



**CENTRAL BANK OF SRI LANKA
BANK SUPERVISION DEPARTMENT**

14 February 2020 FREQUENTLY ASKED QUESTIONS (FAQs) No. 01 of 2020

Last updated on 15 June 2020

**Banking Act Directions No. 04 of 2018 on Financial Derivative Transactions for
Licensed Commercial Banks and Licensed Specialised Banks**

- 1) Is an underlying transaction (a current transaction or a permitted capital transaction in terms of the Foreign Exchange Act and the Regulations issued thereunder) required when a licensed commercial bank or a licensed specialized bank in Sri Lanka (i.e. Eligible Bank as defined in the said Direction) is entering into a derivative transaction with a foreign counterparty?

Yes, a valid underlying transaction is necessary when an Eligible Bank enters into a derivative transaction with any counterparty in Sri Lanka or abroad other than an inter-bank transaction.

- 2) Are derivative transactions which Eligible Banks are permitted to enter into with foreign counterparties limited to End User Deals (as described in paragraph 5.1 (a) of the said Direction) and hedging on back-to-back basis of its Non-Market Maker (NMM) Deals with its local customers and other Eligible Banks (as described in paragraph 5.1 (b) of the said Direction)?

End User Deals and Non-Market Maker Deals can be entered into with foreign counterparties. However, Derivative Market Maker Deals are not permitted to enter into with foreign counterparties.

- 3) What is the position with respect to transfers of cash and securities under a Credit Support Annex? Are Eligible Banks permitted to make such transfers to a foreign counterparty without a specific regulatory approval?



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The Direction requires to sign ISDA agreement with the counterparty. CSA is part of the ISDA agreement and a CSA cannot be executed without an ISDA. Accordingly, if both parties want to sign CSA they should enter into ISDA. However, if both parties agree, they can refrain from signing an ISDA. Specific regulatory approval is not required for the transfer of cash and securities under CSA.

- 4) Paragraph 6.3 of the said Direction prohibits Eligible Bank to make an upfront payment other than option premiums, to a customer in relation to a derivative transaction. Does this prohibition apply to upfront payments by an Eligible Bank entering into a derivative transaction with a foreign counterparty?

Direction 6.3 equally applies to derivative transactions with a foreign counterparty as well.

- 5) Can a bank extend or unwind and re-book a FX forward contract at the historical rate (i.e., originally contracted rate)?

In terms of the Direction 5.7 of Banking Act Directions No. 04 of 2018 on Financial Derivative Transactions, unwinding and re-booking of derivative contracts shall be done as follows:

- **Parties may unwind/sell back a derivative partially or fully, if such derivative is no longer required.**
- **All derivative contracts once unwound are eligible to be rebooked subject to the terms specified in the cited Directions.**
- **In the case of unwinding a derivative contract before maturity while the underlying transaction still exists, marked-to-market loss should be charged to such customer.**



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- **Any marked-to-market gain (financial gain) should not be paid to the customer.**
- **However, the rate benefit may be passed on to the customer at the time of rebooking.**

In terms of Direction 4.1 (xii) of Banking Act Directions No. 03 of 2009 on Risk Management Relating Foreign Exchange Businesses, FX transactions should be executed at current market rates and off-market or historical rate rollovers are not permitted.

However, under the prevailing COVID-19 business environment, customers may not be in a position to absorb FX losses due to their inability to deliver the FX forward contracts at maturity. Therefore, licensed banks may extend the FX forward contracts as at 19.03.2020, as and when maturing, at the contracted rate after adjusting the forward premium applicable for the extended period. However, banks should take the necessary steps to verify that the customer is genuinely unable to deliver the forward contract on the due date, due to the current global pandemic.

- 6) **Can the marked-to-market gain (financial gain) be paid to the customer, in the case of unwinding and rebooking of a derivative transaction?**

In terms of the Direction 5.7 of Banking Act Directions No. 04 of 2018 on Financial Derivative Transactions, unwinding and re-booking of derivative contracts shall be done as follows:

- **Parties may unwind/sell back a derivative partially or fully, if such derivative is no longer required.**



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- **All derivative contracts once unwound are eligible to be rebooked subject to the terms specified in the cited Directions.**
 - **In the case of unwinding a derivative contract before maturity while the underlying transaction still exists, marked-to-market loss should be charged to such customer.**
 - **Any marked-to-market gain (financial gain) should not be paid to the customer.**
 - **The rate benefit may be passed on to the customer at the time of rebooking.**

However, considering the importance to retain foreign investors in Government securities, banks may pay the marked-to-market gain arising from unwinding/ selling back of derivatives for which the underlying transaction is an investment in Government Securities, by foreign investors.
