



# *Bangko Sentral ng Pilipinas*

## OFFICE OF THE DEPUTY GOVERNOR SUPERVISION AND EXAMINATION SECTOR

MEMORANDUM NO. M-2007- 041  
Series of 2007

**TO : All Universal and Commercial Banks, and their  
Subsidiary Banks and Quasi-Banks**

**SUBJECT: Frequently Asked Questions (FAQs) on the Revised Risk-  
Based Capital Adequacy Framework**

To facilitate the successful implementation of the revised risk-based capital adequacy framework (the "Framework") for the Philippine banking system that took effect on 1 July 2007 issued under Circular No. 538 dated 4 August 2006, the following clarifications are hereby issued:

### **QUALIFYING CAPITAL – TIER 1 CORE CAPITAL**

**1. *Where should we report the surplus and surplus reserve in the new reporting template?***

Surplus and Surplus Reserve shall be reported under Retained Earnings in the new reporting template. Banks will note that the revised CAR reporting template is aligned with the Financial Reporting Package (FRP), which uses the account Retained Earnings in place of Surplus and Surplus Reserve.

**2. *What if the Cumulative Foreign Currency Translation account is negative? How should it be presented in the CAR Report?***

If the Cumulative Foreign Currency Translation is negative, this negative balance will still be reported as part of core Tier 1 capital (Item (7) in Part II. A.1 of the report).

**3. *For branches of foreign banks, how should we present the balance of Due to head office/branches/agencies? Should it be presented "net" of the Due from accounts?***

The amount to be presented in Net Due to head office/branches/agencies (Item (10) in Part II. A.1 of the report) should be in accordance with Subsection X121.5 of the MORB, i.e., any balance in the "Due to" account,

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net of (1) any balance in the "Due From" account, (2) unbooked valuation reserves and other capital adjustments as may be required by the BSP, (3) total outstanding unsecured credit accommodations to DOSRI, and (4) deferred income tax, but subject to the limits prescribed under Subsection X121.6 of the MORB.

#### **QUALIFYING CAPITAL – HYBRID TIER 1 CAPITAL**

***4. Why is it that the basis of computing the eligible amount of hybrid tier 1 capital is multiplied by 17.65% and not by the 15% limit?***

The 17.65% is derived by taking the ratio of 15% Hybrid Tier 1 (HT1) capital to 85% core T1 capital. This is because HT1 is allowed up to the extent of 15% of **total Tier 1 (T1)** capital, which includes both **core T1** and **eligible HT1**. However, since total T1 capital will not be known until after the amount of HT1 is determined, **core T1** is used as the basis for computing the eligible amount for HT1.

#### **QUALIFYING CAPITAL – UPPER TIER 2 CAPITAL**

***5. If the booked amount of the general loan loss provision (GLLP) is higher than the BSP recommended level, should we limit the GLLP to be reported as part of Tier 2 capital to the recommended level?***

The amount to be reported as part of Upper Tier 2 capital should be the **booked amount** provided it does not exceed the limit of 1% of the total credit risk-weighted assets. The booked GLLP in excess of the limit shall be deducted from Total Credit Risk Weighted Assets (Part III.C.1).

#### **QUALIFYING CAPITAL – DEDUCTIONS FROM THE TOTAL TIER 1 AND TIER 2 CAPITAL**

***6. Why are the deductions from capital set at 50% from Tier 1 and 50% from Tier 2?***

The equal distribution of deductions from capital among Tier 1 and Tier 2 elements ensures that banks' qualifying capital consists mainly of Tier 1 elements. This follows from the rule that the eligible amount of Tier 2 capital is limited to 100% of Tier 1 capital.

***7. What if the amount of Tier 2 capital, net of deductions, becomes negative?***

The resulting negative balance shall be deducted from Tier 1 capital.

## **QUALIFYING CAPITAL – DISCLOSURE REQUIREMENT**

- 8. *The quarterly capital adequacy ratio and the Tier 1 ratio are required to be reported in the quarterly Published Balance Sheet (PBS). What ratios should be reported in the PBS if ratios for the current quarter are not yet available?***

Since banks are required to comply with the minimum CAR at all times, and thus, expected to have the systems necessary to compute the CAR on a daily basis, the CAR to be included in the PBS should be as of cut-off date stated in the call letter.

## **QUALIFYING CAPITAL – CAR REPORTING PROCEDURE**

- 9. *We are required to report breaches in the minimum CAR within three banking days to the Board of Directors. How should we report it to the Board if CAR is computed on a quarterly basis?***

As earlier stated, banks must comply with the minimum CAR **at all times**. Thus, reporting to the Board of Directors should be made within 3 days of the identification of the breach. Moreover, this should be done even if the breaches are temporary.

- 10. *When should we report breaches of minimum CAR to the BSP? Is it three banking days after we report it to the Board of Directors?***

The reporting of the breach of the minimum CAR to the Board of Directors and BSP-SES should be done simultaneously within the three banking day period.

## **CREDIT RISK – ON-BALANCE SHEET ITEMS**

- 11. *A commercial paper issued internationally by a domestic entity has an external credit rating which is higher than the sovereign rating. What is the appropriate rating to be used then? Is it limited to the rating of the sovereign?***

In accordance with the general rule, the ratings rendered by BSP-recognized international credit assessment agencies should be used to risk weight an entity's internationally-issued debt obligations, regardless of the rating of the sovereign.

**12. Can a bank subscribe to only one rating agency in determining the external ratings of its exposures?**

Yes, as long as the ratings given by the said rating agency are consistently used/applied to all of the bank's exposures. Hence, if the bank subscribed to only one eligible external credit assessment institution (ECAI), all its exposures should be risk-weighted using the subscribed ECAI's credit assessments. On the other hand, if a bank used two or three eligible ECAIs, it should refer to these institutions for all of its risk-weighting purposes.

**13. Which external credit assessment agencies are eligible for commercial papers issued domestically?**

Domestic debt issuances may be rated by BSP-recognized domestic credit assessment agencies or by international credit assessment agencies which have developed a national rating system acceptable to the BSP.

**14. In an interbank call loan with BSP as the counterparty, what is the risk weight to be used? Is it 20% or the applicable risk weight for a Philippine sovereign?**

The account "Interbank call loans with the BSP as a counterparty" in the old Manual of Accounts has been subsumed in the account "Loans to BSP" in the FRP. As such, this will be risk weighted: (1) at 0% if peso-denominated; or (2) based on the external rating of the Philippine sovereign if foreign-currency denominated, but applied on a staggered basis.

**15. Since interbank call loans receivable are risk weighted at 20%, will the domestic bills purchased, i.e., managers' checks and cashiers' checks, which pass thru clearing, also be risk weighted at 20%?**

No. Domestic bills purchased (classified in the FRP as "Interbank Term Loans Receivable") should be risk weighted according to the external credit assessment on the drawee bank.

**16. Should bills purchased that are usually transacted on a "with recourse" basis be risk weighted using the rating of the seller of the bills instead of the drawee bank?**

Yes. However, note that in the FRP, bills purchased on a "with recourse" basis are classified under "Loans and Receivables – Others", while those that are transacted "without recourse" are classified under "Interbank Term Loans Receivable".

**17. Are government-owned banks classified as Banks or Government Owned or Controlled Corporations?**

Under the Framework, government-owned banks are considered as banks.

**18. The bank reports the following under Held to Maturity securities per its FRP:**

|               |   |        |
|---------------|---|--------|
| GOCC          | - | P 100M |
| Banks (UBs)   | - | 30M    |
| Private Corp. | - | 20M    |
|               |   | -----  |
|               |   | P 150M |
|               |   | -----  |

***If in the above example the Private Corp does not have an external credit rating, should the total of P 20M be reported under Item G of Part III.1 (HTM Financial Assets) or should this be reported under Item N (Other Assets) since the applicable risk weight is the same at 100%?***

In this case, unrated exposures to Private Corp. should still be reported as part of HTM financial assets, as the figures in the CAR Report ought to tie up with the balances in the FRP. However, the unrated exposures would be risk weighted at 100%.

**19. Why do housing loans need to be secured by property to be occupied by the borrower to warrant the use of 50% risk weight?**

Lesser credit risk and probability of default is attributed to housing loans secured by property that are occupied by the borrower, since the borrower is more likely to pay the loan on time so as not to lose his place of residence. Thus, they attract a preferential risk weight of 50%.

**20. A housing loan was availed of to finance the purchase of a 5-unit apartment. The borrower occupied one unit only and the other 4 units were leased out. Do banks have to pro-rate the portion of the housing loan that will be subject to 50% risk weight?**

Yes, only the portion of the loan attributed to the purchase of the occupied unit will be subject to the 50% risk weight; the remainder will be treated as an ordinary loan, which is subject to a 100% risk-weight.

**21. "A highly diversified MSME portfolio should have at least 500 borrowers distributed over a number of industries". How do we define the "number of industries"?**

Though Circular No. 538 does not explicitly define the "number of industries" for a qualified MSME portfolio, a bank must have an internal policy that defines what it considers as a "highly diversified portfolio". One way of doing this is by specifying a threshold portfolio correlation level. However, the definition should be consistently used and the bank should be able to justify its use to the examiner validating the CAR reports.

**22. Banks are required to comply with the regulatory ceilings on Agri-Agra loans and non-compliance will be subject to penalties. However, some of these loans have poor credit quality and are considered non-performing. Thus, they will be risk weighted at 150%. Is it possible for BSP to give preferential treatment for banks' exposures to this loan portfolio like exposures to qualified MSME as an incentive for banks to comply with the regulatory requirement on Agri-Agra loans?**

Circular No. 538 is substantially patterned after Basel II, which does not specifically give preferential treatment to Agri-Agra loans. The lower risk weight given to a qualified MSME portfolio is due to the lower credit risk associated with a highly diversified portfolio; it is not intended to serve as an incentive for banks to comply with the MSME requirement. As such, a further study on Agri-Agra loans should be conducted to analyze its historical default and loss experience before it can be assigned a lower risk weight.

**23. For defaulted exposures, do arrearages include the coupon or interest?**

Yes. Arrearages apply to principal and/or interest payments/amortizations.

**24. For defaulted loan exposures, should we include the non-performing restructured loans?**

Yes, non-performing restructured loans are also risk weighted at 150%.

**25. Is accrued interest receivable pertaining to securities held for trading (HFT) also risk-weighted according to the claim?**

Yes.

**26. Why are Held-for-trading (HFT) and Investment in Non-marketable Equity Securities (INMES) accounts not included in Part III.1 (Risk Weighted On-Balance Sheet Assets)?**

Part III.1 facilitates the computation of credit risk capital charges for banking book items. On the other hand, HFT accounts - both securities and derivatives - attract market risk capital charges; thus, they are reported in Part IV of the CAR Report. However, OTC derivatives and repo-style transactions will appear in Part III.3 and Part III.4 of the report, respectively, in order to account for counterparty credit risk.

INMES is included in Part III.1 under Other Assets. These are risk weighted at 100%.

**27. Are all the asset accounts to be reported at gross amount?**

On-balance sheet items should be reported net of the following: (1) specific provisions/allowance for credit losses; (2) accumulated market gains/losses except for available for sale debt securities; and (3) unamortized discount/(premium).

## **CREDIT RISK – OFF-BALANCE SHEET ITEMS**

### ***28. What is the treatment for revocable and irrevocable letters of credit (LCs)?***

In general, the capital charge for LCs is determined according to the methodology for off-balance sheet items, i.e., the credit equivalent amount (computed by multiplying the notional amount of the contract by its associated credit conversion factor (CCF)) is risk weighted according to the rating of the counterparty.

The effective credit equivalent amount of revocable LCs is zero, since a 0% CCF is used for commitments which can be unconditionally cancelled any time by the bank without prior notice.

The credit equivalent of irrevocable LCs, on the other hand, will depend on the nature of the transaction, since the CCFs to be applied may be 20%, 50%, or 100%.

## **CREDIT RISK – OTC DERIVATIVE CONTRACTS**

### ***29. Are the derivative transactions of a foreign bank branch here in Manila with other foreign bank branches abroad subject to counterparty credit risk capital charges?***

Generally, if a branch of foreign bank in Manila enters into derivative transactions with other branches of its parent bank, said transactions will be subject to zero risk weight for the purpose of computing capital charges for counterparty risk. Note that if the counterparty is considered a subsidiary or affiliate, then a counterparty risk capital charge must be computed.

### ***30. Why do we have to report the credit risk-weighted assets of all derivative contracts, including those not linked to credit?***

OTC derivative contracts – including those not linked to credit – are exposed to counterparty credit risk. As such, they are considered in the computation of credit risk-weighted assets.

### ***31. In a swap transaction wherein the exchanges are based on interest only and not the notional amount, why do we need to charge for credit risk on the notional amount?***

The “charge on the notional amount” for swaps (and OTC transactions, in general) covers the *potential future credit exposure*, or the possible credit exposure that *may* arise as a result of future positive changes in the value of the contract.

Although it is true that only the interest payments are used to value an interest rate swap, the exchanges are based on the notional principal of the contract.

As such, the proxy method for the calculation of the potential future credit exposure prescribed by the Basel Committee uses the notional value of the contract as the base for computing the capital charge.

It will be noted that the *capital charge* on the potential future credit exposure of an interest rate swap only ranges from 0% to 1.5% of its effective notional amount. However, depending on the magnitude of a contract's notional value, the potential future credit exposure can turn out to be significant.

**32. *Why do we still charge for counterparty risk in a credit derivative exposure if we are already computing a specific risk capital charge? Isn't it double charging?***

No. There is no double charging when we compute for both specific risk and counterparty credit risk capital charges for credit derivatives. The former is computed for the exposure on the reference asset while the latter is for the exposure to the counterparty in the contract. For example, in a CDS contract, the protection buyer incurs a short position on the reference asset on which a specific risk capital charge is computed. However, the protection buyer also relies on the protection seller to make his losses whole in case a credit event occurs and must therefore compute a counterparty credit risk charge to cover the risk of non-payment of the protection seller.

**CREDIT RISK – CREDIT RISK MITIGATION AND REPO-STYLE TRANSACTIONS**

**33. *If the bank does not wish to recognize the effect of the CRM due to conservatism, will the bank be penalized for erroneous reporting?***

No.

**34. *What are the types of credit risk mitigants? Should Part III.1a - Exposures covered by credit risk mitigants, be accomplished first before Part III.1?***

The three types of credit risk mitigants defined in Circular No. 538 are (1) guarantees, (2) collateral, and (3) credit derivatives.

Yes, Part III.1a should be accomplished first before Part III.1. Part III.1a is the template for the computation of credit risk weighted assets covered by CRM, gross of materiality threshold. The balances in Part III.1a are needed to derive the exposures, net of CRM, and to compute for total risk-weighted on-balance sheet assets in Part III.1.

**35. Will the exposures guaranteed by the Quedan Corporation still receive a 0% risk-weight?**

The exposures guaranteed by Quedan Corp. will only receive a 0% risk-weight if these are peso-denominated and counter-guaranteed by the Philippine National Government (PNG), provided that the counter-guarantee meets the three (3) conditions stated under paragraph 49, Part III. B of the Framework.

**36. Will the exposures guaranteed by the Small Business Guarantee and Finance Corporation (SBGFC) receive a 0% risk-weight?**

Since the guarantees of SBGFC are not counter-guaranteed by the PNG, exposures covered by the guarantees of the SBGFC will be risk-weighted based on SBGFC's external credit rating, if any, provided that it is lower than the risk weight of the original counterparty.

**37. What is the treatment of guarantees which have an original maturity of less than one year?**

The maturity of underlying exposures and guarantees with original maturities of less than one year must be matched to be recognized. Hence, there would be no capital relief if there is a maturity mismatch. Note, however, that if there is no maturity mismatch but the residual maturity is three months or less, the guarantee is also not recognized.

**38. Home Guaranty Corporation (HGC) guarantees are renewed annually. Will there be a maturity mismatch considering that the exposures being hedged have terms of more than one year, i.e., usually five to ten years?**

If there will be uncertainties in the renewal of the guaranty contract with HGC, then there will be a maturity mismatch. In such a case, an adjustment for the maturity mismatch will be calculated only if the residual maturity of the guarantee is more than three (3) months. If the residual maturity is less than three (3) months, the effect of the guarantee will not be recognized.

**39. What range or definite percentage of positive correlation between counterparty's credit quality and collateral is considered material for collateral to be deemed ineffective?**

The bank should have an internal policy that defines what it considers as material positive correlation, and it should be able to justify this to the BSP. The bank is expected to consistently use this definition.

**40. Why is the haircut applicable to UITF the highest haircut applicable to any security in which the fund can invest in, and not the sum of the products of the weight and the haircut of each of the investments of the fund, similar to the rule where the collateral is a basket of assets?**

UITF is a pooled fund that is invested in various securities, the composition of which changes periodically. In this regard, the weight of each security is not easy to determine and the rule for collateral 'baskets' would be impractical to apply.

**41. Is there a capital requirement (counterparty risk for repo-style transactions) for peso-denominated overnight lending under repurchase agreements with BSP?**

None. The counterparty credit risk capital requirement is effectively zero since peso-denominated exposures to the BSP arising from overnight lending under repurchase agreements receive a risk weight of 0%.

**CREDIT RISK – CREDIT DERIVATIVES (BANKING BOOK)**

**42. How can the materiality threshold be illustrated in practical terms? What are the factors that affect the materiality threshold?**

Materiality threshold provisions may be found in credit derivatives contracts. For instance, Bank A has an investment in ROP bonds and subsequently enters into a credit default swap (CDS) with Bank B for a notional amount of P100.0M. The contract further provides a materiality threshold of P1.0M. Suppose the ROP bonds are restructured and Bank A incurs a loss below P1.0M, Bank A will not yet be compensated for the loss since it did not exceed the P1.0M threshold.

**43. Under what part of the CAR reporting template should credit linked notes (CLNs) be risk weighted?**

The way a CLN held in the banking book is reported for capital adequacy purposes depends on how the bank records the instruments in its books.

A CLN is actually a debt instrument with an embedded CDS. Under Circular No. 494 dated 20 September 2005, banks may be required to bifurcate the CDS from the host contract (the debt instrument). The host contract is booked in the Available for Sale (AFS) category; as such, it would be slotted in Part III.1.F of the CAR report. The derivative, on the other hand, will be marked-to-market with adjustments being charged to profit or loss. Moreover, it will attract a specific market risk capital charge, a general market risk capital charge for the regular payments on the CLN associated with the CDS spread (if this is identified separately), and a counterparty credit risk capital charge.

Banks can also opt to book a CLN as a Financial Asset Designated at Fair Value Through Profit/Loss (FA-DFVPL). In this case, it will enter the CAR report in Part III.5, and the additive rule for determining the risk weight on the

CLN would apply. Moreover, the amount of CLNs would have to be deducted from Other Assets (Item N.3d of Part III.1) since the risk-weighted amount is computed in a separate schedule.

***44. Are holdings of CLNs which were issued by a foreign bank with ROP as reference obligation subject to staggered capital charging?***

The staggered capital charging will only apply to the reference obligation since it represents a foreign-currency denominated debt security issued by the PNG. Capital charges related to the issuer of the CLN will be imposed in full.

**CREDIT RISK – SECURITIZATION**

***45. What is a trapping point?***

Trapping point is a critical level of the excess spread (i. e., the difference between the interest earned on the underlying collateral assets and the interest paid on the debt securities of the SPE/SPV, including senior fees and expenses) on a revolving asset securitization. "Trap" is the term used to lock in the excess spread in a reserve account, as economically required by the structure. In cases where a transaction does not require excess spread to be trapped, the trapping point is deemed to be 4.5 percentage points. The quotient of the excess spread level and the trapping point shall be the basis for determining the appropriate credit conversion factor to be applied to the amount of investors' interest. The closer the level of excess spread to the trapping point, the higher the risk to the bank and the greater the CCF.

***46. From which department in the BSP shall we seek approval of our securitization plan? Which department shall determine whether a securitization transaction would be covered under the securitization framework?***

The securitization plan and other supporting documents should be submitted to the appropriate Central Point of Contact (CPC).

**MARKET RISK**

***47. Does the trading book definition include AFS?***

No. Available-for-sale securities, although being marked-to-market daily, are no longer considered a trading book component as provided under Circular No. 506 dated 23 December 2005. These are now classified under the banking book, and are therefore subject to credit risk capital charges.

**48. Why multiply the market risk capital charges by 125% and then again again by 10?**

Although the BSP prescribes a 10% minimum CAR, the capital charges in our guidelines are calibrated using the 8% minimum CAR prescribed by the Basel Committee on Banking Supervision (BCBS). Since the BSP-required minimum ratio is 25% higher than the BCBS, we need to multiply the capital charge by 125% to align it with the higher BSP requirement.

The resulting capital charge would then have to be multiplied by 10 – the reciprocal of 10% – to convert it to a risk weighted amount so it can be directly added to credit risk and operational risk weighted assets in computing for the regulatory capital ratio.

**49. Are interest rate swaps subject to specific risk? Why are debt derivatives subject to specific risk?**

Interest rate derivatives, which include derivative contracts such as interest rate futures, forward rate agreements, interest rate swaps, cross currency swaps, interest rate options, and forward foreign exchange positions, are not subject to specific risk capital charge. However, in case of debt-related derivatives (e.g., bond futures) wherein the underlying is a debt security, a specific risk capital charge will apply according the credit rating of the issuer and the residual maturity of the underlying debt security.

**50. What are the sample transactions slotted in the short position of debt securities and debt derivatives?**

A good example is a bond future. A bond future contract represents the obligation to buy or sell a specific bond at a future date (the contract's expiry date) at a price determined today. The buyer of the contract (the "long" position, since he is obliged to buy the underlying bond in the future) has increased his exposure to changes in the market price of the underlying bond. Similarly, the seller of the contract, which has a short position (since he is obliged to sell the underlying bond in the future), has reduced his exposure to changes in the value of the said bond.

For CAR purposes, the underlying bond is reported by the future contract 'seller' as a short position subject to specific risk capital charge. In addition, the same bond is subject to general market risk with short position to be reported in the time band based on the remaining maturity of the bond and a corresponding long position to be reported in the time band based on the time to expiry of the futures contract.

**51. Why do we add the capital charges for long and short positions of specific risk?**

Specific risk refers to movements in market prices due to factors unique to individual issuers. Specific risk long and short positions refer to positions to different issuers. Thus, they cannot be offset and have to be added. This is in contrast to general market risk long and short positions which refer to positions to the same market factors. General market risk long and short positions can therefore be offset.

**52. What does the term "disallowance" mean in the computation of general market risk for interest rate exposures? Why do we compute for vertical and horizontal disallowances?**

In the framework, we allow offsetting of risk-weighted positions with different maturities, i.e., offsetting within and across zones. However, to take account of the possibility that interest rates across different maturities do not move in the same direction, we "disallow" certain portions from being offset.

A capital requirement is calculated for the matched weighted positions in each time band (vertical disallowance) to address basis risk. It is the risk that the relationship between changes in prices of similar instruments is not stable over time. Horizontal disallowance on the other hand captures the imperfect correlation of interest rates along the yield curve.

**53. How is a callable bond reported if the embedded derivative has been bifurcated from the debt security?**

The debt security - or the host contract - that is booked under AFS or HTM is reported in Part III.1 of the template. However, the short call option with the debt security as the underlying will be subject to the delta-plus approach for options. As such, the delta-equivalent of the option's underlying is reported under Part IV.1d, while the charges for the option's gamma and vega sensitivities are computed in Part IV. 4c.

**OPERATIONAL RISK**

**54. What will be the basis for the amounts to be used in the computation of the Gross Income (GI) level?**

The amounts to be used in computing for the GI of the bank must be aligned with or equal to the amounts reported in the bank's FRP.

**55. How do we compute for the 3-year average Gross Income (GI)?**

For a given reporting period, say, 2nd Quarter of 2006, the 3-year average GI would be the average of the positive year-end GIs for the past 3 years, i.e., 2003, 2004, and 2005. The said 3 years will be used for all the CAR reporting periods (4 quarters) of 2006. This means that there will be a fixed capital charge for operational risk for the whole year.

**56. Circular No. 538 dated 4 August 2006 (which contains the Revised Capital Adequacy Framework) provides that only the positive GI of the bank for the previous 3 years shall be considered in computing for the average GI of the bank. How do we compute for the GI of a bank that continuously incur zero or negative GI?**

In this case, the bank has to consult their corresponding CPC at the BSP on the appropriate computation of operational risk capital charge.

**57. In consolidated CAR reporting, is it possible for the parent to use The Standardized Approach (TSA) while its subsidiaries use the Basic Indicator Approach (BIA)?**

The same approach should be used by all entities in the same domestic banking group.

For guidance.

  
NESTOR A. ESPENILLA, JR.  
Deputy Governor

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