



**MONETARY BOARD
CENTRAL BANK OF SRI LANKA**

21 August 2018

BANKING ACT DIRECTIONS

No. 04 of 2018

**FINANCIAL DERIVATIVE TRANSACTIONS FOR
LICENSED COMMERCIAL BANKS AND LICENSED SPECIALISED BANKS**

The Monetary Board issues the following Directions on Financial Derivative Transactions for Licensed Commercial Banks (LCBs) and Licensed Specialised Banks (LSBs).

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| 1. Empowerment under the Banking Act | 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 LCB and LSB, respectively, regarding the manner in which any aspect of the business of such banks is to be conducted. |
| 2. Applicability | <div>2.1 These Directions will cover derivative transactions in foreign currency of LCBs and LSBs which are authorised to offer such derivative transactions in terms of the Foreign Exchange Act of Sri Lanka. The LCBs and LSBs shall hereinafter be referred to as Eligible Banks (EBs).</div> <div>2.2 These Directions shall be applicable to the Domestic Banking Units (DBUs) and Off-shore Banking Units (OBUs) of EBs.</div> |
| 3. Commencement of derivative transactions | <div>3.1 LCBs which intend to engage in financial derivative transactions shall notify its interest, prior to the commencement of the initial transaction, to the Director of Bank Supervision (DBS) with a copy to the Director of International Operations Department of the Central Bank of Sri Lanka (CBSL).</div> <div>3.2 LSBs shall obtain the written approval of DBS to engage in each derivative specified in 5.2.</div> |
| 4. Board approved policies and procedures | <div>4.1 EBs shall have in place Board approved policies and procedures on derivative transactions and risk management framework to identify, quantify and evaluate the exposures, manage risk and monitor performances related to derivative transactions.</div> <div>4.2 EBs shall ensure that appropriate expertise and capacity building are in place to engage in financial derivative transactions.</div> |



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**5. General Terms
and Conditions**

- 5.1 Derivatives transactions may be entered into for the following purposes:
- a) **End User (EU) Deals:** Transactions for the purpose of hedging EBs own assets and liabilities (other than the assigned capital and retained earnings) and managing their own risk profile as may be necessary from time to time, however, not for speculative purposes.
 - b) **Non Market Maker (NMM) Deals:** Transactions executed by EBs with their customers, i.e., any party other than an EB or with another EB with the intention of making a spread. In these transactions an EB shall not take any market risk into its own books and shall cover the transaction on the same day on a back-to-back basis with another EB in Sri Lanka or with a foreign counterparty.
 - c) **Derivative Market Maker (DMM) Deals:** Transactions executed by EBs with their customers or with another EB while taking the market risk into its own books.
- 5.2 Derivatives permitted under these Directions are as follows:
- a) Swaps
 - b) Options
 - c) Forward Rate Agreements
 - d) Forward Contracts
 - e) Swaptions
 - f) Such other instruments as may be specified by the Monetary Board from time to time.
- 5.3 EBs shall ensure the following:
- a) all derivatives offered to customers are based on valid underlying transactions which include current account transactions and permitted capital account transactions;
 - b) the notional principal amount, including any leverage of the derivative shall not exceed the outstanding amount of the underlying transaction/asset or liability or the underlying exposure;



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- c) Directions 5.3 (a) and (b) above shall not be applicable for interbank derivative transactions.
- 5.4 EBs shall use products listed in 5.2 above to enter in to back to back transactions with a foreign counterpart.
- 5.5 EBs are permitted to hedge contingent exposures or such risks arising from balance sheet exposures of their customers.
- 5.6 EBs may allow importers and exporters to hedge their exposure including a contract based on estimated transaction value. The estimated transaction value shall be determined based on their audited financials or by averaging the preceding three contract values or immediately preceding contract value, whichever is higher, subject to confirmation by an EB.
- 5.7 Parties may unwind/sell back a derivative partially or fully, if they consider such a derivative is no longer required, as follows:
- a) all derivative contracts once unwound are eligible to be rebooked, subject to the terms specified in these Directions;
 - b) any customer who wishes to unwind a derivative contract before maturity while the underlying transaction still exists may do so with the marked-to-market loss charged to such customer;
 - c) a marked-to-market gain (financial gain) should not be paid to the customer;
 - d) the rate benefit, if any, may be passed to the customer at the time of rebooking.
- 5.8 The cost of a derivative transaction with non-residents shall be paid out of repatriable funds and/or inward remittances through normal banking channels.



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- 5.9 All derivatives entered in to by an EB under Directions on Financial Derivative Products issued on 01 August 2009 (Ref: 33/03/001/0029/002) and Directions to Authorized Dealers on Forward Contracts in Foreign Currencies issued on the 11 March 2010 (Ref: 06/04/02/2010) can be continued till the maturity of the underlying transactions, adhering to the previously issued Directions. The unwound derivative contracts entered under previous Directions can be rebooked only under the terms of the new Directions.
- 5.10 Contracts may be entered into with customers whose underlying transactions are established with another authorised dealer provided documentary evidence is furnished by the said authorised dealer on each transaction.
6. Prohibited Activities
- 6.1 EBs shall not engage in facilitating derivative transactions on behalf of any foreign counterpart with resident customers unless the resident customer has obtained specific approval of the Head of the Department of Foreign Exchange of CBSL.
- 6.2 EBs shall not enter in to derivative transactions in respect of any foreign currency exposures or risks arising from foreign currency deposits or retained earnings, held overseas.
- 6.3 Derivatives involving making of an upfront payment other than option premiums, in any currency by EB to the customer shall not be permitted.
7. International Swap and Derivative Association (ISDA)
- 7.1 EBs shall sign ISDA Master Agreement with the counterparty for derivatives, unless otherwise both parties agree to refrain from signing ISDA.
- 7.2 EBs shall obtain a written consent from the counterparty where it was agreed to refrain from signing ISDA. It will not be necessary for EBs to obtain a written consent for inter-bank foreign exchange Forwards and Swaps transactions with a contractual maturity of one year or less.
- 7.3 EBs shall maintain transaction specific agreements and records.



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| 8. Customer Awareness | <p>8.1 EBs shall ensure that the customers clearly understand the risks of the derivative transactions and that the customers have established sufficient measures to monitor and manage the risks arising from the prospective transactions entering into.</p> <p>8.2 EBs shall provide adequate information on the transaction, especially with regard to the conditions and clauses to be incorporated into the product indicating the relevant benchmarks, fixing rates, strike prices and premium as the case may be, and a detailed risk scenario analysis to ensure the highest level of transparency.</p> <p>8.3 EBs shall obtain a written confirmation from the customer prior to entering into a derivative transaction that the customer has understood the nature of the products and their inherent risks.</p> <p>8.4 EBs shall obtain an undertaking in writing from customers that their total value of the derivative transactions with all EBs do not exceed the exposure or the value of underlying transactions.</p> <p>8.5 EBs shall also satisfy themselves on a professional analysis, of the institutional capacity and the overall suitability of the customer to engage in the derivative products offered by EB prior to entering into such contracts.</p> <p>8.6 In the case of small value foreign exchange Forwards and Swap transactions with a contractual maturity of one year or less, EBs shall, at a minimum, provide basic information and conditions pertaining to the transaction to the customers. For this purpose, EBs shall internally determine a threshold for small value foreign exchange forwards and swap transactions considering the risk appetite and trading volume of EBs.</p> |
| 9. Eligible Currencies | <p>9.1 EBs shall conduct derivative transactions in designated currencies¹ as per the request of the customer and in accordance with internal policies approved by its Board of Directors.</p> |

1- Designated currencies determined under the Banking (Off-shore Banking Business Scheme) Orders issued in terms of the Banking Act, from time to time, will be applicable for this Direction.



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| 10. Tenure | 10.1 EBs shall ensure that the date of maturity of the derivative contract shall correspond to the maturity date of the underlying transaction and shall not, under any circumstance, extend beyond the date of the underlying transaction, and the maximum maturity period of a derivative transaction shall not exceed ten (10) years. |
| 11. Reference/
Valuation
Benchmark | 11.1 The parties involved shall be free to use any benchmark with sufficient transparency on mutual agreement for reference and valuation purposes. |
| 12. Reporting | <p>12.1 EBs shall submit to the International Operations Department of CBSL on a monthly basis within 15 days from the end of the month, a statement of the transactions undertaken within the month in the format attached in Annex I.</p> <p>12.2 The above requirement shall not be applicable for foreign exchange Forwards and Swap transactions with a contractual maturity of one year or less. However, EBs shall maintain records relating to such transactions with customers.</p> |
| 13. Definition | <p>The following definitions shall be applicable for purposes of these Directions.</p> <p>13.1 Derivative</p> <p>A derivative is a financial instrument or a contract as defined in Sri Lanka Accounting Standards.</p> <p>13.2 Foreign Counterpart</p> <p>A foreign counterpart shall mean:</p> <ul style="list-style-type: none">a) A bank outside Sri Lankab) An internationally recognised derivative exchange <p>13.3 Permitted Derivative Transactions</p> <p>a) Swaps</p> <p>A swap is a bilateral agreement to exchange cash flows at specified intervals (payment dates) during the agreed-upon life of the transaction (maturity or tenure). Entering into a swap typically does not require the</p> |



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payment of a fee. Under this direction EBs are eligible to enter into interest rate, cross-currency and commodity swaps.

b) Options

An option is an agreement that gives the buyer, who pays a fee (premium), the right but not the obligation to buy or sell a specified amount of an underlying asset at an agreed upon price (strike or exercise price) on or until the expiration of the contract (expiry). A call option is an option to buy the underlying and a put option is an option to sell the underlying. Under this Direction EBs are eligible to issue options based on an underlying interest rate, currency and commodity.

c) Forward Rate Agreements (FRA)

A forward rate agreement is an interest rate contract between two parties that allows an entity to position itself in the interest rate market. An FRA is a contract that calls for one party to make a fixed interest payment and the other party to make an interest payment at a rate to be determined at the contract expiration based on a notional principal amount. On the expiration date, the payments are net settled.

d) Forward Contract

In forward contracts, the contract holders are obligated to buy or sell the currency/commodity at a specified price, at a specified quantity and on a specified future date.

e) Swaptions

The option to enter into a swap. In exchange for an option premium, the buyer gains the right but not the obligation to enter into a specified swap agreement with the issuer on a specified future date. Under this direction EBs are eligible to issue swaptions based on an underlying transaction such as interest rate, currency and commodity.

f) FX Swaps

FX swap is a simultaneous purchase and sale or vice versa of identical



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amounts of one currency for another with two different value dates.

14. Revocation

14.1 The following Directions are hereby revoked:

- a) Direction No. 06 of 2017 dated 29 November 2017 on Financial Derivative Transactions for Licensed Commercial Banks and Licensed Specialised Banks;
- b) Directions on Financial Derivative Products issued on 01 August 2009, Ref: 33/03/001/0029/002 by the Controller of Exchange and the Director of International Operations; and
- c) Directions to Authorized Dealers on Forward Sales and Purchases of Foreign Exchange issued on 02 January 2013, Ref: 06/04/04/2013 by the Controller of Exchange.

15. Implementation

15.1 These Directions shall be effective from the date of the Directions.

Dr. Indrajit Coomaraswamy

*Chairman of the Monetary Board and
Governor of the Central Bank of Sri Lanka*

Financial Derivative Transactions for Licensed Commercial Banks and Licensed Specialised Banks

Table 03 - Monthly Derivative Product Transactions

Product Type: Currency Options[illegible]

*CCY - Currency

Table 04 - Monthly Derivative Product Transactions

Product Type: Options

[illegible]

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Table 05 - Transaction Cancelled and Wound-up (Premature)

Deal Date	Product as reported to CBSL	Customer/ Counterparty	Notional Principle	Reference to original transaction already reported to the CBSL	Original Date of Maturity	Date of cancellation or winding up	Details of Back to Back Transaction	Reference/ Benchmark	Remarks/ Reasons for cancellation

To be reported within 15 days from the end of the month to the International Operations Department of the Central Bank of Sri Lanka through dfx@cbsl.lk.