BANGKO SENTRAL NG PILIPINAS

OFFICE OF THE DEPUTY GOVERNOR
SUPERVISION AND EXAMINATION SECTOR

MEMORANDUM NO. M-2013-008

To: **ALL BSP SUPERVISED FINANCIAL INSTITUTIONS**

Subject: **Frequently Asked Questions on the Basel III Implementing Guidelines**

1. ***What is Basel III?***

   In December 2010, the Basel Committee on Banking Supervision (BCBS) introduced a set of reforms otherwise known as the Basel III. The standards include strengthening the definition of regulatory capital and the introduction of capital buffers to withstand economic and financial stress, among others. In the Philippines, the Bangko Sentral ng Pilipinas (BSP) released the Basel III Implementing Guidelines on Minimum Capital Requirements in January 2013.

2. ***What are the reform agenda under the Basel III Accord? How will the BSP adopt these proposals?***

   Basel III reforms have introduced new standards in capital adequacy and liquidity. Particularly, it aims to:
   a. Strengthen the instruments that will qualify as "bank capital" to ensure better ability to absorb losses
   b. Introduce buffers that will absorb losses in times of stress (conservation buffer) and across the business cycle (countercyclical buffer)
   c. Introduce a new global standard on liquidity risk management
   d. Allow a non-risk weighted leverage ratio to complement the usual Capital Adequacy Ratio (CAR)
   e. Mandate better transparency of prices (trading of derivatives) and secondary market movements (securitization and re-securitization risk)
   f. Set standards for Systemically Important Financial Institutions (SIFIs).

   The BSP will adopt the Basel III agenda in stages. The first component taken up is the capital standards which is contained in the recently issued Circular No. 781 dated 15 January 2013.

3. ***What would be the new capital requirements?***

   The new guidelines are meant to strengthen the composition of bank capital by increasing the level of core capital which is common equity. Only capital that is available to absorb losses, at all times, qualifies as regulatory capital.

On Minimum Capital requirement

Essentially, the BSP retained the total capital ratio requirement at 10.0%. However, two (2) new ratios are introduced by the Basel III agenda as follows:

a. Common Equity Tier 1 (CET1) which the BSP set at 6.0%; and
b. Tier 1 Capital at 7.5%.

On Capital Conservation Buffer

Aside from raising the quality of capital, the BSP mandates a capital conservation buffer of 2.5% composed of CET1 capital on top of the minimum CET1 requirement. This buffer which banks build up during good times will act as a cushion during periods of stress.

4. *Is the BSP implementing all aspects of the Basel III standards on capital?*

The BSP is fundamentally aligned with the Basel Committee's proposals. However, there are facets which we have set the prudential bar higher either by design or because these are the *de facto* practice today in the Philippines. The BSP will implement a full implementation by 1 January 2014. This includes compliance of capital instruments with the new eligibility criteria, deduction approach on regulatory adjustments and treatment of equity investments in non-financial and non-allied undertakings.

On the Derecognition of Ineligible Capital Instruments

Capital instruments that are not eligible for inclusion in any of the three (3) components of capital will be derecognized from the determination of regulatory capital on 1 January 2014. There are instruments issued as Hybrid Tier 1 or Lower Tier 2 capital under Circular Nos. 709 and 716. These shall be recognized as regulatory capital only until 31 December 2015.

On the Treatment of Regulatory Adjustments

Under the new framework, most of the regulatory adjustments are deducted at the level of CET1 capital. The BSP shall implement these adjustments on a full deduction approach instead of the phase-in approach proposed by the Basel Committee. Please note that most of these already exist under Basel II on a 50:50 deduction against Tier 1 and Tier 2 capital.

On the Treatment of Equity Investments in Non-Financial and Non-Allied Undertakings

Risk-weighting generally creates the same effect as the deduction approach. The latter, however, is a cleaner route as it upholds the notion that capital should not be double-counted. The intention is to deduct all investments in equity securities from the highest form of capital.

5. *When will the BSP's requirements take effect? What are the key dates?*

The reckoning date is 1 January 2014. This includes:

a. Revised classification of capital ratios and the new minimum capital requirements;

b. Full deduction of regulatory adjustments to CET1 capital;
c. Derecognition as qualifying capital of all ineligible capital requirements that have been issued as of 31 December 2010;
d. Implementation of the Capital Conservation Buffer of 2.5%; and
e. Loss absorbency features of capital instruments.

Meanwhile, the grandfathering of existing instruments that have been issued as Hybrid Tier 1 or Lower Tier 2 capital under Circular Nos. 709 and 716 but before Circular No. 768 shall be allowed until 31 December 2015.

6. ***Why did BSP accelerate the implementation of Basel III when compared to the standard timeline of the BCBS?***

The BIS timeline was set up to allow internationally active banks to generate capital through internal growth at the time when the world was still coming out of the 2008-2009 crisis. In contrast, the Philippines does not face the same set of difficulties. Given that, forcing the banks to wait until 2019 to fully implement the capital standards under Basel III would only lead to market uncertainty and would deter productive activity (i.e., banks would have a relatively excessively long period to effect what they could in principle do sooner). Rather than wait then, the BSP decided a 1 January 2014 adoption date.

7. ***Do you see any banks being affected by the shift into Basel III in terms of capital?***

The numbers today tell us that the system as a whole can absorb the transition into Basel III. System CAR as a whole is hovering around 16%-17%. Based on the QIS conducted by the banks themselves, they generally have no difficulties with complying with the new minimum capital requirements. This is likewise supported by simulations done by the BSP.

8. ***Are the other types of banks also adopting the Basel Accords?***

Basel III is applicable only to U/KBs and their subsidiary banks and quasi-banks. Stand-alone thrift banks, rural banks and cooperative banks will continue to be under the Basel 1.5 framework implemented in January 2012. This reflects the BSP view that policy needs to be calibrated across different stakeholders.

However, in issuing instruments which are intended to be counted as part of regulatory capital, all banks regardless of classification shall comply with the new eligibility criteria.

9. ***What is the Capital Conservation Buffer? How does it work?***

The capital conservation buffer is a component of the Basel III framework which literally requires banks to "conserve" earnings and build-up capital. This is for the purpose of having above-the-minimum capital which can be drawn in periods of stress (which are not known in advance).

Universal and Commercial Banks (U/KBs) and their subsidiary banks and quasi-banks are required to set up a Capital Conservation Buffer of 2.5% composed of CET1 capital effective 1 January 2014. Restriction on distributions shall continue to be imposed until the required level of CET1 (> 8.5%) is met.

Restrictions on distributions shall be implemented as follows:

Level of CET 1 capital	Restriction on Distributions
<6.0%	No distribution
6.0%-7.25%	No distribution until more than 7.25% CET1 capital is met
>7.25%-8.5%	50% of earnings may be distributed
>8.5%	No restriction on distribution

The purpose of this buffer is to ensure that banks can maintain capital levels throughout a significant downturn and that they have less discretion to deplete their capital buffers through dividend payments. Banks that do not meet the 2.5% Capital Conservation Buffer will be restricted from paying dividends, buying back shares and paying discretionary employee bonuses in accordance with the above table.

10. Is the Capital Conservation Buffer included in the 10.0% minimum capital ratio?

Yes. Given that the Capital Conservation Buffer is applied on top of the minimum CET1 requirement (i.e., 6.0%), it can be counted as part of the 10.0% minimum capital ratio.

11. What do you mean by loss absorbency feature of capital instruments?

Loss absorbency ensures that capital instruments are in a position to fully absorb losses before any public sector funds are injected and taxpayers are exposed to losses. Effectively, debt instruments are required to be treated similar with equity as far as absorbing losses from operations is concerned.

The loss absorbency requirements are to be included in the contractual terms and conditions of each Additional Tier 1 (AT1) capital and Tier 2 capital instruments for them to be eligible as regulatory capital on 1 January 2014.

However, capital instruments issued under Circular Nos. 709 and 716, which initially did not require the loss absorbency features, shall be provided an added two-year window until 31 December 2015.

12. ***Why equity investments appear in each category of capital as regulatory adjustments?***

    This only means that you need to deduct the investments to the same component of capital for which it would qualify if it was issued by the bank. For instance, an investment in common shares must be deducted from CET1. In case the instrument does not qualify with AT1 and Tier 2 criteria, then it will deducted from CET1.

13. ***Is Circular No. 786 dated 15 February 2013 applicable only to a select group of investors (i.e., residing in the Philippines and non-professional investors, among others)?***

    The requirements provided in Circular 786 (Risk Disclosure Requirements) are applicable to **all** prospective investors in Additional Tier 1 and Tier 2 capital instruments.

14. ***How will the BSP monitor bank's compliance with risk disclosure requirements under Circular No. 786?***

    When requested by the BSP, the issuing bank must be able to present the required documentations. Client suitability tests, written certifications and the risk disclosure statements are usually prepared or undertaken by the underwriter/arranger or selling agents (collectively termed as other parties). However, the issuing bank may require the other parties involved to provide them with these documents. This can be explicitly included in the service contracts between the issuing bank and other parties concerned. Even in subsequent negotiations, this process is still applicable.

For information and guidance.

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05 March 2013