



OFFICE OF THE GOVERNOR

CIRCULAR NO. 594
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The Monetary Board, in its Resolution No. 1457 dated 21 December 2007, approved the following amendments to Section X602 and its subsections, Appendices 25 and 26 of the Manual of Regulations for Banks ("MORB") regarding the regulations governing the derivatives activities of banks.

1. Statement of Policy

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

A bank may engage in authorized derivatives activities, provided that the bank:

- 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 X602 and Subsections X602.1-X602.7 and X602.15 are hereby replaced as follows:

"Sec. X602 Derivatives. A bank may engage in financial derivatives activities in accordance with these guidelines. The transacting bank 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 bank shall observe the pertinent foreign exchange ("FX") rules and regulations. For purposes of these guidelines, a 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 any UB or KB, 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 bank 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.

§ X602.1 Generally Authorized Derivatives Activities.

A bank may engage in the following derivatives activities without need of prior BSP approval, provided it observes the provisions of Appendix 25 of the MORB and meets the conditions specified in this Subsection:

- a. Universal banks (UBs) and Commercial banks (KBs) may transact in the following derivatives in the capacities specified:

- 1. **As a Dealer.** A UB or KB may originate and distribute the following “organized market”-traded financial derivatives:

- a. FX Forwards, FX Swaps, Currency Swaps and analogous financial futures with a tenor of three years or less; and
- b. Interest Rate Swaps, Forward Rate Agreements and analogous financial futures with a tenor of ten years or less.

Provided that the issuance of sub-participation in any derivatives held as an end-user shall be deemed as undertaking the role of a dealer; Provided further that the dealer UB or KB observes the provisions of Appendix 26 and other pertinent securities laws, rules and regulations.

For purposes of this Section, an organized market refers to an exchange or a BSP-recognized over-the-counter market governed by transparent and binding market conventions on price transparency, trade reporting, market surveillance and orderly conduct / operations of the market.

- 2. **As End-User.**

- a. A UB or KB, including its trust department, may enter in any financial derivatives transaction for the purpose of hedging its own risks; Provided that it observes all the requirements for hedging transactions under Philippine Accounting Standards ("PAS").
- b. A UB or KB may trade with counterparties in order to take positions for its own account in "organized market"-traded financial instruments enumerated under item 1 above. It can also take long positions in naked FX options with a tenor of three years or less.
- c. Regular Banking Units (RBU) and Expanded Foreign Currency Deposit Units (EFCDU) of UBs and KBs, including its trust departments, may invest, for their own account, in the following SPs:
 - i. Principal-protected foreign currency-denominated SPs, the revenue streams of which are linked to interest rate indices, interest rate instruments, listed equity shares or indices, FX rates, credit rating or index, or gold; Provided that the maximum contractual maturity shall be five years;
 - ii. Plain Vanilla Single-name CLNs where the reference asset is an obligation issued or guaranteed by the Republic of the Philippines.

Provided that the bank or trust entity shall comply with the following conditions:

- Total carrying value of all investments in SPs shall not exceed one hundred percent (100%) of the bank's qualifying tier 1 capital or 50% of a trust entity's trust assets;
- For investments in SPs under the Expanded Foreign Currency Deposit Unit ("EFCDU"), total carrying value of SPs as defined herein shall also not exceed 20 percent of the total FCDU assets; Provided that SPs which are not booked in an investment account (e.g., booked as inter-bank loans), for this purpose, shall be considered as part of the EFCDU assets.

An SP is considered principal-protected if the minimum all-in return for such investment is at least zero and such minimum all-in return is guaranteed by an entity (i.e. issuer or a third party) rated at least "A" or its equivalent by an international rating agency acceptable to the BSP or fully collateralized by an asset with equivalent credit quality

3. **As a Broker** . A UB or KB may facilitate derivatives transactions between dealers and market and/or institutional counterparties and/or sophisticated individual end-users; *Provided*, that the UB/KB, acting as broker, ensures that its client fully understands its limited responsibility as a broker; *Provided further* that the bank adheres to procedures for evaluating client suitability, including risk disclosures, as prescribed in *Appendix 26*; *Provided finally* that the bank complies with other pertinent securities laws, rules and regulations.
- b. Thrift banks, rural banks and cooperative banks may enter in derivatives transactions as end-user with BSP-authorized dealers and brokers solely for hedging purposes; *Provided* that they observe all the requirements for hedging transactions under Philippine Accounting Standards ("PAS"). A thrift, rural or cooperative bank may apply for a Type 3 Authority to enter into a derivatives transactions as end-user for purposes other than hedging, *Provided* that the applicant bank agrees to be covered by all regulations prescribing capital for market risk, notwithstanding any provision to the contrary.
 - c. A trust department of a UB or KB may transact, as an institutional counterparty, with financial derivatives instruments enumerated under Subsection 602.1 (a) (2) on behalf of its trustor/principal/s as may be authorized by such trustor/principal/s; *Provided* that the trust department observes the relevant provisions of Appendices 25 (i.e., risk management) and 26 (i.e., ascertaining client suitability to the derivatives product and minimum risk disclosures). Trust entities other than that within a UB or KB may apply for a Type 3 Authority to enter on behalf of its trustor/principal/s a derivatives transaction under Subsection 602.1 (a) (2). Any trust entity may also apply for Type 3 Authority in order to transact as end-user on behalf of its trustor/principal/s with derivatives instrument outside those enumerated under Subsection 602.1 (a) (2).

§ X602.2 Activities Requiring Additional Derivatives Authority. A bank shall apply for prior BSP approval of additional derivatives authority to engage in all other financial derivatives activities not expressly allowed in Subsection X602.1. A bank may apply for two or more additional authorities. A bank 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 25 and meet other conditions specified under this Subsection.

a. Classification of Additional Derivatives Authority.

1. Type 1 –Expanded Dealer Authority

A UB or KB may apply for a Type 1 Authority. A bank with Type 1 Authority may transact in any financial derivatives as a dealer; *Provided*, that a bank with Type 1 Authority shall comply with the sales and marketing guidelines prescribed in *Appendix 26*. A bank with Type 1 Authority may likewise transact in any financial derivatives as a broker and an end-user.

The BSP expects banks applying for Type 1 Authority to institutionalize a (i) comprehensive and integrated risk management system; and (ii) sales and marketing practices that are deemed appropriate and adequate for the different derivatives activities it expects to engage in. It must be rated at least CAMELS (or ROCA for branches of foreign banks) of "4" or better over-all, notwithstanding any provision to the contrary.

2. Type 2 –Limited Dealer Authority

A UB or KB may apply for a Type 2 Authority. A bank with Type 2 Authority may operate as a dealer in specific types of derivatives products with specific underlying reference, as applied for by the bank, outside those financial derivatives instruments under Section X602.1 (a) (1); *Provided*, that a bank with Type 2 Authority shall comply with the sales and marketing guidelines prescribed in *Appendix 26*. The Type 2 Authority also carries authority to transact as broker and end-user of the said specific derivatives instruments.

3. Type 3 – Limited User Authority

Any bank may apply for a Type 3 Authority. A bank 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 bank, outside of those instruments under Section X602.1 (a) (2). However, as regards a thrift, rural or cooperative bank and trust entity other than that within a UB or KB, a Type 3 Authority will enable said bank/entity to transact as end-user of a derivatives instruments as may be applied for by the bank.

4. Type 4 – Special Broker Authority

A bank, other than a UB or KB, may apply for a Type 4 Authority. A bank with Type 4 Authority may facilitate a derivatives transaction between a UB or KB, as dealer, and market and institutional counterparties and sophisticated individual end-users; *Provided*, that the bank, acting as broker, ensures that its client fully understands its limited responsibility as a broker and observes the provisions of *Appendix 26*.

A UB or KB may likewise apply for a Type 4 Authority to enable itself to broker derivatives transaction for or with Other End-users.

A bank with additional Type 1, 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, FX, equity, credit and commodity.

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

1. Demonstrate adequate competence in its general operations as evidenced by:
 - (a) CAMELS (or ROCA for branches of foreign banks) composite rating of at least "3" with a similar rating for Management;
 - (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. The BSP expects a bank 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 bank'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 25.

c. Applicability to Trust Entities. Trust entities may apply for Type 3 Authority, provided they comply with the requirements prescribed and observe the provisions of Appendix 26.

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 (or equivalent management review body in the case of branches of foreign banks or trust committee, in case of trust entities) approving the application for a specific type of derivatives authority;
2. A notarized certification signed jointly by the President, Treasurer and Compliance Officer of the applicant-bank (or two authorized signatories of equivalent rank of the trust committee in case of trust its entity), stating

that the bank complies with all the requirements for the authority being applied for specified in Subsection X602.2; and

3. A list of the types of derivatives and underlying reference the bank 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 bank 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 bank 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. Payment of a non-refundable processing fee amounting to:

	Amount:
Type 1 Authority	P 200,000.00
Type 2 Authority	100,000.00
Type 3 Authority	50,000.00 (for UBs and KBs)
	25,000.00 (for other applicants)
Type 4 Authority	25,000.00

5. 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.
6. Type 1 Authority shall be subject to approval by the BSP Governor, upon recommendation of the Deputy Governor, SES. All other applications for

additional authority/ies shall be subject to approval by the Deputy Governor, SES.

7. A bank whose application for additional derivatives authority/ies or an upgrade thereof (e.g. From Type 2 to Type 1 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 bank whose authorities have been limited or downgraded.
8. A bank 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.

§ X602.3 *Intra-group transactions.* All derivatives transactions between a bank and any of its subsidiaries and affiliates shall comply with minimum risk management standards for related-party transactions outlined in *Appendix 25*, as part of the bank's internal control procedures. The BSP expects banks 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 X602.1 and X602.2 without prejudice to other BSP rules and regulations such as those related to corporate governance and unsafe and unsound banking practices.

§ X602.4 *Accounting Guidelines.* A bank that engages in derivatives activities must strictly account for such transactions in accordance with PAS.

§ X602.5 *Reporting Requirements.* A bank or trust department/entity engaged in any derivatives transaction shall submit, in addition to the derivatives reports enumerated under the BSP Financial Reporting Package (FRP), 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 (Trust Officer in case of Trust Entities).

§ X602.6 *Sanctions*

a. *Unauthorized transactions*

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

A bank 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 X602.5 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 25 and 26*

Any bank/ trust entity found violating any of the provisions of this Circular and/or Appendices 25 and/or 26 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 bank'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 (or ROCA in the case of branches of foreign banks) composite rating or component Management rating Composite Rating of lower than that prescribed under Subsection 602.2 of the MORB, in the most recent regular examination.
- ii. The bank 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 bank has conducted business in an unsafe and unsound manner.

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

§ X602.7 – X602.13 (Reserved)

§ X602.15 *Definition of Terms*

- a. Credit Default Swaps - refers to a financial contract between two parties, the protection buyer and protection seller, with reference to a certain notional value of a reference credit or a basket of reference credits, whereby the former pays a premium to the latter, and in return the latter agrees to make certain protection payments to the former contingent upon the occurrence of a credit event with respect to the reference entity(ies)/asset(s).
- b. Credit-linked Note – refers to a pre-funded credit derivative instrument under which the note holder effectively accepts the transfer of credit risk pertaining to a reference asset or basket of assets issued by a reference entity/ies. The repayment of the principal to the note holder is contingent upon the occurrence of a defined credit event. In consideration thereof, the note holder receives an economic return reflecting the underlying credit risk of the reference assets. For purposes of Section X602, the term shall generically include similar instruments such as Credit-linked Deposits (CLDs) and Credit-linked Loans (CLLs). Unless otherwise stated, the term shall refer only to plain vanilla CLNs. Plain vanilla CLNs are composed of a debt or deposit instrument and a credit default swap. Non-plain vanilla CLNs are those that are leveraged and/or include features of other SPs (e.g., coupon payments linked to interest or FX rate movements) and/or contains more than one embedded derivative.
- c. Currency Swaps – refers to an arrangement in which two parties exchange a series of cash flows in one currency for a series of cash flows in another currency, at specified exchange and/or interest rates and at agreed intervals over an agreed period.
- d. Forward FX contracts – refers to an agreement for delayed delivery of a foreign currency in which the buyer agrees to purchase and the seller agrees to deliver at a specified future date a specified amount at a specified exchange rate.
- e. Forward Rate Agreement – refers to an agreement fixing the interest rates for a specified period whereby the buyer receives (or pays) and the seller pays (or receives) the interest rate differential if the reference rate rises above (or falls below) the contract rate, respectively.

- f. FX exposure - refers to an FX risk arising from an existing commitment to or from a non-resident or Authorized Agent Bank (AAB) which leads to payment of an FX obligation or receipt of an FX asset based on verifiable documents on deal date.
- g. FX Obligation – refers to an actual FX commitment to a nonresident or any AAB where the amount, payment tenor and party have been determined.
- h. FX Options – refers to option contracts which convey the right or the obligation depending upon whether the bank is the purchaser or the writer respectively to buy or sell at a specified price by a specified future date, for a fee or a premium, two different currencies at a specified exchange rate.
- i. FX Swaps – refers to an agreement involving an initial exchange of two currencies, usually at the prevailing spot rate, and a simultaneous commitment to reverse the exchange of the same two currencies at a date further in the future at a rate (different from the rate applied to the initial exchange) agreed on deal date.
- j. Interest Rate Swaps - refers to an agreement in which the parties agree to exchange interest cash flows on a principal amount at certain times in the future according to an agreed upon formula.
- k. Non-Deliverable Forward (NDF) – refers to a forward FX contract where only the net difference between the contracted forward rate and the market rate shall be settled at maturity.
- l. Non-Resident – refers to an individual, a corporation or other juridical person not included in the definition of resident.
- m. Resident – refers to:
 - (1) An individual citizen of the Philippines residing therein; or
 - (2) An individual who is not a citizen of the Philippines but is permanently residing therein; or
 - (3) A corporation or other juridical person organized under the laws of the Philippines; or
 - (4) A branch, subsidiary, affiliate, extension office or any other unit of corporations or juridical persons which are organized under the laws of any country and operating in the Philippines, except Offshore Banking Units (OBUs).
- n. Structured Product – refers to a financial instrument where the total return is a function of one or more underlying indices, such as interest rates, equities and exchange rates. It is composed of a host contract (e.g., plain vanilla debt or equity securities) and an embedded derivative (e.g., swaps, forwards or

options) that re-shape the risk-return pattern of the hybrid instrument. For purposes of guidelines under Section X602, the term SP does not include asset-backed securities. Provisions under BSP Circular No. 468 shall continue to apply for securities overlying securitization structures.

3. The revised appendices 25 and 26 of the MORB are attached.

4. Transitory provisions

Expanded or any other derivatives authority granted prior to the effectivity of this Circular shall be operative for one year from effectivity date of this Circular; Provided that a bank undertaking any derivatives activities pursuant thereto shall immediately comply with the pertinent provisions of Appendices 25 and 26. A bank which intends to continue its existing derivatives authority not covered by those generally authorized under Section X602.1 of the MORB, as amended, must submit an application for the appropriate additional derivatives authority within the one-year transitory period. After the lapse of the one-year transitory period, a bank can only perform those activities which are permissible under this Circular.

A bank whose SPs, at the time of the effectivity of this Circular, exceed the prudential limits prescribed under Subsection 602.1 (a) (3) may maintain existing positions but cannot increase its exposures or invest in additional SPs until such time when its exposure levels are within the prescribed limits.

5. Repealing Clause

The provisions of Circular No. 417, dated 28 January 2004, and Circular No. 466, dated 5 January 2005, on the allowed CLNs and SPs, respectively, for UBs and KBs without expanded derivatives authority are hereby amended.

Subsection X602.7 of the MORB and Memorandum to All Universal and Commercial Banks, dated 11 May 2005, on the reporting requirements pertaining to CLNs and SPs are 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.

6. Effectivity

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

FOR THE MONETARY BOARD:

A handwritten signature in black ink, appearing to read 'Amando M. Tetangco, Jr.', with a long horizontal flourish extending to the right.

AMANDO M. TETANGCO, JR.
Governor

8 January 2008

APPENDIX 25 – MANUAL OF REGULATIONS FOR BANKS (Appendix to Section X602 of the MORB)

Subject: Risk Management Guidelines for Derivatives

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 banking activities, provides a framework on which a bank 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.

A bank, 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 banks considering that the structure and level of derivatives activities will vary from one bank to another. Each bank 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 bank'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 a bank's risk management. The Board of Directors ("BOD")¹ has the responsibility of ensuring that a bank's risk management system appropriately captures its risk exposures and affords proper management of these.
3. A trust entity within a bank must have a separate risk management system. However, the trust department may in-source back office functions of its risk management system with the bank proper only upon prior BSP approval on the basis that such in-sourcing will not give rise to potential conflict of interest.

II. RISKS ASSOCIATED WITH DERIVATIVES

¹ In case of a local branch of a foreign bank, the equivalent management review arrangement (e.g. management committee, regional review committee). In case of a trust entity, the trust committee.

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 a bank to complicated risks. Thus, derivatives can aggravate the risks of banks and of counterparties if derivatives are not clearly understood and properly managed.

A single derivatives product may expose a bank 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 a bank's overall risk management system using a conceptual framework common to the bank'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. A bank must likewise identify the impact of its derivatives activities on its overall risk profile. To properly identify risks, a bank 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. A bank must have measurement models or tools to quantify the risks identified. These measurement tools should be suitable to the nature and volume of a bank'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 bank management.
3. **Monitor** the risks arising from its derivatives activities. Derivatives products are very sensitive to market factors, which continually change. Thus, a bank 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 bank's derivatives positions.

4. **Control** the risks arising from its derivatives activities. A bank must establish limits to its derivatives exposure. These limits should be comprehensive and aligned with a bank's overall risk tolerance. A bank's policies and procedures on control should provide for contingencies when limits are breached. A bank must allot lead time and have a mechanism that enables management to act in time to control unacceptable or undesired exposures. A bank 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 a bank's risk management system for its derivatives activities in accordance with the following basic principles:

A. Active and Appropriate Board² and Senior Management Oversight

A bank's BOD must set the general policy or the policy direction relating to the management of a bank's risks, including those arising from its derivatives activities. This policy should be consistent with the bank's business strategies, capital strength, management expertise and risk profile. Accordingly, the BOD must understand the nature and purpose of the bank's derivatives activities and the role derivatives play in the bank'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.

² In case of a local branch of a foreign bank, the equivalent management review arrangement. (e.g. management committee, regional review committee). In case of a trust entity, the trust committee.

The BOD must be apprised of the bank'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 bank's risk exposures from derivatives, including the impact to the bank'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 bank'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 a bank'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 bank'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 bank personnel comply with prescribed risk management standards and sales and marketing guidelines.

B. Adequate Risk Management Policies and Procedures

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

A bank 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 bank's over-all risk management system to the fullest extent possible using a conceptual framework common to the bank's other activities. Risk management policies should be comprehensive, covering all activities of the bank. The BSP will evaluate the degree to which controls covering derivatives activities have been integrated in other issuances of the bank covering aggregate risk-taking activities.

For banks 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. A bank 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, a bank 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 a bank'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 bank'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

A bank 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 bank to the fullest extent possible. A bank must develop a risk measurement model appropriate to its portfolio. Accordingly, a bank 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 bank'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 bank'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 bank and assessing the ability of the bank 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.

A bank'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 bank's measurement models, including the compatibility of the measurement model with the bank'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 bank'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. A bank 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

A bank must specify individual limits for all types of risks involved in a bank's derivatives activities. A bank 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 bank-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 bank'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 bank's capacity to take risks. A bank 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 bank'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, a bank must have a mechanism that can track and analyze the effect of market movements on its derivatives exposures.

To ensure proper monitoring of risks, a bank 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, bank traders are expected to actively monitor their positions to ensure that they do not breach their limits. Bank 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

A bank 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 bank's derivatives exposures. A bank 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 bank 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 bank's risk exposures. The electronic data processing capability must be commensurate to the volume and complexity of the bank'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 bank 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 bank. In determining whether a bank's internal controls meet these objectives, the BSP will consider the overall control environment of the bank, 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

A bank should have an independent risk control unit responsible for the design and implementation of the bank'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 senior management of the bank. The role and structure of risk control function should be commensurate to the nature, complexity and extent of a bank'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 bank'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.

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

a. Formal approval process for new products

A bank should have an effective process to evaluate and review risks involved in products that are either new to the bank or new to the market and of potential interest to the bank. A bank 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 bank 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 bank'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).

A bank 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

A bank 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.

A bank 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.

A bank 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.

A bank should avoid dealing in transactions conducted at off-market rates. A bank 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 bank'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. A bank 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 bank'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 bank traders are in high demand and are often recruited in teams.

To mitigate business continuity and succession risk arising from a high staff turnover, a bank 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 bank 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 bank'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 bank'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 bank 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 26 – MANUAL OF REGULATIONS FOR BANKS

(Appendix to Section X602 of the MORB)

Subject: Sales and Marketing Guidelines for Derivatives

I. General Principle

A bank, 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, a bank acting as dealer or broker must have appropriate controls and procedures to ensure the suitability of the transactions to its clients. A bank 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. A bank 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 banks acting as dealers or brokers of derivatives.

II. Client Suitability Guidelines

A bank 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

A bank, 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. A bank should ensure that the clients' risk and return objectives are clearly identified. This can be done through questionnaires and interviews. A bank 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, a bank should be able to ascertain, at a minimum, a client's classification according to financial sophistication as embodied in

Circular No. 594 on Derivatives¹ and his/its risk tolerance. The client classification should serve as basis for a bank product/service offerings and level of disclosures required.

In dealing with corporate clients, a bank 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 bank 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 bank should require the client to incorporate in its board resolution authorizing the latter's derivatives activities that it likewise has appropriate risk management techniques and systems sufficient to manage and monitor the risks it will take.

In determining an individual client's classification, a bank 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 a bank 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.

A bank 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 or 2 Authorities 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, a bank should consider the following in choosing the derivatives products/services offerings to its clients:

¹ A bank, however, may adopt its own sub-classification for its own purposes.

- 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.

A bank should maintain a record of all the information as bases of its suitability assessment. It is highly recommended that a bank 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, a bank 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, a bank 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 bank 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. A bank, however, can apply a degree of standardization to aid quality control. A bank should clearly link its proposed or recommended derivatives product to the client's own needs, priorities and attitude toward risk. A bank may mention alternative products suitable for the client. The suitability letter should be signed by the client and the officer authorized by the bank to advise/sell/propose the recommended product.

A bank 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 bank should be able to provide sufficient support for its classification.

III. Disclosures

A bank 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. A bank 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. A bank can tailor-fit information, marketing and sales presentations/materials in accordance with the client classification under Circular No. 594. A bank 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). A bank should adopt standards for its publications/materials/disclosure statements and review the aforementioned documents regularly to ensure that they meet the standards.

A bank, 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)

A bank 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. A bank 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;.

A bank should consider the client's knowledge of the transaction to which a given information relates. A bank should not assume that clients/recipients necessarily have an understanding of the derivatives product being promoted. A bank 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

A bank 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 a 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, a bank 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 bank must disclose the fee or charge for the same. A bank 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. A bank, when applicable, should state if the guaranteed or protected amount is payable only at the end of the term.

Product disclosures for leveraged products/transactions² 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, a bank should require its client to sign or initial the disclosure statement as affirmation of the client's receipt and understanding of the disclosure statement. A bank 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 bank is not the issuing institution, (i.e. the bank 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

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

- All termination clauses, when appropriate, including charges and restrictions³.
- 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 bank 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, a bank 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 (i.e. those outside the enumeration of instruments under Subsection X602.1 (a) (2) of MORB as amended by Circular No. 594) 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 26A contains sample disclosure statements which a bank 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. A bank, 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

³ For instance, for a structured deposit, the bank 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.

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, a bank 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, a bank 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 a bank's derivatives products and ensure client suitability.

The bank's board of directors and senior management⁴ 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, a bank's board of director and senior management are not precluded from filing the necessary action against the erring sales and marketing personnel.

⁴ For purposes of this appendix, senior management shall comprehend officers starting from the level of the president down to the level of vice presidents.

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 bank 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.

(A bank 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 bank 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 Bank]

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

Date

[Signature of Customer]