

GUIDELINES TO INCORPORATE MARKET RISK IN THE RISK-BASED CAPITAL ADEQUACY FRAMEWORK

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Pursuant to Monetary Board Resolution No. 1616 dated November 7, 2002, approving the guidelines to incorporate market risk in the risk-based capital adequacy framework for universal banks and commercial banks, the provisions of the Manual of Regulations for Banks are amended as follows:

1. A new subsection is hereby added after Subsection X116.4 of the Manual to read as follows:

"§ 1116.5. Market Risk Capital Requirement. Universal banks (UBs)/commercial banks (KBs) shall also measure and apply capital charges for market risk, in addition to the credit risk capital requirement described above, in accordance with the Guidelines to Incorporate Market Risk in the Risk-Based Capital Adequacy Framework (Appendix __)."

2. Subsections X116.5 and X116.6 of the Manual are hereby renumbered as Subsections X116.6 and X116.7, respectively.

3. Subsection X116.6 of the Manual (formerly Subsection X116.5) is hereby amended to read as follows:

"§ X116.6. Sanctions. Whenever the capital accounts of a bank are deficient with respect to the prescribed risk-based capital adequacy ratio (which for UBs/KBs shall pertain to adjusted capital adequacy ratio covering combined credit risk and market risk), the Monetary Board after considering a report of the appropriate supervising and examining department of the BSP on the state of solvency of the institution concerned, shall limit or prohibit the distribution of the net profits and shall require that part or all of net profits be used to increase the capital accounts of the bank until the minimum requirement has been met. The Monetary Board may restrict or prohibit the making of new investments of any sort by the bank, with the exception of purchases of readily marketable evidences of indebtedness issued by the Philippine national government and BSP included in Item a(2)i of Subsec. X116.2, until the minimum required capital ratio has been restored."

This Circular shall take effect on July 1, 2003: Provided, That covered banks shall submit trial reports (solo basis and consolidated basis) using the prescribed new report forms commencing with the end-March 2003 reports.

Adopted: 3 Dec. 2002

(SGD.) AMANDO M. TETANGCO, JR.
Deputy Governor

Appendix I

GUIDELINES TO INCORPORATE MARKET RISK IN THE RISK-BASED CAPITAL ADEQUACY FRAMEWORK

Introduction

1. These guidelines describe the approach to be used by the BSP to determine the minimum level of capital to be held by a bank against its market risk. The guidelines are broadly consistent with the recommendations of the Basel Committee on Banking Supervision in a document entitled "Amendment to the Capital Accord to Incorporate Market Risks" issued in January 1996.
2. Under these guidelines, banks shall be required to measure and apply capital charges against their market risk, in addition to their credit risk.
3. Market risk is defined as the risk of losses in on and off balance sheet positions arising from movements in market prices. The risks addressed by these guidelines are:
 - The risks pertaining to interest rate-related instruments and equities in the trading book; and
 - Foreign exchange risk throughout the bank.

Coverage of capital requirement for market risk

4. The capital requirement for market risk shall apply to all universal banks and commercial banks.
5. The minimum capital adequacy ratio covering combined credit risk and market risk shall apply to banks which are subject to market risk capital requirement on both solo basis (i.e., head office plus branches) and consolidated basis (i.e., parent bank plus subsidiary financial allied undertakings, but excluding insurance companies).

Methods of measuring market risk

6. There are two alternative methods recognized for the measurement of market risk, as follows:
 - (a) The standardized approach shall be used by all banks which are subject to market risk capital requirement, except by those which may be allowed by BSP to use the alternative method described in paragraph (b) below. The method of measuring market risk under the standardized approach is set out in the Instructions for Accomplishing the Report on Computation of the Adjusted Risk-Based Capital Adequacy Ratio Covering Combined Credit Risk and Market Risk.
 - (b) The internal models approach allows banks with the necessary system to use their own internal risk management models to calculate market risk. The use of this approach is subject to prior BSP approval. Approval shall be based on meeting certain qualitative and quantitative conditions relating to the models themselves and the controls surrounding them, as set out in Annex "A". Banks may on a transitional basis be allowed to use a combination of the standardized approach and the models approach to measure their market risk, provided any such "partial" model shall cover a complete risk category (e.g., interest rate risk or foreign exchange risk). The reporting under the internal models approach is contained in the Instructions for Accomplishing the Report on Computation of the Adjusted Risk-Based Capital Adequacy Ratio Covering Combined Credit Risk and Market Risk.

Calculation of the capital adequacy ratio (CAR)

7. The adjusted capital adequacy ratio covering combined credit risk and market risk shall be calculated using the qualifying capital expressed as a percentage of the total risk-weighted assets (including credit risk and market risk-weighted assets). The components of this calculation are as follows:
 - Market risk-weighted assets are the sum of the capital charges for all market risk categories calculated using either the standardized approach or the internal models approach (multiplied by 125 percent for those

calculated using the standardized methodology to be consistent with the higher capital charge for credit risk, i.e., 10 percent as opposed to BIS recommended 8 percent) multiplied by 10. (The multiplier 10 is the reciprocal of the BSP required minimum capital adequacy ratio for credit risk of 10 percent. The effect is to convert the sum of the market risk capital charges into a risk-weighted assets equivalent which can then be directly added to the total credit risk-weighted assets.);

- Credit risk-weighted assets are the total risk-weighted assets calculated in accordance with Subsection X116.2 of the Manual of Regulations for Banks, less the part calculated for on-balance sheet debt securities and equities in the trading book. (The credit risk-weighted assets for on-balance sheet debt securities and equities are deducted because they represent an element now covered by the market risk capital charge); and

- Qualifying capital is the same as that calculated in accordance with Subsection X116.1 of the Manual of Regulations for Banks.

8. Banks shall maintain a minimum adjusted risk-based capital adequacy ratio covering combined credit risk and market risk of 10 percent calculated in this manner on solo basis and on consolidated basis.

The trading book

9. A key feature of the market risk framework is the definition of the trading book of a bank. This is set out in the Instructions for Accomplishing the Report on Computation of the Adjusted Risk-Based Capital Adequacy Ratio Covering Combined Credit Risk and Market Risk. Banks are expected to adopt a consistent approach to allocating transactions into their trading and non-trading (i.e., banking book), and clear audit trail for this purpose should be created at the time each transaction is entered into. The BSP shall monitor banks' practices to ensure that there is no abusive switching between different books to inappropriately reduce capital charges.

Required reports

10. Banks shall submit quarterly reports of their adjusted risk-based capital adequacy ratio covering combined credit risk and market risk on solo basis and on consolidated basis to the appropriate supervising and examining department of the BSP in accordance with the attached prescribed forms within 15 banking days and 30 banking days after the end of reference quarter for solo report and consolidated report, respectively. These reports shall be in addition to the reports on risk-based capital adequacy ratio covering credit risk required to be submitted in Subsection X116.4 of the Manual of Regulations for Banks.

11. One of three alternative report forms, a copy each attached, shall be used depending on the complexity of the bank's operations, to wit:

- (a) For UBs/KBs with expanded derivatives authority;
- (b) For UBs/KBs with expanded derivatives authority but without option transactions; or
- (c) For UBs/KBs without expanded derivatives authority.

12. The abovementioned reports shall be classified as category A-2 Reports.

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