

GUIDELINES ON THE IMPLEMENTATION OF THE BASEL III LEVERAGE RATIO FRAMEWORK

(Appendix to Section 129)

The Banko Sentral will adopt a leverage ratio framework that is designed to act as a credible supplementary measure to the risk-based capital requirements. The leverage ratio intends to:

- Restrict the build-up of leverage in the banking sector to avoid destabilizing deleveraging processes which can damage the broader financial system and the economy; and
- Reinforce the risk-based requirements with a simple, non-risk based “backstop” measure.

This framework is largely based on the document issued by the Basel Committee on Banking Supervision (“Basel Committee” or “BCBS”) released in January 2014 entitled “Basel III Leverage Ratio Framework and Disclosure Requirements”.

A. Definition, Minimum Requirement and Scope of Application

Leverage ratio is defined as the capital measure (the numerator) divided by the exposure measure (the denominator), expressed as a percentage:

$$\text{Basel III Leverage Ratio} = \frac{\text{Tier 1 Capital}}{\text{Exposure Measure}}$$

The leverage ratio shall not be less than 5.0 percent and will be applied to all universal and commercial banks (U/KBs) and their subsidiary banks/quasi-banks (QBs) computed on both solo¹ and consolidated² bases, similar with the capital adequacy framework, i.e., computed on a daily basis and reported on a quarterly basis.

1. Capital Measure

The capital measure for the leverage ratio is Tier 1 capital calculated in accordance with *Appendix 59*.

Tier 1 capital should be net of regulatory deductions³ applicable to Tier 1 capital. Items that are deducted completely from capital do not contribute to leverage, hence, should also be deducted from the exposure measure.

2. Exposure Measure

The Exposure Measure for derivative contracts⁴ consists of an exposure arising from the underlying of the derivative contract and a counterparty credit risk (CCR) exposure. In general, the Exposure Measure for derivatives is calculated as follows:

$$\begin{array}{r}
 \text{Exposure Measure =} \\
 \text{for Derivatives} \\
 \\
 \text{Replacement Cost (RC)} \\
 + \\
 \text{Potential Future} \\
 \text{Exposure (PFE)} \\
 \pm \\
 \text{Adjustments for Written Credit Derivatives}
 \end{array}$$

Where:

RC = Positive mark-to-market value of the contract (or zero if the mark-to-market value is zero or negative);

*PFE*⁵ = This represents an add-on arising from the potential exposure over the remaining life of the contract calculated by multiplying the notional principal amount of the contract to the appropriate potential future credit conversion factor; and

Adjustments for Written Credit Derivatives = effective notional amount⁶ referenced by the written credit derivative

In the computation of the PFE, the following add-on factors shall apply to financial derivatives, based on residual maturity:

Residual Maturity	Interest Rate Contract	Exchange Rate Contract	Equity Contract
One (1) year or less	0.0 percent	1.0 percent	6.0 percent
Over 1 year to five (5) years	0.5 percent	5.0 percent	8.0 percent
Over 5 years	1.5 percent	7.5 percent	10.0 percent

For contracts with multiple exchanges of principal, the factors are to be multiplied by the number of remaining payments in the contract. For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be set equal to the time until the next reset date, and in the case of interest rate contracts with remaining maturities of more than one (1) year that meet these criteria, the potential future CCF is subject to a floor of 0.5 percent.

For credit derivatives, which refer to credit default swaps (CDS), total return swaps (TRS) and credit-linked notes (CLN), two approaches shall be applied, as follows:

- a) For single-name credit derivatives, a 5.0 percent add-on factor for the computation of the potential future credit exposure shall be used by both protection buyers and protection sellers if the reference obligation is rated as investment grade by at least two credit rating agencies, i.e., rated Baa or higher by Moody's and BBB or higher by Standard & Poor's. A 10.0 percent add-on factor applies to all other reference obligations. However, a protection seller in a CDS shall only be subject to the add-on factor if it is subject to closeout upon the insolvency of the protection buyer while the underlying is still solvent. The add-on in this case should be capped to the amount of unpaid premiums.
- b) With regard to multiple name derivatives, where the credit derivative is a first to default transaction, the add-on will be determined by the lowest credit quality underlying in the basket (i.e., if there are any non-investment grade or unrated items in the basket), the 10.0 percent add-on should be used. For second and subsequent nth-to-default transactions, underlying assets should continue to be allocated according to the credit quality (i.e., the second lowest credit quality will determine the add-on for a second or nth-to-default transaction respectively). On the other hand, where the credit derivative is referenced proportionately to multiple obligations, the add-on factor will follow the add-on factor applicable to the obligation with the biggest share. If the protection is equally proportioned, the highest add-on factor should be used.

Written Credit Derivatives

In addition to the CCR exposure arising from the fair value of the contracts, written credit derivatives⁷ create a notional credit exposure arising from the creditworthiness of the reference entity. As such, written credit derivatives shall be treated consistently with cash instruments (i.e., loans, bonds) for the purpose of the exposure measure.

In order to capture the credit exposure to the underlying reference entity, the effective notional amount⁸ referenced by a written credit derivative is incorporated into the Exposure Measure. However, the effective notional amount of a written credit derivative may be reduced by any negative change in fair value amount that has been incorporated into the calculation of Tier 1 capital with respect to the written credit derivative. The resulting amount may be further reduced by the effective notional amount of a purchased credit derivative on the same reference name⁹, *Provided*; That

- The credit protection purchased on a reference obligation which ranks *pari passu* with or

is junior to the underlying reference obligation of the written credit derivative in the case of single name credit derivatives; and

- The remaining maturity of the credit protection purchased is equal to or greater than the remaining maturity of the written credit derivative.

The Exposure Measure of a written credit derivative may be overstated by the inclusion in the Exposure Measure of both (1) PFE representing counterparty credit exposure and (2) effective notional amount representing reference entity exposure. To avoid double counting, a PFE of zero is assigned to a written credit derivative whose effective notional amount is already included in the Exposure Measure. Hence, the total exposure measure for written credit derivatives equals RC and its corresponding effective notional amount.

3. Securities Financing Transactions (SFTs)

SFTs are transactions such as repurchase agreements, reverse repurchase agreements, security lending and borrowing and margin lending transactions, where the value of the transactions depends on market valuation and the transactions are often subject to margin agreements.

- For bank/non-bank acting as principal, the Exposure Measure calculations for SFTs shall be computed as follows:

$$\text{Exposure Measure for SFTs} = \frac{\text{Adjusted SFT Assets} + \text{Counterparty Credit Risk Exposure (E)}}{2}$$

Where:

Adjusted SFT Assets = the gross SFT assets¹⁰ recognized for accounting purposes (i.e., with no recognition of accounting netting) will be adjusted to exclude the value of any securities received under an SFT, where the bank has recognized the securities as an asset on its balance sheet¹¹.

Counterparty Credit Risk Exposure (E) = the measure of CCR is calculated as the current exposure (i.e., without PFE) with respect of the SFT.

The current exposure for transactions with a counterparty must be calculated on a transaction by transaction basis: that is, each individual SFT is treated as its own netting set, computed as the difference between the fair value of securities and cash lent to a counterparty for a transaction and the fair value of securities and cash received to a counterparty for a transaction. In other words, it shall follow the formula:

$$E = \max, \{0, [E_i - C_i]\}$$

Where:

E_i = cash and the fair value of securities lent to a counterparty for a transaction, and

C_i = cash and the fair value of securities received from a counterparty for a transaction.

- b. If a bank/non-bank acting as an agent in an SFT provides an indemnity or guarantee to a customer or counterparty for any difference between the value of the security or cash the customer has lent and the value of the collateral the borrower has provided, the bank/non-bank should include in its Exposure Measure only the measure for Counterparty Credit Risk Exposure (E). Otherwise, the treatment when the bank is acting as a principal shall be applied.

4. Off-balance sheet (OBS) Items

The leverage ratio exposure measure for Off-balance sheet (OBS) items is generally calculated by multiplying the notional amount of the OBS item by a credit conversion factor (CCF), as follows:

- a. 100 percent CCF – this shall apply to OBS securitization exposures except an eligible liquidity facility or an eligible servicer cash advance facility, direct credit substitutes, e.g., general guarantees of indebtedness (including standby letters of credit serving as financial guarantees for loans and securities) and acceptances (including endorsements with the character of acceptances) as follows:
- Guarantees issued other than shipperside bonds/airway bills; and
 - Financial standby letters of credit.
- b. Fifty (50) percent CCF – this shall apply to OBS securitization exposures that qualify as eligible liquidity facilities¹² and certain transaction-related contingent items, e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions) as follows:
- Performance standby letters of credit (net of margin deposits), established as a guarantee that a business transaction will be performed;
 - Note issuance facilities (NIFs) and revolving underwriting facilities (RUFs); and
 - Other commitments, e.g., formal standby facilities, commitments with an original maturity over one (1) year and Underwritten Accounts Unsold.

c. Twenty (20) percent CCF – this shall apply to short-term self-liquidating trade letters of credit arising from the movement of goods¹³, e.g., documentary credits collateralized by the underlying shipments, such as:

- Trade-related guarantees:
 - Shipment bonds/airway bills
 - Letters of credit – confirmed
- Sight letters of credit outstanding (net of margin deposit);
- Usance letters of credit outstanding (net of margin deposit);
- Deferred letters of credit (net of margin deposit);
- Revolving letters of credit (net of margin deposit) arising from movements of goods and/or services; and
- Commitments with an original maturity up to one (1) year.

d. Ten (10) percent CCF – this shall apply to commitments that are unconditionally cancellable at any time by the bank without prior notice (i.e., Credit Card Lines), undrawn service cash advances or facility¹⁴ or that effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness.

This shall also apply to those not involving credit risk, as follows:

- Spot foreign exchange contracts (bought and sold);
- Late deposits / payments received;
- Inward bills for collection;
- Outward bills for collection;
- Travelers' checks unsold;
- Deficiency claims receivable; and
- Others.

B. Reporting and disclosure requirements

Starting 31 December 2014 and every quarter thereafter until 30 June 2018, banks concerned shall submit the Basel III Leverage Ratio reporting template on both solo and consolidated bases for monitoring purposes. The report shall use the prescribed forms and shall be submitted to the appropriate supervising department of the Banko Sentral. The report submission is summarized below:

Report Date	Reference Date	Deadline of Submission
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30 September 2017 31 December 2017	31 December 2017	Fifteen (15) banking days from end of reference date on solo basis, and Thirty (30) banking days from end of reference date on consolidated basis
31 March 2018	31 March 2018	
30 June 2018	30 June 2018	

Upon migration to a Pillar 1 minimum requirement effective on 1 July 2018, the Basel III Leverage Ratio report shall be submitted along with the Basel III CAR report.

The Basel III Leverage Ratio reporting template shall be composed of four (4) parts:

- Part I – Calculation of Basel III Leverage Ratio
- Part II – Derivative Exposures
- Part III – Securities and Financing Transactions
- Part IV – Off-Balance Sheet Items

In addition to the reporting template to be submitted to the Bangko Sentral, banks will be required to publicly disclose their Basel III leverage ratio on both solo and consolidated bases. The public disclosure requirements include:

- a summary comparison table that provides a banks' total accounting assets amounts and leverage ratio exposures;
- a common disclosure template that provides a breakdown of the main leverage ratio regulatory elements;
- a reconciliation requirement that details the source(s) of material differences between banks' total balance sheet assets in their financial statements and on-balance sheet exposures in the common disclosure template; and
- other disclosures (i.e., material period changes in the leverage ratio from the end of the previous reporting period to the end of the current reporting period).

The public disclosure requirements shall be made either through inclusion of the requirements in the bank's annual reports or published financial statements that are posted in the banks' websites. An ongoing archive of all the reconciliation templates, disclosure templates and explanatory tables relating to prior periods must be made available by banks in their website. All disclosures must be made according to the defined templates.

At a minimum, three (3) items must be publicly disclosed in the quarterly published balance sheet: (i) the numerator (Tier 1 capital); (ii) the denominator (exposure measure); and (iii) the Basel III Leverage Ratio.

(Circular Nos. 990 dated 22 January 2018, 943 dated 26 January 2017 and 881 dated 09 June 2015)

Footnotes

1. Pertains to the reporting entity's head office and branches
2. Pertains to the reporting entity and its financial allied subsidiaries except insurance companies that are required to be consolidated on a line-by-line basis for the purpose of preparing consolidated financial statements
3. Refers to Regulatory Adjustments to CET1 Capital (Items A.2.1 to A.2.24) and Regulatory Adjustments to Additional Tier 1 (AT1) Capital (Items A.5.1 to A.5.8) of Part II (Qualifying Capital) of the BASEL III CAR Template (Version 3)
4. This approach makes reference to the Current Exposure Method (CEM) which is used under the Basel II framework to calculate the CCR exposure amounts associated with derivative exposures. The Basel Committee is considering alternatives to the CEM. If an alternative approach is adopted as a replacement for the CEM, Basel Committee will consider whether that alternative approach is appropriate in the context of the need to capture both types of exposures created by derivatives.
5. No potential future credit exposure shall be calculated for single currency floating/floating interest rate swaps, the credit exposure on these contracts would be evaluated solely on the basis of their mark- to-market valuation.
6. For credit derivative contracts where the stated notional amount differs from the effective notional amount, banks/ non-banks must use the greater of the effective notional amount and the notional amount. The effective notional amount is obtained by adjusting the notional amount to reflect the true exposure of contracts that are leveraged or otherwise enhanced by the structure of the transaction.
7. Written credit derivatives refer to credit default swaps, total return swaps and credit-link notes where banks act as guarantor.
8. For credit derivative contracts where the stated notional amount differs from the effective notional amount, banks/ non-banks must use the greater of the effective notional amount from the notional amount. The effective notional amount is obtained by adjusting the notional amount to reflect the true exposure of contracts that are leveraged or otherwise enhanced by the structure of the transaction.
9. Two reference names are considered identical only if they refer to the same legal entity.
10. For SFT assets subject to novation, "gross SFT assets recognized for accounting purposes" are replaced by the final contractual exposure, given that pre-existing contracts have been replaced by new legal obligations through the novation process.
11. Gross SFT assets recognized for accounting purposes must not recognize any accounting netting of cash payables against cash receivables (e.g., under the Philippine Accounting Standards).
12. These OBS securitization exposures must meet the definition and minimum requirements under Sec. 125.
13. Applied to both issuing and confirming banks.
14. Issued under Memorandum M-2014-044 dated 24 November 2014