

FRAMEWORK FOR DEALING WITH DOMESTIC SYSTEMICALLY IMPORTANT BANKS ***(Appendix to Sec. 128 on Domestic Systemically Important Banks [DSIBs])***

Introduction

This document outlines the Bangko Sentral ng Pilipinas' implementing guidelines on the framework for dealing with domestic systemically important banks (DSIBs) in accordance with the reform packages proposed by the Basel Committee on Banking Supervision (BCBS)¹ and introduced in Basel III: A global regulatory framework for more resilient banks and banking systems.

It is the thrust of the Bangko Sentral to ensure that its capital adequacy framework is consistent with the Basel principles. Hence, the Bangko Sentral is adopting policy measures for DSIBs, which are essentially aligned with the documents issued by BCBS on global systemically important banks (GSIBs) and DSIBs. The broad aim of the policies is to reduce the probability of failure of DSIBs by increasing their going-concern loss absorbency and to reduce the extent or impact of failure of DSIBs on the domestic / real economy.

The guidelines shall apply on a consolidated basis to all UBs and KBs including branches of foreign banks established under R.A. No. 7721 (An Act Liberalizing the Entry and Scope of Operations of Foreign Banks in the Philippines and for Other Purposes), as amended by R.A. No. 10641.

Submission of data requirements for the identification of DSIBs shall take effect starting with 2014 data while compliance with the additional higher loss absorbency requirement shall be phased-in from 01 January 2017 with full implementation by 01 January 2019.

Part I. Assessment Methodology

A. Indicator-Based Measurement Approach

1. The systemic importance of a bank is assessed in relation to the impact of its failure on the domestic economy using an indicator-based measurement approach.
2. The impact of a DSIB's failure to the domestic economy shall be assessed based on bank-specific factors, to wit: (a) size; (b) interconnectedness; (c) substitutability / financial institution infrastructure; and (d) complexity. Ten indicators related to these categories shall be used to identify DSIBs. These indicators reflect the factors or criteria which make a bank significant for the stability of the financial system and the economy.
3. The UBs and KBs operating in the Philippines shall be assessed based on the four (4) categories

and on data that relate to the consolidated group (i.e., unit of analysis is the consolidated group). For foreign banks, the computation of systemic importance shall be done on the basis of data that relates to their local consolidated balance sheet. Each category is given an equal weight of twenty five percent (25%) in determining the final score (Table 1). In the case of categories with more than one (1) indicator, the weight of twenty five percent (25%) is equally divided across all indicators within the category.

Table 1. Indicator-Based Measurement Approach

| Category (and weighting) | Individual Indicator | Indicator Weighting |
|---|---|---------------------|
| Size (25%) | Total exposures as defined for use in the Basel III leverage ratio | 25.00% |
| Interconnectedness (25%) | Intra-financial system assets | 8.33% |
| | Intra-financial system liabilities | 8.33% |
| | Securities outstanding | 8.33% |
| Substitutability/financial institution infrastructure (25%) | Assets under custody | 8.33% |
| | Payments activity | 8.33% |
| | Underwritten transactions in debt and equity markets | 8.33% |
| Complexity (25%) | Notional amount of over-the-counter (OTC) derivatives | 8.33% |
| | Unquoted debt securities classified as loans and investments in non-marketable equity securities | 8.33% |
| | Trading and available-for-sale securities, and financial assets designated at fair value through profit or loss | 8.33% |

- For each bank, the score for a particular indicator is calculated by dividing the individual bank amount by the aggregate amount for the indicator summed across all banks in the sample. This amount is then multiplied by 10,000 to express the indicator score in terms of basis points. The category score for each bank is determined by taking a simple average of the indicator scores in the category. The overall score for each bank is then calculated by taking a simple average of its four (4) category scores. The maximum total score, i.e., the score that a bank would have if it were the only bank in the sample, is 10,000 basis points (i.e., 100 percent).
- The succeeding paragraphs briefly describe each of the four categories used in the assessment methodology. The specific definition of the indicators can be found in Annex I which sets out the data requirements for the identification of DSIBs. The guidelines and the line item instructions

for the reporting template are set out in Annex II.

a. Size

A bank's distress or failure is more likely to damage the local economy or financial markets if its activities comprise a large share of the domestic activity. The larger the bank, the more difficult it is for its activities to be quickly replaced by other banks and for it to be resolved, therefore, the greater the chance that its distress or failure will cause disruption to the financial markets. The distress or failure of a large bank is also more likely to damage confidence in the financial system as a whole. Size is therefore a key measure of systemic importance. One (1) indicator is used to measure size: the measure of total exposures used in the Basel III leverage ratio².

b. Interconnectedness

Financial distress at one (1) institution can materially increase the likelihood of distress at other institutions given the network of contractual obligations in which they operate. A bank's systemic impact is considered to be positively related to its interconnectedness vis-à-vis other financial institutions. Three (3) indicators are used to measure interconnectedness:

- (i) intra-financial system assets;
- (ii) intra-financial system liabilities; and
- (iii) securities outstanding.

c. Substitutability/Financial Institution Infrastructure

The systemic impact of a bank's distress or failure is expected to be negatively related to its degree of substitutability as both a market participant and client service provider, i.e., it is expected to be positively related to the extent to which the bank provides financial institution infrastructure. At the same time, the cost to the failed bank's customers in having to seek the same service from another institution is likely to be higher for a failed bank with relatively greater market share in providing that service. Three (3) indicators are used to measure substitutability / financial institution infrastructure:

- (i) assets under custody;
- (ii) payments activity; and
- (iii) underwritten transactions in debt and equity markets.

d. Complexity

The systemic impact of a bank's distress or failure is expected to be positively related to its overall complexity – that is, its business, structural and operational complexity. The more complex a bank is, the greater are the costs and time needed to resolve the bank. Three (3) indicators are used to measure complexity:

- (i) notional amount of over-the-counter (OTC) derivatives;
- (ii) assets booked under unquoted debt securities classified as loans and investments in non-marketable equity securities; and
- (iii) trading and available-for-sale securities and financial assets designated at fair value through profit or loss.

B. Bucketing Approach

6. Banks that have a score produced by the indicator-based measurement approach that exceeds a cut-off level determined using cluster analysis shall be classified as DSIBs. Supervisory judgment may also be used when warranted under certain circumstances to add banks to the list of DSIBs. This judgment shall be exercised according to the principles set out in Part I.C.
7. Bangko Sentral shall group DSIBs into different categories of systemic importance using cluster analysis based on the scores produced by the indicator-based measurement approach. DSIBs shall be initially allocated into two (2) buckets with different levels of additional loss absorbency requirements depending on the degree of systemic importance.
8. The thresholds for the buckets shall correspond to the gaps identified by a cluster analysis of the scores. The use of cluster analysis in grouping the DSIBs will ensure a meaningful and objective measurement and classification of the systemic importance of domestic banks.
9. Each year, Bangko Sentral shall run the assessment, and reallocate DSIBs into the categories of systemic importance based on their scores. It should be noted that the number of DSIBs, and their bucket allocations, will evolve over time as banks change their behavior in response to the incentives of the DSIBs framework as well as other aspects of Basel III and Bangko Sentral regulations.
10. An empty bucket shall be added on top of the highest-numbered populated bucket to provide incentives for banks to avoid becoming more systemically important. If the empty bucket becomes populated in the future, a new empty bucket shall be added with a required higher additional loss absorbency level. The size of the empty bucket shall be determined by the average size of the preceding buckets.

C. Supervisory Judgment

11. As stated earlier, supervisory judgment may be used to add banks with scores below the cutoff to the list of DSIBs. It shall be used on exceptional cases and presumed to be rare. The judgment overlay shall comprise well-documented and verifiable quantitative and qualitative information.
12. Qualitative information is intended to capture information that cannot be easily translated or quantified in the form of an indicator. This may include but not limited to the following: major restructuring of a bank's operation; merger; and niche market or other aspects which are unique to the concerned bank. Qualitative judgments shall also be thoroughly explained and supported by verifiable arguments.

D. Periodic Review and Refinement

13. The assessment methodology provides a framework for periodically reviewing the DSIBs status of a given bank. Thus, banks have incentives to change their risk profile and business models in ways that reduce their systemic spillover effect. The Banko Sentral does not intend to develop a fixed list of DSIBs. Through the criteria discussed above, banks can migrate in and out of DSIB status, and between categories of systemic importance, over time.
14. The list of DSIBs shall be assessed/determined annually based on year-end data submitted by each bank and shall be subject to approval of the Monetary Board. The results shall be released every June. Banks identified as DSIBs shall be informed individually, including the bucket they belong to and the individual score for each indicator.
15. The assessment methodology shall be reviewed every three (3) years in order to capture developments in the banking sector and any progress in methods and approaches for measuring systemic importance.

Part II. Higher Loss Absorbency (HLA) and Interaction with Other Elements of Basel III Framework

16. Banks that will be identified as DSIBs shall be required to have HLA. The HLA requirement is aimed at ensuring that DSIBs have a higher share of their balance sheets funded by instruments which increase their resilience as a going concern, considering that the failure of a DSIB is expected to have a greater impact on the domestic financial system and economy.
17. The imposition of HLA shall be based on the degree of domestic systemic importance. This is to

provide the appropriate incentives to banks which are subject to the HLA requirements to reduce (or at least not increase) their systemic importance over time.

18. The HLA requirement is to be met with CET 1 capital as defined by the Basel III framework and implemented under *Appendix 63b*. This is to ensure a maximum degree of consistency in terms of effective loss absorbing capacity.
19. The magnitude of additional loss absorbency for the higher populated bucket shall be two and a half percent (2.5%) of risk-weighted assets at all times, with the initial empty bucket at three and a half percent (3.5%) of risk-weighted assets. The magnitude of additional loss absorbency for the lower bucket shall be one and a half percent (1.5%) of risk-weighted assets. Table 2 shows the additional loss absorbency requirement for each bucket.

Table 2. Bucketing Approach

| Bucket | Score Range | Minimum additional loss absorbency (common equity as a percentage of risk-weighted assets) |
|-----------|-------------------|--|
| 3 (Empty) | B - C | 3.5% |
| 2 | A - B | 2.5% |
| 1 | Cut-off point - A | 1.5% |

20. Although the buckets thresholds are set initially such that bucket 3 is empty, if this bucket should become populated in the future, a new bucket shall be added to maintain incentives for banks to avoid becoming more systemically important. Minimum HLA requirement for the new buckets shall increase in increments of one percent (1%) of risk-weighted assets.
21. The HLA requirement shall be on top of the combined requirement for capital conservation buffer (CCB) and Countercyclical Capital Buffer (CCyB) under Appendix 59. Table 3 shows a sample total CET1 capital requirement for banks identified as DSIBs per bucket.

Table 3. Sample Total CET 1 Capital Requirement when:

A. CCyB rate is at 0%

| Bucket | 3 (Empty) | 2 | 1 |
|------------------------------------|-----------|------|------|
| Minimum CET 1 Requirement (a) | 6.0% | 6.0% | 6.0% |
| Capital Conservation Buffer (b) | 2.5% | 2.5% | 2.5% |
| Countercyclical Capital Buffer (c) | 0% | 0% | 0% |

| | | | |
|---|-------|-------|-------|
| DSIB HLA Requirement (d) | 3.5% | 2.5% | 1.5% |
| Total Additional CET1 Requirement (b+c+d) | 6.0% | 5.0% | 4.0% |
| Total Required CET1 (a+b+c+d) | 12.0% | 11.0% | 10.0% |

B. CCyB rate is at 2.5%

| Bucket | 3 (Empty) | 2 | 1 |
|---|--------------|-------|-------|
| Minimum CET 1 Requirement (a) | 6.0% | 6.0% | 6.0% |
| Capital Conservation Buffer (b) | 2.5% | 2.5% | 2.5% |
| Countercyclical Capital Buffer (c) | 2.5% | 2.5% | 2.5% |
| DSIB HLA Requirement (d) | 3.5% | 2.5% | 1.5% |
| Total Additional CET1 Requirement (b+c+d) | 8.5% | 7.5% | 6.5% |
| Total Required CET1 (a+b+c+d) | 14.5% | 13.5% | 12.5% |

To help ensure that the banking sector can meet the higher capital requirements through reasonable earnings retention and capital raising activities, while still supporting lending to the economy, transitional arrangements to implement the HLA requirement shall be implemented. Thus, in the case of banks included in the first list of DSIBs (to be released in June 2015 based on December 2014 data), compliance with the HLA requirement shall be phased-in starting 01 January 2017, with full compliance on 01 January 2019 (See Table 4 for the timeline to comply with the HLA requirement). After the phased-in period, banks identified as DSIBs shall be allowed a period of 18 months to comply with the required HLA.

Table 4. Timeline of Release of List of DSIBs and Compliance with the HLA Requirement

| Date Cut-Off | Release of DSIBs List | Compliance Period |
|--------------|-----------------------|---|
| Dec-14 | Jun-15 | Phased-in implementation starting 01 January 2017 until 01 January 2019 |
| Dec-15 | Jun-16 | Phased-in implementation starting 01 January 2018 until 01 January 2019 |
| Dec-16 | Jun-17 | 01 January 2019 to 31 December 2019 |
| Dec-17 | Jun-18 | 01 January 2020 to 31 December 2020 |
| Dec-18 | Jun-19 | 01 January 2020 to 31 December 2021 |

22. To determine banks' compliance with the additional CET1 requirement for DSIBs, the minimum ratio shall be complied with by the parent bank and its subsidiary banks and quasi-banks on both solo and consolidated bases.

23. Foreign bank branches operating in the Philippines with head office/consolidated group declared as global systemically important bank (GSIB) but not declared as DSIB will not be required to put up in the Philippine branch the required HLA for GSIB. However, if identified as DSIB in the Philippines, the required HLA for DSIBs shall be complied with locally by the Philippine branch.
24. Capital distribution constraints shall be imposed when capital levels fall within certain range as illustrated in Table 5 below. Conversely, a DSIB shall not be subject to any restriction on distribution if the following conditions are met:
- Has positive retained earnings as of the preceding quarter and has complied with the requirements on declaration of dividends under Section 124;
 - Has CET1 of more than the total required (minimum CET1 ratio of six percent (6.0%) plus the combined requirement for CCB of two and a half percent (2.5%) and the CCyB at the rate determined by the Monetary Board – zero percent (0%) to two and a half percent (2.5%), and DSIBs HLA requirement) before the distribution; and
 - Has complied with the minimum capital ratios (CET1 ratio of six percent (6%), Tier 1 ratio of seven and a half (7.5%) and ten percent (10%) CAR) after the distribution.

Table 5. Sample Restriction on Distributions when

A. CCyB rate is 0%

| Restriction on Distributions | Level of CET1 Capital | |
|--|-----------------------|----------------|
| | Bucket 1 | Bucket 2 |
| No distribution (until the minimum CET1 requirement, the combined requirement for CCB and CCyB and more than 50% of DSIB HLA requirement are met; and conditions "a" and "c" above are complied with) | <=9.25% | <=9.25% |
| 50% of earnings may be distributed (if the minimum CET1 requirement, the combined requirement for CCB and CCyB and more than 50% of the DSIB HLA requirements are met; and conditions "a" and "c" above are complied with) | >=9.25%-10.00% | <=9.75%-11.00% |

B. CCyB rate is at 2.5%

| Restriction on Distributions | Level of CET1 Capital | |
|------------------------------|-----------------------|----------|
| | Bucket 1 | Bucket 2 |

| | | |
|---|--------------------------|--------------------------|
| No distribution (until the minimum CET1 requirement, the combined requirement for CCB and CCyB and more than 50% of DSIB HLA requirement are met; and conditions "a" and "c" above are complied with) | $\leq 11.75\%$ | $\leq 12.25\%$ |
| 50% of earnings may be distributed (if the minimum CET1 requirement, the combined requirement for CCB and CCyB and more than 50% of the DSIB HLA requirement are met; and conditions "a" and "c" above are complied with) | $\geq 11.75\%$ to 12.50% | $\leq 12.25\%$ to 13.50% |

During the phased-in implementation period from 2017 to 2019, the general principle above on restriction on distribution shall likewise be applied. Annex III shows the restriction on distributions by year for each bucket during the phased-in implementation from 2017 to 2019, assuming there is no change in the HLA requirement. In case of change in the HLA requirement during the phased-in period, the required HLA shall be distributed equally over the remaining period until the full implementation in 2019.

25. Elements subject to the restriction on distributions include dividends, share buybacks, discretionary payments on other Tier 1 capital instruments and discretionary bonus payments to directors, officers and staff. Payments which do not result in the depletion of CET1 are not considered capital distributions.
26. Earnings refer to distributable profits calculated prior to the deduction of elements subject to the restriction on distributions. The earnings is computed after the tax, which would have been reported had none of the distributable items been paid.

Part III. Intensive Supervisory Approach

27. Banks identified as DSIBs shall include in their Internal Capital Adequacy Assessment Process (ICAAP) document concrete and reasonable recovery plans which shall be implemented in case the bank breaches the HLA capital requirement. The recovery plans shall include guidelines and action plans to be taken to restore the DSIB's financial condition to viable level in cases of significant deterioration in certain scenarios. This shall include specific initiatives appropriate to the Bank's risk profile such as capital raising activities, streamlining of businesses, restructuring and disposal of assets, to improve capital position.
28. Moreover, the banks designated as DSIBs shall be subject to more intensive supervision, which may include but not limited to, greater intensity of offsite supervision and monitoring, more structured interaction with board and senior management, and higher supervisory expectation on controls for significant businesses/operations, data aggregation capabilities and corporate governance.

(Circular No. 1024 dated 06 December 2018)

Annex A

Schedule of Restriction on Distribution During the Phased-In Implementation Period
of the Higher Loss Absorbency Requirement³
(Appendix to Sec. 128 on DSIBs)

| Level of CET 1 Capital | | | | | | |
|---|----------------------------|----------------------------|----------------------------|----------------------------|----------------------------|----------------------------|
| Restriction on Distribution | Bucket 1 | | | Bucket 2 | | |
| | 01 Jan 2017 to 31 Dec 2017 | 01 Jan 2018 to 31 Dec 2018 | 01 Jan 2019 to 31 Dec 2019 | 01 Jan 2017 to 31 Dec 2017 | 01 Jan 2018 to 31 Dec 2018 | 01 Jan 2019 to 31 Dec 2019 |
| No distribution (until the minimum CET 1, CCB and more than fifty percent (50%) of DSIB HLA are met; and conditions a and c of paragraph 24 of Appendix 110 are complied with) | <=8.75% | <=9.0% | <=9.25% | <=8.9167% | <=9.3333% | <=9.75% |
| Fifty percent (50%) of earnings may be distributed (if the minimum CET 1, CCB and more than 50% of the DSIB HLA requirements are met; and conditions a and c of Appendix 110 are complied with) | >8.75%-9.0% | >9.0%-9.5% | >9.25%-10.00% | >8.9167%-9.3333% | >9.3333%-10.1667% | >9.75%-11.00% |

Footnotes

1. The Basel Committee on Banking Supervision consists of senior representatives of bank supervisory authorities and central banks from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. It usually meets at the Bank for International Settlements (BIS) in Basel, Switzerland, where its permanent Secretariat is located.
2. To be computed in accordance with the guidelines to be issued by the Bangko Sentral on leverage ratio.
3. Assuming there is no change in the bucket/required HLA during the phased-in implementation period. In case of change in the HLA requirement during the phased-in period, the required HLA shall be distributed equally over the remaining period until the full implementation in 2019.