



**MONETARY BOARD
CENTRAL BANK OF SRI LANKA**

06 June 2018

FINANCE BUSINESS ACT DIRECTIONS

No. 3 of 2018

CAPITAL ADEQUACY REQUIREMENTS

In terms of powers conferred by Section 12 of the Finance Business Act, No. 42 of 2011, the Monetary Board has determined the minimum capital adequacy ratios for Licensed Finance Companies (LFCs) as given below.

1. Minimum Capital Adequacy Requirements
- 1.1 Commencing from 01 July 2018, every LFC shall, at all times, maintain the minimum capital adequacy ratios in relation to total risk weighted assets as prescribed in Table 1 and 2 below.

Table 1: LFCs with assets less than Rs.100 billion

Components of capital	01.07.2018	01.07.2019	01.07.2020	01.07.2021
Tier 1 Capital	6.00	6.50	7.00	8.50
Total Capital	10.00	10.50	11.00	12.50

Table 2: LFCs with assets of Rs.100 billion and above

Components of capital	01.07.2018	01.07.2019	01.07.2020	01.07.2021
Tier 1 Capital	6.00	7.00	8.00	10.00
Total Capital	10.00	11.00	12.00	14.00

- 1.2 The capital adequacy ratios referred above shall be computed in accordance with the methodologies and requirements set out in the framework on capital adequacy requirements for LFCs given in Schedule I hereto.
2. Regulatory Reporting
- 2.1 Every LFC shall submit details of computation of capital adequacy requirements through the web-based system in accordance with the formats given in Schedule II as per the following manner.
- i. Monthly: report the position as at the last calendar day of each month, and should be submitted within 15 days.
 - ii. Annual (audited): report the position as at the last calendar day of the financial year, and should be submitted within three months after the closure of each financial year.



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| 3. Regulatory Measures in the Event of Non-Compliance | 3.1 In the event of non-compliance by an LFC with above Directions, the Director shall act on any one or more of the following.
<ul style="list-style-type: none">i. Restrict distribution of dividends or repatriation of profits.ii. Suspend any business activity that will further deteriorate the regulatory capital position. |
| | 3.2 The Director shall lift the above regulatory measures when such non-compliance is rectified. |
| 4. Interpretations | 4.1 In these Directions,
<ul style="list-style-type: none">i. Assets value of an LFC with reference to Table 1 and 2 of Section 1.1 shall be determined based on the latest available audited financial statements.ii. “Director” means the Director of the Department of Supervision of Non-Bank Financial Institutions of the Central Bank of Sri Lanka. |
| 5. Revocation of Previous Direction | 5.1 The Finance Companies (Risk Weighted Capital Adequacy Ratio) Direction No. 02 of 2006 and the circular dated 15.03.2007 are hereby revoked. |

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

Schedule I

Regulatory Framework on Capital Adequacy Requirements of Licensed Finance Companies

1. Introduction

- 1.1. The new capital adequacy framework is intended to foster a strong emphasis on risk management and to encourage improvements in LFC's risk assessment capabilities.
- 1.2. The existing capital adequacy direction was adopted in 2006 for LFCs in line with the Capital Adequacy Accord recommended by the Basel Committee on Banking Supervision (BCBS) issued for banks in 1988. Under this direction risks were confined to credit risk and no capital requirements for other risks such as market and operational risks.
- 1.3. Therefore, the new capital adequacy framework provides for maintenance of capital adequacy ratios on a more risk sensitive focus covering credit risk and operational risks under basic approach available in Basel II accord.
- 1.4. The market risk is not considered at this moment as the sector exposure to market risks is considered to be minimal. However, if the necessity arises the Directions would be issued to capture the market risk under the capital adequacy framework.
- 1.5. Further, a capital surcharge has been introduced for Domestic Systemically Important LFCs in view of creating higher capacity for greater loss absorbency in large institutions as announced in Basel III framework.

2. Capital adequacy requirements

2.1. Total Regulatory Capital

Total regulatory capital of LFCs will consist the following:

- i. Tier 1 Capital

This represents core capital of the company representing shareholders' equity and reserves.

- ii. Tier 2 Capital

This represents supplementary capital such as instruments containing characteristics of equity and debt, revaluation gains and general provisioning/impairment allowances.

2.2. Risk Weighted Assets

Capital adequacy requirements shall be maintained as a percentage of Risk Weighted Assets (RWA) calculated based on the following approaches adopted by Basel Committee on Banking Supervision for banks:

- i. The Standardized Approach for credit risk
- ii. The Basic Indicator Approach for operational risk

2.3. Capital Buffer for larger LFCs

- i. Capital surcharge for Domestic Systemically Important LFCs (D-SILFC) with total assets equal or more than Rs.100 billion shall be implemented on a staggered basis.

- ii. D-SILFC must have a higher capacity for loss absorbance to cover the greater risks that they pose to the financial system.
- iii. The capital surcharge requirement for D-SILFC are to be met with Tier 1 capital.
- iv. The phase-in arrangement for capital surcharge on D-SILFC is indicated in Table 1.

Table 1: Capital surcharge on D-SILFC

	01.07.2018	01.07.2019	01.07.2020	01.07.2021
Capital surcharge on D-SILFC (%)	-	0.50	1.00	1.50

2.4. Capital adequacy ratios

Timeline for implementation of capital adequacy requirements is given at Table 2 and 3 below:

Table 2: LFCs with assets less than Rs.100 billion

Components of capital	01.07.2018	01.07.2019	01.07.2020	01.07.2021
Tier 1 Capital (%)	6.00	6.50	7.00	8.50
Total Capital (%)	10.00	10.50	11.00	12.50

Table 3: LFCs with assets of Rs.100 billion and above (including capital surcharge on D-SILFC)

Components of capital	01.07.2018	01.07.2019	01.07.2020	01.07.2021
Tier 1 Capital (%)	6.00	7.00	8.00	10.00
Total capital (%)	10.00	11.00	12.00	14.00

3. Other Comprehensive Income (OCI) as per accounting standards

Accumulated OCI gains reflected in the statement of changes in equity shall not be included in the regulatory capital. However, OCI losses not adjusted in the retained earnings must be immediately deducted.

4. Reporting format

The reporting formats given at Schedule II collect information relating to capital adequacy computation of LFCs.

Part 1 - (A) Computation of Capital Ratios

(B) Computation of Total Capital

Part 2 - (A) Computation of Risk Weighted Assets amount for Credit Risk

(B) Credit Equivalent of Off-Balance Sheet Items

(C) Exposures Recognized under Credit Risk Mitigation (CRM)

(D) Computation of Risk Weighted Assets amount for Operational Risk

5. Instructions for completing the reporting formats

The instructions and details/definitions for completion of the capital adequacy formats given in Schedule II are described with the web-based return codes as follows.

Part 1: Computation of capital adequacy requirements of LFCs

Part 1 (A): Computation of Capital Ratios

Code	Item	Amount/%
20.1.1.0.0.0	Tier 1 Capital The Tier 1 capital should be after regulatory adjustments. The amount must agree with item 20.2.3.0.0.0 of Part 1 (B)	
20.1.2.0.0.0	Total capital The amount must agree with item 20.2.8.0.0.0 of Part 1 (B)	
20.1.3.0.0.0	Total Risk Weighted Assets Amount Total risk-weighted assets are determined by adding the resulting figures to the sum of risk-weighted assets for credit risk and operational risk.	
20.1.3.1.0.0	Risk Weighted Assets Amount for Credit Risk The amount must agree with item 20.3.0.0.0.0 of Part 2 (A)	
20.1.3.2.0.0	Risk Weighted Assets Amount for Operational Risk The amount must agree with item 20.6.3.0.0.0 of Part 2 (D)	
20.1.4.0.0.0	Core Capital (Tier 1) Ratio, % (20.1.1.0.0.0/20.1.3.0.0.0) *100	
20.1.5.0.0.0	Total Capital Ratio, % (20.1.2.0.0.0/20.1.3.0.0.0) *100	

Part 1 (B) - Computation of Total Capital

Code	Item
20.2.1.0.0.0	Tier 1 Capital
20.2.1.1.0.0	Stated capital <ol style="list-style-type: none"> 1. Issued and fully paid ordinary shares. 2. Comprise both voting and non-voting ordinary share capital, including share premium/discounts. 3. Non-voting ordinary shares should be identical in all aspects to voting ordinary shares except for voting rights.
20.2.1.2.0.0	Non-cumulative, Non-redeemable Preference Shares Issued and fully paid non-cumulative, non-redeemable preference shares where the payment of dividends could be reduced or waived off permanently in the event of profitability being inadequate to support such payment in part or full.
20.2.1.3.0.0	Reserve fund Reserve fund as in the latest audited financial statements maintained in terms of Section 18 of the Finance Business Act No.42 of 2011.
20.2.1.4.0.0	Audited retained earnings/(losses) <ol style="list-style-type: none"> 1. Accumulated retained earnings/(losses) reflected in the statement of changes in equity in the latest audited financial statements. Further, any qualified opinion affecting the equity shall be adjusted.

	2. Dividends declared (not distributed) shall be deducted from retained earnings.
20.2.1.4.1.0	Less: revaluation gains/surplus of investment property Sri Lanka Accounting Standard - LKAS 40 – Investment Property will be applicable.
20.2.1.5.0.0	General and other disclosed reserves General and other disclosed reserves created or increased by appropriation of retained earnings as in the latest audited financial statements excluding reserves maintained for specific purposes and accumulated Other Comprehensive Income.
20.2.1.6.0.0	Current year profit/(loss) 1. The unaudited current year profit shall be included with the certification of the external auditor in the panel of external auditors for the LFC sector. 2. The unaudited current year loss reflected in the income statement shall be deducted.
20.2.2.0.0.0	Total adjustments to Tier 1 Capital
20.2.2.1.0.0	Less: Goodwill (net) 1. Goodwill as shown in the balance sheet. 2. Goodwill shall be in accordance with the Sri Lanka Accounting Standard – SLFRS 3 on Business Combinations.
20.2.2.2.0.0	Less: Other intangible assets Intangible assets shall be in accordance with the Sri Lanka Accounting Standard - LKAS 38 on Intangible Assets.
20.2.2.3.0.0	Less: Other Comprehensive Income losses Cumulative OCI losses not adjusted in the retained earnings must be immediately deducted.
20.2.2.4.0.0	Less: Deferred Tax Assets (DTAs) (net) 1. DTAs shall be netted with Deferred Tax Liability (DTL). Any DTL deducted in the case of goodwill and other intangible assets should be excluded. 2. Sri Lanka Accounting Standard - LKAS 12 on Income Taxes will be applicable.
20.2.2.5.0.0	Less: Shortfall of the cumulative impairment to total provisions and interest in suspense Any shortfall in total (specific and general) provisions and interest in suspense as per Finance Business Act Directions issued on provisioning for bad and doubtful debt over cumulative impairment (as per accounting standards).
20.2.2.6.0.0	Less: 50% of investment in banking and financial subsidiary companies 50% of investments in capital by way of shares, perpetual/ hybrid capital instruments or subordinated term debt in unconsolidated banking and financial subsidiary companies (refer 20.2.9.0.0.0).
20.2.2.7.0.0	Less: 50% of investment in other banking and financial institutions 50% of investments in capital by way of shares, perpetual/ hybrid capital instruments or subordinated term debt in other banks and financial institutions

	(refer 20.2.9.0.0.0).												
20.2.2.8.0.0	Less: Shortfall of capital in financial subsidiaries Any shortfall of regulatory capital applicable for its financial subsidiaries.												
20.2.3.0.0.0	Tier 1 Capital after adjustments												
20.2.4.0.0.0	Tier 2 Capital This includes qualifying Tier 2 capital instruments, revaluation gains and general provisions/collective impairment allowances.												
20.2.4.1.0.0	<p>Instruments qualified as Tier 2 Capital</p> <p>Criteria for classification/inclusion in Tier 2 Capital</p> <ol style="list-style-type: none"> 1. Prior approval of the Monetary Board is required for inclusion in Tier 2 capital. 2. Issued and fully paid-in cash. Only the net proceeds received from the issuance of the instrument shall be included as capital. 3. Subordinated to the claims of depositors and general creditors. 4. Is neither secured nor covered by a guarantee or any other arrangement that legally or economically enhances the seniority of the claim above the depositors and general creditors of the LFC. 5. The total approved Tier 2 instruments shall not exceed 50% of Tier 1 capital. 6. Maturity of the instrument: <ol style="list-style-type: none"> i. Minimum original maturity of at least five years. Where the agreement governing the issuance of the capital instrument provides for the loan to be drawn in a series of tranches, the minimum original maturity for each tranche shall be 5 years from the date of its issuance. ii. For the purpose of computation of the regulatory capital, the remaining five years before maturity will be amortized on a straight-line basis as specified in Table 4. <p style="text-align: center;">Table 4: The Amortization Schedule for Tier 2 Instruments</p> <table border="1" style="margin-left: auto; margin-right: auto;"> <thead> <tr> <th>Remaining years to maturity (X)</th> <th>Amount eligible to be included in Tier 2 capital</th> </tr> </thead> <tbody> <tr> <td>$X > 4$</td> <td>100%</td> </tr> <tr> <td>$3 < X \leq 4$</td> <td>80%</td> </tr> <tr> <td>$2 < X \leq 3$</td> <td>60%</td> </tr> <tr> <td>$1 < X \leq 2$</td> <td>40%</td> </tr> <tr> <td>$X \leq 1$</td> <td>20%</td> </tr> </tbody> </table> <ol style="list-style-type: none"> 7. The instrument may be callable at the initiative of the issuer only after a minimum of five years from the date of issue, subject to the following minimum requirements: <ol style="list-style-type: none"> i. The LFC must obtain prior approval of the Monetary Board to exercise a call option; and ii. The LFC shall not exercise a call option unless: <ol style="list-style-type: none"> a. The capital instrument is replaced by the LFC with capital of the same or better quality and the replacement of this capital is done in a manner that does not affect the income of the issuing LFC; or 	Remaining years to maturity (X)	Amount eligible to be included in Tier 2 capital	$X > 4$	100%	$3 < X \leq 4$	80%	$2 < X \leq 3$	60%	$1 < X \leq 2$	40%	$X \leq 1$	20%
Remaining years to maturity (X)	Amount eligible to be included in Tier 2 capital												
$X > 4$	100%												
$3 < X \leq 4$	80%												
$2 < X \leq 3$	60%												
$1 < X \leq 2$	40%												
$X \leq 1$	20%												

	<p>b. The LFC demonstrates that its capital position/ratios will be maintained well above the minimum after the call option is exercised.</p> <p>8. Any other conditions stipulated by the Monetary Board.</p>
20.2.4.2.0.0	<p>Revaluation gains/surpluses 50% of the revaluation gains of land & building (specified in LKAS 16 on Property Plant and Equipment) and investment property (specified in LKAS 40 on investment property) that satisfies the following conditions:</p> <ol style="list-style-type: none"> i. Prior approval of the Director is required. ii. Valuation of such properties shall be carried out as per the Finance Business Act, Direction on the Regulatory Framework for Valuation of Immovable Property of LFCs. iii. Impairment charges taken against any land & building and Investment Property are not netted against the revaluation gains from any other asset. iv. Revaluation gains of the newly acquired or developed properties shall be included in Tier 2 capital after completing 3 years from the completion of acquisition/development.
20.2.4.3.0.0	<p>General provisions/collective impairment allowances Any general provisions/collective impairment for financial assets shall be eligible for inclusion in Tier 2 capital with a maximum of 1.25% of RWAs on credit risk.</p>
20.2.5.0.0.0	<p>Eligible Tier 2 Capital Out of the Tier 2 capital, the eligible Tier 2 capital is limited to a maximum of 100% of Tier 1 capital (20.2.1.0.0.0). If Tier 1 capital is negative, a 'nil' amount should be reported as eligible Tier 2 capital.</p>
20.2.6.0.0.0	<p>Total adjustments to eligible Tier 2 Capital</p>
20.2.6.1.0.0	<p>Less: 50% of investment in banking and financial subsidiary companies 50% of investments in capital by way of shares, perpetual/ hybrid capital instruments or subordinated term debt in unconsolidated banking and financial subsidiary companies (refer 20.2.9.0.0.0).</p>
20.2.6.2.0.0	<p>Less: 50% of investment in other banking and financial institutions 50% of investments in capital by way of shares, perpetual/ hybrid capital instruments or subordinated term debt in other banks and financial institutions (refer 20.2.9.0.0.0).</p>
20.2.7.0.0.0	<p>Eligible Tier 2 Capital after adjustments</p>
20.2.8.0.0.0	<p>Total Capital Addition of Tier 1 Capital after Adjustments (20.2.3.0.0.0) and Eligible Tier 2 Capital after Adjustments (20.2.7.0.0.0)</p>
20.2.9.0.0.0	<p>Indicative List of Financial subsidiaries/institutions An indicative list of institutions which may be deemed to be financial subsidiaries/institutions for the purposes of items 20.2.2.6.0.0, 20.2.2.7.0.0, 20.2.6.1.0.0 and 20.2.6.2.0.0 above is as follows:</p> <ol style="list-style-type: none"> i. Licensed commercial banks and licensed specialized banks licensed under

	<p>the Banking Act No.30 of 1988 (as amended).</p> <ul style="list-style-type: none"> ii. Licensed finance companies licensed under the Finance Business Act No. 42 of 2011. iii. Specialized leasing companies registered under the Finance Leasing Act No. 56 of 2000. iv. Licensed microfinance institutions registered under the Microfinance Act No. 6 of 2016. v. Insurance companies, their agents and insurance brokers registered under the Insurance Industry Act No. 43 of 2000 (as amended). vi. Primary dealers licensed under the Local Treasury Bills Ordinance No. 8 of 1923 (as amended) and Registered Stocks and Securities Ordinance No. 7 of 1937 (as amended). vii. Merchant/investment banks and venture capital companies incorporated under the Companies Act No. 7 of 2007. viii. Registered market intermediaries, including margin providers, investment managers, underwriters, securities clearing houses, credit rating agencies, stock brokers/dealer companies and managing companies of unit trust registered under the Securities and Exchange Commission of Sri Lanka Act No. 36 of 1987 (as amended).
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Part 2: Computation of Total Risk Weighted Assets

1. General Rules for Measuring Credit Risk

- 1.1 The rating assigned by the eligible External Credit Assessment Institutions (ECAIs) will largely support the measure of credit risk. LFCs may rely upon the ratings assigned by ECAIs recognized by the Central Bank for assigning risk weights for capital requirement purposes as per the mapping furnished in these guidelines.
- 1.2 Claims (exposures) on a counterparty would include placements with banks, investments, loans and advances or any other credit exposure.
- 1.3 Credit risk on claims would be measured as follows;
 - i. Aggregate the below relating to a counterparty to obtain the exposure;
 - a) On-balance sheet claims excluding eligible CRMs
 - b) Risk weighted CRMs in Part 2(C)
 - c) Off-balance sheet items converted to credit equivalents using the credit conversion factors given in part 2(B)
 - d) Exclude specific provision and interest in suspense
 - ii. Thereafter, multiply the aggregated claim according to the risk weight applicable to the counterparty.

2. External Credit Assessments

2.1 Recognition of ECAIs

- i. LFCs are required to recognize ECAIs and develop a mapping process to assign the ratings issued by eligible credit rating agencies to the risk weights. The Central Bank has identified the following ECAIs operating in Sri Lanka for the purposes of risk weighting;
 - a) Fitch Ratings Lanka Ltd.
 - b) ICRA Lanka Ltd.
- ii. Further, the following internationally recognized credit ratings agencies are also accepted as ECAIs.
 - a) Fitch Ratings
 - b) Moody's
 - c) Standard and Poor's
- iii. LFCs are required to obtain the prior approval of the Central Bank for the use of other ECAIs. Further, any changes to the aforementioned list shall be announced by the Central Bank, time to time.

2.2 Scope of Application of External Ratings

- i. LFCs should use the chosen ECAIs and their ratings consistently for each type of claim, for both risk weighting and risk management purposes.
- ii. LFCs shall not use one ECAI's rating for one exposure, while using another ECAI's rating for another exposure to the same counterpart, unless the respective exposures are rated by only one of the chosen ECAIs, whose ratings the LFC has decided to use.
- iii. External assessments for one entity within a corporate group cannot be used to risk weight other entities within the same group.

2.3 Mapping Process

The rating mapping furnished in the tables below shall be adopted by all LFCs.

Table 5 - Mapping of Notations of the Credit Rating Agencies in Sri Lanka

Fitch Rating Lanka	ICRA Lanka Limited	Rating Scale for Capital
AAA (lka)	(SL) AAA	AAA
AA+ (lka)	(SL) AA+	AA+
AA (lka)	(SL) AA	AA
AA- (lka)	(SL) AA-	AA-
A+ (lka)	(SL) A+	A+
A (lka)	(SL) A	A
A- (lka)	(SL) A-	A-
BBB+(lka)	(SL) BBB+	BBB+
BBB (lka)	(SL) BBB	BBB
BBB- (lka)	(SL) BBB-	BBB-
BB+(lka)	(SL) BB+	BB+
BB (lka)	(SL) BB	BB
BB- (lka)	(SL) BB-	BB-
B+(lka)	(SL) B+	B+
B (lka)	(SL) B	B
B-(lka) & Lower	(SL) B- & Lower	B- & Lower

Table 6 - Mapping of Notations of the International Credit Rating Agencies

Standard and Poor's	Moody's	Fitch Ratings	Rating Scale for Capital
AAA	Aaa	AAA	AAA
AA+	Aa1	AA+	AA+
AA	Aa2	AA	AA
AA-	Aa3	AA-	AA-
A+	A1	A+	A+
A	A2	A	A
A-	A3	A-	A-
BBB+	Baa1	BBB+	BBB+
BBB	Baa2	BBB	BBB
BBB-	Baa3	BBB-	BBB-
BB+	Ba1	BB+	BB+

BB	Ba2	BB	BB
BB-	Ba3	BB-	BB-
B+	B1	B+	B+
B	B2	B	B
B- & Lower	B3 & Lower	B- & Lower	B- & Lower

2.4 Use of Unsolicited Ratings

A rating would be treated as solicited only if the issuer of the instrument has requested the credit rating agency for the rating and has accepted the rating assigned by the agency. Generally, LFC should use only solicited rating from the chosen ECAs. No ratings issued by the credit rating agencies on an unsolicited basis should be considered for risk weight computation.

2.5 Issuer versus Issues Assessment

Where a LFC's exposure is to a particular issue that has an issue-specific assessment, the risk weight of the claim will be based on this assessment.

2.6 Use of Multiple Rating Assessments

LFCs shall be guided by the following in respect of exposures having multiple ratings from the eligible ECAs chosen by LFC for the purpose of risk weight computation:

- i. If there is only one rating by an ECAI for a particular claim, that rating would be used to determine the risk weight of the claim.
- ii. If there are two ratings given by an ECAI, which map into different risk weights, the higher risk weight should be applied.
- iii. If there are three or more ratings given by an ECAI with different risk weights, the ratings corresponding to the two lowest risk weights should be referred to and the higher of those two risk weights should be applied, i.e., the second lowest risk weight.

Part 2 (A): Computation of Risk Weighted Assets Amount for Credit Risk

Code	Item	Risk Weight %
20.3.0.0.0.0	Total Risk-Weighted Amount for Credit Risk The total amount of on-balance sheet items (excluding eligible CRMs, specific provision and interest in suspense), risk weighted CRMs and total amount of credit equivalent of off-balance sheet items after applying the specific risk weight assigned.	
20.3.1.0.0.0	Claims on Government of Sri Lanka, Public Sector Entities and Central Bank of Sri Lanka	
20.3.1.1.0.0	Government of Sri Lanka All claims on Government of Sri Lanka	0
20.3.1.1.1.0	Outright purchase	0

20.3.1.1.2.0	Others Investments in unit trust gilt edge funds subject to below conditions: a) Gilt edge fund should be 100% on government securities b) Unit trust entity which operate such fund should be regulated by Securities and Exchange Commission of Sri Lanka	0																					
20.3.1.2.0.0	Public Sector Entities All performing claims on domestic public-sector entities (including public corporations, statutory boards, provincial authorities, local government bodies, etc.) <table border="1" data-bbox="518 510 1294 719"> <thead> <tr> <th>Web return code</th> <th>Credit rating</th> <th>Risk weight</th> </tr> </thead> <tbody> <tr> <td>20.3.1.2.1.0</td> <td>AAA to BBB-</td> <td>20</td> </tr> <tr> <td>20.3.1.2.2.0</td> <td>BB+ to B-</td> <td>50</td> </tr> <tr> <td>20.3.1.2.3.0</td> <td>Below B-</td> <td>150</td> </tr> <tr> <td>20.3.1.2.4.0</td> <td>Unrated</td> <td>100</td> </tr> </tbody> </table>	Web return code	Credit rating	Risk weight	20.3.1.2.1.0	AAA to BBB-	20	20.3.1.2.2.0	BB+ to B-	50	20.3.1.2.3.0	Below B-	150	20.3.1.2.4.0	Unrated	100							
Web return code	Credit rating	Risk weight																					
20.3.1.2.1.0	AAA to BBB-	20																					
20.3.1.2.2.0	BB+ to B-	50																					
20.3.1.2.3.0	Below B-	150																					
20.3.1.2.4.0	Unrated	100																					
20.3.1.3.0.0	Central Bank of Sri Lanka All claims on the Central Bank of Sri Lanka	0																					
20.3.2.0.0.0	Claims on financial institutions 1) All performing claims on all banks and financial institutions. 2) Exclude the investments adjusted under Form 2- 20.2.2.6.0.0, 20.2.2.7.0.0, 20.2.6.1.0.0 and 20.2.6.2.0.0.																						
20.3.2.1.0.0	Banks Total performing claims on all banks. <table border="1" data-bbox="518 1111 1294 1319"> <thead> <tr> <th>Web return code</th> <th>Credit rating</th> <th>Risk weight</th> </tr> </thead> <tbody> <tr> <td>20.3.2.1.1.0</td> <td>AAA to BBB-</td> <td>20</td> </tr> <tr> <td>20.3.2.1.2.0</td> <td>BB+ to B-</td> <td>50</td> </tr> <tr> <td>20.3.2.1.3.0</td> <td>Below B-</td> <td>150</td> </tr> <tr> <td>20.3.2.1.4.0</td> <td>Unrated</td> <td>100</td> </tr> </tbody> </table>	Web return code	Credit rating	Risk weight	20.3.2.1.1.0	AAA to BBB-	20	20.3.2.1.2.0	BB+ to B-	50	20.3.2.1.3.0	Below B-	150	20.3.2.1.4.0	Unrated	100							
Web return code	Credit rating	Risk weight																					
20.3.2.1.1.0	AAA to BBB-	20																					
20.3.2.1.2.0	BB+ to B-	50																					
20.3.2.1.3.0	Below B-	150																					
20.3.2.1.4.0	Unrated	100																					
20.3.2.2.0.0	Financial Institutions Total performing claims on Licensed Finance Companies, Specialized Leasing Companies, Primary Dealers and Insurance Companies. <table border="1" data-bbox="518 1518 1294 1816"> <thead> <tr> <th>Web return code</th> <th>Credit rating</th> <th>Risk weight</th> </tr> </thead> <tbody> <tr> <td>20.3.2.2.1.0</td> <td>AAA to AA-</td> <td>20</td> </tr> <tr> <td>20.3.2.2.2.0</td> <td>A+ to A-</td> <td>50</td> </tr> <tr> <td>20.3.2.2.3.0</td> <td>BBB+ to BBB-</td> <td>75</td> </tr> <tr> <td>20.3.2.2.4.0</td> <td>BB+ to BB-</td> <td>100</td> </tr> <tr> <td>20.3.2.2.5.0</td> <td>Below BB-</td> <td>150</td> </tr> <tr> <td>20.3.2.2.6.0</td> <td>Unrated</td> <td>100</td> </tr> </tbody> </table>	Web return code	Credit rating	Risk weight	20.3.2.2.1.0	AAA to AA-	20	20.3.2.2.2.0	A+ to A-	50	20.3.2.2.3.0	BBB+ to BBB-	75	20.3.2.2.4.0	BB+ to BB-	100	20.3.2.2.5.0	Below BB-	150	20.3.2.2.6.0	Unrated	100	
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20.3.3.0.0.0	<p>Claims on Corporates</p> <p>1) This section includes all performing claims to corporate customers.</p> <p>2) Exclude claims secured by commercial real estate reported in 20.3.5.0.0.0.</p> <table border="1" data-bbox="507 259 1281 555"> <thead> <tr> <th>Web return code</th> <th>Credit rating</th> <th>Risk weight</th> </tr> </thead> <tbody> <tr> <td>20.3.3.1.0.0</td> <td>AAA to AA-</td> <td>20</td> </tr> <tr> <td>20.3.3.2.0.0</td> <td>A+ to A-</td> <td>50</td> </tr> <tr> <td>20.3.3.3.0.0</td> <td>BBB+ to BBB-</td> <td>75</td> </tr> <tr> <td>20.3.3.4.0.0</td> <td>BB+ to BB-</td> <td>100</td> </tr> <tr> <td>20.3.3.5.0.0</td> <td>Below BB-</td> <td>150</td> </tr> <tr> <td>20.3.3.6.0.0</td> <td>Unrated</td> <td>100</td> </tr> </tbody> </table>	Web return code	Credit rating	Risk weight	20.3.3.1.0.0	AAA to AA-	20	20.3.3.2.0.0	A+ to A-	50	20.3.3.3.0.0	BBB+ to BBB-	75	20.3.3.4.0.0	BB+ to BB-	100	20.3.3.5.0.0	Below BB-	150	20.3.3.6.0.0	Unrated	100	
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20.3.3.6.0.0	Unrated	100																					
20.3.4.0.0.0	<p>Retail claims</p> <p>1) All performing retail claims include exposure given to an individual person or persons or to a Small and Medium Enterprises (SMEs).</p> <p>2) SME is a defined as an entity where the annual turnover (at the time of granting) does not exceed Rs.750 million.</p> <p>3) If the annual turnover exceeds Rs.750 million of a retail counterparty it should be classified under corporate claims.</p> <p>4) The annual turnover should be based on the latest available financial statements at the time of granting the facility. The LFC shall adopt their own mechanism to verify the annual turnover.</p>																						
20.3.4.1.0.0	<p>Retail claims in respect of motor vehicles and machinery</p> <p>Any credit facilities granted for the purpose of purchase or utilization of motor vehicles and machinery where the absolute ownership lies with the company</p>	100																					
20.3.4.2.0.0	<p>Retail claims Secured by Gold</p> <p>The outstanding claim amount and the market value shall be as at the reporting date.</p> <table border="1" data-bbox="459 1328 1417 1536"> <thead> <tr> <th>Web return code</th> <th>Threshold</th> <th>Risk weight</th> </tr> </thead> <tbody> <tr> <td>20.3.4.2.1.0</td> <td>Outstanding claim portion up to 70% of the market value</td> <td>0</td> </tr> <tr> <td>20.3.4.2.2.0</td> <td>Remaining outstanding claim portion over 70% of the market value</td> <td>100</td> </tr> </tbody> </table>	Web return code	Threshold	Risk weight	20.3.4.2.1.0	Outstanding claim portion up to 70% of the market value	0	20.3.4.2.2.0	Remaining outstanding claim portion over 70% of the market value	100													
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20.3.4.3.0.0	<p>Retail claims secured by immovable property</p> <p>Claims secured by mortgages on commercial real estate shall be excluded from here and reported under 20.3.5.0.0.0.</p> <p>1) 20.3.4.3.1.0 - Claims that qualify for regulatory capital purposes</p> <p>a) Claim is fully secured by a primary mortgage.</p> <p>b) The claims should strictly meet the following qualifying criteria to be able to use the preferential risk weight:</p> <p>i. Claim should be directly for residential purposes.</p> <p>ii. A margin of at least 25% on the forced sale value of the</p>	50																					

	<p>property based on the latest valuation report;</p> <p>iii. Valuation of property should be conducted as per the Direction on the Regulatory Framework for Valuation of Immovable Property.</p> <p>c) Mortgages other than primary mortgages will qualify for the same risk weight, subject to the above conditions, and the mortgage is with the same LFC.</p>										
	<p>2) 20.3.4.3.2.0 - Claims that do not qualify for regulatory capital purposes Performing claims that do not meet the criteria given above.</p>	100									
20.3.4.4.0.0	<p>Other retail claims All other retail claims which do not meet the criteria in 20.3.4.1.0.0 to 20.3.4.3.0.0</p>	125									
20.3.5.0.0.0	<p>Claims Secured by Commercial Real Estate Commercial real estate exposure is defined as exposures secured by mortgages on commercial real estate such as office buildings, multi-purpose or multi-tenanted commercial premises, multi-family residential buildings, industrial or warehouse space, hotels, land development and construction.</p>	100									
20.3.6.0.0.0	<p>Non-Performing Assets (NPAs) The NPAs, net of specific provision/individual impairment will be risk weighted.</p>										
20.3.6.1.0.0	<p>Non-performing retail claims secured by immovable property</p> <p>1) The outstanding non-performing claims (without netting the value of the property mortgaged), net of specific provision/individual impairment shall be reported.</p> <p>2) For this purpose, follow the below steps:</p> <p>a) Determine whether the specific provision/individual impairment of the outstanding NPA is more or less than 20%. For the computation, the outstanding amount of the NPA shall be without netting the value of the property mortgage and provisions.</p> <p style="text-align: center;"> $\frac{\text{Specific provision/individual impairment}}{\text{Outstanding NPAs (without netting collateral and specific provisioning/individual impairment)}} \times 100\% = < \text{or} > 20\%$ </p> <p>b) The outstanding non-performing claim (without netting the value of the property mortgaged), net of specific provisioning/individual impairment shall be risk weighted based on the level of provision coverage computed in (a) above as below.</p> <table border="1" style="margin-left: auto; margin-right: auto;"> <thead> <tr> <th>Web return code</th> <th>Criteria</th> <th>Risk weight</th> </tr> </thead> <tbody> <tr> <td>20.3.6.1.1.0</td> <td>Specific provisions/individual impairment are equal or more than 20%</td> <td>50</td> </tr> <tr> <td>20.3.6.1.2.0</td> <td>Specific provisions/individual impairment are less than 20%</td> <td>100</td> </tr> </tbody> </table>	Web return code	Criteria	Risk weight	20.3.6.1.1.0	Specific provisions/individual impairment are equal or more than 20%	50	20.3.6.1.2.0	Specific provisions/individual impairment are less than 20%	100	
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20.3.6.1.2.0	Specific provisions/individual impairment are less than 20%	100									

20.3.6.2.0.0	<p>Other Non-Performing Assets</p> <p>1) The unsecured portion of all other NPAs (after deducting eligible collaterals under CRM), net of specific provision/individual impairment shall be reported.</p> <p>2) For this purpose, follow the below steps:</p> <p>a) Determine whether the specific provision/individual impairment of the outstanding NPA is more or less than 20%. For the computation, the outstanding amount of the NPA shall be without netting the value of the eligible collaterals and provisions.</p> <p style="text-align: center;">$\frac{\text{Specific provision /individual impairment}}{\text{Outstanding NPAs (without netting collateral and specific provisioning/individual impairment)}} \times 100\% = < \text{ or } > 20\%$</p> <p>b) Compute the unsecured portion of the NPA. For this purpose, eligible collateral can be deducted as secured which was recognized for Credit Risk Mitigation purposes. However, other forms of collaterals like lands, building, plant machinery, current assets, etc. shall not be considered as the secured portion of NPAs for capital requirement purpose.</p> <p style="text-align: center;">Unsecured NPA = NPA -eligible secured CRMs</p> <p>c) The unsecured portion of NPA, net of specific provisioning/individual impairment shall be risk weighted based on the level of provision coverage computed in (a) above as below.</p> <table border="1" data-bbox="485 1070 1407 1317"> <thead> <tr> <th>Web return code</th> <th>Criteria</th> <th>Risk weight</th> </tr> </thead> <tbody> <tr> <td>20.3.6.2.1.0</td> <td>Specific provisions/individual impairment are equal or more than 20%</td> <td>100</td> </tr> <tr> <td>20.3.6.2.2.0</td> <td>Specific provisions/individual impairment are less than 20%</td> <td>150</td> </tr> </tbody> </table>	Web return code	Criteria	Risk weight	20.3.6.2.1.0	Specific provisions/individual impairment are equal or more than 20%	100	20.3.6.2.2.0	Specific provisions/individual impairment are less than 20%	150	
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20.3.7.0.0.0	<p>Higher-Risk Categories</p> <p>Performing claims to venture capital funds and private equity investments, which are considered as high-risk exposures.</p> <p>All investments in financial institutions that have not been adjusted under part 1(B) – 20.2.2.6.0.0, 20.2.2.7.0.0, 20.2.6.1.0.0 and 20.2.6.2.0.0</p>	150									
20.3.8.0.0.0	Other claims (assets)										
20.3.8.1.0.0	<p>Notes and Coins</p> <p>Local currency notes and coins held by tellers, in ATMs, in vault and petty cash</p>	0									
20.3.8.2.0.0	<p>Gold Bullion held in own vault</p> <p>Gold and bullion held in the LFC's vaults. Gold items held in safe custody shall be excluded.</p>	0									

20.3.8.3.0.0	Cash Items in the Process of Collection Cheques, drafts and other cash items, such as money orders, postal orders drawn on banks and other authorized institutions and paid immediately on presentation and cash in transit. Trade bills, such as import bills and export bills, in the process of collection should be excluded from this item and considered as loans and advances.	20
20.3.8.4.0.0	Fixed Assets The item includes premises, immovable property, machinery and equipment, motor vehicles, furniture and fittings and other fixed assets, reported at cost or at revalued amount, net of accumulated depreciation excluding intangible assets.	100
20.3.8.5.0.0	Other Assets/Exposures All other assets/exposures which are not specified elsewhere.	100

Part 2 (B): Computation of Credit equivalent of Off-Balance Sheet Item

Code	Item	Credit Conversion Factor (%)
20.4.0.0.0.0	Off-balance Sheet Items The exposure on off-balance sheet items is to be included in the computation of the risk weighted capital ratio. The conversion of the credit risk inherent in each off-balance sheet item would be converted into an on-balance sheet credit equivalent by multiplying the principal amount by a credit conversion factor. The credit equivalent amount would then be weighted according to the corresponding asset item in Part 2(A).	
20.4.1.0.0.0	General Guarantees of Indebtedness General guarantees of indebtedness where the risk of loss in the transaction may crystallize into a direct liability and become a direct claim on the counterparty. These include guarantees in respect of counterparties like insurance agents, sales agents, etc. to cover any non-payment by them of premium, sales proceeds, etc. to their beneficiaries. Company guarantees in favor of customs would cover any non-payment of customs duties by their counterparties.	100
20.4.2.0.0.0	Performance Bonds, Bid Bonds & Warranties Transaction-related contingent items such as Performance Bonds, Bid Bonds and Warranties, where the risk of loss arises from an irrevocable obligation to pay a third party, the non-financial obligation of the customer upon his failure to fulfill obligations under a contract or a transaction. Such contingencies would crystallize into actual liabilities dependent upon the occurrence or non-occurrence of an event other than that of a default in payment by the counterparty.	50
20.4.3.0.0.0	Commitments This includes formal standby facilities & credit lines, undrawn credit facilities and others which cannot be cancelled at any time.	
20.4.3.1.0.0	With an original maturity, up to 1 year	20

20.4.3.2.0.0	With an original maturity of over one year	50
20.4.4.0.0.0	Foreign Exchange Contracts Exchange rate contracts shall include the following items ('a' to 'e'), but exclude exchange rate contracts which have an original maturity of 14 calendar days or less. a) Forward foreign exchange contracts b) Currency futures c) Currency options purchased d) Cross currency FX swaps e) Other similar instruments To arrive at the credit equivalent amounts of exchange rate contracts, applying the original exposure method, an LFC will have to apply one of the conversion factors as given from 20.4.4.1.0.0 to 20.4.4.3.0.0 to the notional principal amounts of each instrument according to the nature of the instrument and its maturity.	
20.4.4.1.0.0	Original maturity-less than one year	2
20.4.4.2.0.0	Original maturity-more than one year and less than two years	5
20.4.4.3.0.0	Original maturity-more than two years (for each additional year)	3
20.4.5.0.0.0	Interest Rate Contracts Interest rate contracts shall include, a) Single currency interest rate swaps b) Basis swaps c) Forward rate agreements d) Interest rate futures e) Interest rate options purchased, and f) Other similar instruments To arrive at the credit equivalent amounts of interest rate contracts, applying the original exposure method, an LFC will have to apply one of the conversion factors as given from 20.4.5.1.0.0 to 20.4.5.3.0.0 to the notional principal amounts of each instrument according to the nature of the instrument and its maturity.	
20.4.5.1.0.0	Original maturity-less than one year	0.5
20.4.5.2.0.0	Original maturity-more than one year and less than two years	1
20.4.5.3.0.0	Original maturity-more than two years (for each additional year)	1
20.4.6.0.0.0	Others	100

Part 2 (C) – Guidelines on recognizing exposures under Credit Risk Mitigation

1. Overview of Credit Risk Mitigation (CRM)

- 1.1 LFCs use many techniques to mitigate the credit risks to which they are exposed. For example, exposures may be collateralized by first priority claims, in whole or in part with cash or securities, a loan exposure may be guaranteed by a third party, or an LFC may buy a credit derivative to offset various forms of credit risk. Additionally, LFCs may agree to net loans owed to them against deposits from the same counterpart.
- 1.2 Credit risk mitigation allows a wider range of credit risk mitigation options to be recognized for regulatory capital purposes provided that these techniques meet the minimum conditions described below.

- 1.3 While the use of CRM techniques reduces or transfers credit risk, it simultaneously may increase other risks (residual risks). Residual risks include legal, operational, liquidity and market risks. Therefore, it is imperative that LFCs employ robust procedures and processes to control these risks, including strategy, consideration of the underlying credit, valuation, policies and procedures, systems, control of roll-off risks and management of concentration risk arising from the LFCs' use of CRM techniques and its interaction with the LFC's overall credit risk profile.
- 1.4 Total exposure of eligible collateralized transactions and other CRM techniques should be reported in this return. Any non-eligible collateralized transactions and other CRM's need to be reported in Part 2(A) similar to a usual claim.

2. Treatment of Pools of CRM Techniques

In case where an LFC has multiple CRM techniques covering a single exposure (e.g., a LFC has both collateral and guarantee partially covering an exposure), the LFC will be required to sub-divide the exposure into portions covered by each type of CRM technique (e.g., portion covered by collateral, portion covered by guarantee) and the risk-weighted assets of each portion must be calculated separately. When credit protection provided by a single protection provider has differing maturities, they must be sub-divided into separate protection as well.

Code	CRM Techniques
20.5.0.0.0.0	<p>Total CRM exposure</p> <p>1) Total exposure of eligible collateralized transactions and other CRM techniques.</p> <p>2) The exposures with zero risk weighted CRM's reported in this part, should not be reported in the other parts of the capital requirements return, however, exposures with risk weighted CRM's need to be reported in this part under relevant CRM as well as in part 2 (A) under the appropriate counterparty.</p>
20.5.1.0.0.0	<p>Collateralized transactions</p> <p>The sum of collateralized exposures.</p> <p>1) A collateralized transaction is one in which: LFC have a credit exposure or potential credit exposure and such exposure is hedged in whole or in part by collateral posted by a counterpart or by a third party on behalf of the counterpart.</p> <p>2) The Simple Approach will be followed in computing the effects of CRM</p> <p>a) In the Simple Approach, the portions of claims collateralized by the market value of recognized collateral receive the risk weight applicable to the collateral instrument.</p> <p>b) The risk weight on the collateralized portion will be subject to a floor of 20%. The remainder of the credit exposure should be assigned with</p>

the risk weight applicable to the counterparty.

- c) Mismatches in the maturity of the underlying exposure and collateral will not be allowed, i.e., the collateral must be pledged for at least the life of the exposure.

3) Exemptions from the floor of 20% risk weights

The 20% floor for the risk weight on a collateralized transaction will not be applied and 0% risk weight can be applied provided the exposure and the collateral are denominated in the same currency, and either:

- a) the collateral is cash on deposit, or
- b) the collateral is a Government security, or
- c) the collateral is in the form of provident fund balances maintained by Superintendent, Employees Provident Fund of the Central Bank of Sri Lanka.

4) Minimum Conditions

- a) **Legal Certainty:** All documentation used in collateralized transactions and guarantees must be binding on all parties and legally enforceable in all relevant jurisdictions. LFCs must have conducted sufficient legal review, which should be well documented, to verify this. Such verification should have a well-founded legal basis for reaching the conclusion about the binding nature and enforceability of the documents. LFCs should also undertake such further review as necessary to ensure continuing enforceability.
- b) **Ability to Liquidate:** The LFC should have the right to liquidate or take legal possession of it, in a timely manner, in the event of the default, insolvency or bankruptcy (or one or more otherwise-defined credit events set out in the transaction documentation) of the counterparty (and, where applicable, of the custodian holding the collateral). Furthermore, LFCs must take all steps necessary to fulfil those requirements under the law applicable to the LFC's interest in the collateral for obtaining and maintaining an enforceable security interest.
- c) **Material Correlation:** In order for collateral to provide protection, the credit quality of the counterparty and the value of the collateral must not have a positive correlation. For example, securities issued by the counterparty or by any related group entity - would provide little protection and so would be ineligible.
- d) **Recovery Procedures:** LFCs must have clear and robust procedures for the timely liquidation of collateral to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed, and that collateral can be liquidated promptly. Where the collateral is held by a custodian, LFC must take reasonable steps to ensure that the custodian segregates the collateral from its own assets.

20.5.1.1.0.0	Cash Cash (as well as certificates of deposit or comparable instruments, including fixed deposit receipts)
20.5.1.2.0.0	Government Securities
20.5.1.3.0.0	Provident Fund Balances
20.5.1.4.0.0	Debt securities rated by a recognized ECAI Rating of the collateral or the issuing entity should be at least BBB-
20.5.1.5.0.0	Debt securities not rated by a recognized ECAI These are: 1) Issued by a bank; and 2) Listed on a recognized exchange, and 3) Classified as senior debt or; 4) Other securities, specified by the Central Bank
20.5.1.6.0.0	Equities that are included in a main index Equities those are included in the S & P SL20 index, subject to a discount of 25% on the market value.
20.5.2.0.0.0	Other CRM Techniques The total amount of exposures against the other CRM techniques (other than collateralized transactions).
20.5.2.1.0.0	On-balance sheet netting 1) The total amount of exposures against the on-balance sheet netting. 2) An LFC may use the net exposure of loans and deposits as the basis for its capital ratio computation, where the LFC: a) has a well-founded legal basis for concluding that the netting or offsetting agreement is enforceable in each relevant jurisdiction regardless of whether the counterpart is insolvent or bankrupt; b) is able at any time to determine those assets (loans) and liabilities (deposits) with the same counterpart, maturity and currency that are subject to the netting agreement; c) monitors and controls its roll-off risks; and d) monitors and controls the relevant exposures on a net basis.
20.5.2.2.0.0	Guarantees 1) The total amount of exposures against the guarantees should be reported in line with the instructions given below. 2) Guaranteed Transactions Where guarantees are direct, explicit, irrevocable and unconditional, LFCs may take account of such credit protection in calculating capital requirements. 3) Minimum Conditions a) A guarantee (or counter-guarantee) must represent a direct claim on the protection provider and must be explicitly referenced to specific exposures or a pool of exposures, so that the extent of the cover is clearly defined and incontrovertible. b) Other than non-payment by a protection purchaser of money due in respect of the credit protection contract it must be irrevocable; there

	<p>must be no clause in the contract that would increase the effective cost of cover as a result of deteriorating credit quality in the hedged exposure.</p> <p>c) It must also be unconditional; there should be no clause in the protection contract outside the control of the LFC that could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original counterpart fails to make the payment(s) due.</p> <p>d) In addition to the legal certainty requirements above, the following conditions must also be satisfied:</p> <ol style="list-style-type: none"> i. On the qualifying default or non-payment of the counterpart, the LFC may in a timely manner pursue the guarantor for any monies outstanding under the documentation governing the transaction. The guarantor may make one lump sum payment of all monies under such documentation to the LFC, or the guarantor may assume the future payment obligations of the counterpart covered by the guarantee. The LFC must have the right to receive any such payments from the guarantor without first having to take legal actions in order to pursue the counterpart for payment. ii. The guarantee is an explicitly documented obligation assumed by the guarantor. iii. Except as noted in the following sentence, the guarantee covers all types of payments the underlying obligor is expected to make under the documentation governing the transaction, for example notional amount, margin payments, etc. iv. Where a guarantee covers payment of principal only, interests and other uncovered payments should be treated as an unsecured amount. <p>4) Eligible Guarantors Credit protection given by the following entities will be recognized:</p> <ol style="list-style-type: none"> a) Sovereign entities b) Public Sector Entities c) Other entities with a risk weight of 20% <p>5) Risk Weights:</p> <ol style="list-style-type: none"> a) The protected portion is assigned the risk weight of the protection provider. b) A zero-risk weight will be applied to that portion of loans guaranteed by government of Sri Lanka and Central Bank of Sri Lanka. c) The uncovered portion of the exposure is assigned the risk weight of the underlying counterpart.
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Part 2 (D): Guidelines on computation of Risk-Weighted Assets Amount for Operational Risk

1. Overview

1.1 Definition of operational risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

1.2 The measurement methodologies

There are several ways of calculating operational risk capital charge. However, the Basic Indicator Approach (BIA) has been used to calculate the capital charge for the operational risks.

2. The Basic Indicator Approach (BIA)

2.1 Under BIA, an LFC must hold capital for operational risk equal to the average over the previous three years of a fixed percentage (denoted as alpha) of positive annual gross income.

2.2 An LFC shall calculate its operational risk capital requirement as follows:

$$K_{BIA} = [\sum(GI_{1...n} \times \alpha)] / n$$

Where;

K_{BIA} = capital charge for operational risk under BIA

GI = annual gross income, where positive, over the preceding three years as set out in items 2.3 to 2.5

n = Number of years (three years when all three years annual gross income is positive)

α = 15%

2.3 An LFC shall calculate its gross income as the sum of net interest income and non-interest income, excluding;

a) Any realized profits/losses arising from the sale of securities classified as “held to maturity” or “available for sale”, in accordance with Sri Lanka Accounting Standard - LKAS 39;

b) Any income or expenses not derived from the ordinary activities of the LFC and not expected to occur frequently or regularly, i.e., sale of fixed assets, income derived from insurance recoveries, etc.

2.4 Figures for any year in which annual gross income is negative or zero should be excluded from both the numerator and denominator when calculating the average. If it is negative for all years, the regulators discretion will apply.

2.5 An LFC shall calculate its annual gross income for the most recent year by aggregating the gross income of the last 12 months and follow same to calculate annual gross income for each of the two years preceding the most recent year.

Code	Description																																																			
20.6.1.0.0.0	<p>Gross income Gross Income = Interest Income (20.6.1.1.0.0) - Interest Expenses (20.6.1.2.0.0) +Non-Interest Income (20.6.1.3.0.0) (+/-) Realized Profits/losses from the Sale of Securities (20.6.1.4.0.0) (+/-) Extraordinary/Irregular Items of Income/expense (20.6.1.5.0.0)</p> <p>Example:</p> <p>Table 7: Illustration of Calculation of Annual Gross Income (Rs. '000)</p> <table border="1"> <thead> <tr> <th>Item</th> <th>Amount</th> <th>Amount</th> </tr> </thead> <tbody> <tr> <td>Interest Income</td> <td>200,000</td> <td>200,000</td> </tr> <tr> <td>Less: Interest Expense</td> <td>(100,000)</td> <td>(100,000)</td> </tr> <tr> <td>Net Interest Income</td> <td>100,000</td> <td>100,000</td> </tr> <tr> <td>Non-interest Income</td> <td>200,000</td> <td>110,000</td> </tr> <tr> <td>Fee and Commission Income</td> <td>50,000</td> <td>50,000</td> </tr> <tr> <td>Dividend Income</td> <td>30,000</td> <td>30,000</td> </tr> <tr> <td>Gain on sale of fixed assets</td> <td>40,000</td> <td></td> </tr> <tr> <td>Profit/loss from Trading</td> <td>20,000</td> <td>20,000</td> </tr> <tr> <td>Realized gains/losses from sale of securities</td> <td>50,000</td> <td></td> </tr> <tr> <td>Others</td> <td>10,000</td> <td>10,000</td> </tr> <tr> <td>Operating Income</td> <td>300,000</td> <td>210,000</td> </tr> <tr> <td>Less: Operating expenses</td> <td>(100,000)</td> <td></td> </tr> <tr> <td>Less: Provisioning/impairment</td> <td>(50,000)</td> <td></td> </tr> <tr> <td>Less: Taxes</td> <td>(30,000)</td> <td></td> </tr> <tr> <td>Profit/loss for the period</td> <td>120,000</td> <td></td> </tr> <tr> <td>Gross Income for the purpose of operational risk capital requirement</td> <td></td> <td>210,000</td> </tr> </tbody> </table> <p>Aggregate the gross income for the 3 years as reported and divide by 3 (number of years). The number of years may change in accordance with the item 2.4.</p>	Item	Amount	Amount	Interest Income	200,000	200,000	Less: Interest Expense	(100,000)	(100,000)	Net Interest Income	100,000	100,000	Non-interest Income	200,000	110,000	Fee and Commission Income	50,000	50,000	Dividend Income	30,000	30,000	Gain on sale of fixed assets	40,000		Profit/loss from Trading	20,000	20,000	Realized gains/losses from sale of securities	50,000		Others	10,000	10,000	Operating Income	300,000	210,000	Less: Operating expenses	(100,000)		Less: Provisioning/impairment	(50,000)		Less: Taxes	(30,000)		Profit/loss for the period	120,000		Gross Income for the purpose of operational risk capital requirement		210,000
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20.6.2.0.0.0	<p>Capital Charges for Operational Risk Multiply 20.6.1.0.0.0 in to 15%</p>																																																			
20.6.3.0.0.0	<p>Risk-Weighted Amount for Operational Risk The capital charge arrived in 20.6.2.0.0.0 multiplied by the reciprocal of total capital ratio [e.g.: if the total capital ratio is 10% the reciprocal would be 10 (100/10)].</p>																																																			

Schedule II

**Reporting formats for Capital Adequacy of
Licensed Finance Companies**

Part 1 (A): Computation of Capital Ratios (LKR '000)

Code	Item	Amount
20.1.1.0.0.0	Tier 1 Capital	
20.1.2.0.0.0	Total Capital	
20.1.3.0.0.0	Total Risk Weighted Amount	
20.1.3.1.0.0	Risk Weighted Assets Amount for Credit Risk	
20.1.3.2.0.0	Risk Weighted Assets Amount for Operational Risk	
20.1.4.0.0.0	Tier 1 Capital Ratio, %	
20.1.5.0.0.0	Total Capital Ratio, %	

Part 1 (B): Computation of Total Capital (LKR '000)

Code	Item	Amount
20.2.1.0.0.0	Tier 1 capital	
20.2.1.1.0.0	Stated capital	
20.2.1.2.0.0	Non-cumulative, Non-redeemable Preference Shares	
20.2.1.3.0.0	Reserve fund	
20.2.1.4.0.0	Audited retained earnings/(losses)	
20.2.1.4.1.0	(less) Revaluation gains/surplus of investment property	
20.2.1.5.0.0	General and other disclosed reserves	
20.2.1.6.0.0	Current year profit/(loss)	
20.2.2.0.0.0	Total adjustments to Tier 1 capital	
20.2.2.1.0.0	Goodwill (net)	
20.2.2.2.0.0	Other intangible assets (net)	
20.2.2.3.0.0	Other Comprehensive Income losses	
20.2.2.4.0.0	Deferred tax assets (net)	
20.2.2.5.0.0	Shortfall of the cumulative impairment to total provisions and interest in suspense	
20.2.2.6.0.0	50% of investment in banking and financial subsidiary companies	
20.2.2.7.0.0	50% of investment in other banking and financial institutions	
20.2.2.8.0.0	Shortfall of capital in financial subsidiaries	
20.2.3.0.0.0	Tier 1 Capital after adjustments	
20.2.4.0.0.0	Tier 2 Capital	
20.2.4.1.0.0	Instruments qualified as Tier 2 Capital	
20.2.4.2.0.0	Revaluation gains	
20.2.4.3.0.0	General provisions/collective impairment allowances	
20.2.5.0.0.0	Eligible Tier 2 Capital	
20.2.6.0.0.0	Total adjustments to eligible Tier 2 Capital	
20.2.6.1.0.0	50% of investment in banking and financial subsidiary companies	
20.2.6.2.0.0	50% of investment in other banking and financial institutions	
20.2.7.0.0.0	Eligible Tier 2 Capital after adjustments	
20.2.8.0.0.0	Total Capital	

Part 2 (A): Computation of Risk Weighted Assets Amount for Credit Risk (LKR '000)

Code	Item	Amount	Credit equivalent of Off-balance sheet items	Total	Risk Weight %	Risk Weighted Assets amount
20.3.0.0.0.0	Total Risk-weighted Amount for Credit Risk					
20.3.1.0.0.0	Claims on Government of Sri Lanka, Public Sector Entities and Central Bank of Sri Lanka					
20.3.1.1.0.0	Government of Sri Lanka					
20.3.1.1.1.0	Outright purchase				0	
20.3.1.1.2.0	Others				0	
20.3.1.2.0.0	Public Sector Entities					
20.3.1.2.1.0	AAA to BBB-				20	
20.3.1.2.2.0	BB+ to B-				50	
20.3.1.2.3.0	Below B-				150	
20.3.1.2.4.0	Unrated				100	
20.3.1.3.0.0	Central Bank of Sri Lanka				0	
20.3.2.0.0.0	Claims on financial institutions					
20.3.2.1.0.0	Banks					
20.3.2.1.1.0	AAA to BBB-				20	
20.3.2.1.2.0	BB+ to B-				50	
20.3.2.1.3.0	Below B-				150	
20.3.2.1.4.0	Unrated				100	
20.3.2.2.0.0	Financial Institutions					
20.3.2.2.1.0	AAA to AA-				20	
20.3.2.2.2.0	A+ to A-				50	
20.3.2.2.3.0	BBB+ to BBB-				75	
20.3.2.2.4.0	BB+ to BB-				100	
20.3.2.2.5.0	Below BB-				150	
20.3.2.2.6.0	Unrated				100	
20.3.3.0.0.0	Claims on Corporates					
20.3.3.1.0.0	AAA to AA-				20	
20.3.3.2.0.0	A+ to A-				50	
20.3.3.3.0.0	BBB+ to BBB-				75	
20.3.3.4.0.0	BB+ to BB-				100	
20.3.3.5.0.0	Below BB-				150	
20.3.3.6.0.0	Unrated				100	
20.3.4.0.0.0	Retail claims					
20.3.4.1.0.0	Retail claims in respect of motor vehicles and machinery				100	
20.3.4.2.0.0	Retail claims Secured by Gold					
20.3.4.2.1.0	Outstanding claim portion up to 70% of the market value				0	

20.3.4.2.2.0	Remaining outstanding claim portion over 70% of the market value				100	
20.3.4.3.0.0	Retail claims secured by immovable property					
20.3.4.3.1.0	Retail claims that qualify for regulatory capital purposes				50	
20.3.4.3.2.0	Retail claims that do not qualify for regulatory capital purposes				100	
20.3.4.4.0.0	Other retail claims				125	
20.3.5.0.0.0	Claims Secured by Commercial Real Estate				100	
20.3.6.0.0.0	Non-Performing Assets					
20.3.6.1.0.0	Non-performing retail claims secured by immovable property					
20.3.6.1.1.0	Specific provisions are equal or more than 20%				50	
20.3.6.1.2.0	Specific provisions are less than 20%				100	
20.3.6.2.0.0	Other Non-Performing Assets					
20.3.6.2.1.0	Specific provisions are equal or more than 20%				100	
20.3.6.2.2.0	Specific provisions are less than 20%				150	
20.3.7.0.0.0	Higher-Risk Categories				150	
20.3.8.0.0.0	Other claims(assets)					
20.3.8.1.0.0	Notes and Coins				0	
20.3.8.2.0.0	Gold Bullion held in own vault				0	
20.3.8.3.0.0	Cash Items in the Process of collection				20	
20.3.8.4.0.0	Fixed Assets				100	
20.3.8.5.0.0	Other Assets/Exposures				100	

Part 2 (B): Credit equivalent of Off-Balance Sheet Item (LKR '000)

Code	Item	Principal amount of Off-Balance Sheet Items	Credit Conversion Factor (%)	Credit equivalent of Off-Balance Sheet Items
20.4.0.0.0.0	Off-balance Sheet Items			
20.4.1.0.0.0	General Guarantees of Indebtedness		100	
20.4.2.0.0.0	Performance Bonds, Bid Bonds & Warranties		50	
20.4.3.0.0.0	Commitments			
20.4.3.1.0.0	With an original maturity, up to 1 year		20	
20.4.3.2.0.0	With an original maturity of over one year		50	
20.4.4.0.0.0	Foreign Exchange Contracts			
20.4.4.1.0.0	Original maturity-less than one year		2	
20.4.4.2.0.0	Original maturity-more than one year and less than two years		5	

20.4.4.3.0.0	Original maturity-more than two years (for each additional year)		3	
20.4.5.0.0.0	Interest Rate Contracts			
20.4.5.1.0.0	Original maturity-less than one year		0.5	
20.4.5.2.0.0	Original maturity-more than one year and less than two years		1	
20.4.5.3.0.0	Original maturity-more than two years (for each additional year)		1	
20.4.6.0.0.0	Others		100	

Part 2 (C): Exposures recognized under Credit Risk Mitigation (CRM) (LKR '000)

Code	CRM Techniques	Amount
20.5.0.0.0.0	Total CRM exposure	
20.5.1.0.0.0	Collateralized transactions	
20.5.1.1.0.0	Cash	
20.5.1.2.0.0	Government Securities	
20.5.1.3.0.0	Employee Provident Fund Balances	
20.5.1.4.0.0	Debt securities rated by a recognized ECAI	
20.5.1.5.0.0	Debt securities not rated by a recognized ECAI	
20.5.1.6.0.0	Equities that are included in a main index	
20.5.2.0.0.0	Other CRM Techniques	
20.5.2.1.0.0	On-balance sheet netting	
20.5.2.2.0.0	Guarantees	

Part 2 (D): Computation of Risk Weighted Assets Amount for Operational Risk (LKR '000)

Code	Item	1 st Year	2 nd Year	3 rd Year	Total	Average
20.6.1.0.0.0	Gross Income	x	x	x	x	x
20.6.1.1.0.0	Interest Income	x	x	x	x	x
20.6.1.2.0.0	Interest Expenses	(x)	(x)	(x)	(x)	(x)
20.6.1.3.0.0	Non-interest income	x	x	x	x	x
20.6.1.4.0.0	Realized Profits/losses from the Sale of Securities	(x)/x	(x)/x	(x)/x	(x)/x	(x)/x
20.6.1.5.0.0	Extraordinary/Irregular Item of Income/expenses	(x)/x	(x)/x	(x)/x	(x)/x	(x)/x
20.6.2.0.0.0	Capital Charges for Operational Risk (20.6.1.0.0.0 * 15%)					x
20.6.3.0.0.0	Risk-Weighted Amount for operational Risk Approach (20.6.2.0.0.0*....)					x

