CA-10.1 Rationale and Objective

Scope and Factors Leading to Leverage

CA-10.1.1 **The requirements in this Chapter are applicable to <u>Bahraini Islamic bank licensees</u>.**

CA-10.1.2 The use of non-equity funds to fund assets is referred to as financial leverage. It 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 Sharia compliant hedging 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.

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 and, thus its risk profile.

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

Leverage Ratio Requirement and Computational Details

CA-10.2.1 **Bahraini Islamic bank licensees must meet a 3% leverage ratio minimum requirement at all times, calculated on a consolidated basis.**

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 Section CA-10.3). The leverage ratio is expressed as a percentage as follows:**

Tier 1 Capital

{Self-financed exposures adjusted in CA-10.3

Plus

∝ [exposures funded by UPSIAs adjusted in CA-10.3
Less
PER and IRR of UPSIAs]}

CA-10.2.3 **A proportion of assets financed by unrestricted UPSIA 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 UPSIA are not included in the denominator of the leverage ratio.**

CA-10.2.4 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 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.

CA-10.2.5 **Bahraini Islamic bank licensees using a proportional consolidation for regulatory capital purposes must apply the same criteria for the purpose of computation of leverage ratio.**

CA-10.2.6 **Bahraini Islamic bank licensees identified as DSIBs must also meet a leverage ratio buffer requirement set at 50% of HLA consistent with the capital measure required to meet the requirements of Module DS.**

CA-10.3 Exposure Measure

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 (non Sharia compliant hedging instrument) 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 sheet 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 Islamic bank licensee following the corresponding deduction approach in Paragraphs CA-2.4.20 to CA-2.4.26 must be deducted from Total Exposures.

[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-10.3.5 **Commitments other than securitisation liquidity facilities with an original maturity up to one year and commitments with an original maturity over one year receive a CCF of 20% and 50%, respectively. However, any commitments that are unconditionally cancellable at any time by the Bahraini Islamic bank licensee without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness, receive a 10% CCF[2].**

CA-10.3.6 **Other off-balance sheet items, which include but are not limited to, direct credit substitutes, letters of credit, guarantees and Shari'a-compliant alternatives to repurchase agreements and securities financing transactions must be converted into credit exposure equivalents through the use of credit conversion factors specified in Section CA-4.5.**

[2] In Bahrain, retail commitments such as credit cards and overdrafts are considered unconditionally cancellable where the terms permit the bank to cancel them without notice.

CA-10.4 Additional Supervisory Guidance

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 Bahraini Islamic bank licensee-level.

CA-10.4.2 The leverage ratio can be used for both micro- and macro prudential surveillance; for example, as a macro prudential tool, a consistent leverage ratio can be applied for all Bahraini Islamic bank licensees as an indicator for monitoring vulnerability. As a micro prudential 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 **Bahraini Islamic Bank Licensees shall implement the requirements of this Module with effect from 1st January 2019. Quarterly reporting of leverage ratio to the CBB and in public disclosures shall commence with reference to the quarter ending on 31st March 2019.**