



Bangko Sentral ng Pilipinas

MAYNILA, PILIPINAS

OFFICE OF THE GOVERNOR

CIRCULAR NO. 297
Series of 2001

The Monetary Board, in its Resolution No. 1318 dated August 23, 2001, approved the following amendments to Sections X602 and 4603Q of the Manual of Regulations for Banks and the Manual of Regulations for Non-Bank Financial Institutions, respectively, on the rules and regulations on financial derivatives activities of banks, non-banks with quasi-banking functions and their subsidiaries/affiliates.

SECTION 1. Subsections X602.1 and 4603Q.1 are hereby amended to read as follows:

"Subsection _____. Scope and pre-qualification requirements

The following provisions shall govern the scope and pre-qualification requirements for the grant of authority to engage in derivatives activities.

a. For expanded derivatives authority

- 1) **Scope.** Only UBs and KBs may apply for an expanded derivatives license. The licensee may trade, sell, deal and take positions in currency swap and forward of any tenor as well as all other derivatives for their own account or on behalf of customers.
- 2) **Pre-qualification requirements.** A bank applying for expanded derivatives activities may be granted license only upon determination by the BSP that the applicant possesses:
 - a) Comprehensive risk management system approved by the bank's board of directors (or equivalent management committee in the case of foreign bank branches) containing clear delineations of responsibility for risk management, adequate risk measurement systems, appropriately structured risk limits, effective internal controls, and efficient risk-reporting system as determined by the BSP, which should include a Board-approved Policy Manual.

The Policy Manual shall have the following minimum features:

- (1) Scope of derivatives activities, types of services and products offered to clients;
- (2) Authorities and responsibilities of –

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- (a) Board of Directors
 - (b) Management Committees;
 - (c) Chief Executive Officer;
 - (d) Other Senior Officers;
 - (e) Department Managers; and
 - (f) Trading or Dealing Officers/Staff
- (3) Policies and procedures to govern trading and documentation;
- (4) Policies and procedures for controlling and measuring risks including, as a minimum:
 - (a) Trading, exposure, counterparty, and gap limits;
 - (b) Earnings -- or Capital-at-Risk and Value-at-Risk assumptions, calculations, and limits; and
 - (c) Mark-to-Market policies and procedures.
- (5) Internal control system and audit policies;
- (6) Policy review
- (7) System of financial and regulatory reporting;
- (8) Job description of and minimum qualification standards for key positions; and
- (9) Procedure for evaluating client suitability;
- b) Electronic data processing capability commensurate to the volume and complexity of the bank's derivatives activities; and
- c) Technical competence of key officers/traders responsible for derivatives.
- 3) **Other requirements.** BSP shall evaluate bank's financial soundness and track record of compliance with major prudential requirements, such as, but not limited to:
 - a) CAMELS composite rating of at least "3" in the last regular examination;
 - b) Minimum applicable capital adequacy ratio;

- c) Minimum reserves against deposit liabilities, deposit substitutes, and common trust;
- d) Liquidity floor for government deposits;
- e) FCDU/EFCDU foreign currency asset cover on FCDU/EFCDU foreign currency liabilities; and
- f) Maximum allowable open foreign exchange position.

b. For regular derivatives authority

- 1) **Scope.** Other financial institutions (FIs) supervised by the BSP may apply for a regular derivatives license. A licensed FI may sell derivatives products to its customers: *Provided*, That the FI shall hedge such derivatives and *Provided, further*, That the risk being hedged is already existing with the FI itself.
- 2) **Pre-qualification requirements.** An application to engage in a regular derivatives activities may be granted upon determination by the BSP that the applicant possesses:
 - a) The ability to account for its currency exposures on a per currency basis through its Multi-Currency Subsidiary Ledger;
 - b) The ability to account for swaps and forwards either via the accrual or net present value basis. Swaps and forwards designated as hedge only at inception may be accounted for using the accrual method. Forwards designated as trading shall be marked-to-market daily using the net present value methodology;
 - c) The ability to manage and monitor price risks for the whole derivatives portfolio to ensure continuous assessment of the effectiveness of the hedge. While the ideal method of measuring these risks is through "value-at-risk" methodology, alternative systems are acceptable: *Provided*; That these are:
 - (1) Capable of measuring and aggregating risks across trading and non-trading activities;
 - (2) Approved by the Bank's Board of Directors;

- (3) Consistent with Board-approved risk appetite;
 - (4) Consistent with the level and complexity of the institution's trading activities; and
 - (5) Fully documented and independently validated.
- d) The ability to monitor counterparty risks on outstanding contracts through a methodology that reflects changes in credit exposure as market rates change;
 - e) The technical competence of key officers/traders responsible for the derivative products; and
 - f) The procedures for evaluating client suitability.
- 3) **Other requirements.** BSP shall evaluate bank's/NBQB's and other BSP supervised financial institution's financial soundness and track record of compliance with major prudential requirements, such as, but not limited to:
- a) CAMELS composite rating of at least "3" in the last regular examination;
 - b) Minimum applicable capital adequacy ratio;
 - c) Minimum reserves against deposit liabilities, deposit substitutes and common trust;
 - d) FCDU/EFCDU foreign currency asset cover on FCDU/EFCDU foreign currency liabilities.
 - e) Maximum allowable open foreign exchange position.

c. No license derivatives

- 1) **Scope.** A UB/KB with no derivatives license may trade, sell, deal and take positions for their own account or in behalf of customers in currency swaps and forwards with tenor of one year or less. The bank may also sell other derivative products of licensed entities to its customers: *Provided*, That the customer currently has a risk with the bank it wishes to hedge.

- 2) ***Pre-qualification requirements.*** The bank shall submit a certification by its President or any officer of equivalent rank and function that the bank possesses:
- a) The ability to account for its currency exposures on a per currency basis through their Multi-Currency Subsidiary Ledger.
 - b) The ability to account for swaps and forwards either via the accrual or net present value basis. Swaps and forwards designated as hedge only at inception may be accounted for using the accrual method. Forwards designated as trading shall be marked-to-market daily using the net present value methodology;
 - c) The ability to manage and monitor price risks for the whole derivatives portfolio to ensure continuous assessment of the effectiveness of the hedge. While the ideal method of measuring these risks is through "value-at-risk" methodology, alternative systems are acceptable: *Provided*, That these are:
 - (1) Capable of measuring and aggregating risks across trading and non-trading activities;
 - (2) Approved by the bank's board of directors;
 - (3) Consistent with Board-approved risk appetite;
 - (4) Consistent with the level and complexity of the institution's trading activities; and
 - (5) Fully documented and independently validated.
 - d) The ability to monitor counterparty risks on outstanding contracts through a methodology that reflects changes in credit exposure as market rates change.
 - e) The technical competence of key officers/traders responsible for the derivative products; and
 - f) Procedures for evaluating client suitability.

d. For engaging in derivatives transactions as end-users

- 1) **Scope.** Banks/NBQBs/Other BSP-supervised financial institutions may engage in derivatives transactions purely as end-users and do not need a license for such activities.
- 2) **Requirements.** The banks/NBQBs/Other BSP supervised FIs shall show proof of approval by its board of directors to use derivatives. Such approval must clearly specify the following as a minimum guidelines:
 - a) Derivatives products to be used and the type of transactions to be hedged shall be specified;
 - b) Transactions shall be limited to hedging purpose only; there shall be no speculative activity;
 - c) Dealings shall only be with licensed/authorized counterparties; and
 - d) Transactions shall be reported regularly to the board of directors

SECTION 2. Subsections X602.2 and 4603Q.2 shall read as follows:

"Subsection _____. **Transactions between parent and subsidiary.** All derivatives transactions between parent bank/NBQB/FI and subsidiary (e.g. Forex Corporation) shall be with prior BSP approval."

SECTION 3. Subsections X602.3 and 4603Q.3 are hereby added to read as follows:

"Subsection _____. **Renewals.** The license to engage in derivatives activities shall be for a period of one year. The license may be renewed subject to compliance with the following

- a. BSP standard of financial soundness and track record of compliance with major prudential regulations;
- b. Adequate risk management systems; and
- c. Adequate internal control system and procedures including record keeping for derivatives activities.

SECTION 4. Subsections X602.3, X602.4, 4603Q.3 and 4603Q.4 are renumbered as Subsection X602.4, X602.5, 4603Q.4 and 4603Q.5, respectively.

SECTION 5. Subsections X602.6 and 4603Q.6 are hereby added to read as follows:

"Subsection _____, Reporting Requirements. Aside from the daily/monthly FX position reports, a monthly report on transaction/outstanding derivatives transaction shall also be required for Banks/NBQBs/FIs which enter into derivatives contracts as end-user."

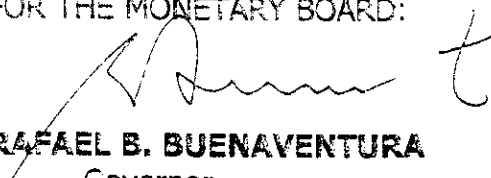
SECTION 6. Existing Subsections X602.5 and 4603Q.5 are renumbered as Subsections X602.7 and 4603Q.7, respectively, and amended to read as follows:

"Subsection _____, Sanctions. Monetary penalties prescribed under Sections 35, 36 and 37 of R.A. No. 7653 (The New Central Bank Act) and/or suspension of foreign exchange operations, shall be imposed on any bank/NBQB/their subsidiaries/affiliates (including its directors or officers) that engage in derivatives activities without prior BSP approval.

If the bank/NBQB/FI submits an erroneous written representation or certification, a cease and desist order shall be imposed, in addition to a monetary penalty of P10,000 per transaction. Banks/NBQBs/FI's operations may only be resumed after the appropriate supervising and examining Department has made a thorough validation of the bank's compliance with requirements.

This Circular shall take effect immediately.

FOR THE MONETARY BOARD:


RAFAEL B. BUENAVENTURA
Governor

September 17, 2001