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Financial Reporting Package : Enhancing Banking Statistics

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ABSTRACT

The adoption of the Philippine Financial Reporting Standards/ Philippine Accounting Standards is considered as one of the major reforms in the financial industry. It involved an extensive reform process with far-reaching implications on the policies, system and financial reporting of institutions.

The necessary infrastructure to migrate to the new standards is the revision of the Manual of Account (MOA) and the reportorial requirements for banks. It is in this view that the Financial Reporting Package (FRP) was developed and issued under Circular No : 512 dated February 3, 2006. The FRP was designed primarily to comply with the provisions of the PFRS/ PAS, to provide the reportorial platform for the adoption of the simple approaches of the Basel 2 framework, and to serve the various data requirements of the BSP.

The paper lays out differences in terms of the information contained in the old MOA and the new FRP. The FRP provides different dimensions to the reported transactions, which is deemed to enhance banking statistics. The basic structure of the FRP is to report transaction based on the bank's counterparty and such information will then be plotted against matrices serving different statistical requirements. Further, the FRP requires disclosure of information that would be used to generate reports that are currently submitted separately and to validate collected from other sources.

I. Introduction

The Bangko Sentral ng Pilipinas' (BSP) shift to risk-based supervision entails a reliance on prudential reports. The various reports submitted to the BSP enable supervisory personnel to assess the performance as well as the potential risks of individual banks. This way, these reports are quite valuable in tailor-fitting the on-site examination approach and focus for each bank.

On the other hand, aside from supervision of individual banks, it is also the BSP's mission to bring about a strong banking system that would support a sustainable economic growth. Towards this end, the BSP is also monitoring macro-prudential indicators that give light as to the current state of health of the financial system and its potential vulnerabilities. Most of these macro-prudential indicators are derived by aggregating indicators of the health of individual banking institutions, which are in turn derived from banks' prudential reports.

Hence, there is a distinct advantage to design the prudential reports such that it would also be responsive to the needs of macro-prudential monitoring. However, prudential reports are influenced by accounting standards while macro-prudential reports have to meet

statistical standards. Harmonization of the two standards to the fullest extent possible should therefore be a supervisory goal.

The BSP's implementation of the Financial Reporting Package (FRP) is a huge step towards this goal. This paper describes the revisions introduced into the FRP to accommodate the needs of the various uses and users of the reports. Section 2 talks about the adoption of the new accounting standards that triggered the implementation of the FRP. Section 3 and Section 4 describes the new and the old reportorial requirements, respectively. Section 5 discusses in detail the features of the FRP that enhanced banking statistics. Section 6 concludes.

II. The new accounting standards and the FRP

The Philippine Financial Reporting Standards (PFRS)/Philippine Accounting Standards (PAS) is the new set of accounting standards issued by the Financial Reporting Standards Council¹, which shall govern the preparation of financial statements. These standards are patterned after the revised International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS) issued by the International Accounting Standards Board (IASB). The Bangko Sentral ng Pilipinas (BSP) pronounced its adoption of the PFRS/PAS effective the annual financial statements beginning 1 January 2005 in its Memorandum to All Banks and Other BSP Supervised Financial Institutions dated 11 January 2005.

The basic infrastructure on the adoption of the new accounting standards are the revised Manual of Accounts (MOA) and reportorial framework that would be able to capture the extent of change introduced by PFRS/PAS. Towards this end, the BSP designed a reportorial framework that addresses not only the concerns in respect of the adoption of PFRS/PAS but also captures the information requirements for both supervisory and macro-prudential purposes. The FRP serves as the platform that integrates the information requirements of the BSP.

III. The Financial Reporting Package

The FRP was issued under BSP Circular No. 512 dated 3 February 2006, as amended. It is composed of the new MOA for banks, the reportorial template and the line

¹ Formerly Accounting Standards Council

item instructions to accomplish the report. All banks are required to submit the said report on solo basis and if applicable, on consolidated basis as well. The former refers to the combined financial statements of the head office and its branches/other offices, while the latter refers to the combined financial statements of the parent bank and its financial allied subsidiaries, except insurance companies, consolidated on a line-by-line basis. This is the first time that the BSP required banks to submit their financial statements on a consolidated basis, which is seen as a tool in strengthening its consolidated approach to supervision as well as its macro-prudential monitoring.

The FRP reflects the two sets of books maintained by banks, namely: (1) the regular books, comprising of the peso and foreign regular accounts; and (2) the FCDU books for foreign currency transactions authorized under Circular No. 1389 dated 13 April 1993, as amended.

The FRP is composed of two main reports, which are the balance sheet and the income statement and 75 sets of supporting schedules. The supporting schedules in the FRP provide the breakdown for specific balance sheet and income statement accounts, which generally require classification of transactions reported based on the counterparties of the reporting bank, broadly grouped as to residents and non-residents. The supporting schedules of the FRP also capture different perspectives of the transactions because the counterparty breakdown is plotted against different matrices relevant to the account. The supporting schedules likewise have an “additional Information” section, which requires disclosure of data necessary for validating bank’s compliance with the prescribed regulatory limits and other statistical requirements of the BSP.

General Guidelines in the Preparation of the FRP

Banks are required to adopt the provisions of PFRS/PAS in all respect in preparing the FRP, except in the following cases: (1) in preparing consolidated financial statements, only financial allied subsidiaries, except insurance companies, shall be consolidated with the financial statements of the parent bank on a line-by-line basis. Non-financial allied subsidiaries and insurance subsidiaries shall be accounted for using the equity method; and (2) the BSP recommended provisioning for loans and receivables should be met.

The former was required to facilitate BSP’s assessment of the financial industry, thus only financial institutions with the same risk profile are consolidated (on a line-by-line basis)

with the financial statements of the parent bank. On the other hand, the latter was prescribed because the BSP recommended provisioning is deemed to be more prudent than the impairment provisioning required under PAS 39 because it covers both incurred and expected losses, in contrast with only the incurred loss concept of the standard.

IV. CSOC and CSIE

The Consolidated Statement of Condition (CSOC) and the Consolidated Statement of Income and Expense (CSIE) are the old reportorial requirements that shall be replaced by the FRP upon its live implementation. The general structure of the CSOC is similar to that of the FRP, which requires reporting of transactions under the regular and the FCDU books. The CSIE, on the other hand, does not have the same framework as it only requires reporting of the income and expense accounts under the FCDU books and the aggregate amount of income and expense under the two books.

The two-book framework was likewise not consistently adopted for all the supporting schedules of the CSOC and CSIE as some only required reporting the aggregate amount under the two books. Moreover, the design of the supporting schedules for the select accounts in the CSOC and CSIE does not follow a consistent reporting format, e.g., counterparty classification is only required for the following accounts: Due from Other Banks, debt securities booked under different categories, Loan Portfolio, Deposit Liabilities and Bills Payable.

V. Areas of Enhancement in Banking Statistics

The FRP required reporting of information using the counterparty-based format in all its supporting schedules. Further, said report aims to capture information that were not previously gathered in the CSOC and CSIE. The following is a discussion on the enhancements in banking statistics with the adoption of the FRP, both from the supervisory and macro-prudential³ perspectives. These enhancements shall be described from two points – those arising from the improvement in the general structure of the report, and those that are unique to certain financial asset accounts.

³ The macro prudential statistical requirements referred to in this paper are based on the Financial Soundness Indicators (FSI) Compilation Guide of the International Monetary Fund (IMF).

Structure of the Report

- *Counterparty Classification of Transactions*

As discussed in the preceding section, the supporting schedules in the FRP require classification of reported transactions based on the banks' counterparties. In the case of debt or equity securities, counterparties pertain to the issuer of said instruments. This framework enables the BSP to evaluate on an aggregate basis the exposure of the banking system to the different groups of counterparties – from the National Government to individuals for resident counterparties, and from Central Governments/Central Banks in other jurisdictions to non-resident individuals. Moreover, for selected supporting schedules, the geographical regions of non-resident counterparties were required to be disclosed which allows assessment of the impact of any adverse event⁴ in those regions in the domestic banking industry.

Classifying by counterparty, in addition to classifying the loan portfolio into the various economic sectors, likewise supply critical information on the extent of exposure of the banking industry to a particular counterparty group or sector of the economy. As Evans, et. al. (2000) have explained, "Many financial crises in the past (including the Asian crises) have been caused or amplified by downturns in particular sectors of the economy spilling over into financial system via concentrated loan books of financial institutions."

Moreover, the adoption of the same format for deposit accounts would generally give an estimate of the total amount of stable deposits in the banking industry. The Financial Soundness Indicators (FSI) Compilation Guide of the International Monetary Fund (IMF) recommends that the "type of depositor be the primary factor in defining customer deposits because of both its relevance and general applicability." Under the guide, deposits placed by other deposit takers and other financial corporations are more prone to shift as risks increase. These depositor sub-classifications are all provided for in the FRP.

From a supervisory perspective, classification by counterparty facilitates the assessment of the risk profile of the reporting bank, hence, enabling the supervisors to assess adequacy of the reporting bank's current capital level vis-à-vis its risk exposure. Moreover, similar to the macro-prudential concern, concentration of exposure of the

⁴ Financial Soundness Indicators (FSI) Compilation Guide (2006). International Monetary Fund (IMF).

reporting bank to a particular counterparty or sector may indicate red flags in its operations particularly in the event of financial weaknesses in the concerned counterparty or sector.

- *Classification of Financial Assets*

The FSI Compilation Guide classifies financial assets by functional type such as loans, equities, securities and derivatives. In contrast, the classification of financial assets in the FRP is generally based on the intention of the reporting bank for holding them, which is consistent with the provisions of PAS 39.

However, the FRP's detailed sub-categorization of accounts per classification of financial asset satisfies the functional type grouping required by the Guide. An example of which is further sub-classifying into debt, equity and derivatives the financial instruments that are held for trading.

The more detailed account classification provided in the FRP allows a more thorough analysis on the type of exposure of financial institutions to a particular counterparty.

- *Original Maturity and Residual Maturity*

The FRP captures the maturity of financial assets and liabilities on two fronts: First, as part of the "Additional Information Section" of the supporting schedules wherein banks are requested to classify financial instruments based on the original term of the account; and Second, as a separate schedule in the FRP, where banks are required to report the residual maturity of the financial instruments.

Disclosing the original and residual maturity of financial instruments is aimed at determining the liquidity of the banking system and the reporting financial institution, respectively. From a macro-prudential standpoint, original maturity indicates whether funds were raised in the short-term or long-term market, while from a supervisory view, residual maturity shows the liquidity profile of the reporting bank⁵.

⁵ FSI Compilation Guide (2006). IMF.

- *Income and Expense Accounts*

The information that may be generated from the FRP in respect of income and expense account will give the BSP a better hand in evaluating the earnings performance of each bank and the entire banking system.

Interest Related Income and Expense Accounts

Unlike in the old CSIE where banks are only required to provide in detail the interest income from loan portfolio accounts, the FRP requires dissection of the interest income account also for debt instruments classified under the different categories provided. In this regard, the levels of breakdown of interest income shall start from the account classification, sub-classified as to the counterparty of the reporting bank and further sub-classified as to the type of instrument accruing the interest, i.e., debt security or derivatives.

This marked improvement in the breakdown of interest income would lead to a more thorough analysis of the sources of interest income and it would also reflect the strategies employed by the bank particularly if there was a shift in the use of its funds from granting loans to investing in securities. The same format is required for interest expense accounts of the reporting bank.

Non-interest Related Gains/Losses from Financial Assets

Another source of gains and losses that was given an equal importance in the FRP is that arising from trading activities. The realized and unrealized gains/losses from trading activities of the bank have been provided with adequate breakdown, which would allow the BSP to assess the types of instruments that the bank is trading and its effect in the bottom-line figure. Further, gains/losses from selling financial assets that are not part of the trading activities of the bank are also captured in the report in the same breadth of details as that of interest income and expense.

The importance of capturing the unrealized gains and losses from financial assets is highlighted in the FSI Compilation Guide wherein it cited that “understanding the causes of volatility in the return on capital and observing trend over time provides a more robust basis for macro-prudential analysis.”

Other Income and Expense Accounts

The FRP also captures other sources of income of the bank such as fees and commission, which requires breakdown based on the type of services performed by the bank such as payment services, intermediation services, custodianship, underwriting and securities dealership, securitization activities, income from fiduciary activities and other services. On the other overhead expenses incurred by the bank, such as compensation and fringe benefits, other administrative expenses, and depreciation/amortization expense, sufficient details are also provided.

These breakdown would enable the BSP to assess the ratio of the banking system's other sources of income and overhead expenses relative to the total income earned by the industry. On an individual bank basis, this would indicate any shift from interest-based to fee-based banking activities.

- *Additional Information Section*

The objectives of the additional information section are: (1) to extract balances of accounts that are inputs to generate the other reportorial requirements of the BSP; (2) to validate the amounts reported in other prudential reports; and (3) to generate statistics for macro-prudential purposes.

Examples of reports that may be generated from the FRP are the FCDU foreign currency cover requirements, derivatives exposure, and the investments in the equity of subsidiaries, associates and joint ventures. As for the second objective of the "Additional Information Section", a number of reports may be cross-validated with the FRP such as, among others, the report on the Capital Adequacy Ratio (CAR) of banks and Agri-Agra. In respect of the third objective, the FRP may be used to generate other statistical requirements of the IMF's FSI.

Financial Asset Accounts

The focus here is on account specific information requirements that are considered as milestones in prudential reporting. The enhancements that shall be discussed are those that are unique to financial assets categories.

- *Repurchase and Securities Lending and Borrowing Transactions*

Repurchase and securities lending and borrowing transactions are treated as collateralized borrowing, which is consistent with their accounting treatment under PAS 39. In this regard, the party selling/lending the securities shall not derecognize the subject securities from its books.

Securities booked under the Held for Trading (HFT), Available for Sale (AFS), or Held to Maturity (HTM) categories may be the subject of repurchase and securities lending and borrowing transactions. The FRP provided a separate schedule for each of the categories mentioned above, which requires banks to disclose the types of securities that were sold/lent. Under said schedule, banks would breakdown its current balance of securities per category to those that are held by the bank but sold under repurchase agreement, those that are lent under securities lending and borrowing agreements, those that are sold under certificates of assignment participation with recourse, and those that are not used under any of the said purposes.

This requirement, if evaluated on an aggregate basis, would reflect the liquidity in the banking system as it shows the increase in the pool of securities that are available in the market. If used to assess an individual bank as seller/lender of securities, this requirement could either reflect a means to source additional funding for the bank's operations, if it is a repurchase transaction, or as an alternative source of profit, in the case of securities lending and borrowing transactions.

From the other end of the transaction, which is from the buyer/borrower of securities or lender of cash, the FRP requires banks to record the amount extended according to its counterparty. Moreover, a separate matrix requires the reporting bank to plot the amount extended to its counterparty against the type of security received as collateral, showing the quality of collateral accepted for the loan.

- *Status of Accounts*

The AFS, HTM and Unquoted Debt Securities Classified as Loans (UDSCL) categories, each has a separate supporting schedule that requires plotting the securities held against a counterparty-account status matrix. This matrix requires banks to decompose its financial asset account balance per counterparty and further break it down as to the status and age of the account.

Financial assets may fall under any of the following status: (1) unimpaired and not in past due status; (2) past due but not impaired; and (3) impaired. Accounts that are past due but not impaired are further required to be sub-classified according to the age of the account. It is worth mentioning that this particular matrix follows the definition of impaired accounts under PAS 39, in which case, past due accounts do not necessarily translate to impairment. Moreover, the schedule likewise requires banks to report the specific allowance for the impaired accounts and the fair value of any collateral or credit enhancement received as security for the exposure, thereby reflecting the net exposure of the bank to a specific counterparty as of the reporting date.

Further, although the BSP requires banks to meet the BSP recommended provisioning, the same schedule as above is likewise required for the loans and receivables account. This is in order to facilitate comparison of the provisioning requirements under PAS 39 and the BSP loan classification buckets⁶. Moreover, this would provide a different perspective in analyzing the industry and the individual banks' non-performing loans ratio because, as discussed above, the total non-performing loans per BSP definition is not equal to the impaired accounts per PAS 39 definition.

- *Movements in Allowances for Credit Losses*

Setting-up of provisions has been used in certain cases as a scheme to manage earnings, wherein a bank may defer booking of provisions to show a better result of operations or booking excessive provisions in the current year and reversing a substantial amount of which in the succeeding reporting period.

A schedule in the FRP requires disclosure of the movement in the allowance account thereby showing the adjustments made by the banks in the said account from booking additional provisions to reversals made, if any. The said schedule likewise captures any direct charge-offs in the account, which did not pass through the allowance account.

This information is seen to enhance the analysis of the level of non-performing loans in the industry and on a per bank basis. Moreover, this would give BSP a general idea on the policies of each bank's management in providing allowance or in writing-off loan accounts.

⁶ Loan classification buckets under existing regulations that attract provisions: Special Mention, Substandard, Doubtful and Loss.

- *Derivatives*

Before the adoption of the new accounting standards, derivative transactions are only reported as part of the “off-balance sheet items” and only the notional amounts of the contracts are disclosed. This accounting treatment has changed with the adoption of PAS 39, which requires recording “on-books” the fair value of said instruments.

Derivatives may either be held for trading and booked under the HFT category or used as hedging instruments and booked under Derivatives with Positive/Negative fair Value Held for Hedging. Under both cases, derivatives are measured at fair value and recorded on balance sheet. The changes in fair value of the instruments are recorded in the income statement or in the equity section of the balance sheet, if it was used as a hedging instrument in a cash flow hedge.

The FRP captures different dimensions of derivatives transactions, which are adopted for both accounts capturing these financial instruments. The notional amounts of outstanding derivatives contracts are disclosed off-balance sheet while the fair values are recorded on-balance sheet.

Generally, derivatives transactions are required to be classified as to stand-alone contracts or embedded in host contracts. Each of these broad classifications is further sub-categorized based on the underlying, i.e. interest rate, foreign exchange and equity. Each underlying is broken down as to the type of derivatives contract entered into by the reporting bank such as forwards, swaps, options and futures and each type of derivative contract is further sub-classified based on the position held by the reporting bank, e.g. as a fixed interest receiver in a plain vanilla interest rate swap or as a call option buyer in over the counter foreign exchange option contracts.

A separate classification for credit derivatives is likewise provided in the report, capturing whether the reporting bank is the protection seller or the protection buyer.

In respect of derivatives that are used as hedging instruments, apart from the breadth of details and sub-classification required in the preceding paragraph, banks are also required to categorize the instrument as to the type of hedging transaction, i.e., fair value hedge, cash flow hedge or hedge of a net investment in a foreign operation.

Derivatives transactions, which value is more volatile than cash positions, could potentially result in large losses for banks. Thus, explicit recognition of derivatives transactions in banks' balance sheets could provide a more accurate picture of banks' risk exposure. From a macro-prudential standpoint, detailed information on system-wide derivatives transactions would help assess the system's vulnerability to the underlying markets (i.e., credit, FX, interest rate markets).

VI. Concluding Remarks

One of the recommendations of Evans, et. al. (2000) is that "supervisory agencies take upon themselves the responsibility for the collection, compilation and dissemination of data on banks to meet the needs of users." These data should be on solo and consolidated basis and should include key indicators of capital, asset quality, earnings and liquidity. The FRP provides the mechanism by which BSP can accomplish this responsibility.

Although its design is driven primarily by changes in the accounting standards, it also includes features that render the report useful not only for supervisory purposes but also for macro-prudential monitoring. Deriving from a single report information used for multiple purposes would hopefully reduce the extent of confusion among the different users of banking data.

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