**Annex III**



**Leverage Ratio Guideline**

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#### **LIST OF ABBREVIATIONS**

|  |  |
| --- | --- |
| CBK | Central Bank of Kenya |
| CCP | Central Counterparty |
| CM | Clearing Member |
| MNA | Master Netting Agreement |
| OBS | Off-Balance Sheet |
| OTC | Over the Counter |
| PFE | Potential Future Exposure |
| QCCP | Qualified Central Counterparty |
| RC | Replacement Cost |
| SFT | Security Financing Transactions |

#### **GLOSSARY**

**"Bilateral netting"** means the consolidation of agreements between a financial organization and a counterparty, which results in a single legally enforceable arrangement between a financial organization and a counterparty covering all, included individual contracts including master netting agreements.

**“Counterparty credit risk (CCR)”** is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows. An economic loss would occur if the transactions or portfolio of transactions with the counterparty has a positive economic value at the time of default. Unlike a firm's exposure to credit risk through a loan, where the exposure to credit risk is unilateral and only the lending bank faces the risk of loss, CCR creates a bilateral risk of loss: the market value of the transaction can be positive or negative to either counterparty to the transaction. The market value is uncertain and can vary over time with the movement of underlying market factors.

**"Central counterparty (CCP)"** is a clearing house that interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer and thereby ensuring the future performance of open contracts. A CCP becomes counterparty to trades with market participants through novation, an open offer system, or another legally binding arrangement. For the purposes of the capital framework, a CCP is a financial institution..

**“Clearing member”** is a member of, or a direct participant in, a CCP that is entitled to enter into a transaction with the CCP, regardless of whether it enters into trades with a CCP for its own hedging, investment or speculative purposes or whether it also enters into trades as a financial intermediary between the CCP and other market participants.

**"Clearing relationship"** means a service arrangement that enables customers to transfer funds (or securities) indirectly through direct participants in domestic settlement systems to final recipients. Such services are limited to the following activities: transmission, reconciliation and confirmation of payment orders, daylight overdraft, overnight financing and maintenance of post-settlement balances, and determination of intra-day and final settlement positions.

**“Qualifying central counterparty (QCCP)”** is an entity that is licensed to operate as a CCP (including a license granted by way of confirming an exemption), and is permitted by the appropriate regulator/overseer to operate as such with respect to the products offered. This is subject to the provision that the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the Principles for Financial Market Infrastructures issued by the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions.

**“Initial margin”** means a clearing member's or client's funded collateral posted to the CCP to mitigate the potential future exposure (PFE) of the CCP to the clearing member arising from the possible future change in the value of their transactions. Initial margin includes collateral deposited by a clearing member or client in excess of the minimum amount required, provided the CCP or clearing member may, in appropriate cases, prevent the clearing member or client from withdrawing such excess collateral.

**“Variation margin”** means a clearing member's or client's funded collateral posted on a daily or intraday basis to a CCP based upon price movements of their transactions.

**"Security financing transaction (SFT)"** 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.

**“Long settlement transactions**” are transactions where a counterparty undertakes to deliver a security, a commodity, or a foreign exchange amount against cash, other financial instruments, or commodities, or vice versa, at a settlement or delivery date that is contractually specified as more than the lower of the market standard for this particular instrument and five business days after the date on which the bank enters into the transaction.

**“Margin lending transactions”** are transactions in which a bank extends credit in connection with the purchase, sale, carrying or trading of securities. Margin lending transactions do not include other loans that happen to be secured by securities collateral. Generally, in margin lending transactions, the loan amount is

collateralised by securities whose value is greater than the amount of the loan.

**“Netting set”** is a group of transactions with a single counterparty that are subject to a legally enforceable bilateral netting arrangement and for which netting is recognised for regulatory capital purposes that are applicable to the group of transactions. Each transaction that is not subject to a legally enforceable bilateral netting arrangement that is recognised for regulatory capital purposes should be interpreted as its own netting set for the purpose of these rules.

# **INTRODUCTION**

1. The leverage ratio is a simple, transparent, non-risk-based measure that is calibrated to act as a credible supplementary measure to the risk-based capital requirements. The leverage ratio is intended to achieve the following objectives:
   * constrain the build-up of leverage in the banking sector, helping avoid destabilizing deleveraging processes which can damage the broader financial system and the economy; and
   * reinforce the risk-based requirements with a simple, non-risk based “backstop” measure.

# **SCOPE OF APPLICATION**

1. The leverage ratio framework follows the same scope of regulatory consolidation, including consolidation criteria, as is used for the risk-based capital framework. Where a banking, financial, insurance or commercial entity is outside the scope of regulatory consolidation, only the investment in the capital of such entities is to be included in the leverage ratio exposure measure. However, investments in the capital of such entities that are deducted from Tier 1 capital may be excluded from the leverage ratio exposure measure.

# **CALCULATION**

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:
2. The capital measure for the leverage- - ratio is core capital (Tier 1 capital) measure’ applicable at that time under the risk-based framework. The exposure measure for the leverage ratio is defined in the next section.
3. Banks must meet a 4 percent leverage ratio minimum requirement at all times.

# **Exposure Measure**

1. A bank's total leverage ratio exposure measure is the sum of the following exposures:
   1. On-balance sheet exposures (excluding on-balance sheet derivative and SFTs exposures);
   2. derivative exposures;
   3. Securities financing transaction exposures; and
   4. Off-balance sheet items.
2. The leverage ratio exposure measure generally follows gross accounting values.
3. 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.
4. To ensure consistency, any item deducted from Tier 1 capital according to the Basel framework and regulatory adjustments other than those related to liabilities may be deducted from the leverage ratio exposure measure. For example, where a banking, financial or insurance entity is not included in the regulatory scope of consolidation, the amount of any investment in the capital of that entity that is totally or partially deducted from Tier 1 capital of the bank may also be deducted from the leverage ratio exposure measure.
5. Liability items must not be deducted from the leverage ratio exposure measure. For example, gains/losses on fair valued liabilities or accounting value adjustments must not be deducted from the leverage ratio exposure measure.

### **On-balance sheet exposures**

1. 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 under section II. Derivatives exposures.
2. 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 which have reduced Tier 1 capital may be deducted from the leverage ratio exposure measure.

### **Derivative exposures**

1. For the purpose of the leverage ratio exposure measure, exposures to derivatives are included by means of two components:
   1. replacement cost (RC); and
   2. potential future exposure (PFE).
2. Banks must calculate their exposures associated with all derivative transactions as a scalar multiplier alpha set at 1.4 times the sum of the RC and the PFE[[1]](#footnote-2). If the derivative exposure is covered by an eligible bilateral netting contract, a specific treatment may be applied.
3. The amount to be included in the leverage ratio exposure measure is calculated according to:

(See Capital Adequacy section 4.3.1.3).

1. For derivative transactions not covered by an eligible bilateral netting contract[[2]](#footnote-3), the amount to be included in the leverage ratio exposure measure is determined, for each transaction separately. When an eligible bilateral netting contract is in place, the formula below is applied at the netting set level.
2. When calculating the exposure amount, a bank must not reduce the leverage ratio exposure measure amount by any collateral received from the counterparty. 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.
3. Where a bank acting as clearing member (CM) offers clearing services to clients, the CM’s trade exposures to the CCP that arise when the CM is obligated to reimburse the client for any losses suffered due to changes in the value of its transactions in the event that the CCP defaults must be captured by applying the same treatment that applies to any other type of derivative transaction. However, if the CM, based on the contractual arrangements with the client, is not obligated to reimburse the client for any losses suffered in the event that a QCCP defaults, the CM need not recognize the resulting trade exposures to the QCCP in the leverage ratio exposure measure.
4. For derivative exposures associated with the bank's offering of client clearing services, the RC and the PFE of the exposure to the client may be calculated according to the rules set out in the Capital Adequacy prudential Guidelines for CCR.
5. Where a client enters directly into a derivative transaction with the CCP and the CM guarantees the performance of its client's derivative trade exposures to the CCP, the bank acting as the CM for the client to the CCP must calculate its related leverage ratio exposure resulting from the guarantee as a derivative exposure, as if it had entered directly into the transaction with the client, including with regard to the receipt or provision of cash variation margin.
6. For the purposes of 4.12 and 4.14, an entity affiliated to the bank acting as a CM may be considered a client if it is outside the relevant scope of regulatory consolidation at the level at which the leverage ratio is applied. In contrast, if an affiliate entity falls within the regulatory scope of consolidation, the trade between the affiliate entity and the CM is eliminated in the course of consolidation but the CM still has a trade exposure to the CCP. In this case, the transaction with the CCP will be considered proprietary and the exemption in 4.12 will not apply.
7. 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:
   1. For trades not cleared through a qualifying central counterparty (QCCP) the cash received by the recipient counterparty is not segregated.
   2. Variation margin is calculated and exchanged on at least a daily basis based on mark-to-market valuation of derivative positions.
   3. The variation margin is received in a currency specified in the derivative contract, governing master netting agreement (MNA), credit support annex to the qualifying MNA or as defined by any netting agreement with a CCP.
   4. 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.
   5. Derivative transactions and variation margins are covered by a single MNA between the legal entities that are the counterparties in the derivative transaction.
8. If the conditions in 4.16 are met, the cash portion of variation margin received may be used to reduce the replacement cost 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.
9. Banks won’t be allowed to use credit derivatives without prior authorization of the CBK.

### **Securities financing transaction exposures**

1. SFTs are an important source of leverage and therefore should be included in the exposure measure SFTs are included in the leverage ratio exposure measure according to the treatment described below.
2. For a bank acting as principal the sum of the amounts in (1) and (2) is to be included in the leverage ratio exposure measure:
   * 1. Gross SFT assets recognized for accounting purposes[[3]](#footnote-4), adjusted as follows:
   1. excluding from the leverage ratio exposure measure the value of any securities received under an SFT, where the bank has recognized the securities as an asset on its balance sheet;
   2. cash payables and cash receivables in SFTs with the same counterparty may be measured net if all the following criteria are met:
      1. Transactions have the same explicit final settlement date;
      2. 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 default, insolvency, or bankruptcy; and
      3. 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.
      4. A measure of CCR calculated as the current exposure without an add-on for PFE calculated as follows. For the purposes of this subparagraph, 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.
         1. Where a qualifying MNA[[4]](#footnote-5) 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 (ΣEi), less the total fair value of cash and securities received from the counterparty for those transactions (ΣCi). This is illustrated in the following formula: E\* = max( 0, ΣEi - ΣCi).
         2. 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\* = max( 0, (Ei - Ci)).
         3. Ei\* may be set to zero if:
3. Ei is the cash lent to a counterparty;
4. this transaction is treated as its own netting set; and
5. the associated cash receivable is not eligible for the netting treatment in (1).
6. The effects of bilateral netting agreements for covering SFTs should be recognized 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:
   1. 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;
   2. 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;
   3. allow for the prompt liquidation or setoff of collateral upon the event of default; and
   4. be, together with the rights arising from provisions required in (1) and (3) above, legally enforceable in each relevant jurisdiction upon the occurrence of an event of default regardless of the counterparty's insolvency or bankruptcy.
7. Netting across SFT positions held in the banking book and trading book shall only be recognized when the netted transactions fulfil the following conditions:
   1. all transactions are marked to market daily; and
   2. the collateral instruments used in the transactions are recognized as eligible financial collateral in the banking book.
8. 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, then the bank will be required to calculate its exposure measure by applying only a measure of CCR calculated as the current exposure without an add-on for PFE. Where 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 recognize those SFTs in its exposure measure.

### **Off-balance-sheet exposures**

1. 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.
2. For the purposes of the leverage ratio, OBS items will be converted into credit exposures by multiplying the committed but undrawn amount by a CCF set out in the prudential guidelines (Capital Adequacy section 4.3.1.3). 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.
3. 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 (ie the exposure amount after the application of the relevant CCF). However, the resulting total off-balance-sheet equivalent amount for OBS exposures cannot be less than zero.

# **REPORTING REQUIREMENT AND TRANSITIONAL ARRANGEMENTS**

1. Banks are required, at a minimum, to report both the capital measure and the exposure measure on a quarterly basis. They should also be able to calculate and report the leverage ratio on a quarterly basis, 15 days after the end of the quarter for internal monitoring purposes to ensure ongoing compliance with internal limits.
2. Banks are required to provide an explanation for the key drivers of material changes in their Basel III leverage ratio observed from the end of the previous reporting period to the end of the current reporting period.

1. Or “PFE Add-on” as renamed under the Basel III SA-CCR standard. [↑](#footnote-ref-2)
2. See the conditions under which bilateral netting will be allowed under the Capital Adequacy Prudential guidelines (section 4.3.1.3 subsection on Bilateral Netting). [↑](#footnote-ref-3)
3. Gross SFT assets recognized for accounting purposes must not recognize any accounting netting of cash payables against cash receivables (e.g. as currently permitted under the IFRS). [↑](#footnote-ref-4)
4. A qualifying MNA is the one that meets the requirements under 4.21 and 4.22. [↑](#footnote-ref-5)