MONETARY BOARD
CENTRAL BANK OF SRI LANKA

14 September 2021	BANKING ACT DIRECTIONS	No. 14 of 2021

CLASSIFICATION, RECOGNITION AND MEASUREMENT OF FINANCIAL ASSETS OTHER THAN CREDIT FACILITIES IN LICENSED BANKS

In the exercise 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 of the Central Bank of Sri Lanka (CBSL) hereby issues the following Directions on Classification, Recognition and Measurement of financial assets other than credit facilities in licensed commercial banks and licensed specialised banks, hereinafter referred to as licensed banks, with a view to further strengthening and harmonising the regulatory framework on classification, recognition and measurement of financial assets other than credit facilities in licensed banks with the Sri Lanka Accounting Standard, 'SLFRS 9: Financial Instruments' (hereinafter referred to as SLFRS 9) and establishing consistent and prudent practices in the banking industry.

1. Empowerment

1.1 In terms of Section 46(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 licensed commercial banks, regarding the manner in which any aspect of the business of such bank or banks is to be conducted.

1.2 In terms of Section 76J (1) of the Banking Act, the Monetary Board is empowered to give Directions to licensed specialised banks or to any category of licensed specialised banks, regarding the manner in which any aspect of the business of such banks is to be conducted.

2. Scope and Applicability

2.1 All requirements in these Directions shall be applicable to licensed banks in addition to the requirements of the Sri Lanka Accounting Standards.

3. Definitions

3.1 The following definitions shall be applicable for purposes of these Directions.

3.1.1 Financial assets covered by these Directions shall mean all financial assets covered under SLFRS 9, and excludes financial assets covered by the Banking Act Directions No 13 on Classification, Measurement and Recognition of Credit Facilities.

3.1.2 Borrower shall include individuals, companies, the Government of Sri Lanka, public corporations, statutory bodies, firms, state owned entities (SOEs), associations of persons and any other entity.

3.1.3 Board of Directors shall mean the Board of Directors of locally incorporated licensed banks and in the case of foreign banks, the Head Office/ Regional Monitoring Office.

3.1.4 Chief Executive Officer (CEO) and Key Management Personnel (KMPs) shall mean CEO and Officers Performing Executive Functions of licensed banks as determined under the Banking Act.

4. Governance Framework for Financial Assets Other than Credit Facilities

4.1 The Board of Directors, CEO and the respective KMPs are responsible for ensuring that licensed banks have an approved business model and policy in place at a minimum in addition to requirements stipulated in Banking Act Directions on Integrated Risk Management Frameworks for licensed banks to facilitate classification, recognition and measurement of financial assets in accordance with the applicable Sri Lanka Accounting Standards and relevant regulatory and supervisory guidance.

4.2 Such policy at a minimum shall:

4.2.1 Identify objectives, definitions, characteristics, criteria and operating policies along with adequate procedures and systems for assessing the business models of financial assets on an on-going basis;

4.2.2 The decision-making authorities for business model decisions, level of sales to be considered as infrequent and insignificant, time period for near term selling to be considered for trading purposes, election of fair value option for instruments through profit or loss and through other comprehensive income; and

4.2.3 Document and maintain standardised processes, detailed checklists and decision trees in order to assess and identify Solely Payments of Principal and Interest (SPPI) test (contractual cash flows to meet SPPI) features of their products and contracts.

4.3 Board of Directors shall ensure transparency and comparability establishing a mechanisms to provide timely, relevant, and useful information of the licensed bank through relevant disclosures and maintaining adequate data/records and systems to identify, reconcile and report requirements under the Sri Lanka Accounting Standards and the existing regulatory framework.

4.4 The Board of Directors shall establish a comprehensive validation policy in respect of models used for classification, recognition and measurement of financial assets other than credit facilities in licensed banks including clear roles & responsibilities, validation frequency and procedures & methodologies to be used by the bank;

4.5 A Board approved policy shall include clear guidelines on:

4.5.1 Staging of Investments (including how to differentiate stage 2 and 3 loans based potential risk criteria);

4.5.2 Methodologies for determining the Probability of Default (PD), Loss Given Default (LGD), economic factor adjustment etc. for impairment purposes;

4.5.3 Collateral to be considered for impairment along with valuation requirements on such collateral and specification of techniques and data to be used for such valuations;

4.5.4 A comprehensive model validation policy including clear roles & responsibilities, validation frequency and procedures & methodologies to be used by the bank;

4.5.5 Use of overlays to impairments models to ensure expected loss computations do reflect potential economic shocks, which are not captured otherwise; and

4.5.6 Guidance on upgrading of Investments in line with Direction 9 below.

4.6 CEO and KMPs of the licensed bank shall ensure that Board approved policies and guidelines on Financial Assets are implemented as intended, and adequate internal controls and validation processes are established to ensure the same.

5. Classification of Financial Assets (Other than Credit Facilities) and Financial Liabilities

5.1 Licensed banks shall classify Financial Assets (Other than Credit Facilities), and Financial Liabilities as per the Sri Lanka Accounting Standards. A broad summary of classification and subsequent measurement of Financial Assets and Liabilities is given in Annex 1.

5.2 If a licensed bank is accounting for its financial liabilities as designated through profit or loss, the licensed bank shall assess and account the changes in value of financial liabilities due to changes in its own credit risk, through other comprehensive income. The licensed bank shall formulate Board approved internal guidelines for this purpose.

6. Significant Increase in Credit Risk/ Default of Financial Assets other than Credit Facilities

6.1 For the purpose of calculating life-time expected losses under SLFRS 9, at a minimum, if one or more of the following factors/conditions are met, it shall be considered as a significant increase in credit risk or as defaulted facilities.

6.1.1 Contractually obligated payments of a financial asset are past due for more than 30 days (subject to the rebuttable presumption under SLFRS 9);

6.1.2 Credit rating of an instrument has been subsequently downgraded to B+ or below under the Sri Lankan National Rating Scale by an External Credit Assessment Institution (ECAI).

6.1.3 A two-notch downgrade under the internal rating of the licensed bank (if available). Licensed banks are required to map their internal investment ratings with the ratings issued by ECAI. For this purpose, licensed banks are required to refer the mapping of external credit ratings given in Banking Act Directions on capital requirements;

6.1.4 Reasonable and supportable forecasts of future economic conditions show a direct negative impact on the performance of portfolios or instruments;

6.1.5 A significant change in the geographical locations or natural catastrophes that directly impact the instrument;

6.1.6 Frequent changes in the Board of Directors and Senior Management and any Going Concern issues of the issuer;

6.1.7 A fall of 50% or more in the turnover and/or profit before tax of the borrower when compared to the previous year for two consecutive years and/or erosion of net-worth of the borrower by more than 25% (other than due to changes in equity structure and dividend policy) when compared to the previous financial year.

6.1.8 The issuer is deceased/insolvent;

6.1.9 Non-receipt of dividends/returns for a consecutive period of three years (along with a cumulative decline in net asset value of 30 per cent or more); and

6.1.10 A continuously declining trend in market prices, with the investment value being below cost for over three years.

6.2 Licensed banks may request to rebut one or more criteria listed from 6.1.2 to 6.1.10 when determining significant increase of credit risk, subject to the following:

6.2.1 The KMP heading the Risk Management Function shall recommend such rebuttal to the Board of Directors providing valid rationale and justifications to ensure that such criteria do not result in significant increase of credit risk to the bank, and Board of Directors shall grant approval or reject the proposal after considering the information provided.

6.2.2 Disclose the rebutted criteria if any and the estimated impact of such rebuttal on the respective bank's impairment provisions and profitability in their audited annual financial statements.

7. Impairment Charges for Financial Assets Other than Credit Facilities

7.1 Licensed banks shall compute the impairment charges for credit facilities as per the Sri Lanka Accounting Standards and Directions/Guidelines issued by CBSL from time to time.

7.2 The measurement of impairment allowances should build upon robust methodologies and result in the appropriate and timely recognition of expected credit losses in accordance with the applicable Sri Lanka Accounting Standards.

7.3 The aggregate amount of impairment allowances of licensed banks, regardless of whether allowance components are determined on a collective or an individual basis, should be adequate and consistent with the objectives of the applicable Sri Lanka Accounting Standards.

7.4 Additional guidance on impairment of licensed banks is provided in Annex II.

8. Models for Calculation of Impairment for Financial Assets other than Credit Facilities

8.1 The CEO and other relevant KMPs of the licensed bank under the guidance provided by the Board of Directors, shall ensure that the licensed bank:

8.1.1 Develops robust models to determine expected credit losses as per the Sri Lanka Accounting Standards, which should be in line with the licensed bank's business model and risk profile;

8.1.2 Considers all available and relevant internal and external data when estimating expected credit losses, ensuring that the estimates are robust, unbiased and reflective of current exposures;

8.1.3 Consist of officers who are well trained, competent and have a thorough understanding of the models adopted by the bank;

8.1.4 Adheres to rigorous governance and internal control processes, when obtaining support from external vendors/consultants in respect of model development.

8.1.5 Documents the reasons for selecting a specific model as the appropriate mode, if different models are used for different portfolios and instruments and ensure that all credit models are reviewed at least annually;

8.1.6 Establishes an effective model validation process to ensure that the credit risk assessment and measurement methods are capable of generating accurate, consistent and unbiased predictive estimates on an ongoing basis; and

8.1.7 Desists from making changes in the parameters, inputs and assumptions used for the purpose of profit smoothening. However, if any changes in the credit models are required, the rationale and justification for such change shall be evaluated by the Chief Risk Officer, Integrated Risk Management Committee and approved by the Board of Directors.

8.2 In cases where licensed banks incorporated outside Sri Lanka use models developed by their head office or regional office, such licensed banks shall assess the appropriateness of the credit models in the Sri Lankan context and a local team headed by a KMP shall carry out appropriate validation procedures.

9. Reclassification of Financial Assets Other than Credit Facilities

9.1 Licensed banks may reclassify financial assets under the provisions of the Sri Lanka Accounting Standards, provided the objective of the business model of the licensed bank for its financial assets has changed and its previous model assessment would no longer apply.

9.2 In line with the requirements under the Sri Lanka Accounting Standards, such changes in business models and reclassifications shall be approved by the Board of Directors and shall be notified to the Director of Bank Supervision within 7 working days of the date of such approval.

10 Upgrading of Financial Assets other than Credit Facilities

10.1 Licensed banks shall upgrade Financial Assets from a higher stage in accordance with a policy approved by the Board of Directors, and the rationale for such upgrading shall be properly documented.

10.2 Licensed banks shall exercise prudence in upgrading Financial Assets and shall ensure that the upgraded asset has exhibited a sustained trend/status of improvement to justify the improved classification status.

11 Fair Value Measurement of Financial Assets other than Credit Facilities

11.1 Licensed banks shall comply with the requirements given in 'Sri Lanka Accounting Standard - SLFRS 13: Fair Value Measurement' when financial instruments are subsequently measured at fair value, and are required to:

11.1.1 Use an appropriate valuation technique for which sufficient data is available;

11.1.2 Apply the selected valuation techniques consistently (exercising prudence);

11.1.3 Maximise the use of relevant observable inputs. In exceptional circumstances, unobservable inputs may be used; and

11.1.4 Obtain confirmation from the Chief Risk Officer, with regard to the appropriateness and reliability of inputs under level 3 hierarchy, if such inputs are used in the respective valuation technique.

12 Role of Internal Audit

12.1 The Internal audit function shall independently evaluate the effectiveness of the credit risk assessment, measurement systems and processes of the licensed bank and shall ensure the acceptability of credit judgments.

12.2 The Internal Audit function shall at least annually, validate and evaluate all credit risk assessment models, inputs and assumptions used along with data smoothening, if any.

12.3 The Internal audit function shall provide an assurance on the adequacy and effectiveness of back testing in order to ensure that the key drivers have been captured and calibrated accurately.

13 Regulatory Reporting

13.1 Licensed banks are required to submit the statutory returns introduced for these Directions, as stipulated below, or as stipulated otherwise by the Director of Bank Supervision.

13.1.1 Monthly Submission - on or before the 15th day of the following month

13.1.2 Quarterly Submission - on or before the 15th day from the end of a quarter.

14 Effective Date

14.1 These Directions shall be in effect from 01 January 2022.

15 Revocation of Directions

15.1 The following Directions will be revoked from 01 January 2022:

15.1.1 Banking Act Directions on Prudential Norms for Classification, Valuation and Operation of the Bank's Investment Portfolio dated 01.03.2006 issued to licensed commercial banks and licensed specialised banks.

Prof. W D Lakshman

Chairman of the Monetary Board and

Governor of the Central Bank of Sri Lanka

Annex I

Classification and Measurement of Financial Assets and Financial Liabilities other than Credit Facilities

Table 1 - Classification and Measurement of Financial Assets

Business Model	**Key Characteristics**	**Classification & Subsequent Measurement**
	Debt Instruments[1]	
Held-to-collect	- Hold assets to collect contractual cash flows - Meet SPPI test - Infrequent and insignificant sales	Amortised Cost
Both held to collect and for sale	- Both collecting contractual cash flows and sales - More frequent and significant sales	Fair value through other comprehensive income
Other business models, including; - Trading - Managing assets on a fair value basis - Maximising cash flows through sale	- Neither 'held-to-collect' nor 'held to collect and for sale' - Collection of contractual cash flows is incidental	Fair value through profit or loss
	Equity and Derivative Instruments	
Equity Instruments	- Held for trading	Fair value through profit or loss
	- Not for trading and not elected the irrevocable OCI option	Fair value through profit or loss
	- Not for trading and elected the irrevocable OCI option	Fair value through other comprehensive income
Derivative Instruments		Fair value through profit or loss

[1] In addition to these key characteristic's other features of the product such as management compensation, risk management aspects, frequency and significance of sales, etc. must also be considered.

Table 2 - Classification and Subsequent Measurement of Financial Liabilities

Classification of Financial Liabilities	Subsequent Measurement	Accounting for Fair Value Gain
Financial liabilities held for trading	Fair value	Through profit or loss
Financial liabilities designated at fair value	Fair value	The amount of change in fair value attributable to changes in credit risk in liability presented in other comprehensive income[2] and remaining amount shall be presented in income statement.
Other financial liabilities at amortised cost	Amortised Cost	-

[2] If that treatment creates or enlarges an accounting mismatch in profit or loss, an entity shall present all gains or losses on that liability (including the effects of changes in the credit risk of that liability) in profit or loss.

Annex II

Guidance on Impairment Computation for Licensed Banks

1. **Computation of the Probability of Default (PD) and Loss Given Default (LGD)**
   - (i) Licensed banks shall, at a minimum, use five years of data, unless a shorter time horizon provides better estimations and is better suited when calculating PDs and LGDs. Any smoothing of data or inputs must be validated by the Risk Management Department.
   - (ii) Licensed banks shall not use proxies to compute PDs and LGDs, unless the bank is a newly incorporated bank or the product category was newly introduced by the bank and has a credit history of less than 5 years.
   - (iii) When the licensed banks are unable to compute LGDs due to lack of data or inputs, licensed banks shall use a minimum LGD of 45 per cent for such exposures.
   - (iv) When required to calculate impairment with respect to exposures denominated in foreign currencies issued by the sovereigns, following shall be considered:
     - (a) Licensed banks shall compute respective Sovereign PD, appropriately linking to an external credit rating scale.
     - (b) A minimum LGD of 20 per cent shall be applied for exposures denominated in foreign currencies issued by the sovereigns.
   - (v) When required to calculate LGD for exposures guaranteed by the Government of Sri Lanka:
     - (a) An LGD of zero may be applied to exposures with a guarantee of the Government provided that the guarantee fully covers the principle and interest and is reported as a liability of the Government.
     - (b) LGD for any other form of assurance provided by the Government other than in item (a) above, shall be computed instead of using an LGD of zero percent.
     - (c) A minimum LGD of 20 per cent shall be applied for Government guarantees denominated in foreign currency.

2. Economic Factor Adjustment

(i) Licensed banks shall use forecasts and projections published by the CBSL when adjusting credit provisioning models to reflect the economic conditions and forecasts, on a consistent basis.

(ii) If CBSL forecasts are not available, licensed banks shall use credible alternative sources on a consistent basis and shall maintain relevant documentary evidence.

(iii) Board approved policies shall specify the sources to be used and licensed banks shall not cherry pick sources in their favor.