CA-10.1 Rationale and Objective

Scope and Factors Leading to Leverage

CA-10.1.1 **The content of this Chapter is applicable to all Bahraini Islamic bank licensees.**

CA-10.1.2 Financial leverage – that is, the use of non-equity funds to fund assets – allows a financial institution to increase the potential returns on its equity capital, with a concomitant increase in the riskiness of the equity capital and its exposure to losses since the non-equity funds are either not, or only partially risk-absorbent. Consequently, leverage is commonly accomplished through the use of borrowed funds, debt capital or derivative instruments, etc. It is common for banks to engage in leverage by borrowing to acquire more assets, with the aim of increasing their return on equity. Similarly, the contingent exposure of the banks can expose them to risk of losses much greater than is observable on the balance sheet.

Comment [RE1]: IFSB15 section 2.4.1 para 73

CA-10.1.3 The leverage ratio serves as a supplementary measure to the risk-based capital requirements of the rest of this Module. The leverage ratio is a simple, transparent ratio and is intended to achieve the following objectives:

(a) To constrain the build-up of leverage in the banking sector, helping avoid destabilising deleveraging processes which can damage the broader financial system and the economy; and

(b) To reinforce the risk based requirements with a simple, non-risk based "backstop" measure; and

(c) To serve as a broad measure of both the on- and off-balance sheet sources of bank leverage.

Comment [RE2]: B3 P152

CA-10.2 Definition, Calculation and Scope of the Leverage Ratio

Computational Details

Comment [RE3]: 2.4.3 IFSB 15

CA-10.2.1 This Section presents the definition and calculation of the leverage ratio. Transitional arrangements are set out in Section CA-10.5.

Comment [RE4]: B3 P153

CA-10.2.2 The leverage ratio is defined as follows: The Numerator of the leverage ratio is Tier 1 capital as defined in Paragraph CA-1.1.2. The Denominator is composed of self-financed exposures and adjusted exposures funded by UPSIAs (see CA-10.3). <u>Bahraini Islamic bank licensees</u> must exceed a minimum Tier One leverage ratio of 3% from 1 January 2018, calculated on a consolidated basis.

CA-10.2.3 The basis of calculation is the average of the monthly leverage ratio over the quarter based on the definitions of capital and total exposure (the exposure measure) specified in Section CA-10.3. The formula for calculation of the leverage ratio is:

Comment [RE5]: B3 P153 adapted and IFSB p81

$$\frac{\text{Tier 1 Capital}}{\begin{gathered}\{\text{Self-financed exposures adjusted in CA-10.3 (Credit + Market Risks) + Operational Risks)} \\ \text{Plus} \\ \alpha\ [\text{exposures funded by UPSIAs adjusted in CA-10.3 (Credit + Market Risks) - PER and IRR of UPSIAs}]\}\end{gathered}}$$

CA-10.2.3 The leverage ratio framework follows the same scope of regulatory consolidation for Tier One Capital and Total Exposures as is used in CA-B.1.2A, except for the following: Where a banking, financial, insurance or commercial entity is outside the scope of regulatory consolidation, only the investment in the capital of such entities (i.e. only the carrying value of the investment, as opposed to the underlying assets and other exposures of the investee) is to be included in the total exposures measure. However, investments in the capital of such entities that are deducted from Tier One Capital must also be deducted from the exposures measure for the purpose of the leverage ratio calculation.

Comment [RE6]: B3 Lev P8 & 9

CA-10.3 Exposure Measure

Comment [RE7]: Section 2.4.3.2 IFSB15

General Measurement Principles

CA-10.3.1 The calculation of total exposure for the leverage ratio must generally follow the accounting measures of exposures (i.e. as reported in the financial statements of the Bahraini Islamic bank licensee). All the on-balance sheet, non-derivative exposures must be included net of specific provisions and valuation adjustments (e.g. credit valuation adjustments). The impact of credit risk mitigation (including physical or financial collateral, guarantees, Urbun, Hamish Jiddiyah, etc.) must not be considered, and on-balance sheet exposures must not be adjusted for the purpose of calculating the total exposure (i.e. they must be unweighted). Netting of financing exposures against PSIA/deposits is not allowed. Specific details on the treatment of on- and off-balance sheet items in the calculation of total exposure are provided in this Section.

On-balance Sheet Items

CA-10.3.2 All the on-balance sheet items on the assets side of the Bahraini Islamic bank licensee's balance must be included. This includes all the Shari'a-compliant alternatives to repurchase transactions and securities financing transactions. AAOIFI accounting measures for Bahraini Islamic bank licensees must be used for taking account of such transactions.[1] For Shari'a-compliant hedging instruments, the accounting measure of the exposure must be used (i.e. unweighted and 100% C.C.F.). In addition, potential future exposures must be computed on an unweighted basis according to the Current Exposure Method, as delineated in Paragraph CA-4.5.16.

CA-10.3.3 Items (such as goodwill) that are deducted completely from Tier One Capital must be deducted from Total Exposures.

CA-10.3.4 According to the treatment outlined in Paragraphs CA-2.4.20 to CA-2.4.24, where a financial entity is not included in the regulatory scope of consolidation in CA-B.1.2A, the amount of any investment in the capital of that entity that is totally or partially deducted from CET1 or from AT1 capital of the Bahraini conventional bank licensee following the corresponding deduction approach in Paragraphs CA-2.4.20 to CA-2.4.26 must be deducted from Total Exposures.

CA-10.3.5 Liability items must not be deducted from the measure of exposure.

[1] Unless there are no applicable AAOIFI accounting standards, in which case IFRS must be used.

CA-10.3 Exposure Measure (continued)

Off-balance Sheet Items

CA-10.3.6 The off-balance sheet items must, at a minimum, include, but are not limited to, letters of credit, guarantees, unconditionally cancellable commitments, liquidity facilities, and Shari'a-compliant alternatives to repurchase agreements and securities financing transactions (see Section CA-4.5). All off-balance sheet items must carry a 100% credit conversion factor (CCF). For any commitments that are unconditionally cancellable at any time by the Bahraini Islamic bank licensee without prior notice, a CCF of 10% applies. Securitised assets that are de-recognised from the balance sheet of the sponsor or originator are not taken into account in the leverage ratio (see Section CA-8.2 for details).

CA-10.3.7 A proportion of assets financed by unrestricted PSIA must be included in the exposure calculation, whether considered on- or off-balance sheet by the Bahraini Islamic bank licensee. The proportion of such assets is calculated by multiplying the relevant assets by the alpha parameter (30%) for capital adequacy purposes. Assets financed by restricted PSIA are not included in the denominator of the leverage ratio.

Comment [RE8]: This is in addition to V1 for obvious reasons.

CA-10.4 Additional Supervisory Guidance

Comment [RE9]: IFSB15 2.4.4

CA-10.4.1 A higher ratio may be required for any Bahraini Islamic bank licensee if warranted by its risk profile or circumstances. The CBB may use stress testing as a complementing tool to adjust the leverage ratio requirement at the macro- and/or individual Islamic bank licensee-level.

CA-10.4.2 The leverage ratio can be used for both micro- and macroprudential surveillance; for example, as a macroprudential tool, a consistent leverage ratio can be applied for all Bahraini Islamic bank licensees as an indicator for monitoring vulnerability. As a microprudential tool, it can be used as a trigger for increased surveillance or capital requirements for specific licensees under the supervisory review process.

CA-10.5 Transitional Arrangements

CA-10.5.1 Quarterly reporting of the pro-forma leverage ratio commenced with effect from March 2013 data. Monitoring of the leverage ratio by the CBB using a standardised reporting format in the PIRI commences with effect from 30 September 2015 data.

CA-10.5.2 The initial monitoring period runs until 31st December 2017. During this period, the leverage ratio and its components will be monitored, including its behaviour relative to the capital adequacy ratios. Mandatory public disclosure of the leverage ratio and its components will start with end March 2017 data. Bahraini Islamic bank licensees are encouraged to start public disclosure of their leverage ratio earlier than the mandatory date. Disclosure of the ratio will be closely monitored by the CBB.

Comment [RE10]: B3 Lev P60

CA-10.5.3 Based on the results of the monitoring period, any final adjustments to the definition and calibration of the leverage ratio will be carried out by 31st December 2017, with a view to migrating to a Pillar One treatment on 1st January 2018 based on appropriate review and calibration.

Comment [RE11]: B3 Lev P61