CAYMAN ISLANDS MONETARY AUTHORITY

PRIVATE SECTOR CONSULTATION

RULES AND GUIDELINES ON THE LEVERAGE RATIO FOR BANKS

A. Introduction

1. Section 34(1)(a) of the Monetary Authority Law (2016 Revision) (as amended) ("MAL") states that –

"After private sector consultation and consultation with the Minister charged with responsibility for Financial Services, the Authority may –

(a) issue or amend rules or statements of principle or guidance concerning the conduct of licensees and their officers and employees, and any other persons to whom and to the extent that the regulatory laws may apply;".

2. Requirements specific to the private sector consultation are outlined in section 4(1) of the MAL as follows:

"When this Law requires private sector consultation in relation to a proposed measure –

(a) the Authority shall give to each private sector association a draft of the proposed measure, together with –

i. an explanation of the purpose of the proposed measure;

ii. an explanation of the Authority's reasons for believing that the proposed measure is compatible with the Authority's functions and duties under section 6;

iii. an explanation of the extent to which a corresponding measure has been adopted in a country or territory outside the Islands;

iv. an estimate of any significant costs of the proposed measure, together with an analysis of the benefits that will arise if the proposed measure is adopted; and

v. notice that representations about the proposed measure may be made to the Authority within a period specified in the notice (not being less than thirty days or such shorter period as may be permitted by subsection (3)); and

(b) before proceeding with the proposed measure, the Authority shall have regard to any representations made by the private sector associations, and shall give a written response, which shall be copied to all the private sector associations."

3. The Cayman Islands Monetary Authority ("the Authority" or "CIMA") seeks consultation and comment from the private sector associations concerning the proposed *Rules and Guidelines on the Leverage Ratio for Banks* ("LR Rules and Guidelines")(see appendix 1). The proposed measures will be applicable to banks incorporated in the Cayman Islands under the Banks and Trust Companies Law (2018 Revision) ("BTCL")

B. <u>Background/ Scope of Application</u>

4. The Basel III framework is a central element of the Basel Committee on Banking Supervision's ("BCBS") response to the 2007 global financial and economic crisis. It sought to address shortcomings of the pre-crisis regulatory framework and provides a regulatory foundation for a resilient banking system that supports the real economy. The Basel III comprehensive set of reform measures aims to:

    a) Improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source;
    b) Improve risk management and governance; and
    c) Strengthen banks' transparency and disclosures.

5. "*Leverage is an inherent and essential part of modern banking systems. Banks have a range of financial incentives to operate with high leverage and, at least up to a point, those benefits flow through to society more generally when that leverage is managed well. But there comes a point beyond which leverage becomes dangerous – something that was painfully obvious during the financial crisis. For this reason, sound prudential controls are needed to ensure that private incentives do not result in excessive leverage*."[1]

6. The BCBS introduced a leverage ratio in the 2010 Basel III package of reforms and subsequently issued the *Basel III leverage ratio framework and disclosure requirements* in January 2014, to provide a non-risk based leverage ratio to act as a credible supplementary measure to risk-based capital requirements and to address the potential for build-up of excessive leverage in the banking system. In December 2017, the BCBS issued the document - *Basel III: Finalising post-crisis reforms* to help restore credibility in the calculation of risk weighted assets by complementing the risk-weighted capital ratio with a finalised leverage ratio.

7. Implementation of the leverage ratio requirements by BCBS-member jurisdictions began with only bank-level reporting to national supervisors until 1 January 2015, thereafter, public disclosure started on 1 January 2015. The BCBS monitored and conducted comprehensive assessments and consultations on the impact of the requirements. The final definition and calibration of the leverage ratio was completed in December 2017, which included a decision to make the provisional 3.0% target ratio a binding requirement. Migration to a Pillar 1 (minimum capital requirements) treatment commenced on 1 January 2018.

8. The leverage ratio is defined as a capital measure divided by an exposure measure, expressed as a percentage:

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[1] *Banking on leverage*, Stefan Ingves Chairman, Basel Committee on Banking Supervision and Governor, Sveriges Riksbank, February 2014

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

9. A minimum leverage ratio requirement serves as the ultimate backstop against a shortage of equity based on risk-weighted capital requirements. It is calculated by dividing the amount of high-quality capital of a financial institution by its total non-risk-weighted exposure[2]. Therefore, the leverage ratio requirement mitigates the sensitivity of risk-weighted capital requirements to fluctuations in the perceived riskiness of assets. Commencing 2022, a capital add-on will raise the leverage ratio requirements for global systemically important banks.

10. A theoretical and empirical assessment of the introduction of a leverage ratio alongside a risk-based capital framework for European Union banks concluded that "*the introduction of an LR (leverage ratio) requirement into the Basel III regulatory framework should lead to more stable banks… the LR (leverage ratio) and the risk-based capital framework reinforce each other by covering risks which the other is less able to capture, making sure banks do not operate with excessive leverage, and at the same time, have sufficient incentives for keeping risk-taking in check*."[3]

11. The BCBS' postulates that "*a simple leverage ratio framework is critical and complementary to the risk-based capital framework and that a credible leverage ratio is one that ensures broad and adequate capture of both the on- and off-balance sheet sources of banks' leverage".* In keeping with these international developments, and as a complement to the ongoing implementation of key Basel reforms in the Cayman Islands, the Authority is seeking to develop a Basel III leverage ratio framework.

12. The proposed LR Rules and Guidelines applies to banks incorporated in the Cayman Islands and regulated by the Authority under the BTCL. The LR Rules and Guidelines will provide the basis for a comprehensive framework to ensure that the high leverage inherent in bank business models is carefully and prudently managed, through the imposition of an absolute cap on leverage for banks in the Cayman Islands.

13. The leverage ratio framework being proposed for Cayman banks was developed in accordance with the Basel III requirements but adjustments were made to account for differences in the Cayman Islands regulatory framework. These differences include, for example, differences in off-balance sheet credit conversion factors and the fact that the Authority has not implemented the BCBS's updated Standardised Approach for Counterparty Credit Risk. The measure also allows the Authority, in its discretion, to set different leverage ratio requirements on a case-by-case basis.

14. The key premise of the measure is that a bank must maintain a minimum leverage ratio of 3% at all times and comply with the minimum requirements established with respect to the computation and reporting of the leverage ratio as of the

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[2] Total Exposure is the exposure value of all assets, both on- and off-balance sheet.

[3] *The leverage ratio, risk-taking and bank stability,* Smith, Grill and Lang, European Central Bank – Working Paper Series, 2017

implementation date. Both the capital measure and the exposure measure are to be calculated on a quarter-end basis.

C. Purpose of Proposed Measure and Consistency with Authority's Functions

15. Pursuant to section 6(1)(b) of the Monetary Authority Law (2016 Revision) ("the Law"), one of the principal functions of the Authority is:
"*b) regulatory functions, namely -*
   (i) to regulate and supervise financial services business carried on in or from within the Islands in accordance with this Law and the regulatory laws;
   (ii) to monitor compliance with the money laundering regulations; and
   (iii) to perform any other regulatory or supervisory duties that may be imposed on the Authority by any other law;"

16. Section 6(3) of the MAL provides that in performing its regulatory functions, the Authority shall, *inter alia*:

   i. endeavour to promote and enhance market confidence and the reputation of the Islands as a financial centre;
   ii. recognise the international character of financial services and markets and the necessity of maintaining the competitive position of the Islands, vis a vis both consumers and suppliers of financial services, while conforming to internationally applied standards insofar as they are relevant and appropriate to the circumstances of the Islands;
   iii. recognise the principle that a burden or restriction which is imposed on a person or activity should be proportionate to the benefits, considered in general terms; and
   iv. recognise the need for transparency and fairness on the part of the Authority.

17. The proposed LR Rules and Guidelines will enhance the regulatory function of the Authority in line with Sections 6(1) and 6(3) of the MAL, as stated above. The proposed LR Rules and Guidelines will reflect the international enhancements in mitigating the excess build up of leverage; and support the Authority's objective to maintain the competitiveness of the Cayman Islands' financial sector through, *inter alia*, conformity with relevant international standards for its licensees.

D. International Standards

18. The Leverage Ratio is a core component of the *Basel III: International Regulatory Framework for Banks*. The importance of implementing measures which prevent excessive build-up of leverage, such as a minimum leverage ratio, is also evidenced in the BCBS' Core Principles for Effective Banking Supervision[4] ("BCP"). The BCBS remains the globally recognised and respected standard-setter for international banking activity. Compliance with BCPs represents a hallmark of prudent and sound operations. As the Cayman Islands seek to maintain its standing as a well-regulated financial centre, alignment with international financial standards is crucial.

19. *BCP 16 – Capital adequacy, states: "The supervisor sets prudent and appropriate capital adequacy requirements for banks that reflect the risks undertaken by, and*

presented by, a bank in the context of the markets and macroeconomic conditions in which it operates. The supervisor defines the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, capital requirements are not less than the applicable Basel standards." The specific criteria under Principle 16 are outlined in Table I:

Table I: International Standards on the Leverage Ratio for Banks

BCP 16: ***Capital Adequacy***	***<u>Essential Criteria</u>*** *1. Laws, regulations or the supervisor require banks to calculate and consistently observe prescribed capital requirements, including thresholds by reference to which a bank might be subject to supervisory action. Laws, regulations or the supervisor define the qualifying components of capital, ensuring that emphasis is given to those elements of capital permanently available to absorb losses on a going concern basis.* *2. At least for internationally active banks, the definition of capital, the risk coverage, the method of calculation and thresholds for the prescribed requirements are not lower than those established in the applicable Basel standards.* ***3.*** *The supervisor has the power to impose a specific capital charge and/or limits on all material risk exposures, if warranted, including in respect of risks that the supervisor considers not to have been adequately transferred or mitigated through transactions (eg securitisation transactions) entered into by the bank. Both on-balance sheet and off-balance sheet risks are included in the calculation of prescribed capital requirements.* ***4. The prescribed capital requirements reflect the risk profile and systemic importance of banks in the context of the markets and macroeconomic conditions in which they operate and constrain the build-up of leverage in banks and the banking sector. Laws and regulations in a particular jurisdiction may set higher overall capital adequacy standards than the applicable Basel requirements...*** ***<u>Additional Criterion</u>*** *1. For non-internationally active banks, capital requirements, including the definition of capital, the risk coverage, the method of calculation, the scope of application and the capital required, are broadly consistent with the principles of the applicable Basel standards relevant to internationally active banks.* *2. The supervisor requires adequate distribution of capital within different entities of a banking group according to the allocation of risks*

20. Since the crisis, the FSB has continued to contribute to the body of work on financial stability and the importance of regulatory reforms, including implementation of the leverage ratio, to manage prudential outcomes. The FSB postulates that "*Full, timely and consistent implementation of Basel III is fundamental to a sound and properly functioning banking system that is able to support economic recovery and growth on a sustainable basis. Consistent implementation of Basel standards will also foster a level playing field for internationally active banks*." [5]

E. Jurisdictional Comparisons

21. The developed jurisdictions reviewed including, Australia, Canada, United States of America and United Kingdom (UK), all have comprehensive Basel III frameworks. The Bank of International Settlements, in October 2017, issued its *Thirteenth progress report on adoption of the Basel regulatory framework.* The report highlights that the large majority of Financial Stability Board (FSB) member jurisdictions had enforced final rules and disclosure requirements on the leverage ratio.

Australia

22. With its initial implementation of the Basel III framework, the Australian Prudential Regulation Authority (APRA) proposed in 2011 to implement the Basel Committee's leverage ratio requirement. Application of the minimum leverage ratio requirement will take effect on 1 July 2019. In calibrating the leverage ratio, APRA intends to apply a differential minimum leverage ratio requirement for authorised deposit-taking institutions (ADIs) which use the standardised approach (standardised ADIs) and those that use the internal ratings-based approach to determining capital adequacy (IRB ADIs). APRA is proposing a minimum leverage ratio of 4% for IRB ADIs and 3% for standardised ADIs.

Bermuda

23. The Bermuda Monetary Authority (BMA) issued the document – *Basel III for Bermuda Banks: November 2017 Rule Update* in January 2018. The document introduces a 5% leverage ratio calculated as the ratio of Tier 1 Capital to Total Exposure. The BMA articulates that the leverage ratio was chosen "…*because it reflects an appropriate capital backstop for a jurisdiction that does not have a central bank or a fully funded deposit insurance scheme, thus ensuring that a robust capital framework is in place to support financial stability*."

Canada

24. In October 2014, the Office of the Superintendent of Financial Institutions issued the Leverage Requirements Guideline. Beginning in quarter one of 2015, institutions will be expected to maintain a leverage ratio that meets or exceeds 3% at all times. The Superintendent also has the mandate to prescribe authorised leverage ratio requirements for individual institutions.

[5] FSB website – Basel III Implementation

Hong Kong

25. The Hong Kong Monetary Authority issued its Leverage Ratio Framework document in May 2014. The framework closely mirrors the BCBS guidance in terms of requirements and timelines. Institutions were required to commence the parallel run period for the leverage ratio on 1 January 2013 until 1 January 2017. Public disclosure of the ratio commenced on 1 January 2015 and the minimum leverage ratio of 3% was incorporated as a Pillar 1 requirement under Basel III on 1 January 2018

Malaysia

26. Bank Negara Malaysia[6] issued a policy document on the Leverage Ratio in December 2017, applicable to all banks, investment banks and Islamic banks in Malaysia. The Policy requires all banking institutions to comply with a minimum leverage ratio of 3% beginning 1 January 2018. This issuance followed an observation period for reporting leverage positions.

United Kingdom

27. In April 2015, the UK Government passed secondary legislation giving the Financial Policy Committee (FPC) powers of Direction over leverage ratio requirements and buffers for banks, building societies and Prudential Regulation Authority (PRA)-regulated investment firms. The PRA Rulebook specifies that a firm must hold sufficient tier 1 capital to maintain, at all times, a minimum leverage ratio of 3.25%. It is important to note that the FPC plans on conducting a comprehensive review of the elements of the leverage ratio framework in 2018, including the level and scope of application.

F. Cost-Benefit Assessment of Implementing the Proposed LR Rules and Guidelines

28. The relevant costs and benefits associated with the implementation of the LR Rules and Guidelines are presented in Table II.

Table II: Costs and Benefits of Issuing the LR Rules and Guidelines

	Costs	Benefits
CIMA	The Authority will incur the usual administrative costs associated with conducting industry consultation, publication and amending supervisory manuals. These costs are not deemed to be overly burdensome and represent usual costs of the Authority carrying out its mandate. More significantly, with the	CIMA will have more comprehensive insights into the operations of regulated banks. From this insight, the Authority will be better able to identify risks emanating from leverage, inherent in licensees. With improvements in risk identification and mitigation, the Authority can expect a reduced regulatory burden in the future at both the entity and financial system levels.

[6] The Central Bank of Malaysia

	Costs	Benefits
	implementation of this new leverage ratio requirement, CIMA will need to train staff and dedicate staffing resources to ensure that banks are adequately implementing and reporting on the leverage ratio framework. Staffing resources will also be required to review the quarterly reports submitted by banks.	Implementation of a minimum leverage ratio for banks will allow CIMA to more adequately review and assess the potential for excessive build-up of leverage in a timely manner and enhance the Authority's ability to apply appropriate pre-emptive remedial measures to avert issues and potential crisis at an early stage. The Authority also stands to improve the quality of banking supervision through better compliance with the BCPs and implementing a meaningful complement and backstop to the risk-based capital adequacy regime.
Cayman Islands	It is not anticipated that there will be any costs to the jurisdiction, as a whole, with the implementation of these requirements.	Compliance with Basel standards represents an important element of a comprehensive regulatory framework for banks and remains a good indicator of prudent and sound banking operations. This perceived strength and safety is at the core of the stability of any financial system, including that of the Cayman Islands. The implementation of system wide leverage ratio framework will promote enhanced risk management and reinforce prudent behaviour which contribute to a more efficient, stable and resilient financial market which is less susceptible to failures. Additionally, from a macro-prudential perspective, the requirements will help guard against the build-up of excessive leverage in the banking sector and attendant risks of this which could prove financially and economically destabilising. As the jurisdiction moves towards full Basel compliance, the implementation of a leverage ratio framework will significantly and positively impact confidence in the Cayman Islands as a strong well-regulated financial centre.
Banks	Banks will incur costs associated with the implementation of the new	Banks will be able to reduce risk build-up as regular monitoring of compliance

	Costs	Benefits
	requirements, particularly as it relates to: 1. Upgrading systems to build in the computation criteria and required reporting format for the leverage ratio; 2. Amending internal policies and procedures; 3. Staff training; and 4. Dedicating additional resources to preparing reports for submission to the Authority. Beyond the direct costs of implementation, banks which are currently not in compliance with the 3% minimum requirement, will incur costs to make adjustments to their exposures.	with the set leverage ratio will help to keep risks within manageable levels. This will improve bank resilience, particularly during times of stress. The leverage ratio requirement will ensure that overall exposure of individual banks, independent of their risk, is underpinned by a minimum amount of capital, making for better capitalised institutions. Additionally, banks will benefit from the positive spill-overs associated with the benefits of maintaining the leverage ratio for the jurisdiction and the managed build up or leverage in the system, that is, a stronger financial system and heightened confidence. This may positively impact, in both separate and related ways, profitability, customer growth and satisfaction and all-encompassing bank performance.
Summary	Consequent on the above, it is determined that benefits far outweigh costs and the implementation of the LR Rules and Guidelines should proceed.	

G. Comments and Consultation

29. The Authority seeks consultation through written comments and representations from the private sector associations concerning the *Rules* and *Guidelines on the Leverage Ratio for Banks.*

30. The Authority must receive representations by **Monday, 29 October, 2018**

31. Comments and representations must be addressed to:

The Managing Director
Cayman Islands Monetary Authority
P.O. Box 10052
80e Shedden Road
Elizabethan Square
Grand Cayman KY1-1001
Cayman Islands
Tel: 345-949-7089
Fax: 345-946-5611
Email:
Consultation@cimoney.com.ky
With copy to: A.Glace@cimoney.com.ky

32. The Authority shall have due regard to any representation made by the private sector associations and industry stakeholders. The Authority shall provide a written response collating the feedback received and the Authority's position on this feedback. This response shall be copied to all relevant private sector associations only.