

Appendix 1

In this Appendix underlining indicates new text and striking through indicates deleted text.



The DFSA Rulebook

Prudential – Investment, Insurance
Intermediation and
Banking Module

(PIB)

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1.2 Glossary for PIB

Guidance

Set out under Rule 1.2.1 are a number of mainly technical definitions used solely in PIB. Such definitions do not also appear in GLO unless they are used elsewhere in the Rulebook. GLO also contains definitions of abbreviations, terms and phrases used in PIB and those are also included in 1.2.1 for convenience purposes where such definitions are embedded in PIB specific definitions. Commonly used definitions such as “Authorised Firms”, “Domestic Firms”, and “Financial Services” appear only in GLO.

1.2.1 The following terms and abbreviations bear the following meanings for the purpose of this module:

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Large Exposure	An Exposure, whether in an Authorised Firm's Non-Trading Book or Trading Book, or both, to a Counterparty or group of Closely Related Counterparties or a group of Counterparties Connected to the Authorised Firm which in aggregate equal or exceeds 10% of the Authorised Firm's Capital Resources. Has the meaning given in Rule 4.15.4.
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<u>Qualifying CCP</u>	<u>Means a CCP:</u> <u>(a) that is operated by an Authorised Person in accordance with its Licence; or</u> <u>(b) in respect of which all of the following conditions are met:</u> <u>(i) the CPP is authorised and supervised by a Financial Services Regulator in a jurisdiction other than the DIFC;</u> <u>(ii) the Financial Services Regulator has publicly stated that it applies on an ongoing basis rules and regulations that are consistent with the CPSS-IOSCO Principles for Financial Market Infrastructures; and</u> <u>(iii) the CPP satisfies the Basel Committee requirements for calculating its capital requirements for its default fund exposures.</u>

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4.13 Credit Risk mitigation

Guidance

This section sets out the principles and methodologies for the recognition of Credit Risk mitigation in the calculation of Credit RWA.

General Requirements

- 4.13.1** (1) An Authorised Firm must not recognise the effects of Credit Risk mitigation unless:
- (a) all documentation relating to that mitigation is binding on all relevant parties and legally enforceable in all relevant jurisdictions; and
 - (b) the Authorised Firm complies with the Rules set out in this section, as applicable.
- (2) Where the calculation of Credit RWA already takes into account the Credit Risk mitigant, the provisions of this section do not apply.
- (3) Where an Authorised Firm uses a specific Credit Risk mitigation technique for the purposes of its Capital, the same Credit Risk mitigation technique must be used if the Authorised Firm also uses Credit Risk mitigation for Large Exposure reduction, where permitted, under the requirements in chapter 4.

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4.15 Concentration Risk

Applicability and limits

- 4.15.1** This section applies with respect to Trading Book transactions as calculated in App2 and Non-Trading Book transactions as calculated in section 4.8.
- 4.15.2** For the purposes of this section an Exposure that arises in the Trading Book is calculated by summing the following:
- (a) the net positive position (long positions net of short positions) for each financial instrument as set out in Rules A4.11.10 to A4.11.28;
 - (b) the ~~firm's~~ Authorised Firm's net Underwriting Exposures for any Counterparty; and
 - (c) any other Exposures arising from transactions, agreements and contracts that would give rise to Counterparty Credit Risk.
- 4.15.3** For the purposes of this section an Authorised Firm must:

- (a) identify its Exposures;
- (b) identify its Counterparties, including whether any are Closely Related to each other or Connected to the Authorised Firm;
- (c) measure the size of its Exposures;
- (d) establish the value of its Exposures;
- (e) determine the size of its Exposures as a proportion of its Capital Resources;
- (f) identify whether it has Exposures which are subject to the requirements of section 4.13 (Credit Risk mitigation);
- (g) identify which, if any, of its Exposures are exempt in accordance with section A4.11 from the limits set out in Rules 4.15.4 to 4.15.7;
- (h) aggregate its Exposures to the same Counterparty or group of Closely Related Counterparties or group of Connected Counterparties;
- (i) monitor and control its Exposures on a daily basis within the Concentration Risk limits; and
- (j) notify the DFSA immediately of any breach of the limits set out in this section and confirm it in writing.

Large Exposure limits

4.15.4 A Large Exposure of an Authorised Firm means a total Exposure which is ~~greater than~~ equal to or exceeds 10% of the firm's ~~Capital Resources~~ Tier 1 Capital, to any Counterparty, Connected Counterparty, group of Connected Counterparties, or group of Closely Related Counterparties, whether in the Authorised Firm's Trading Book or Non-Trading Book, or both.

- 4.15.5** (1) Subject to IFR Rule 5.4.15, an Authorised Firm must ensure that Exposures in its Non-Trading Book and, subject to Rule 4.15.6, Trading Book to a Counterparty or to a group of Closely Related Counterparties or to a group of Connected Counterparties, after taking into account the effect of any eligible Credit Risk mitigations, do not exceed 25% of its ~~Capital Resources~~ Tier 1 Capital, except as otherwise provided in (2), (3) or (4).
- (2) An Authorised Firm's Exposure must not exceed 15% of its Tier 1 Capital if the Authorised Firm is a G-SIB and the Exposure is to another G-SIB in or outside the DIFC.
- (3) The DFSA may, by written notification, require an Authorised Firm which is a subsidiary of a G-SIB to apply the Exposure limit of 15% of its Tier 1 Capital if the Exposure is to another G-SIB, or to a subsidiary of a G-SIB, in or outside the DIFC.

- (4) The DFSA may, by written notification, require an Authorised Firm which is a D-SIB to apply a specified Exposure limit of between 15% to 25% of its Tier 1 Capital, if the Exposure is to another D-SIB, or to a subsidiary of a D-SIB, in or outside the DIFC.

4.15.6 Where an Authorised Firm's Trading Book Exposure to a Counterparty or to a group of Closely Related Counterparties or to a group of Connected Counterparties, on its own or when added to any Non-Trading Book Exposure, is likely to exceed 25% of its ~~Capital Resources~~ Tier 1 Capital, the Authorised Firm must immediately give the DFSA written notice, explaining the nature of its Trading Book Exposure and seeking specific guidance from the DFSA regarding the prudential treatment of any such Exposure.

4.15.7 Subject to IFR Rule 5.4.16 an Authorised Firm must ensure that the sum of its Large Exposures does not exceed 800% of its ~~Capital Resources~~ Tier 1 Capital.

Guidance

1. Exposures can arise in the Non-Trading Book and in the Trading Book from Credit Risk (for example on loans and advances) Counterparty Risk (for example, on unsettled trades and on Derivative contracts) and from Issuer risk (for example, on holdings of equities and bonds).
2. Some Derivatives contracts may result in an Authorised Firm being exposed to an Issuer as well as the Derivatives Counterparty. For example, a Derivative referenced on a Security may result in an Exposure to the Counterparty, to the transaction and to the Issuer of the underlying Security.
3. Examples of an Exposure are actual or potential claims on a Counterparty including contingent liabilities arising in the normal course of an Authorised Firm's business.
4. App4 includes further Rules and Guidance on:
 - a. fully and partially exempt Exposures, Exposures to undisclosed Counterparties, parental guarantees and capital maintenance agreements;
 - b. identification of Exposures;
 - c. identification of Closely Related and Connected Counterparties, and exemptions for Connected Counterparties;
 - d. measuring Exposures to Counterparties and Issuers in relation to Derivatives, equity indices, and other items; and
 - e. country risk Exposure.

Exclusions from the Large Exposure limits

4.15.8 (1) For the purposes of this section, Exposure excludes:

- (a) claims and other assets required to be deducted for the purposes of calculating an Authorised Firm's ~~Capital Resources~~ Tier 1 Capital;
 - (b) a transaction entered into by an Authorised Firm as depository or as agent that does not create any legal liability on the part of the Authorised Firm;
 - (c) claims resulting from foreign exchange transactions where an Authorised Firm has paid its side of the transaction and the countervalue remains unsettled during the 2 business days following the due payment or due delivery date. After 2 business days the claim becomes an Exposure;
 - (d) claims arising as a result of money transmission, payment services, clearing and settlement, correspondent banking or financial instruments clearing, settlement and custody services to clients, delayed receipts in funding and other Exposures arising from client activity which do not last longer than the following business day;
 - (e) in the case of the services outlined in (d) intra-day Exposures to Financial Institutions who provide these services are excluded;
 - (f) claims resulting from the purchase and sale of Securities during settlement where both the Authorised Firm and the Counterparty are up to five business days overdue in settling. The five business days include the due payment or due delivery date. After five business days, the claim becomes an Exposure; and
 - (g) Exposures that are guaranteed by the Authorised Firms Parent in accordance with Rule 4.15.18.
- (2) For the purposes of this section, Exposure to a CCP which carry a 0% CCR in accordance with section 4.8 are excluded.

4.15.9 An Authorised Firm need not include fully exempt Exposures, as referred to in Rule A4.11.1 when monitoring compliance with the limits in Rules 4.15.5, 4.15.6 and 4.15.7.

Institutional exemption

4.15.10 (1) This Rule applies to an Authorised Firm in Category 2 and 3A.

- (2) For Exposures to a Financial Institution, or a group of Connected Counterparties one of which is a Financial Institution, the total amount of an Authorised Firm's Exposures may exceed 25% of its ~~Capital Resources~~ Tier 1 Capital, provided those institutions are Investment Grade (Credit Quality Grades 1 to 3) and subject to the following:

- (a) Exposures to any entities within the group of Connected Counterparties that are not Financial Institutions are limited to 25% of ~~Capital Resources~~ Tier 1 Capital after taking account of Credit Risk mitigation;
- (b) the Exposures must not form part of the ~~Capital Resources~~ Tier 1 Capital of the Counterparty;
- (c) the Counterparty Risk profile must be subject to review on at least an annual basis; and
- (d) Exposures of this nature must not in any case exceed a maximum of US\$ 100 million or 100% of ~~Capital Resources~~ Tier 1 Capital, whichever is the lower.

Guidance

The DFSA will, in exceptional circumstances, consider an application to waive or modify the limits set out above. In such circumstances the Authorised Firm will have to make a submission to the DFSA as to why its specific circumstances would warrant a relaxation of the limits specified in (d) above.

Systems and Controls

- 4.15.11** (1) An Authorised Firm must implement and maintain systems and controls to identify its Exposures and effectively manage Concentration Risks as a result of its activities.
- (2) Such systems and controls in place must be proportionate to the nature, scale and complexity of the Authorised Firm and must include written policies and procedures to address Concentration Risks, both on and off balance sheet, which:
- (a) are approved by the Governing Body on at least an annual basis; and
 - (b) include internal approval limits for Exposures as well as limits for the risks associated with specific sectors, geographic location and single economic risk factors.

Guidance

The DFSA expects the systems and controls to include:

- a. processes for the tiered approval of Exposures based on size, risk profile and complexity;
- b. mechanisms for identifying, recording and monitoring all Exposures with particular focus on Large Exposures;
- c. mechanisms in place for the monitoring and control of Exposures to Counterparties and Groups of Connected Counterparties;
- d. mechanisms for monitoring and recording Exposures within its Group;

- e. mechanisms to monitor Counterparties in the same economic sector and exposed to single economic risks;
- f. mechanisms to identify and control risks arising from single geographic jurisdictions; and
- g. mechanisms to identify risks arising from related activities or commodities.

Recognition of Credit Risk mitigations

- 4.15.12** (1) For the purposes of this section, an Authorised Firm may reduce the value of its Exposures, at its discretion, by any one or more of the following:
- (a) the amount of any specific provision made, where the provision relates to the risk of a credit loss occurring on that Exposure and is not held as part of a general provision or reserve against its Credit Risks;
 - (b) Netting its claims on and liabilities to a Counterparty, provided that the conditions in section 4.13 of Credit Risk mitigation are met;
 - (c) the amount of Collateral held against its Exposures, where that Collateral is of a type listed based on the FCSA and FCCA approaches and meeting the requirements under section 4.13, provided that supervisory haircuts are used for valuing that Collateral under the FCCA;
 - (d) the amount of any eligible guarantees as permitted under section 4.13.9;
 - (e) the value of a Credit Derivative, where the Credit Derivative is an instrument included in Rule 4.13.11 and the transaction meets the conditions set out in that section; and
 - (f) the effects of transactions transferring Credit Risks from the Authorised Firm to another party through securitisation, provided that the conditions in section 4.14 are met.
- (2) An Authorised Firm must, where Credit Risk mitigation is used against an Exposure, reduce the value of the original Exposure and recognise an equal Exposure to the Credit Risk mitigation provider, except where a credit default swap is used and neither the reference entity, nor the credit default swap provider, is a Financial Institution.
- (3) For the purposes of Exposure shifting under (2), the amount subject to shifting is:
- (a) the value of the protected portion for an unfunded credit protection;
 - (b) where the FCSA is used, the market value of the collateral; and

(c) where the FCCA is used, the market value of the collateral adjusted by applying the standard supervisory haircuts to the FCCA.

4.15.13 An Authorised Firm intending to utilise any of the provisions contained in section 4.13 (Credit Risk mitigation) for the purposes of reducing Exposure values should have in place policies and procedures addressing the following:

- (a) risks arising from maturity mismatches between Exposures and any credit protection on those Exposures;
- (b) the Concentration Risk arising from the application of Credit Risk mitigation techniques, including indirect Large Exposures – for example to a single Issuer of Securities taken as Collateral; and
- (c) the conduct of stress testing on Credit Risk mitigation taken as Collateral.

4.15.14 Where an Authorised Firm has availed itself of the reductions to Exposure values as set out in A4.11 the Authorised Firm must calculate the Exposure as a percentage of its ~~Capital Resources~~ Tier 1 Capital on both a gross and net basis.

4.15.15 An Authorised Firm that avails itself of the reduction in its Exposure value through the application of Rule A4.11 must conduct periodic stress tests on its Exposures against the realisable value of any Collateral considered under with the FCSA or FCCA.

4.15.16 Where the value of the Collateral under the stress scenario is lower than the value applied under Rule 4.15.12 the lower value should be used when determining the Exposure value for the purposes of this section.

Guidance

Such stress tests should include market value changes of underlying Collateral, risks relating to liquidity and realisation of such Collateral in stress scenarios. An assessment of the impact of any such changes on the Exposure value and the capital position of the Authorised Firm should be conducted. Stress testing of these positions should be conducted at least once a year.

4.15.17 An Authorised Firm must document its policy for the use of any of the exclusions in Rule 4.15.12.

Guidance

Such policy should include risks such as maturity mismatches, stress testing of Collateral values, indirect Exposures arising from Credit Risk mitigation, such as mitigation provided on Exposures by the same Counterparty.

Treatment of Parental Guarantees

4.15.18 ~~An Authorised Firm may exclude an Exposure from the Concentration Risk limits set out in Rules 4.15.5 to 4.15.7 if the Authorised Firm's Parent;~~

- ~~(a) is set to increase, on the basis of a legally binding agreement, the Authorised Firm's Capital Resources, promptly and on demand, by:
 - ~~(i) an amount that is sufficient to reverse completely the effect of any loss the Authorised Firm may sustain in connection with that Exposure; or~~
 - ~~(ii) the amount required to ensure that the Authorised Firm complies with its Capital Requirement set out in chapter 3; or~~~~
- ~~(b) guarantees the Exposure to a Counterparty or to a group of Closely Related Counterparties which are not Connected to the Authorised Firm only if the following conditions are met:
 - ~~(i) the guarantee is to be provided by the Authorised Firm's Parent, or regulated member of its Group;~~
 - ~~(ii) the criteria for guarantees must be in line with the Credit Risk mitigation requirements as set out in section 4.13;~~
 - ~~(iii) the entity providing the guarantee must be a bank regulated to standards acceptable to the DFSA;~~
 - ~~(iv) the total amount of guarantees provided to the Authorised Firm must be less than 10% of the Parent (or other) Authorised Firm's Capital Resources;~~
 - ~~(v) the Parent must be rated as a Credit Quality Grade of 1 or 2 by a recognised credit rating agency;~~
 - ~~(vi) the Authorised Firm must provide confirmation from the home state Financial Services Regulator that it is satisfied that the Parent Authorised Firm has sufficient resources to provide such guarantees and has no objection to the provision of such guarantees;~~
 - ~~(vii) the Authorised Firm should provide an annual confirmation that there are no changes to the enforceability of such guarantees; and~~
 - ~~(viii) the Authorised Firm must notify the DFSA when such guarantees represent 200%, 400% and 600% of Capital Resources. The overall Large Exposure limit of 800% will apply.~~~~

4.15.18 Where an Authorised Firm's Parent guarantees an Exposure to a Counterparty or to a group of Closely Related Counterparties, and the Counterparty or Counterparties are not Connected to the Authorised Firm, the Authorised Firm may exclude that Exposure from the Concentration Risk limits set out in Rules 4.15.5 to 4.15.7 only if the following conditions are met:

- (a) the guarantee is to be provided by the Authorised Firm's Parent, or regulated member of its Group;
- (b) the criteria for guarantees must be in line with the Credit Risk mitigation requirements as set out in section 4.13;
- (c) the entity providing the guarantee must be a bank regulated to standards acceptable to the DFSA;
- (d) the total amount of guarantees provided to the Authorised Firm must be less than 10% of the Parent (or other) Authorised Firm's Tier 1 Capital;
- (e) the Parent must be rated as a Credit Quality Grade of 1 or 2 by a recognised credit rating agency;
- (f) the Authorised Firm must provide confirmation from the home state Financial Services Regulator that it is satisfied that the Parent Authorised Firm has sufficient resources to provide such guarantees and has no objection to the provision of such guarantees;
- (g) the Authorised Firm should provide an annual confirmation that there are no changes to the enforceability of such guarantees; and
- (h) the Authorised Firm must notify the DFSA when such guarantees represent 200%, 400% and 600% of Tier 1 Capital and the overall Large Exposure limit must not exceed 800%.

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A4.9 Exposures to Central Counterparties (CCPs)

A4.9.1 An Authorised Firm may determine the Exposure value of a Credit Risk Exposure outstanding with a CCP in accordance with A4.9.2, provided that the CCP's Counterparty Credit Risk Exposure with all participants in its arrangements are fully collateralised on a daily basis and the CCP is a qualifying CCP.

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A4.9.5 (1) An Authorised Firm shall determine the Exposure value for clearing Exposures to non-qualifying CCPs as the amount in the table below:

<u>Type of Clearing Exposure</u>	<u>Exposure Amount</u>
<u>Segregated initial margin</u>	<u>Nil</u>
<u>Non-segregated initial margin</u>	<u>Nominal amount of initial margin posted</u>

<u>Pre-funded default fund contributions</u>	<u>Nominal amount of the funded contribution</u>
<u>Unfunded default fund contributions</u>	<u>Nil</u>
<u>Equity stakes</u>	<u>Nominal amount</u>

- (2) For the purposes of (1), a “non-qualifying CCP” is a CCP that does not meet the criteria set out in Rule 1.2.1. for a qualifying CCP.

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A4.11 Concentration Risk

Exempt Exposures

A4.11.1 (1) An Authorised Firm may treat the following Exposures as exempt from the Concentration Risk limits in chapter 4 if they are to Counterparties not Connected to the Authorised Firm:

- (a) asset items or Exposures constituting claims on central governments, ~~and~~ Central Banks and Public Sector Entities (PSEs) which receive a Credit Quality Grade rating 1 or 2 in accordance with Rule 4.12.4;
- (b) asset items or Exposures constituting claims on international organisations and multi-lateral development banks (MDBs) which receive a 0% (Credit Quality Grade rating of 1) risk weight as set out at Rule 4.12.7;
- (c) asset items or Exposures carrying the explicit guarantees of either (a) or (b) where the claims on the entity providing the guarantee would receive a 0% weighting (Credit Quality Grade rating of 1);
- (d) Exposures for which the Authorised Firm has Collateral in the form of cash deposits or certificates of deposit, including certificates of deposit issued by the Authorised Firm, held by the Authorised Firm, or held by the Authorised Firm's Parent Regulated Financial Institution or a Subsidiary of the Authorised Firm, but only if:
 - (i) the Authorised Firm and its Parent Regulated Financial Institution or the Subsidiary of the Authorised Firm concerned are subject to consolidated supervision; ~~and~~
 - (ii) the enforceability requirements in section 4.13 (Credit Risk mitigation) are met; and
- ~~(e) Exposures arising from undrawn credit facilities that are classified as low risk off balance sheet items and provided that an agreement has been concluded with the client or group of~~

~~Connected clients under which the facility can only be drawn only if it has been ascertained that it will not cause the limit as set out in Rule 4.15.5 to be exceeded;~~

~~(f) Exposures secured by mortgages on residential property and leasing transactions under which the lessor retains full ownership of the residential property leased for as long as the lessee has not exercised his option to purchase, in all cases up to 50% of the value of the residential property concerned; and~~

~~(g)(iii) material holdings in Regulated Financial Institutions and other Exposures which have been deducted from an Authorised Firm's Capital Resources Tier 1 Capital as required in chapter 3.~~

(2) If an Authorised Firm obtains credit protection relating to an exempt Exposure under (1)(a), the Authorised Firm must nevertheless apply the Large Exposure limits to the Exposure to the credit protection provider, notwithstanding that the original Exposure is exempt.

(3) An Authorised Firm must report to the DFSA Exposures which are exempt under (1)(a), (b) and (c).

Guidance:

1. In order to be applicable under (c) the guarantees must meet the requirements of section 4.13.9 in relation to Credit Risk mitigation.
2. An Authorised Firm can only treat Exposures as Collateralised provided the conditions of Rules 4.13.5 to 4.13.8 (relating to Credit Risk mitigation) are met. Item (d) also includes cash received under a credit linked note issued by the Authorised Firm and loans and deposits of a Counterparty to or with the Authorised Firm which are subject to an on balance sheet Netting agreement recognised under section 4.13 (Credit Risk mitigation).
3. The DFSA may consider a waiver for other sovereign Exposures where there is a local regulatory requirement to hold assets with a national regulatory authority. Authorised Firms will be required to apply for a waiver of the Large Exposure requirements in this regard and will be considered by the DFSA on a case by case basis.
4. The DFSA may, where it considers it appropriate, allow two or more Exposures to a sovereign not to be treated as connected or related if the sole reason for linking them is being controlled or economically dependent on the sovereign (including eligible PSEs). An eligible PSE is a PSE referred to in Rule A4.11.1(a).

A4.11.2 Where Exposures to a client are guaranteed by a third party, or secured by Collateral issued by a third party, an Authorised Firm may:

- (a) provided the Collateral meets the requirements of section 4.13 (Credit Risk mitigation), and would be assigned a lower risk weight under section 4.12, treat that portion of the Exposure which is secured by Collateral as an Exposure to the third party. An Authorised Firm must treat the portion secured by Collateral as having being incurred to the

third party providing the Collateral rather than to the Client for the purposes of considering the limits as set out at Rule 4.15.5; or

- (b) provided the guarantee meets the requirements of section 4.13 (Credit Risk mitigation), and would be assigned a lower risk weight under section 4.12, treat that portion of the Exposure which is guaranteed as an Exposure to the third party. An Authorised Firm must treat the portion guaranteed as having being incurred to the third party rather than to the Client for the purposes of considering the limits as set out at Rule 4.15.5. When considering the guarantee there must not be any maturity mismatch between the guarantee and the underlying Exposure.

A4.11.3 If an Exposure is partially guaranteed by an Authorised Firm's Parent Regulated Financial Institution, and would be assigned a lower risk weight under section 4.12, only that part of the Exposure subject to the guarantee is exempt from the Concentration Risk limits in Rule 4.15.5. When considering the treatment of this Rule an Authorised Firm may also consider the exemptions permitted under Rule 4.15.18 relating to parental guarantees.

Identification of Counterparties

A4.11.4 When calculating the Exposures of an Authorised Firm, the ~~firm~~ Authorised Firm must include Trading Book Exposures and Non-Trading Book Exposures to:

- (a) a single Counterparty;
- (b) group of Closely Related Counterparties;
- (c) Connected Counterparties; and,
- (d) Transactions, schemes or Funds.

Guidance

1. An individual Counterparty is a natural or legal person, which include governments, local authorities, public sector enterprises (PSEs), trusts, corporations, unincorporated businesses and non-profit-making bodies.
2. Examples of a Counterparty include:
 - a. the customer or borrower;
 - b. where the Authorised Firm is providing a guarantee, the person guaranteed;
 - c. for a Derivatives contract, the person with whom the contract was made;
 - d. for most exchange-traded contracts involving a central clearing mechanism, that central clearing mechanism; and
 - e. where a bill held by an Authorised Firm has been accepted by another Financial Institution, the acceptor.

Group of Closely Related Counterparties

- A4.11.5** (1) For Concentration Risk purposes, Persons are Closely Related if:
- (a) the insolvency or default of one of them is likely to be associated with the insolvency or default of the others;
 - (b) it would be prudent when assessing the financial condition or creditworthiness of one to consider that of the others; or
 - (c) there is, or is likely to be, a close relationship between the financial performance of those Persons.
- (2) Without limiting (1), an Authorised Firm must treat Persons as Closely Related to one another if they are assessed to be economically interdependent due to one or more of the following factors:
- (a) 50% or more of the annual receipts or expenditures of one is derived from transactions with the other;
 - (b) a guarantee issued by one in favour of the other party is likely to result in the provider default if called;
 - (c) significant output is sold to the other party and an alternative buyer is not easily found;
 - (d) single source of funds to repay loans for both parties with no alternative; or
 - (e) common reliance on the same funding provider that is hard to replace.
- (3) An Authorised Firm need not assess economic interdependence under (2) for a transaction where the value of the total Exposure is less than 5% of the Authorised Firm's T1 Capital.
- ~~(2)~~(4) Persons who are Closely Related to each other are also Connected with each other.
- (5) The DFSA may by notice in writing disapply the requirement to aggregate the Exposures in relation to Persons who are Closely Related, where an Authorised Firm can demonstrate that despite meeting the criteria in (2), it is unlikely that the Persons will default at the same time.
- A4.11.6** (1) A single group of Closely Related Counterparties means, in relation to an Authorised Firm, all the Persons to which the Authorised Firm has an Exposure and which are Closely Related to each other.
- (2) An Authorised Firm must treat two or more Persons as falling within a group of Closely Related Counterparties if the Authorised Firm has Exposures to them all and any loss to the Authorised Firm on any of the

Exposures to one is likely to be associated with a loss to the Authorised Firm with respect to at least one Exposure to each of the others.

Guidance:

Two or more Counterparties between whom there is no relationship of control as described in Rules A4.11.5 and A4.11.6 will be regarded as constituting a single risk if they are so interconnected that, if one of them were to experience financial problems, in particular funding or repayment difficulties, the other or all of the others would also be likely to encounter funding or repayment difficulties.

Connected Counterparties

A4.11.7 (1) For Concentration Risk purposes, and in relation to a Person, a Connected Counterparty means another Person to whom the first Person has an Exposure and who fulfils one of the following conditions:

- (a) he is Connected to the first Person;
- (b) he is an Associate of the first Person;
- (c) the same Persons significantly influence the Governing Body or senior management of each of them; ~~or~~
- (d) one of those Persons has an Exposure to the other that was not incurred for the clear commercial advantage of both of them and which is not on arm's length terms; or
- (e) one of those Persons:
 - (i) has influence over the appointment or dismissal of the Board or senior management of the other party;
 - (ii) is entitled to exercise, or controls the exercise of 50% or more of the voting rights in the other party including through voting agreements; or
 - (iii) has effective control over the other party under the criteria adopted by the International Financial Reporting Standards.

(2) The DFSA may by notice in writing specify that a person is not to be treated as a Connected Counterparty under (1), where an Authorised Firm can satisfy the DFSA that effective governance and controls are in place to mitigate risks resulting from effective control of one Person by the other.

Guidance:

A group of Connected Counterparties would be considered to be such where the entities share the same ultimate owner even though they may not be formally structured as a Group.

Exposures to transactions, schemes or Funds

- A4.11.8** (1) Where an Authorised Firm has an Exposure to a transaction, scheme, Fund, or other Exposure to a pool of underlying Exposures, the Authorised Firm must assess the Exposure to determine whether the Exposure is to a group of Closely Related Counterparties in its economic substance.
- (2) Where the Exposure is to a group and the Authorised Firm can demonstrate that the Exposure amount to each underlying asset of the structure is less than 0.25% of its Tier 1 Capital, the Authorised Firm may assign the Exposure amount to the structure itself.
- (3) An Authorised Firm need not look through a structure for the purposes of (2) if the Authorised Firm can demonstrate that its Exposure to each asset in the structure is less than 0.25% of its Tier 1 Capital.
- (4) Where the Exposure is to a group, the Authorised Firm must look through the structure to identify those underlying assets for which the underlying exposure value is equal to or exceed 0.25% of its Tier 1 Capital and identify each underlying asset and add that Exposure to the other Exposures of the same counterparty.
- (5) If an Authorised Firm looks through the structure to identify underlying assets and one or more underlying assets cannot be identified, the Authorised Firm must aggregate and assign that Exposure to a single "unknown customer" to which the Large Exposure limits apply.
- (6) If the Exposure to the underlying assets in a structure depends on the hierarchy of loss distribution to investors in the event of the winding up of the structure, an Authorised Firm must treat its Exposure to the structure:
- (a) as the pro rata share of the firm's Exposure multiplied by the value of the underlying asset, where all investors rank equally; or
- (b) as the pro rata share of the firm's investment in the structure multiplied by the lower of the tranche value or the nominal value of the underlying assets in the structure, where the seniority differs.
- (7) An Authorised Firm must aggregate its Exposures to any additional risks inherent in the structure itself, if that would result in Exposures to the same third party.

Guidance:

1. When considering this Rule the Authorised Firm should consider the following factors:
 - a. the structure, independence and control of the transaction, including governance arrangements;

- b. the inter relatedness of the underlying Exposures;
 - c. beneficial owners of the underlying Exposures and whether they could be deemed Connected or Closely Related; and
 - d. whether the transactions are conducted on an arm's length basis.
2. An Authorised Firm should look through the structure to determine whether there are any Counterparties or Exposures that should be considered a Concentration Risk.

Connected Counterparty exemptions

A4.11.9 (1) This Rule applies to an Authorised Firm in Category 2 and 3A.

- (2) An Authorised Firm may treat as exempt from the Concentration Risk limits in chapter 4 an Exposure to a Counterparty or Counterparties Connected to the Authorised Firm if all of the following conditions are met:
- (a) the Authorised Firm has given the DFSA written notice one month in advance of its intention to use the exemption and explained how it will ensure that it will still meet the Concentration Risk limits on a continuing basis when using the exemption;
 - (b) the total amount of the Exposures that an Authorised Firm is treating as exempt under this Rule does not exceed 50% of the Authorised Firm's ~~Capital Resources~~ Tier 1 Capital;
 - (c) the Authorised Firm makes and retains a record that identifies each Exposure it has treated in this way;
 - (d) the Authorised Firm is subject to consolidated supervision;
 - (e) the Counterparty is:
 - (i) an Authorised Firm which is the subject of consolidated supervision; or
 - (ii) a member of the Authorised Firm's Group which is the subject of consolidated supervision to the satisfaction of the DFSA; and
 - (f) the Exposure satisfies one or more of conditions (i) to (iii):
 - (i) it is a loan made by the Authorised Firm with a maturity of one year or less in the course of the Authorised Firm carrying on a treasury role for other members of its Group;
 - (ii) it is a loan to the Parent of the Authorised Firm made in the course of a business carried on by the Authorised Firm of lending to its parent cash that is surplus to the needs of the

Authorised Firm, provided that the amount of that surplus fluctuates regularly; or

- (iii) it arises from the Authorised Firm or a Counterparty Connected to the Authorised Firm operating a central risk management function for Exposures arising from Derivatives contracts.

Measuring Exposure to Counterparties and Issuers

A4.11.10 Rules A4.11.12 to A4.11.28 apply to both Non-Trading Book and Trading Book Exposures.

A4.11.11 When calculating an Exposure, an Authorised Firm must include accrued interest and dividends due.

A4.11.12 An Authorised Firm must not offset Non-Trading Book and Trading Book Exposures.

A4.11.13 A net short position is not an Exposure for the purposes of Concentration Risk.

A4.11.14 (1) Subject to (2), the value of an Authorised Firm's Exposure to a Counterparty, whether in its Non-Trading Book or its Trading Book, is the amount at risk calculated in accordance with chapter 4.

(2) For the purposes of calculating the value of an Authorised Firm's Exposure to a Counterparty under (1), the CCF factors taken into account under A4.2 are subject to a minimum floor of 10%.

Exposures to Issuers

A4.11.15 An Authorised Firm must calculate the value of an Exposure to the Issuer of a Security which is held in the Authorised Firm's Non-Trading Book as the sum of the excess, where positive, of the book value of all long positions over all short positions (the net long position), for each identical instrument issued by that Issuer.

A4.11.16 For the purposes of Rule A4.11.15, short positions in one Security may be used to offset long positions in a non-identical Security issued by the same Issuer if:

- (a) both Securities are denominated in the same currency; and
- (b) where both Securities are:
 - (i) fixed rate or index-linked, and are within the same residual maturity time band; or
 - (ii) floating rate.

A4.11.17 An Authorised Firm must calculate the value of an Exposure to the Issuer of a Security or a credit derivative used as a hedge that is held in the Authorised Firm's Trading Book by calculating the excess of the current market value of all

long positions over all short positions in all the Securities or credit derivatives issued by that Issuer, based on the seniority of those Securities or credit derivatives in the liquidation of the Issuer.

A4.11.18 An Authorised Firm must not offset an Exposure to one Issuer against an Exposure to another even where the Issuers are in a group of Closely Related Counterparties.

A4.11.19 An Authorised Firm must include as a long position a commitment by it to buy:

- (a) a debt Security or an equity at a future date; and
- (b) under a note issuance facility, at the request of the Issuer, a Security that is unsold on the issue date.

A4.11.20 An Authorised Firm must include as a short position a commitment by it to sell a debt Security or equity at a future date.

A4.11.21 Where the equity leg of an equity swap is based on the change in value of an individual equity, it is treated as an Exposure to the Issuer of the equity.

Guidance

An interest rate leg of an equity swap, or interest rate or currency swap does not generate an Exposure to an Issuer.

A4.11.22 ~~When determining its Exposure to an Issuer arising from an Option, an Authorised Firm must value the notional principal of an Option as the amount of principal underlying the Option.~~

An Authorised Firm must, when determining its Exposure to an Issuer arising from an Option, use an Exposure value based on the level of change in the price that will result from the default of the underlying instrument.

A4.11.23 ~~An Authorised Firm must treat:~~

- ~~(a) a written put Option as a long position in the underlying instrument valued at the strike price;~~
 - ~~(b) a written call Option as a short position in the underlying instrument valued at the strike price;~~
 - ~~(c) a purchased put Option as a short position in the underlying instrument valued at the strike price; and~~
 - ~~(d) a purchased call Option as a long position in the underlying instrument equal to the book value of the Option.~~
- (1) An Authorised Firm must treat the value of:
- (a) a call Option as equal to market value; and

(b) a put Option as equal to the strike price minus market value.

(2) An Authorised Firm must aggregate the resulting option Exposures to each underlying counterparty and if there is a negative net Exposure after aggregation of all option Exposures, the option Exposure must be set to nil.

A4.11.24 An Authorised Firm must, for the purposes of Concentration Risk, treat an Exposure to an Issuer arising from an index or basket of debt Securities or a non-broad-based equity index or basket, as a series of Exposures to the Issuers of the underlying instruments or equities in accordance with the procedures in chapter 4.

Guidance

Broadly based equity indices should not be broken down into their constituent stocks. A position related to a broadly based equity index does not generate an Exposure to any Issuer.

A4.11.25 An Authorised Firm which receives cash on a repurchase agreement must treat the cash as if it is on its balance sheet and in accordance with sections 4.9 and 4.13. Any Collateral received against repurchase agreements or Securities and commodities borrowing must also be treated as a balance sheet item under sections 4.9 and 4.13.

A4.11.26 An Authorised Firm must treat a reverse repurchase agreement or Securities and commodities lending in its Non-Trading Book as a collateralised loan and the Collateral it holds as an asset, provided that the Collateral is eligible financial Collateral as defined in Rule 4.13.5. If the Collateral is not such an eligible financial Collateral, the Authorised Firm must treat the transaction as an unsecured loan to the Counterparty.

A4.11.27 An Authorised Firm with repurchase agreements and reverse repurchase agreements in its Trading Book has an Exposure to:

- (a) the Issuer of the Security it has sold in a repurchase agreement; and
- (b) the Counterparty where the Securities or cash given by the Authorised Firm exceed the Securities or cash it receives (i.e. there is a net margin given by the Authorised Firm) in a repurchase agreement or reverse repurchase agreement.

A4.11.28 An Authorised Firm must calculate in accordance with section 5.10 an Exposure to the Issuer arising from the Underwriting or sub-underwriting of a new Issue of Securities.