MONETARY BOARD
CENTRAL BANK OF SRI LANKA

28 **December 2018** **BANKING ACT DIRECTIONS** **No. 12 of 2018**

LEVERAGE RATIO UNDER BASEL III FOR LICENSED COMMERCIAL BANKS AND LICENSED SPECIALISED BANKS

In terms of the powers conferred by Sections 46(1) and 76(J)(1) of the Banking Act No. 30 of 1988, as amended, the Monetary Board issues these Directions for the implementation of Leverage Ratio under Basel III for licensed commercial banks and licensed specialised banks (hereinafter referred to as licensed banks) in accordance with "Basel III: Finalising post-crisis reforms" issued by the Basel Committee on Banking Supervision in December 2017. The aim of these Directions is to introduce a framework with a simple, transparent, non-risk based Leverage Ratio to act as a credible supplementary measure to the risk based capital requirement in order to restrict the build-up of leverage in the banking sector, helping to avoid any destabilising deleveraging processes which can damage the broader financial system and the economy, and reinforce the risk-based requirements with a simple, non-risk based "backstop" measure.

1. **Empowerment**

1.1 In terms of Sections 46(1) and 76J(1) of the Banking Act, in order to ensure the soundness of the banking system, the Monetary Board is empowered to issue Directions to all or any licensed bank, regarding the manner in which any aspect of the business of such bank or banks is to be conducted.

2. **Scope of Application**

2.1 These Directions shall be applicable to every licensed bank:

(a) incorporated in Sri Lanka on a solo and consolidated basis; and

(b) branches of banks incorporated or established outside Sri Lanka on a standalone basis.

3. **Leverage Ratio Computation**

3.1 Commencing 1 January 2019, the minimum Leverage Ratio for licensed banks shall be 3 per cent.

3.2 Leverage Ratio shall be computed as prescribed below:

$$\text{Leverage Ratio} = \frac{\text{Capital Measure}}{\text{Exposure Measure}}$$

3.3 The Leverage Ratio to be calculated on a quarterly basis.

4. **Capital Measure**

4.1 Licensed banks shall use Tier 1 capital (after deductions) as specified in the Banking Act Directions No. 01 of 2016 on Capital Requirements under Basel III as Capital measure for Leverage Ratio computation.

5. **Exposure Measure**

5.1 The exposure measure is computed as follows:

Exposure Measure = On balance sheet exposures (excluding on-balance sheet derivative and Securities Financing Transaction exposures) + Derivative exposures + Securities Financing Transactions exposures + Off balance Sheet exposures

5.2 Licensed banks shall not take account of physical or financial collateral, guarantees or other credit risk mitigation techniques in calculating the exposure measure.

5.3 To ensure consistency, any item deducted from Tier 1 capital according to the Basel III framework and regulatory adjustments other than those related to liabilities shall be deducted from the exposure measure.

5.4 Guidance on calculation of exposure measure is in Schedule I hereto.

6. **Steps to Secure Compliance**

6.1 Where a licensed bank has failed to comply with the minimum Leverage Ratio, such bank shall not pay dividends or repatriate profits or adopt any other measure that will further deteriorate the regulatory capital position of the licensed bank until such compliance is effected and confirmed by the Director of Bank Supervision.

7. **Disclosure Requirements**

7.1 The disclosure requirements prescribed in the Banking Act Directions No. 01 of 2016 on Capital Requirements under Basel III shall be applicable in respect of Leverage Ratio.

8. **Regulatory Reporting**

8.1 Every licensed bank shall report the Leverage Ratio as at the last calendar day of each quarter through the web-based off-site surveillance system via the quarterly return (BSD-QF-36-LR and BSD-QF-36-EM) within one month after the end of each quarter.

Dr. Indrajit Coomaraswamy
Chairman of the Monetary Board and
Governor of the Central Bank of Sri Lanka

Banking Act Directions No.12 of 2018

Leverage Ratio under Basel III

for Licensed Commercial Banks and Licensed Specialised Banks

SCHEDULE I

Calculation of Exposure Measure of Leverage Ratio under Basel III

1 On-Balance Sheet Exposures

1.1 The on-balance sheet values included in the exposure measure must be in line with the reported values under the regulatory reporting balance sheet except for derivative assets and securities financing transactions (SFT).

1.2 The on-balance sheet assets deducted from Tier 1 capital should be deducted from the exposure measure, which ensures that Tier 1 capital and the leverage ratio exposure measure are treated consistently and therefore, avoids double-counting.

1.3 Netting of loans and deposits are not allowed.

1.4 The basis for leverage ratio exposure measure for cash pooling arrangements should be the single account balance and not the individual participating customer accounts. Cash pooling refers to arrangements involving treasury products whereby a bank combines the credit and/or debit balances of a several accounts of an individual or a group into a single account balance to facilitate cash and/or liquidity management.

2 Derivative Exposures

2.1 Licensed banks shall calculate the amount to be included in the exposure measure for each derivative transaction separately as follows:

$$\text{Derivative Exposure} = \alpha \times (RC + PFE)$$

α = Alpha is set at 1.4

RC = Replacement Cost

PFE = Potential Future Exposure over the remaining life of the contract

2.2 **Replacement Cost (RC)**

RC of a transaction is the positive mark to market value of the contract:

$$RC = \max \{(V - CVMr) + CVMp; 0\}$$

V = Market value of the individual derivative transaction or of the derivative transactions in a netting set

CVMr = Cash Variation Margin (CVM) received by the bank

CVMp = CVM provided by the bank

2.3 **Potential Future Exposure (PFE)**

(a) PFE represents an 'Add-On' arising from the potential exposure over the remaining life of the contract.

$$PFE = Multiplier \times Add\ on\ Aggregate$$

(b) Multiplier is fixed at one.

(c) Add-on Aggregate is calculated by multiplying the notional principal amount of the contract from potential add on factor given in Table 1.

(d) The following Add-on factors will apply to financial derivative contracts based on the residual maturity.

Table 1 – Add on Factors for Financial Derivatives

Residual Maturity	Add-on Factors		
	Interest Rate	Exchange Rate	Other
One year or less	0%	1%	10%
Over one year to five years	0.5%	5%	12%
Over five years	1.5%	7.5%	15%

(e) For contracts with multiple exchanges of notional principal, the notional principal amounts are to be multiplied by the number of remaining payments in the contract.

(f) No PFE shall be calculated for single currency floating swaps / floating interest rate swaps.

(g) For exchange rate and interest rate hybrid products, e PFE must be calculated by adding the applicable two respective Add-on factors.

3 Securities Financing Transaction

3.1 SFTs are transactions such as repurchase agreements, reverse repurchase agreements, security lending and borrowing and margin lending transactions, where the value of the transactions depends on market valuations.

3.2 Exposure Measure for SFT are calculated as follows:

(a) When a bank acts as a principal

SFT Exposure = Gross SFT Assets + max $\{0, [\Sigma(Ei) - \Sigma(Ci)]\}$

(b) When a bank acts as an agent

SFT Exposure = max {0, [Σ(Ei) – Σ(Ci)]}

Ei = total fair value of securities and cash lent to a counterparty for all transactions included

Ci = total fair value of cash and securities received from the counterparty for all transactions

3.3 The gross SFT assets must be adjusted as follows:

(a) Exclude the value of any securities received under a SFT, where the bank has recognised the securities as an asset on the balance sheet, and

(b) Cash payables and cash receivables in SFTs with the same counterparty may be measured net if all the following criteria are met:

(i) Transactions have the same explicit final settlement date.

(ii) The right to set off the amount owed to the counterparty with the amount owed by the counterparty is legally enforceable both in the normal course of business and in the event of default, insolvency and bankruptcy.

(iii) The counterparties intend to settle net, settle simultaneously, or the transactions are subject to a settlement mechanism that results in the functional equivalent of net settlement.

3.4 Bilateral Netting for SFTs (Applicable to counterparty exposure[1])

(a) With respect to a netting set of SFTs subject to a valid bilateral netting agreement referred in item 6 below, the current exposure for the netting set is calculated as the greater of the current market value of securities and cash provided to a counterparty under the SFTs less the current market value of securities and cash received from the counterparty under the SFTs and zero.

(b) For purpose of the current exposure calculation for SFTs, only the effects of a valid bilateral netting agreement will be recognized. Where no valid bilateral netting agreement is in place, each individual SFT must be treated individually.

3.5 SFT Exposure:

(a) If a bank acts as an agent in respect of an SFT (or a portfolio of SFTs) entered into by a customer of the bank and the bank provides an indemnity or guarantee

[1] max {0, [Σ(Ei) – Σ(Ci)]}

to the customer for any difference between the value of the security or cash provided by the customer under the SFT and the value of security or cash received by the customer, the bank will only be required to calculate its current exposure using the given formula, as in paragraph 3.2 (b).

(b) If, however, a bank's exposure in respect of SFT goes beyond an indemnity or a guarantee for the difference in value between the assets provided and received and includes exposure to the underlying cash or securities in the SFT, the bank will need to calculate its SFT exposure as the bank is acting as principal. This would be the case where a bank manages collateral received in connection with an SFT for its own account rather than for the customer's account.

4 Off Balance Sheet Exposures (OBS)

4.1 OBS exposures considered shall be the value after applying Credit Conversion Factors (CCF) specified under the Banking Act Directions No. 01 of 2016 on Capital Requirements under Basel III excluding any items considered as derivative exposures or SFT.

4.2 In calculating OBS exposures, any provisions in respect of OBS, if any, shall be deducted from OBS exposures after the application of the relevant CCF.

5 Conditions for Eligible Cash Variation Margins

5.1 In calculating derivative exposure measure, the cash portion of variation margin exchanged between counterparties may be viewed as a form of pre-settlement payment, if the following conditions are met:

(a) Cash variation margin (CVM) would satisfy the non-segregation criterion if the recipient counterparty has no restrictions by law, regulation, or any agreement with the counterparty on the ability to use the cash received.

(b) Variation margin is calculated and exchanged at least daily, based on mark-to-market valuation of derivative positions. The cash variation margin is received in the same currency as the currency of settlement of the derivative contract.

(c) Variation margin exchanged is the full amount that would be necessary to fully extinguish the mark to market exposure of the derivative subject to the threshold and minimum transfer amounts applicable to the counterparty.

(d) Derivative transactions and variation margins are covered by a single master netting agreement (MNA) between the legal entities that are the counterparties in the derivatives transaction. The MNA must explicitly stipulate that the counterparties agree to settle net of any payment obligations covered by such a netting agreement, taking into account of any variation margin received or provided if a credit event occurs involving either counterparty.

5.2 If the conditions in paragraph 5.1 above are met following adjustments shall be carried out.

(a) In the case of CVMr, the receiving bank may reduce the RC (but not the PFE component) of the exposure amount of the derivative by the amount of cash received if the positive mark-to-market value of the derivative contract(s) has not already been reduced by the same amount of CVMr under the reporting requirements.

(b) In the case of CVMp, the posting bank may deduct the resulting receivable from its Leverage Ratio exposure measure and instead include the CVMp in the calculation of the derivative RC.

6 Bilateral Netting

6.1 For purposes of the Leverage Ratio, a bilateral netting agreement is considered valid if the following criteria are met:

a) The agreement is in writing.

b) The agreement creates a single legal obligation for all individual contracts covered by the agreement and the bank would have a single claim or obligation to receive or pay only the net amount of the sum of the positive and negative mark-to-market values of the individual contracts covered by the agreement in the event that a counterparty to the agreement, or a counterparty to whom the agreement has been validly assigned, fails to comply with any obligation under the agreement due to default, insolvency, bankruptcy, or similar circumstance.

c) The licensed bank has been given independent legal advice in writing to the effect that in the event of a challenge in a court of law, including a challenge resulting from default, insolvency, bankruptcy, or similar circumstance, the relevant court or administrative authority would find the banks' exposure to be the net amount under:

(i) The law of the jurisdiction in which the counterparty is incorporated or the equivalent location in the case of non-corporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located.

(ii) The law which governs the individual contracts covered by the agreement.

(iii) The law which governs the agreement.

d) The bank manages the transactions covered by the agreement on a net basis.

e) The bank maintains documentation adequate to support the netting of the contracts covered by the agreement.

f) The agreement is not subject to a provision that permits the non-defaulting counterparty to make only limited payment or no payment at all, to the defaulter or the state of the defaulter, regardless of whether or not the defaulter is a net creditor under the agreement.

Reporting Formats for Leverage Ratio

Part I – Computation of Leverage Ratio

Web Based Return Code	Item	Bank Only	Consolidated
		Amount (Rs. 000)	Amount (Rs. 000)
36.1.1.0.0.0	**Tier 1 Capital After Adjustments**		
36.1.2.0.0.0	**Exposure Measure**		
36.1.3.0.0.0	**Leverage Ratio**		

Part II – Computation of Exposure Measure

Web Based Return Code	Item	Bank Only	Consolidated
		Amount (Rs. 000)	Amount (Rs. 000)
36.2.1.0.0.0	**Exposure Measure**		
36.2.1.1.0.0	**On Balance Sheet Exposures**		
36.2.1.1.1.0	On-balance sheet Assets (excluding derivatives and SFTs)		
36.2.1.1.2.0	Asset amounts adjusted in determining Basel III Tier 1 capital		
36.2.1.2.0.0	**Derivative Exposures**		
36.2.1.2.1.0	Replacement cost associated with all derivatives transactions		
36.2.1.2.2.0	Add-on amounts for PFE associated with all derivatives transactions		
36.2.1.2.3.0	Alpha	1.4	1.4
36.2.1.3.0.0	**Securities Financing Transaction (SFT) Exposures**		
36.2.1.3.1.0	Gross SFT assets		
36.2.1.3.2.0	Counterparty credit risk exposure for SFT assets where a bank acts as a principal		
36.2.1.3.3.0	Agent transaction exposures		
36.2.1.4.0.0	**Other Off-Balance Sheet Exposures**		
36.2.1.4.1.0	Exposures with a 20% CCF		
36.2.1.4.2.0	Exposures with a 50% CCF		
36.2.1.4.3.0	Exposures with a 100% CCF		