REVISED RULES AND REGULATIONS TO GOVERN ACCOUNTING FOR INVESTMENTS IN DEBT AND EQUITY SECURITIES

BSP CIRCULAR NO. 476, S. 2005, February 16, 2005

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The Monetary Board in its Resolution Nos. 1868 and 42 dated 23 December 2004 and 13 January 2005, respectively, approved the following revised rules and regulations to govern accounting for investments in debt and equity securities. Accordingly, Appendices 33 and Q-20 of the Manuals of Regulations for Banks and for Non-Bank Financial Institutions, respectively, are amended as follows:

Section 1. Statement of Policy. It is the policy of the Bangko Sentral ng Pilipinas to promote full transparency of the financial statements of banks and other supervised institutions in order to strengthen market discipline, encourage sound risk management practices, and stimulate the domestic capital market. Towards these ends, the BSP desires to align local financial accounting standards with international accounting standards as prescribed by the International Accounting Standards Board (IASB) to the greatest extent possible.

Section 2. Scope. This Circular covers accounting for investments in debt and equity securities except:

a. those that are part of hedging relationship;
b. those that are hybrid financial instruments;
c. those financial liabilities that are held for trading;
d. those financial assets and financial liabilities which, upon initial recognition, are designated by the financial institutions as at fair value through profit or loss; and
e. those that are classified as loans and receivables.

It also does not include accounting for derivatives and non-derivative financial instruments other than debt and equity securities. The foregoing exceptions and exclusions shall be covered by separate Circulars.

Section 3. Investments in Debt and Equity Securities. Depending on the intent, investments in debt and equity securities shall be classified into one of four categories and accounted for as follows:

a. Held to Maturity Securities (HTM) — These are debt securities with fixed or determinable payments and fixed maturity that a financial institution has the positive intention and ability to hold to maturity other than:

(1) those that meet the definition of Securities at Fair Value Through Profit or Loss; and

(2) those that the financial institution designates as Available-for-Sale Securities (AFS).

A financial institution shall not classify any debt security as HTM if the financial institution has, during the current financial year or during the two preceding financial years, sold or reclassified more than an insignificant amount of HTM investments before maturity (more than insignificant in relation to the total amount of HTM investments) other than sales or reclassifications that:

(1) are so close to maturity or the security's call date (i.e., less than three months before maturity) that changes in the market rate of interest would not have a significant effect on the security's fair value;

(2) occur after the financial institution has substantially collected all (i.e., at least 85 percent) of the security's original principal through scheduled payments or prepayments; or

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(3) are attributable to an isolated event that is beyond the financial institution's control, is non-recurring and could not have been reasonably anticipated by the financial institution.

For this purpose, the phrase "more than an insignificant amount" refers to sales or reclassification of one percent (1%) or more of the outstanding balance of the HTM portfolio: Provided, however, That sales or reclassifications of less than one percent (1%) shall be evaluated on case to case basis.

Sales or reclassifications before maturity that do not meet any of the conditions prescribed in this Circular shall require the entire HTM portfolio to be reclassified to AFS. Further, the financial institution shall be prohibited from using the HTM account during the reporting year of the date of sales or reclassifications and for the succeeding two full financial years. Failure to reclassify the HTM portfolio to AFS on the date of sales or reclassifications, shall subject the financial institution and concerned officers to penalties and sanctions provided under Section 7 of this Circular. This provision shall be applied prospectively, i.e. on prohibited sales or reclassifications occurring upon the effectivity of this Circular and thereafter.

Securities held in compliance with BSP regulations, e.g. securities held as liquidity reserves and for the faithful performance of trust duties, may be classified either as HTM, Securities Held-for-Trading (HFT) or AFS: Provided, That the provision of Item (4) of paragraph 2 of Section 3.a.1 shall not apply to sales or reclassifications of the said securities booked under HTM.

a.1. Positive intention and ability to hold investments in HTM securities to maturity - A financial institution does not have a positive intention to hold to maturity an HTM security if:

(1) the financial institution intends to hold the security for an undefined period;

(2) the financial institution stands ready to sell the security (other than if a situation arises that is non-recurring and could not have been reasonably anticipated by the financial institution) in response to changes in market interest rates or risks, liquidity needs, changes in the availability of and the yield on alternative investments, changes in financing sources and terms or changes in foreign currency risk; or

(3) the issuer has a right to settle the security at an amount significantly below its amortized cost.

Sales before maturity could satisfy the condition of HTM classification and therefore need not raise a question about the financial institution's intention to hold other HTM securities to maturity if they are attributable to any of the following:

(1) A significant deterioration in the issuer's creditworthiness; For example, a sale following a downgrade in a credit rating by an external rating agency would not necessarily raise a question about the financial institution's intention to hold other investments to maturity if the downgrade provides evidence of a significant deterioration in the issuer's creditworthiness judged by reference to the credit rating at initial recognition. Similarly, if a financial institution uses internal ratings for assessing exposures, changes in those internal ratings may help to identify issuers for which there has been a significant deterioration in creditworthiness, provided the financial institution's approach to assigning internal ratings and changes in those ratings give a consistent, reliable and objective measure of the credit quality of the issuers. If there is evidence that an instrument is impaired, the deterioration in creditworthiness is often regarded as significant.

(2) A change in tax law that eliminates or significantly reduces the tax-exempt status of interest on the HTM security (but not a change in tax law that revises the marginal tax rates applicable to interest income);

(3) A major business combination or major disposition (such as sale of a segment) that necessitates the sale or transfer of HTM securities to maintain the financial institution's existing interest rate risk position or credit risk policy: Provided, That the sale or transfer of HTM security shall be done only once and within a period of six months from the date of the business combination or major disposition: Provided further, That prior BSP approval is required for sales or transfers occurring after the prescribed six-month time frame. In this case,

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financial institutions shall submit to the appropriate supervision and examination department of the BSP, a plan stating the reason for the extension and the proposed schedule for the disposition of the HTM security.

(4) A change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment or the maximum level of particular types of investments, thereby causing a financial institution to dispose of an HTM security;

(5) A significant increase in the industry's regulatory capital requirements that causes the financial institution to downsize by selling HTM securities; or

(6) A significant increase in the risk weights of HTM securities used for regulatory risk-based capital purposes.

A financial institution does not have a demonstrated ability to hold to maturity an investment in HTM security if:

(1) it does not have the financial resources available to continue to finance the investment until maturity; or

(2) it is subject to an existing legal or other constraint that could frustrate its intention to hold the security to maturity.

Sales before maturity due to events that are non-recurring and could not have been reasonably anticipated by the financial institution such as a run on a bank, likewise satisfy the condition of HTM classification and therefore need not raise a question about the financial institution's intention and ability to hold other HTM investments to maturity.

A financial institution assesses its intention and ability to hold its investment in HTM securities to maturity not only when those securities are initially recognized, but also at each time that the financial institution prepares its financial statements.

a.2. HTM securities shall be measured upon initial recognition at their fair value plus transaction costs that are directly attributable to the acquisition of the securities.

For this purpose, transactions costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

After initial recognition, a financial institution shall measure HTM securities at their amortized cost using the effective interest method.

For this purpose, the effective interest method is a method of calculating the amortized cost of a security (or group of securities) and of allocating the interest income over the relevant period using the effective interest rate. The effective interest rate shall refer to the rate that exactly discounts the estimated future cash receipts through the expected life of the security or when appropriate, a shorter period to the net carrying amount of the security. When calculating the effective interest rate, a financial institution shall estimate cash flows considering all contractual terms of the security (for example, prepayment, call and similar options) but shall not consider future credit losses. The calculation includes all fees and points paid to the other party to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar securities can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a security (or group of securities), the financial institution shall use the contractual cash flows over the full contractual terms of the security.

A gain or loss arising from the change in the fair value of the HTM security shall be recognized in profit or loss when the security is derecognized or impaired, and through the amortization process.

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A financial institution shall assess at each time it prepares its financial statements whether there is any objective evidence that an HTM security is impaired.

If there is objective evidence that an impairment loss on HTM securities has been incurred, the amount of the loss is measured as the difference between the security's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the security's original effective interest rate (i.e. the effective interest rate computed at initial recognition). The carrying amount of the security shall be reduced through the use of an allowance account. The amount of the loss shall be recognized in profit or loss.

As a practical expedient, a creditor may measure impairment of HTM securities on the basis of an instrument's fair value using an observable market price.

A financial institution first assesses whether objective evidence of impairment exists individually for HTM securities that are individually significant, and individually or collectively for HTM securities that are not individually significant. If an entity determines that no objective evidence of impairment exists for an individually assessed HTM security, whether significant or not, it includes the asset in a group of HTM securities with similar credit risk characteristics and collectively assesses them for impairment. HTM securities that are individually assessed for impairment and for which an impairment loss is or continues to be recognized are not included in a collective assessment of impairment.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized (such as an improvement in the debtor's credit rating), the previously recognized impairment loss shall be reversed by adjusting the allowance account. The reversal shall not result in a carrying amount of the security that exceeds what the amortized cost would have been had the impairment not been recognized at the date the impairment is reversed. The amount of the reversal shall be recognized in profit or loss.

b. Securities at Fair Value through Profit or Loss - These consist initially of HFT Securities. HFT are debt and equity securities that are:

(a) acquired principally for the purpose of selling or repurchasing them in the near term; or

(b) part of a portfolio of identified securities that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking.

For this purpose, a financial institution shall adopt its own definition of short-term which shall be within a 12-month period. Said definition which shall be included in its manual of operations, shall be applied and used consistently.

b.1 HFT securities shall be measured upon initial recognition at their fair value. Transaction costs incurred at the acquisition of HFT securities shall be recognized directly in profit or loss. After initial recognition, a financial institution shall measure HFT securities at their fair values without any deduction for transaction costs that it may incur on sale or other disposal. A gain or loss arising from a change in the fair value of HFT securities shall be recognized in profit or loss under the account "Trading Gain/(Loss)".

c. Available-for-Sale Securities (AFS) — These are debt or equity securities that are designated as Available-for-Sale Securities (AFS) or are not classified/designated as (a) HTM, (b) Securities at Fair Value through Profit or Loss, or (d) Investment in Non-Marketable Equity Securities (INMES).

c.1 AFS securities shall be measured upon initial recognition at their fair value plus transaction costs that are directly attributable to the acquisition of the securities. After initial recognition, a financial institution shall measure AFS securities at their fair values, without any deduction for transaction costs it may incur on sale or other disposal. A gain or loss arising from a change in the fair value of an AFS security shall be recognized

directly in equity under the account "Net Unrealized Gains/(Losses) on Securities Available for Sale" and reflected in the statement of changes in equity, except for impairment losses and foreign exchange gains and losses, until the security is derecognized, at which time the cumulative gain or loss previously recognized in equity shall be recognized in profit or loss. However, interest calculated using the effective interest method is recognized in profit or loss. Dividends on an AFS equity security are recognized in profit or loss when the financial institution's right to receive payment is established.

For the purpose of recognizing foreign exchange gains and losses on a monetary AFS security that is denominated in a foreign currency, it shall be treated as if it were carried at amortized cost in the foreign currency. Accordingly, for such an AFS security, exchange differences resulting from changes in amortized cost are recognized in profit or loss and other changes in carrying amount are recognized directly in equity. For AFS securities that are not monetary items (for example, equity instruments), the gain or loss that is recognized directly in equity includes any related foreign exchange component.

A financial institution shall assess at each time it prepares its financial statements whether there is any objective evidence that an AFS security is impaired.

When a decline in the fair value of an AFS security has been recognized directly in equity and there is objective evidence that the asset is impaired, the cumulative loss that had been recognized directly in equity shall be removed from equity and recognized in profit or loss even though the security has not been derecognized.

The amount of the cumulative loss that is removed from equity and recognized in profit or loss shall be the difference between the acquisition cost (net of any principal repayment and amortization) and current fair value, less any impairment loss on that security previously recognized in profit or loss.

Impairment losses recognized in profit or loss for an investment in an equity instrument classified as AFS shall not be reversed through profit or loss.

If, in a subsequent period, the fair value of a debt instrument classified as AFS increases and the increase can be objectively related to an event occurring after the impairment loss was recognized in profit or loss, the impairment loss shall be reversed, with the amount of the reversal recognized in profit or loss.

c.2. Underwriting Accounts (UA) shall be a sub-account under AFS. These are debt and equity securities purchased which have remained unsold/locked-in from underwriting ventures on a firm basis. UA account is applicable only to universal banks and investment houses.

d. Investments in Non-Marketable Equity Securities (INMES) - These are equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured.

INMES shall be measured upon initial recognition at its fair value plus transaction costs that are directly attributable to the acquisition of the security. After initial recognition, a financial institution shall measure INMES at cost. A gain or loss arising from the change in fair value of the INMES shall be recognized in profit or loss when the security is derecognized or impaired.

A financial institution shall assess at each time it prepares its financial statements whether there is any objective evidence that an INMES is impaired.

If there is objective evidence that an impairment loss has been incurred on an INMES, the amount of impairment loss is measured as the difference between the carrying amount of the security and the estimated future cash flows discounted at the current market rate of return for a similar financial instrument. Such impairment loss shall not be reversed.

For Securities at Fair Value through Profit or Loss and AFS, a financial institution is required to book the mark-to-market valuation on a daily basis. However, a financial institution may opt to book the

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mark-to-market valuation every end of the month: Provided, That an adequate mechanism is in place to determine the daily fair values of securities.

A financial institution shall recognize an investment in debt or equity security on its balance sheet when, and only when, the financial institution becomes a party to the contractual provisions of the financial instrument. A regular way purchase or sale of financial assets shall be recognized and derecognized, as applicable using trade date accounting or settlement date accounting. The method used is applied consistently for all purchases and sale of financial assets that belong to the same category.

Section 4. Reclassifications.

a. A financial institution shall not reclassify a security into or out of the Fair Value through Profit Loss category while it is held.

b. If, as a result of a change in intention or ability, it is no longer appropriate to classify a debt security as HTM, it shall be reclassified as AFS and remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with Section 3.c.1.

c. Whenever sales or reclassifications of more than an insignificant amount of HTM investments do not meet any of the conditions in Section 3.a, any remaining HTM investments shall be reclassified as AFS. On such reclassification, the difference between the carrying amount and fair value shall be accounted for in accordance with Section 3.c.1.

d. If a reliable measure becomes available for an INMES, it shall be reclassified as AFS and remeasured at fair value, and the difference between its carrying amount and the fair value shall be accounted for in accordance with Section 3.c.1.

e. If, as a result of a change in intention or ability, or because the ‘two preceding financial years' referred to in Section 3.a have passed, it becomes appropriate to carry the debt security at amortized cost (i.e, HTM) rather than at fair value (i.e, AFS), the fair value carrying amount of the security on that date becomes its new amortized cost. Any previous gain or loss on that debt security that has been recognized directly in equity in accordance with Section 3.c.1 shall be amortized to profit or loss over the remaining life of the HTM using the effective interest method. Any difference between the new amortized cost and maturity amount shall also be amortized over the remaining life of the security using the effective interest method, similar to the amortization of a premium and a discount. If the security is subsequently impaired, any gain or loss that has been recognized directly in equity is recognized in profit or loss in accordance with Section 3.c.1.

f. If, in the rare circumstance that a reliable measure of fair value is no longer available, it becomes appropriate to carry the equity security at cost (i.e, INMES) rather than at fair value (i.e, AFS), the fair value carrying amount of the security on that date becomes its new cost. Any previous gain or loss on that equity security that has been recognized directly in equity in accordance with Section 3.c.1 shall remain in equity until the security is sold or otherwise disposed of, when it shall be recognized in profit or loss. If the financial asset is subsequently impaired, any previous gain or loss that has been recognized directly in equity is recognized in profit or loss in accordance with Section 3.c.1.

Section 5. Impairment. A debt or equity security is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of event that occurred after the initial recognition of the security (a "loss event") and that loss event has impact on the estimated future cash flows of the securities. Losses expected as a result of future events, no matter how likely, are not recognized. Objective evidence that the security is impaired includes observable data that comes to the attention of the holder of the security about the following loss events:

a. significant financial difficulty of the issuer or obligor;

b. a breach of contract, such as a default or delinquency in interest or principal payments;

c. the financial institution, for economic or legal reasons relating to the issuer's financial difficulty, granting to the issuer a concession that the financial institution would not otherwise consider;

d. it becoming probable that the issuer will enter bankruptcy or other financial reorganization;

e. the disappearance of an active market for that security because of financial difficulties; or

f. observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of securities since the initial recognition of those assets, although the decrease cannot yet be identified with the individual securities in the portfolio, including:

(i) adverse change in the payment status of issuers in the portfolio; or

(ii) national or local economic conditions that correlate with defaults on the securities in the portfolio.

The disappearance of an active market because a financial institution's held securities are no longer publicly traded is not evidence of impairment. A downgrade of an issuer's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. A decline in the fair value of a security below its cost or amortized cost is not necessarily evidence of impairment (for example, a decline in fair value of an investment in debt security that results from an increase in the risk free interest rate).

In addition to the types of events enumerated in items a to f in this Section, objective evidence of impairment for an investment in an equity instrument includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates and indicates that the cost of the investment in the equity instrument may not be recovered. A significant or prolonged decline in the fair value of an investment in an equity security below its cost is also objective evidence of impairment.

Section 6. Operations Manual. The financial institution shall maintain an operations manual for booking and valuation of HTM, Securities at Fair Value through Profit or Loss, AFS and INMES.

Section 7. Penalties and Sanctions. The following penalties and sanctions shall be imposed on financial institutions and concerned officers found to violate the provisions of these regulations:

a. Fines to be imposed on financial institutions for each violation, reckoned from the date the violation was committed up to the date it was corrected:

- P20,000/banking day for universal banks;
- P10,000/banking day for commercial banks;
- P2,000/banking day for thrift banks/non-bank financial institutions; and
- P1,000/banking day for rural and cooperative banks.

b. Sanctions to be imposed on concerned officers:

- First offense - reprimand the officers responsible for the violation; and

- Subsequent offenses - suspension of ninety (90) days without pay for officers responsible for the violation.

This Circular supersedes Circular No. 161 dated 30 March 1998.

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

Adopted: 16 Feb. 2005

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For the Monetary Board:

(Sgd.) RAFAEL B. BUENAVENTURA
Governor

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