



Bangko Sentral ng Pilipinas

OFFICE OF THE GOVERNOR

MEMORANDUM TO ALL BANKS AND NON-BANK FINANCIAL INSTITUTIONS WITH QUASI-BANKING FUNCTIONS (NBQBs)

The Monetary Board, in its Resolution Nos. 917 and 1199 dated 26 June 2003 and 21 August 2003, respectively, approved the following accounting guidelines on the sale of non-performing assets (NPAs) to Special Purpose Vehicles (SPVs) and to qualified individuals for housing under "The Special Purpose Vehicle (SPV) Act of 2002".

General Principles

These guidelines set out alternative regulatory accounting treatment of the sale of non-performing assets (NPAs) by banks and other financial institutions (FIs) under BSP supervision to Special Purpose Vehicles (SPVs) and to qualified individuals for housing under Republic Act No. 9182, otherwise known as "The Special Purpose Vehicle (SPV) Act of 2002".

The guidelines recognize that banks/FIs may need temporary regulatory relief, in addition to tax relief under the SPV Law, particularly in the timing of recognition of losses, so that they may be encouraged to maximize the sale of their NPAs even at substantial discounts: *Provided, however,* That in the interest of upholding full transparency and sustaining market discipline, banks/FIs that avail of such regulatory relief shall fully disclose its impact in all relevant financial reports.

The guidelines cover the following areas:

- (1) Derecognition of NPAs sold/transferred to an SPV and initial recognition of financial instruments issued by the SPV to the selling bank/FI as partial or full settlement of the NPAs sold/transferred to the SPV;
- (2) Subsequent measurement of the carrying amount of financial instruments issued by the SPV to the selling bank/FI;
- (3) Capital adequacy ratio (CAR) calculation; and
- (4) Disclosure requirement on the selling bank/FI.

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The sale/transfer of NPAs to SPV referred to in these guidelines shall be in the nature of a "true sale" pursuant to Section 13 of the SPV Law and its Implementing Rules and Regulations.

I. Derecognition of NPAs Sold and Initial Recognition of Financial Instruments Received

A bank/FI should derecognize an NPA when, and only when, the bank/FI loses control of the contractual rights of that NPA, as in a "true sale" transaction.

On derecognition, any excess of the carrying amount of the NPA (i.e., net of specific allowance for probable loss after booking the BSP recommended valuation reserve) over the proceeds received in the form of cash and/or financial instruments issued by the SPV represents an actual loss that should be charged to current period's operations. However, such loss may be booked as a "Deferred Charges" account which may be written down over the next seven (7) years based on the following schedule:

End of Period From Date of Transaction	Cumulative Write-down of Deferred Charges
Year 1	5%
Year 2	10%
Year 3	28%
Year 4	46%
Year 5	64%
Year 6	82%
Year 7	100%

In case the face amounts of the financial instruments exceed the excess of the carrying amount of the NPA over the cash proceeds, the same shall be adjusted by setting up specific allowance for probable losses so that no gain shall be recognized from the transaction.

The carrying amount of the NPA (i.e., net of specific allowance for probable losses after booking the BSP recommended valuation reserves) may be initially assumed to be the NPA's fair value. The excess of the carrying amount of the NPA over the cash proceeds or the face amounts of the financial instruments, whichever is lower, shall then be the initial cost of financial instruments received.

Banks/FIs shall book such financial instruments under the general ledger account "Investments in Bonds and Other Debt Instruments" for debt instruments or "Equity Investments in Allied Undertakings" for equity instruments.

II. Subsequent Measurement of Financial Instruments Received

- (a) A bank/FI should assess at end of each fiscal year or more frequently whether there is any objective evidence or indication based on analysis of expected net cash inflows that the carrying amount of financial

instruments issued by an SPV may be impaired. A financial instrument is impaired if its carrying amount (i.e., net of specific allowance for probable loss) is greater than its estimated recoverable amount. The estimated recoverable amount is determined based on the net present value of expected future cash flows discounted at the current market rate of interest for a similar financial instrument.

In applying discounted cash flow analysis, a bank/FI should use the discount rate(s) equal to the prevailing rate of return for financial instruments having substantially the same terms and characteristics, including the creditworthiness of the issuer.

- (b) Alternatively, the estimated recoverable amount of the financial instruments may be determined based on an updated estimate of residual net present value (NPV) of the issuing SPV.

The estimated recoverable amount of the financial instrument shall be the present value of the excess of expected cash inflows (e.g., proceeds from the sale of collaterals and/or ROPOAs, which in no case shall exceed the contract price of the NPAs sold/transferred, interest on the reinvestment of proceeds) over expected cash outflows (e.g., direct costs to sell, administrative expenses, principal and interest payments on senior obligations, interest payments on the financial instruments).

The fair market value of the collateral and/or ROPOAs should under this method be considered only under the following conditions:

- (1) The appraisal was performed by an independent appraiser acceptable to the BSP; and
- (2) The valuation of the independent appraiser is based on current market valuation of similar assets in the same locality as underlying collateral rather than other valuation methods such as replacement cost, etc.

The assumptions regarding the timing of sale, the direct cost to sell, administrative expenses, reinvestments rate and current market rate should be disclosed in sufficient detail in the audited financial statements. The applicable discount rate should be based on the implied stripped yield of the Treasury note or bond for the tenor plus an appropriate risk premium.

- (c) In case of impairment, the carrying amount of the financial instrument should be reduced to its estimated recoverable amount, through the use of specific allowance for probable losses account that should be charged to current period's operations. However, for the end of the first fiscal year following the sale/transfer of NPA, such setting up of specific

allowance for probable losses account may be booked on a staggered basis over the next seven (7) years based on the following schedule:

End of Period From Date of Transaction	Cumulative Booking of Allowance for Probable Losses
Year 1	5%
Year 2	10%
Year 3	28%
Year 4	46%
Year 5	64%
Year 6	82%
Year 7	100%

After initially recognizing an impairment loss, the bank/FI should review the financial instruments for future impairment in subsequent financial reporting date.

If in a subsequent period, the estimated recoverable amount of the financial instrument decreases, the bank/FI availing of the staggered booking of specific allowance for probable losses should immediately book additional allowance for probable losses corresponding to the decrease.

If in a subsequent period, the estimated recoverable amount of the financial instrument increases exceeding its carrying amount, and the increase can be objectively related to an event occurring after the write-down, the write-down of the financial instruments should be reversed by adjusting the specific allowance for probable losses account. The reversal should not result in a carrying amount of the financial instrument that exceeds what the cost would have been had the impairment not been recognized at the date the write-down of the financial instrument is reversed. The amount of the reversal should be included in the profit for the period.

Illustrative accounting entries for derecognition of NPAs, initial recognition of financial instruments issued by the SPV, and subsequent measurement of the carrying amount of the financial instrument are in Annex 1.

III. Capital Adequacy Ratio (CAR) Calculation

Banks/FIs may, for purposes of calculating capital adequacy ratio (CAR), likewise stagger over a period of seven (7) years the recognition of:

- (1) actual loss on sale/transfer of NPAs; and
- (2) impairment, if any, upon remeasurement of financial instruments at end of the first fiscal year following the sale/transfer of NPAs,

in accordance with the following schedule:

End of Period From Date of Transaction	Cumulative Recognition of Losses/Impairment
Year 1	5%
Year 2	10%
Year 3	28%
Year 4	46%
Year 5	64%
Year 6	82%
Year 7	100%

Provided, That no cash dividend on common stock and/or preferred stock shall be declared by the bank/FI while the staggered recognition of actual loss on sale/transfer of NPA and/or impairment, if any, on the remeasurement of financial instruments at end of the first fiscal year following the sale/transfer of NPA exist:

The financial instruments received by the selling bank/FI shall be risk weighted in accordance with Circular No. 280 dated 29 March 2001, as amended.

IV. Disclosure

Banks/FIs should disclose as "Additional Information" in periodic reports submitted to the BSP, as well as in published reports and audited financial statements and all relevant financial reports the staggered recognition of actual loss on sale/transfer of NPAs and/or impairment, if any, on the remeasurement of financial instruments at end of the first fiscal year following the sale/transfer of NPAs. In addition, banks/FIs which receive financial instruments issued by the SPVs as partial or full settlement of the NPAs transferred to the SPVs should disclose in the audited financial statements the method used and the significant assumptions applied in estimating the recoverable amount of the financial instruments, including the timing of the sale, the direct cost to sell, administrative expenses, reinvestment rate, current market rate, etc. (The pro-forma disclosure requirements on the staggered recognition of actual loss on sale/transfer of NPAs and/or impairment, if any, on the remeasurement of financial instruments at end of the first fiscal year following the sale/transfer of NPAs, are shown in Annex 2.)

This memorandum shall take effect after 15 days following its publication either in the Official Gazette or in a newspaper of general circulation.

FOR THE MONETARY BOARD:


ALBERTO V. REYES
Officer In-Charge

26 September 2003

Attachments -

ILLUSTRATIVE ACCOUNTING ENTRIES TO RECORD SALE OF NPAs TO SPV UNDER THE SPV LAW OF 2002

	Mode of Payment (Cash, Financial Instruments)			
	Cash Only (30, 0)	Financial Instruments Only (0, 120)	Part Cash, Part Financial Instruments 1/ (30, 90)	Part Cash, Part Financial Instruments 2/ (30, 70)
Assumptions:				
Loans/ROPOAs, gross	120	120	120	120
All. for probable losses	20	20	20	20
Loans/ROPOAs, net	100	100	100	100
Cash payment received	30	0	30	30
Financial instruments received	0	120	90	70

1/ Face amounts of financial instruments exceed the excess of the carrying amount of the NPAs over the cash proceeds.

2/ Face amounts of financial instruments do not exceed the excess of the carrying amount of the NPAs over the cash proceeds.

Accounting Entries	Cash Only (30, 0)		Financial Instruments Only (0, 120)		Part Cash, Part Financial Instruments <u>1/</u> (30, 90)		Part Cash, Part Financial Instruments <u>2/</u> (30, 70)	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
1 Cash IBODI/Equity Investments Deferred Charges All. for Probable Losses –NPAs sold Loans/ROPOAs All. for Probable Losses – IBODI/Equity Investments To record sale of NPAs, receipt of financial instruments as full or partial payment, and recognition of loss (if any)	30 0 70 20	120 0	0 120 0 20	120 20	30 90 0 20	120 20	30 70 0 20	120 0
2 Amortization – Deferred Charges Deferred Charges To record annual write down of deferred charges based on staggered recognition of losses	xxx	xxx	0	0	0	0	0	0

Accounting Entries	Cash Only (30, 0)		Financial Instruments Only (0, 120)		Part Cash, Part Financial Instruments 1/ (30, 90)		Part Cash, Part Financial Instruments 2/ (30, 70)	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
3 Provision for Probable Losses -- IBODI/Equity Investments All. for Probable Losses - IBODI/ Equity Investments To record annual build up of allowance for probable losses on financial instruments based on scheduled staggering	0		xxx		xxx	xxx	xxx	xxx

PRO-FORMA DISCLOSURE REQUIREMENT

A. Statement of Condition

Particulars	Amount
<i>Additional Information:</i>	
NPA's sold, gross	xxx
Less: All. for probable losses (specific)	xxx
Carrying amount of NPA's sold	xxx
Cash received	xxx
Financial instruments received, gross	xxx
Less: All. for probable losses (specific)	xxx
Carrying amount of financial instruments received	xxx
Less: Unbooked all. for probable losses (specific)	xxx
Adj. carrying amount of financial instruments received	xxx
Deferred charges, gross	xxx
Less: Deferred charges written down	xxx
Carrying amount of deferred charges	xxx

B. Statement of Income and Expenses

Particulars	Amount
<i>Additional Information:</i>	
Net income after income tax <i>(with regulatory relief)</i>	xxx
Less: Deferred charges not yet written down	xxx
Unbooked all. for probable losses (specific) on financial instruments received	xxx
Total	xxx
Add: Deferred tax liability, if applicable	xxx
Net deductions	xxx
Net income after income tax <i>(without regulatory relief)</i>	xxx