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

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

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

(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, 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.

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: