

613 DERIVATIVES ACTIVITIES

A bank may engage in authorized derivatives activities: *Provided*, That the bank:

- a. Understands, measures, monitors and controls the risks assumed from its derivatives activities;
- b. Adopts effective risk management practices whose sophistication are commensurate to the risks being monitored and controlled; and
- c. Maintains capital commensurate with the risk exposures assumed.

Further, a bank may likewise engage in financial derivatives activities in accordance with these guidelines. The transacting bank shall have the responsibility to comply with the guidelines set out in this Section, including the relevant appendices, and other applicable laws, rules and regulations governing derivatives transaction. In case of derivatives instruments involving foreign currencies and/or other foreign currency- denominated assets, the transacting bank shall observe the pertinent FX rules and regulations. For purposes of these guidelines, a bank that transacts (i.e., transacting bank) whether as end-user, broker or dealer, in derivatives instruments is considered to be engaging in a derivatives activity.

Derivative is broadly defined as a financial instrument that primarily derives its value from the performance of an underlying variable. For purposes of these guidelines, a *financial derivative* is any financial instrument or contract with all of the following characteristics:

- a. Its value changes in response to a change in a specified interest rate, financial instrument price, commodity price, FX rate, index of prices or rates, credit spread, credit rating or credit index or other variables not prohibited under existing laws, rules and regulations (the “underlying”);
- b. It requires either no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- c. It is settled at a future date.

Financial derivatives activities shall also include transactions in cash instruments with embedded derivatives that reshape the risk-return profile of the host instrument, such as credit-linked notes (“CLNs”) and other structured products (“SPs”).

A market participant may take any of the following roles in a derivatives transaction:

- a. An *end-user* is defined as a financial market participant that enters, for its own account, in a

derivatives transaction for legitimate economic purposes. These purposes may include, but are not limited to, the following: hedging, proprietary trading, managing capital or funding costs, obtaining indirect exposures to desired market factors, investment, yield- enhancement, and/or altering the risk-reward profile of a particular item or an entire balance sheet.

An end-user may be classified according to its financial sophistication:

- (1) *Market counterparty* - refers to any UB or KB, only with respect to the instruments for which it is authorized to engage in as a dealer.
 - (2) *Institutional counterparty* - refers to an institution which is not a market counterparty and has the level of net worth, knowledge, expertise, and experience to deal with financial derivatives.
 - (3) *Sophisticated individual end-user* - refers to an individual who has demonstrated to the bank as having the level of net worth, knowledge and experience in dealing with financial products, including financial derivatives. An individual may register as a sophisticated individual end-user with the appropriate supervising department of the Bangko Sentral.
 - (4) *Other end-user* - This refers to all other institutional or individual clients not categorized as market counterparty, institutional counterparty or sophisticated individual end-user.
- b. A *broker* is a financial market participant that facilitates a derivatives transaction between a dealer and its client, for a fee or commission. The counterparties to the derivatives contract are the client and an authorized dealer.
- c. A *dealer* is defined as a financial market participant that engages in a derivatives activity as an originator of derivatives products or as market-maker in derivatives products. A dealer can distribute its own derivatives products, including those of others. A dealer can also act as broker and/or end-user of derivatives instruments.

Definition of terms.

- a. *Credit default swaps (CDS)* - refers to a financial contract between two (2) parties, the protection buyer and protection seller, with reference to a certain notional value of a reference credit or a basket of reference credits, whereby the former pays a premium to the latter, and in return the latter agrees to make certain protection payments to the former contingent upon the occurrence of a credit event with respect to the reference entity(ies)/asset(s).

- b. *Credit-linked note (CLN)* – refers to a pre-funded credit derivative instrument under which the note holder effectively accepts the transfer of credit risk pertaining to a reference asset or basket of assets issued by a reference entity/ies. The repayment of the principal to the note holder is contingent upon the occurrence of a defined credit event. In consideration thereof, the note holder receives an economic return reflecting the underlying credit risk of the reference assets. For purposes of this Section, the term shall generically include similar instruments such as credit-linked deposits (CLDs) and credit-linked loans (CLLs). Unless otherwise stated, the term shall refer only to plain vanilla CLNs. Plain vanilla CLNs are composed of a debt or deposit instrument and a CDS. Non-plain vanilla CLNs are those that are leveraged and/or include features of other SPs (e.g., coupon payments linked to interest or FX rate movements) and/or contains more than one (1) embedded derivative.
- c. *Currency swaps* – refers to an arrangement in which two parties exchange a series of cash flows in one (1) currency for a series of cash flows in another currency, at specified exchange and/or interest rates and at agreed intervals over an agreed period.
- d. *Forward FX contracts* – refers to an agreement for delayed delivery of a foreign currency in which the buyer agrees to purchase and the seller agrees to deliver at a specified future date a specified amount at a specified exchange rate.
- e. *Forward rate agreement (FRA)* – refers to an agreement fixing the interest rates for a specified period whereby the buyer receives (or pays) and the seller pays (or receives) the interest rate differential if the reference rate rises above (or falls below) the contract rate, respectively.
- f. *FX exposure* – refers to an FX risk arising from an existing commitment to or from a non-resident or AAB which leads to payment of an FX obligation or receipt of an FX asset based on verifiable documents on deal date.
- g. *FX obligation* – refers to an actual FX commitment to a non-resident or any AAB where the amount, payment tenor and party have been determined.
- h. *FX options* – refers to option contracts which convey the right or the obligation depending upon whether the bank is the purchaser or the writer, respectively to buy or sell at a specified price by a specified future date, for a fee or a premium, two (2) different currencies at a specified exchange rate.
- i. *FX swaps* – refers to an agreement involving an initial exchange of two (2) currencies, usually at the prevailing spot rate, and a simultaneous commitment to reverse the exchange of the same two (2) currencies at a date further in the future at a rate (different from the rate applied to the

initial exchange) agreed on deal date.

j. *Interest rate swaps (IRS)* – refers to an agreement in which the parties agree to exchange interest cash flows on a principal amount at certain times in the future according to an agreed upon formula.

k. *Non-deliverable forward (NDF)* – refers to a forward FX contract where only the net difference between the contracted forward rate and the market rate shall be settled at maturity.

l. *Non-resident* – refers to an individual, a corporation or other juridical person not included in the definition of resident.

m. *Resident* – refers to:

- (1) An individual citizen of the Philippines residing therein; or
- (2) An individual who is not a citizen of the Philippines but is permanently residing therein; or
- (3) A corporation or other juridical person organized under the laws of the Philippines; or
- (4) A branch, subsidiary, affiliate, extension office or any other unit of corporations or juridical persons which are organized under the laws of any country and operating in the Philippines, except OBUs.

n. *Structured product (SP)* – refers to a financial instrument where the total return is a function of one (1) or more underlying indices, such as interest rates, equities and exchange rates. It is composed of a host contract (e.g., plain vanilla debt or equity securities) and an embedded derivative (e.g., swaps, forwards or options) that re-shape the risk-return pattern of the hybrid instrument. For purposes of guidelines under this Section, the term SP does not include asset-backed securities. Provisions under Sec. 627-A shall continue to apply for securities overlying securitization structures.

Generally authorized derivatives activities. A bank may engage in the following derivatives activities without need of prior Bangko Sentral approval: *Provided*, That it observes the provisions of *Appendix 22* and meets the following conditions:

a. UBs and KBs may transact in the following derivatives in the capacities specified:

(1) *As a dealer.* A UB or KB may originate and distribute the following “organized market”-traded financial derivatives:

(a) FX forwards, FX swaps, currency swaps and analogous financial futures with a tenor of

three (3) years or less; and

- (b) Interest rate swaps, forward rate agreements and analogous financial futures with a tenor of ten (10) years or less: *Provided*, That the issuance of sub- participation in any derivatives held as an end-user shall be deemed as undertaking the role of a dealer: *Provided, further*, That the dealer UB or KB observes the provisions of *Sec. 612* and other pertinent securities laws, rules and regulations.

For purposes of this Section, an *organized market* refers to an exchange or a Bangko Sentral-recognized over-the-counter market governed by transparent and binding market conventions on price transparency, trade reporting, market surveillance and orderly conduct/operations of the market.

(2) *As end-user*¹.

- (a) A UB or KB, including its trust department, may enter in any financial derivatives transaction for the purpose of hedging its own risks: *Provided*, That it observes all the requirements for hedging transactions under PAS.
- (b) A UB or KB may trade with counterparties in order to take positions for its own account in “organized market” – traded financial instruments enumerated under Item “1” above. It can also take long positions in naked FX options with a tenor of three (3) years or less.
- (c) RBU and EFCDU of UBs and KBs, including its trust departments, may invest, for their own account, in the following SPs:
- (i) Principal-protected foreign currency- denominated SPs, the revenue streams of which are linked to interest rate indices, interest rate instruments, listed equity shares or indices, FX rates, credit rating or index, or gold: *Provided*, That the maximum contractual maturity shall be five (5) years;
- (ii) Plain vanilla single-name CLNs where the reference asset is an obligation issued or guaranteed by the Republic of the Philippines.

Provided, That the bank or trust entity shall comply with the following conditions:

- (aa) Total carrying value of all investments in SPs shall not exceed 100% of the bank’s qualifying Tier 1 capital or fifty percent (50%) of a trust entity’s trust assets; and

- (bb) For investments in SPs under the EFCDU, total carrying value of SPs as defined herein shall also not exceed twenty percent (20%) of the total FCDU assets: *Provided*, That SPs which are not booked in an investment account (e.g., booked as inter-bank loans), for this purpose, shall be considered as part of the EFCDU assets.

An SP is considered principal-protected if the minimum all-in return for such investment is at least zero and such minimum all-in return is guaranteed by an entity (i.e., issuer or a third party) rated at least "A" or its equivalent by an international rating agency acceptable to the Bangko Sentral or fully collateralized by an asset with equivalent credit quality.

- (3) *As a broker*. A UB or KB may facilitate derivatives transactions between dealers and market and/or institutional counterparties and/or sophisticated individual end-users: *Provided*, That the UB/ KB, acting as broker, ensures that its client fully understands its limited responsibility as a broker: *Provided, further*, That the bank adheres to procedures for evaluating client suitability, including risk disclosures, as prescribed in *Sec. 612*: *Provided, finally*, That the bank complies with other pertinent securities laws, rules and regulations.

- b. TBs, RBs and Coop Banks may enter in derivatives transactions as end-user with Bangko Sentral - authorized dealers and brokers solely for hedging purposes: *Provided*, That they observe all the requirements for hedging transactions under PAS². A TB, RB or Coop Bank may apply for a Type 3 authority to enter into derivatives transactions as end-user for purposes other than hedging: *Provided*, That the applicant bank agrees to be covered by all regulations prescribing capital for market risk, notwithstanding any provision to the contrary; and
- c. A trust department of a UB or KB may transact, as an institutional counterparty, with financial derivatives instruments enumerated under item "(a)(2)" above on behalf of its trustor/principal/s as may be authorized by such trustor/principal/s: *Provided*, That the trust department observes the relevant provisions of *Appendix 22* and *Sec. 612*. Trust entities other than that within a UB or KB may apply for a Type 3 authority to enter on behalf of its trustor/principal/s in derivatives transactions under item "(a)(2)" above. Any trust entity may also apply for Type 3 authority in order to transact as end-user on behalf of its trustor/ principal/s with derivatives instrument outside those enumerated under item "(a)(2)" above.

Activities requiring additional derivatives authority. A bank shall apply for prior Bangko Sentral approval of additional derivatives authority to engage in all other financial derivatives activities not expressly allowed under this Section on Generally authorized derivatives activities. A bank may apply for two (2) or more additional authorities. A bank applying for additional derivatives authority/ies must have and maintain a risk management system commensurate to the additional authority/ies being applied for, in accordance with the provisions of *Appendix 22* and meet other conditions specified under

this Section.

a. *Classification of additional derivatives authority*

(1) *Type 1 – Expanded dealer authority*

A UB or KB may apply for a Type 1 authority. A bank with Type 1 authority may transact in any financial derivatives as a dealer: *Provided*, That a bank with Type 1 authority shall comply with the sales and marketing guidelines prescribed in Sec. 612. A bank with Type 1 authority may likewise transact in any financial derivatives as a broker and an end-user.

The Bangko Sentral expects banks applying for Type 1 authority to institutionalize a (a) comprehensive and integrated risk management system; and (b) sales and marketing practices that are deemed appropriate and adequate for the different derivatives activities it expects to engage in. It must be rated at least CAMELS (or ROCA for branches of foreign banks) of “4” or better over-all, notwithstanding any provision to the contrary.

(2) *Type 2 – Limited dealer authority*

A UB or KB may apply for a Type 2 authority. A bank with Type 2 authority may operate as a dealer in specific types of derivatives products with specific underlying reference, as applied for by the bank, outside those financial derivatives instruments under item “(a)(1)” of this Section on Generally authorized derivatives activities: *Provided*, That a bank with Type 2 authority shall comply with the sales and marketing guidelines prescribed in Sec. 612. The Type 2 authority also carries authority to transact as broker and end-user of the said specific derivatives instruments.

A TB with an existing authority to issue foreign letters of credit and pay/accept/ negotiate import/export drafts/ bills of exchange under Sec. 101-B may apply for a Type 2 authority to operate as a dealer of deliverable FX forwards in order to service the trade-related hedging requirements of its clients: *Provided*, That the tenor of the FX forwards dealt shall match the term of the underlying trade transaction: *Provided, further*, That the applicant bank shall be covered by all regulations prescribing capital for market risk, notwithstanding any provision to the contrary: *Provided, furthermore*, That the TB shall comply with the sales and marketing guidelines prescribed in Sec. 612. The Type 2 authority also carries the authority to transact as a broker and an end-user of deliverable FX forwards.

(3) *Type 3 – Limited user authority*

Any bank may apply for a Type 3 authority. A bank with Type 3 authority may transact, as an end-user, in specific types of derivatives products, with specific underlying reference, as applied for by the bank, outside of those instruments under item “(a)(2)” of this Section on Generally authorized derivatives activities. However, as regards a TB, RB or Coop Bank and trust entity other than that within a UB or KB, a Type 3 authority will enable said bank/entity to transact as end-user of a derivative instrument as may be applied for by the bank/entity.

(4) Type 4 - *Special broker authority*

A bank, other than a UB or KB, may apply for a Type 4 authority. A bank with Type 4 authority may facilitate a derivatives transaction between a UB or KB, as dealer, and market and institutional counterparties and sophisticated individual end-users: *Provided*, That the bank, acting as broker, ensures that its client fully understands its limited responsibility as a broker and observes the provisions of Sec. 612.

A UB or KB may likewise apply for a Type 4 authority to enable itself to broker a derivatives transaction for or with other end-users.

A bank with additional Type 1, 2 or 4 authorities shall be responsible for complying with pertinent securities laws, rules and regulations.

For purposes of this Section, the types of derivatives are classified as follows: forwards, swaps and options. Underlying reference pertains to the following: interest, FX, equity, credit and commodity.

b. *Qualification requirements.* A bank applying for additional authority to engage in expanded derivatives activities shall:

(1) Demonstrate adequate competence in its general operations as evidenced by:

- (a) CAMELS (or ROCA for branches of foreign banks) composite rating of at least “3” with a similar rating for Management;
- (b) No unresolved major safety and soundness issues that threaten liquidity or solvency; and
- (c) Substantial compliance with regulations on anti-money laundering, corporate governance and risk management.

(2) Hold capital commensurate to the risks assumed or to be assumed from the derivatives activities. The Bangko Sentral expects a bank applying for or holding additional derivatives authority to have adequate capital to accommodate existing and future risks from additional

and generally authorized derivatives activities as well as risks arising from the bank's other business activities. For this purpose, the Bangko Sentral may require capital higher than the minimum required under prudential regulations.

- (3) Have and maintain a risk management system that conforms to the principles and complies with the minimum standards prescribed in *Appendix 22*.
- c. *Applicability to trust entities.* Trust entities may apply for Type 3 authority: *Provided*, That they comply with the requirements prescribed and observe the provisions of Sec. 612.
- d. *Application procedures.* The applicant shall submit to the appropriate supervising department of the Bangko Sentral a written application for additional derivatives authority/ies accompanied by:
- (1) A copy of the board resolution (or equivalent management review body in the case of branches of foreign banks or trust committee, in case of trust entities) approving the application for a specific type of derivatives authority;
 - (2) A notarized certification signed jointly by the president, treasurer and compliance officer of the applicant-bank (or two (2) authorized signatories of equivalent rank of the trust committee in case of trust entities), stating that the bank complies with all the requirements for the authority being applied for specified under this Section on Activities requiring additional derivatives authorities; and
 - (3) A list of the types of derivatives and underlying reference the bank intends to engage in, including the following information for each derivatives class or type:
 - (a) Target customers for such derivatives;
 - (b) The capacity in which the bank intends to engage in such derivatives;
 - (c) Description of each type of derivatives and underlying reference with which it will deal;
 - (d) Analysis of the risks involved in transacting in each type of derivatives;
 - (e) Procedures/methodologies that the bank will implement to measure, monitor (including risk management reports) and control the risks inherent in the types of derivatives;
 - (f) Relevant accounting guidelines, including pro-forma accounting entries;
 - (g) Analysis of any actual or potential legal/regulatory restrictions; and
 - (h) Process flow chart, from deal initiation to risk reporting, indicating the departments and personnel involved in identified processes.
 - (4) Payment of a non-refundable processing fee amounting to:

Authority	Amount	
Type 1	P 200,000	(UBs and KBs)
Type 2	100,000	
Type 3	50,000	
	25,000	(other applicants)
Type 4	25,000	(all banks)

- (5) The Bangko Sentral will not accept applications lacking any of the above-stated requirements. The Bangko Sentral, however, may require additional documents to aid its evaluation of the application. By virtue of the application, the applicant automatically authorizes the Bangko Sentral to conduct an on-site evaluation of the applicant's risk management capabilities, if this is deemed necessary.
- (6) Type 1 authority shall be subject to approval by the Governor, upon recommendation of the Deputy Governor of the appropriate sector of the Bangko Sentral. All other applications for additional authority/ies shall be subject to approval by the Deputy Governor of the appropriate sector of the Bangko Sentral.
- (7) A bank whose application for additional derivatives authority/ies or an upgrade thereof (e.g., from Type 2 to Type 1 authority) has been denied cannot submit a new application for additional derivatives authorities until after six (6) months from receipt of denial. The same rule applies for a bank whose authorities have been limited or downgraded.
- (8) A bank that holds an additional derivatives authority may apply for additional derivatives authorities (e.g., currently holding Type 3 authority who wish to apply for Type 4 authority) or an upgrade thereof only after the lapse of six (6) months from the grant of the previous additional derivatives authority.

Intra-group transactions. All derivatives transactions between a bank and any of its subsidiaries and affiliates shall comply with minimum risk management standards for related-party transactions outlined in *Appendix 22*, as part of the bank's internal control procedures. The Bangko Sentral expects banks to establish internal reporting and monitoring system for derivatives activities for related-party transactions. Failure to comply with minimum standards shall be a ground for citing non-compliance with under this Section on Generally authorized derivatives activities, and Activities requiring additional derivatives authority without prejudice to other Bangko Sentral rules and regulations such as those related to corporate governance and unsafe or unsound banking.

Accounting guidelines. A bank that engages in derivatives activities must strictly account for such

transactions in accordance with PAS.

Reporting requirements. A bank or trust department/ entity engaged in any derivatives transaction shall submit, in addition to the derivatives reports enumerated under the Bangko Sentral FRP, a monthly report on derivatives transactions/outstanding derivatives within fifteen (15) banking days from end of the reference month. The reports shall be certified by the treasurer.

Sanctions.

- a. *Unauthorized transactions.* Sanctions prescribed under Sections 36 and 37 of R.A. No. 7653 shall be imposed on any bank (including its directors and officers) found to have engaged in an unauthorized derivatives activity.

A bank undertaking unauthorized derivatives activities may be considered as conducting its business in an unsafe or unsound manner under Section 56 of R.A. No. 8791.

- b. *Delayed/erroneous/inaccurate reporting.* Banks failing to submit the reports required under this Section on Reporting requirements within the prescribed deadline shall be subject to monetary penalties applicable for delayed reporting under existing regulations. Moreover, submission of incomplete, uncertified or improperly certified or otherwise erroneous reports shall be considered non-reporting, subject to applicable penalties for amended/ delayed reports. For purposes of imposing monetary penalties, the reports shall be classified as a *Category A-1* report. Habitual delayed or erroneous reporting may be a ground for further sanction, including limitation of generally authorized activities and/or additional authorities and/or suspension of authority to engage in such derivatives activities.
- c. *Non-compliance with the provisions of this Section and Sec. 612 and Appendix 22.* Any bank/trust entity found violating any of the provisions of this Section, Sec. 612 and *Appendix 22* shall be sanctioned with the penalties prescribed under Sections 36 and 37 of R.A. No. 7653 in accordance with the gravity/seriousness of the offense taking into consideration the number of times the offense was committed, possible consequent losses on the clients, effect on the financial markets and other relevant factors.
- d. *Curtailment of derivatives authority.* The Bangko Sentral reserves the right to suspend, modify, downgrade, limit or revoke any bank's derivatives authority (including any or all of those generally authorized activities) for prudential reasons as may be evidenced by any or all of the following:

- (1) The bank is assigned a CAMELS (or ROCA in the case of branches of foreign banks) composite

rating or component management rating of lower than that prescribed under this Section on Activities requiring additional derivatives authority, in the most recent regular examination.

- (2) The bank has not maintained adequate risk management systems given the level and type of derivatives activities it has engaged in as may be determined by the Bangko Sentral in any on-site evaluation and confirmed by the Monetary Board.
- (3) The Monetary Board has confirmed a finding of the appropriate supervising department of the Bangko Sentral that the bank has conducted business in an unsafe or unsound manner.

An erring bank may apply for reinstatement of its derivatives authority only after six (6) months from lapse of the implementation of the sanction: *Provided*, That the bank has satisfactorily addressed all Bangko Sentral concerns.

(Circular Nos. 917 dated 08 July 2016, and 864 dated 22 December 2014)

Footnotes

1. All transactions involving warrants issued under the ROP's "Paired Warrants Program" shall be considered as among the generally authorized derivatives activities that banks (including TBs and RBs/Coop Banks) may engage in as end-user, without need for additional derivatives authority required under this Section: *Provided*, That banks holding such instruments shall comply with the requirements of *Appendix 22*, where applicable.
2. All transactions involving warrants issued under the ROP's "Paired Warrants Program" shall be considered as among the generally authorized derivatives activities that banks (including TBs and RBs/Coop Banks) may engage in as end-user, without need for additional derivatives authority required under this Section: *Provided*, That banks holding such instruments shall comply with the requirements of *Appendix 22*, where applicable.