624-A CREDIT-LINKED NOTES AND SIMILAR CREDIT DERIVATIVES PRODUCTS

The following are the guidelines for the capital treatment of investments in CLNs and similar credit derivative products such as credit-linked deposits (CLDs) and credit linked loans (CLLs).

Definitions.

a. A CLN pertains 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, the note holder receives an economic return reflecting the underlying credit risk of the reference asset/s.

   All references to CLNs in this Section shall be taken to generically include similar instruments, such CLDs and CLLs.

b. *A special purpose vehicle* (SPV), for purposes of this Section, refers to an entity specifically established to issue CLNs of a single, homogeneous risk class that are fully collateralized as to principal by high-grade securities purchased out of the proceeds of the note issuance. Collateral shall be limited to securities with an assignable risk weight of not more than twenty percent (20%) under existing regulations.

Qualified banks. In general, only banks with expanded derivatives authority may invest in CLNs as defined above on the principle that such banks have already demonstrated a more sophisticated ability to manage risks. Subject to the provisions in Sec. 627-A, they may also invest in SPV-issued CLNs that co-exist with other CLNs of different seniority of claims against the reference asset pool. As an exception to the general rule, a UB/KB without expanded derivatives authority may invest in single name CLNs where the reference asset is a direct ROP obligation or an obligation fully guaranteed by the ROP.

Capital treatment of investments in CLNs.

a. *Banking book.* Positions in CLNs in the banking book shall be reported in the computation of the risk-based capital adequacy ratio covering credit risks under applicable and existing capital adequacy framework.

   Through holding a CLN, a bank acquires credit exposure on two (2) fronts – to the reference entity of the note and also to the note issuer. The on-balance sheet exposure arising from the CLN should be weighted by the higher of the risk weight of the reference entity or the risk weight of the note issuer. The amount of exposure is the book value of the note. If the CLN principal is fully collateralized by securities that are acceptable as credit risk mitigant under applicable and existing capital adequacy framework and provided such collateral is constituted in a legally effective manner as to give priority to the note holders' interest in the event of bankruptcy of the note issuer, the risk weight of the note issuer is substituted with the risk weight associated with the relevant security.

When the CLN is referenced to a basket of reference entities and the contract terminates and pays out on the first entity to default in the basket, capital should be held to consider the cumulative risk of all the reference entities in the basket. This means that the risk weights of all the reference entities are added up and the sum compared with the risk weight of the note issuer. If the sum of the risk weights of all the reference entities in the basket is higher than the risk weight of the note issuer, then this sum is adopted. The resultant risk-weighted exposure to the basket is, however, capped at ten (10) times the book value of the note. Accordingly, the maximum capital charge is 100% of the book value of the note. The multiplier ten (10) is the reciprocal of the Bangko Sentral-required minimum capital adequacy ratio of ten percent (10%).

If, on the other hand, the risk weight of the note issuer is still higher than the sum of the risk weights of all the reference entities in the basket, then the risk weight of the note issuer is adopted.

When the contract terminates and pays out on the n^{th} (other than the first) entity to default in the basket, the treatment above shall apply except that in aggregating the risk weights of reference entities, the risk weight/s of n–1 entity/ies is/are excluded from the computation. The bank may choose which entity/ies to exclude.

If a CLN that pays out on the n^{th} entity to default is rated such that it meets the criteria of a security with the "highest credit quality" as defined under *Appendix 42*, only the highest risk weight in the basket of reference entities is compared with the risk weight of the note issuer.

If the CLN is issued by an SPV, the bank is exposed to both the reference entity and the collateral held by the SPV. Thus, the risk weight/s of the reference entity/ies should be compared with the risk weight of the riskiest eligible collateral for purposes of computing the risk-weighted exposure of the note and the corresponding capital charge.

Subject to prior Bangko Sentral clearance, a bank may disapply the additive rule when a very strong correlation among the reference entities in the basket can be demonstrated.

A CLN which is referenced to entities in the basket proportionately should be risk-weighted according to each reference entity's share of protection under the contract. Thus, if there are two (2) reference entities in a P100.0 million contract, one (1) with a 100% risk weight and a twenty percent (20%) share and the other with a twenty percent (20%) risk weight and an eighty percent (80%) share, the risk weighted exposure is P36.0 million, i.e., P100.0 million x 20% x 100% + P100.0 million x 80% x 20%. The corresponding capital charge is P3.6 million (P36.0 million x 10%).

b. *Trading book.* Positions in CLNs taken up in the trading book should be reported in the computation of the adjusted risk-based capital adequacy ratio covering combined credit risk and market risk under *Appendix 42.*

(1) *Standardized approach*

The following describes the positions to be reported for investments in CLNs for purposes of calculating specific risk and general market risk charges under the standardized approach.

A CLN investment is treated as a position in the note itself, with an embedded credit default product. The CLN is subject to the specific risk associated with the issuer or the collateral when the issuer is an SPV. In addition, it is subject to general market risk that is a function of the maturity and coupon or interest rate of the note. The embedded credit default product creates a notional position in the specific risk of the reference obligation (with no additional general market risk position created).

Specific risk
A CLN investment should be reported as a long position on the reference obligation and a long position on the note itself.

When a CLN is referenced to multiple obligations in a basket, the positions reported shall depend on the structure of the contract. When the contract terminates and pays out on the first obligation to default in the basket, the note should be reported as long positions in each of the reference obligations in the basket, with the total capital charge for the product capped at the book value of the note.

When the contract terminates and pays out on the nth (other than the first) entity to default in the basket, the treatment above shall apply except that in aggregating the risk weights of the reference obligations, the risk weight/s of n-1 obligations is/are excluded from the computation. The bank may choose which obligations to exclude.

Subject to prior Bangko Sentral clearance, a bank may disapply the additive rule when a very strong correlation among the reference obligations in the basket can be demonstrated.

The additive treatment may also be disapplied when an nth-to-default CLN is rated such that it meets the criteria of a security with the *"highest credit quality"* as defined under *Appendix 42.* Positions in the reference obligations can be reported as a single long position in a debt security with the *"highest credit quality".* A long position on the note should also be reported whether or not the CLN meets the criteria of a security with the *"highest credit quality".*

When the CLN is referenced to multiple obligations under a proportionate structure, positions in the reference obligations should be reported according to their respective proportions in the contract.

General market risk
A CLN investment creates a long position in the note itself.

(2) Internal models approach

Banks may seek the Bangko Sentral's approval to include CLNs in their recognized models for calculating capital charges. The detailed requirements relating to the use of internal models are set out in *Annex A* of *Appendix 42.*

While some banks may not be able to run full internal models to calculate market risk capital charges, they may, with the necessary expertise and systems, use preprocessing techniques to calculate capital charge for CLNs. Banks wishing to adopt these techniques should seek Bangko Sentral's prior consent. The preprocessing models are subject to verification by the Bangko Sentral.

***Risk management**.* CLN structures are considered to be exposed to greater risks than comparable investments in direct obligations. In particular, investing banks should be aware of the potential legal risk arising from an unenforceable contract. They should consult their legal advisors about these and related legal issues before engaging in such transactions. In addition, all investments in CLNs must be duly approved by a bank's board of directors and subjected to appropriate risk management procedures.

***Bangko Sentral approval not required**.* No prior Bangko Sentral approval is required to invest in CLNs and similar products. However, it shall be the responsibility of UBs/KBs to fully comply with appropriate risk management standards including, as a minimum, those prescribed under this Section. The regulatory requirements enumerated in *Appendix 64* shall be fully complied with by UBs/KBs investing in products allowed under this Section.

Investment in credit-linked notes (CLNs) and similar structured products with embedded credit derivatives, as defined under this Section, including those that were reclassified from HFT to Available for Sale (AFS)/Held to Maturity (HTM)/Unquoted Debt Securities Classified as Loans (UDSCL) or from AFS to HTM/UDSCL in accordance with the reclassification rules under Circular No. 626 dated 23 October 2008 and Circular No. 628 dated 31 October 2008, shall be classified and measured at FVPL upon initial application of PFRS 9.

The accounting treatment for investments in CLNs and other structured products under Bangko-Sentral Memorandum M-2008-10 dated 07 March 2008 and the guidelines on reclassification of CLNs and other similar instruments that are linked to the ROP under Memorandum M-2009-12 dated 16 April 2009 shall no longer apply to financial assets that are accounted for in accordance with PFRS 9.

(Circular Nos. 890 dated 02 November and 827 dated 28 February 2014)