GUIDELINES ON THE ACCOUNTING TREATMENT FOR INVESTMENTS IN CREDIT-LINKED NOTES (CLNs) AND OTHER STRUCTURED PRODUCTS (SPs)

(Appendix to Section 623-A)

In line with the policy of promoting fairness and accuracy in reporting financial transactions, banks are enjoined to observe the following guidelines on accounting for investments in (CLNs) and other (SPs) in addition to those prescribed under PAS 39: CLNs and other SPs are financial instruments which consist of the host contract (e.g., debt or equity contract) and one or more embedded derivatives. Said financial instruments may be accounted for as compound financial instruments or as bifurcated financial instruments where the embedded derivatives shall be separated from the host contracts. PAS 39 provides the conditions on when the embedded derivative may be bifurcated from the host contract.

Booking of CLNs and other SPs as a compound instrument

a. CLNs may be booked under the “Held for Trading” (HFT) or “Designated at Fair Value through Profit or Loss” (DFVPL) category according to intention as provided under Circular No. 494 dated 20 September 2005.

b. Other SPs, shall also be booked under the HFT or DFVPL category according to intention as provided in PAS 39.

In either case, the compound instrument (host contract and embedded derivatives) shall be carried at fair value with fair value changes reflected in profit or loss.

Booking of CLNs and other SPs as bifurcated financial instrument

Investment in CLNs and other SPs that are not intended to be traded (i.e., not to be booked as HFT) or to be designated at fair value through profit or loss shall be accounted for as bifurcated financial instruments.

Accounting for host contracts. When the embedded derivatives are bifurcated (separated) from the host contract, the host contract shall be accounted for as follows:

a. In the case of CLN, the host contract shall be booked under the “Available for Sale” (ASS) but not under the “Held to Maturity” (HTM) nor under the “Unquoted Debt Securities Classified as Loans” (UDSCL) category in accordance with Circular No. 494.

b. In the case of other SPs, the host contract shall be booked under the ASS, HTM or UDSCL category in accordance with Sec. 381.

Host contracts of investments in CLNs and Other SPs shall in no case be booked under the “Due from Other Banks” or “Interbank Loans Receivable” accounts.

Accounting for embedded derivatives. The bifurcated embedded derivatives shall be accounted for as “Derivatives Held for Trading” with fair value changes reflected in profit or loss, except in cases where the bifurcated embedded derivatives are designated and effective hedging instruments, which shall be booked under the “Derivatives Held for Hedging” account. The following shall be observed for purposes of FRP reporting of bifurcated embedded derivatives:

- The entire notional amount (or leveraged notional amount in cases of leveraged exposures) of the hybrid contract and the corresponding positive/(negative) fair value of the embedded derivatives shall be reported in Schedule 4 (Derivatives Held for Trading – Embedded Derivatives) of the FRP.

- In the case of CLNs and Other SPs that have more than one embedded derivatives (multiple embedded derivatives) that are required to be separated from the hybrid contract, the entire notional amount (or leveraged notional amount in cases of leveraged exposures) of the hybrid contract and the corresponding positive/(negative) fair value of the embedded derivatives shall be reported in Schedule 4 (Derivatives Held for Trading – Embedded Derivatives) of the FRP for each type of bifurcated derivatives.

Generally, multiple embedded derivatives in a single instrument are treated as a single compound embedded derivative. However, embedded derivatives that are classified as equity are accounted for separately from those classified as assets or liabilities. In addition, if an instrument has more than one embedded derivatives and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.

Marking to market guidance. In addition to the marking to market guidelines provided under PAS 39, banks should likewise consider apart from the carrying amount of the host contract the notional amount (or leveraged notional amount in cases of leveraged exposures) of embedded derivatives in marking to market the hybrid financial instrument.

For this purpose, the term CLN shall include similar instruments such as credit linked deposits (CLDs) and credit linked loans (CLLs) where the repayment of the principal to the note holder is contingent upon the occurrence of a defined credit event. On the other hand, other SPs (as defined under Sec. 622) shall refer to a financial instrument where the total return is a function of one or more underlying indices, such as interest rates, equities and exchange rates. It is composed of a host contract (e.g., plain vanilla debt or equity securities) and an embedded derivative (e.g., swaps, forwards or options) that re-shape the risk-return pattern of the hybrid instrument. The term SP does not include asset-backed securities.