factor. Once again, government economic managers cut their growth targets while local and international businesses remained either conservative or cautiously optimistic.

On top of the declaration of a week-long state of national emergency in late February to counter coup attempts and which hurt temporarily the tourism industry, there is still the attendant political uncertainty being faced by the country on the impending charter change. Nevertheless, government remains confident the economy will grow at a faster pace in 2006 than in 2005.

Consumption is seen as the main driver from the demand side with support from remittances. It is feared that the EVAT and the volatile oil prices could dampen personal consumption. However, the low interest rate environment, conducive to greater consumer credit and mortgage loans resulting to vibrant private consumption, coupled with the on-going government pump-priming activities, may boost the expenditure sector. Increasing globalization can reverse trade directions for countries with restricted markets such as the continued dependence of RP exports on the US market. While prospects are bleak from exports, capital inflows, particularly Foreign Direct Investments (FDIs), remain positive. The Philippines is getting new attention, thanks to a budgetary makeover that has put the country in a position to benefit from an anticipated surge of foreign funds into the region this year. Also, while the electronics exports may be anemic, the country's biggest export – labor – is booming. OFW remittances account for 10% of GDP. The backlash, of course, is that with this labor exodus of select professionals, rosy government projects have been negated.

From the supply side, Services will remain as the major contributor to GDP with key growth drivers seen in BPO, information technology and IT-enabled services, telecommunication, and tourism. A rejuvenated agricultural sector is expected on a mild La Niña scenario, otherwise, a slowdown may occur on increased rainfall that could hurt farm production and have spill-over effects on the food and beverage sector. In Industry, not much growth is expected from the manufacturing sector, particularly the export-oriented ones, while mining growth is hopefully not stymied by environmental concerns. On a global basis, the mining sector will be robust with RP catering to the mineral needs of China, India, Japan and Korea.

The year 2006 is a tough year ahead. Political developments could sideline economic reforms and put a break on growth momentum. The peso's continued strength could pull down growth way below government targets. On the other hand, it has reduced foreign debts with its falling borrowing costs and spreads.

I M A G E S

DBP in 2005: THE YEAR IN REVIEW

The state of affairs in 2005 was obviously anything but perfect in general. Good thing, DBP's optimism prevailed over challenging developments on the world and local stage.

Against a backdrop of economic, political and social uncertainties, the Bank never lost sight of its mission. Imbued with resiliency, it turned challenges into opportunities to persevere in what it has set out to achieve for the nation and to continue with its task of making life better for every Filipino.

A look at the past year, in fact, reveals that DBP continued to cover a lot of ground in its mandate of influencing and accelerating sustainable economic growth for the continued well-being of the Filipino people. This, certainly, augurs well for 2006.

- The Bank ventured into an unsecured lower Tier 2 subordinated notes offering of up to P10 billion to strengthen its capital base in view of an improving investor appetite, marking the first time a government financial institution (GFI) is issuing capital notes.

- A P137-million term loan was extended to Calapan Waterworks Corporation to finance the rehabilitation and expansion of its existing water distribution system in Calapan City. The project marks DBP's first partnership initiative with a private firm in the area of local water utilities. It is expected to provide better access to safe and clean water for the residents of Calapan City and complements efforts to improve its basic utilities in line with its development as a prime destination in Southern Luzon.

- DBP tapped a US$10 million-fund from the AB Svensk Exportkredit (SEK) through the Swedish International Development Cooperation Agency, which will be made available to finance environmental investments under the Credit Facility for Environmental Management Project.

- The government's energy audit team gave the Bank a five-star rating with a corresponding grade of 90% for complying with the national government's energy conservation directive.

- The Japan Bank for International Cooperation conferred on DBP an overall rating of 'A' for its successful implementation of the Yen 5.158 Billion Environmental Infrastructure Support Credit Program (EISCP) 1. The rating was based on the relevance, efficiency, effectiveness, impact, and sustainability of environmental projects and investments financed under the EISCP I.

- The Social Security System once again named DBP the 2005 Best Participating Financial Institution for Social Development Loans in recognition of its support to the SSS Financing Program for Educational Institutions. This achievement marks the Bank's eighth citation under the Balikat ng Bayan Awards, making it the most awarded partner of the SSS.

I M A G E S

- DBP, together with the Philippine National Bank and Allied Banking Corporation, participated in the P1.5 billion syndicated committed credit line/ term loan to the Bases Conversion Development Authority to partially finance its counterpart fund for the Subic-Clark-Tarlac Expressway Project (SCTEP). The SCTEP is among the infrastructure projects identified in President Arroyo's ten-point agenda, as well as in the Medium-Term Philippine Development Plan that is expected to develop Clark and Subic as centers of excellence in international service and logistics in the entire Southeast Asian Region.

- DBP was one of the joint issue managers and lead underwriters for the five-year Pag-IBIG Housing Bonds which exceeded the original P5-billion issuance. Owing to high market demand, the bond offering was 2.2 times oversubscribed as total volume awarded by the Home Development Mutual Fund reached P7 billion. Proceeds of the bond offering are intended to finance the various housing programs of the Pag-IBIG Fund.

- The P62.5-million DBP-OWWA Credit Program for Overseas Filipino Workers (OFWs) was established to provide non-collateral credit assistance to ready to leave members of the Overseas Workers Welfare Administration and their eligible dependents to tide them over during emergency situations.

- The Bank and the Rizal Commercial Banking Corporation (RCBC) signed a P3-billion loan agreement to assist North Triangle Depot Commercial Corporation in the development of an integrated retail center located at North Triangle along EDSA, Quezon City. The project reflects DBP's continuing efforts to build the infrastructure to further encourage community development.

- In furtherance of its sustainable development advocacy, DBP launched in April the DBP Forest Program to support and encourage the reforestation of open and denuded areas through the planting of relatively high value fruit trees and other useful plant species. With an initial seed fund of P50 million from the KfW of Germany, the Program is envisioned to contribute to the protection of coastal areas and the conservation of soil and water in the uplands, while improving spawning grounds for terrestrial and marine aquatic life. In the long run, it also aims to help in the development of downstream industries in the countryside. As of December 2005, 17 forest projects have already been launched in identified areas in Bataan,

DBP in 2005: THE YEAR IN REVIEW

Sarangani, Davao City, Bukidnon, Palawan, Cagayan, Quezon, Guimaras and Iloilo.

- DBP with Banco de Oro participated in the P600-million syndicated term loan to finance the Leyte-Cebu Interconnection Uprating Project, a major power project aimed at sustaining the reliability and stability of electricity supply in the Visayas. The project, which marks another partnership initiative to fast track the country's geothermal power industry, is one of several initiatives under the Visayas Transmission Augmentation Program that is envisioned to provide medium- and long-term solutions to the looming power crisis in the area.

- A P110-million credit support was extended to the local government of Mandaue for its solid waste management system. The project envisions a modern, durable and multi-sized container system to enable the City to achieve a more efficient waste collection system that would complement the national government's efforts to address problems related to solid waste management and disposal.

- The Sustainable Partnership for Energizing Entrepreneurship Development (SPEED) Program was launched to encourage the growth and development of micro, small and medium enterprises. Beyond financing, the SPEED Program represents DBP's consistent thrust to extend assistance to mSMEs in a more integrated and complete way. Business Assistance Centers (BACs) were established under the Program to provide Filipino entrepreneurs with convenient and efficient access to market information, technology research and development, and credit and technical assistance. Seven BACs are now fully operational in Benguet State University, Mariano Marcos State University, Pampanga Agricultural College, Camarines Sur State Agricultural College, Aklan State University, Central Philippine University, and Foundation University. Funding support was also extended to jumpstart the operations of BAC hosted by the Palawan State University.

- DBP retained its ISO 14001 certification for its continuing commitment and efforts to sustain the implementation of its environmental management system (EMS) in all areas of its banking, lending and investment operations. In December, an upgrade audit was conducted by AJA Registrars Limited to assess the conformance of the Bank's EMS to the new requirements of the 2004 version of this international standard. A new certificate will soon be issued to DBP by AJA attesting to its compliance under ISO14001:2004.

Review

DBP classifies its financing initiatives into four priority development programs. These are: environment, social services, infrastructure and logistics, and MSMEs (Micro, Small and Medium Enterprises).

# of Operations

A review of the Bank's annual operations always underscores the fact that financing development is a unique mandate. Each year provides new insights on how management has addressed its twin goals of profitability as a bank and relevance as a development institution. The thread of continuity over the years has been how the DBP has attained a delicate balance between these two opposing pursuits, moreover, how one complemented the other, in the achievement of the Bank's development mission.

Since the last quarter of 2004, the Bank has been utilizing the built-in strengths of its balance sheets more effectively. As a result, the Treasury under Financial Markets Sector, a new sector under the refined organization, significantly increased its revenue generation in 2005. Treasury introduced new products intended to maximize income possibilities from financial market developments here and abroad. It was clearly in management's mind that these income windfalls could fund the new scope products, particularly those in the remittance business and microfinance.

PROGRAM DEVELOPMENT

At the core of DBP's role in financing development is program lending. It starts with an appreciation of the national government's thrusts and private sector initiatives. Such appreciation primes the program development activity that entails the design of the appropriate financing packages. What follows is the fund sourcing efforts that require touching base with multilateral and bilateral fund sources. Then it is the task of the Bank's delivery system to ensure that the program facilities reach their intended beneficiaries.

DBP classifies its financing initiatives into four priority development programs. These are: environment, social services, infrastructure and logistics, and MSMEs (Micro, Small and Medium Enterprises). Credit facilities and technical grants sourced from official development assistance (ODA) funds support these priority development programs. Program Development (PD) Sector formulates the funding programs through its three departments. PD I handles environment and social services programs, and PD II carries infrastructure and logistics and MSMEs. These departments are the program champions that provide technical assistance to the marketing units. The third department, Fund Sourcing mobilizes funding facilities in support of the programs to be moved by the Bank's delivery system.

Environmental Development Programs

DBP's environmental programs do not merely form part of its business mandate. They are integral to the Bank's way of doing business as an ISO 14001-certified institution. Integrating environmental considerations in its lending programs is one of the basic principles of the Bank's Environmental Management System that has been in place since 2002 and re-certified in 2005.

1. **DBP Forest Program**. This program aims to expand the efforts in conserving and protecting the environment while stimulating rural productivity. It was initially funded with P50 million seed money from KfW, and continuously built up from front-end fees on big-ticket loans. DBP's direct contribution to the Program, on the other hand, reached almost P68.5 million as of year-end 2005 covering a total of 17 re-greening projects nationwide with a total area of more than 3,900 hectares. These projects were implemented with local government units (LGUs), state universities and colleges (SUCs) and people's organizations (POs) as partners. Department of Environment and Natural Resources, Department of Agriculture, and Department of Science and Technology also provided the needed support.

2. **Clean Development Mechanism (CDM)**. The Bank put in place the Greenhouse Gas Emission Reduction Program to identify greenhouse gases emitted from the Bank's lending activities, calculate the emissions and target their reduction. DBP established carbon market links with investors/buyers from Japan, Singapore, United Kingdom, as well as with various CDM consultants. The Climate Change Program and Financing Option for CDM projects were presented in Hongkong, Bangkok, Malaysia and Jakarta as well as in local seminars and briefings, thus generating interest in CDM.

3. **Rural Power Project (RPP)**. This World Bank-funded program, with total of US$150 million over a 14-year period, aims to raise electrification in the countryside from the estimated present level of 80% to 90%. The first of four RPP-Adaptable Program Loans (APLs), APL I of P530 million, has been fully committed to seven accounts. Negotiations with National Transmission Company for DBP to finance the purchase of Transco's sub-transmission assets by electric cooperatives have been concluded. In anticipation of subsequent APLs, PD I conducted training seminars on renewable energy projects for officers and staff of the DBP marketing units.

4. **Solid and Hazardous Waste Management**. Five projects amounting to P167 million were approved under the KfW – Credit Line for Solid Waste Management. The facility financed the construction of material recovery facility, purchase of collection and transport equipment, and acquisition of heavy equipment for the construction and operation of sanitary landfill. Another 29 projects amounting to about P1.4 billion were in the pipeline. PD I also briefed 43 provinces, cities and municipalities on solid waste management, and initiated research studies on ethanol and coco methyl ester.

5. **Pollution Prevention & Control**. Loans released to 17 projects reached P2.8 billion, funded under the JBIC Environmental Infrastructure Support Credit Program (EISCP) and the KfW Industrial Pollution Control Loan Program (IPCLP). PD I and the Area Management Offices also provided assistance and inputs to the JBIC Pre-Appraisal Mission for the crafting of the Environment Development Program.

6. **Water Resources**. World Bank-funded LGU Urban Water and Sanitation Program aims to provide potable and sustainable water supply throughout the country in line with the Administration's Ten-Point Legacy Agenda. Loan approvals reached an estimated P2.5 billion, with releases totaling P113 million as of year-end with bulk of the loans approved projected to be released during the first quarter of 2006. PD I, in partnership with the Department of Interior and Local Government (DILG) and the Municipal Development Fund Office (MDFO) of the Department of Finance also conducted capacity-building workshops in Baguio City for Luzon LGUs, and in Cagayan de Oro City for Visayas and Mindanao LGUs.

Social Services Development Programs

This priority area covers education, healthcare and community development among others. Because this priority area includes the public services devolved to LGUs by the Local Government Code, DBP finds itself working very closely with them, and with other stakeholders in local development. Most of the social services programs concern the development of human capital. Oftentimes, this priority area intersects with environmental development programs since a number of projects under the latter are also necessary services to community development.

1. **OWWA Credit Program**. In 2005, DBP strengthened its funding support for the overseas Filipino workers (OFWs) through its Overseas Workers Welfare Administration (OWWA) Credit Program. An initial funding of P62.5 million was set up for the program that caters to the financing

needs of OFWs. The program addresses two categories of financing requirements of the OFW. One is his pre-departure needs such as placement/processing fees, and the other is for subsistence allowance or assistance to his family members during emergency situations.

2. **Housing Program**. The Bank initiated a review of the ADB-funded Development of Poor Urban Community Sector Project (DPUCSP). The review addressed the need to streamline the requirements and transaction flows of DPUCSP. With the streamlining, the banks were able to give a fresh push in marketing the housing program cum livelihood to the urban poor communities in coordination with LGUs.

3. **Health and Education Programs**. In 2005, PD I undertook three initiatives in these areas to enhance these programs. One is the coordinative role it assumed in the study for the creation of a nationwide health program. It also developed qualification standards for state universities and colleges, and surveyed the investment requirements of educational institutions, hospitals and LGUs. The marketing units endorsed to PD I for technical evaluation 21 schools availing a total of P232 million loans, and four healthcare projects for P171 million.

Infrastructure & Logistics

DBP has been carving out a name in its initiatives at supplementing the national government's efforts in addressing the country's infrastructure requirements. It came at a time when ballooning debt service significantly curtailed the national budget for infrastructure outlays. More than just supporting infrastructure projects, DBP formulated a development rationale through its Sustainable Logistics Development Program (SLDP). Railroads, airports and expressways are lodged under this priority program, so too are utilities, transportation and communications.

A major component of the SLDP is the Road-RORO Terminal System (RRTS). RRTS links up the islands comprising the Philippine archipelago, by roll-on, roll-off (RORO) ships. DBP created this project from studies made proving that significant losses and costs are incurred from handling and transfers along transport routes. RRTS reduced these losses and, in addition, required LGUs to provide the terminal facilities. The strategic importance of RRTS led to its adoption as the Strong Republic Nautical Highway.

In 2005, the Central Nautical Highway took shape, a third alternative in addition to the Eastern and Western nautical highways. This route traverses the provinces of Quezon, Sorsogon, Masbate and Cebu. DBP is also encouraging shorter island link-ups that crisscross these three parallel main highways. DBP approved P210 million RRTS projects in 2005.

The other two components of SLDP are the Grains Highway and the Cold Chain. The Grains Highway includes the network of post-harvest facilities mainly for rice and corn, bulk storage and loading facilities. The Cold Chain, on the other hand, provides specialized facilities to maintain the freshness, and therefore, the quality and value of perishable goods like fruits, vegetables and meat products. In 2005, DBP approved P297 million for the Grains Highway and another P310 million for the Cold Chain.

Micro, Small & Medium Enterprises (MSMEs)

With MSMEs playing a vital role in the Ten-Point Legacy Agenda of the Administration, DBP has continuously been searching for ways to be involved in very meaningful ways. The MSME as a priority development program poses the greatest challenge to DBP. Both the Bank's infrastructure and business economics are no longer well-suited for MSME financing. In 2005, it gained some headway in responding to this challenge.

DBP created a Microfinance Department under its wholesale operations. This entailed dedicated resources and personnel and more relevant accreditation process and criteria for the participation of smaller financial institutions. Prior to this, DBP's wholesale banking technology catered only to the biggest banks in the country. At the close of the year, DBP began to undertake initiatives towards a vertical organization for microfinance in the Bank.

As signatory to the memorandum of understanding that gave rise to the SME Unified Lending Opportunity for National Growth (SULONG), DBP pursued SME loans through the branches and its Factoring Department. For the year, it released a total of P10.5 billion to SMEs, not counting the credit lines approved for SB Corporation and for People's Credit and Finance Corporation in the total amount of P465 million.

To benefit the SMEs, DBP launched the Sustainable Partnership for Energizing Entrepreneurship Development (SPEED) Program in 2005. Under SPEED, DBP set up an initial seven Business Assistance Centers (BACs) in Luzon and the Visayas. Four more are under process to cover Mindanao, Cebu and Palawan.

As with its other programs, DBP collaborated with other stakeholders in setting up the BACs. Among its partners are the state/private universities and colleges who, through their e-business centers, provide the BAC with an office and officer-in-charge. DTI and DOST provide business counselors and technology assistance. In certain areas, the BACs count on outreach programs of MASICAP Foundation to touch base with entrepreneurs, and on participating financial and microfinance institutions to serve as financing conduits. To put the players of the BAC together, DBP provides the initial seed operating capital, promotes SPEED, and brings into the equation the assemblers and consolidators of the supply chains made up of small businessmen and farmers.

DBP's Factoring Facility gained substantial scale in 2005. This facility for SMEs doing supply business with "Big Brother" corporations topped its 2004 performance by over 60% in all benchmarks, including accounts receivable purchased, releases, collections and income. Factoring Department also conducted roadshows to invite more participants to the program, and held a Factoring Forum to disseminate the lessons and improvements among the Bank's officers and support units. It organized a Factoring Summit attended by about 70 clients to get their views on how to further improve the Bank's factoring service.

Fund Sourcing

DBP, through Fund Sourcing, developed new and strengthened existing partnerships with European agencies. These efforts resulted in the conclusion of Euro 25 million from the European Investment Bank (EIB), and US$10 million from the Swedish International Development Authority (SIDA). The EIB facility covers a wide scope of qualified projects to include power, commercial and social infrastructure, agro-industry, transportation, environment and tourism. The SIDA facility, on the other hand, is dedicated to environmental projects. The third tranche of the Credit Line for Micro, Small & Medium Enterprises (CMSME) of US$5.3 million from KfW became available in 2005 to support local government units (LGUs) and microfinance institutions (MFIs). Altogether, the fresh funds from these three facilities for developmental loans of private and public sector projects amounted to P2.4 billion.

DELIVERY SYSTEM

The search for a more responsive delivery system of the Bank's products and services is the primary reason for continuing organizational refinements. There really is no long-lasting equilibrium in the Bank's organization because the balance between profitability and relevance objectives of DBP is constantly changing. Significant organizational adjustments were made in 2005 to make the Bank more responsive to market opportunities and the developmental thrusts of the national government.

Organizational Strengthening

Starting April 2005, the Bank pushed a continuing organizational refinement. It was prompted in part by the on-going early retirement programs, ERIP IV and the new ERIP V availed of by a number of senior officers and staff. But the larger consideration

was the need to be responsive to the Bank's target markets and the pursuit of its development mandate.

The Board approved the first phase of a function-based organizational refinement that aligned DBP to the marketplace on April 20, 2005. One of the key changes was the creation of the position of the Chief Finance Officer to head the Financial Markets Sector and spearhead the strengthening of treasury, institutional relationships and remittance center operations. This led to the creation of two major units. One is the Financial Institutions to enhance wholesale banking to cover as well the wider area of correspondent banking. The other is the Remittance Center, a proactive move to bid for greater involvement in the welfare of OFWs.

Program Development Sector gained more focus from the organizational adjustments; its marketing functions were transferred to either Marketing Head Office Sector or Marketing Branches Sector. The refinements also embodied the matrix system, an internal structure that emphasizes collaboration, and places operating personnel under more than one leader in appreciation of specialized capabilities in the Bank, e.g., banking relationships of branches and technical expertise of program development.

The second phase of organizational strengthening took place in December 2005, after the completion of the 2006 budget hearings. This made sure that all the key result areas of the Bank are addressed in terms of logistics and personnel. The various sectors of the Bank streamlined further to promote efficiency and responsiveness.

Corporate and Investment Banking

Marketing Head Office Sector (MHS) posted strong performance records in 2005. Its loan portfolio rose to P23.8 billion for a 76% growth over the previous year. Intensified marketing efforts, particularly in the priority areas, resulted in a significant build-up of pipeline projects. Loan approvals hit P37.8 billion and loan releases P46.6 billion, both registering impressive growth marks of 125% and 206%, respectively, over comparable 2004 figures. MHS continued its lending activities to existing clients belonging to the country's top 1000 corporations and pursued projects with development impact. It also focused on activities that maintained the soundness of its existing portfolio, and exerted extra efforts in assisting clients affected by the slowdown of the economy. Among its 2005 highlights are the following:

1. Participated in the P8 billion Long Term Notes for National Food Authority in the pursuit of food security, price stabilization, and access to affordable rice by the poorest of the poor.

2. Participated in National Transmission Corporation's Leyte-Cebu Interconnection Uprating Project designed to avert a looming power crisis in the Visayas area caused mainly by transmission congestion. The project promotes the use of "clean electricity" generated by the geothermal plants in Leyte, dispensing the over-reliance on fossil-fueled power generators of Cebu-based plants that have been run to capacity.

3. Along with other banks, participated in the P5.0 billion Syndicated Term Loan arranged for Globe Telecom, Inc. to finance its "Phase 10" Expansion Projects. These projects installed additional cell sites in both rural and urban areas either previously unserved or where capacity was already inadequate, thereby providing a vital factor in spurring regional development.

4. Partially funded the construction of the 14-storey School of Design & Arts (SDA) of the De La Salle College of St. Benilde. The SDA building features specialized rooms and laboratories, a 500-seat theater, a museum, and other amenities and facilities in design and arts.

5. Investment Banking (InB) acted as coordinating arranger and underwriter to Nutri-Asia Pacific Limited for US$215 million Syndicated Bridge Facility for the acquisition of Del Monte Pacific Ltd.

6. Acted as one of the issue managers and one of 18 accredited selling agents in the Republic's 7th Retail Treasury Bond (RTB) offering in August 2005. DBP contributed close to 7% of the P3.1 billion mobilized, with an estimated 45% tapping the targeted retail market.

7. Took the role of joint issue manager and lead underwriter for the Pag-IBIG Housing Bond Flotation. Tenders at the auction reached P11 billion enabling HDMF to exercise a P2 billion greenshoe option on top of the P5.0 billion original issue size.

8. Acted as underwriter in the P140 million Balanghay Bond Float of the City Government of Butuan. Proceeds will be used for the construction of two middle buildings within the proposed D.O. Plaza Regional Center, a one-stop government service hub.

9. With HSBC, acted as arranger in the P3.0 billion loan and note issuance for the North Triangle Depot Commercial Corporation.

10. Through the Factoring Department, purchased P2.9 billion worth of accounts receivable from 61 SME suppliers of 23 big corporate buyers. As a continuing response to the needs of SME suppliers, Factoring presented its facility and invited other big prospects, such as Petron Haulers Association, Ford Philippines, and Manila Water Company, to participate in the program.

11. Asset Management (AM) under MHS carried on the efforts to reduce non-performing assets of the Bank and to maximize capital recovery. AM implemented the work-out solutions for 20 non-performing loans with outstanding balance of P1.6 billion for a 23% reduction of its P7.0 billion NPL portfolio. It also realized 76 sale transactions and four write-offs of acquired asset accounts. AM also began the spadework for the sale of a significant portion of the Bank's NPAs through the SPV mode.

Area Management Offices (AMOs)

Marketing Branches Sector (MBS) has five AMOs that have jurisdiction over 77 branches nationwide. These five AMOs in 15 regional areas where 77 branches are based provide the presence of DBP in the countryside. They accounted for a combined loan portfolio of P17.1 billion or 19.7% of the Bank's total loan portfolio as of 2005. They also generated P30.1 billion in deposits accounting for 59.2% of total. Since they are the relationship managers in their respective areas, they provide the entry point of DBP's products and services. The branch officers and staff are the ones who rub shoulders with other development partners such as the LGU officials, local entrepreneurs and businessmen. It should be no surprise then that illustrative development projects abound in the AMOs.

1. **LGU Loans**. In responding to the financing needs of LGUs, the AMOs dealt with the biggest LGUs such as the City of Manila as well as with the smaller municipalities in Mindanao and Bicol Provinces. Sample LGU projects in 2005 include school facilities like the new campus and buildings of City College of Manila at Mehan Garden and the 15 new school houses for various barangays in the City of Lucena. Two municipalities in Sorsogon accessed DBP's funding facilities for water supply and sanitation. Major and fast growing cities like Mandaue City in Cebu and Iligan City in Lanao del Norte funded their solid waste management systems from DBP. DBP also prodded LGUs, especially those in missionary routes of the Road-RORO Terminal System, to invest in port and terminal facilities. These sample LGU projects have something in common: they all cater to a public need.

2. **Water Districts & Electric Cooperatives**. Local water districts and electric cooperatives are among the clients of the AMO. Both sets of utility providers aimed at improving their service deliveries and efficiencies. Financing to water districts ensured both adequate potable supply as well as sanitation. In 2005, a total of P1.98 billion to four water districts were at various stages of loan release. In the case of electric cooperatives, financing addressed renewable power sources, reduction of systems losses and acquisition of transmission lines from Transco. Bohol Electric Cooperative I harnessed a 2.68 MW mini-hydro power plant, while Antique Electric Cooperative improved the link-up among its three substations.

3. **Private Schools and Hospitals**. Both LGUs and private businesses tapped the branches for funds to support the financing of schools and hospitals. Aside from smaller private technical and vocational centers, the Bank also supported the Davao Medical School Foundation for the completion of a 100-bed tertiary hospital. This facility augments the hospital facilities in Davao City which also caters to its neighboring provinces. The foundation, a consortium of five educational institutions with healthcare related

courses, has its own medical school which will also access the hospital as training facility.

4. **Small Borrowers**. The branches under the AMOs also served as outlets for new services of the Bank. In 2005, six branches were chosen to extend OWWA Credit Program in their locality. Branches in Commonwealth Avenue (NCR), Iloilo City, Cebu City, San Fernando - Pampanga, and San Fernando - La Union, being major areas of origin of OFWs, were tapped to offer the OWWA Credit Program. The combined availments in these branches totaled P31.4 million from 932 OFW borrowers. Another role that the AMOs fulfill is to identify partners in the delivery of service. AMO-Mindanao, for example, facilitated the firming-up of a rediscounting facility for One Network Rural Bank. Some 8,400 public school teachers will benefit from this facility to fund their livelihood projects for supplemental family income. Branches under the five AMOs also catered to the bulk of the Bank's P11.8 billion retail loan portfolio to MSMEs.

Treasury and Financial Institutions

The Bank's organizational refinement in early 2005 formed the Financial Markets Sector to house Treasury, Financial Institutions and Remittance Center. This move was accompanied by strong capability build-up efforts, tapping the available expertise from the private sector. By the 2005 financial results, these management decisions did not only prove correct but also timely given the global market developments and the BSP policy stance. Treasury took the cudgels in building up the Bank's resources and shoring up its income to effectively supplement loans as source of revenues.

Foreign currency-based businesses of the Bank fared exceptionally well in 2005. FCDU resources scaled to a new level of US$589 million, up by 107%, brought about by significant increases in cash assets, interbank loans and investments. FCDU deposits rose 40% to hit $176.7 million from intensive marketing, especially to government entities. Bills payable also registered a 157% rise to $392.5 million. While costs, mainly financial charges and interest expenses also rose, adept investment decisions and bond asset selection boosted trading gain and interest income. FCDU operations produced net income improvements, hitting $8.26 million for 2005.

On the other hand, the newly-created unit under Financial Institutions, Correspondent Banking and Trade Development (CBTD), renewed emphasis on trade business. This resulted in a 470% jump in trade volume to reach $889 million in 2005. The move generated a fee income of P7.5 million, but more importantly, DBP learned how to leverage its correspondent banking business relationships and to harness reciprocity.

Wholesale lending, also handled by Financial Institutions, continued to do its role as a catalyst for sustainable development through its partnership with various financial institutions. Wholesale portfolio inched higher by 3.1% in 2005 to reach a level of P38.9 billion to account for 45% of the Bank's loan portfolio. Our main beneficiary industries were transport, storage and communication for P9.8 billion, followed by construction with P8.3 billion and MSME with P6.7 billion. However, the continuing consolidation among banks and their liquid positions connived to threaten the growth of the wholesale portfolio. For 2005, approvals and releases amounted to P5 billion and P9.4 billion, respectively, 60% and 14.6% lower than the 2004 comparable figures.

Domestic operations of Treasury in 2005 also recorded very credible results. From the P40 billion average investment portfolio in government securities, Treasury earned accrual interest income of P3.3 billion, and further realized gains on trading and sale of securities of P857 million, higher by 47.25% than year ago. Throughout 2005, the Bank complied with regulatory reserves and met the funding needs for operations and investments. Treasury increased placements in BSP's reverse repo averaging P8.4 billion and earning P608 million, both significantly higher than the year ago figures. It also worked on the issuance of the Bank's Tier 2 Capital Notes whose offering period began in December 2005.

FINANCIAL HIGHLIGHTS

As of 2005, DBP climbed two rungs in the country's Top 10 ranking among banks, from No. 9 to No. 7 in asset size. Its net income performance in 2005 was even more impressive, ranking No. 4, after BPI, Metrobank, and Citibank. DBP also set a record high in loan portfolio (net) at P79.3 billion, and in deposits (P50.8 billion), capital (P25.6 billion), gross income (P16.2 billion) and net income (P3.2 billion). All these support the sustainability of DBP.

Record Net Income

The consolidated net income recorded in 2005 is unprecedented. The adoption of the Philippine Financial Reporting Standards (PFRS) did not adversely affect the Bank's profitability. Compared to the preceding year, the net income of P3.2 billion for a 31.6% improvement was quite a feat considering a restrained economic growth in 2005. The Bank maximized marginal income from high cost deposits, indicating Treasury's keen market sense. Aside from raising the deposit level to P50.8 billion, an all-time high, this capability facilitated access to prime clients, thereby opening up more banking opportunities with them.

Other income at P2.8 billion was 14% better than last year. Providing the momentum were the profits from investments and securities trading that posted a 114% increase to P1.9 billion. The gross income of P16.2 billion, or the combined contributions of interest income and other income, was likewise an all-time high, enabling the Bank to absorb higher interest expenses, and to brace for the impact of its early retirement program that runs up to 2008. The efficiency ratio (operating expense over gross income margin) slightly rose to 56% from 55%. That income delivery in 2005 which was also incentive-driven may be argued by the increase in variable pay given out in 2005. Provisions for the early retirement program were also built-up. Operating expenses rose 14% mainly from manpower-related expenses in 2005.

Resource Build-up

A much tamer year-on-year balance sheet growth resulted from the adherence to the Philippine Financial Reporting Standards. Consolidated resource level hit P213 billion for a 3.3% growth in 2005 over comparable, PFRS-adjusted 2004 figures. The fair value measurement of financial assets on trading and available for sale securities, certain derivative instruments and real and other properties owned modified the 2004 financial statements.

These valuation adjustments, however, did not affect the loan portfolio. At P79.3 billion (net of unearned discount and including accrued interest receivable) in 2005 loans rose by 12.6%. This is the biggest annual increase attained since the turn of the millennium. Interbank loans, on the other hand, trebled to P24.7 billion to suggest DBP's much-enhanced correspondent banking and overall relationships with domestic and foreign banks.

Both the heightened activity in Treasury and the nuances of PFRS translated to significant changes in the values of financial assets. The reduction in marketable securities reflected Treasury's strategy, given the interest rate environment, to sell down these investments to realize profits. The money market transactions executed by Treasury translated to an increase in the level of deposits with other banks and interbank loans. Also underpinning the Treasury activities was the growth in deposit liabilities which rose by P14.3 billion or unprecedented growth of 39.3% with growth momentum coming from FCDU deposits.

Measures of Performance

Close to 60% of the Bank's outstanding loan portfolio in 2005 were in developmental projects, with the remaining 40% in commercial loans. The four priority development programs guided marketing work and funding, particularly the ODA funds, to specific priority areas. Infrastructure and logistics had P21.7 billion or 25% of the Bank's loan portfolio, followed by MSME at P18.5 billion or 21.3%, environment had P6 billion for a 6.9% share and social services at P5.2 billion accounted for 6%.

Various financial measures vouch for the strong performance of DBP in 2005. Profitability ratios (non-consolidated) carried the impact of the Bank's scale and scope strategies. Return on equity improved to 14.80% from 12.76% in 2004 or a very material rise of 204 basis points. Return on assets likewise increased but at less impressive rate, improving from 1.55% in 2004 to 1.76%. A salient factor to higher profitability in 2005 was the improvement in asset quality. Past due rate, excluding interbank, improved by 237 basis points, from 11.92% to 9.55%. A greater portion of the loan portfolio yielded interest income and reduced the need to set up additional provisions.

Improved profitability was attained despite hikes in costs. Net interest margin narrowed from 4% to 3.80% in 2005. While this suggests higher cost of funds, what the Bank succeeded to do was turn around a bigger volume even on lower spreads for bigger absolute income results. Manpower related costs also rose, but this was more from higher performance incentives and retirement contributions as the early retirement program of the Bank has been into full swing.

While DBP focused on developmental projects, it never lost sight of the conditions for its sustainability. It pushed both scale and scope strategies to maximize its profitability in support of developmental objectives. Scale factors included the continued volume increases in loans and investments that provided a steady stream of income to the Bank. Scope factors, on the other hand, could be grouped into two types. One catered to new products, mostly Treasury instruments, which resulted in short-term or "windfall" income. Another set of new initiatives addressed the long-term thrusts of DBP as a development bank. The latter scope products entailed investments of longer gestation periods with income streams in the future yet. Among the scope products in 2005 are remittance business, microfinance, and capital notes.

Corporate Governance and Risk Management

The spate of bank closures in the global scene during recent years had changed the behavior of bankers, as well as of their regulators, here and abroad. In the domestic scene, Bangko Sentral ng Pilipinas (BSP) issued a series of circulars to compel greater involvement on the part of the Board of Directors in bank affairs, and to shift capital adequacy determination to the risk-based framework. BSP defined the duties and responsibilities of the Board and required each bank director to attend the special seminar on corporate governance. In line with the capital adequacy measurement, risk management became a focal point for bank transactions and resource build-up.

GOVERNANCE

Adherence to the principles and best practices in corporate governance is a declared commitment of the Development Bank of the Philippines. The Bank acknowledges that the observance of the fundamental principles of fairness, transparency and accountability starts with the Board and serves as guide in the attainment of Bank's goals. For these principles to flourish in the Bank, the Board ensures that a culture of ethics, compliance and social responsibility pervades at all levels of DBP's operations. In this sense, good governance underpins proper risk management.

The Board of Directors

The Board of Directors consists of nine members, all of whom are appointed by the President of the Republic of the Philippines. Their selection factored in the perspective that they give to the Board, so that as a body, the Board is very much multi-faceted.

The Board members of 2005 are proud to possess sterling records in business, finance and banking. They showed genuine concern and expertise in SMEs, NGOs, labor and human resource, political economy, business management, legal and audit. Aside from their unassailable characters, they spoke for all the regions in the country. Mostly hailing from Luzon and Metro Manila, the Visayas and Mindanao, too found voice in the Board.

Board Committees

Bangko Sentral ng Pilipinas ascertained that the Board of Directors of a bank is fully aware that one of its responsibilities is to ensure good governance. DBP strictly conformed to the BSP stipulations on Board concerns, including the creation of several Board committees.

Executive Committee (ExCom). The ExCom is a scale down of the Board. It is composed of only five members including the Chairman and the President/CEO, with the Chief Operating Officer and Chief Legal Counsel as Ex-officio members. In 2005, it addressed the Board agenda of matters that are within its delegated authority in 15 meetings on top of the Board's 32 meetings.

Governance Committee. This committee is comprised of at least five members of the Board who elect a chairman among themselves. The President/CEO and the Chief Operating Officer serve as Ex-officio members. During the year, the committee ensured adherence to the Bank's Manual on Good Governance approved under Board Resolution No. 0445 on December 19, 2003 and the Code of Ethics formalized by Board Resolution No. 0246 on July 07, 2004. It reviewed certain major transactions to aid the Board in the formulation of policies to safeguard the Bank's credit and investment activities. As one of its basic functions, it oversaw the periodic performance evaluation of the Board and its committees.

Audit and Compliance Committee (AuditCom). This committee, made up of three members of the Board, is the overseer of the activities of the Bank's Internal Audit (IA) and Compliance Monitoring Office (CoM). Sitting as Ex-officio members are the President/CEO, the Chief Operating Officer and a representative of the Office of the Legal Counsel. In 2005, the committee reviewed 65 regular and special reports of Internal Audit, a majority of which were credit and operations review of the branches that served to improve risk awareness and proper control procedures. It also delineated the functions of CoM vis-à-vis Internal Audit, Risk Management, Credit Review and Policy Supervision and Office of the Legal Counsel. The Board approved the Updated Manual on the Protection Against Money Laundering on May 25, 2005 and the Revised Compliance Program of the Bank on September 28, 2005.

Committee on Risk Management (CRM). The CRM includes three members of the Board with the President/CEO, the Chief Operating Officer, the Chairman of the Audit and Compliance Committee, the Chairman of the Executive Credit Committee (ExCreCom), and the heads of Internal Audit, Risk Management, Treasury and the Chief Legal Counsel as Ex-officio members. The CRM, through the Risk Management, is principally responsible for the development and oversight of the Bank's Risk Management Program. The membership of CRM resulted from its reconstitution in 2005 to ensure adequate representation and independence. Among the matters it tackled were the Operating Principles of the Bank's Risk Management and Risk Assessment System, the Risk Roadmap towards Basel II Compliance, and the revised charter of the CRM.

Human Resource Committee (HRC). The HRC has at least three members of the Board, with the President/CEO as Ex-Officio member, and is back-staffed by Human Resource Management. In 2005, it met 12 times and formulated over 30 major policy decisions that addressed organizational concerns and employee welfare. Among these were the early retirement programs (ERIP IV – 2nd tranche and ERIP V) and the series of refinements of the Bank's organizational structure. Various improvements on employee benefits and compensation structure were also deliberated upon and decided by the HRC.

RISK MANAGEMENT

The Bank sees risk management as a personal responsibility that is ingrained in the policies, procedures and controls in the discharge of one's functions. Officers of line units have well-defined approving authorities and credit limits.

The Management Committee (ManCom) has an overarching coverage on the more specialized concerns of the other top management committees. Each critical risk area has its own specialized management committee, such as the Executive Credit Committee (ExCreCom) for credit matters and the Assets and Liabilities Committee (ALCO) for investments. They also have support units to provide assistance in transactions review, policy formulation, capability build-up and management information.

For a more structured approach to managing risk, however, the Bank created the Risk Management (RM). RM provides direct assistance to Management and to the Board of Directors. It undertakes risk identification, measurement, monitoring and control to serve as inputs in the oversight function of the Board Committee on Risk Management (CRM) that is also overseeing the development of the Risk Management Program of the Bank.

Management of Credit Risk

Credit risk management is built-in to the operating systems and policies of the Bank. Credit Review and Policy Supervision (CRPS), a specialized support unit, reviews credit transactions, formulates responsive credit policies, promotes a strong credit culture and strengthens the Bank's Credit Risk Management System. All credit proposals go through the ExCreCom where deliberations are enriched by the various disciplines of its members. Approving authorities and credit limits are clearly defined, so that accounts exceeding certain limits go to the Board for approval. Since credit risk is part of the overall risk management concern of the Bank, it is also monitored by RM and forms part of its report to the CRM of the Board.

The Bank has implemented an Internal Credit Risk Rating System (ICRRS) for corporate borrowers with asset size of more than P15 million. It has likewise put in place a pre-approval rating review of accounts. Internal Audit also evaluates all credit transactions as well as the operating procedures and controls of lending.

As a corollary activity, RM strictly monitors the prudential limits set by the BSP. One of these is the Single Borrower's Limit (SBL) applied on the Bank's retail lending operations (25% SBL), as well as on its wholesale lending operations (35% SBL on participating financial institutions). However, the Bank has set more conservative internal limits on retail borrowers as well as on counterparties. RM monitors these limits against exposures and reports to Management and the Board. It is also finalizing more risk-sensitive credit concentration limits than those set by BSP guidelines. There is also a continuing build-up of information towards compliance with the Basel II framework. These include default data gathering and warehousing.

Management of Market and Liquidity Risks

Developments in the financial markets affect the trading and investment positions of the Bank. They pose the market risks faced by the Bank's Treasury operations, in the form of interest rate and price risks, foreign currency risks, and liquidity risks. To address these market risks, the treasury officials make use of technical/analytical tools, provide hedges through swaps and derivatives, and adhere to internal prudential limits set by the Board and those stipulated by the regulatory authority.

Positions in debt instruments, both peso and foreign currency-denominated, and derivatives have set limits based on the Value-at-Risk (VaR) methodology. VaR, using historical simulations, measures maximum potential loss on these positions. Conservative limits are thus guided by the VaR analyses. Other methods serving to ensure investment positions from risks include mark-to-market valuation, sensitivity analysis and stress testing. Aside from keeping positions and transactions within prudential limits, interest rate and foreign currency exchange rate risks, when necessary and feasible, are further hedged through interest rate and currency swaps.

Liquidity risk, or the ability of the Bank to honor maturing obligations and funding commitments, is minimized through the proper matching of fund uses and sources. Basic liquidity provision is addressed by the compliance with BSP's statutory reserve requirement. The Bank also sets maximum limits for pre-determined tenor buckets. To facilitate the setting of these limits separately for FCDU and regular banking units, it makes use of the Liquidity Gap and Maximum Cumulative Outflow (MCO) analysis. RM also monitors adherence to the MCO limits. Off balance sheet risk items are duly accounted for in the preparation of MCO and Capital Adequacy Ratio computations (CAR).

The Bank's positions in derivative instruments are strictly in accordance with BSP Circular Nos. 466, 468 and 469 (series of 2005), respectively. While DBP does not have an expanded derivative authority to invest, it observes the above BSP guidelines in terms of specific approvals, qualified parties and transactions, and risk weights.

Management of Operational Risk

The primary means to control operational risk is to have an effective system of internal control. Under this guiding principle, clear lines of management responsibility, accountability and reporting have been duly considered in the approving authorities. Conflicts of interest are avoided by separation of responsibilities and reporting lines between risk control functions (middle office), business lines (front office) and support functions (back office). Operating and product manuals include control processes and procedures. Dual control is observed over all transactions and items of value. Compliance checks, verification and reconciliation of transactions are regularly conducted. The Bank has a Business Disaster Recovery Plan in place, including an automated retrieval system for actual operational loss data requirement.

In 2005, RM started tracking the requirements of Basel II and best practices in the area of operational risks. It undertook three initiatives to address operational risks, namely: product manuals, documentation of operational losses, and the red flag reporting system to ensure the effectiveness of internal control systems. The re-issuance of DBP Circular No. 24, dated July 15, 2005, institutionalized the preparation of product manuals. It covered existing and new products and services to ensure that inherent risks in all products, services, transactions, processes and systems are identified and assessed for purposes of mitigating or controlling such risks. The manuals also serve as reference for process improvements and documentation of risk systems.

The build-up of bankwide historical data on operational losses is a preliminary stage to more sophisticated risk assessment methods. Its preparation and consolidation shall subsequently be automated. This monitoring tool for assessing risk exposures aims to modify internal policies and procedures, and design controls and contingency plans for risk mitigation. Once the Bank can develop a more advanced internal model for operational risk assessment, it can free more capital for enhancing its business.

Assessment of the Bank's current financial condition is facilitated through the set up of a red flag reporting system. This integrates in the assessment of the Bank's performance an early warning or alert system to pinpoint possible risk compromises. Some of the indicators used in the red flag reporting system are the budget variance analysis and marked deviations from industry benchmarks.

Culture of Risk Awareness

Management has been inculcating a risk awareness culture in the Bank. This is the best mode for actualizing the risk management roadmap along the framework charted in Basel II and pursued by the BSP. In view of this objective, the various support units were likewise geared at enhancing an enterprise-wide risk awareness program, aside from just the primary risk-takers.

Support units promoted the risk management objectives in their respective support roles. Human Resource Management facilitated the training programs designed to strengthen the skills and capabilities of employees in various critical areas of bank operations, such as loan documentation, signature verification and counterfeit detection, credit appraisal and review, among others. The Office of the Legal Counsel provided the technical resource in many of these seminars and facilitated access to the Legal Library through the intranet portal. More direct interventions characterized the activities of Risk Management, Credit Review and Policy Supervision, Compliance Office and Internal Audit. Accounting, Systems and Methods, and Corplan, Budget and Special Projects also made adjustments in the support activities.

The Global Compact

and DBP's CORPORATE SOCIAL RESPONSIBILITY

As a signatory to the United Nations Global Compact since 2002, DBP sustained the implementation of its corporate citizenship program in active advocacy of the ten universal principles spanning Human Rights, Labor, Environment and Anti-Corruption. This section presents the significant advances made by the Bank in this global campaign for corporate social responsibility. This Communication on Progress highlights DBP's own contributions to enabling the Global Compact mission and principles gain a foothold among businesses amid the challenges of globalization.

Human Rights

DBP's human rights initiatives encompass equality, life and security, and economic, social and cultural freedoms as basic premises. The Bank's program of assistance in this area involves activities that address the identified needs of specific target beneficiaries which include victims of calamities, abandoned elderly, orphaned children, the sick, indigenous peoples, and other marginalized groups.

Complementing efforts to enable identified beneficiaries gain adequate access to basic needs and services such as health and medical care, food, and education, while at the same time safeguarding their basic rights, the Bank's program of assistance in 2005 was carried out in partnership with concerned government and non-government organizations and other relevant agencies and institutions.

In response to the calamity caused by typhoons "Yoyong" and "Winnie" that hit the country towards the end of 2004, DBP launched an integrated relief and rehabilitation program for affected areas in the provinces of Nueva Ecija and Quezon. Led by the Bank's key officials, on-site relief assistance was immediately extended to affected families through the then regional management offices in Southern Tagalog and Central Luzon. Rehabilitation efforts, on the other hand, involved support for identified livelihood activities and projects. Volunteer groups were also involved in post-calamity missions designed to rebuild and restore normal activities in affected communities.

In October 2005, DBP participated in relief efforts for victims of typhoon "Labuyo" in Libon and Oas in Albay. The Bank turned over relief assistance to the local government of these towns that included sacks of rice, medicines, canned goods, and other basic necessities for distribution to affected families.

The Bank's Share-a-Gift outreach mission in December, on the other hand, benefited 100 Alangan-Mangyan families in Sitio Banilad, Oriental Mindoro. DBP conducted a medical mission, feeding project, and gift-giving activity. Cash donations were likewise turned over to the local chieftain to support the community livelihood project.

The Bank was also among the first government agencies to respond to the call for relief assistance when mudslides severely hit Guinsaugon, Southern Leyte and neighboring towns in February 2006. The disaster claimed hundreds of lives and caused millions of losses in damaged properties and livelihood. The Bank is also currently mapping out its support strategy for rehabilitation efforts, particularly in the area of educational assistance.

Integrating thrusts cognizant of the economic, social and cultural right indispensable to human dignity, DBP organized in the second half of 2005 a roundtable discussion on the proposed Free and Prior Informed Consent Guidelines of the Indigenous Peoples Rights Act. It provided a venue to assess the guidelines in response to new operational policies issued by the World Bank, which underscore the need for poverty reduction and sustainable development efforts that fully respect the dignity, human rights, economies, and cultures of indigenous peoples.

Labor

DBP's corporate philosophy is anchored on the basic principle of respect for each person. All human resource policies and decisions, therefore, promote concern for the employee and his welfare, his family, and life outside of DBP.

As a government institution, DBP's human resource policies are strictly guided by civil service rules and regulations being enforced by the Civil Service Commission (CSC), the central personnel agency of the Philippine government.

To motivate its employees towards continually improving performance, DBP continued to provide adequate compensation and other benefits that enable employees to meet the basic economic needs of their families. A system of rewards and accountabilities was sustained to encourage service excellence and high standards of work performance.

Several mechanisms were also put in place to ensure that the institution was able to keep up with prevailing industry practices and acceptable benchmarks governing human resource management and relations.

In 2004, the Bank, represented by a Management panel composed of selected key officers, and the DBP Employees Union (DBPEU) entered into a three-year collective negotiation agreement (CNA). This landmark agreement – the first in DBP's 59-year history – was founded on Management and the employees' shared goal of achieving and maintaining industrial peace in the Bank. The CNA is set to expire in January 2007.

In addition to the DBPEU, two other employee organizations – the Association of DBP Career Officers (ADCO) and the Association of DBP Junior Officers (ADJO) – exist in the Bank. The presence of these groups attests to the Bank's continued adherence to an institutionalized system of employee communication that helps maintain a healthy dialogue between management and the staff, promote direct resolution of employee-related concerns in an atmosphere of mutual trust, sustain a culture of trust, and keep employees abreast of developments on the Bank's operations and work environment.

Reflective of its continued emphasis on the provision of training to develop the appropriate skills and technical competencies, the Bank has allocated a bigger training budget for 2006. Fifty-two percent of the budget has been earmarked for technical and skills-oriented training activities to be disbursed by the respective operating units. The remaining 48% of the budget, which is lodged with Human Resource Management, has been set aside for focused officer training program and management development program for senior officers.

In addition to these institution-directed efforts, DBP also continued to encourage compliance to acceptable labor practices among businesses. The Bank has incorporated safeguards in its qualification standards to ensure that prospective borrowers and projects also comply with applicable labor laws and regulations.

Environment

DBP holds the distinction of being the first Philippine bank to be ISO 14001-certified since 2002 for its successful establishment and implementation of an Environmental Management System (EMS). Its sustained compliance to this international environmental standard in all aspects of its business operations and decisions was re-affirmed by AJA Registrars following a full EMS audit in December 2005.

Taking its environmental advocacy a step further, the Bank launched in April 2005 the DBP Forest Program to support and encourage the reforestation of open and denuded areas through the planting of relatively high value fruit trees and other useful plant species. The Program was launched in response to the government's call to preserve the environment and to step up reforestation efforts in light of the calamities that struck Nueva Ecija and Quezon Province in 2004.

With an initial seed fund of P50 million from KfW of Germany, the Program was initiated to contribute to the protection of coastal areas and the conservation of soil and water in the uplands,

while improving spawning grounds for terrestrial and marine aquatic life. In the long run, it is also envisioned to help in the development of downstream industries in the countryside. These projects are expected to benefit a total of 2,500 poor families from partner-peoples' organizations (POs) through increased livelihood opportunities.

The Bank's environmental lending programs, meanwhile, provided assistance to various sectors amounting to P3 Billion in 2005. This supported projects in pollution control, cleaner production, solid waste management, water supply, renewable energy and alternative clean fuel.

Preliminary studies were undertaken with respect to the full commercialization of bio-ethanol and Coco Methyl Ester projects. There are two projects which are under evaluation.

To further influence industries to observe environmental responsibility in their operations, DBP also undertook the publication of sectoral guidebooks and manuals for target industries like hospitals, furniture, textile, transport, plastics, hotels and resorts, and SMEs. An Environmental Performance Monitoring (EPM) was also institutionalized as a tool for managing environmental risks to evaluate borrowers' compliance with environmental requirements.

As a signatory to the global Carbon Disclosure Project, DBP sustained efforts towards the continued improvement of its Climate Change Program.

Another project-in-progress being developed with several partners is the Environmental Portal, a web-based system that provides easily accessible information on the environment. The Portal, better known as "one-environment.ph" started as a partnership venture between the DENR and the DBP. The Portal seeks to provide relevant information that will help guide the business and industry comply with regulatory requirements and conform to standards.

Anti-Corruption

An institutionalized corporate culture of excellence that emphasizes a firm adherence to positive values, commitment to high standards of productivity and competence, and a deep spirit of service to the Bank as an institution, its clientele, and to the economy forms DBP's first line of defense against corruption. It promoted a culture of excellence through strong corporate values, proactive talent acquisition and retention strategies, relevant training and leadership program, and an effective performance management system aligned with the Bank's thrusts.

As a sustaining activity under its corporate culture program, officers and employees regularly gather during the Monday forum to share their reflections on weekly themes that espouse the four pillars of the DBP corporate culture. These are: Integrity, Competence, Teamwork and Professionalism.

To promote enterprise-wide risk management, the Bank's human resource management collaborated with various institutions in updating and strengthening personnel skills on Loan Documentation, Examination of Questioned Documents, Signature Verification and Counterfeit Money Detection, Credit Review, International Financial Reporting Standards and Credit Appraisal.

DBP also continued to enforce strict compliance with relevant laws and regulations such as the procurement of contracts for goods and services as stipulated under RA No. 9184.

The Manual on Code of Ethics guides the office behavior of employees. It has been disseminated to all Bank units in pamphlet form, and is integrated in the Personnel Manual which is accessible to all employees through the Intranet. The Code underscores the duties and obligations of DBP to its various stakeholders. It also stipulates the duties and obligations of officers and employees to DBP, and sets the standards of behavior and performance, particularly on confidentiality and conflict of interest.

Complementing the Code as basis for discipline in the Bank are the Uniform Rules on Administrative Cases and the Grievance Machinery. The former defines the process whereby erring officers and staff are complained against, charged, investigated, heard and disciplined. The latter addresses employee dissatisfaction, by providing the mechanism for expeditious resolution of employee complaint at all times and at the lowest level possible in the organization. These avenues to complain and be complained against strengthen the fight against anomalies, including corruption.