

Leverage Ratio
Rules and Guidelines

1 December 2019



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List of Acronyms

| | |
|------|-----------------------------------|
| CCF | Credit Conversion Factors |
| CCR | Counterparty Credit Risk |
| CIMA | Cayman Islands Monetary Authority |
| CSA | Credit Support Annex |
| DVP | Delivery-versus-payment |
| MNA | Master Netting Agreement |
| NGR | Net-to-Gross Ratio |
| NIF | Note Issuance Facilities |
| OBS | Off-Balance Sheet |
| PFE | Potential Future Exposure |
| RC | Replacement Cost |
| RUF | Revolving Underwriting Facilities |
| SFT | Securities Financing Transaction |

1. Introduction

1.1. The Cayman Islands Monetary Authority (the “Authority” or “CIMA”) is introducing a simple, transparent, non-risk based leverage ratio to supplement its risk-based capital requirements in its Rules, Conditions and Guidelines on Minimum Capital Requirements (Pillar I) (the “Minimum Capital Requirements”).¹ **The implementation date of these Rules and Guidelines is 1 December 2019.**

1.2. These Rules and Guidelines are being issued in line with Section 10(1) of the Banks and Trust Companies Law which states:

“A licensee holding a licence for the carrying on of banking business and incorporated under the Companies Law (2018 Revision) shall not, at any time, have a capital adequacy ratio of less than ten per cent (or such other percentage as may be determined by the Authority from time to time) as calculated in accordance with such form, content and manner as may be prescribed.”

1.3. In order to highlight the Authority’s leverage ratio rules within the compendium, a rule is written in light blue and designated with the letter “R” in the right margin.

2. Scope of application

2.1. The scope of application of the leverage ratio requirements applies to all banks which apply the capital adequacy rules as defined in the Scope of Application section of the Minimum Capital Requirements.

3. Definition and minimum requirement

3.1. The leverage ratio is defined as the capital measure (the numerator) divided by the exposure measure (the denominator), with this ratio expressed as a percentage:

$$\text{Leverage Ratio} = \frac{\text{Capital measure}}{\text{Exposure measure}}$$

3.2. A bank is required to maintain a minimum leverage ratio of 3% at all times. At its discretion, the Authority may set different leverage ratio requirements on a case-by-case basis. R

3.3. A bank is required to comply with the minimum requirements with respect to the computation of the leverage ratio, as specified in these Rules and Guidelines. R

3.4. Both the capital measure and the exposure measure are to be calculated on a quarter-end basis. The Authority may set different calculation frequencies on a case-by-case basis. Subject to approval from the Authority, banks may opt to use more frequent calculations, however, this must be done consistently.

3.5. Section 4 defines the capital measure and section 5 defines the exposure measure.

¹ These leverage requirements are based on Basel Committee on Banking Supervision Basel III framework - <https://www.bis.org/bcbs/publ/d424.pdf>. The Committee has also issued FAQs to clarify the leverage ratio framework - <https://www.bis.org/bcbs/publ/d364.pdf>.

4. Capital measure

- 4.1. The capital measure for the leverage ratio is a bank's Tier 1 capital as defined in paragraph 23 of the Minimum Capital Requirements, taking into account the regulatory deductions specified in paragraphs 28 and 29.

5. Exposure Measure

- 5.1. A bank's total leverage ratio exposure measure is the sum of the following exposures, each of which are defined in the paragraphs below:
 - a) on-balance sheet exposures (excluding on-balance sheet derivative and securities financing transaction exposures);
 - b) derivative exposures;
 - c) securities financing transaction ("SFT") exposures²; and
 - d) off-balance sheet ("OBS") items.

- 5.2. The exposure measure for the leverage ratio generally follows gross accounting values. Unless specified differently below, banks must not take account of physical or financial collateral, guarantees or other credit risk mitigation techniques to reduce the leverage ratio exposure measure, nor may banks net assets and liabilities. However, to ensure consistency, balance sheet assets deducted from Tier 1 capital, as set out in paragraphs 28 and 29 of the Minimum Capital Requirements, may be deducted from the exposure measure.

- 5.3. **Liability items must not be deducted from the leverage ratio exposure measure.** For example, gains/losses on fair valued liabilities or accounting value adjustments on derivative liabilities due to changes in the bank's own credit risk must not be deducted from the leverage ratio exposure measure. R

A. On-balance sheet exposures

- 5.4. **Banks must include all balance sheet assets in their leverage ratio exposure measure,** including on-balance sheet derivatives collateral and collateral for SFTs, with the exception of on-balance sheet derivative and SFT assets that are covered in sections C and D below.³ R

- 5.5. On-balance sheet, non-derivative assets are included in the leverage ratio exposure measure at their accounting values less deductions for associated specific provisions. In addition, general provisions or general loan loss reserves, as defined in paragraph 12 of the Statement of Guidance on Credit Risk Classification, Provisioning and Management, which have reduced Tier 1 capital, may be deducted from the leverage ratio exposure measure.

- 5.6. The accounting for regular-way purchases or sales⁴ of financial assets that have not been settled (hereafter "unsettled trades") differs across and within accounting frameworks, with the result that those unsettled trades can be accounted for either on the trade date (trade date accounting) or on the settlement date (settlement date accounting). For the purpose of the leverage ratio exposure measure, banks using

² SFTs are transactions such as repurchase agreements, reverse repurchase agreements, security lending and borrowing, and margin lending transactions, where the value of the transactions depends on market valuations and the transactions are often subject to margin agreements.

³ Where a bank according to its operative accounting standard recognises fiduciary assets on the balance sheet, these assets can be excluded from the leverage ratio exposure measure provided that the assets meet the IFRS 9 criteria for derecognition and, where applicable, IFRS 10 for deconsolidation.

⁴ For the purposes of this treatment, "regular-way purchases or sales" are purchases or sales of financial assets under contracts for which the terms require delivery of the assets within the time frame established generally by regulation or convention in the marketplace concerned.

trade date accounting must reverse out any offsetting between cash receivables for unsettled sales and cash payables for unsettled purchases of financial assets that may be recognised under the applicable accounting framework, but may offset between those cash receivables and cash payables (regardless of whether such offsetting is recognised under the applicable accounting framework) if the following conditions are met:

- a) the financial assets bought and sold that are associated with cash payables and receivables are fair valued through income and included in the bank's regulatory trading book; and
- b) the transactions of the financial assets are settled on a delivery-versus-payment (DVP) basis.

Banks using settlement date accounting will be subject to the treatment set out in section D below and section IV in the Annex.

5.7. Cash pooling refers to arrangements involving treasury products whereby a bank combines the credit and/or debit balances of several individual participating customer accounts into a single account balance to facilitate cash and/or liquidity management. For purposes of the leverage ratio exposure measure, where a cash pooling arrangement entails a transfer at least on a daily basis of the credit and/or debit balances of the individual participating customer accounts into a single account balance, the individual participating customer accounts are deemed to be extinguished and transformed into a single account balance upon the transfer provided the bank is not liable for the balances on an individual basis upon the transfer. Thus, the basis of the leverage ratio exposure measure for such a cash pooling arrangement is the single account balance and not the individual participating customer accounts. When the transfer of credit and/or debit balances of the individual participating customer accounts does not occur daily, for purposes of the leverage ratio exposure measure, extinguishment and transformation into a single account balance is deemed to occur and this single account balance may serve as the basis of the leverage ratio exposure measure provided all of the following conditions are met. In the event the conditions are not met, the individual balances of the participating customer accounts must be reflected separately in the leverage ratio exposure measure.

- a) in addition to providing for the several individual participating customer accounts, the cash pooling arrangement provides for a single account, into which the balances of all individual participating customer accounts can be transferred and thus extinguished;
- b) the bank (i) has a legally enforceable right to transfer the balances of the individual participating customer accounts into a single account so that the bank is not liable for the balances on an individual basis and (ii) at any point in time, the bank must have the discretion and be in a position to exercise this right;
- c) the bank's supervisor does not deem as inadequate the frequency by which the balances of individual participating customer accounts are transferred to a single account;
- d) there are no maturity mismatches among the balances of the individual participating customer accounts included in the cash pooling arrangement or all balances are either overnight or on demand; and

- e) the bank charges or pays interest and/or fees based on the combined balance of the individual participating customer accounts included in the cash pooling arrangement.

B. Derivative exposures

5.8. For the purpose of the leverage ratio exposure measure, exposures to derivatives are included by means of two components: (a) replacement cost (RC); and (b) potential future exposure (PFE). The methods used to capture both of these components are set out below.

5.9. Banks must calculate their exposures associated with all derivative transactions, including where a bank sells protection using a credit derivative, as the RC for the current exposure plus an add-on for PFE, as described in paragraph 5.10. If the derivative exposure is covered by an eligible bilateral netting contract as specified in section II of the Annex, a specific treatment may be applied.⁵ Written credit derivatives are subject to an additional treatment, as set out in paragraphs 5.18 to 5.23 below.

5.10. For derivative transactions not covered by an eligible bilateral netting contract as specified in section II of the Annex, the amount to be included in the leverage ratio exposure measure is determined, for each transaction separately, as follows:

$$\text{exposure measure} = RC + \text{add-on}$$

where

- a) RC = the replacement cost of the contract (obtained by marking to market), where the contract has a positive value (as defined in paragraph 175 of the Minimum Capital Requirements); and
- b) Add-on = an amount for PFE over the remaining life of the contract calculated by applying an add-on factor to the notional principal amount of the derivative. The add-on factors are included in paragraphs 1 to 3 of the Annex.

Bilateral netting

5.11. When an eligible bilateral netting contract is in place as specified in section II of the Annex, the RC for the set of derivative exposures covered by the contract will be the net replacement cost and the add-on will be A_{Net} as calculated in paragraph 9 of the Annex.

Treatment of related collateral

5.12. Collateral received in connection with derivative contracts has two countervailing effects on leverage:

- a) it reduces counterparty exposure; but
- b) it can also increase the economic resources at the disposal of the bank, as the bank can use the collateral to leverage itself.

Collateral received

5.13. Collateral received in connection with derivative contracts does not necessarily reduce the leverage inherent in a bank's derivatives position, which is generally the case if the

⁵ These are netting rules of the Minimum Capital Requirements excepting the rules for cross-product netting in paragraph C.2.3 (i.e. netting across product categories such as derivatives and SFTs is not permitted in determining the leverage ratio exposure measure). However, where a bank has a cross-product netting agreement in place that meets the eligibility criteria of section II of the Annex, it may choose to perform netting separately in each product category provided that all other conditions for netting in this product category that are applicable to the current framework are met.

settlement exposure arising from the underlying derivative contract is not reduced. As a general principle, collateral received may not be netted against derivative exposures whether or not netting is permitted under the bank's operative accounting or risk-based framework. Hence, when calculating the exposure amount by applying paragraphs 5.8 to 5.10 above, a bank must not reduce the leverage ratio exposure measure amount by any collateral received from the counterparty.

5.14. Similarly, with regard to collateral provided, banks must gross up their leverage ratio exposure measure by the amount of any derivatives collateral provided where the provision of that collateral has reduced the value of their balance sheet assets under their operative accounting framework.

Treatment of cash variation margin

5.15. In the treatment of derivative exposures for the purpose of the leverage ratio exposure measure, the cash portion of variation margin exchanged between counterparties may be viewed as a form of pre-settlement payment, if the following conditions are met:

- a) If the recipient counterparty has no restrictions by law, regulation, or any agreement with the counterparty on the ability to use the cash received (i.e. the cash variation margin received is used as its own cash).
- b) Variation margin is calculated and exchanged on at least a daily basis based on mark-to-market valuation of derivatives positions. To meet this criterion, derivative positions must be valued daily and cash variation margin must be transferred at least daily to the counterparty or to the counterparty's account, as appropriate. Cash variation margin exchanged on the morning of the subsequent trading day based on the previous, end-of-day market values would meet this criterion.
- c) The variation margin is received in a currency specified in the derivative contract, governing master netting agreement (MNA), or credit support annex (CSA) to the qualifying MNA.
- d) Variation margin exchanged is the full amount that would be necessary to extinguish the mark-to-market exposure of the derivative subject to the threshold and minimum transfer amounts applicable to the counterparty.
- e) Derivative transactions and variation margins are covered by a single MNA between the legal entities that are the counterparties in the derivative transaction. The MNA must explicitly stipulate that the counterparties agree to settle net any payment obligations covered by such a netting agreement, taking into account any variation margin received or provided if a credit event occurs involving either counterparty. The MNA must be legally enforceable and effective (i.e. it satisfies the conditions in paragraph 7c) and paragraph 8 of the Annex) in all relevant jurisdictions, including in the event of default and bankruptcy or insolvency. For the purposes of this paragraph, the term "MNA" includes any netting agreement that provides legally enforceable rights of offset and a Master MNA may be deemed to be a single MNA.

5.16. If the conditions in paragraph 5.15 are met, the cash portion of variation margin received may be used to reduce the RC portion of the leverage ratio exposure measure, and the receivables assets from cash variation margin provided may be deducted from the leverage ratio exposure measure as follows:

- a) In the case of cash variation margin received, the receiving bank may reduce the RC (but not the add-on portion) of the exposure amount of the derivative asset by the amount of cash received if the positive mark-to-market value of the derivative contract(s) has not already been reduced by the same amount of cash variation margin received under the bank's operative accounting standard.
- b) In the case of cash variation margin provided to a counterparty, the posting bank may deduct the resulting receivable from its leverage ratio exposure measure where the cash variation margin has been recognised as an asset under the bank's operative accounting framework.

5.17. Cash variation margin may not be used to reduce the PFE amount (including the calculation of the net-to-gross ratio (*NGR*) as defined in paragraph 9 of the Annex).

Additional treatment for written credit derivatives

5.18. In addition to the counterparty credit risk (*CCR*) exposure arising from the fair value of the contracts, written credit derivatives create a notional credit exposure arising from the creditworthiness of the reference entity. Therefore it is appropriate to treat written credit derivatives consistently with cash instruments (e.g. loans, bonds) for the purposes of the leverage ratio exposure measure.

5.19. In order to capture the credit exposure to the underlying reference entity, in addition to the above treatment for derivatives and related collateral, the effective notional amount referenced by a written credit derivative is to be included in the leverage ratio exposure measure. The "effective notional amount" is obtained by adjusting the notional amount to reflect the true exposure of contracts that are leveraged or otherwise enhanced by the structure of the transaction. Further, the effective notional amount of a written credit derivative may be reduced by any negative change in fair value amount that has been incorporated into the calculation of Tier 1 capital with respect to the written credit derivative.⁶ The resulting amount may be further reduced by the effective notional amount of a purchased credit derivative on the same reference name, provided:

- a) the credit protection purchased through credit derivatives is otherwise subject to the same or more conservative material terms as those in the corresponding written credit derivative. This ensures that if a bank provides written protection via some type of credit derivative, the bank may only recognise offsetting from another purchased credit derivative to the extent that the purchased protection is certain to deliver a payment in all potential future states. Material terms include the level of subordination, optionality, credit events, reference and any other characteristics relevant to the valuation of the derivative;
- b) the remaining maturity of the credit protection purchased through credit derivatives is equal to or greater than the remaining maturity of the written credit derivative;
- c) the credit protection purchased through credit derivatives is not purchased from a counterparty whose credit quality is highly correlated with the value of the

⁶ This treatment is consistent with the rationale that the effective notional amounts included in the exposure measure may be capped at the level of the maximum potential loss, which means that the maximum potential loss at the reporting date is the notional amount of the credit derivative minus any negative fair value that has already reduced Tier 1 capital.

- reference obligation;⁷
- d) in the event that the effective notional amount of a written credit derivative is reduced by any negative change in fair value reflected in the bank's Tier 1 capital, the effective notional amount of the offsetting credit protection purchased through credit derivatives must also be reduced by any resulting positive change in fair value reflected in Tier 1 capital; and
 - e) the credit protection purchased through credit derivatives is not included in a transaction that has been cleared on behalf of a client and for which the effective notional amount referenced by the corresponding written credit derivative is excluded from the leverage ratio exposure measure according to this paragraph.

5.20. For the purposes of paragraph 5.19, the term "written credit derivative" refers to a broad range of credit derivatives through which a bank effectively provides credit protection and is not limited solely to credit default swaps and total return swaps. For example, all options where the bank has the obligation to provide credit protection under certain conditions qualify as "written credit derivatives". The effective notional amount of such options sold by the bank may be offset by the effective notional amount of options by which the bank has the right to purchase credit protection which fulfils the conditions of paragraph 5.19. For example, the condition of same or more conservative material terms as those in the corresponding written credit derivatives as referenced in paragraph 5.19 can be considered met only when the strike price of the underlying purchased credit protection is equal to or lower than the strike price of the underlying sold credit protection.

5.21. For the purposes of paragraph 5.19, two reference names are considered identical only if they refer to the same legal entity. Credit protection on a pool of reference names purchased through credit derivatives may offset credit protection sold on individual reference names if the credit protection purchased is economically equivalent to purchasing credit protection separately on each of the individual names in the pool (this would, for example, be the case if a bank were to purchase credit protection on an entire securitisation structure). If a bank purchases credit protection on a pool of reference names through credit derivatives, but the credit protection purchased does not cover the entire pool (i.e. the protection covers only a subset of the pool, as in the case of an nth-to-default credit derivative or a securitisation tranche), then the written credit derivatives on the individual reference names may not be offset. However, such purchased credit protection may offset written credit derivatives on a pool provided that the credit protection purchased through credit derivatives covers the entirety of the subset of the pool on which the credit protection has been sold.

5.22. Where a bank purchases credit protection through a total return swap and records the net payments received as net income, but does not record offsetting deterioration in the value of the written credit derivative (either through reductions in fair value or by an addition to reserves) in Tier 1 capital, the credit protection will not be recognised for the purpose of offsetting the effective notional amounts related to written credit derivatives.

5.23. Since written credit derivatives are included in the exposure measure at their effective

⁷ Specifically, the credit quality of the counterparty must not be positively correlated with the value of the reference obligation (ie the credit quality of the counterparty falls when the value of the reference obligation falls and the value of the purchased credit derivative increases). In making this determination, there does not need to exist a legal connection between the counterparty and the underlying reference entity.

notional amounts, and are also subject to add-on amounts for PFE, the exposure measure for written credit derivatives may be overstated. Banks may therefore choose to deduct the individual PFE add-on amount relating to a written credit derivative (which is not offset according to paragraph 5.19 and whose effective notional amount is included in the exposure measure) from their gross add-on in paragraphs 5.8 to 5.10.⁸

C. Securities Financing Transaction exposures

5.24. SFTs are included in the leverage ratio exposure measure according to the treatment described below. The treatment recognises that secured lending and borrowing in the form of SFTs is an important source of leverage, and ensures consistent international implementation by providing a common measure for dealing with the main differences in the operative accounting frameworks.

Bank acting as principal

5.25. When the bank acts as principal, the sum of the amounts in paragraphs 5.26 and 5.27 below is to be included in the leverage ratio exposure measure:

5.26. Gross SFT assets recognised for accounting purposes (i.e. with no recognition of accounting netting)⁹, adjusted as follows:

- a) excluding from the leverage ratio exposure measure the value of any securities received under an SFT, where the bank has recognised the securities as an asset on its balance sheet;¹⁰ and
- b) cash payables and cash receivables in SFTs with the same counterparty may be measured net if all the following criteria are met:
 - i. Transactions have the same explicit final settlement date; in particular, transactions with no explicit end date but which can be unwound at any time by either party to the transaction are not eligible;
 - ii. The right to set off the amount owed to the counterparty with the amount owed by the counterparty is legally enforceable both currently in the normal course of business and in the event of the counterparty's: (i) default; (ii) insolvency; and (iii) bankruptcy; and
 - iii. The counterparties intend to settle net, settle simultaneously, or the transactions are subject to a settlement mechanism that results in the functional equivalent of net settlement, that is, the cash flows of the transactions are equivalent, in effect, to a single net amount on the settlement date. To achieve such equivalence, both transactions are settled through the same settlement system and the settlement arrangements are supported by cash and/or intraday credit facilities intended to ensure that settlement of both transactions will occur by the end of the business day, and any issues arising from the securities legs of the SFTs do not interfere with the completion of the net settlement of the cash receivables and payables. In

⁸ In these cases, where effective bilateral netting contracts are in place, and when calculating $ANet = 0.4 \cdot AGross + 0.6 \cdot NGR \cdot AGross$ as per paragraphs 5.8 to 5.10, $AGross$ may be reduced by the individual add-on amounts (i.e. notional amounts multiplied by the appropriate add-on factors) which relate to written credit derivatives whose notional amounts are included in the leverage ratio exposure measure. However, no adjustments must be made to NGR . Where effective bilateral netting contracts are not in place, the PFE add-on may be set to zero in order to avoid the double-counting described in this paragraph.

⁹ Gross SFT assets recognised for accounting purposes must not recognise any accounting netting of cash payables against cash receivables (e.g. as currently permitted under the IFRS and US GAAP accounting frameworks). This regulatory treatment has the benefit of avoiding inconsistencies from netting which may arise across different accounting regimes.

¹⁰ This may apply, for example, under US GAAP, where securities received under an SFT may be recognised as assets if the recipient has the right to rehypothecate but has not done so.

particular, this latter condition means that the failure of any single securities transaction in the settlement mechanism may delay settlement of only the matching cash leg or create an obligation to the settlement mechanism, supported by an associated credit facility. If there is a failure of the securities leg of a transaction in such a mechanism at the end of the window for settlement in the settlement mechanism, then this transaction and its matching cash leg must be split out from the netting set and treated gross¹¹.

5.27.A measure of CCR calculated as the current exposure without an add-on for PFE, calculated as follows:

- a) Where a qualifying MNA¹² is in place, the current exposure (E^*) is the greater of zero and the total fair value of securities and cash lent to a counterparty for all transactions included in the qualifying MNA ($\sum E_i$), less the total fair value of cash and securities received from the counterparty for those transactions ($\sum C_i$). This is illustrated in the following formula:

$$E^* = \max\left\{0, \left[\sum E_i - \sum C_i\right]\right\}$$

- b) Where no qualifying MNA is in place, the current exposure for transactions with a counterparty must be calculated on a transaction by transaction basis: that is, each transaction i is treated as its own netting set, as shown in the following formula:

$$E_i^* = \max\{0, [E_i - C_i]\}$$

E_i^* may be set to zero if (i) E_i is the cash lent to a counterparty, (ii) this transaction is treated as its own netting set and (iii) the associated cash receivable is not eligible for the netting treatment in paragraph 5.26.

5.28. For the purposes of paragraph 5.27, the term “counterparty” includes not only the counterparty of the bilateral repo transactions but also triparty repo agents that receive collateral in deposit and manage the collateral in the case of triparty repo transactions. Therefore, securities deposited at triparty repo agents are included in “total value of securities and cash lent to a counterparty” (E) up to the amount effectively lent to the counterparty in a repo transaction. However, excess collateral that has been deposited at triparty agents but that has not been lent out may be excluded.

Sale accounting transactions

5.29. Leverage may remain with the lender of the security in an SFT whether or not sale accounting is achieved under the operative accounting framework. As such, where sale accounting is achieved for an SFT under the bank’s operative accounting framework, the bank must reverse all sales-related accounting entries, and then calculate its exposure as if the SFT had been treated as a financing transaction under the operative accounting framework (i.e. the bank must include the sum of amounts in paragraphs 5.26 and 5.27 for such an SFT) for the purposes of determining its leverage ratio exposure measure.

¹¹ Specifically, the criteria in this sub-paragraph are not intended to preclude a DVP settlement mechanism or other type of settlement mechanism, provided that the settlement mechanism meets the functional requirements set out in this sub-paragraph. For example, a settlement mechanism may meet these functional requirements if any failed transactions (i.e. the securities that failed to transfer and the related cash receivable or payable) can be re- entered in the settlement mechanism until they are settled.

¹² A “qualifying” MNA is one that meets the requirements under section III of the Annex.

Bank acting as agent

- 5.30. A bank acting as agent in an SFT generally provides an indemnity or guarantee to only one of the two parties involved, and only for the difference between the value of the security or cash its customer has lent and the value of collateral the borrower has provided. In this situation, the bank is exposed to the counterparty of its customer for the difference in values rather than to the full exposure to the underlying security or cash of the transaction (as is the case where the bank is one of the principals in the transaction).
- 5.31. Where a bank acting as agent in an SFT provides an indemnity or guarantee to a customer or counterparty for any difference between the value of the security or cash the customer has lent and the value of collateral the borrower has provided and the bank does not own or control the underlying cash or security resource, then the bank will be required to calculate its exposure measure by applying only paragraph 5.27.¹³
- 5.32. A bank acting as agent in an SFT and providing an indemnity or guarantee to a customer or counterparty will be considered eligible for the exceptional treatment set out in paragraph 5.31 only if the bank's exposure to the transaction is limited to the guaranteed difference between the value of the security or cash its customer has lent and the value of the collateral the borrower has provided. In situations where the bank is further economically exposed (i.e. beyond the guarantee for the difference) to the underlying security or cash in the transaction,¹⁴ a further exposure equal to the full amount of the security or cash must be included in the leverage ratio exposure measure.
- 5.33. Where a bank acting as agent provides an indemnity or guarantee to both parties involved in an SFT (i.e. securities lender and securities borrower), the bank will be required to calculate its leverage ratio exposure measure in accordance with paragraphs 5.30 to 5.32 separately for each party involved in the transaction

D. Off-balance sheet ("OBS") items

- 5.34. OBS items include commitments (including liquidity facilities), whether or not unconditionally cancellable, direct credit substitutes, acceptances, standby letters of credit and trade letters of credit.
- 5.35. OBS items are converted under the standardised approach for credit risk into credit exposure equivalents through the use of credit conversion factors ("CCFs"). For the purpose of determining the exposure amount of OBS items for the leverage ratio, the CCFs set out in section IV of the Annex must be applied to the notional amount.
- 5.36. If the OBS item is treated as a derivative exposure per the bank's relevant accounting standard, then the item must be measured as a derivative exposure for the purpose of the leverage ratio exposure measure. In this case, the bank does not need to apply the OBS item treatment to the exposure.
- 5.37. In addition, specific and general provisions set aside against OBS exposures that have decreased Tier 1 capital may be deducted from the credit exposure equivalent amount of those exposures (i.e. the exposure amount after the application of the relevant

¹³ Where, in addition to the conditions in paragraphs 5.29 to 5.31, a bank acting as an agent in an SFT does not provide an indemnity or guarantee to any of the involved parties, the bank is not exposed to the SFT and therefore need not recognise those SFTs in its exposure measure.

¹⁴ For example, due to the bank managing collateral received in the bank's name or on its own account rather than on the customer's or borrower's account (e.g. by on-lending or managing unsegregated collateral, cash or securities).

CCF). However, the resulting total off-balance sheet equivalent amount for OBS exposures cannot be less than zero.

These Rules and Guidelines are in force from 1 December 2019.

Annex

This Annex includes the relevant provisions from the Rules, Conditions and Guidelines on Minimum Capital Requirements (Pillar I) (the "Minimum Capital Requirements") applicable for the purposes of calculating the leverage ratio exposure measure.

I. Derivative exposures (paragraphs 175 to 183 of the Minimum Capital Requirements)

Add-on factors for determining potential future exposure ("PFE")

1. The following add-on factors apply to financial derivatives, based on residual maturity:

| | Interest rates | FX and gold | Equities | Precious metals except gold | Other commodities |
|-----------------------|----------------|-------------|----------|-----------------------------|-------------------|
| One year or less | 0.0% | 1.0% | 6.0% | 7.0% | 10.0% |
| Over one year to five | 0.5% | 5.0% | 8.0% | 7.0% | 12.0% |
| Over five years | 1.5% | 7.5% | 10.0% | 8.0% | 15.0% |

Notes:

- For contracts with multiple exchanges of principal, the factors are to be multiplied by the number of remaining payments in the contract.
- For contracts that are structured to settle outstanding exposures following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be set equal to the time until the next reset date. In the case of interest rate contracts with remaining maturities of more than one year that meet the above criteria, the add-on is subject to a floor of 0.5%.
- Forwards, swaps, purchased options and similar derivative contracts not covered by any of the columns in this matrix are to be treated as "other commodities".
- No potential future credit exposure would be calculated for single currency floating / floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

2. In the event that the stated notional amount is leveraged or enhanced by the structure of the transaction, banks must use the effective notional amount when determining potential future exposure.

3. The following add-on factors apply to single-name credit derivatives:

| | Protection buyer | Protection seller |
|---------------------------------------|------------------|-------------------|
| Total return swaps | | |
| "Qualifying" reference obligation | 5% | 5% |
| "Non-qualifying" reference obligation | 10% | 10% |
| Credit default swaps | | |
| "Qualifying" reference obligation | 5% | 5%** |
| "Non-qualifying" reference obligation | 10% | 10%** |

There will be no difference depending on residual maturity.

** The protection seller of a credit default swap shall only be subject to the add-on factor where it is subject to closeout upon the insolvency of the protection buyer while the underlying is still solvent. The add-on should then be capped to the amount of unpaid premiums.

4. Where the credit derivative is a first-to-default transaction, the add-on will be determined by the lowest credit quality underlying the basket, i.e. if there are any non-qualifying items in the basket, the non-qualifying reference obligation add-on should be used. For second

and subsequent nth-to-default transactions, underlying assets should continue to be allocated according to the credit quality, i.e. the second or, respectively, nth lowest credit quality will determine the add-on for a second-to-default or an nth-to-default transaction, respectively.

5. The "qualifying" category includes securities issued by public sector entities and multilateral development banks, plus other securities that are:
 - a) rated investment grade (e.g. rated Baa or higher by Moody's and BBB or higher by Standard & Poor's) by at least two credit rating agencies; or
 - b) rated investment grade by one rating agency and not less than investment grade by any other rating agency.
6. Furthermore, the "qualifying" category shall include securities issued by institutions that are deemed to be equivalent to investment grade quality and subject to supervisory and regulatory arrangements comparable to those under the Minimum Capital Requirements.

II. Bilateral netting (Paragraphs 188, 189 & 191 of the Minimum Capital Requirements)

7. For the purposes of the leverage ratio exposure measure, banks must apply the requirements of paragraphs 188 and 189 of the Minimum Capital Requirements, which are included here for ease of reference:
 - a) Banks may net transactions subject to novation under which any obligation between a bank and its counterparty to deliver a given currency on a given value date is automatically amalgamated with all other obligations for the same currency and value date, legally substituting one single amount for the previous gross obligations.
 - b) Banks may also net transactions subject to any legally valid form of bilateral netting not covered in a), including other forms of novation.
 - c) In both cases a) and b), a bank will need to satisfy the Authority that it has:
 - i. a netting contract or agreement with the counterparty that creates a single legal obligation, covering all included transactions, such that the bank would have either a claim to receive or obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions in the event that a counterparty fails to perform due to any of the following: default, bankruptcy, liquidation or similar circumstances;
 - ii. written and reasoned legal opinions that, in the event of a legal challenge, the relevant courts and administrative authorities would find the bank's exposure to be such a net amount under:
 - a) the law of the jurisdiction in which the counterparty is chartered and, if the foreign branch of a counterparty is involved, then also under the law of jurisdiction in which the branch is located;
 - b) the law that governs the individual transactions; and
 - c) the law that governs any contract or agreement necessary to effect the netting.
 - iii. when necessary, the Authority after consultation with other relevant supervisors must be satisfied that the netting is enforceable under the laws of each of the relevant jurisdictions. Thus, if any of these supervisors are dissatisfied about enforceability under its laws, the netting contract or agreement will not meet this condition and neither counterparty could obtain supervisory benefit.
 - iv. procedures in place to ensure that the legal characteristics of netting arrangements are kept under review in the light of possible changes in relevant law.
8. Contracts containing walkaway clauses will not be eligible for netting for the purpose of calculating the leverage ratio exposure measure pursuant to this Statement of Guidance. A

walkaway clause is a provision that permits a non-defaulting counterparty to make only limited payments, or no payment at all, to the estate of a defaulter, even if the defaulter is a net creditor.

9. Credit exposure on bilaterally netted forward transactions will be calculated as the sum of the net mark-to-market replacement cost, if positive, plus an add-on based on the notional underlying principal. The add-on for netted transactions (A_{Net}) will equal the weighted average of the gross add-on (A_{Gross}) and the gross add-on adjusted by the ratio of net current replacement cost to gross current replacement cost (NGR). This is expressed through the following formula:

$$A_{Net} = 0.4 \cdot A_{Gross} + 0.6 \cdot NGR \cdot A_{Gross}$$

where:

- a) NGR = level of net replacement cost/level of gross replacement cost for transactions subject to legally enforceable netting agreements.
 - b) A_{Gross} = sum of individual add-on amounts (calculated by multiplying the notional principal amount by the appropriate add-on factors set out in paragraphs 1 to 6 of this Annex) of all transactions subject to legally enforceable netting agreements with one counterparty.
10. For the purposes of calculating potential future credit exposure to a netting counterparty for forward foreign exchange contracts and other similar contracts in which the notional principal amount is equivalent to cash flows, the notional principal is defined as the net receipts falling due on each value date in each currency. The reason for this is that offsetting contracts in the same currency maturing on the same date will have lower potential future exposure as well as lower current exposure.

III. SFT exposures (Paragraphs 132 & 133 of the Minimum Capital Requirements)

Qualifying master netting agreement

11. The effects of bilateral netting agreements¹⁵ for covering SFTs will be recognised on a counterparty by counterparty basis if the agreements are legally enforceable in each relevant jurisdiction upon the occurrence of an event of default and regardless of whether the counterparty is insolvent or bankrupt. In addition, netting agreements must:
- a) provide the non-defaulting party with the right to terminate and close out in a timely manner all transactions under the agreement upon an event of default, including in the event of insolvency or bankruptcy of the counterparty;
 - b) provide for the netting of gains and losses on transactions (including the value of any collateral) terminated and closed out under it so that a single net amount is owed by one party to the other;
 - c) allow for the prompt liquidation or setoff of collateral upon the event of default; and
 - d) be, together with the rights arising from provisions required in a) and c) above, legally enforceable in each relevant jurisdiction upon the occurrence of an event of default regardless of the counterparty's insolvency or bankruptcy.
12. Netting across positions held in the banking book and trading book will only be recognised when the netted transactions fulfil the following conditions:
- a) all transactions are marked to market daily; and
 - b) the collateral instruments used in the transactions are recognised as eligible financial

¹⁵ The provisions related to qualifying master netting agreements for SFTs are intended for the calculation of the counterparty credit risk measure for SFTs as set out in paragraph 5.26 only.

collateral in the banking book.

IV. Off-balance sheet items (Paragraph 80 of the Minimum Capital Requirements)

13. For the purpose of the leverage ratio, OBS items will be converted into credit exposures by multiplying the committed but undrawn amount by a credit conversion factor ("CCF"). For these purposes, commitment means any contractual arrangement that has been offered by the bank and accepted by the client to extend credit, purchase assets or issue credit substitutes. It includes any such arrangement that can be unconditionally cancelled by the bank at any time without prior notice to the obligor. It also includes any such arrangement that can be cancelled by the bank if the obligor fails to meet conditions set out in the facility document, including conditions that must be met by the obligor prior to any initial or subsequent drawdown arrangement.
14. A 100% CCF will be applied to the following items:
 - a) Direct credit substitutes, e.g. general guarantees of indebtedness (including standby letters of credit serving as financial guarantees for loans and securities) and acceptances (including endorsements with the character of acceptances).
 - b) Sale and repurchase agreements.
 - c) Asset sales with recourse where the credit risk remains with the Bank.¹⁶
 - d) Forward asset purchases, forward deposits and partly-paid shares and securities, which represent commitments with certain drawdown.
15. A 50% CCF will be applied to the following items:
 - a) Commitments with an original maturity exceeding one year, including underwriting commitments and commercial credit lines.
 - b) Certain transaction-related contingent items (e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions).
 - c) Note issuance facilities ("NIFs") and revolving underwriting facilities ("RUFs").
16. A 20% CCF will be applied to the following items:
 - a) Commitments with an original maturity up to one year.
 - b) Short-term self-liquidating trade letters of credit arising from the movement of goods (e.g. documentary credits collateralised by the underlying shipment), (a 20% CCF will be applied to both issuing and confirming banks).
17. A 0% CCF will be applied to the following items:
 - a) Commitments that are unconditionally cancellable at any time by the Bank without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness.
18. Where there is an undertaking to provide a commitment on an OBS item, banks are to apply the lower of the two applicable CCFs.

¹⁶ These items are to be weighted according to the type of asset and not according to the type of counterparty with whom the transaction has been entered into.