Criteria for Designating Domestic Systemically Important Banks (D-SIBs)

Large financial institutions whose failure could pose systemic risks to the financial sector would not only threaten financial stability but could cause disruptions to the broader economy. These banks, often labelled as "too big to fail," are characterised by their size, complexity, interconnectedness, and lack of available substitutes. This designation leads to potential negative consequences for the financial system, as it may encourage banks to take excessive risks with the assumption of government support in a crisis. This expectation creates what is known as **moral hazard**, weakening market discipline, distorting competition, and increasing the risk of future financial instability. Thus, the Domestic Systemically Important Banks (D-SIBs) classification framework for Sri Lanka is designed to introduce criteria for designating such entities and thereby enabling enhanced supervision.

In alignment with the Basel Committee on Banking Supervision (BCBS) principles, the primary goal of designating D-SIBs is to reduce the likelihood of failure of systemically important banks by requiring them to maintain higher capital buffers and incentivising them to reduce their systemic impact. This approach aims to strengthen the resilience of Sri Lanka's financial system and safeguard depositor funds.

Key Components of the Designation

1. **Assessment of Systemic Importance:** The criteria are based on a data-driven approach to assess domestic banks based on four categories: **size**, **interconnectedness**, **substitutability**, and **complexity**.
    - **Size:** Measures total exposures, with larger banks seen as having greater potential for economic disruption in the event of failure.
    - **Interconnectedness:** Evaluates a bank's linkages with other financial institutions, with highly interconnected banks carrying greater systemic risk.
    - **Substitutability:** Assesses how easily a bank’s role or services can be replaced, especially if they support critical functions or infrastructure.
    - **Complexity:** Considers the intricacy of a bank’s operations, including cross-jurisdictional claims and liabilities, which complicate crisis management and resolution.

2. **Data Collection and Scoring:** Each bank's score for these indicators is calculated based on its proportion of total activity in the market. The scores for each category are then aggregated to determine an overall score. Banks are grouped into **buckets** based on their systemic importance, with each bucket having progressively higher capital requirements. Scores may be adjusted at the discretion of supervisors in exceptional cases.

3. **Inclusion and Disclosure:** Banks are required to disclose relevant information if they meet certain criteria, such as exceeding a Leverage Ratio exposure threshold of Rs. 500 billion. These disclosures include 11 high-level indicators used in the assessment, reported annually in their **Annual Reports** or on their websites. Banks designated as D-SIBs in previous assessments or added due to supervisory discretion must also comply with disclosure requirements.

4. **Supervisory Judgement and Ancillary Indicators:** Supervisors retain the ability to adjust a bank's score based on **quantitative and qualitative factors** not fully captured in the indicator-based assessment. Ancillary indicators may be used to support these adjustments, ensuring that the assessment reflects the full scope of each bank's systemic risk.

5. **Periodic Review and Operational Timeline:** To ensure relevance, these criteria will undergo a review every three years, incorporating updates from BCBS as needed. The designation is set to take effect on **17th April, 2025**, with regular D-SIB assessments conducted in accordance with the updated guidelines.

The designation of D-SIBs aims to reduce the risk of systemic disruptions by holding D-SIBs to a higher standard, thus bolstering the resilience of the Sri Lankan financial sector and protecting the economy against the fallout of potential bank failures.

Central Bank's Rules and Directions in this regard are available at:

https://www.cbsl.gov.lk/en/laws/directions-circulars-guidelines-for-banks