MONETARY BOARD
CENTRAL BANK OF SRI LANKA

20 **December 2019** **BANKING ACT DIRECTIONS** **No. 10 of 2019**

FRAMEWORK FOR DEALING WITH DOMESTIC SYSTEMICALLY IMPORTANT BANKS

In terms of the powers conferred by Sections 19(7)(a) and 76G(7) of the Banking Act No. 30 of 1988, as amended, the Monetary Board has determined a framework for dealing with Domestic Systemically Important Banks (D-SIBs) and Higher Loss Absorbency Requirements (HLA) as capital surcharge on D-SIBs having regard to the guidelines issued by the Basel Committee on Banking Supervision.

This framework attempts to identify the banks whose failure has a larger impact on the financial system due to size, interconnectedness, lack of substitutability and complexity and requires maintaining HLA by such banks.

1. Empowerment

1.1 In terms of Section 102 of the Monetary Law Act, the Monetary Board may from time to time by Order prescribe the minimum capital ratios which the capital of licensed banks shall bear to the total volume of their assets or to any specified category of such assets.

1.2 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:

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

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

3. Capital Surcharge on D-SIBs

3.1 D-SIBs shall maintain, at all times, the minimum capital surcharge as prescribed in 3.2 below.

3.2 The minimum capital surcharge on D-SIBs are in Table 1 below:

Table 1: Minimum Capital Surcharge on D-SIBs

Bucket	HLA Requirement (CET1 as a % of risk-weighted assets)
3	2.0
2	1.5
1	1.0

3.3 The capital surcharge on D-SIBs shall be met with Common Equity Tier 1 (CET1) as defined in Banking Act Directions No. 01 of 2016 of Capital Requirements under Basel III.

4. Framework

4.1 Framework for Dealing with Domestic Systemically Important Banks is in Schedule I.

5. Disclosure Requirement

5.1 For each financial year-end, licensed banks with a Leverage Ratio exposure measure, that exceeds Rs. 400 billion shall comply with the disclosure requirements in Schedule I.

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

SCHEDULE I

FRAMEWORK FOR DEALING WITH DOMESTIC SYSTEMICALLY IMPORTANT BANKS

1. Introduction

1.1 The Basel Committee on Banking Supervision (BCBS) issued an assessment methodology for global systemically important banks (G-SIBs) and prescribed higher capital surcharge in November 2011. Later in July 2013 and July 2018 the assessment methodology was reviewed and amended.

1.2 Similar to the case of G-SIBs, failure of a large interconnected financial institution that is not significant from an international perspective, may severely impact the domestic financial market and the real economy. Therefore, BCBS issued an extension of the G-SIB assessment methodology to domestic systemically important banks (D-SIBs) in October 2012.

1.3 Primary objective of the implementation of the D-SIBs framework is D-SIBs to hold higher capital buffers and to provide incentives to reduce their systemic importance on the domestic economy.

2. The D-SIBs Framework

2.1 The D-SIBs framework is based on the 12 principles of BCBS and appropriate national discretion is exercised in selection of indicators to accommodate structural characteristics of the domestic financial system.

2.2 Scope of assessment: all locally incorporated domestic banks, subsidiaries bank branches of foreign banks are included in the assessment based on the criteria specified in 2.4 below.

2.3 D-SIB framework assesses locally incorporated banks on consolidated basis and foreign bank branches will be on a standalone basis.

2.4 Sample of banks: Basel specified criteria on G-SIBs are considered when selecting the sample for D-SIBs as below:

(i) 10 largest banks based on Basel III leverage ratio exposure measure;

(ii) Banks that were previously designated as D-SIBs in the previous year, if necessary; and

(iii) Banks added based on supervisory judgement, if necessary.

2.5 The impact of a D-SIB's failure on the domestic economy in principle is to be assessed having regard to bank-specific factors as below:

(i) Size
(ii) Interconnectedness
(iii) Substitutability/financial institution infrastructure
(iv) Complexity

2.6 Details of bank specific factors, individual indicators under each factor and their weights are as follows:

Table 01 - Factors Considered in Assessment of D-SIBs

Category	Individual Indicator	Category Weighting
Size	Total exposure	40%
Interconnectedness	Intra-financial system assets	20%
	Intra-financial system liabilities	
	Securities outstanding	
Substitutability / financial institution infrastructure	Assets under custody	20%
	Trading volume	
	Payments activity	
Complexity	Notional amount of derivatives	20%
	Level 2 assets as reported under Liquidity Coverage Ratio	
	Cross jurisdictional liabilities	
	Cross jurisdictional claims	
	Trading and available for sale (AFS) securities	

2.7 The indicators are briefly described below.

(i) **Size**

(a) The larger the bank, the more difficult it is for its activities to be quickly replaced by other banks and therefore the greater the chance that its distress or failure would cause disruption to the financial markets in which it operates.

(b) The distress or failure of a large bank is also more likely to damage confidence of the depositor and the financial system as a whole.

(c) The indicator used to measure size is the measure of total exposures used in the Basel III leverage ratio.

(d) Larger the size of a bank, the greater its market share of critical financial services, greater the cross jurisdictional activities, more interconnected it is to the banking sector and the domestic economy, and therefore it is more difficult to substitute.

(e) Considering the systemic importance placed in the “size” indicator and the impact its having on other four indicators, the highest weight of 40% is allocated.

(ii) **Interconnectedness**

(a) Financial distress at one bank can materially increase the likelihood of distress at another bank given the network of contractual obligations in which these banks operate.

(b) A bank’s systemic impact is likely to be positively related to its interconnectedness vis-à-vis other financial institutions.

(c) Three indicators are used to measure interconnectedness: (i) intra-financial system assets; (ii) intra-financial system liabilities; and (iii) securities outstanding.

(d) Each indicator is allocated an equal weight of 6.66% and the overall category is weighted at 20%.

(iii) **Substitutability**

(a) The systemic impact of a bank’s distress or failure is expected to be negatively related to its degree of substitutability as both a market participant and a client service provider.

(b) Three indicators are used to measure substitutability: (i) assets under custody; (ii) payments activity; (iii) trading volume.

(c) Underwritten transactions in debt and equity market were not considered since banks do not have an exposure in underwriting based on the data submitted by banks. This indicator will be considered at the next review of the framework which will be performed once in 3 years.

(d) Each indicator is allocated an equal weight of 6.66% and the overall category is weighted at 20%.

(e) Substitutability is capped at 500 basis points.

(iv) **Complexity**

(a) The systemic impact of a bank's distress is expected to be positively related to its overall complexity including its business, structural and operational complexity.

(b) The international impact of a bank's distress or failure would vary in line with its share of cross-jurisdictional assets and liabilities. The greater a bank's global reach, the more difficult it is to coordinate its resolution and the more widespread the spillover effects from its failure. Therefore, cross-jurisdictional activity is included into the complexity.

(c) The more complex a bank is, the greater the costs and time needed to resolve.

(d) Five indicators are used to measure complexity: (i) notional amount of Over the Counter (OTC) derivatives; (ii) level 2 assets; (iii) trading and available for sale securities; (iv) cross-jurisdictional claims; and (v) cross-jurisdictional liabilities.

(e) Each indicator is allocated an equal weight of 4% and the overall category is weighted at 20%.

2.8 **Ancillary Indicators**

Ancillary indicators are considered relating to specific aspect of the systemic importance of the bank that may not be captured by the indicator based measurement approach alone. These indicators are used to support the judgement overlay.

2.9 **Score Calculation**

(i) Sample of banks are selected for the computation of systemic importance based on the size reported in the exposure measure of the Basel III Leverage Ratio as in 2.4 above.

(ii) Data in Annex I is collected from the sample of banks.

(iii) To calculate the score for a given indicator, the bank's reported value for that indicator is divided by the corresponding sample total, and the resulting value is then expressed in basis points by multiplying by 10000. The maximum score for substitutability is capped at 500 basis points.

(iv) To calculate the scores for the four bank specific factors, the scores for the indicators that fall within each specific factor are averaged.

(v) The final score is produced by averaging the four bank specific factor scores and then rounding to the nearest whole basis point.

2.10 **Supervisory Judgment**

(i) Bank's score may be adjusted based on supervisory judgment. Supervisory judgment is used to override the indicator-based measurement approach in exceptional cases.

(ii) In these exceptional cases, the published bucket does not align with the calculated score. The decision to exercise supervisory judgment generally reflects a variety of quantitative or qualitative factors not captured in the indicators.

2.11 **Bucketing Approach**

(i) Banks that have a score exceeding the regulator determined cut-off level are classified as D-SIBs.

(ii) D-SIBs are allocated into 3 buckets with varying HLA requirements in the range of 1.0% to 2.0% as shown in the Table 02 below.

(iii) Based on the annual assessment, if necessary, D-SIBs will be allocated into different buckets based on the score and the supervisory judgment. In future, if bucket 3 becomes populated, a new bucket will be added.

Table 02 - D-SIBs Bucketing Approach

Bucket	**HLA Requirement** **(CET1 as a % of risk-weighted assets)**
3	2.0
2	1.5
1	1.0

2.12 **Interaction with Capital Buffers and Consequences of Breaching the Capital Surcharge on D-SIBs**

(i) If a D-SIB breaches HLA requirement, it is required to agree on a capital remediation plan to return to compliance over a defined time frame. Until returned to compliance, it is subject to restrictions on discretionary distributions of dividend payout and other restrictions as required by the Regulator.

(ii) For a newly identified D-SIB and for a D-SIB that progresses to a bucket requiring a higher HLA requirement, a time frame of 12 months will be permitted to meet the additional requirement. In the event, the bank does not meet the HLA requirement within the time period same restrictions above will be applied.

(iii) If on the other hand when D-SIB score falls resulting in a lower HLA requirement, CBSL based on supervisory judgement may decide on a timeline for such bank to be released from its previous HLA requirement.

2.13 **Disclosure Requirements**

(i) For each financial year-end, all banks with a leverage ratio exposure measure, that exceeds Rs. 400 billion are required to publicly disclose 10 high level indicators used in the assessment methodology in their Annual Reports and/or websites as per the format in Annex I.

(ii) Banks below this threshold that have been added to the sample owing to supervisory judgment or as a result of being classified as a D-SIB in the previous year would also be required to comply with the disclosure requirements.

(iii) Banks should also publicly disclose in their websites if the data used to calculate the D-SIB scores differ from the figures previously disclosed. Banks should disclose the accurate figures in the financial quarter immediately following the finalisation of the D-SIB score calculation.

2.14 **Operational Timeline**

(i) The framework is to be effective immediately and going forward the D-SIBs assessment will be conducted based on below timelines:

Table 03 – Timeline for implementation

Time	Task
April	Collect data as in Annex I from the selected banks
August	Assess collected data and identify the list of D-SIBs
October	Publish the list of D-SIBs that are subject to HLA requirement with the approval of the Monetary Board

(ii) The timeline given above will be adhered and practiced annually to decide on the D-SIBs.

(iii) The framework of D-SIB assessment will be reviewed once in three years to incorporate any revisions or amendments in accordance with BCBS reviews.

Annex I

D-SIBs Assessment Exercise

(a) Report data as at 31 December each year, unless otherwise specified.
(b) Locally incorporated banks - report consolidated basis.
(c) Foreign bank branches - solo basis.
(d) Financial Institution definition is in accordance with Direction No. 01 of 2016 of Capital Requirement under Basel III.

General Information	
Name of the bank	

Rs. (Mn)

Size Indicator	
Section 1 - Total Exposures	
Total exposures measure	
Interconnectedness Indicators	
Section 2 - Intra-Financial System Assets	
a. Funds deposited with or lent to other financial institutions (including unused portion of committed lines extended)	
(i) Funds deposited	
(ii) Lending	
b. Holdings of securities issued by other financial institutions	
c. Net positive current exposure of securities financing transactions (SFTs) with other financial institutions	
d. Over-the-counter (OTC) derivatives with other financial institutions that have a net positive mark to market value	
Intra-financial system assets	
Section 3 - Intra-Financial System Liabilities	
a. Funds deposited by or borrowed from other financial institutions (including unused portion of committed lines obtained)	
(i) Funds deposited	
(ii) Borrowings	
b. Net negative current exposure of securities financing transactions with other financial institutions	
c. Over-the-counter derivatives with other financial institutions that have a net negative mark to market value	
Intra-financial system liabilities	
Section 4 - Securities Outstanding	
Securities outstanding	
Substitutability/Financial Institution Infrastructure Indicators	
Section 5 - Payments made in the reporting year (excluding intragroup payments)	
Payments activity	
Section 6 - Assets Under Custody	
Assets under custody	
Section 7 - Underwritten Transaction	
Underwritten transaction	
Section 8 - Trading Volume	
Trading volume	
Complexity indicators	
Section 9 - Notional Amount of Over-the-Counter (OTC) Derivatives	
OTC derivatives	
Section 10 - Level 2 Assets	
Level 2 assets	
Section 11 - Trading and available for sale (AFS) securities	
Trading and AFS securities	
Section 12 - Cross-Jurisdictional Liabilities	
Foreign liabilities (excluding derivatives and intragroup liabilities)	
Cross-jurisdictional liabilities	
Section 13 - Cross-Jurisdictional Claims	
Foreign claims (excluding derivatives and intragroup claims)	
Cross-jurisdictional claims	

Guide to Fill the Required Information

Section	Guide
1	Report the total exposure measure used for the leverage ratio.
2a	Report all funds deposited with or lent to other financial institutions (other financial institutions through out this return are financial institutions outside of the consolidated reporting group). Deposits include placements. Lending should include all forms of term/revolving lending, overdraft and other extensions of credit to financial institutions.
2b	Report all holdings of securities issued by other financial institutions. This includes debentures, trust certificates, trading and non-trading shares.
2c	This item should include the following: (a) Net positive reverse repurchase agreement exposure, where the value of the cash provided exceeds the fair value of the securities received; (b) Net positive repurchase agreement exposure, where the fair value of the securities provided exceeds the value of the cash received; (c) Net positive securities lending exposure, where the fair value of securities lent exceeds the value of cash collateral received (or the fair value of non-cash collateral received); and (d) Net positive securities borrowing exposure, where the value of cash collateral provided (or the fair value of non-cash collateral provided) exceeds the fair value of securities borrowed.
2d	Report the sum of "net positive fair value" and "the potential future exposure" for OTC derivatives with other financial institutions that have a net positive mark to market value. Netting is valid if the criteria in the Direction No. 12 of 2018 on Leverage Ratio under Basel III is met. Only netting sets with a positive value should be reported here. Netting sets where the net result is negative should be reported in item 3c below.
3a	Report any funds deposited by or borrowed from other financial institutions that are accounted for as payables. Do not include any liability arising from 4 below.
3b	This item should include the following: (a) Net negative reverse repurchase agreement exposure, where the fair value of securities received exceeds the value of the cash provided. (b) Net negative repurchase agreement exposure, where the value of the cash received exceeds the fair value of the securities provided. (c) Net negative securities lending exposure, where the value of cash collateral received (or the fair value of non-cash collateral received) exceeds the fair value of securities lent. (d) Net negative securities borrowing exposure, where the fair value of securities borrowed exceeds the value of cash collateral provided (or the fair value of non-cash collateral provided).
3c	Report the sum of "net negative fair value" and "the potential future exposure" for OTC derivatives with other financial institutions that have a net negative mark to market value. Netting is valid if the criteria in the Direction No. 12 of 2018 on Leverage Ratio under Basel III is met. Only netting sets with a negative value should be reported here. Netting sets where the net result is positive should be reported in item 2d above.
4	Report the value of all outstanding securities that were issued by, or on behalf of, the reporting entity. Accordingly, securities should be reported regardless of whether or not they are held by other financial institutions. Exclude the shares issued.
5	Payments should be reported regardless of purpose, location, or settlement method done during the reporting period . This includes RTGS gross payments, ATM withdrawals, credit/debit card payments, cheque payments, internet banking and mobile banking payments. Only include outgoing payments (i.e. exclude payments received). Do not include intragroup transactions.
6	Report the value of all assets, including cross-border assets that the reporting group holds as a custodian on behalf of customers, including other financial institutions.
7	Include all underwriting (public and private) over the reporting year where the bank was obligated to purchase unsold securities. Exclude intragroup and self-led transactions.
8	Number of shares or contracts of a security traded by the bank during the reporting year.
9	Report the notional amount outstanding of OTC derivative positions.
10	Report Level 2 assets unweighted amount reported in Liquidity Coverage Ratio.
11	Report financial assets which are recognised under fair value through other comprehensive income and fair value through profit or loss. This includes but not limited to debt instruments, equity instruments and derivative instruments.
12	Report the sum of cross-jurisdictional liabilities. Do not include local liabilities in foreign currency. Exclude derivatives and intragroup liabilities.
13	Report the sum of cross-jurisdictional claims. Do not include local claims in foreign currency. Exclude derivatives and intragroup liabilities.