



# *Bangko Sentral ng Pilipinas*

## OFFICE OF THE GOVERNOR

### **CIRCULAR NO. 668**

Series of 2009

#### **Subject: Derivatives Guidelines for Non-Bank Financial Institutions with Quasi-banking Authority**

The Monetary Board, in its Resolution No. 1323 dated 17 September 2009, approved the following amendments to Section X4603Q and its subsections, Appendices Q-15 and Q-16 of the Manual of Regulations for Non Bank Financial Institutions ("MORNBFI") regarding the regulations governing the derivatives activities of Quasi-banks.

#### **1. Statement of Policy**

The Bangko Sentral ng Pilipinas ("BSP") supports the development of the Philippine financial market by providing non-bank financial institutions (NBFI) and their clients with expanded opportunities for financial risk management and investment diversification through the prudent use of derivatives.

A non-bank financial institution with quasi-banking authority (also referred here as "quasi-bank", "QB" or "NBQB") may engage in authorized derivatives activities, provided that the QB:

- Understands, measures, monitors and controls the risks assumed from its derivatives activities;
- Adopts effective risk management practices whose sophistication are commensurate to the risks being monitored and controlled; and
- Maintains capital commensurate with the risk exposures assumed.

#### **2. Section X4603Q and Subsections X4603Q.1-X4603Q.7, are hereby replaced as follows:**

**"Sec. X4603Q Derivatives.** Quasi-banks (QB) may engage in financial derivatives activities in accordance with these guidelines. The transacting QB shall have the responsibility to comply with the guidelines set out in this Section, including the relevant appendices, and other applicable laws, rules and regulations governing derivatives transaction. In case of derivatives instruments involving foreign currencies and/or other foreign currency - denominated assets, the transacting QB shall observe the pertinent foreign exchange ("FX") rules and regulations. For purposes of these guidelines, a quasi-bank that transacts (i.e., transacting bank), whether as end-user, broker or dealer, in derivatives instruments is considered to be engaging in a derivatives activity.

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Derivative is broadly defined as a financial instrument that primarily derives its value from the performance of an underlying variable. For purposes of these guidelines, a financial derivative is any financial instrument or contract with all of the following characteristics:

- (1) Its value changes in response to a change in a specified interest rate, financial instrument price, commodity price, FX rate, index of prices or rates, credit spread, credit rating or credit index or other variables not prohibited under existing laws, rules and regulations (the "underlying");
- (2) It requires either no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- (3) It is settled at a future date.

Financial derivatives activities shall also include transactions in cash instruments with embedded derivatives that reshape the risk-return profile of the host instrument, such as credit-linked notes ("CLNs") and other structured products ("SPs").

A market participant may take any of the following roles in a derivatives transaction:

1. An **end-user** is defined as a financial market participant that enters, for its own account, in a derivatives transaction for legitimate economic purposes. These purposes may include, but are not limited to, the following: hedging, proprietary trading, managing capital or funding costs, obtaining indirect exposures to desired market factors, investment, yield-enhancement, and/or altering the risk-reward profile of a particular item or an entire balance sheet.

An end-user may be classified according to its financial sophistication:

- a. Market Counterparty – refers to FI, only with respect to the instruments for which it is authorized to engage in as a dealer.
- b. Institutional Counterparty – refers to an institution which is not a market counterparty and has the level of net worth, knowledge, expertise, and experience to deal with financial derivatives.
- c. Sophisticated Individual End-User – refers to an individual who has demonstrated to the FI as having the level of net worth, knowledge and experience in dealing with financial products, including financial derivatives. An individual may register as a sophisticated individual end-user with the Centralized Applications and Licensing Group of the BSP.

- d. **Other End-user** – This refers to all other institutional or individual clients not categorized as market counterparty, institutional counterparty or sophisticated individual end-user.

2. A **broker** is a financial market participant that facilitates a derivatives transaction between a dealer and its client, for a fee or commission. The counterparties to the derivatives contract are the client and an authorized dealer.

3. A **dealer** is defined as a financial market participant that engages in a derivatives activity as an originator of derivatives products or as market-maker in derivatives products. A dealer can distribute its own derivatives products, including those of others. A dealer can also act as broker and/or end-user of derivatives instruments.

#### **§ X4603Q.1 Generally Authorized Derivatives Activities.**

A quasi-bank may enter in any financial derivatives transaction with BSP-authorized dealers and brokers without need of prior BSP approval solely for hedging purposes; Provided that it observes all the requirements for hedging transactions under Philippine Accounting Standards ("PAS") and Provided further, that it observes the provisions of Appendix Q-15 of the MORNBFI.

A trust department of a quasi-bank may enter, as an institutional counterparty, into any financial derivatives with BSP-approved authorized dealers and brokers, on behalf of its trustor/principal/s as may be authorized by such trustor/principal/s without need for prior BSP approval, solely for hedging purposes; Provided that the trust department observes all the requirements for hedging transactions under PAS and Provided further, that it observes the provisions of Appendix Q-15 of the MORNBFI.

**§ X4603Q.2 Activities Requiring Additional Derivatives Authority.** Quasi-banks (QB) may apply for prior BSP approval of additional derivatives authority to engage in all other financial derivatives activities not expressly allowed in Subsection X4603Q.1. A QB may apply for two or more additional authorities. A QB applying for additional derivatives authority/ies must have and maintain a risk management system commensurate to the additional authority/ies being applied for, in accordance with the provisions of Appendix Q-15 and meet other conditions specified under this Subsection.

#### *a. Classification of Additional Derivatives Authority.*

##### **1. Type 2 –Limited Dealer Authority**

A QB that is also an investment house may apply for a Type 2 Authority. A QB with Type 2 Authority may operate as a dealer in specific types of derivatives products with specific underlying reference, as applied for by the QB, Provided, that a QB with Type 2 Authority shall comply with the

sales and marketing guidelines prescribed in *Appendix Q-16*. The Type 2 Authority also carries authority to transact as broker and end-user of the said specific derivatives instruments.

## 2. Type 3 – Limited User Authority

A QB or a trust department of a QB, may apply for a Type 3 Authority. A QB or a trust department of a QB with Type 3 Authority may transact, as an end-user, in specific types of derivatives products, with specific underlying reference, as applied for by the QB, outside of those instruments that meet the conditions under subsection X4603Q.1. A Type 3 Authority will enable said QB or trust department to transact as end-user of derivatives instruments as may be applied for by the QB or trust department.

## 4. Type 4 – Special Broker Authority

A QB that is also an investment house may likewise apply for a Type 4 Authority. A QB with Type 4 Authority may facilitate a derivatives transaction between a BSP-authorized dealer and end-user clients; *Provided*, that the QB, acting as broker, ensures that its client fully understands its limited responsibility as a broker and observes the provisions of *Appendix Q-16*.

A QB with additional Type 2 or 4 Authorities shall be responsible for complying with pertinent securities laws, rules and regulations.

For purposes of this Subsection, the types of derivatives are classified as follows: forwards, swaps and options. Underlying reference pertains to the following: interest, foreign currencies/foreign exchange, equity, credit and commodity.

*b. Qualification requirements.* A QB applying for additional authority to engage in additional derivatives activities shall:

1. Demonstrate adequate competence in its general operations as evidenced by:
  - (a) CAMELS composite rating of at least "3" with a similar rating for Management, as applicable;
  - (b) No unresolved major safety and soundness issues that threaten liquidity or solvency; and
  - (c) Substantial compliance with regulations on anti-money laundering, corporate governance and risk management.
2. Hold capital commensurate to the risks assumed or to be assumed from the derivatives activities. A QB applying for or holding a Type 2 Limited Dealer Authority or Type 3 Limited User Authority automatically agrees

to be covered by all regulations prescribing capital for market risk, notwithstanding any provision to the contrary. In addition, the BSP expects a QB applying for or holding additional derivatives authority to have adequate capital to accommodate existing and future risks from additional and generally authorized derivatives activities as well as risks arising from the QB's other business activities. For this purpose, the BSP may require capital higher than the minimum required under prudential regulations.

3. Have and maintain a risk management system that conforms to the principles and complies with the minimum standards prescribed in Appendix Q-15.
  4. Demonstrate the relevance of proposed derivatives activities to the QB's main purpose as an institution. The BSP reserves the right to deny applications whose proposed derivatives activities do not reasonably fit the nature of their business operations.
- c. *Applicability to Trust Departments of QBs.* Trust departments of QBs may apply for Type 3 Authority, provided they comply with the requirements prescribed and observe the provisions of Appendix Q-15 and Q-16.
- d. *Application Procedures.* The applicant shall submit to the Capital Markets Specialist Group, Supervision and Examination Sector ("SES") of the BSP a written application for additional derivatives authority/ies accompanied by:
1. A copy of the board resolution approving the application for a specific type of derivatives authority;
  2. A notarized certification signed jointly by the President, Treasurer or equivalent Trust Officer and Compliance Officer of the applicant QB stating that the QB complies with all the requirements for the authority being applied for specified in Subsection X4603Q.2; and
  3. A list of the types of derivatives and underlying reference the QB intends to engage in, including the following information for each derivatives class or type:
    - a) Target customers for such derivatives;
    - b) The capacity in which the QB intends to engage in such derivatives;
    - c) Description of each type of derivatives and underlying reference with which it will deal;
    - d) Analysis of the risks involved in transacting in each type of derivatives;

- e) Procedures/methodologies that the QB will implement to measure, monitor (including risk management reports) and control the risks inherent in the types of derivatives;
  - f) Relevant accounting guidelines, including pro-forma accounting entries;
  - g) Analysis of any actual or potential legal/regulatory restrictions; and
  - h) Process flow chart, from deal initiation to risk reporting, indicating the departments and personnel involved in identified processes.
4. The BSP will not accept applications lacking any of the above-stated requirements. The BSP, however, may require additional documents to aid its evaluation of the application. By virtue of the application, the applicant automatically authorizes the BSP to conduct an on-site evaluation of the applicant's risk management capabilities, if this is deemed necessary.
  5. Payment of the following non-refundable processing fee shall be made upon approval or denial of the QB's application:

|                  | Amount:   |
|------------------|-----------|
| Type 2 Authority | 50,000.00 |
| Type 3 Authority | 25,000.00 |
| Type 4 Authority | 25,000.00 |

6. A QB whose application for additional derivatives authority/ies or an upgrade thereof (e.g. From Type 3 to Type 2 Authority) has been denied cannot submit a new application for additional derivatives authorities until after six months from receipt of denial. The same rule applies for a QB whose authorities have been limited or downgraded.
7. A QB that holds an additional derivatives authority may apply for additional derivatives authorities (e.g., currently holding Type 3 Authority who wish to apply for Type 4 Authority) or an upgrade thereof only after the lapse of 6 months from the grant of the previous additional derivatives authority.

**§ X4603Q.3 Intra-group transactions.** All derivatives transactions between a quasi-bank and any of its subsidiaries and affiliates shall comply with minimum risk management standards for related-party transactions outlined in *Appendix Q-15* as part of the QB's internal control procedures. The BSP expects QBs to establish internal reporting and monitoring system for derivatives activities for related-party transactions. Failure to comply with minimum standards shall be a ground for citing non-compliance with provisions under Subsections X4603Q.1

and X4603Q.2 without prejudice to other BSP rules and regulations such as those related to corporate governance and unsafe and unsound banking practices.

**§ X4603Q.4 Accounting Guidelines.** A QB that engages in derivatives activities must strictly account for such transactions in accordance with relevant PAS.

**§ X4603Q.5 Reporting Requirements.** A QB engaged in any derivatives transaction shall submit a monthly report on derivatives transactions/outstanding derivatives in the attached format (Annex "A") within fifteen (15) banking days from end of the reference month. The reports shall be certified by the Treasurer.

**§ X4603Q.6 Sanctions**

a. *Unauthorized transactions*

Sanctions prescribed under Sections 36 and 37 of Republic Act ("R.A.") No. 7653 shall be imposed on any quasi-bank (including its directors and officers) found to have engaged in an unauthorized derivatives activity.

A QB undertaking unauthorized derivatives activities may be considered as conducting its business in an unsafe and unsound manner under Section 56 of R.A. No. 8791.

b. *Delayed/Erroneous/Inaccurate Reporting*

Banks failing to submit the reports required under Section X4603Q.5 within the prescribed deadline shall be subject to monetary penalties applicable for delayed reporting under existing regulations. Moreover, submission of incomplete, uncertified or improperly certified or otherwise erroneous reports shall be considered non-reporting, subject to applicable penalties for amended/delayed reports. For purposes of imposing monetary penalties, the reports shall be classified as a Category A-1 report. Habitual delayed or erroneous reporting may be a ground for further sanction, including limitation of generally authorized activities and/or additional authorities and/or suspension of authority to engage in such derivatives activities.

c. *Non-Compliance with the Provisions of the Circular and Appendices Q-15 and Q-16*

Any QB found violating any of the provisions of this Circular and/or Appendices Q-15 and/or Q-16 shall be sanctioned with the penalties prescribed under Sections 36 and 37 of R.A. no. 7653 in accordance with the gravity/seriousness of the offense taking into consideration the number of times the offense was committed, possible consequent losses on the clients, effect on the financial markets and other relevant factors.

d. *Curtailment of Derivatives Authority*

The BSP reserves the right to suspend, modify, downgrade, limit or revoke any QB's derivatives authority (including any or all of those generally authorized activities) for prudential reasons as may be evidenced by any or all of the following:

- i. The bank is assigned a CAMELS composite rating or component Management rating Composite Rating of lower than that prescribed under Subsection 4603Q.2 of the MORNBF, in the most recent regular examination.
- ii. The QB has not maintained adequate risk management systems given the level and type of derivatives activities it has engaged in as may be determined by the BSP in any on-site evaluation and confirmed by the Monetary Board.
- iii. The Monetary Board has confirmed an SES finding that the QB has conducted business in an unsafe and unsound manner.

An erring QB may apply for reinstatement of its derivatives authority only after 6 months from lapse of the implementation of the sanction, provided the QB has satisfactorily addressed all BSP concerns.

**§ X4603Q.7 – X4603.13 (Reserved)**

**3. The revised appendices Q-15 and Q-16 of the MORNBF are attached.**

**4. Repealing Clause**

Subsection X4603Q.1– X4603Q.13 of the MORNBF is hereby repealed.

All other existing rules, regulations, orders or circulars or any part thereof inconsistent with provisions of this Circular are hereby repealed, amended or modified accordingly.

**5. Effectivity**

This Circular shall take effect fifteen (15) days following its publication in a newspaper of general circulation.

FOR THE MONETARY BOARD:

  
NESTOR A. ESPENILLA, JR.  
Officer-In-Charge

02 October 2009

## **APPENDIX Q-15 – RISK MANAGEMENT GUIDELINES FOR DERIVATIVES (Appendix to Section X4603Q of the MORNBF1)**

### **I. INTRODUCTION**

This appendix, together with the Guidelines on Supervision by Risk (i.e. Circular No. 510) and other BSP issuances on management of the different risks attendant to FI activities, provides a framework on which a FI can establish its risk management activities. Accordingly, this set of risk management guidelines for derivatives should be read and used in conjunction with all related BSP issuances on risk management.

An FI, in using these guidelines to evaluate the propriety and adequacy of its risk management, must consider the following principles:

1. No single risk management system for derivatives is expected to work for all FIs considering that the structure and level of derivatives activities will vary from one FI to another. Each FI should apply the principles set in these guidelines in a manner appropriate to its needs and circumstances. The BSP shall evaluate the quality of a FI's risk management system based on the principles and minimum requirements of these guidelines, scaled to the derivatives activities being undertaken.
2. The requirements prescribed in these guidelines are merely minimum standards and therefore, should not be taken as the "be-all" for all FI's risk management. The Board of Directors ("BOD") has the responsibility of ensuring that an FI's risk management system appropriately captures its risk exposures and affords proper management of these.

### **II. RISKS ASSOCIATED WITH DERIVATIVES**

While derivatives primarily help manage existing and anticipated risks, derivatives themselves are exposed to the risks they are designed to manage. Moreover, simple derivatives, when combined with other financial instruments, may result in a structure that exposes an FI to complicated risks. Thus, derivatives can aggravate the risks of FIs and of counterparties if derivatives are not clearly understood and properly managed.

A single derivatives product may expose an FI to multiple risks as enumerated under Section III of Circular No. 510, dated 3 February 2006. These categories are not mutually exclusive of each other. Hence, derivatives activities must be managed with consideration of all of these risks.

### III. RISK MANAGEMENT PROCESS FOR DERIVATIVES

The management of derivatives activities should be integrated into an FI's overall risk management system using a conceptual framework common to the FI's other businesses. For example, price risk exposure arising from derivatives transactions should be assessed in a manner comparable to and aggregated with all other price risk exposures. Risk consolidation is particularly important because the various risks contained in derivatives and other market activities can be interconnected and may transcend specific markets.

At a minimum, the risk management process for derivatives should be able to:

1. **Identify** the risks arising from its derivatives activities in whatever capacity it deals with the same. An FI must likewise identify the impact of its derivatives activities on its overall risk profile. To properly identify risks, an FI must understand the derivatives products with which it is transacting and the factors that affect them. Considering that changes in the value of derivatives are highly influenced by changes in market factors, risk identification should be a continuing process and should occur at both a transaction and portfolio level.
2. **Measure** the risks arising from its derivatives activities. An FI must have measurement models or tools to quantify the risks identified. These measurement tools should be suitable to the nature and volume of an FI's derivatives activities. As the complexity and volume of the derivatives activity increases, the measurement tools should correspondingly be more sophisticated. The primary criteria for the propriety of the measurement tools are accuracy, timeliness, efficiency and comprehensiveness with which these tools can capture the risks involved and their contribution to the decision-making process of FI management.
3. **Monitor** the risks arising from its derivatives activities. Derivatives products are very sensitive to market factors, which continually change. Thus, a FI should have a mechanism to monitor the responsiveness of derivatives to market factors to enable it to review and assess its risk positions. In order to effectively monitor the risks, reports must be timely generated in order to aid management in determining whether there is need to adjust the FI's derivatives positions.
4. **Control** the risks arising from its derivatives activities. An FI must establish limits to its derivatives exposure. These limits should be comprehensive and aligned with a FI's overall risk tolerance. An FI's policies and procedures on control should provide for contingencies when limits are breached. An FI must allot lead time and have a mechanism that enables management to act in time to control unacceptable or undesired exposures. An FI must also establish a system that separates functions susceptible to conflicts of interest.

#### **IV. SOUND RISK MANAGEMENT PRACTICES FOR DERIVATIVES**

Consistent with the criteria for sound risk management practices in Section V of Circular Nos. 544 and 545, the BSP shall assess the propriety and adequacy of an FI's risk management system for its derivatives activities in accordance with the following basic principles:

##### **A. Active and Appropriate Board and Senior Management Oversight**

An FI's BOD must set the general policy or the policy direction relating to the management of an FI's risks, including those arising from its derivatives activities. This policy should be consistent with the FI's business strategies, capital strength, management expertise and risk profile. Accordingly, the BOD must understand the nature and purpose of the FI's derivatives activities and the role derivatives play in the FI's overall business strategy. Passive BOD approval is not acceptable. There must be verifiable evidence of the BOD approval processes and that senior management exerted effort to explain the nature and purpose of the derivatives activities to the BOD (e.g. minutes of BOD meetings documenting presentations and reports to the BOD and the approval processes).

The BOD must review and pre-approve new derivatives products as well as significant related policies and procedures. Central to the approval of new products is defining when a product or activity is new in order to ensure that variations on existing products receive the proper review and authorization. Policies should also detail authorized activities (e.g. at what stages approvals should be obtained, from whom approvals should be obtained), those that require one-time approval and those that are considered inappropriate.

The BOD must be apprised of the FI's derivatives exposures on a timely basis in order to enable the BOD to act on such exposures accordingly. Consequently, there should be an established reporting methodology to ensure that the BOD receives, on a continuing basis, detailed information regarding the FI's risk exposures from derivatives, including the impact to the FI's overall risk profile, earnings and capital. These reports should include both normal and stress scenarios.

Pursuant to the general policy or policy direction on risk management set by the BOD, senior management must adopt adequate policies and procedures for conducting the FI's derivatives activities on both a long-range and day-to-day basis. Policies should clearly delineate responsibility for managing risk, and provide effective internal controls and a comprehensive risk-reporting process. Policies must also keep pace with the changing nature of derivatives products and markets and therefore must be reviewed on an on-going basis. Senior management should ensure that the various components of an FI's risk management process are regularly reviewed and evaluated. Internal evaluations may be supplemented by external auditors or other qualified outside parties.

The quality of oversight provided by the BOD and senior management to a FI's derivatives activities will be reflected in the overall risk management process, the adequacy of resources (financial, technical expertise, and systems technology) devoted to handle derivatives activities and its use of the monitoring reports. The BOD and SM shall be responsible for ensuring that FI personnel comply with prescribed risk management standards and sales and marketing guidelines.

## **B. Adequate Risk Management Policies and Procedures**

An FI must establish policies and procedures to guide its personnel in conducting derivatives activities. These risk management policies must be reflective of an FI's current strategy and practice.

An FI should not issue policies and procedures for derivatives in isolation. All aspects of the risk management process for derivatives activities should be integrated into the FI's over-all risk management system to the fullest extent possible using a conceptual framework common to the FI's other activities. Risk management policies should be comprehensive, covering all activities of the FI. The BSP will evaluate the degree to which controls covering derivatives activities have been integrated in other issuances of the FI covering aggregate risk-taking activities.

For FIs that conduct derivatives transactions with subsidiaries and affiliates, there should be policies and procedures that describe the nature, pricing, monitoring, and reporting of acceptable related-party transactions,.

All risk management policies and procedures must be written, well-communicated to all personnel involved in the derivatives activities and readily available in user-friendly form, whether the same is a hard or soft copy thereof. An FI must also put up systems and procedures to ensure an audit trail evidencing the dissemination process for new and amended policies and procedures.

At a minimum, an FI is expected to have:

1. Comprehensive, updated and relevant Risk Policy Manual(s);
2. Operations Manual(s) or similar documents that describe the flow of transactions among and between the relevant units and personnel in an FI's treasury (front office, back office and accounting) and risk management unit;
3. Approved product manual(s) that includes product definition, benefits and risks, pricing mechanisms, risk management processes, capital allocation guidelines, tax implications and other operating procedures and controls for the FI's derivatives activities.

## **C. Appropriate risk measurement methodologies, limits structure, monitoring and management information system**

The process of measuring, monitoring and controlling risk should be carried out independently from individuals conducting derivatives activities. An independent system of reporting exposures to both senior level management and to the BOD is critical to the effectiveness of the process.

#### 1. Measurement Methodologies

An FI must be able not only to accurately quantify the multiple risk exposures arising from its derivatives activities but also aggregate similar risks across the different activities of the FI to the fullest extent possible. An FI must develop a risk measurement model appropriate to its portfolio. Accordingly, an FI must evaluate the assumptions used, computational requirements, procedures for computing the risk metric, sourcing of inputs used in the measurement process, including the theoretical reasons for a particular input choice, and how these concepts apply to the FI's portfolio.

The risk measurement system should be structured to enable management to initiate prompt remedial action, facilitate stress-testing, and assess the potential impact of various changes in market factors on earnings and capital. A risk measurement system is considered sound if it is capable of comprehensively capturing risks from: (a) the FI's on and off-balance sheet exposure; (b) all relevant market factors; and (c) normal circumstances and stress events. Sound risk measurement practice includes identifying possible events or changes in market behavior that could have unfavorable effects on the FI and assessing the ability of the FI to withstand these events or changes. The stress testing should include not only quantitative exercises that compute potential gains or losses but also qualitative analyses of actions that management might take under particular scenarios.

An FI's risk measurement system should provide appropriate pricing and valuation procedures to ensure best execution for both proprietary trading and those undertaken for clients and a mark-to-market/model (MTM) methodology for derivatives instruments that follows established MTM regulations and Philippine Accounting Standards (PAS 39).

New measurement models, whether developed internally or purchased from vendors, should be subject to an initial validation before it is used. Internally developed models require more intensive evaluation where they have not been market-tested by external parties. The validation process should consist of a review of the logic, mathematical or statistical theories, assumptions, internal processes and overall reliability of a FI's measurement models, including the compatibility of the measurement model with the FI's technology and systems. The validation must be undertaken by a technical expert independent from the unit that developed the model. For example, pricing systems developed by a trader is required to be independently validated by a corresponding technical expert from the FI's risk management unit. If no such personnel from the risk management unit exists, an independent validation may be performed by internal audit provided that internal audit has the necessary expertise. An FI may also avail of the services of an independent outside expert. Thereafter,

the frequency and extent to which models are validated depends on changes that affect pricing, risk presentation or the existing control environment. Changes in market conditions that affect pricing and risk conventions, which model performance, should trigger additional validation review.

Risk management policies should clearly address the scope of the validation process, the frequency of validations, documentation requirements, and management responses. At a minimum, policies should require the evaluation of significant underlying algorithms and assumptions before the model is put in regular use, and as market conditions warrant thereafter. Such internal evaluations should be conducted by parties who, where practicable, are independent of the business sector using or developing the model. The evaluation may, if necessary, be conducted or supplemented with reviews by qualified outside parties, such as experts in highly technical models and risk management techniques.

## 2. Limits Structure

An FI must specify individual limits for all types of risks involved in a FI's derivatives activities. A FI should use a variety of limits to adequately capture the range of risks or to address risks that the measurement system does not capture. These limits should be integrated into the FI-wide limit structure to ensure consistency with the BOD-approved risk appetite and business strategy.

The limit structure should be realistic taking into consideration the target budget, level of earnings and capital. Limits must be documented and promptly communicated to all relevant personnel. Limits must be reviewed at least annually or more frequently, if circumstances warrant, in order to ensure that limits reflect the FI's past performance and current position.

Limits should be continually analyzed as regards its impact on target income, earnings and capital. These analyses should be submitted/ reported to the BOD. Any excess over the limit must be approved only by authorized personnel and immediately reported to senior management and depending on the seriousness, also to the BOD. The seriousness of limit exceptions depends upon management's approach towards setting limits and on the actual size of individual and organizational limits relative to the FI's capacity to take risks. An FI with relatively conservative limits may encounter more exceptions to those limits than that with less restrictive limits. There must also be mechanisms for the correction of breach of these limits.

A FI's limit structure should address the following:

- a. Definition of a credit exposure;
- b. Maximum credit exposure to an individual counterparty;
- c. Credit concentrations;
- d. Maximum nominal exposure:
  - i. per trader and per transaction; and

- ii. position limits
- e. Approved credit risk mitigation techniques;
- f. Appropriate loss exposure triggers:
  - i. loss Alert
  - ii. stop loss
  - iii. value-at-Risk
  - iv. earnings-at-Risk

### 3. Monitoring

Monitoring of risk exposures, market conditions, and trading positions should be done at least daily. Derivatives instruments are highly influenced by movements in market factors. Thus, an FI must have a mechanism that can track and analyze the effect of market movements on its derivatives exposures. To ensure proper monitoring of risks, an FI is expected to have technology and systems that can (a) track movements in reference variables (underlying) and other market factors affecting the value of the derivatives instruments, such as trigger events; and (b) incorporate observed market movements into the pricing and valuation of derivatives instruments.

While monitoring is undertaken independently from the personnel conducting derivatives activities, FI traders are expected to actively monitor their positions to ensure that they do not breach their limits. FI traders should not wait until a limit is breached to alert senior management and risk control units. Instead, traders should promptly report unanticipated changes and progressively deteriorating positions, as well as other significant issues arising from their positions, to the risk control function and responsible management.

### 4. Management Information System

An FI must institute an information system that generates accurate and incisive reports to ensure that management and the BOD are timely and regularly apprised of the FI's derivatives exposures. An FI is expected to have policies and procedures pertaining to the derivatives reporting specifying, among others, the types of derivatives reports to be generated, the purpose and contents thereof, responsible units that will generate the reports, frequency and deadlines of reports, recipients/users of reports, and the type of action expected from the users of the report. At a minimum, management reports should contain the following: outstanding derivatives positions, compliance with or status of positions as against limits, analysis of derivatives positions, along with other FI exposures, in relation to the impact to earnings and capital, monitoring of trigger events, and deviations from established policies and procedures and justifications thereof.

The management information system must be able to translate the measured risks from derivatives activities from a technical and quantitative format to one that can easily be read and understood by senior managers and directors, who may not have specialized and technical knowledge of derivatives products. Such a system enables management and the BOD to judge the changing

nature of the FI's risk exposures. The electronic data processing capability must be commensurate to the volume and complexity of the FI's derivatives activities to facilitate the generation of needed reports.

The frequency and content of BOD and management reporting will ultimately depend upon the nature and significance of derivatives activities. Where applicable, BOD and management reports should consolidate information across functions and divisions. BOD and management reporting should be tailored to the intended audience, providing summary information to senior management and the BOD and more detailed information to FI traders.

Management reports should be generated by control departments independent of the risk-takers. When risk-takers provide information (e.g., valuations or volatilities on thinly traded derivatives contracts) for management reports, senior management should be informed of possible weaknesses in the data, and these positions should be audited frequently.

#### **D. Comprehensive internal controls and independent audits.**

A sound system of internal controls promotes effective and efficient operations, reliable financial and regulatory reporting, and compliance with relevant laws, regulations and policies of the FI. In determining whether an FI's internal controls meet these objectives, the BSP will consider the overall control environment of the FI, particularly, the process of identifying, measuring, analyzing and managing risk, the adequacy of management information systems, and degree of adherence to control activities such as approvals, confirmations and reconciliations. Control of the reconciliation process is particularly important where there are differences in the valuation methodologies or systems used by the front and back offices.

##### **1. Risk Control**

An FI should have an independent risk control unit responsible for the design and implementation of the FI's risk management system. A strong risk control function is a key element in fulfilling the oversight responsibilities of BOD members and senior managers. This unit must be independent from business trading units and should report directly to the BOD. The role and structure of risk control function should be commensurate to the nature, complexity and extent of a FI's derivatives activities.

A risk control unit should regularly evaluate risk-taking activities by assessing risk levels and the adequacy of risk management processes. It should also monitor the development and implementation of control policies and risk measurement systems. It should analyze daily reports produced by the FI's risk measurement model, including an evaluation of the relationship between measures of risk exposure and trading limits. Risk control personnel staff should periodically communicate their observations to senior management and the BOD.

An FI's control structure shall be considered sound if all the following elements are present:

a. Formal approval process for new products

A FI should have an effective process to evaluate and review risks involved in products that are either new to the FI or new to the market and of potential interest to the FI. An FI that desires to engage in new products and transactions must first subject these products and transactions to a rigorous review and approval process. This will ensure that all FI personnel involved in the activity have sufficient knowledge of the product or transaction, and that the ensuing risk exposures can be identified, measured and analyzed. The process must be contained in a BOD-approved policy that is fully documented and must be implemented consistently and with integrity.

Before initiating a new derivatives activity, all relevant personnel should understand the product. Risks arising from the new product should be integrated into the FI's risk measurement and control systems. The new product approval process should include a sign-off by all relevant areas such as risk control, operations, accounting, legal, audit, and senior management and trading operations.

Defining a product or activity as "new" is central to ensuring that variations on existing products receive the proper review and authorization. Factors that should be considered in classifying a product/activity as "new" include: capacity changes (e.g., end-user to dealer), structure variations (e.g., non-amortizing swap versus amortizing interest rate swap), products which require a new pricing methodology, legal or regulatory considerations, or market characteristics (e.g., foreign exchange forwards in major currencies as opposed to emerging market currencies).

An FI should introduce new products in a manner that adequately limits potential losses and permits the testing of internal systems.

b. Segregation of functions/units subject to conflict of interest

An FI must separate the business unit conducting the derivatives activities from the unit/s tasked with the checking, accounting, reporting and control functions of its derivatives activities.

An FI should have policies and procedures addressing conflicts of interest, particularly among the following functions: proprietary trading, sales or marketing desks/units, personal trading, and asset management.

An FI that conducts derivatives activities with its subsidiaries and/or affiliates must establish policies and procedures to avoid actual, or even the appearance of a conflict of interest. Off-market rates between related parties should generally be forbidden.

An FI should avoid dealing in transactions conducted at off-market rates. An FI should have internal policies defining what constitutes "market rates" and identify the range of deviation from the benchmark rates which could still be considered as "market rates". The FI's monitoring system should be able to alert management of any breaches in the rate tolerance levels and the appropriate action that should be taken. An FI must be able to justify any off-market transaction.

c. Competent and adequate personnel who are properly supervised.

The increased complexity of derivatives activities requires highly skilled staff particularly in the risk-taking, risk control, and operational functions. Management should regularly review the knowledge, skills and number of people needed to engage in the FI's derivatives activities. The staff must be appropriately balanced among the different areas involved in derivatives activities such that no area is understaffed in terms of number or skill.

Staff turnover can create serious problems, especially if knowledge is concentrated in a few individuals. The impact of staff turnover can be particularly acute in specialized trading markets where FI traders are in high demand and are often recruited in teams.

To mitigate business continuity and succession risk arising from a high staff turnover, an FI should devise a system of building technical expertise across involved personnel through continuous technical training, periodic rotation and cross-training of staff members performing key functions and developing understudies.

The BOD should ensure that the power and control delegated to these expert personnel are not abused. Therefore, the BOD must establish appropriate controls over their activities.

d. Independent control functions or units.

The risk control and audit units should possess the authority, independence, and corporate stature to enable them to identify and report their findings, unimpeded by FI traders. It is equally important to employ individuals with sufficient experience and technical expertise to be credible to the business line they monitor and senior executives to whom they report.

## 2. Audit

Audits should be conducted by qualified professionals who are independent of the business line being audited. Audits should supplement, and not be a substitute for, risk control function.

The scope of audit coverage should be commensurate with the level of risk and volume of derivatives activity. The audit should include an appraisal of the effectiveness and independence of the FI's risk management process; the

adequacy of operations, compliance, accounting and reporting systems; propriety of risk measurement models; and the effectiveness of internal controls. Auditors should test compliance with the FI's policies, including limits.

The level of auditor expertise should be consistent with the level and complexity of activities and degree of risk assumed. A FI may choose to out-source audit coverage to ensure that the professionals performing the work possess sufficient knowledge and experience.

Procedures should be in place to ensure that auditors are informed of significant changes in product lines, risk management methods, risk limits, operating systems, and internal controls so that the auditors can update their scope and procedures accordingly. Auditors should periodically review and analyze performance and risk management reports to ensure that areas showing significant changes are given appropriate attention.

The audit function must have the support of management and the BOD in order to be effective. Management should respond promptly to audit findings by investigating identified system and internal control weaknesses and implementing corrective action. Thereafter, management should periodically monitor newly implemented systems and controls to ensure they are working appropriately. The BOD, or designated committee, should receive reports tracking management's actions to address identified deficiencies.

## **APPENDIX Q-16 – SALES AND MARKETING GUIDELINES FOR DERIVATIVES**

(Appendix to Section X4603Q of the MORNBF)

### **I. General Principle**

An FI, in dealing with its clients, should always act with honesty, fairness and in pursuance of the best interests of its clients. Due to the complex nature of derivatives and the increasingly sophisticated products introduced into the market, an FI acting as dealer or broker must have appropriate controls and procedures to ensure the suitability of the transactions to its clients. An FI should ensure that (1) a client understands the nature of the transaction and the risks involved and (2) the transaction meets the client's financial objectives and risk tolerance. An FI should also disclose sufficient, accurate and comprehensible information about derivatives products, including inherent risks, in a clear and balanced presentation in order to enable its clients to make informed investment decisions.

These guidelines prescribe the minimum standards for sales and marketing procedures for FIs acting as dealers or brokers of derivatives.

### **II. Client Suitability Guidelines**

An FI should ensure that the derivatives products it offers to a client are appropriate for that client through a client suitability process which involves obtaining client information, classifying a client according to his/its financial sophistication and conducting a suitability review.

#### *Client Information*

An FI, at the inception of a possible business relationship with a client, should obtain from said client information about his/its financial situation, experience, and financial objectives relevant to his/its desired products/services. An FI should ensure that the clients' risk and return objectives are clearly identified. This can be done through questionnaires and interviews. An FI may design and use its own system for obtaining client information that would be responsive to its client suitability process.

At a minimum, client information, including client classification, should be reviewed and updated annually or earlier, in cases of material changes in the client's financial situation or goals.

#### *Client Classification*

Based on the information obtained from a client, an FI should be able to ascertain, at a minimum, a client's classification according to financial sophistication as embodied in Circular No. 668 series of 2009 on Derivatives<sup>1</sup> and his/its risk tolerance. The client

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<sup>1</sup> An FI, however, may adopt its own sub-classification for its own purposes.

classification should serve as basis for an FI product/service offerings and level of disclosures required.

In dealing with corporate clients, a FI should determine whether the client is specifically authorized to enter into all or specific kinds of derivatives transactions and the person/s authorized to act in its behalf. A FI should also determine if a corporate client has competent/qualified personnel to handle the proposed derivatives activities. If a corporate client seeks to participate in highly sophisticated/more complex products, a FI should obtain written confirmation from the client that it has sophisticated risk management techniques and appropriate systems to manage and monitor the risks it will take.

In determining an individual client's classification, an FI should consider the following:

- The client's knowledge and understanding of derivative transactions, related investments and the risks involved therein, including the derivatives markets;
- The length of time the client has been actively dealing with investment and/or derivative products, the frequency of dealings and the extent to which he has relied on the investment advice of an FI or any financial advisor, if any;
- The size and nature of investment transactions that have been undertaken by the client; and
- The client's financial standing, which may include an assessment of his net worth or the value of his portfolio.

An FI must make a record of the classification under which each client is categorized, including sufficient information to support the categorization.

Only banks with Type 1 Authority or FIs with Type 2 Authority may originate or distribute authorized derivatives products to non-sophisticated end-users for investment purposes. Non-sophisticated end-users should be provided greatest protection compared to all other client types.

### *Suitability Review*

Before presenting, proposing or recommending a particular derivatives product to a client, a dealer should determine that the derivatives product is suitable to the client's financial situation and consistent with the clients' mandates, financial objectives and constraints

At a minimum, an FI should consider the following in choosing the derivatives products/services offerings to its clients:

- Investment amount or investible funds;
- Concentration ratio (i.e. asset allocation of the client's investible funds);

- Purpose for transacting in derivatives transaction (e.g. hedging vs. investment; long-term buy and hold as opposed to short-term active trading);
- Holding period or investment horizon;
- Client's regulatory and legal circumstances;
- Liquidity needs;
- Returns objectives (e.g. income, growth in principal, maintenance of purchasing power);
- Risk tolerance; and
- Client's understanding of the risks.

An FI should maintain a record of all the information as bases of its suitability assessment. It is highly recommended that an FI requires a client to sign its conformity to the suitability assessment (including the information basis of the assessment) in order to avoid disputes with the client on its suitability assessment.

For non-sophisticated clients, an FI should adopt a suitability statement explaining simply and clearly why the product offered is viewed suitable, considering the client's needs and preferences. To ensure the statement will be effective, an FI should consider the following features:

- Simple and plain language: when technical terms need to be incorporated, they should be explained if the client is unlikely to understand their meaning; and
- Concise and clear messages: lengthy explanations and extensive statements are likely to reduce the effectiveness of the statement and make the client less likely to read the statement properly.

Ideally, each suitability letter for non-sophisticated will be different, reflecting the approach taken by the FI representative in obtaining client information, the derivatives product presentation, the client's profile and considerations on which the investment proposal was based, all of which involve professional judgment. An FI, however, can apply a degree of standardization to aid quality control. An FI should clearly link its proposed or recommended derivatives product to the client's own needs, priorities and attitude toward risk. An FI may mention alternative products suitable for the client. The suitability letter should be signed by the client and the officer authorized by the FI to advise/sell/propose the recommended product.

An FI does not need to comply with the requirement of suitability review in cases where the client is classified as a market counterparty, considering its recognized sophistication. However, a FI should be able to provide sufficient support for its classification.

### **III. Disclosures**

An FI should always be mindful of its statements regarding its products/services, whether the statements pertain to promotion, marketing or sale thereof or in the course

of making the required disclosures. An FI must institute measures to ensure that its clients understand the nature and risks in a derivatives transaction. These procedures may vary with the sophistication of its client. An FI can tailor-fit information, marketing and sales presentations/materials in accordance with the client classification under Circular No. \_\_\_\_\_. An FI should take further steps to adequately disclose the attendant risks of specific types of transactions when dealing with an unsophisticated client, either generally or with respect to a particular derivatives transaction (e.g. non-sophisticated client or sophisticated client with respect to complex product types). An FI should adopt standards for its publications/materials/disclosure statements and review the aforementioned documents regularly to ensure that they meet the standards.

An FI, when providing information to its clients, including potential clients, must not knowingly misrepresent or give a false impression in any of its advertisements, electronic communications, written materials (whether publicly disseminated or not) or oral representations regarding the financial derivatives offered. A misrepresentation is any statement that deviates from the truth or omits a material fact or even tends to mislead the recipients.

#### *Financial Promotion (Marketing and Sales)*

An FI embarking on a financial promotion, whether through a direct offer or information/sales publications, should ensure it gives sufficient information to enable a client to make an informed assessment of the derivatives transaction, including its underlying. An FI must prominently indicate its name in all its promotional materials and must specify its role or capacity in the transaction (e.g. as issuer, dealer/distributor, broker).

A financial promotion is considered clear, fair and not misleading if all the following requisites are present:

- Any statement of fact, promise or prediction is clear, fair and not misleading. A statement should disclose relevant assumptions;
- A client, by himself, can discern from the presentation whether the statement is a fact, promise or prediction.
- The accuracy of all material statements of fact can be substantiated.
- Any comparison or contrast of a product offered should be with another investment intended to meet the same needs or to serve the same purpose. The facts on which any comparison or contrast is made are verified, or alternatively, that relevant assumptions are disclosed. The comparison or contrast should be presented in a fair and balanced way and includes all factors which are relevant to the comparison or contrast.
- The design, content or format of any presentation does not disguise, obscure or diminish the significance of any statement, warning or other matter which the presentation should contain;

- Disclosures on risks and warnings should not be less prominent than any other information on performance.
- No reference to an approval by a regulatory body or its officials shall be made, unless a written approval was actually obtained
- A recommendation to consult/refer to a financial advisor, if the client has doubts on suitability of derivatives product; and
- It does not omit any information, the omission of which causes a material fact to be misleading, unclear, or unfair;

An FI should consider the client's knowledge of the transaction to which a given information relates. An FI should not assume that clients/recipients necessarily have an understanding of the derivatives product being promoted. An FI should assess its usage of terms, especially those which are technical. If promotional or marketing materials are specially designed for a targeted client base reasonably believed to have particular knowledge of the investment, this should be made clear in the materials.

### *Product Disclosures*

An FI must endeavor to explain the derivatives products it offers to its clients to enable the latter make an informed investment decision. Product disclosures should present an adequate description of at least (a) the nature of the derivatives product, including the underlying, (b) the amount of investment required and (c) the risks involved. The adequacy of description depends on the target client classification and type of product offered. In general, disclosure should always be presented in a balanced manner where the potential benefits of an investment are tempered by a fair indication of the risks involved.

A product disclosure, which includes an illustration of past or future performance of the derivatives product or its underlying, must comply with the following:

- a. When using past performance of an derivatives instrument, or its underlying, to illustrate possible returns, the disclosure should state that past performance is not necessarily indicative of future performance. This should be presented in the main text of presentation material. Past performance must be culled from a sufficient time frame to provide a fair and balanced indication of performance; and
- b. When using any forecast on the economy, stock market, bond market and economic trends of markets, the disclosure should state that such forecast is not necessarily indicative of the likely or future performance of the instrument and
- c. Illustrations of returns should include worst case scenarios (i.e. not just the likely or best scenarios). Benefits shown in headline rates (pro-forma returns highlighted) should be realistic and achievable, and not based on unreasonably optimistic view of events;

Product disclosures for derivatives products with some form of guarantee or protection must highlight which benefits are guaranteed/protected and those which are not. In case of structured deposit products, an FI must ensure that any representation or claim of Philippine Deposit Insurance Corporation ("PDIC") guarantee should have been pre-cleared with the PDIC. In instances where the guarantee or protection involves a cost to the client, the FI must disclose the fee or charge for the same. An FI should also disclose the counterparty (e.g. issuer/guarantor) risk involved to clients so that they are not misled about the capital security/principal protection. An FI, when applicable, should state if the guaranteed or protected amount is payable only at the end of the term.

Product disclosures for leveraged products/transactions<sup>2</sup> should emphasize that while these types of products/strategies amplify the potential gain from an investment, they also increase the potential loss thereof. A client who intends to engage in margin buying, a means of applying leverage in investing, must be cautioned on possible loss exceeding the margin or initial cash outlay.

### *Minimum Required Disclosures*

The minimum required disclosure should always be in writing. Except for a market counterparty, an FI should require its client to sign or initial the disclosure statement as affirmation of the client's receipt and understanding of the disclosure statement. An FI may opt to draft individual and separate suitability assessment and disclosure statement to its client or consolidate the same into a separate document or incorporate these with the main derivatives transaction agreement/contract.

Product-specific minimum disclosures should include:

- The nature of the derivatives product, including the underlying financial instruments and how these instruments work;
- Investment horizon or tenor of financial derivatives;
- Fees and charges, whether embedded in the structure or not;
- Details on the issuing entity in case the dealing FI is not the issuing institution, (i.e. the FI acts as a broker/dealer, market maker);
- Returns or benefits likely to be derived from the instrument, the amount and timing thereof and whether the benefits are guaranteed or not.
- All risk factors that may result in the client receiving returns less than the illustrated returns and factors affecting the recoverable amount by the client;
- Details of conflicts of interest, if any
- All termination clauses, when appropriate, including charges and restrictions<sup>3</sup>.

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<sup>2</sup> Leverage or gearing can be employed in a structured product to be able to offer high yields.

<sup>3</sup> For instance, for a structured deposit, the FI should ensure that the customer is fully aware of the tenor of the deposit and that the principal amount is only guaranteed if held to maturity.

- Any warning, exclusion or disclaimer in relation to the product, including, but not limited, to the following:
  - The derivatives products carry higher risks than those associated with ordinary FI savings or time deposits.
  - The transactions are risky and may not be appropriate if client is not willing or able to accept the risk of adverse movements in the underlying securities/reference rates.
  - Past performance of the underlying reference is not a guarantee of future performance.

When applicable, an FI should draw the attention of the client to the following:

- The effect of early redemption of a product on the return (e.g. penalties and a poor return);
- The availability of maximum benefit advertised after a specified period;
- The pre-requisite conditions for the advertised growth rate of income;

Complex products must carry a standard warning that they are not suitable for all clients, and are intended for experienced and sophisticated investors. Complex products should carry appropriate warnings on the high economic risks of complex derivatives transaction, such as:

- Loss of all or a substantial portion of the investment due to leveraging or other sophisticated practices;
- Volatility of returns;
- Lack of liquidity considering that there may be no secondary market for the instrument;
- Restrictions on transferring interests; and
- Absence of information regarding valuation and pricing.

Appendix Q-16A contains sample disclosure statements which an FI may adopt in accordance with the features of the derivatives product offered.

#### **IV. Sales and Marketing Personnel**

Any informational or promotional presentation regarding derivatives products should be undertaken only by personnel who are knowledgeable on derivatives products involved. An FI, in assessing its personnel's knowledge in derivatives transactions, may consider the personnel's educational background, relevant training, professional experience in rendering investment advice, making presentations regarding derivatives products or assessing the propriety of investment products for a client. Personnel involved in derivatives transactions must likewise be familiar with all relevant laws, applicable rules and regulations and must ensure compliance therewith.

At a minimum, an FI should establish qualification standards for personnel involved in derivatives activities as well as comply with certification requirements prescribed by existing securities laws, rules and regulations. In addition, an FI should implement, and maintain a reasonably comprehensive system of training of personnel geared at enhancing technical knowledge of its personnel to enable them to understand, explain the nature and risks of an FI's derivatives products and ensure client suitability.

The FI's board of directors and senior management shall be liable to its clients for the acts performed and representations made by sales and marketing personnel in their official capacity. Notwithstanding the foregoing, an FI's board of director and senior management are not precluded from filing the necessary action against the erring sales and marketing personnel.

In order to avoid client confusion between FI deposit products and derivatives transactions, an FI should physically separate the frontline personnel and premises involved for traditional FI products from derivatives transactions.

## Appendix Q-16A

### **SAMPLE RISK DISCLOSURE STATEMENT FOR DERIVATIVES ACTIVITIES**

While derivatives instruments are utilized for hedging or managing investment risk, derivatives instruments themselves involve a variety of significant risks. Considering the complexity of derivatives products, these products are generally unsuitable for non-sophisticated investors.

You should not deal in derivatives products unless you understand their nature and the extent of your exposure to the attendant risks. And even assuming that you understand derivatives transactions, you should not deal with the same unless the product is suitable for you in the light of your circumstances, experience, financial position and operational resources.

As in any financial transaction, you should ensure that you understand and comply with the regulatory requirements applicable to you and/or limitations set by your board of directors or other governing body. You should also consider the legal, tax and accounting implications of entering into any derivatives transaction.

This product generally carries higher risks than those associated with ordinary FI investments and therefore not a suitable substitute for savings or time deposits. These transactions are risky and may not be appropriate if you are not willing or able to accept the risk of adverse movements in the underlying securities/reference rates.

This transaction does not guarantee a yield, return or income. Past performance of the reference rate or similar instruments is not a guarantee of future performance. The income from the transaction may or may not fluctuate depending on prevailing market conditions.

(An FI need not adopt all the following enumerated statements [in italicized font]. It only has to incorporate those statements that may be applicable to the derivatives products or transactions)

- *This transaction may be used for hedging purposes. If you are entering into the transaction for hedging purposes, this product may not match your exposure perfectly. You may be under or over hedged or may be subject to other exposures as a result of the transaction.*
- *These are over-the-counter derivatives which may pose liquidity risks to you. These are generally not liquid because there is no exchange or secondary trading market through which you can dispose the derivative. Bid and offer prices for these instrument may not be quoted. Bid and offer quotes, if any, are established by the dealers in the instruments and consequently fair price may be difficult to establish.*

- While you may terminate this transaction prior to the specified termination date, the cost of early termination may be substantial. Pre-termination may reduce the expected return or the investment amount, even in the case of principal protected structured products.

*Product specific disclosures:*

- This transaction can be subject to the risk of loss of the entire principal/notional amount of the transaction. You may lose some or all of your investment.
- (For principal protected structured products) While the principal for structured deposits may be protected and carries PDIC guarantee, returns are variable and are often contingent on the performance of complex financial instruments that an average customer may not fully understand. There is still a potential loss of the principal amount invested if the structured deposit is not held to maturity, i.e. there is an early redemption fee.
- (For leveraged products/transactions) If the derivatives transactions require you to put up a margin, you may sustain a loss of the entire margin you deposited with the FI to establish or maintain your position. If the market moves against you (i.e. unfavorably), you may even be called upon to pay additional margin (known as margin call) at short notice to maintain the position. If you fail to do so within the time required, your position may be liquidated at a loss and you will be responsible for the resulting deficit.
- (For non-readily realizable investments) You may have difficulty selling this investment at a reasonable price and, in some circumstances, it may be difficult to sell it at any price. Do not invest in this unless you have carefully thought about whether you can afford it and whether it is right for you.
- These instruments often involve a high degree of gearing or leverage, so that a relatively small movement in the price of the underlying asset or variable can result in a much larger movement, unfavorable or favorable, in the price of the instrument. The price of the instrument can therefore be volatile.
- In buying options, the maximum loss can be limited to the premium (plus any commission or transaction charges) when the price of the underlying asset moves against you because you can simply allow the option to lapse. However, if you buy a call option on another derivatives instrument, e.g. futures contract, the exercise of the option may expose you to the risks for that particular derivatives.
- If you write an option, the risks are considerably greater. You may be liable for margin (i.e. minimum level of collateral) to maintain your position and a loss may be sustained well in excess of the premium received. By writing an option, you are accepting a legal obligation to purchase or sell the underlying asset if the option is exercised against you, however far the exercise price may have moved from the market price of the underlying asset. If you already own the underlying asset (known as covered call option), the risk is reduced. However, if you do not own the underlying asset, the risk can be unlimited. Only experienced persons should contemplate writing uncovered options, and then only after securing full details of the applicable conditions and potential risk exposure.

Any scenario analysis is being provided for illustrative purposes only. It does not represent actual prices that may be available to you. It does not present all possible outcomes or describe all factors that may affect the value of the transaction.

No advice on investments has been given. If you have any doubt about the suitability of the product, you should contact a financial advisor or carefully consider whether the product is suitable for you.

In entering into any derivatives activity with or arranged by us, you should understand that we are not acting in the capacity of your financial adviser due to the inherent conflicts of interests in simultaneously acting as dealer and financial adviser. Notwithstanding the conflict of interest, we may act as your financial adviser only if you have so agreed in writing and only to the extent so provided.

THIS STATEMENT DOES NOT PURPORT TO DISCLOSE ALL OF THE RISKS OR RELEVANT CONSIDERATIONS IN ENTERING INTO DERIVATIVES TRANSACTIONS. YOU SHOULD REFRAIN FROM ENTERING INTO ANY SUCH ACTIVITY UNLESS YOU FULLY UNDERSTAND ALL SUCH RISKS AND HAVE INDEPENDENTLY DETERMINED THAT THE ACTIVITY IS SUITABLE FOR YOU.

[Name of FI]

I/We have read and understood the risk warning set out above.

Date

[Signature of Customer]

[illegible]

| Particulars                                    | No. of Contracts | Notional Amount <sup>3/</sup> |      |              |      | Contracts with Positive Mark-to-Market (MTM) Value |          |      |       | Contracts with Negative MTM Value | Collateral Coverage | Write-Offs | Recoveries | Maturities of Contracts (by Notional Amount) |  |  |
|------------------------------------------------|------------------|-------------------------------|------|--------------|------|----------------------------------------------------|----------|------|-------|-----------------------------------|---------------------|------------|------------|----------------------------------------------|--|--|
|                                                |                  | FI as End-User                |      | FI as Dealer |      | Current                                            | Past Due |      | Total |                                   |                     |            |            |                                              |  |  |
|                                                |                  | In US \$                      | Peso | In US \$     | Peso |                                                    | In US \$ | Peso |       |                                   |                     |            |            |                                              |  |  |
|                                                |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| 3. Equity Contracts                            |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| a. Forwards                                    |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| b. Equity Swap                                 |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| c. Futures                                     |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| d. Equity Options Contracts                    |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| (1) Bought                                     |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| (2) Sold                                       |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| Sub-total                                      |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| 4. Credit Derivatives                          |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| a. FI as Beneficiary                           |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| (1) CDS Bought                                 |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| (2) TROR Payer                                 |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| (3) Credit Spread Call/Put Option Bought       |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| b. FI as Guarantor                             |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| (1) CDS Sold                                   |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| (2) TROR Receiver                              |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| (3) Credit Spread Call/Put Option Sold         |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| Additional Information for Credit Derivatives: |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| Classified by maturity:                        |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| (i) Investment Grade                           |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| (i.a) < 1 year                                 |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| (i.b) 1 - 5 years                              |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| (i.c) > 5 years                                |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| (ii) Sub-Investment Grade                      |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| (ii.a) < 1 year                                |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| (ii.b) 1 - 5 years                             |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| (ii.c) > 5 years                               |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| Sub-total [a.1 to a.3, b.1 to b.3]             |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| Total (a)                                      |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| Less: Netting Benefits <sup>1/</sup> (b)       |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |
| Net Credit Exposure <sup>2/</sup> (a - b)      |                  |                               |      |              |      |                                                    |          |      |       |                                   |                     |            |            |                                              |  |  |

**Notes:**

1/ Netting benefits are acquired where there is a bilateral netting agreement between a financial institution and a counterparty that creates a single legal obligation from all individual contracts. On derivatives contracts (covered by bilateral netting agreement) with positive MTM, present the netting benefits derived from other type of derivatives contract (of the same counterparty) with negative MTM.

2/ For portfolio of derivatives contracts, Net Credit Exposure is the gross fair value of contracts less the amount of netting benefits. For any individual contract, credit exposure is the fair value of the contract if positive, and zero when the fair value is negative or zero.

3/ Please also disclose notional amount of brokered derivative transactions (where a client paid broker fees to the financial institution):  
Total Notional Amount of Brokered Derivative Transactions: \_\_\_\_\_  
No. of Contracts Brokered \_\_\_\_\_

| Particulars                                   | No. of Contracts | Notional Amount <sup>d/</sup> |             |              |             | Current (a)             |             |                               |             | Past Due <sup>e/</sup>  |             |                               |  | Collateral Coverage | Write-Offs | Recoveries | Maturities of Contracts (by Notional Amount) |             |           |
|-----------------------------------------------|------------------|-------------------------------|-------------|--------------|-------------|-------------------------|-------------|-------------------------------|-------------|-------------------------|-------------|-------------------------------|--|---------------------|------------|------------|----------------------------------------------|-------------|-----------|
|                                               |                  | Resident                      |             | Non-Resident |             | MTM Value <sup>2/</sup> |             | Carrying Amount <sup>3/</sup> |             | MTM Value <sup>2/</sup> |             | Carrying Amount <sup>3/</sup> |  |                     |            |            | < 1 year                                     | 1 - 5 years | > 5 years |
|                                               |                  | In US \$                      | Peso Equiv. | In US \$     | Peso Equiv. | In US \$                | Peso Equiv. | In US \$                      | Peso Equiv. | In US \$                | Peso Equiv. |                               |  |                     |            |            |                                              |             |           |
|                                               |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |
| Hybrid Instruments                            |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |
| 1. Credit-Linked Notes (as protection seller) |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |
| By embedded derivatives:                      |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |
| (1 a) Credit Default Swap                     |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |
| (1 b) Total Return Swap                       |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |
| (1 c) Others <sup>5/</sup>                    |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |
| 2. Securitization Structures (as Investor)    |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |
| (2 a) True Sale                               |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |
| (2 b) Synthetic                               |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |
| 3. Other Structured Products                  |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |
| (3 a) Principal Protected                     |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |
| Embedded derivatives: (pls. specify)          |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |
|                                               |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |
| (3 b) Others:                                 |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |
| By type of host contract                      |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |
| (i) Debt <sup>1/</sup>                        |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |
| (ii) Equity <sup>2/</sup>                     |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |
| (iii) Others <sup>3/</sup>                    |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |
| TOTAL                                         |                  |                               |             |              |             |                         |             |                               |             |                         |             |                               |  |                     |            |            |                                              |             |           |

1/ Please specify type of embedded derivatives (e.g., IRS, CDS, Options)

2/ For investments booked under HFT, AFS, DFVPL, Held for Hedging

3/ For investments booked under HTM before allowance for credit losses

4/ Please also disclose notional amount of brokered derivative transactions (where a client paid broker fees to the financial institution):

Total Notional Amount of Brokered Derivative Transactions: \_\_\_\_\_

No. of Contracts Brokered: \_\_\_\_\_

5/ Place CLNs with more than one embedded derivative (i.e., complex CLNs) in this row

(NAME OF FINANCIAL INSTITUTION)  
 REPORT ON TRADING GAINS/(LOSSES) ON FINANCIAL DERIVATIVES  
 AS OF \_\_\_\_\_

| Particulars                                                                 | Month            |          |                | Year-to-Date     |          |                |
|-----------------------------------------------------------------------------|------------------|----------|----------------|------------------|----------|----------------|
|                                                                             | Peso<br>Accounts | Foreign  |                | Peso<br>Accounts | Foreign  |                |
|                                                                             |                  | In US \$ | Peso<br>Equiv. |                  | In US \$ | Peso<br>Equiv. |
| <b>I. Realized Gains/(Losses) Financial Derivatives Bought/Sold</b>         |                  |          |                |                  |          |                |
| <b>A. Stand-alone</b>                                                       |                  |          |                |                  |          |                |
| 1. Interest Rate Contracts                                                  |                  |          |                |                  |          |                |
| a. Interest Rate Forwards                                                   |                  |          |                |                  |          |                |
| b. Interest Rate Swap                                                       |                  |          |                |                  |          |                |
| c. Interest Rate Futures                                                    |                  |          |                |                  |          |                |
| 2. Interest Rate Options Contracts                                          |                  |          |                |                  |          |                |
| 3. Foreign Exchange Contracts                                               |                  |          |                |                  |          |                |
| a. Forward Foreign Exchange Contracts                                       |                  |          |                |                  |          |                |
| b. Currency Swap                                                            |                  |          |                |                  |          |                |
| c. Foreign Exchange Futures                                                 |                  |          |                |                  |          |                |
| d. Foreign Exchange Options Contracts                                       |                  |          |                |                  |          |                |
| 4. Equity Contracts                                                         |                  |          |                |                  |          |                |
| a. Forwards                                                                 |                  |          |                |                  |          |                |
| b. Equity Swap                                                              |                  |          |                |                  |          |                |
| c. Futures                                                                  |                  |          |                |                  |          |                |
| d. Equity Options Contracts                                                 |                  |          |                |                  |          |                |
| 5. Credit Derivatives                                                       |                  |          |                |                  |          |                |
| a. FI as Beneficiary                                                        |                  |          |                |                  |          |                |
| b. FI as Guarantor                                                          |                  |          |                |                  |          |                |
| <b>B. Hybrid Instruments</b>                                                |                  |          |                |                  |          |                |
| 1. Credit-Linked Notes                                                      |                  |          |                |                  |          |                |
| 2. Securitization Structures                                                |                  |          |                |                  |          |                |
| 3. Other Structured Products:                                               |                  |          |                |                  |          |                |
| _____                                                                       |                  |          |                |                  |          |                |
| _____                                                                       |                  |          |                |                  |          |                |
| <b>Total Realized Gains/(Losses) from Financial Derivatives Bought/Sold</b> |                  |          |                |                  |          |                |

| Particulars                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        | Month            |          |                | Year-to-Date     |          |                |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------|----------|----------------|------------------|----------|----------------|
|                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    | Peso<br>Accounts | Foreign  |                | Peso<br>Accounts | Foreign  |                |
|                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |                  | In US \$ | Peso<br>Equiv. |                  | In US \$ | Peso<br>Equiv. |
| <b>II. Unrealized Gains/(Losses) from Marking to Market</b><br><b>A. Stand-alone</b><br>1. Interest Rate Contracts<br>a. Interest Rate Forwards<br>b. Interest Rate Swap<br>c. Interest Rate Futures<br>d. Interest Rate Options Contracts<br>2. Foreign Exchange Contracts<br>a. Forward Foreign Exchange Contracts<br>b. Currency Swap<br>c. Foreign Exchange Futures<br>d. Foreign Exchange Options Contracts<br>3. Equity Contracts<br>a. Forwards<br>b. Equity Swap<br>c. Futures<br>d. Equity Options Contracts<br>4. Credit Derivatives<br>a. FI as Beneficiary<br>b. FI as Guarantor<br><b>B. Hybrid Instruments</b><br>1. Credit-Linked Notes<br>2. Securitization Structures<br>3. Other Structured Products:<br>_____<br>_____<br>_____ |                  |          |                |                  |          |                |
| <b>Total Unrealized Gains/(Losses) from Marking to Market</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |                  |          |                |                  |          |                |
| <b>Total Trading Gains/(Losses) from Financial Derivatives</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |                  |          |                |                  |          |                |