RISK-BASED CAPITAL ADEQUACY FRAMEWORK FOR THE PHILIPPINE BANKING SYSTEM

(Appendix to Sec. 125)

Introduction

This Appendix outlines the Bangko Sentral implementing guidelines of the *revised International Convergence of Capital Measurement and Capital Standards,* popularly known as Basel II, and the reforms introduced in *Basel III: A global regulatory framework for more resilient banks and banking systems.* Basel II and Basel III comprise the international capital standards set by the Basel Committee on Banking Supervision (BCBS)[1].

The guidelines revise the risk-based capital adequacy framework for UBs and KBs, as well as their subsidiary banks and QBs. TBs and RBs as well as QBs that are not subsidiaries of UBs and KBs shall be subject to a different set of guidelines except the criteria for eligibility as qualifying capital.

The guidelines shall take effect on 01 January 2014.

Part I. Risk-based capital adequacy ratio (CAR)

1. UBs and KBs and their subsidiary banks and QBs shall be subject to the following risk-based CARs:

   a. Common Equity Tier (CET1) must be at least six percent (6%) of risk-weighted assets at all times;
   b. Tier 1 capital must be at least seven and a half percent (7.5%) of risk-weighted assets at all times; and
   c. Qualifying capital (Tier 1 plus Tier 2 capital) must be at least ten percent (10%) of risk-weighted assets at all times.

2. CET1 capital, Tier 1 capital and qualifying capital are computed in accordance with the provisions of Part II. Risk-weighted assets is the sum of (1) credit- risk weighted assets (Parts IV, V and VI),(2) market risk-weighted assets (Parts VI and VII), and (3) operational risk-weighted assets (Part VIII).

3. The CAR requirement will be applied to all UBs and KBs and their subsidiary banks, and QBs on both solo[2]and consolidated[3] bases. The application of the requirement on a consolidated basis is the best means to preserve the integrity of capital in banks with subsidiaries by eliminating double gearing. However, as one of the principal objectives of supervision is the protection of

depositors, it is essential to ensure that capital recognized in capital adequacy measures is readily available for those depositors. Accordingly, individual banks should likewise be adequately capitalized on a stand-alone basis.

4. To the greatest extent possible, all banking and other relevant financial activities (both regulated and unregulated) conducted by a bank and its subsidiaries will be captured through consolidation. Thus, majority-owned or -controlled financial allied undertakings should be fully consolidated on a line by line basis. Exemptions from consolidation shall only be made in cases where such holdings are acquired through debt previously contracted and held on a temporary basis, are subject to different regulation[4] or where non- consolidation for regulatory capital purposes is otherwise required by law. All cases of exemption from consolidation must be made with prior clearance from the Bangko Sentral.

5. Banks shall comply with the minimum CARs at all times notwithstanding that supervisory reporting shall only be on quarterly basis. Any breach, even if only temporary, shall be reported to the bank's Board of Directors and to Bangko Sentral, SES within three (3) banking days. For this purpose, banks shall develop an appropriate system to properly monitor their compliance.

6. The Bangko Sentral reserves the right, upon authority of the Deputy Governor, SES, to conduct on-site inspection outside of regular or special examination, for the purpose of ascertaining the accuracy of CAR calculations as well as the integrity of CAR monitoring and reporting systems.

Part II. Qualifying capital

1. Qualifying capital consists of the sum of the following elements, net of required deductions

   a. Tier 1 capital (going concern capital) is composed of:

      i. CET1; and
      ii. Additional Tier 1 (AT1) capital; and

   b. Tier 2 (gone-concern) capital.

2. A bank must ensure that any component of capital included in qualifying capital complies with all the eligibility criteria for the particular category of capital in which it is included.

Section A. Domestic banks

CET1 capital

3. CET1 capital consists of:

   a. Paid up common stock issued by the bank that meet the eligibility criteria in "*App. 59 Annex A*";

   b. Common stock dividends distributable;

   c. Additional paid-in capital resulting from the issuance of common stock included in CET1 capital;

   d. Deposit for common stock subscription;

   e. Retained earnings;

   f. Undivided profits;[5]

   g. Other comprehensive income;

      (1) Net unrealized gains or losses on AFS securities[6];
      (2) Cumulative foreign currency translation;
      (3) Remeasurement of Net Defined Benefit Liability/(Asset);
      (4) Gains/(Losses) on Fair Value Adjustments of Hedging Instruments:

         (a) Cash Flow Hedge; and
         (b) Hedge of a Net Investment in Foreign Operations; and

      (5) Others (indicate the nature and amount of the accounts lodged)

   h. Minority interest in subsidiary banks which are less than wholly-owned:[7] *Provided*, That the minority interest arises from issuances of common stock which, if issued by the bank itself, would meet all of the criteria for classification as CET1 capital: *Provided, further*, That the amount to be included as minority interest shall be reduced by the surplus CET 1 of the subsidiary attributable to minority shareholders: *Provided, furthermore,* That the surplus CET 1 capital of the subsidiary attributable to minority shareholders is computed as the available CET1 capital minus the lower of: (1) the minimum CET1 capital requirement of the subsidiary and (2) the portion of the consolidated minimum CET1 requirement that is attributable to the subsidiary, multiplied by the percentage of CET1 held by minority shareholders.

      Illustrative computation is in *App. 59 Annex D.*

Regulatory adjustment to CET1 capital

4. The following must be deducted from/(added to) CET1 capital:

   a. Common stock treasury shares[8] including shares that the bank could be contractually obliged to purchase;

   b. Gains (Losses) resulting from designating financial liabilities at fair value through profit or loss that are due to changes in its own credit worthiness;[9]

   c. Unbooked valuation reserves and other capital adjustments based on the latest report of examination as approved by the Monetary Board;

   d. Total outstanding unsecured credit accommodations, both direct and indirect, to DOSRI;

   e. Total outstanding unsecured loans, other credit accommodations and guarantees granted to subsidiaries;

   f. Total outstanding loans, other credit accommodations and guarantees granted to related parties that are not at arm's length terms as determined by the appropriate supervising department of the Bangko Sentral;

   g. Deferred tax assets that rely on future profitability of the bank to be realized, net of any (1) allowance for impairment and (2) associated deferred tax liability, if and only if the conditions cited in PAS 12 are met: *Provided*, That, if the resulting figure is a net deferred tax liability, such excess cannot be added to Tier 1 capital;

   h. Goodwill, net of any allowance for impairment and any associated deferred tax liability which would be extinguished upon impairment or derecognition, including that relating to unconsolidated subsidiary banks, financial allied undertakings (excluding subsidiary securities dealers/brokers and insurance companies) (on solo basis) and unconsolidated subsidiary securities dealers/ brokers, insurance companies and non- financial allied undertakings (on solo and consolidated bases);

   i. Other intangible assets, net of any allowance for impairment and any associated deferred tax liability which would be extinguished upon impairment or derecognition;

   j. Gain on sale resulting from a securitization transaction;

k. Defined benefit pension fund assets (liabilities);[10]

l. Investments in equity of unconsolidated subsidiary banks and QBs, and other financial allied undertakings (excluding subsidiary securities dealers/ brokers and insurance companies), after deducting related goodwill, if any (for solo basis);

m. Investments in equity of unconsolidated subsidiary securities dealers/ brokers and insurance companies after deducting related goodwill, if any (for both solo and consolidated bases);

n. Significant minority investments (10%- 50% of voting stock) in banks and QBs, and other financial allied undertakings (for both solo and consolidated bases);

o. Significant minority investments (10%-50% of voting stock) in securities dealers/ brokers and insurance companies, after deducting related goodwill, if any (for both solo and consolidated bases);

p. Minority investments (below 10% of voting stock) in banks and QBs, and other financial allied undertakings (excluding subsidiary securities dealers/brokers and insurance companies), after deducting related goodwill, if any (for both solo and consolidated bases);

q. Minority investments (below 10% of voting stock) in securities dealers/brokers and insurance companies, after deducting related goodwill, if any (for both solo and consolidated bases);

For equity investments in financial entities (Items "*k*" to "*p*"), total investments include:

i. common equity exposures in both the banking and trading book; and
ii. underwriting positions in equity and other capital instruments held for more than five (5) days:

Provided, That should the instrument of the entity in which the bank has invested does not meet the criteria for CET1 capital of the bank, the capital is to be considered common shares and thus deducted from CET1.

r. Other equity investments in non- financial allied undertakings and non-allied undertakings;

s. Capital shortfalls of unconsolidated subsidiary securities dealers/brokers and insurance companies (for both solo and consolidated bases);

t. Reciprocal investments in common stock of other banks/QBs and financial allied undertakings

including securities dealers/ brokers and insurance companies, after deducting related goodwill, if any (for both solo and consolidated bases);

u. Materiality thresholds in credit derivative contracts purchased;

v. Credit-linked notes and other similar products in the banking book with issue ratings below investment grade;

w. Securitization tranches and structured products which are rated below investment grade or are unrated; and

x. Credit enhancing interest only strips in relation to a securitization structure, net of the amount of “gain-on-sale” that must be deducted from CET1 capital.

Additional Tier 1 (AT1) capital

5. AT1 capital consists of the following:

a. Instruments issued by the bank that are not included in CET1 capital that meet the following:

i. criteria for inclusion in AT1 capital as set out in “*App. 59 Annex B*”;
ii. required loss absorbency features for instruments classified as liabilities for accounting purposes. The loss absorbency requirements are provided in “*App. 59 Annex E*”; and
iii. required loss absorbency feature at point of non-viability as set out in “*App. 59 Annex F*”.

b. Additional paid-in capital resulting from the issuance of instruments included in AT1 capital;

c. Deposit for subscription of AT1 capital instruments;

d. Minority interest in subsidiary banks which are less than wholly-owned:[11] *Provided*, That the minority interest arises from issuances of Tier 1 instruments, if issued by the bank itself, would meet all of the criteria for classification as Tier 1 capital: *Provided, further,* That the amount to be included as minority interest shall be reduced by the surplus Tier 1 capital of the subsidiary attributable to minority shareholders: *Provided, furthermore,* That the surplus Tier 1 capital of the subsidiary attributable to minority shareholders is computed as the available Tier 1 capital minus the lower of: (1) the minimum Tier 1 capital requirement of the subsidiary and (2) the portion of the consolidated minimum Tier 1 requirement that is attributable to the subsidiary, multiplied by the percentage of Tier 1 held by minority shareholders: *Provided, finally,* That the amount of Tier 1 capital to be recognized in AT1

capital will exclude amounts recognized in CET1 capital.

Illustrative computation is in App. 59 Annex D.

Regulatory adjustments to AT1 capital

6. The following are the adjustments to AT1 capital:

a. AT1 instruments treasury shares[12], including shares that the bank could be contractually obliged to purchase;

b. Investments in equity of unconsolidated subsidiary banks and QBs, and other financial allied undertakings (excluding subsidiary securities dealers/ brokers and insurance companies), after deducting related goodwill, if any (for solo basis);

c. Investments in equity of unconsolidated subsidiary securities dealers/brokers and insurance companies after deducting related goodwill, if any (for both solo and consolidated bases);

d. Significant minority investments (10%-50% of voting stock) in banks and QBs, and other financial allied undertakings (for both solo and consolidated bases);

e. Significant minority investments (10%-50% of voting stock) in securities dealers/brokers and insurance companies, after deducting related goodwill, if any (for both solo and consolidated bases);

f. Minority investments (below 10% of voting stock) in banks and QBs, and other financial allied undertakings (for both solo and consolidated bases);

g. Minority investments (below 10% of voting stock) in securities dealers/brokers and insurance companies, after deducting related goodwill, if any (for both solo and consolidated bases.

For equity investments in financial entities (Items "*b*" to "*g*"), total investments include:

i. other capital instruments in both the banking and trading book; and
ii. underwriting positions in equity and other capital instruments held for more than five (5) days:

Provided, That should the instrument of the entity in which the bank has invested does not meet the criteria for AT1 capital of the bank, the capital is to be considered common shares

and thus deducted from CET1 capital.

h. Reciprocal investments in AT1 capital instruments of other banks/QBs and financial allied undertakings including securities dealers/brokers and insurance companies, after deducting related goodwill, if any (for both solo and consolidated bases);

Tier 2 capital

7. Tier 2 capital is composed of the following:

a. Instruments issued by the bank (and are not included in AT1 capital) that meet the following:

i. criteria for inclusion in Tier 2 capital as set out in "*App. 59 Annex C*"; and
ii. required loss absorbency feature at point of non-viability as set out in "*App. 59 Annex F*".

b. Deposit for subscription of T2 capital;

c. Appraisal increment reserve – bank premises, as authorized by the Monetary Board;

d. General loan loss provision, limited to a maximum of one percent (1.00%) of credit risk-weighted assets, and any amount in excess thereof shall be deducted from the credit risk-weighted assets in computing the denominator of the risk-based capital ratio;

e. Minority interest in subsidiary banks which are less than wholly-owned:[13] *Provided*, That the minority interest arises from issuances of capital instruments, if issued by the bank itself, would meet all of the criteria for classification as Tier 1 or Tier 2 capital: *Provided, further,* That the amount to be included as minority interest shall be reduced by the surplus total capital of the subsidiary attributable to minority shareholders: *Provided, furthermore,* That the surplus total capital of the subsidiary attributable to minority shareholders is computed as the available total capital minus the lower of: (1) the minimum total capital requirement of the subsidiary and (2) the portion of the consolidated minimum total capital requirement that is attributable to the subsidiary, multiplied by the percentage of total capital held by minority shareholders. *Provided, finally,* That the total capital that will be recognized in Tier 2 will exclude amounts recognized in CET1 and AT1 capital.

Illustrative computation in *App. 59 Annex D*.

Regulatory adjustments to Tier 2 capital

8. The following adjustments shall be charged against Tier 2 capital:

a. Tier 2 instruments treasury shares[14], including shares that the bank could be contractually obliged to purchase;

b. Investments in equity of unconsolidated subsidiary banks and QBs, and other financial allied undertakings (excluding subsidiary securities dealers/ brokers and insurance companies), after deducting related goodwill, if any (for solo basis);

c. Investments in equity of unconsolidated subsidiary securities dealers/brokers and insurance companies after deducting related goodwill, if any (for both solo and consolidated bases);

d. Significant minority investments (10%- 50% of voting stock) in banks and QBs, and other financial allied undertakings (for both solo and consolidated bases);

e. Significant minority investments (10%- 50% of voting stock) in securities dealers/ brokers and insurance companies, after deducting related goodwill, if any (for both solo and consolidated bases);

f. Minority investments (below 10% of voting stock) in banks and QBs, and other financial allied undertakings (for both solo and consolidated bases);

g. Minority investments (below 10% of voting stock) in securities dealers/brokers and insurance companies, after deducting related goodwill, if any (for both solo and consolidated bases;

For equity investments in financial entities (Items "*b*" to "*g*"), total investments include:

i. other capital instruments in both the banking and trading book; and
ii. underwriting positions in equity and other capital instruments held for more than five (5) days:

Provided, That should the instrument of the entity in which the bank has invested does not meet the criteria for T2 capital of the bank, the capital is to be considered common shares and thus deducted from CET1 capital.

h. Sinking fund for the redemption of T2 capital instruments; and

i. Reciprocal investments in T2 capital instruments of other banks and financial allied undertakings including securities dealers/brokers and insurance companies, after deducting

related goodwill, if any (for both solo and consolidated bases).

9. Any asset deducted from qualifying capital in computing the numerator of the risk-based capital ratio shall not be included in the risk-weighted assets in computing the denominator of the ratio.

Section B. Branches of Foreign Banks CET1 capital

10. CET1 Capital shall be comprised of:

a. Permanently assigned capital[15]:
b. Undivided profits;
c. Retained earnings;
d. Accumulated net earnings[16]:
e. Other comprehensive income

(1) Net unrealized gains or losses on AFS securities[17];
(2) Cumulative foreign currency translation;
(3) Remeasurement of Net Defined Benefit Liability/(Asset);
(4) Gains/(Losses) on Fair Value Adjustments of Hedging Instruments:

(a) Cash Flow Hedge; and
(b) Hedge of a Net Investment in Foreign Operations; and

(5) Others (indicate the nature and amount of the accounts lodged)

Regulatory adjustments to CET1 capital

11. The regulatory adjustments to CET1 capital are provided in paragraph 4, as applicable.

In addition, the *Net due from* head office, branches and subsidiaries outside the Philippines, excluding accumulated net earnings shall be deducted from CET1 capital.

Additional Tier 1 (AT1) capital

Tier 2 Capital

12. Tier 2 capital shall consist of general loan loss provision, limited to a maximum of one percent (1%) of credit risk-weighted assets, and any amount in excess thereof shall be deducted from the risk-weighted assets in computing the denominator of the risk-based capital ratio.

Regulatory adjustments to Tier 2 capital

13. The regulatory adjustments to T2 capital for branches of foreign banks are provided in paragraph 8, as applicable.

14. Any asset deducted from qualifying capital in computing the numerator of the risk-based capital ratio shall not be included in the risk-weighted assets in computing the denominator of the ratio.

Part III. Capital conservation buffer

1. A capital conservation buffer of two and a half percent (2.5%) of risk-weighted assets, comprised of CET1 capital, shall be required of UBs/KBs (both domestic and branches of foreign banks) and their subsidiary banks and QBs.

2. This buffer is meant to promote the conservation of capital and build up of adequate cushion that can be drawn down by banks to absorb losses during periods of financial and economic stress.

3. Where a bank does not have positive earnings, has CET1 of not more than eight and a half percent (8.5%) (CET1 ratio of six percent (6%) plus conservation buffer of two and a half percent (2.5%) and has not complied with the ten percent (10%) minimum CAR, it would be restricted from making positive distributions, as illustrated below:

Level of CET 1 capital	Restriction on Distributions
<6.0%	No distribution
6.0%-7.25%	No distribution until more than 7.25% CET1 capital is met
>7.25%-8.5%	50% of earnings may be distributed
>8.5%	No restriction on Distribution

4. Elements subject to the restriction on distributions include dividends, profit remittance, in the case of foreign bank branches, share buybacks, discretionary payments on other Tier 1 capital instruments, and discretionary bonus payments to staff.

5. Payments which do not result in the depletion of CET1 are not considered distributions.

6. 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.

7. The framework shall be applied on both solo and consolidated basis. The distribution constraints when applied to solo basis (individual bank level) would allow conservation of resources in specific parts of the group.

8. Drawdowns on the capital conservation buffers are generally allowed, subject to certain restrictions on distributions. However, UBs/KBs and their subsidiary banks and QBs shall be subject to a capital restoration plan within the timeframe determined by the Bangko Sentral. This restoration plan shall likewise be required for banks under the PCA framework.

9. While banks are not prohibited from raising capital from private sector in case they wish to distribute in excess of the constraints, this matter should be discussed with the Bangko Sentral and included in the capital planning process.

Part IV. Countercyclical Capital Buffer

1. A Countercyclical Capital Buffer (CCyB) set as percent of risk-weighted assets shall be required of UBs/KBs and their subsidiary banks and quasi-banks. It shall be comprised of CET1 capital.

2. The buffer is meant to ensure that banking sector capital requirements take account of the macrofinancial environment in which banks operate. The primary aim of the countercyclical capital buffer regime is to use a buffer of capital to achieve the broader macroprudential goal of protecting the banking sector from the build-up of systemic vulnerabilities. Protecting the banking sector in this context is not simply ensuring that individual banks remain solvent through a period of stress, as the minimum capital requirement and capital conservation buffer are together designed to fulfill this objective. Rather, the aim is to ensure that the banking sector in aggregate has the capital on hand to help maintain the flow of credit in the economy without its solvency being questioned, when the broader financial system experience stress.

3. The countercyclical buffer requirement will extend the size of the capital conservation buffer. The ban shall not be subject to any restriction on distribution if the following conditions are met:

   a. Has positive retained earnings as of the preceding quarter and has complied with the requirements on the declaration of dividends as provided in the MORB.

   b. Has CET1 of more than the total required (minimum CET1 ratio of six percent (6%) plus CCB of two and a half percent (2.5%) plus CCyB at the rate determined by the Monetary Board) before the distribution; and

   c. Has complied with the minimum capital ratios (CET1 ratio to six percent (6%) Tier 1 ratio of

seven and a half percent (7.5%) and ten percent (10%) (CAR) after the distribution.

Otherwise, the policy framework of the capital conservation buffer on the restriction on distributions shall apply, except for drawdowns. Thresholds on the restriction on distribution shall consider the CCyB requirement as an extension of the capital conservation buffer.

4. Drawdowns on the CCyB are not allowed unless the Bangko Sentral announces a decision to lower the buffer rate. The capital surplus created when the CCyB is lowered should be unfettered, i.e., there are no restrictions on distributions when the buffer is released.

5. The uniformly applicable rate of the countercyclical buffer shall initially be set at zero percent (0%), subject to recalibration as determined by the Monetary Board. CCyB decisions shall be based on a set of indicators including, but not limited to, the credit-to-GDP gap as well as the growth and quality of credit, among others.

6. Any increase in the countercyclical buffer shall have a preannouncement period of twelve (12) months in consideration of the capital planning process of banks while reductions in the buffer would take effect immediately to help reduce the risk of the supply of credit being constrained by regulatory capital requirement.

Part V. Credit risk-weighted assets

A. Risk-weighting

1. Banking book exposures shall be risk- weighted based on third party credit assessment of the individual exposure given by eligible external credit assessment institutions listed in Part IV.C.

The table below sets out the mapping of external credit assessments with the corresponding risk weights for banking book exposures. Exposures related to credit derivatives and securitizations are dealt with in Parts V and VI, respectively. Exposures should be risk-weighted net of specific provisions.

STANDARDIZED CREDIT RISK WEIGHTS								
Credit Assessment[18]	AAA Below	AA+ to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB	B+ to B-	Below B-	Unrated
Sovereigns	0%	0%	20%	50%	100%	100%	150%	100%
MDBs	0%	20%	50%	50%	100%	100%	150%	100%
Banks	20%	20%	50%	50%	100%	100%	150%	100%[19]

Interbank call loans	20%							
Local government units	20%	20%	50%	50%	100%	100%	150%	100%[20]
Government corporations	20%	20%	50%	100%	100%	150%	150%	100%[21]
Corporates	20%	20%	50%	100%	100%	150%	150%	100%[22]
Housing loans	50%							
MSME qualified portfolio	75%							
Defaulted exposures								
Housing loans	100%							
Others	150%							
ROPA	150%							
All other assets	100%							

Sovereign Exposures

2. These include all exposures to central governments and central banks. All Philippine peso (Php) denominated exposures to the Philippine National Government (NG) and the Bangko Sentral shall be risk-weighted at zero percent (0%). Foreign currency denominated exposures to the NG and the Bangko Sentral, however, shall be risk-weighted according to the table above: *Provided,* That only one-third (1/3) of the applicable risk weight shall be applied from 01 July 2007, two-thirds (2/3) from 01 January 2008, and the full risk weight from 01 January 2009[23]. Exposures to the Bank for International Settlements (BIS), the International Monetary Fund (IMF), and the European Central Bank (ECB) and the European Community (EC) shall also receive zero percent (0%) risk weight.

Multilateral Development Bank (MDB) Exposures

3. These include all exposures to multilateral development banks. Exposures to the World Bank Group comprised of the IBRD and the IFC, the ADB, the AfDB, the EBRD, the IADB, the EIB, the European Investment Fund (EIF), the NIB, the CDB, the Islamic Development Bank (IDB), and the CEDB currently receive zero percent (0%) risk weight. However, it is the responsibility of the bank to monitor the external credit assessments of multilateral development banks to which they have an exposure to reflect in the risk weights any change therein.

Bank Exposures

4. These include all exposures to Philippine-incorporated banks/QBs, as well as foreign-incorporated banks.

Interbank Call Loans

5. Interbank call loans refer to interbank loans that pass through the Interbank Call Loan Funds Transfer System of the Bangko Sentral, the BAP, and the PCHC.

Exposures to Local Government Units

6. These include all exposures to non- central government public sector entities.

Exposures to Government Corporations

7. These include all exposures to commercial undertakings owned by central or local governments. Exposures to Philippine GOCCs that are not explicitly guaranteed by the Philippine NG are also included in this category.

Corporate Exposures

8. These include all exposures to business entities, which are not considered as micro, small, or medium enterprises (MSME), whether in the form of a corporation, partnership, or sole proprietorship. These also include all exposures to FIs, including securities dealers/brokers and insurance companies, not falling under the definition of Bank in paragraph 4.

Housing Loans

9. These include all current loans to individuals for housing purpose, fully secured by first mortgage on residential property that is or will be occupied by the borrower[24].

Micro, Small, and Medium Enterprises (MSME)

10. An exposure must meet the following criteria to be considered as an MSME exposure:

    a) The exposure must be to an MSME as defined under existing Bangko Sentral regulations; and

    b) The exposure must be in the form of direct loans, or unavailed portion of committed credit lines and other business facilities such as outstanding guaranteesissued and unused letters of credit: *Provided,* That the credit equivalent amounts thereof shall be determined in accordance with the methodology for off-balance sheet items.

Qualified portfolio

11. For a bank's portfolio of MSME exposures to be considered as qualified, it must be a highly diversified portfolio, i.e., it has at least 500 borrowers that are distributed over a number of industries. In addition, all MSME exposures in the qualified portfolio must be current exposures. All non-current MSME exposures are excluded from count and are to be treated as ordinary non-performing loans. Current MSME exposures not qualifying under highly diversified MSME portfolio will be riskweighted based on external rating and shall be risk-weighted in the same manner as corporate exposures.

Defaulted Exposures

12. A default is considered to have occurred in the following cases:

a) If a credit obligation is considered non-performing under existing rules and regulations. For non-performing debt securities, they shall be defined as follows:

i. For zero-coupon debt securities, and debt securities with quarterly, semi-annual, or annual coupon payments, they shall be considered non-performing when principal and/or coupon payment, as may be applicable, is unpaid for thirty (30) days or more after due date; and

ii. For debt securities with monthly coupon payments, they shall be considered non-performing when three (3) or more coupon payments are in arrears: *Provided, however,* That when the total amount of arrearages reaches twenty percent (20%) of the total outstanding balance of the debt security, the total outstanding balance of the debt security shall be considered as non- performing.

b) If a borrower/obligor has sought or has been placed in bankruptcy, has been found insolvent, or has ceased operations in the case of businesses;

c) If the bank sells a credit obligation at a material credit-related loss, i.e., excluding gains and losses due to interest rate movements. Banks' board-approved internal policies must specifically define when a material credit-related loss occurs; and

d) If a credit obligation of a borrower/ obligor is considered to be in default, all credit obligations of the borrower/obligor with the same bank shall also be considered to be in default.

Housing loans

13. These include all loans to individuals for housing purpose, fully secured by first mortgage on residential property that is or will be occupied by the borrower, which are considered to be in

default in accordance with paragraph 12.

Others

14. These include the total amounts or portions of all other defaulted exposures, which are not secured by eligible collateral or guarantee as defined in Part IV.B.

ROPA

15. All real and other properties acquired and classified as such under existing regulations.

Other Assets

16. The standard risk weight for all other assets, including bank premises, furniture, fixtures and equipment, will be 100%, except in the following cases:

a) Cash on hand and gold, which shall be risk-weighted at zero percent (0%);

b) Checks and other cash items, which shall be risk-weighted at twenty percent (20%);

c) Loans to small farmer and fisherfolk engaged in palay and/or food production projects/activities to the extent guaranteed by the Agricultural Guarantee Fund Pool (AGFP) created under Administrative Order No. 225-A dated 26 May 2008, which shall be risk weighted at twenty percent (20%): *Provided*, That a separate fund is maintained to guarantee the loans originated by banks: *Provided, further,* That the maximum allowable leveraging ratio of the fund maintained to guarantee bank loans shall be three (3), i.e., the maximum amount of loans guaranteed by the fund is thrice the amount of money in the fund: *Provided, furthermore,* That the fund maintained to guarantee bank loans is invested in assets that are zero percent (0%) risk-weighted under this risk-based capital adequacy framework; and

d) Loans to MSMEs, which are performing, to the extent guaranteed by a qualified Credit Surety Fund (CSF) Cooperative, which shall be risk-weighted at twenty percent (20%). A qualified CSF Cooperative refers to a cooperative that is organized consistent with the provisions of Republic Act (R.A.) No. 10744 and its implementing rules and regulations {IRR): *Provided,* That the maximum allowable leveraging ratio of the CSF Cooperative to guarantee bank loans shall be three (3); *Provided further,* That said leverage ratio shall be subject to periodic review for progressive increase as warranted by the CSF Cooperative’s performance but not to exceed 5x the CSF Cooperative’s Restricted Capital for Surety.

Accruals on a claim shall be classified and risk-weighted in the same way as the claim. Bills purchased shall be classified and risk-weighted as claims on the drawee bank. The treatments of credit derivatives and securitization exposures are presented separately in Parts V and VI, respectively. Investments in equity or other regulatory capital instruments issued by banks or other financial/ nonfinancial allied/non-allied undertakings will be risk-weighted at 100%, unless deductible from the capital base as required in Part II.

Off-balance sheet items

17. For off-balance sheet items, the risk- weighted amount shall be calculated using a two-step process. First, the credit equivalent amount of an off-balance sheet item shall be determined by multiplying its notional principal amount by the appropriate credit conversion factor, as follows:

a) *100% credit conversion factor* – this shall apply to 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), and shall include:

i. Guarantees issued other than shipside bonds/airway bills;
ii. Financial standby letters of credit

b) *Fifty percent (50%) credit conversion factor* – this shall apply to certain transaction-related contingent items, e.g., performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions, and shall include:

i. Performance standby letters of credit (net of margin deposit), established as a guarantee that a business transaction will be performed;

This shall also apply to –

i. Note issuance facilities and revolving underwriting facilities; and
ii. Other commitments, e.g., formal standby facilities and credit lines with an original maturity of more than one (1) year, and this shall also include Underwritten Accounts Unsold.

c) *Twenty percent (20%) credit conversion factor* – this shall apply to short term, self-liquidating trade-related contingencies arising from movement of goods, e.g., documentary credits collateralized by the underlying shipments, and shall include:

i. Trade-related guarantees:

– Shipside bonds/airway bills
– Letters of credit – confirmed

ii. Sight letters of credit outstanding (net of margin deposit);
iii. Usance letters of credit outstanding (net of margin deposit);
iv. Deferred letters of credit (net of margin deposit); and
v. Revolving letters of credit (net of margin deposit) arising from movement of goods and/or services;

This shall also apply to commitments with an original maturity of up to one (1) year, and shall include Committed Credit Line for Commercial Paper Issued.

d) Zero percent (0%) credit conversion factor – this shall apply to commitments which can be unconditionally cancelled at any time by the bank without prior notice, and shall include Credit Card Lines.

This shall also apply to those not involving credit risk, and shall include:

i. Late deposits/payments received;
ii. Inward bills for collection;
iii. Outward bills for collection;
iv. Travelers' checks unsold;
v. Trust department accounts;
vi. Items held for safekeeping/ custodianship;
vii. Items held as collaterals;
viii. Deficiency claims receivable; and
viii. Others.

18. For derivative contracts, the credit equivalent amount shall be the sum of the current credit exposure (or replacement cost) and an estimate of the potential future credit exposure (or add-on). However, the following shall not be included in the computation:

a) Instruments which are traded in an exchange where they are subject to daily receipt and payment of cash variation margin; and
b) Exchange rate contract with original maturity of fourteen (14) calendar days or less.

19. The current credit exposure shall be the positive mark-to-market value of the contract (or zero if the mark-to-market value is zero or negative). The potential future credit exposure shall be the product of the notional principal amount of the contract multiplied by the appropriate potential future credit conversion factor, as indicated below:

Interest Exchange			
Residual Maturity	**Rate Contract**	**Rate Contract**	**Equity Contract**
One (1) year or less	0.0%	1.0%	6.0%
Over One (1) year to five (5) years	0.5%	5.0%	8.0%
Over five (5) years	1.5%	7.5%	10%

Provided, That:

a) For contracts with multiple exchanges of principal, the factors are to be multiplied by the number of remaining payments in the contract;

b) 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 credit conversion factor is subject to a floor of one-half percent (1/2%); and

c) No potential future credit exposure shall be calculated for single currency floating/floating interest rate swaps, i.e., the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

20. The credit equivalent amount shall be treated like any on-balance sheet asset, and shall be assigned the appropriate risk weight, i.e., according to the third party credit assessment of the counterparty exposure.

B. Credit risk mitigation (CRM)

21. Banks use a number of techniques to mitigate the credit risks to which they are exposed. For example, exposures may be collateralized by first priority claims, in whole or in part with cash or securities, or a loan exposure may be guaranteed by a third party. Physical collateral, such as real estate, buildings, machineries, and inventories are not recognized at this time for credit risk mitigation purposes in line with Basel II recommendations.

22. In order for banks to obtain capital relief for any use of CRM techniques, all documentation used in collateralized transactions and for documenting guarantees must be binding on all parties and legally enforceable in all relevant jurisdictions. Banks must have conducted sufficient legal review to verify this and have a well-founded legal basis to reach this conclusion, and undertake

such further review as necessary to ensure continuing enforceability.

23. The effects of CRM will not be double counted. Therefore, no additional supervisory recognition of CRM for regulatory capital purposes will be granted on claims for which an issue-specific rating is used that already reflects that CRM. Principal-only ratings will not be allowed within the framework of CRM.

24. While the use of CRM techniques reduces or transfers credit risk, it simultaneously may increase other risks (residual risks). Residual risks include legal, operational, liquidity and market risks. Therefore, it is imperative that banks employ robust procedures and processes to control these risks, including strategy; consideration of the underlying credit; valuation; policies and procedures; systems; control of roll-off risks; and management of concentration risk arising from the bank's use of CRM techniques and its interaction with the bank's overall credit risk profile.

25. The disclosure requirements under Part IX of this document must also be observed for banks to obtain capital relief (i.e., adjustments in the risk weights of collateralized or guaranteed exposures) in respect of any CRM techniques.

Collateralized transactions

26. A collateralized transaction is one in which:

a) banks have a credit exposure or potential credit exposure; and
b) that credit exposure or potential credit exposure is hedged in whole or in part by collateral posted by a counterparty[25] or by a third party in behalf of the counterparty.

27. In addition to the general requirement for legal certainty set out in paragraph 22, the legal mechanism by which collateral is pledged or transferred must ensure that the bank has the right to liquidate or take legal possession of it, in a timely manner, in the event of default, insolvency or bankruptcy (or one or more otherwise defined credit events set out in the transaction documentation) of the counterparty (and, where applicable, of the custodian holding the collateral). Furthermore, banks must take all steps necessary to fulfill those requirements under the law applicable to the bank's interest in the collateral for obtaining and maintaining an enforceable security interest, e.g., by registering it with a registrar, or for exercising a right to net or set off in relation to title transfer collateral.

28. In order for collateral to provide protection, the credit quality of the counterparty and the value of the collateral must not have a material positive correlation. For example, securities issued by the counterparty – or by any related group entity – would provide little protection and so would

be ineligible.

29. Banks must have clear and robust procedures for the timely liquidation of collateral to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed, and that collateral can be liquidated promptly.

30. Where the collateral is required to be held by a custodian, the Bangko Sentral will only recognize the collateral for regulatory capital purposes if it is held by BSP-authorized third party custodians.

31. A capital requirement will be applied to a bank on either side of the collateralized transaction: for example, both repos and reverse repos will be subject to capital requirements. Likewise, both sides of a securities lending and borrowing transaction will be subject to explicit capital charges, as will the posting of securities in connection with a derivative exposure or other borrowing.

Banking book

32. Where banks take eligible collateral, as listed in paragraph 34, and satisfies the requirements under paragraphs 27 to 31, they are allowed to apply the risk weight of the collateral to the collateralized portion of the credit exposure (equivalent to the fair market value of recognized collateral), subject to a floor of twenty percent (20%). The twenty percent (20%) floor shall not apply and a zero percent (0%) risk weight can be applied when the exposure and the collateral are denominated in the same currency, and either:

    a) The collateral is cash as defined in paragraph 34.a; or

    b) The collateral is a sovereign debt security eligible for zero percent (0%) risk weight, or a Php-denominated debt obligation issued by the Philippine NG or the Bangko Sentral, which fair market value has been discounted by twenty percent (20%).

33. For collateral to be recognized, however, the collateral must be pledged for at least the life of the exposure and it must be marked to market and revalued with a minimum frequency of every six (6) months.

34. The following are the eligible collateral instruments:

    a) Cash (as well as certificates of deposit or comparable instruments issued by the lending bank) on deposit with the bank which is incurring the counterparty exposure;

b) Gold;

c) Debt obligations issued by the Philippine NG or the Bangko Sentral;

d) Debt securities issued by central governments and central banks (and PSEs treated as sovereigns) of foreign countries as well as MDBs with at least investment grade external credit ratings;

e) Other debt securities with external credit ratings of at least BBB- or its equivalent;

f) Unrated senior debt securities issued by banks with an issuer rating of at least BBB- or its equivalent, or with other debt issues of the same seniority with a rating of at least BBB- or its equivalent;

g) Equities included in the main index of an organized exchange; and

h) Investments in Unit Investment Trust Funds (UITF) and the Asian Bond Fund 2 (ABF2) duly approved by the Bangko Sentral.

Trading book

35. A credit risk capital requirement should also be applied to banks' counterparty exposures in the trading book (e.g., repo-style transactions, OTC derivatives contracts). Where banks take eligible collateral for these trading book transactions, as listed in paragraph 34, and satisfies the requirements under paragraphs 27 to 31, they are to compute for the credit risk capital requirement according to the following paragraphs: *Provided*, That, for repo-style transactions in the trading book, all instruments which are included in the trading book may be used as eligible collateral.

36. For collateralized transactions in the trading book, the exposure amount after risk mitigation is calculated as follows:

$$E^* = \max \{0, [E \times (1 + He) - C \times (1 - Hc - Hfx)]\}$$

Where:

E* = the exposure value after risk mitigation
E = the current value of the exposure
He = haircut appropriate to the exposure

C = the current value of the collateral received
Hc = haircut appropriate to the collateral
Hfx= haircut appropriate for currency mismatch between the collateral and exposure set at 8% (based on a 10-business day holding period and daily marking to market)

37. The treatment of transactions where there is a maturity mismatch between the maturity of the counterparty exposure and the collateral is given in paragraphs 50 to 54.

38. These are the haircuts to be used (based on a 10-business day holding period, daily marking to market and daily remargining), expressed as percentages:

		Haircut	
Issue rating for debt securities[26]	Residual maturity	Sovereign (and PSEs treated as sovereign) and MDB (with 0% risk weight) issuers	Other Issuers
Php – denominated securities issued by the Philippine NG and Bangko Sentral	<1 year	0.5	
	>1 yr. to < 5 yrs.	2	
	> 5 years	4	
AAA to AA-	<1 year	0.5	1
	>1 yr. to < 5 yrs.	2	4
	> 5 years	4	8
A+ to BBB-/ Unrated bank debt securities as defined in paragraph 34.f	<1 year	1	2
	>1 yr. to < 5 yrs.	3	6
	> 5 years	6	12
Equities included in the main index and gold		15	
UITF and ABF2		Highest haircut applicable to any security in which the fund can invest	
Cash per paragraph 34.a in the same currency		0	
Other financial instruments in the trading book (applies to repostyle transactions in the trading book only)		25	

39. Where the collateral is a basket of assets, the haircut on the basket will be $H = \Sigma a_i H_i$, where ai i, is the weight of the asset in the basket and Hi is the haircut applicable to that asset.

40. For collateralized OTC derivatives transactions in the trading book, the credit equivalent amount will be computed according to paragraphs 18 to 19, but adjusted by deducting the volatility adjusted collateral amount as computed according to paragraphs 36 to 39.

41. The exposure amount after risk mitigation will be multiplied by the risk weight of the counterparty to obtain the risk weighted asset amount for the collateralized transaction.

Guarantees

42. Where guarantees are direct, explicit, irrevocable and unconditional, banks may be allowed to take account of such credit protection in calculating capital requirements.

43. A guarantee must represent a direct claim on the protection provider and must be explicitly referenced to specific exposures or a pool of exposures, so that the extent of the cover is clearly defined and incontrovertible. Other than non-payment by a protection purchaser of money due in respect of the credit protection contract, the guarantee must be irrevocable; there must be no clause in the contract that would allow the protection provider unilaterally to cancel the credit cover or that would increase the effective cost of cover as a result of deteriorating credit quality in the hedged exposure. It must also be unconditional; there should be no clause in the protection contract outside the direct control of the bank that could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original counterparty fails to make the payment(s) due.

44. In addition to the legal certainty requirement in paragraph 22, in order for a guarantee to be recognized, the following conditions must be satisfied:

a) On the qualifying default/non- payment of the counterparty, the bank may in a timely manner pursue the guarantor for any monies outstanding under the documentation governing the transaction. The guarantor may make one lump sum payment of all monies under such documentation to the bank, or the guarantor may assume the future payment obligations of the counterparty covered by the guarantee. The bank must have the right to receive any such payments from the guarantor without first having to take legal actions in order to pursue the counterparty for payment;

b) The guarantee is an explicitly documented obligation assumed by the guarantor; and

c) The guarantee must cover all types of payments the underlying obligor is expected to make under the documentation governing the transaction, for example, notional amount, margin payments, etc. Where a guarantee covers payment of principal only, interests and other

uncovered payments should be treated as an unsecured amount.

45. Where the bank's exposure is guaranteed by an eligible guarantor, as listed in paragraph 47, and satisfies the requirements under paragraphs 42 to 44, the bank is allowed to apply the risk weight of the guarantor to the guaranteed portion of the credit exposure.

46. The treatment of transactions where there is a mismatch between the maturity of the counterparty exposure and the guarantee is given in paragraphs 50 to 54.

47. The following are the eligible guarantors:

a) Philippine NG and the Bangko Sentral;
b) Central governments and central banks and PSEs of foreign countries as well as MDBs with a lower risk weight than the counterparty;
c) Banks with a lower risk weight than the counterparty;
d) Other entities with external credit assessment of at least A- or its equivalent;
e) The Agricultural Guarantee Fund Pool (AGFP) created under Administrative Order No. 225-A dated 26 May 2008; and
f) Qualified Credit Surety Fund (CSF) Cooperative as defined in Part IV. A.

48. Where a bank provides a credit protection to another bank in the form of a guarantee that a third party will perform on its obligations, the risk to the guarantor bank is the same as if the bank had entered into the transaction as a principal. In such circumstances, the guarantor bank will be required to calculate capital requirement on the guaranteed amount according to the risk weight corresponding to the third party exposure. In this instance, and provided the credit protection is deemed to be legally effective, the credit risk is considered transferred to the bank providing credit protection. However, the bank receiving credit protection on its exposure to a third party shall recognize a corresponding risk- weighted credit exposure to the bank providing credit protection.

49. An exposure that is covered by a guarantee that is counter-guaranteed by the Philippine NG or Bangko Sentral, may be considered as covered by the guarantee of the Philippine NG or Bangko Sentral: *Provided*, That:

a) the counter-guarantee covers all credit risk element of the exposure;

b) both the original guarantee and the counter-guarantee meet all operational requirements for guarantees, except that the counter guarantee need not be direct and explicit to the original exposure; and

c) the cover is robust and that no historical evidence suggests that the coverage of the counter-guarantee is less than effectively equivalent to that of a direct guarantee of the Philippine NG and Bangko Sentral.

Currently, Php-denominated exposures to the extent guaranteed by Industrial Guarantee and Loan Fund (IGLF), Home Guaranty Corporation (HGC)[27], and Trade and Investment Development Corporation of the Philippines (TIDCORP), which guarantees are counter-guaranteed by the Philippine NG receive zero percent (0%) risk weight.

Maturity mismatch

50. For collateralized transactions in the trading book and guaranteed transactions, the credit risk mitigating effects of such transactions will still be recognized even if a maturity mismatch occurs between the hedge and the underlying exposure, subject to appropriate adjustments.

51. For purposes of calculating risk- weighted assets, a maturity mismatch occurs when the residual maturity of a hedge is less than that of the underlying exposure.

52. The maturity of the hedge and the maturity of the underlying exposure should both be defined conservatively. For the hedge, embedded options which may reduce the term of the hedge should be taken into account so that the shortest possible effective maturity is used. Where a call is at the discretion of the guarantor/protection seller, the maturity will always be at the first call date. If the call is at the discretion of the protection buying bank but the terms of the arrangement at origination of the hedge contain a positive incentive for the bank to call the transaction before contractual maturity, the remaining time to the first call date will be deemed to be the effective maturity. For example, where there is a step- up in cost in conjunction with a call feature or where the effective cost of cover increases over time even if credit quality remains the same or increases, the effective maturity will be the remaining time to the first call. The effective maturity of the underlying, on the other hand, should be gauged as the longest remaining time before the counterparty is scheduled to fulfill its obligation, taking into account any applicable grace period.

53. Hedges with maturity mismatches are only recognized when their original maturities are greater than or equal to one year. As a result, the maturity of hedges for exposures with original maturities of less than one (1) year must be matched to be recognized. In all cases, hedges will no longer be recognized when they have a residual maturity of three months or less.

54. When there is a maturity mismatch with recognized credit risk mitigants, the following adjustment will be applied.

Pa = P x (t – 0.25)/ (T – 0.25)

Where:

Pa = value of the credit protection adjusted for maturity mismatch
P = credit protection (e.g., collateral amount, guarantee amount) adjusted for any haircuts
T = min (T, residual maturity of the credit protection arrangement) expressed in years
T= min (5, residual maturity of the exposure) expressed in years

C. Use of third party credit assessments

55. The following third party credit assessment agencies are recognized by the Bangko Sentral for regulatory capital purposes:

International credit assessment agencies:

a) Standard & Poor's;
b) Moody's;
c) Fitch Ratings; and
d) Such other rating agencies as may be approved by the Monetary Board.

Domestic credit assessment agencies:

a) PhilRatings; and
b) Such other rating agencies as may be approved by the Monetary Board.

56. The tables below set out the mapping of ratings given by the recognized credit assessment agencies for purposes of determining the appropriate risk weights.

Agency	INTERNATIONAL RATINGS						
S&P	AAA	AA+	AA	AA-	A+	A	A1
Moody's	Aaa	Aa1	Aa2	Aa3	A1	A2	A3
Fitch	AAA	AA+	AA	AA-	A+	A	A-

Agency	INTERNATIONAL RATINGS						
S&P	BBB+	BBB	BBB-	BB+	BB	BB-	B+
Moody's	Baa1	Baa2	Baa3	Ba1	Ba2	Ba3	B1
Fitch	BBB+	BBB	BBB-	BB+	BB	BB-	B+

Agency	DOMESTIC RATINGS						
PhilRatings	Baa+	Baa1	Baa-	Ba+	Ba	Ba-	B+

Agency	INTERNATIONAL RATINGS		
S&P	B	B-	
Moody's	B2	B3	
Fitch	B	B-	

Agency	DOMESTIC RATINGS		
PhilRatings	B	B-	

57. The Bangko Sentral will issue the mapping of ratings of other rating agencies as soon as it is recognized by the Bangko Sentral for regulatory capital purposes.

National rating systems

58. With prior Bangko Sentral approval, international credit rating agencies may have national rating systems developed exclusively for use in the Philippines using the Philippines using the Philippine sovereign as reference highest credit quality anchor.

Multiple assessments

59. If an exposure has only one rating by any of the Bangko Sentral recognized credit assessment agencies, that rating shall be used to determine the risk weight of the exposure; in cases where there are two or more ratimgs which map into different risk weights, the higher of the two lowest risk weights should be used.

Issuer versus issue assessments

60. Any reference to credit rating shall refer to issue-specific rating; the issuer rating may be used only if the exposure being risk- weighted is:

a) an unsecured senior obligation of the issuer and is of the same denomination applicable to the issuer rating (e.g., local currency issuer rating may be used for risk weighting local currency denominated senior claims);

b) short-term; and

c) in cases of guarantees.

61. For loans, risk weighting shall depend on either the rating of the borrower or the rating of the unsecured senior obligation of the borrower: *Provided*, That in case of the latter, the loan is of the same currency denomination as the unsecured senior obligation.

Domestic versus international debt issuances

62. Domestic debt issuances may be rated by Bangko Sentral-recognized domestic credit assessment agencies or by international credit assessment agencies which have developed a national rating system acceptable to the Bangko Sentral. Internationally-issued debt obligations shall be rated by Bangko Sentral-recognized international credit assessment agencies only.

Level of application of the assessment

63. External credit assessments for one entity within a corporate group cannot be used to proxy for the credit assessment of other entities within the same group. Such other entities should secure their own ratings.

Part VI. Credit Derivatives

1. This Part sets out the capital treatment for credit derivatives. Banks may use credit derivatives to mitigate its credit risks or to acquire credit risks. For credit derivatives that are used as credit risk mitigants (CRM), the general requirements for the use of CRM techniques in paragraphs 21 to 25, Part IV.B, have to be satisfied, in addition to the specific operational requirements for credit derivatives in paragraphs 8 to 14.

2. The contents of this Part are just the general rules to be followed in computing capital requirements for credit derivatives. A bank, therefore, is expected to consult the BSP-SES when there is uncertainty about the computation of capital requirements, or even about whether a given transaction should be treated under the credit derivatives framework.

A. Definitions and general terminology

3. *Credit derivative* – a contract wherein one party called the protection buyer or credit risk seller transfers the credit risk of a reference asset or assets issued by a reference entity or entities, which it may or may not own, to another party called the protection seller or credit risk buyer. In return, the protection buyer pays a premium or interest-related payments to the protection seller reflecting the underlying credit risk of the reference asset/s. Credit derivatives may refer to

credit default swaps (CDS), total return swaps (TRS), and credit-linked notes (CLN) and similar products.

4. *Credit default swap* – a credit derivative wherein the protection buyer may exchange the reference asset or any deliverable obligation of the reference entity for cash equal to a specified amount, or get compensated to the extent of the difference between the par value and market value of the asset upon the occurrence of a defined credit event.

5. *Total return swap* – a credit derivative wherein the protection buyer exchanges the actual collections and variations in the prices of the reference asset with the protection seller in return for a fixed premium.

6. *Credit-linked note* – a pre-funded credit derivative wherein the note holder acts as a protection seller while the note issuer is the protection buyer. As such, the repayment of the principal to the note holder is contingent upon the non-occurrence of a defined credit event. All references to CLNs shall be taken to generically include similar instruments, such as credit-linked deposits (CLDs).

7. *Special purpose vehicle* – refers to an entity specifically established to issue CLNs of a single, homogeneous risk class that are fully collateralized as to principal by eligible collateral instruments listed in paragraph 34, Part IV.B, and which are purchased out of the proceeds of the note issuance.

B. Operational requirements for credit derivatives

8. A credit derivative must represent a direct claim on the protection seller and must be explicitly referenced to specific exposures or a pool of exposures, so that the extent of the cover is clearly defined and incontrovertible. Other than non-payment by a protection buyer of money due in respect of the credit derivative contract, it must be irrevocable; there must be no clause in the contract that would allow the protection seller unilaterally to cancel the credit cover or that would increase the effective cost of cover as a result of deteriorating credit quality in the hedged exposure. It must also be unconditional; there should be no clause in the credit derivative contract outside the direct control of the protection buyer that could prevent the protection seller from being obliged to pay out in a timely manner in the event of a defined credit event.

9. The credit events specified by the contracting parties must at a minimum cover:

   a) failure to pay the amounts due under terms of the underlying obligation that are in effect at the time of such failure (with a grace period that is closely in line with the grace period in the

underlying obligation);

b) bankruptcy, insolvency or inability of the obligor to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and analogous events; and

c) restructuring of the underlying obligation involving forgiveness or postponement of principal, interest or fees that results in a credit loss event (i.e., charge- off, specific provision or other similar debit to the profit and loss account).

10. The credit derivative shall not terminate prior to expiration of any grace period required for a default on the underlying obligation to occur as a result of a failure to pay, subject to the provisions of paragraph 52 of Part IV.B.

11. Credit derivatives allowing for cash settlement are recognized for capital purposes insofar as a robust valuation process is in place in order to estimate loss reliably. There must be a clearly specified period for obtaining post-credit event valuations of the underlying obligation.

12. If the protection buyer's right or ability to transfer the underlying obligation to the protection seller is required for settlement, the terms of the underlying obligation must provide that any required consent to such transfer may not be unreasonably withheld.

13. The identity of the parties responsible for determining whether a credit event has occurred must be clearly defined. This determination must not be the sole responsibility of the protection seller. The bank as protection buyer must have the right/ability to inform the protection seller of the occurrence of a credit event.

14. Asset mismatches (underlying obligation is different from the obligation used for purposes of determining cash settlement or the deliverable obligation, or from the obligation used for purposes of determining whether a credit event has occurred) are permissible if:

a) the obligation used for purposes of determining cash settlement or the deliverable obligation, or the obligation used for purposes of determining whether a credit event has occurred ranks pari passu with or is junior to the underlying obligation; and

b) both obligations share the same obligor (i.e., the same legal entity) and legally enforceable cross-default or cross-acceleration clauses are in place.

C. Capital treatment for protection buyers

15. A bank that enters into a credit derivative transaction as a protection buyer in order to hedge an existing exposure in the banking book may only get capital relief if all the general requirements for the use of CRM techniques in paragraphs 21 to 25, Part IV.B and the conditions in paragraphs 8 to 14 are satisfied. In addition, only the eligible guarantors listed in paragraph 47, Part IV.B are considered as eligible protection sellers.

16. If all of the conditions in paragraph 15 are satisfied, banks that are protection buyers may apply the risk weight of the protection seller to the protected portion of the exposure being hedged. The risk weight of the protection seller should therefore be lower than the risk weight of the exposure being hedged for capital relief to be recognized. Exposures that are protected through the issuance of CLNs will be treated as transactions collateralized by cash and a zero percent (0%) risk weight is applied to the protected portion. The uncovered portion shall retain the risk weight of the bank's underlying counterparty.

17. The protected portion of an exposure is measured as follows:

    a) The fixed amount, if such is to be paid upon the occurrence of a credit event; or

    b) The notional value of the contract if either (1) par is to be paid in exchange for physical delivery of the reference asset, or (2) par less market value of the asset is to be paid upon the occurrence of a credit event.

18. A bank may obtain credit protection for a basket of reference entities where the contract terminates and pays out on the first entity to default. In this case, the bank may substitute the risk weight of the protection seller for the risk weight of the asset within the basket with the lowest risk-weighted amount, but only if the notional amount is less than or equal to the notional amount of the credit derivative.

19. Where the contract terminates and pays out on the nth (other than the first) entity to default, the bank will only be able to recognize any reductions in the risk weight of the underlying asset if (n-1)th default- protection has also been obtained or when n-1 of the assets within the basket has already defaulted.

20. Where the contract is referenced to entities in the basket proportionately, reductions in the risk weight will only apply to the extent of the underlying asset's share of protection in the contract.

21. When a bank conducts an internal hedge using a credit derivative (i.e., hedging the credit risk of an exposure in the banking book with a credit derivative booked in the trading book), in order for the bank to receive any reduction in the capital requirement for the exposure in the banking

book, the credit risk in the trading book must be transferred to an outside third party (i.e., an eligible protection seller).

22. Where a bank buys credit protection through a TRS and records the net payments received on the swap as net income, but does not record offsetting deterioration in the value of the asset that is protected (either through reductions in fair value or by an addition to reserves), the credit protection will not be recognized.

23. Materiality thresholds on payments below which no payment is made in the event of loss are equivalent to retained first loss positions and must be deducted in full from the capital of the bank buying the credit protection.

24. Where the credit protection is denominated in a currency different from that in which the exposure is denominated – i.e., there is a currency mismatch – the protected portion of the exposure will be reduced by the application of a haircut, as follows:

$$G_a = G \times (1 - H_{fx})$$

Where:

Ga = adjusted protected portion of the exposure
G = protected portion of the exposure prior to haircut
Hfx = haircut appropriate for currency mismatch between the credit protection and underlying obligation set at eight percent (8%) (based on a 10-business day holding period and daily marking to market)

25. Where a maturity mismatch occurs between the credit protection and the underlying exposure, the protected portion of the exposure adjusted for maturity mismatch will be computed according to paragraph 50 to 54, Part IV.B.

D. Capital treatment for protection sellers

26. Where a bank is a protection seller in a CDS or TRS transaction, it must calculate a capital requirement on the reference asset as if it were a direct investor in the reference asset. The risk weight of the reference asset is multiplied by the nominal amount of the protection provided by the credit derivative to obtain the risk-weighted exposure.

27. For a bank holding a CLN, credit exposure is acquired on two fronts. As such, the on-balance sheet exposure arising from the note should be weighted by adding the risk weights of the

reference entity and the risk weight of the note issuer. The amount of exposure is the carrying amount of the note. If the CLN principal is fully collateralized by an eligible collateral listed in paragraph 34, Part IV.B, and which satisfies the requirements in paragraphs 27 to 31, Part IV.B, the risk weight of the note issuer is substituted with the risk weight associated with the relevant collateral.

28. When the credit derivative 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 multiplied by the amount of the protection provided by the credit derivative to obtain the risk-weighted exposure to the basket. However, the risk- weighted exposure is capped at ten (10) times the protection provided under the contract. Accordingly, the maximum capital charge is 100% of the protection provided under the contract. The multiplier ten (10) is the reciprocal of the BSP-required minimum CAR of ten percent (10%). For CLNs, the risk weight of the issuer is likewise included in the summing of the risk weights.

29. When the contract terminates and pays out on the nth (other than the first) entity to default, the treatment above shall apply except that in aggregating the risk weights of the reference entities, the risk weight/s of the n-1 lowest risk-weighted entity/ies is/ are excluded from the computation. For CLNs, the risk weight of the issuer is likewise included in the summing of the risk weights.

30. When a first or an nth-to-default credit derivative has an external credit rating acceptable to the Bangko Sentral, the risk weight in paragraph 21, Part VI.F will be applied.

31. A contract that is referenced to entities in the basket proportionately should be risk-weighted according to each reference entity’s share of protection under the contract.

E. Credit derivatives in the trading book

32. The following describes the positions to be reported for credit derivative transactions for purposes of calculating specific risk and general market risk charges under the standardized approach.

33. A CDS creates a notional position in the specific risk of the reference obligation. A TRS creates notional positions on the specific and general market risks of the reference obligation, and an opposite notional position on a zero coupon government security representing the fixed payments or premium under the TRS. A CLN creates a notional position in the specific risk of the

reference obligation, a position on the specific risk associated with the issuer, and a position on the general market risk of the note.

Specific risk

34. The specific risk position/s on the reference obligation/s created by credit derivatives are reported as short positions by protection buyers and long positions by protection sellers. In addition, holders of CLNs should report a long position on the specific risk of the note issuer.

35. The protection buyer in a first-to- default transaction should report a short position in the reference obligation with the lowest specific risk charge. A protection buyer in an nth (other than the first)-to- default transaction shall only be allowed to report a short position in a reference obligation only if n-1 obligations in the reference basket has/have already defaulted.

36. When a credit derivative is referenced to multiple entities and the contract terminates and pays out on the first obligation to default in the basket, the transaction should be reported by the protection seller as long positions in each of the reference obligations in the basket. A CLN should likewise be reported as a long position on the note issuer. The total capital charge is capped at the notional amount of the derivative or, in the case of a CLN, the carrying amount of the note.

37. 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 the protection seller may exclude the long position/s on n-1 reference obligations with the lowest risk- weighted exposures in its report. A CLN should likewise be reported as a long position on the note issuer. The total capital charge is capped at the notional amount of the derivative or, in the case of a CLN, the carrying amount of the note.

38. When an nth-to-default credit derivative has an external credit rating acceptable to the Bangko Sentral, the specific risk weights in Part VII.B will be applied.

39. When the contract 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

40. A protection buyer/seller in a TRS should report a short/long notional position on the reference obligation and a long/short notional position on a zero coupon government security representing

the fixed payment under the contract.

41. A protection buyer/seller in a CLN should report a short/long position on the note.

Counterparty credit risk

42. CDS and TRS transactions in the trading book attract counterparty credit risk charges. A five percent (5%) 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 has an external credit rating of at least BBB- or its equivalent. A ten percent (10%) 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.

43. 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 ten percent (10%) add-on should be used. For second and subsequent 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 to default transaction, etc.

44. Where the credit derivative is referenced proportionately to multiple obligations, the add-on factor will follow the add-on factor applicable for the obligation with the biggest share. If the protection is equally proportioned, the highest add-on factor should be used.

Part VII. Securitization

1. Banks must apply the securitization framework for determining regulatory capital requirements on their securitization exposures. Securitization exposures can include but are not restricted to the following: asset-backed securities, mortgage- backed securities, credit enhancements, liquidity facilities, interest rate or currency swaps, and credit derivatives. Underlying instruments in the pool being securitized may include but are not restricted to the following: loans, commitments, asset- backed and mortgage-backed securities, corporate bonds, equity securities, and private equity investments.

2. Since securitizations may be structured in many different ways, the capital treatment of a securitization exposure must be determined on the basis of its economic substance rather than its legal form. The contents of this Part are just the general rules to be followed in computing

capital requirements for securitization exposures. A bank should therefore consult the BSP- SES when there is uncertainty about the computation of capital requirements, or even about whether a given transaction should be considered a securitization.

A. Definitions and general terminology

3. *Traditional securitization* – a structure where the cash flow from an underlying pool of exposures is used to service at least two (2) different stratified risk positions or tranches reflecting different degrees of credit risk. Payments to the investors depend upon the performance of the specified underlying exposures, as opposed to being derived from an obligation of the entity originating those exposures. The stratified/tranched structures that characterize securitizations differ from ordinary senior/subordinated debt instruments in that junior securitization tranches can absorb losses without interrupting contractual payments to more senior tranches, whereas subordination in a senior/subordinated debt structure is a matter of priority of rights to the proceeds of liquidation.

4. *Synthetic securitization* – a structure with at least two (2) different stratified risk positions or tranches that reflect different degrees of credit risk where credit risk of an underlying pool of exposures is transferred, in whole or in part, through the use of funded (e.g., credit-linked notes) or unfunded (e.g., credit default swaps) credit derivatives or guarantees that serve to hedge the credit risk of the portfolio. Accordingly, the investors' potential risk is dependent upon the performance of the underlying pool.

5. *Originating bank* – a bank that originates directly or indirectly underlying exposures included in the securitization.

6. *Clean-up call* – an option that permits the securitization exposures to be called before all of the underlying exposures or securitization exposures have been repaid. In the case of traditional securitizations, this is generally accomplished by repurchasing the remaining securitization exposures once the pool balance or outstanding securities have fallen below some specified level. In the case of a synthetic transaction, the cleanup call may take the form of a clause that extinguishes the credit protection.

7. *Credit enhancement* – a contractual arrangement in which the bank retains or assumes a securitization exposure and, in substance, provides some degree of added protection to other parties to the transaction.

8. *Early amortization provisions* – mechanisms that, once triggered, allow investors to be paid out prior to the originally stated maturity of the securities issued. For risk-based capital purposes, an

early amortization provision will be considered either controlled or non-controlled.

A controlled early amortization provision must meet all of the following conditions:

a) The bank must have an appropriate capital/liquidity plan in place to ensure that it has sufficient capital and liquidity available in the event of an early amortization;

b) Throughout the duration of the transaction, including the amortization period, there is the same pro rata sharing of interest, principal, expenses, losses and recoveries based on the bank's and investors' relative shares of the receivables outstanding at the beginning of each month;

c) The bank must set a period for amortization that would be sufficient for at least ninety percent (90%) of the total debt outstanding at the beginning of the early amortization period to have been repaid or recognized as in default; and

d) The pace of repayment should not be any more rapid than would be allowed by straight-line amortization over the period set out in criterion (c).

An early amortization provision that does not satisfy the conditions for a controlled early amortization provision will be treated as non-controlled early amortization provision.

9. *Eligible liquidity facilities* – an off- balance sheet securitization exposure shall be treated as an eligible liquidity facility if the following minimum requirements are satisfied:

a) The facility documentation must clearly identify and limit the circumstances under which it may be drawn. Draws under the facility must be limited to the amount that is likely to be repaid fully from the liquidation of the underlying exposures and any seller-provided credit enhancements. In addition, the facility must not cover any losses incurred in the underlying pool of exposures prior to a draw, or be structured such that draw-down is certain (as indicated by regular or continuous draws);

b) The facility must be subject to an asset quality test that precludes it from being drawn to cover credit risk exposures that are considered non-performing under existing Bangko Sentral regulations. In addition, liquidity facilities should only fund exposures that are externally rated investment grade at the time of funding;

c) The facility cannot be drawn after all applicable (e.g., transaction-specific and program-wide) credit enhancements from which the liquidity would benefit have been exhausted; and

d) Repayment of draws on the facility (i.e., assets acquired under a purchase agreement or loans made under a lending agreement) must not be subordinated to any interests of any note holder in the program or subject to deferral or waiver.

10. *Eligible servicer cash advance facilities* – cash advance that may be provided by servicers to ensure an uninterrupted flow of payments to investors. The servicer should be entitled to full reimbursement and this right is senior to other claims on cash flows from the underlying pool of exposures.

11. *Excess spread* – generally defined as gross finance charge collections and other income received by the trust or special purpose entity (SPE, specified in paragraph 13) minus certificate interest, servicing fees, charge-offs, and other senior trust or SPE expenses.

12. *Implicit support* – arises when a bank provides support to a securitization in excess of its predetermined contractual obligation.

13. *Special purpose entity* – a corporation, trust, or other entity organized for a specific purpose, the activities of which are limited to those appropriate to accomplish the purpose of the SPE, and the structure of which is intended to isolate the SPE from the credit risk of an originator or seller of exposures. SPEs are commonly used as financing vehicles in which exposures are sold to a trust or similar entity in exchange for cash or other assets funded by debt issued by the trust.

B. Operational requirements for the recognition of risk transference in traditional securitizations

14. An originating bank may exclude securitized exposures from the calculation of risk-weighted assets only if all of the following conditions have been met. Banks meeting these conditions, however, must still hold regulatory capital against any securitization exposures they retain.

a) Significant credit risk associated with the securitized exposures has been transferred to third parties.

b) The transferor does not maintain effective or indirect control over the transferred exposures. The assets are legally isolated from the transferor in such a way (e.g., through the sale of assets or through subparticipation) that the exposures are put beyond the reach of the transferor and its creditors, even in bankruptcy or receivership. These conditions must be supported by an opinion provided by a qualified legal counsel.

The transferor is deemed to have maintained effective control over the transferred credit risk exposures if it:

i. is able to repurchase from the transferee the previously transferred exposures in order to realize their benefits; or

ii. is obligated to retain the risk of the transferred exposures.

The transferor's retention of servicing rights to the exposures will not necessarily constitute indirect control of the exposures.

c) The securities issued are not obligations of the transferor. Thus, investors who purchase the securities only have claim to the underlying pool of exposures.

d) The transferee is an SPE and the holders of the beneficial interests in that entity have the right to pledge or exchange them without restriction.

e) Clean-up calls must satisfy the conditions set out in paragraph 17.

f) The securitization does not contain clauses that (i) require the originating bank to alter systematically the underlying exposures such that the pool's weighted average credit quality is improved unless this is achieved by selling assets to independent and unaffiliated third parties at market prices; (ii) allow for increases in a retained first loss position or credit enhancement provided by the originating bank after the transaction's inception; or (iii) increase the yield payable to parties other than the originating bank, such as investors and third-party providers of credit enhancements, in response to a deterioration in the credit quality of the underlying pool.

C. Operational requirements for the recognition of risk transference in synthetic securitizations

15. For synthetic securitizations, the use of CRM techniques (i.e., collateral, guarantees and credit derivatives) for hedging the underlying exposure may be recognized for risk-based capital purposes only if the conditions outlined below are satisfied:

a) Credit risk mitigants must comply with the requirements as set out in Part IV.B and Part V of this Framework.

b) Eligible collateral is limited to that specified in paragraph 34, Part IV.B. Eligible collateral pledged by SPEs may be recognized.

c) Eligible guarantors are defined in paragraph 47, Part IV.B. SPEs are not recognized as eligible guarantors in the securitization framework.

d) Banks must transfer significant credit risk associated with the underlying exposure to third parties.

e) The instruments used to transfer credit risk must not contain terms or conditions that limit

the amount of credit risk transferred, such as those provided below:

i. Clauses that materially limit the credit protection or credit risk transference (e.g., significant materiality thresholds below which credit protection is deemed not to be triggered even if a credit event occurs or those that allow for the termination of the protection due to deterioration in the credit quality of the underlying exposures);

ii. Clauses that require the originating bank to alter the underlying exposures to improve the pool's weighted average credit quality;

iii.Clauses that increase the banks' cost of credit protection in response to deterioration in the pool's quality;

iv. Clauses that increase the yield payable to parties other than the originating bank, such as investors and third-party providers of credit enhancements, in response to a deterioration in the credit quality of the reference pool; and

v. Clauses that provide for increases in a retained first loss position or credit enhancement provided by the originating bank after the transaction's inception.

f) An opinion must be obtained from a qualified legal counsel that confirms the enforceability of the contracts in all relevant jurisdictions.

g) Clean-up calls must satisfy the conditions set out in paragraph 17.

16. For synthetic securitizations, the effect of applying CRM techniques for hedging the underlying exposure are treated according to Part IV.B and Part V of this Framework. In case there is a maturity mismatch, the capital requirement will be determined in accordance with paragraphs 50 to 54, Part IV.B. When the exposures in the underlying pool have different maturities, the longest maturity must be taken as the maturity of the pool. Maturity mismatches may arise in the context of synthetic securitizations when, for example, a bank uses credit derivatives to transfer part or all of the credit risk of a specific pool of assets to third parties. When the credit derivatives unwind, the transaction will terminate. This implies that the effective maturity of the tranches of the synthetic securitization may differ from that of the underlying exposures. Originating banks of synthetic securitizations with such maturity mismatches must deduct all retained positions that are unrated or rated below investment grade. Accordingly, when deduction is required, maturity mismatches are not taken into account. For all other securitization exposures, the bank must apply the maturity mismatch treatment set forth in paragraphs 50 to 54, Part IV.B.

D. Operational requirements and treatment of clean-up calls

17. For securitization transactions that include a clean-up call, no capital will be required due to the presence of a clean-up call if the following conditions are met: (i) the exercise of the clean-up call must not be mandatory, in form or in substance, but rather must be at the discretion of the originating bank; (ii) the clean-up call must not be structured to avoid allocating losses to credit enhancements or positions held by investors or otherwise structured to provide credit enhancement; and (iii) the clean-up call must only be exercisable when ten percent (10%) or less of the original underlying portfolio, or securities issued remain, or, for synthetic securitizations, when ten percent (10%) or less of the original reference portfolio value remains.

18. Securitization transactions that include a clean-up call that does not meet all of the criteria stated in paragraph 17 result in a capital requirement for the originating bank. For a traditional securitization, the underlying exposures must be treated as if they were not securitized. Additionally, banks must not recognize in regulatory capital any gain-on-sale, as defined in paragraph 23. For synthetic securitization, the bank purchasing protection must hold capital against the entire amount of the securitized exposures as if they did not benefit from any credit protection. Same treatment applies for synthetic securitization that incorporates a call, other than a cleanup call, that effectively terminates the transaction and the purchased credit protection on a specified date.

19. If a clean-up call, when exercised, is found to serve as a credit enhancement, the exercise of the clean-up call must be considered a form of implicit support provided by the bank and must be treated in accordance with paragraph 26.

E. Operational requirements for use of external credit assessments

20. The following operational criteria concerning the use of external credit assessments apply in the securitization framework:

    a) To be eligible for risk-weighting purposes, the external credit assessment must take into account and reflect the entire amount of credit risk exposure the bank has with regard to all payments owed to it. For example, if a bank is owed both principal and interest, the assessment must fully take into account and reflect the credit risk associated with timely repayment of both principal and interest.

    b) The external credit assessments must be from an eligible External Credit Assessment Institution (ECAI) as recognized by the bank's national supervisor in accordance with Part IV.C. An eligible credit assessment must be publicly available. In other words, a rating must

be published in an accessible form and included in the ECAI's transition matrix. Consequently, ratings that are made available only to the parties to a transaction do not satisfy this requirement.

c) Eligible ECAIs must have a demonstrated expertise in assessing securitizations, which may be evidenced by strong market acceptance.

d) A bank must apply external credit assessments from eligible ECAIs consistently across a given type of securitization exposure. Furthermore, a bank cannot use the credit assessments issued by one ECAI for one or more tranches and those of another ECAI for other positions (whether retained or purchased) within the same securitization structure that may or may not be rated by the first ECAI. Where two or more eligible ECAIs can be used and these assess the credit risk of the same securitization exposure differently, paragraph 59 of Part IV.C will apply.

e) Where CRM is provided directly to an SPE by an eligible guarantor defined in paragraph 47 of Part IV.B and is reflected in the external credit assessment assigned to a securitization exposure(s), the risk weight associated with that external credit assessment should be used. In order to avoid any double counting, no additional capital recognition is permitted. If the CRM provider is not an eligible guarantor, the covered securitization exposures should be treated as unrated.

f) In the situation where a credit risk mitigant is not obtained by the SPE but rather applied to a specific securitization exposure within a given structure (e.g., ABS tranche), the bank must treat the exposure as if it is unrated and then use the CRM treatment outlined in Part IV.B to recognize the hedge.

F. Risk-weighting

21. The risk-weighted asset amount of a securitization exposure is computed by multiplying the amount of the position by the appropriate risk weight determined in accordance with the following table. For off- balance sheet exposures, banks must apply a credit conversion factor (CCF) and then risk weight the resultant credit equivalent amount.

Credit assessment[28]	**AAA to AA-**	**A+ to A-**	**BBB+ to BBB-**	**Below BBB- and unrated**
Risk weight	20%	50%	100%	Deduction from Tier 1 capital

22. The capital treatment of implicit support, liquidity facilities, securitizations of revolving exposures, and credit risk mitigants are identified separately.

23. Banks must deduct from CET 1 capital any increase in equity capital resulting from a securitization transaction, such as that associated with expected future margin income resulting in a gain-on-sale that is recognized in regulatory capital. Such an increase in capital is referred to as a “gain-on-sale” for the purposes of the securitization framework.

24. Credit enhancing IOs (interest only), net of the amount that must be deducted from CET 1 as in paragraph 23.

25. Deductions from capital may be calculated net of any specific provisions taken against the relevant securitization exposures.

26. When a bank provides implicit support to a securitization, it must, at a minimum, hold capital against all of the exposures associated with the securitization transaction as if they had not been securitized. Additionally, banks would not be permitted to recognize in regulatory capital any gain-on-sale, as defined in paragraph 23. Furthermore, the bank is required to disclose publicly that (a) it has provided non-contractual support and (b) the capital impact of doing so.

27. As a general rule, off-balance sheet securitization exposures will receive a CCF of 100%, except in the cases below.

28. A CCF of twenty percent (20%) and fifty percent (50%) will be applied to eligible liquidity facilities as defined in paragraph 9 above with original maturity of one year or less and more than one year, respectively. However, if an external rating of the facility itself is used for risk weighting the facility, a 100% CCF must be applied. A zero percent (0%) CCF may be applied to eligible liquidity facilities that are only available in the event of a general market disruption (i.e., whereupon more than one SPE across different transactions are unable to roll over maturing commercial paper, and that inability is not the result of an impairment in the SPE’s credit quality or in the credit quality of the underlying exposures). To qualify for this treatment, the conditions provided in paragraph 9 must be satisfied. Additionally, the funds advanced by the bank to pay holders of the capital market instruments (e.g., commercial paper) when there is a general market disruption must be secured by the underlying assets, and must rank at least pari passu with the claims of holders of the capital market instruments.

29. A CCF of zero percent (0%) will be applied to undrawn amount of eligible servicer cash advance facilities, as defined in paragraph 10 above, that are unconditionally cancellable without prior notice.

30. An originating bank is required to hold capital against the investors’ interest (i.e., against both the drawn and undrawn balances related to the securitized exposures) when:

a) It sells exposures into a structure that contains an early amortization feature; and

b) The exposures sold are of a revolving nature. These involve exposures where the borrower is permitted to vary the drawn amount and repayments within an agreed limit under a line of credit (e.g., credit card receivables and corporate loan commitments).

31. Originating banks, though, are not required to calculate a capital requirement for early amortizations in the following situations:

a) Replenishment structures where the underlying exposures do not revolve and the early amortization ends the ability of the bank to add new exposures;

b) Transactions of revolving assets containing early amortization features that mimic term structures (i.e., where the risk of the underlying facilities does not return to the originating bank);

c) Structures where a bank securitizes one or more credit line(s) and where investors remain fully exposed to future draws by borrowers even after an early amortization event has occurred; and

d) The early amortization clause is solely triggered by events not related to the performance of the securitized assets or the selling bank, such as material changes in tax laws or regulations.

32. As described below, the CCFs depend upon whether the early amortization repays investors through a controlled or non-controlled mechanism. They also differ according to whether the securitized exposures are uncommitted retail credit lines (e.g., credit card receivables) or other credit lines (e.g., revolving corporate facilities). A line is considered uncommitted if it is unconditionally cancellable without prior notice.

33. For uncommitted retail credit lines (e.g., credit card receivables) that have either controlled or non-controlled early amortization features, banks must compare the three-month average excess spread defined in paragraph 11 to the point at which the bank is required to trap excess spread as economically required by the structure (i.e., excess spread trapping point). In cases where such a transaction does not require excess spread to be trapped, the trapping point is deemed to be 4.5 percentage points.

34. The bank must divide the excess spread level by the transaction's excess spread trapping point to determine the appropriate segments and apply the corresponding conversion factors, as outlined in the following tables:

	Controlled		Non-controlled	
	3-month average excess spread- credit conversion factor (CCF)	**Credit conversion factor (CCF)**	**3-month average excess spread- credit conversion factor (CCF)**	**Credit conversion factor (CCF)**
	Uncommitted	**Committed**	**Uncommitted**	**Committed**
Retail credit lines	133.33% of trapping point or more – 0% CCF	90% CCF	133.33% of trapping point or more – 0% CCF	100% CCF
	less than 133.33% to 100% of trapping point – 1% CCF		less than 133.33% to 100% of trapping point – 5% CCF	
	less than 100% to 75% of trapping point – 2% CCF		less than 100% to 75% of trapping point – 15% CCF	
	less than 75% to 50% of trapping point – 10% CCF		less than 75% to 50% of trapping point – 50% CCF	
	less than 50% to 25% of trapping point – 20% CCF		less than 50% of trapping point – 100% CCF	
	less than 25% of trapping point – 40%			
Non-retail credit lines	90% CCF	90% CCF	100% CCF	100% CCF

35. All other securitized revolving exposures with controlled and non- controlled early amortization features will be subject to CCFs of ninety percent (90%) and 100%, respectively, against the off-balance sheet exposures.

36. The CCF will be applied to the amount of the investors' interest. The resultant credit equivalent amount shall then be applied a risk weight applicable to the underlying exposure type, as if the exposures had not been securitized.

37. For a bank subject to the early amortization treatment, the total capital charge for all of its positions will be subject to a maximum capital requirement (i.e., a 'cap') equal to the greater of (i) that required for retained securitization exposures, or (ii) the capital requirement that would apply had the exposures not been securitized. In addition, banks must deduct the entire amount of any gain-on-sale and credit enhancing IOs arising from the securitization transaction in accordance with paragraphs 23 and 25.

G. Credit risk mitigation

38. The treatment below applies to a bank that has obtained or given a credit risk mitigant on a securitization exposure. Credit risk mitigants include collateral, guarantees, and credit derivatives. Collateral in this context refers to that used to hedge the credit risk of a

securitization exposure rather than the underlying exposures of the securitization transaction.

Collateral

39. Eligible collateral is limited to that recognized in paragraph 34, Part IV.B. Collateral pledged by SPEs may be recognized.

Guarantees and credit derivatives

40. Credit protection provided by the entities listed in paragraph 47, Part IV.B may be recognized. SPEs cannot be recognized as eligible guarantors.

41. Where guarantees or credit derivatives fulfill the minimum operational requirements as specified in Part IV.B and Part V, respectively, banks can take account of such credit protection in calculating capital requirements for securitization exposures.

42. Capital requirements for the collateralized or guaranteed/protected portion will be calculated according to Part IV.B and Part V.

43. A bank other than the originator providing credit protection to a securitization exposure must calculate a capital requirement on the covered exposure as if it were an investor in that securitization. A bank providing protection to an unrated credit enhancement must treat the credit protection provided as if it were directly holding the unrated credit enhancement.

Maturity mismatches

44. For the purpose of setting regulatory capital against a maturity mismatch, the capital requirement will be determined in accordance with paragraphs 50 to 54, Part IV.B, except for synthetic securitizations which will be determined in accordance with paragraph 16.

Part VIII. Market Risk-weighted Assets

1. *Market risk* is defined as the risk of losses in on- and off-balance sheet positions arising from movements in market prices. The risks addressed in these guidelines are:

   a) The risks pertaining to interest rate-related instruments and equities in the trading book; and
   b) Foreign exchange risk throughout the bank.

A. Definition of the trading book

2. A *trading book* consists of positions in financial instruments held either with trading intent or in order to hedge other elements of the trading book. To be eligible for trading book capital treatment, financial instruments must either be free of any restrictive covenants on their tradability or able to be hedged completely. In addition, positions should be frequently and accurately valued, and the portfolio should be actively managed.

3. A *financial instrument* is any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. Financial instruments include both primary financial instruments (or cash instruments) and derivative financial instruments. A *financial asset* is any asset that is cash, the right to receive cash or another financial asset; or the contractual right to exchange financial assets on potentially favorable terms, or an equity instrument. A *financial liability* is the contractual obligation to deliver cash or another financial asset or to exchange financial liabilities under conditions that are potentially unfavorable.

4. *Positions held with trading intent* are those held intentionally for short-term resale and/or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits, and may include for example proprietary positions, positions arising from client servicing (e.g. matched principal brokering) and market making.

5. The following will be the basic requirements for positions eligible to receive trading book capital treatment:

   a) Clearly documented trading strategy for the position/instrument or portfolios, approved by senior management (which would include expected holding horizon);
   b) Clearly defined policies and procedures for the active management of the position, which must include:

      i. positions are managed on a trading desk;

      ii. position limits are set and monitored for appropriateness;

      iii. dealers have the autonomy to enter into/manage the position within agreed limits and according to the agreed strategy;

      iv. positions are marked to market at least daily, and when marking to model the parameters must be assessed on a daily basis;

      v. positions are reported to senior management as an integral part of the institution's risk management process; and

vi. positions are actively monitored with reference to market information sources (assessment should be made of the market liquidity or the ability to hedge positions or the portfolio risk profiles). This would include assessing the quality and availability of market inputs to the valuation process, level of market turnover, sizes of positions traded in the market, etc.

c) Clearly defined policy and procedures to monitor the positions against the bank's trading strategy including the monitoring of turnover and stale positions in the bank's trading book.

6. The documentations of the basic requirements of Part VII, Item "*5*" should be submitted to the Bangko Sentral.

7. In addition to the above documentation requirements, the bank should also submit to the Bangko Sentral a documentation of its systems and controls for the prudent valuation of positions in the trading book including the valuation methodologies.

B. Measurement of capital charge

8. The market risk capital charge shall be computed according to the methodology set under Subsec. 125, subject to certain modifications as outlined in the succeeding paragraphs.

9. The specific risk weights for trading book positions in debt securities and debt derivatives shall depend on the third party credit assessment of the issue or the type of issuer, as may be appropriate, as follows:

Credit ratings of debt securities/derivatives issued by sovereigns[29]	Credit ratings of debt securities/derivatives issued by MDBs	Credit ratings of debt securities/derivatives issued by other entities	Unadjusted specific risk weight
Php-denominated debt securities/derivatives issued by the Philippine NG and Bangko Sentral			0.00%
LGU Bonds covered by Deed of Assignment of Internal Revenue Allotment and guaranteed by LGU Guarantee Corporation			4.00%
AAA to AA-	AAA		0.00%
A+ to BBB-	AA+ to BBB-	AAA to BBB-	
Residual maturity ≤ 6 months	Residual maturity ≤ 6 months	Residual maturity ≤ 6 months	0.25%
Residual maturity > 6 months, ≤ 24 months	Residual maturity > 6 months, ≤ 24 months	Residual maturity > 6 months, ≤ 24 months	1.0%
Residual maturity > 24 months	Residual maturity > 24 months	Residual maturity > 24 months	1.60%

		All other debt securities/derivatives	8.00%

10. Foreign currency denominated debt securities/derivatives issued by the Philippine NG and Bangko Sentral[30] shall be risk-weighted according to the table above: *Provided*, That only one-third (1/3) of the applicable risk weight shall be applied from 01 July 2007, two-thirds (2/3) from 01 January 2008, and the full risk weight from 01 January 2009.

11. A security, which is the subject of a repo-style transaction, shall be treated as if it were still owned by the seller/lender of the security, i.e., to be reported by the seller/ lender.

12. In addition to capital charge for specific and general market risk, a credit risk capital charge should be applied to banks' counterparty exposures in repo-style transactions and OTC derivatives contracts. The computation of the credit risk capital charge for counterparty exposures arising from trading book positions are discussed in paragraphs 35 to 41 of Part IV.B.

C. Measurement of risk-weighted assets

13. Market risk-weighted assets are determined by multiplying the market risk capital charge by ten (10) [i.e., the reciprocal of the minimum capital ratio of ten percent (10%)].

Part IX. Operational Risk-weighted Assets

A. Definition of operational risk

1. *Operational risk* is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.

2. Banks should be guided by the Basel Committee on Banking Supervision's recommendations on Sound Practices for the Management and Supervision of Operational Risk (February 2003). The same may be downloaded from the BIS website (www.bis.org).

B. Measurement of capital charge

3. In computing for the operational risk capital charge, banks may use either the basic indicator approach or the standardized approach.

4. Under the basic indicator approach, banks must hold capital for operational risk equal to fifteen

percent (15%) of the average gross income over the previous three (3) years of positive annual gross income. Figures for any year in which annual gross income is negative or zero should be excluded from both the numerator and denominator when calculating the average.

5. Banks that have the capability to map their income accounts into the various business lines given in paragraph 7 may use the standardized approach subject to prior Bangko Sentral approval[31]. In order to qualify for use of the standardized approach, a bank must satisfy Bangko Sentral that, at a minimum:

   a) Its board of directors and senior management are actively involved in the oversight of the operational risk management framework;
   b) It has an operational risk management system that is conceptually sound and is implemented with integrity; and
   c) It has sufficient resources in the use of the approach in the major business lines as well as the control and audit areas.

6. Operational risk capital charge is calculated as the three (3)-year average of the simple summation of the regulatory capital charges across each of the business lines in each year. In any given year, negative capital charges (resulting from negative gross income) in any business line may offset positive capital charges in other business lines without limit. However, where the aggregate capital charge across all business lines within a given year is negative, then figures for that year shall be excluded from both the numerator and denominator.

7. The business lines and their corresponding beta factors are listed below:

Business lines		**Activity Groups**	**Beta Factors**
Level 1	**Level 2**		
Corporate Finance	Corporate finance	Mergers and acquisitions, underwriting, privatization, securitization, research, debt (government, high yield), equity, syndications, IPO, secondary private placements	18%
	Municipal/Government Finance		
	Advisory Services		
Trading and Sales	Sales	Fixed income, equity, foreign exchanges, commodities, credit, funding, own position securities, lending and repos, brokerage, debt, prime brokerage	18%
	Market Making		
	Proprietary Positions		
	Treasury		

Retail Banking	Retail Banking	Retail lending and deposits, banking services, trustand estates	12%
	Private Banking	Private lending and deposits, banking services, trust and estates, investment advice	
	Card Services	Merchant/commercial/corporate cards, private labels and retail	
Commercial Banking	Commercial Banking	Project finance, real estate, export finance, trade finance, factoring, leasing, lending, guarantees, bills of exchange	15%
Payment and Settlement	External Clients	Payments and collections, funds transfer, clearing and settlement	18%
Agency Services	Custody	Escrow, depository receipts, securities lending (customers) corporate actions	15%
	Corporate Agency	Issuer and paying agents	
	Corporate Trust		
Asset Management	Discretionary Fund Management	Discretionary and non-discretionary fund management, whether pooled, segregated, retail, institutional, closed, open, private equity	12%
	Non-Discretionary Fund Management		
Retail Brokerage	Retail Brokerage	Execution and full service	12%

8. Gross income, for the purpose of computing for operational risk capital charge, is defined as net interest income plus non-interest income. This measure should:

   a) be gross of any provisions for losses on accrued interest income from financial assets;
   b) be gross of operating expenses, including fees paid to outsourcing service providers;
   c) include fees and commissions;
   d) exclude gains/(losses) from the sale/redemption/derecognition of non-trading financial assets and liabilities;
   e) exclude gains/(losses) from sale/derecognition of non-financial assets; and
   f) include other income (i.e., rental income, miscellaneous income, etc.)

C. Measurement of risk-weighted assets

9. The resultant operational risk capital charge is to be multiplied by 125% before multiplying by ten (10) [i.e., the reciprocal of the minimum capital ratio of ten percent (10%)].

Part X. Disclosures in the Annual Reports and Published Financial Statements

1. This section lists the specific information that banks have to disclose, at a minimum, in their Annual Reports, except Item "*j*", paragraph 3 which should also be disclosed in banks' quarterly Published Balance Sheet.

2. Full compliance of these disclosure requirements is a prerequisite before banks can obtain any capital relief (i.e., adjustments in the risk weights of collateralized or guaranteed exposures) in respect of any credit risk mitigation techniques.

A. Capital structure and capital adequacy

3. The following information with regard to banks' capital structure and capital adequacy shall be disclosed in banks' Annual Reports, except Item "*j*" below which should also be disclosed in banks' quarterly published Balance Sheet:

   a) CET1 capital and a breakdown of its components;
   b) Tier 1 capital and a breakdown of its components;
   c) Tier 2 capital and a breakdown of its components;
   d) Total qualifying capital;
   e) Capital conservation buffer;
   f) Countercyclical capital buffer;
   g) Capital requirements for credit risk (including securitization exposures);
   h) Capital requirements for market risk;
   i) Capital requirements for operational risk; and
   j) Total CAR, Tier 1 and CET1 ratios on both solo and consolidated bases.

4. In addition to the above disclosure requirements, the following shall likewise be disclosed to improve transparency of regulatory capital and enhance market discipline:

   a) Full reconciliation of all regulatory capital elements back to the balance sheet in the audited financial statements;
   b) All regulatory adjustments/ deductions, as applicable;
   c) Description of the main features of capital instruments issued; and
   d) Comprehensive explanations of how ratios involving components of regulatory capital are calculated.

5. On top of the above disclosure requirements, banks/QBs shall be required to make available on their websites the full terms and conditions of all instruments included in regulatory capital.

B. Risk exposures and assessments

6. For each separate risk area (credit, market, operational, interest rate risk in the banking book), banks must describe their risk management objectives and policies, including:

   a) Strategies and processes;
   b) The structure and organization of the relevant risk management function;
   c) The scope and nature of risk reporting and/or measurement systems; and
   d) Policies for hedging and/or mitigating risk, and strategies and processes for monitoring the continuing effectiveness of hedges/mitigants.

Credit risk

7. Aside from the general disclosure requirements stated in paragraph 4, the following information with regard to credit risk have to be disclosed in banks' Annual Reports:

   a) Total credit risk exposures (i.e., principal amount for on-balance sheet and credit equivalent amount for off-balance sheet, net of specific provision) broken down by type of exposures as defined in Part IV;

   b) Total credit risk exposure after risk mitigation, broken down by:

      i. type of exposures as defined in Part IV; and
      ii. risk buckets, as well as those that are deducted from capital;

   c) Total credit risk-weighted assets broken down by type of exposures as defined in Part IV;

   d) Names of external credit assessment institutions used, and the types of exposures for which they were used;

   e) Types of eligible credit risk mitigants used including credit derivatives;

   f) For banks with exposures to securitization structures, aside from the general disclosure requirements stated in paragraph 4, the following minimum information have to be disclosed:

      i. Accounting policies for these activities;
      ii. Total outstanding exposures securitized by the bank; and
      iii. Total amount of securitization exposures retained or purchased broken down by exposure type;

   g) For banks that provide credit protection through credit derivatives, aside from the general

disclosure requirements stated in paragraph 4, total outstanding amount of credit protection given by the bank broken down by type of reference exposures should also be disclosed; and

h) For banks with investments in other types of structured products, aside from the general disclosure requirements stated in paragraph 4, total outstanding amount of other types of structured products issued or purchased by the bank broken down by type should also be disclosed.

Market risk

8. Aside from the general disclosure requirements stated in paragraph 4, the following information with regard to market risk have to be disclosed in banks' Annual Reports:

   a) Total market risk-weighted assets broken down by type of exposures (interest rate, equity, foreign exchange, and options); and
   b) For banks using the internal models approach, the following information have to be disclosed:

      i. The characteristics of the models used;
      ii. A description of stress testing applied to the portfolio;
      iii. A description of the approach used for backtesting/validating the accuracy and consistency of the internal models and modeling processes;
      iv. The scope of acceptance by the Bangko Sentral; and
      v. A comparison of VaR estimates with actual gains/losses experienced by the bank, with analysis of important outliers in backtest results.

Operational risk

9. Aside from the general disclosure requirements stated in paragraph 4, banks have to disclose their operational risk- weighted assets in their Annual Reports.

Interest rate risk in the banking book

10. Aside from the general disclosure requirements stated in paragraph 4, the following information with regard to interest rate risk in the banking book have to be disclosed in banks' Annual Reports:

    a) Internal measurement of interest rate risk in the banking book, including assumptions regarding loan prepayments and behavior of nonmaturity deposits, and frequency of measurement; and

b) The increase (decline) in earnings or economic value (or relevant measure used by management) for upward and downward rate shocks according to internal measurement of interest rate risk in the banking book.

(Circular No. 1027 dated 28 December 2018, and 1024 dated 06 December 2018)

Annex A

COMMON SHARES

Criteria for classification as common shares for regulatory capital purposes

1. It represents the most subordinated claim in liquidation.

2. It is entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (i.e., has an unlimited and variable claim, not a fixed or capped claim).

3. Its principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law).

4. The bank does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory or contractual terms provide any feature which might give rise to such an expectation.

5. The distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that a bank is unable to pay distributions that exceed the level of distributable items).

6. There are no circumstances under which the distributions are obligatory. Non-payment is therefore not an event of default.

7. The distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no

preferential distributions, including in respect of other elements classified as the highest quality issued capital.

8. It is the issued capital that takes the first and proportionately greatest share of any losses as they occur[32]. Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and pari passu with all the others.

9. The paid in amount is recognized as equity capital (i.e., not recognized as a liability) for determining balance sheet insolvency.

10. The paid in amount is classified as equity under the relevant accounting standards.

11. It is directly issued and paid-in and the bank cannot directly or indirectly have funded the purchase of the instrument.

12. It must be underwritten by a third party not related to the issuer bank nor acting in reciprocity for and in behalf of the issuer bank.

13. The paid in amount is neither secured nor covered by a guarantee of the issuer or related entity[33] or subject to any other arrangement that legally or economically enhances the seniority of the claim.

14. It is only issued with the approval of the owners of the issuing bank, either given directly by the owners or, if permitted by applicable law, given by the board of directors or by other persons duly authorized by the owners.

15. It is clearly and separately disclosed in the bank’s balance sheet.

Annex B

ADDITIONAL TIER 1 CAPITAL

Criteria for inclusion in Additional Tier 1 capital

1. It must be issued and paid-in.

2. It must be subordinated to depositors, general creditors and subordinated debt of the bank.

3. It is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors.

4. It is perpetual, ie., there is no maturity date and there are no step-ups or other incentives to redeem.

5. It may be callable at the initiative of the issuer only after a minimum of five (5) years, subject to the following conditions:

   a. To exercise a call option a bank must receive prior supervisory approval;
   b. A bank must not do anything which creates an expectation that the call will be exercised; and
   c. Banks must not exercise a call unless:

      i. They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank[34]; or

      ii. The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised;

6. Any repayment of principal (e.g. through repurchase or redemption) must be with prior supervisory approval and banks should not assume or create market expectations that supervisory approval will be given.

7. With regard to dividend/coupon discretion:

   a. The bank must have full discretion at all times to cancel distributions/payments[35];
   b. Cancellation of discretionary payments must not be an event of default;
   c. Banks must have full access to cancelled payments to meet obligations as they fall due;
   d. Cancellation of distributions/ payments must not impose restrictions on the bank except in relation to distributions to common stockholders.

8. Dividends/coupons must be paid out of distributable items.

9. The instrument cannot have a credit sensitive dividend feature, that is a dividend/ coupon that is reset periodically based in whole or in part on the bank's credit standing.

10. The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law.

11. Instruments classified as liabilities for accounting purposes must have principal loss absorption through either (i) conversion to common shares or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The trigger point is set at CET1 ratio of 7.25% or below or as determined by the Bangko Sentral. The bank must submit an expert's opinion on the accounting treatment/classification of the instruments.

    The guidelines on loss absorbency features of AT1 capital as provided in *App. 63b- Annex E* shall likewise be observed.

12. It must have a provision that requires the instrument to either be written off or converted into common equity upon the occurrence of a trigger event.

    The trigger event occurs when a bank is considered non-viable as determined by the Bangko Sentral. Non-viability is defined as a deviation from a certain level of CET1 Ratio, inability of the bank to continue business (CLOSURE), or any other event as may be determined by the Bangko Sentral, whichever comes earlier.

    The issuance of any new shares as a result of the trigger event must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted.

    The guidelines on loss absorbency features of AT1 capital at point of non- viability as provided in *App. 63b Annex F* shall likewise be observed.

13. The write-down will have the following effects:

    a. Reduce the claim of the instrument in liquidation;
    b. Reduce the amount re-paid when a call is exercised; and
    c. Partially or fully reduce coupon/ dividend payments on the instrument.

14. Neither the bank nor a related party over which the bank exercises control nor significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument.

15. The instrument cannot have any features that hinder recapitalization, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.

16. It must be underwritten by a third party not related to the issuer bank or acting in reciprocity for and in behalf of the issuer bank;

17. It must clearly state on its face that it is not a deposit and is not insured by the Philippine Deposit Insurance Corporation (PDIC).

18. The bank must submit a written external legal opinion that the above-mentioned requirements, including the subordination and loss absorption features have been met.

19. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. a special purpose vehicle – "SPV"), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 capital.[36]

Annex C

Annex C

TIER 2 CAPITAL

Criteria for inclusion in Tier 2 Capital

1. It must be issued and paid-in.

2. It must be subordinated to depositors and general creditors of the bank.

3. It is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis depositors and general creditors of the bank.

4. With regard to maturity:

    a. It must have a minimum original maturity of at least five (5) years;
    b. Its recognition in regulatory capital in the remaining five (5) years before maturity will be amortized on a straight line basis as shown in the table below; and

Remaining maturity	Discount factor
5 years & above	0%
4 years to <5 years	20%
3 years to <4 years	40%
2 years to <3 years	60%
1 year to <2 years	80%
< 1 year	100%

    c. There are no step-ups or other incentives to redeem.

5. It may be callable at the initiative of the issuer only after a minimum of five (5) years:

    a. To exercise a call option, a bank must receive prior supervisory approval; and
    b. A bank must not do anything which creates an expectation that the call will be exercised[37]; and
    c. Banks must not exercise a call unless:

        i. They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank[38]; or

        ii. The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.

6. The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.

7. The instrument cannot have a credit sensitive dividend feature, that is a dividend/ coupon that is reset periodically based in whole or in part on the bank's credit standing.

8. Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded

the purchase of the instrument.

9. It must be underwritten by a third party not related to the issuer bank nor acting in reciprocity for and in behalf of the issuer bank.

10. It must have a provision that requires the instrument to either be written off or converted into common equity upon the occurrence of a trigger event.

The trigger event occurs when a bank is considered non-viable as determined by the Bangko Sentral. Non-viability is defined as a deviation from a certain level of Common Equity Tier 1 (CET1) Ratio, inability of the bank to continue business (CLOSURE) or any other event as determined by the Bangko Sentral, whichever comes earlier.

The issuance of any new shares as a result of the trigger event must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted.

The guidelines on loss absorbency features of Tier 2 capital at point of nonviability as provided in *App. 63b Annex F* shall likewise be observed.

11. The write-down will have the following effects:

 a. Reduce the claim of the instrument in liquidation;
 b. Reduce the amount re-paid when a call is exercised; and
 c. Partially or fully reduce coupon/ dividend payments on the instrument

12. The bank must submit a written external legal opinion that the above-mentioned requirements, including the subordination and loss absorption features have been met.

13. It must clearly state on its face that it is not a deposit and is not insured by the Philippine Deposit Insurance Corporation (PDIC).

14. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g .a special purpose vehicle – "SPV"), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other.[39]

Annex D

Illustrative Sample

Computation of eligible minority interests to be included in parent bank's capital base

The case:

A banking group consists of two (2) legal entities that are both banks – Bank P is the parent and Bank S is the subsidiary. Their individual balance sheets are set out below:

Bank P- Balance Sheet		Bank S-Balance Sheet	
Assets		Assets	
Loans	90	Loans	160
CET 1 investment in Bank S	30		
ATI investment in Bank B	9		
Tier 2 investment in Bank S	4		
Liabilities and Equity		Liabilities and Equity	
Deposits	70	Deposits	90
Tier 2 capital instruments	20	Tier 2 capital instruments	16
ATI capital instruments	12	ATI capital instruments	11
CET1 capital instruments	11	CET1 capital instruments	43

The consolidated balance sheet of the banking group is set out below:

Consolidated Balance Sheet	
Assets	
Loans	250
Liabilities and Equity	
Deposits	160
Tier 2 issued by subsidiary to third parties	12
Tier 2 issued by parent	20
AT1 issued by subsidiary to third parties	2
AT1 issued by parent	12
Common Equity issued by subsidiary to third parties (i.e., minority interest)	13
Common Equity issued by parent	31

The balance sheet of Bank P shows that in addition to its loans to customers, it has investments in Bank S as follows:

1. 70% of common shares;

2. 82% of Additional Tier 1 capital; and
3. 25% of Tier 2 capital.

	Amount issued to Bank P		Amount issued to third parties		Total
CET1	30	*70%*	13	*30%*	43
AT1	9	*82%*	2	*18%*	11
Tier 1	39		15		54
Tier 2	4	*25%*	12	*75%*	16
Total Capital	43		27		70

(A) Computation of minority interests arising from ordinary shares issued by a consolidated bank subsidiary

Step 1 –

Calculate the surplus CET1 of Bank S in excess of its 8.5% minimum CET1 plus conservation buffer requirement (i.e., 6.0% + 2.5%). Bank S is assumed to have risk weighted assets of 100.

Minimum Capital Surplus of Bank S		
	Minimum plus capital conservation buffer	Surplus capital
CET1	**8.5 (= 8.5% * 100)**	**34.5 (= 43 – 8.5)**

Step 2 –

Calculate the eligible portion of minority interest (MI) arising from CET1 issued by Bank S that is allowed to be included in the consolidated capital of Bank P [i.e., item (e)].

Bank S : amount of capital issued to third parties included in consolidated capital					
	Total amount issued (a)	Amount issued to third parties (b)	Surplus capital (c)	Surplus attributable to third parties (i.e., amount excluded from consolidated capital) (d) = (c) * (b)/(a)	Amount included in consolidated capital (e) = (b) – (d)
CET1	43	13	34.5	10.4	2.6

Step 3 –

The eligible amount of MI to be included in the consolidated CET1 Capital of Bank P is 2.6.

	Total amount issued by Bank P (all of which is to be included in consolidated capital)	Amount issued by Bank S to third parties to be included in consolidated capital of	Total amount issued by Bank P and Bank S to be included in consolidated capital of Bank P

CET1	31	2.6	33.6

(B) Minority interests arising from ordinary shares and Additional Tier 1 capital instruments issued by a consolidated bank subsidiary

Step 1 –

Calculate the surplus Tier 1 Capital of Bank S in excess of its 10% minimum Tier 1 capital plus capital conservation buffer requirement (i.e., 7.5% + 2.5%). Bank S is assumed to have risk weighted assets of 100.

Minimum and surplus capital of Bank S		
	Minimum plus capital conservation buffer	Surplus capital
Tier 1	10 (= 10% * 100)	44 (=(43+11) – 10)

Step 2 –

Calculate the eligible portion of MI arising from Tier 1 Capital issued by Bank S that is allowed to be included in the consolidated capital of Bank P [i.e., item (e)]

Bank S : amount of capital issued to third parties included in consolidated capital					
	Total amount issued (a)	Amount issued to third parties (b)	Surplus capital (c)	Surplus attributable to third parties (i.e., amount excluded from consolidated capital) (d) = (c) * (b)/(a)	Amount included in consolidated capital (e) = (b) – (d)
CET1	43	13	34.5	10.4	2.6
Tier 1	**54**	**15**	**44**	**12.2**	**2.8**

Step 3 –

The eligible amount for inclusion in Bank P's consolidated AT1 Capital is 0.2, arrived at by excluding from the eligible amount for inclusion as Tier 1 Capital (i.e., 2.8) the amount that has already been recognized in CET1 (i.e., 2.6).

	Total amount issued by Bank P (all of which is to be included in consolidated capital)	Amount issued by Bank S to third parties to be included in consolidated capital of	Total amount issued by Bank P and Bank S to be included in consolidated capital of Bank P
CET1	31	2.6	33.6
AT1	**12**	**.2**	**12.2**
Tier 1	**43**	**2.8**	**45.8**

(C) Minority interests arising from Tier 1 capital instruments and Tier 2 capital instruments issued by a consolidated bank subsidiary

Step 1 –

Calculate the surplus total capital of Bank S in excess of 12.5% minimum total capital plus conservation buffer requirement (i.e., 10% + 2.5%). Bank S is assumed to have risk weighted assets of 100.

Minimum Capital Surplus of Bank S		
	Minimum plus capital conservation buffer	Surplus capital
Tier 1	**12.5 (= 12.5% * 100)**	**57.5 (= (43+11+16) – 12.5)**

Step 2 –

Calculate the eligible portion of MI arising from total capital by Bank S that is allowed to be included in the consolidated capital of Bank P (i.e., item (e)).

Bank S : amount of capital issued to third parties included in consolidated capital					
	Total amount issued (a)	Amount issued to third parties (b)	Surplus capital (c)	Surplus attributable to third parties (i.e., amount excluded from consolidated capital) (d) = (c) * (b)/(a)	Amount included in consolidated capital (e) = (b) – (d)
CET1	43	13	34.5	10.4	2.6
Tier 1	**54**	**13**	**34.5**	**12.2**	**2.8**
Total Capital	**70**	**27**	**57.5**	**22.2**	**4.8**

Step 3 –

The eligible amount for inclusion in Bank P's consolidated capital is 2.0, arrived at by excluding from the eligible amount for inclusion as total capital (i.e., 4.8) the amount that has already been recognized in Tier 1 Capital (i.e., 2.8)

	Total amount issued by Bank P (all of which is to be included in consolidated capital)	Amount issued by Bank S to third parties to be included in consolidated capital of	Total amount issued by Bank P and Bank S to be included in consolidated capital of Bank P
CET1	31	2.6	33.6
AT1	12	.2	12.2
Tier 1	**43**	**2.8**	**45.8**
Tier 2	**20**	**2.0**	**22.0**

Total Capital	63	4.8	67.8

Annex E

LOSS ABSORBENCY REQUIREMENTS FOR ADDITIONAL TIER 1 CAPITAL

1. Capital instruments classified as liabilities for accounting purposes must have principal loss absorption when the pre- specified trigger point is breached, through either:

   a. conversion to common shares; or
   b. write-off mechanism which allocates losses to the instrument.

2. The trigger point for conversion or write-off is set at 7.25% Common Equity Tier 1 (CET 1) or below or as determined by the Bangko Sentral.

3. The write-off or conversion to common equity must generate CET1 under the relevant accounting standards. The instrument will only receive recognition in Tier 1 (CET 1) up to the amount of CET1 generated by a full write-off of the instrument.

4. The aggregate amount to be written off or converted for all such instruments on breaching the trigger point must be at least the amount needed to immediately return the bank's CET1 ratio at more than 7.25%, or if this is not possible, the full principal value of the instrument.

5. The bank has the option to choose its main loss absorption mechanism for its AT1 instruments which must be explicitly provided in the terms and condition of the issuance of the instruments.

   In case the conversion mechanism was chosen as an option, the terms and condition of the issuance shall likewise provide that in case said conversion cannot be implemented due to certain legal constraints, the write-off mechanism shall take effect.

6. Banks opting to use the conversion mechanism must address all legal impediments and obtain all prior authorization to ensure immediate recapitalization through conversion when the trigger point is breached. Failure to satisfy these requirements would render the instruments ineligible for inclusion in AT1 capital.

7. Banks must make the necessary adjustments to their Articles of Incorporation to accommodate the conversion of capital instruments to common shares for loss absorbency. Moreover, banks must ensure that it has an appropriate buffer of authorized capital stock.

8. Where AT1 capital instruments provide for conversion into common shares when the trigger point is breached, the issue documentation must include among others:

   a. the specific number of common shares to be received upon conversion, or specify the conversion formula for determining the number of common shares received; and
   b. number of shares to be received based on the specified formula:

   Provided, That the capital instruments converting into ordinary shares shall have a maximum conversion rate of fifty percent (50%) of the ordinary share price at the time of issue.

9. In issuing AT1 capital, the bank may:

   a. differentiate between/among instruments as to whether the instrument is required to be converted or written off upon breaching the trigger point; and
   b. provide for a hierarchy as to which AT1 instruments will be converted or written off.

10. Where the issue documentation provides for a ranking of the conversion or write-off, the terms attached to such hierarchy must not impede the ability of the capital instrument to be immediately converted or written off, as required.

11. Written commitment to undertake the necessary actions to effect the conversion must be accomplished by the bank. Otherwise, the write-off mechanism will take effect as the main loss absorbency mechanism.

12. Where, following the breach of the trigger point, the conversion cannot be undertaken, the write-off mechanism shall likewise take effect.

13. The write-off mechanism shall have the following effects:

    a. reduce the claim of the instrument in liquidation;
    b. reduce the amount re-paid when a call is exercised; and
    c. partially or fully reduce coupon/ dividend payments on the instruments.

14. The conversion to common shares or write-off of capital instruments prompted by the breach of the trigger point does not preclude the Bangko Sentral from requiring further conversion or

write-off upon the occurrence of the trigger event.

Annex E-1

RISK DISCLOSURE REQUIREMENTS ON LOSS ABSORBENCY FEATURES OF CAPITAL INSTRUMENTS

The following are the risk disclosure requirements on the loss absorbency features of Additional Tier 1 (AT1) and Tier 2 (T2) capital instruments eligible under the BASEL III framework which aim to uphold investor protection through enhanced disclosure and transparency.

When marketing, selling and distributing AT1 and T2 instruments eligible as capital under the Basel III framework, banks must:

a. Subject investors to a client suitability test to determine their understanding of the specific risks related to these investments and their ability to absorb risks arising from these instruments;

b. Provide the appropriate Risk Disclosure Statement for the issuance of AT1 and T2 capital instruments. The said disclosure statement shall explain the loss absorbency feature for AT1 and T2 capital instruments as well as the resulting processes that will be effected when the triggers for loss absorbency are breached;

c. Secure a written certification from each investor stating that;

(1) The investor has been provided with a Risk Disclosure Statement which, among others, explains the concept of loss absorbency for AT1 and T2 capital instruments as well as the resulting processes should the case triggers are breached;

(2) The investor has read and understood the terms and conditions of the issuance;

(3) The investors are aware of the risks associated with the capital instruments; and

(4) Said risks include permanent write- down or conversion of the debt instrument into common equity at a specific discount;

d. Make available to the Bangko Sentral, as may be required, the:

(1) Risk Disclosure Statement;
(2) Certification cited in Item "*c(3)*" above duly signed by the investor; and
(3) Client Suitability Test of the investor.

Annex F

LOSS ABSORBENCY REQUIREMENTS FOR ADDITIONAL TIER 1 CAPITAL AND TIER 2 CAPITAL AT THE POINT OF NON-VIABILITY

1. Additional Tier 1 (AT1) and Tier 2 (T2) capital instruments are required to have loss absorbency features at the point of non- viability.

2. Upon the occurrence of the trigger event, AT1 and T2 capital instruments should be able to absorb losses either through:

   a. conversion to common shares; or
   b. write-off mechanism which allocates losses to the instrument.

3. AT1 and T2 capital instruments will then be converted to common shares or written off upon the occurrence of the trigger event.

   The trigger event occurs when a bank is considered non-viable as determined by the Bangko Sentral. Non-viability is defined as a deviation from a certain level of Common Equity Tier 1 (CET1) Ratio, inability of the bank to continue business (CLOSURE) or any other event as determined by the Bangko Sentral, whichever comes earlier.

4. The write-off or conversion to common equity must generate CET1 and Total Capital under the relevant accounting standards. The instrument will only receive recognition in Tier 1 and Total Capital up to the amount of CET1 generated by a full write-off of the instrument.

5. In the absence of any contractual terms to the contrary, AT1 capital instruments shall be utilized first before Tier 2 capital instruments are converted or written off, until viability of the bank is re-established.

6. In the event that the bank does not have any AT1 instruments, then the conversion/write off shall automatically apply to T2 capital.

7. The bank has the option to choose its main loss absorption mechanism at the point of non-viability which must be explicitly provided in the terms and condition of the issuance of the instruments.

   In case the conversion mechanism was chosen as an option, the terms and condition of the issuance shall likewise provide that in case, said conversion cannot be implemented due to certain legal constraints, the write-off mechanism shall take effect.

8. Banks opting to use the conversion mechanism must address all legal impediments and obtain all prior authorization to ensure immediate recapitalization through conversion when the trigger event occurs. Failure to satisfy these requirements would render the instruments ineligible for inclusion as either AT1 capital or T2 capital.

9. Banks must make the necessary adjustments to their Articles of Incorporation to accommodate the conversion of capital instruments to common shares for loss absorbency at the point of non-viability. Moreover, banks must ensure that it has an appropriate buffer of authorized capital stock.

10. Where AT1 or T2 capital instruments provide for conversion into common shares when the trigger event occurs, the issue documentation must include among others:

    a. the specific number of common shares to be received upon conversion, or specify the conversion formula for determining the number of common shares received; and
    b. number of shares to be received based on the specified formula.

    Provided, That the capital instruments converting into ordinary shares shall have a maximum conversion rate of fifty percent (50%) of the ordinary share price at the time of issue.

11. In issuing AT1 or T2 capital, the bank may:

    a. differentiate between/among instruments as to whether the instrument is required to be converted or written off upon the occurrence of the trigger event; and
    b. provide for a hierarchy as to which instruments will be converted or written off among the AT1 capital instruments as well as among the T2 capital instruments.

12. Where the issue documentation provides for a ranking of the conversion or write-off, the terms

attached to such hierarchy must not impede the ability of the capital instrument to be immediately converted or written off, as required.

13. Written commitment to undertake the necessary actions to effect the conversion must be accomplished by the bank. Otherwise, the write-off mechanism will take effect as the main loss absorbency mechanism.

14. Where, upon the occurrence of the trigger event, the conversion cannot be undertaken, the write-off mechanism shall likewise take effect.

15. The write-off mechanism shall have the following effects:

    a. reduce the claim of the instrument in liquidation;
    b. reduce the amount re-paid when a call is exercised; and
    c. partially or fully reduce coupon/ dividend payments on the instruments.

16. In case of bank closure prior to the breach of the trigger event, a provision that provides for automatic write-off of AT1 and T2 instruments must be included in the terms and conditions of the issuance.

GROUP TREATMENT

17. The relevant jurisdiction in determining the trigger event is the jurisdiction in which the capital is being given recognition for regulatory purposes. However, the group treatment will only apply to wholly-owned subsidiary banks.

18. Where an issuing bank is a subsidiary of a wider banking group regulated by the Bangko Sentral or its parent wishes the instrument to be included in the capital of the consolidated group in addition to its solo capital, the terms and conditions of the subsidiary bank AT1 and T2 capital instruments must specify an additional trigger event as follows:

    AT1 and T2 capital instruments will be converted to common shares or written off once the parent bank is considered non-viable.

19. In case of a Bangko Sentral supervised entity that is a subsidiary of another institution that is not regulated by the Bangko Sentral, if the instruments are to be recognized as capital under Bangko Sentral requirements, in addition to the applicability of the trigger event, said instruments must provide that:

a. any supervisor of the parent entity cannot impede the right of Bangko Sentral to require the write-off or conversion of the instruments in relation to the Bangko Sentral supervised entity; and

b. any right of write-off or conversion by the parent supervisor must generate CET1 in the Bangko Sentral supervised entity.

20. Further, any common stock paid as compensation to the holders of the instrument must be common stock of either the issuing bank or the parent company of the consolidated group.

Annex G

RISK DISCLOSURE REQUIREMENTS ON LOSS ABSORBENCY FEATURES OF CAPITAL INSTRUMENTS

I. When marketing, selling and/or distributing AT1 and Tier 2 instruments eligible as capital under the Basel III framework, in the Philippines, banks must:

1. Subject investors to a client suitability test to determine their understanding of the specific risks related to these investments and their ability to absorb risks arising from these instruments;

2. Provide the appropriate Risk Disclosure Statement for the issuance of AT1 and Tier 2 capital instruments. The said disclosure statement shall explain the loss absorbency features for AT1 and Tier 2 capital instruments as well as the resulting processes that will be effected when the triggers for loss absorbency are breached;

3. Secure a written certification from each investor stating that:

   a. The investor has been provided a Risk Disclosure Statement which, among others, explains the concept of loss absorbency for AT1 and Tier 2 capital instruments as well as the resulting processes should the case triggers are breached;

   b. The investor has read and understood the terms and conditions of the issuance;

c. The investor is aware of the risks associated with the capital instruments; and

d. Said risks include permanent write- down or conversion of the debt instrument into common equity at a specific discount;

4. Make available to the Bangko Sentral, as may be required, the:

a. Risk disclosure statement;
b. Certification cited in Item "*3*" above duly signed by the investor; and
c. Client suitability test of the investor.

II. For offshore issuances of AT1 and Tier 2 capital instruments, the risk disclosure requirements shall be governed by the applicable rules and regulations of the country where these instruments are issued.

The subsequent sale and/or distribution of AT1 and Tier 2 capital instruments in the Philippines, originally issued overseas, shall comply with all the risk disclosure requirements for issuance in the Philippines.

(Circular No. 979 dated 25 October 2017, 934 dated 23 December 2016, 914 dated 23 June 2016, and 826 dated 14 February 2014)

Footnotes

1. The Basel Committee on Banking Supervision is a committee of banking supervisory authorities that was established by the central bank governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Argentina, Australia, Belgium, 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 in Basel, Switzerland where its permanent Secretariat is located.
2. Pertains to the reporting entity's head office and branches
3. 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
4. These currently pertain to insurance companies and securities brokers/dealers
5. For early adopters of PFRS 9, this account should include the net unrealized gains/losses on available-for-sale (AFS) debt securities;
6. For early adopters of PFRS 9, this account shall refer only to "Net Unrealized gains(losses) on AFS equity securities; For AFS debt securities, refer to Footnote No.5. In view of the continuing evaluation by the Basel Committee on the appropriate treatment of unrealized gains/losses with respect to the evolution of the ac- counting framework, the Bangko Sentral will revise its relevant regulation once the treatment of fair value adjustments in the calculation of CET1 has been determined.

7. Minority interest in a subsidiary that is a bank is strictly excluded from the parent bank's common equity if the parent bank or affiliate has entered into any arrangements to fund directly or indirectly minority investment in the subsidiary whether through an SPV or through another vehicle or arrangement. The treatment of minority interest set out above is strictly available where all minority investments in the bank subsidiary solely represent genuine third party common equity contributions to the subsidiary.
8. Treasury shares are: (1) shares of the parent bank held by a subsidiary financial allied undertaking in a consolidated statement of condition, or (2) the reacquired shares of a subsidiary bank/QB that is required to compute its capital adequacy ratio in accordance with this framework.
9. This adjustment shall only apply to banks/non-banks which would not early adopt the provisions of PFRS 9 and recognize the gains/losses (relative to changes in own credit worthiness) in undivided profits.
10. The adjustment pertains to the defined benefit asset or liabilitiy that is recognized in the balance sheet. Such that CET1 cannot be increased by derecognizing the liabilities, in the same manner, any asset recognized in the balance sheet should be deducted from CET1 capital;
11. Same footnote as in Part II, Item "*3.g.2.a*".
12. Same footnote as in Part II, Item "*4.a*"
13. Same footnote as in Part II, Item "*3.g.2.a*"
14. Same footnote in Part II, Item "*4.a*"
15. Same footnote in Part II, Item "*4.a*"
16. Shall include unremitted earnings elected by the branch to be part of assigned capital.
17. For early adopters of PFRS 9, this account shall refer only to Net Unrealized gains (losses) on AFS equity securities. For AFS debt securities, refer to footnote in Part II, Item "*3f*" In view of the continuing evaluation by the Basel Committee on the appropriate treatment of unrealized gains/losses with respect to the evolution of the accounting framework, the Bangko Sentral will revise its relevant regulation once the treatment of fair value adjustments in the calculation of CET1 has been determined.
18. The notations follow the rating symbols used by Standard & Poor's. The mapping of ratings of all recognized external rating agencies is in Part IV.C
19. Or risk weight applicable to sovereign of incorporation, whichever is higher
20. Or risk weight applicable to sovereign of incorporation, whichever is higher
21. Or risk weight applicable to sovereign of incorporation, whichever is higher
22. Or risk weight applicable to sovereign of incorporation, whichever is higher
23. The capital treatment of banks holdings of ROP Global Bonds paired with Warrants under the Bangko Sentral's revised risk-based capital adequacy framework is contained in *Appendix 60*.
24. Includes housing microfinance loans under Sec. 314
25. Counterparty refers to a party to whom a bank has an on- or off-balance sheet credit exposure or a potential credit exposure.
26. The notations follow the rating symbols used by Standard & Poor's. The mapping of ratings of all recognized external rating agencies is in Part IV.C
27. Housing microfinance loans under Sec. 314 to the extent guaranteed by the HGC, shall be subject to a zero percent (0%) risk weight.
28. [1] The notations follow the rating symbols used by Standard & Poor's. The mapping of ratings of all recognized external rating agencies is in Part IV.C

29. The notations follow the rating symbols used by Standard & Poor's. The mapping of ratings of all recognized external rating agencies is in Part IV.C. For purposes of this framework, debt securities/derivatives issued by sovereigns include foreign currency denominated debt securities/derivatives issued by the Philippine NG.
30. Warrants paired with ROP Global Bonds shall be exempted from capital charge for market risk only to the extent of bank's holdings of bonds paired with warrants equivalent to not more than fifty percent (50%) of total qualifying capital, as defined under Part II of this Appendix.
31. Refer to Appendix 63b-2 for the Guidelines on the Use of the Standardized Approach in Computing the Capital Charge for Operational Risk
32. In cases where capital instruments have a permanent write-down feature, this criterion is still deemed to be met by common shares.
33. A related entity includes a parent company, a sister company, a subsidiary or any affiliate. A holding company is a related entity irrespective of whether it forms part of the consolidated banking group.
34. Replacement issues can be concurrent with but not after the instrument is called.
35. A consequence of full discretion at all times to cancel distributions/payments is that “dividend pushers” are prohibited. An instrument with a dividend pusher obliges the issuing bank to make a dividend/coupon payment on the instrument if it has made a payment on another (typically more junior) capital instrument or share. This obligation is inconsistent with the requirement for full discretion at all times. Furthermore, the term “cancel distributions/payments” means extinguish these payments. It does not permit features that require the bank to make distributions/payments in kind.
36. Capital issued to third parties out of an SPV cannot be included in CET1. Instruments meeting the criteria for eligibility as AT1 capital will be treated as if the bank itself has issued the capital directly to 3rd parties. In cases where the capital has been issued to 3rd parties through an SPV via a fully consolidated subsidiary of the bank, such capital subject to the requirements for eligibility as AT1 capital, be treated as if the subsidiary itself had issued it directly to the 3rd parties and may be included in the bank's consolidated AT 1 capital based on the treatment of minority interest.
37. An option to call the instrument after five (5) years) but prior to the start of the amortization period will not be viewed as an incentive to redeem as long as the bank does not do anything that creates an expectation that the call will be exercised at this point.
38. Replacement issues can be concurrent with but not after the instrument is called.
39. Capital issued to third parties out of an SPV cannot be included in CET1. Instruments meeting the criteria for eligibility as Tier 2 capital will be treated as if the bank itself has issued the capital directly to 3rd parties. In cases where the capital has been issued to 3rd parties through an SPV via a fully consolidated subsidiary of the bank, such capital subject to the requirements for eligibility as Tier 2 capital, be treated as if the subsidiary itself had issued it directly to 3rd parties through an SPV via a fully consolidated subsidiary of the bank, such capital subject to the requirements for eligibility as AT1 capital, be treated as if the subsidiary itself had issued it directly to the 3rd parties and may be included in the banks consolidated AT1 capital based on the treatment of minority interest.