Risk-Based Capital Adequacy Framework for the Philippine Banking System

A Revision[*]

Introduction

This document outlines the Bangko Sentral ng Pilipinas' (BSP) implementing guidelines of the revised *International Convergence of Capital Measurement and Capital Standards*, or popularly known as Basel II. Basel II is the new international capital standards set by the Basel Committee on Banking Supervision (BCBS)[1]. It aims to replace Basel I, which was issued in 1988 with an amendment in 1996, to make the risk-based capital framework more risk sensitive. This document revises the risk-based capital adequacy framework for universal banks and commercial banks, as well as their subsidiary banks and quasi-banks. Thrift banks and rural banks as well as quasi-banks that are not subsidiaries of universal banks and commercial banks shall continue to be subject to the current risk-based capital adequacy framework, pending issuance of applicable revised regulations.

Part I. Risk-based capital adequacy ratio

1. The risk based capital adequacy ratio (CAR) of universal banks (UBs) and commercial banks (KBs) and their subsidiary banks and quasi-banks, expressed as a percentage of qualifying capital to risk-weighted assets, shall not be less than 10%.
2. Qualifying capital is computed in accordance with the provisions of Part II. Risk weighted assets is the sum of (1) credit-risk weighted

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[*] This document is an excerpt lifted from http://www.bsp.gov.ph/downloads/Regulations/attachments/2006/circ538.pdf. **The intention is to show that BASEL II is likewise being implemented in the Philippines, as part of the country's efforts to comply with sound international banking practices**.

[1] The guidelines contained in this document shall take effect on 1 July 2007. 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 Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, 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.

assets (Parts III, IV, and V), (2) market risk weighted assets (Parts IV and VI), and (3) operational risk weighted assets (Part VII)

3. The CAR requirement will be applied to all UBs and KBs and their subsidiary banks, and quasi-banks on both solo and consolidated 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, 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 BSP.

5. Banks shall comply with the minimum CAR 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 BSP-SES within 3 banking days. For this purpose, banks shall develop an appropriate system to properly monitor their compliance.

6. The BSP 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 Tier 1 (core plus hybrid) capital and Tier 2 (supplementary) capital elements, net of required deductions from capital.

A. Tier 1 Capital

2. Tier 1 capital is the sum of core Tier 1 capital and allowable amount of hybrid Tier 1 capital, as set in paragraph 12.
3. Core Tier 1 capital consists of:

   a) Paid-up common stock; b) Paid-up perpetual and non-cumulative preferred stock; c) Additional paid-in capital; d) Retained earnings; e) Undivided profits (for domestic banks only); f) Net gains on fair value adjustment of hedging instruments in a cash flow hedge of available for sale equity securities; g) Cumulative foreign currency translation; and h) Minority interest in subsidiary financial allied undertakings which are less than wholly-owned: *Provided*, That a bank shall not use minority interests in the equity accounts of consolidated subsidiaries as avenue for introducing into its capital structure elements that might not otherwise qualify as Tier 1 capital or that would, in effect, result in an excessive reliance on preferred stock within Tier 1: Less: i. Common stock treasury shares; ii. Perpetual and non-cumulative preferred stock treasury shares; iii. Net unrealized losses on available for sale equity securities purchased; iv. Gains (Losses) resulting from designating financial liabilities at fairvalue through profit or loss that are due to own credit worthiness; v. Unbooked valuation reserves and other capital adjustments based on the latest report of examination as approved by the Monetary Board; vi. Total outstanding unsecured credit accommodations, both direct and indirect, to directors, officers, stockholders and their related interests (DOSRI); vii. Deferred income tax; viii. Goodwill, 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); and ix. Gain on sale resulting from a securitization transaction.

4. Hybrid Tier 1 capital in the form of perpetual preferred stock and perpetual unsecured subordinated debt may be issued subject to prior BSP approval and to the conditions in paragraph 12.

5. In the case of foreign banks, Tier 1 capital is equivalent to: a) Assigned capital including earnings not remitted to the head office which the bank elects to consider as part of assigned capital (in which case it can no longer be remitted to the head office); and b) "Net due to" head office, branches, subsidiaries and other offices outside the Philippines as defined under Subsec. X121.5.d of the MORB (inclusive of earnings not remitted to head office per Subsec. X121.5.c of the MORB, unless considered as part of the assigned capital by the bank), subject to the limit prescribed under Subsec. X121.6 of the MORB, Less: i. Any balance in the "Net due from" account.

B. Tier 2 Capital

6. Tier 2 capital is the sum of upper Tier 2 capital and lower Tier 2 capital.

7. The total amount of lower Tier 2 capital before deductions enumerated in paragraph 10 that may be included in total Tier 2 capital shall be limited to a maximum of 50% of total Tier 1 capital (net of deductions enumerated in paragraph 3). The total amount of upper and lower Tier 2 capital both before deductions enumerated in paragraph 10 that may be included in total qualifying capital shall be limited to a maximum of 100% of total Tier 1 capital (net of deductions enumerated in paragraph 3).

8. Upper Tier 2 capital consists of:

   a) Paid-up perpetual and cumulative preferred stock; b) Paid-up limited life redeemable preferred stock issued with the condition that redemption thereof shall be allowed only if the shares redeemed are replaced with at least an equivalent amount of newly paid-in shares so that the total paid-in capital stock is maintained at the same level prior to redemption; c) Appraisal increment reserve – bank premises, as authorized by the Monetary Board; d) Net unrealized gains on available for sale equity securities purchased subject to a 55% discount; e) General loan loss provision, limited to a maximum of 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; f) With prior BSP approval, unsecured subordinated debt with a minimum original maturity of at least ten (10) years issued subject to the conditions in paragraph 13, in an amount equivalent to its carrying amount discounted by the following rates:

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C. Deductions from the total of Tier 1 and Tier 2 capital

10. The following items should be deducted 50% from Tier 1 and 50% from Tier 2 capital:

a) Investments in equity of unconsolidated subsidiary banks and quasi banks, and other financial allied undertakings (excluding subsidiary securities dealers/brokers and insurance companies), after deducting related goodwill, if any (for solo basis);b) Investments in other regulatory capital instruments of unconsolidated subsidiary banks and quasi-banks (for solo basis); c) Investments in equity of unconsolidated subsidiary securities dealers/brokers, insurance companies, and non-financial allied undertakings, after deducting related goodwill, if any (for both solo and consolidated bases); d) Capital shortfalls of unconsolidated subsidiary securities dealers/brokers and insurance companies (for both solo and consolidated bases); e) Significant minority investments (20%-50% of voting stock) in banks and quasi-banks, and other financial allied undertakings (for both solo and consolidated bases); f) Reciprocal investments in equity of other banks/enterprises; g) Reciprocal investments in other regulatory capital instruments of other banks and quasi-banks; and h) Materiality thresholds in credit derivative contracts purchased; i) Securitization tranches which are rated below investment grade or are unrated; and j) Credit enhancing interest only strips in relation to a securitization structure, net of the amount of "gain-on-sale" that must be deducted from core Tier 1 capital referred to in paragraph 3.

11. 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. Available for sale debt securities shall be risk weighted net of specific provisions as provided in paragraph 1 of Part III.A, but without considering accumulated market gains/losses.

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E. Eligible unsecured subordinated debt

13. Unsecured subordinated debt issuances by banks should comply with the following minimum conditions in order to be eligible as upper Tier 2 (UT2) capital:

a) It must be issued and fully paid-up. Only the net proceeds received from the issuance shall be included as capital

b) It must be available to absorb losses of the bank without it being obliged to cease carrying on business. The agreement governing its issuance should specifically provide for the coupon and principal to absorb losses where the bank would otherwise be insolvent, or for its holders to be treated as if they were holders of a specified class of share capital in any proceedings commenced for the winding up of the bank. Issue documentation must disclose to prospective investors the manner by which the instrument is to be treated in loss situation.

Alternatively, the agreement governing its issuance can provide for automatic conversion into common shares or perpetual and non-cumulative shares or perpetual and cumulative preferred shares upon occurrence of certain trigger events, as follows:

i. Breach of minimum capital ratio;
ii. Commencement of proceedings for winding up of the bank; or
iii. Upon appointment of receiver for the bank.

The rate of conversion must be fixed at the time of subscription to the instrument. The bank must also ensure that it has appropriate buffer of authorized capital stock and appropriate stockholders and board authorization for conversion/issue to take place anytime;

c) Its holders must not have priority claim, in respect of principal and coupon payments in the event of winding up of the bank, which is higher than or equal with that of depositors, other creditors of the bank, and holders of LT2 capital instruments. Its holder must waive his right to set14 off any amount he owes the bank against any subordinated amount owed to him due to the UT2 capital instrument;

d) It must neither be secured nor covered by a guarantee of the issuer or related party or other arrangement that legally or economically enhances the priority of the claim of any holder as against depositors, other creditors of the bank and holders of LT2 capital instruments;

e) It must not be redeemable at the initiative of the holder. It must not be repayable prior to maturity without the prior approval of the BSP: *Provided*, That repayment may be allowed only in connection with a call option after a minimum of five (5) years from issue date:

Provided, however, That a call option may be exercised within the first five (5) years from issue date when:

i. It was issued for the purpose of a merger with or acquisition by the bank and the merger or acquisition is aborted;
ii. There is a change in tax status of the UT2 capital instrument due to changes in the tax laws and/or regulations; or
iii. It does not qualify as UT2 capital as determined by the BSP:

Provided, further, That such repayment prior to maturity shall be approved by the BSP only if the debt is simultaneously replaced with issues of new capital which is neither smaller in size nor of lower quality than the original issue, unless the bank's capital ratio remains more than adequate after redemption, It must not contain any clause which requires acceleration of payment of principal, except in the event of insolvency. The agreement governing its issuance must not contain any provision that mandates or creates an incentive for the bank to repay the outstanding principal of the instrument, e.g., a cross-default or negative pledge or a restrictive covenant, other than a call option which may be exercised by the bank;

f) Its main features must be publicly disclosed by annotating the same on the instrument and in a manner that is easily understood by the investor;

g) The proceeds of the issuance must be immediately available without limitation to the bank;

h) The bank must have the option to defer any coupon payment where the bank:
i. has not paid or declared a dividend on its common shares in the preceding financial year; or
ii. determines that no dividend is to be paid on such shares in the current financial year;

It is acceptable for the deferred coupon to bear interest but the interest rate payable must not exceed market rates;

i) The coupon rate, or the formulation for calculating coupon payments must be fixed at the time of issuance and must not be linked to the credit standing of the bank;

j) It may allow only one (1) moderate step-up in the coupon rate in conjunction with a call option, only if the step-up occurs at a minimum of ten (10) years after the issue date and if it results in an increase over the initial rate that is not more than:

i. 100 basis points less the swap spread between the initial index basis and the stepped-up index basis; or

ii. 50% of the initial credit spread less the swap spread between the initial index basis and the stepped-up index basis.

The swap spread should be fixed as of the pricing date and reflect the differential in pricing on that date between the initial reference security or rate and the stepped-up reference security or rate;

k) 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;

l) It must be issued in minimum denominations of at least five hundred thousand pesos (P500,000.00) or its equivalent;

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

n) The bank must submit a written external legal opinion that the abovementioned requirements, including the subordination and loss absorption features, have been met:

Provided, That it shall be subject to a cumulative discount factor of 20% per year during the last five (5) years to maturity (i.e., 20% if the remaining life is 4 years to less than 5 years, 40% if the remaining life is m3 years to less than 4 years, etc.): *Provided, further,* That where it is denominated in a foreign currency, it shall be revalued in accordance with PAS 21: *Provided, furthermore,* That for purposes of reserve requirement regulation, it shall not be treated as time deposit liability, deposit substitute liability or other forms of borrowings.

14. Unsecured subordinated debt issuances by banks should comply with the following minimum conditions in order to be eligible as lower Tier 2 (LT2) capital:
    a) It must be issued and fully paid-up. Only the net proceeds received from the issuance shall be included as capital;
    b) Its holders must not have priority claim, in respect of principal and coupon payments in the event of winding up of the bank, which is higher than or equal with that of depositors and other creditors of the bank. Its holder must waive his right to set-off any amount he owes the bank against any subordinated amount owed to him due to the LT2 capital instrument;
    c) It must neither be secured nor covered by a guarantee of the issuer or related party or other arrangement that legally or economically enhances the priority of the claim of any holder as against depositors and other creditors of the bank;
    d) It must not be redeemable at the initiative of the holder. It must not be repayable prior to maturity without the prior approval of the BSP:

Provided, That repayment may be allowed only in connection with a call option after a minimum of five (5) years from issue date: *Provided, however*, That a call option may be exercised within the first five (5) years from issue date when:

i. It was issued for the purpose of a merger with or acquisition by the bank and the merger or acquisition is aborted;
ii. There is a change in tax status of the LT2 capital instrument due to changes in the tax laws and/or regulations; or
iii. It does not qualify as LT2 capital as determined by the BSP:

Provided, further, That such repayment prior to maturity shall be approved by the BSP only if the debt is simultaneously replaced with issues of new capital which is neither smaller in size nor of lower quality than the original issue, unless the bank's capital ratio remains more than adequate after redemption, It must not contain any clause which requires acceleration of payment of principal, except in the event of insolvency. The agreement governing its issuance must not contain any provision that mandates or creates an incentive for the bank to repay the outstanding principal of the instrument, e.g., a cross-default or negative pledge or a restrictive covenant, other than a call option which may be exercised by the bank;

e) Its main features must be publicly disclosed by annotating the same on the instrument and in a manner that is easily understood by the investor;
f) The proceeds of the issuance must be immediately available without limitation to the bank;
g) The coupon rate, or the formulation for calculating coupon payments must be fixed at the time of issuance and must not be linked to the credit standing of the bank;
h) It may allow only one (1) moderate step-up in the coupon rate in conjunction with a call option, only if the step-up occurs at a minimum of five (5) years after the issue date and if it results in an increase over the initial rate that is not more than:
   i. 100 basis points less the swap spread between the initial index basis and the stepped-up index basis; or
   ii. 50% of the initial credit spread less the swap spread between the initial index basis and the stepped-up index basis.
   The swap spread should be fixed as of the pricing date and reflect the
   differential in pricing on that date between the initial reference security or
   rate and the stepped-up reference security or rate;
i) 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;
j) It must be issued in minimum denominations of at least five hundred thousand pesos (P500,000.00) or its equivalent;
k) It must clearly state on its face that it is not a deposit and is not insured by the Philippine Deposit Insurance Corporation (PDIC); and
l) The bank must submit a written external legal opinion that the above mentioned requirements, including the subordination features, have been met:

Provided, That it shall be subject to a cumulative discount factor of 20% per year during the last five (5) years to maturity (i.e., 20% if the remaining life is 4 years to less than 5 years, 40% if the remaining life is 3 years to less than 4 years, etc.): *Provided, further,* That where it is denominated in a foreign currency, it shall be revalued in accordance with PAS 21: *Provided, furthermore,* That for purposes of reserve requirement regulation, it shall not be treated as time deposit liability, deposit substitute liability or other forms of borrowings.

Part III. 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 III.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 securitisation are dealt with in Part IV and V, respectively. Exposures should be risk-weighted net of specific provisions.

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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 ng Pilipinas (BSP) shall be risk, weighted at 0%. Foreign currency denominated exposures to the NG and the BSP, 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 12 The notations follow the rating symbols used by Standard & Poor's. The mapping of ratings of all recognized external rating agencies is in Part III.C. 3 Or risk weight applicable to sovereign of incorporation, whichever is higher July 2007, two-thirds (2/3) from 1 January 2008, and the full risk weight from 1 January 2009. 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 0% risk weight.

MDB Exposures

3. These include all exposures to multilateral development banks. Exposures to the World Bank Group comprised of the International Bank for Reconstruction and Development (IBRD) and the International Finance Corporation (IFC), the Asian Development Bank (ADB), the African Development Bank (AfDB), the European Bank for Reconstruction and Development (EBRD), the Inter- American Development Bank (IADB), the European Investment Bank (EIB), the

European Investment Fund (EIF), the Nordic Investment Bank (NIB), the Caribbean Development Bank (CDB), the Islamic Development Bank (IDB), and the Council of Europe Development Bank (CEDB) currently receive 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/quasi-banks, 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 BSP, the Bankers Association of the Philippines (BAP), and the Philippine Clearing House Corporation (PCHC).

Exposures to Local Government Units

6. These include all exposures to non-central government public sector entities. Bonds issued by Philippine local government units (LGU Bonds), which are covered by Deed of Assignment of Internal Revenue Allotment of the LGU and guaranteed by the LGU Guarantee Corporation shall be risk weighted at the lower of 50% or the appropriate risk weight indicated in the table above.

Exposures to Government Corporations

7. These include all exposures to commercial undertakings owned by central or local governments. Exposures to Philippine Government Owned or Controlled Corporations (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 financial institutions, 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.

Micro, Small, and Medium Enterprises (MSME)

10. An exposure must meet the following criteria to be considered as a MSME exposure:
    a) The exposure must be to a micro, small, or medium business enterprise as defined under existing BSP 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 guarantees issued 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 nonperforming loans. Current MSME exposures not qualifying under highly diversified MSME portfolio will be risk weighted 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 debts 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;

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

III.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 0%;

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

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 Part IV and V, respectively.

Investments in equity or other regulatory capital instruments issued by banks or other financial/non-financial 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) *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) 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);
   v. Revolving letters of credit (net of margin deposit) arising from movement of goods and/or services; and 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) *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;
   ix. 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 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:

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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 VIII 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 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

    "Counterparty" refers to a party to whom a bank has an on- or off-balance sheet credit exposure or a potential credit exposure.
26. 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 BSP 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.

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Part VII. 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 15% of the average gross income over the previous three 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 BSP approval. In order to qualify for use of the standardized approach, a bank must satisfy BSP 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-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.

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Part VIII. Disclosures in the Annual Reports and Published Statement of Condition

1. This section lists the specific information that banks have to disclose, at a minimum, in their Annual Reports, except item h, paragraph 4 which should also be disclosed in banks' quarterly published statement of condition. These enhanced disclosures shall commence with Annual Reports for financial year 2007 and quarterly published statement of condition from end-September 2007.
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 h below which should also be disclosed in banks' quarterly published statement of condition:
   a) Tier 1 capital and a breakdown of its components (including deductions solely from Tier 1);
   b) Tier 2 capital and a breakdown of its components;
   c) Deductions from Tier 1 (50%) and Tier 2 (50%) capital;
   d) Total qualifying capital;
   e) Capital requirements for credit risk (including securitization exposures);
   f) Capital requirements for market risk;
   g) Capital requirements for operational risk; and
   h) Total and Tier 1 capital adequacy ratio on both solo and consolidated bases.

B. Risk exposures and assessments

4. 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

5. 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 III;
   b) Total credit risk exposure after risk mitigation, broken down by:
      i. type of exposures as defined in Part III; 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 III;
   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;

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

6. 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 BSP; and
      v. A comparison of VaR estimates with actual gains/losses experienced by the bank, with analysis of important outliers in back test results.

Operational risk

7. 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

8. 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 non-maturity 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.

Part IX. Enforcement

A. Sanctions for non-reporting of CAR breaches

1. It is the responsibility of the bank CEO to cause the immediate reporting of CAR breaches both to its Board and to the BSP. It is likewise the CEO's responsibility to ensure the accuracy of CAR calculations and the integrity of the associated monitoring and reporting system. Any willful violation of the above will be considered as a serious offense for purposes of determining the appropriate monetary penalty that will be imposed on the CEO. In addition, the CEO shall be subject to the following non-monetary sanctions:
   a) First offense – warning
   b) Second offense – reprimand
   c) Third offense – 1 month suspension without pay
   d) Further offense – disqualification

B. Sanctions for non-compliance with required disclosures

2. Willful non-disclosure or erroneous disclosure of any item required to be disclosed under this framework in either the Annual Report or the Published Statement of Condition shall be considered as a serious offense for purposes of determining the appropriate monetary penalty that will be imposed on the bank. In addition, the CEO and the Board shall be subject to the following non-monetary sanctions:
   a) First offense – warning on CEO and the Board
   b) Second offense – reprimand on CEO and the Board
   c) Third offense – 1 month suspension of CEO without pay
   d) Further offense – possible disqualification of the CEO and/or the Board