

CONSULTATION PAPER NO. 132



UPDATING THE LARGE EXPOSURES REGIME

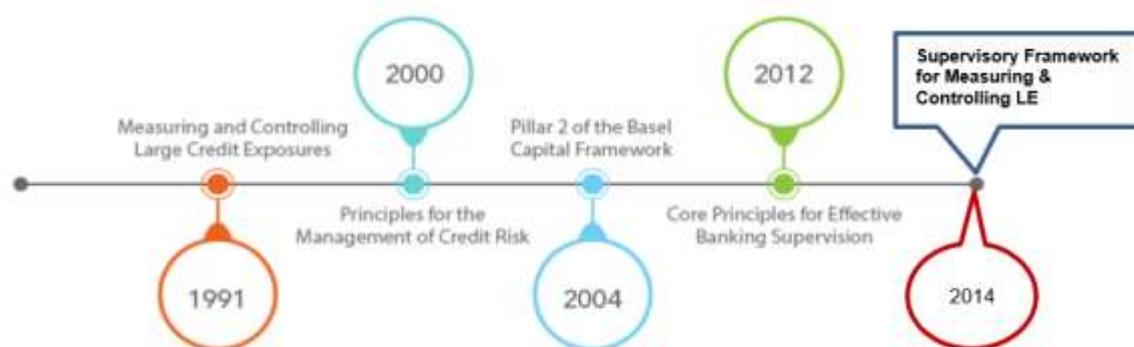
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PREFACE

Why are we issuing this paper?

1. The DFSA aims to implement international standards and best practice in the DIFC, while taking into account specific factors as relevant to the DIFC markets. This includes the standards and recommendations of the Basel Committee on Banking Supervision (BCBS). This Consultation Paper (CP) sets out a number of proposed changes to the DFSA's prudential regime that relate to Large Exposures (LE) of financial institutions regulated by the DFSA. We believe these are necessary to align the DFSA LE requirements with the standard issued by the BCBS in 2014¹ and the best international practice adopted by other regulators² in this area.
2. The 2014 BCBS LE standard aims to address global inconsistency in defining, measuring and controlling LE. The standard complements the existing BCBS Basel III Capital Framework and, in many respects, leverages off existing capital treatments and concepts. The standard also provides for measures that reduce systemic risk in the global and domestic economies.

Figure 1. Evolution of International Large Exposure framework



3. As a risk based regulator, we are proposing to incorporate the main changes introduced by the BCBS LE standard, as relevant, to the DIFC environment. We also propose not to adopt some aspects of more favourable LE treatment that comes with added complexity, under the BCBS LE standard, as we believe DIFC firms are unlikely to benefit, to any significant extent, from the more complex treatments.

Who should read this paper?

4. The proposals in this paper will be of interest to:
 - a) Authorised Firms who are licensed as deposit takers; credit providers and proprietary dealers; dealing as agent on a matched principal basis; or as an Islamic banking institution;
 - b) persons interested in applying for a DFSA licence to conduct the activities specified above;

¹ <https://www.bis.org/publ/bcbs283.pdf>

² For example, by APRA (Australia), SAMA (KSA), HKMA (Hong Kong) and MAS (Singapore)

- c) service providers who assist, or intend to assist, persons conducting the activities in a); and
- d) other industry participants.

Terminology

5. Defined terms are identified by the capitalisation of the initial letter of a word or of each word in a phrase and are defined in the [Glossary Module](#) (GLO). Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning. More commonly used terms in this CP have the following meanings:
- a) 'LE' means Large Exposure as defined in draft PIB Rule 4.15.4;
 - b) 'Tier 1 Capital' means the capital instruments as defined in PIB Rule 3.12.1;
 - c) 'G-SIBs' means Global Systemically Important Banks;
 - d) 'D-SIBs' means Domestic Systemically Important Banks;
 - e) 'Related Counterparty' means a counterparty that meets the criteria set out in draft PIB A4.11.5;
 - f) 'Connected Counterparty' means a counterparty that meets the criteria set out in draft PIB A4.11.7;
 - g) 'SA-CR' means the standardised Credit Risk Capital Requirement as calculated under PIB 4.6; and
 - h) 'CRM' refers to Credit Risk mitigation techniques that are available under PIB 4.13.

What are the next steps?

6. All comments should be submitted to the DFSA using the [online response form](#). The DFSA reserves the right to publish, including on its website, any comments you provide. However, if you wish your comments to be kept confidential, you must expressly request at the time of making comments that this should be the case and your reasons for requesting so.
7. The deadline for providing comments on this consultation is 25 November 2020. Following public consultation, we will proceed to make the relevant changes to the DFSA's Rulebook. You should not act on the proposals until the relevant changes to the laws and DFSA Rulebook are made. We shall issue a notice on our website telling you when this happens.

Structure of this CP

Part 1 – Large Exposures definitions, aggregation and Limits;

Part II – Removal of some Large Exposure exemptions;

Part III – Measurement of Large Exposures;

Part IV – Specific treatment for certain types of exposures;

Appendix 1 – Draft amendments to PIB;

Appendix 2 – Draft amendments to IFR;

Appendix 3 – Draft amendments to GLO; and

Appendix 4 – Questions in this Consultation Paper.

Part 1 Large Exposures definitions, limits and aggregation

Should the DFSA adopt the BCBS new definition, limits and aggregation criteria in relation to Large Exposures?

A. Large Exposure definition

8. The existing definition of LE in PIB 4.15.4 measures LE as a percentage of the Firm's Capital Resources³. Capital Resources currently include both Tier 1 and Tier 2 forms of capital⁴. The new BCBS standard measures a LE as a percentage of Tier 1 capital only.
9. This is a more conservative approach compared to the existing DFSA approach because Capital Resources will always be equal to or higher than Tier 1 Capital, resulting in a higher amount before an exposure is considered a Large Exposure.
10. The DFSA is of the view that using Tier 1 capital, in line with the BCBS standard, is more appropriate than using Capital Resources. This is because a loss resulting from the default of a LE will have to be absorbed by Tier 1 capital of the firm in a going concern situation, while Tier 2 capital can only be used in a gone concern situation or in the insolvency of the firm.
11. We also propose to remove a less significant deviation from the BCBS LE definition in relation to the LE threshold. While the DFSA existing rules recognise a LE once it exceeds 10%, the BCBS standard recognises a LE if it is equal to the 10% threshold. The DFSA believes that aligning with the BCBS standard is warranted, while noting that doing so is unlikely to have a material impact on firms.

Proposal 1

See draft PIB Rules 4.15.4 and IFR 5.4.15 and 5.4.16

12. We propose to amend the definition of LE to use Tier 1 capital as the base for measuring a LE and also make the minor alignment with the BCBS standard referred to in paragraph 11.

Question 1

Do you agree with our amendments to the definition of a Large Exposure? If not, why not?

B. Large Exposure Limits

13. The DFSA has a 25% LE limit set out in PIB 4.15.5⁵ for a single or a group of connected counterparties. The BCBS standard similarly adopts a 25% limit for LE. However, the BCBS standard introduces a more stringent lower limit of 15% for exposures between

³ The total capital resources of an Authorised Firm calculated in accordance with PIB section 3.11.

⁴ See PIB 3.11.1.

⁵ PIB 4.15.5 "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".

two Global Systematically Important Banks (G-SIBs).⁶ The standard also allows applying the lower G-SIB limit to exposures between subsidiaries of G-SIBs.

14. The lower limit applicable to G-SIBs is designed to address the interconnectedness and spill-over effects between significant global banks that have the potential to impact global financial stability. As a measure intended to address some of the issues of the 2008/9 financial crisis, it is important that this is implemented in as many jurisdictions as possible, in order to be fully effective in mitigating future risk.

Proposal 2

15. The DFSA proposes to:
- a) apply the lower LE limit of 15% to G-SIBs; and
 - b) give the power to the DFSA to treat a subsidiary of a G-SIB (that is a DIFC entity) in the same way as G-SIBs for the purpose of LE.

See draft PIB Rules 4.15.5

Question 2

Do you agree with our proposals to introduce a lower LE limit of 15% for interbank exposures between DIFC G-SIBs and to give the DFSA the power in relation to application of this LE rule to subsidiaries of G-SIBs? If not, why not?

Proposal 3

16. Given the status of DIFC as an integral part of the UAE and regional economies, and the nature of cross border exposures that take place within or from the DIFC, we consider it appropriate that the DFSA has a discretionary power to apply a lower LE limit of between 15% and 25% to a DIFC D-SIB or a subsidiary of such a D-SIB for its exposures to a non DIFC D-SIB or a subsidiary of such a D-SIB. This will allow the DFSA, in cooperation with other regulators in the region, to safeguard regional financial stability.

See draft PIB Rules 4.15.5(4)

Question 3

Do you agree that the DFSA should have the power to set lower LE limits for a DIFC D-SIB (or its subsidiaries) exposures to each other, as well as to a non-DIFC D-SIB (or its subsidiaries)? If not, why not?

C. Aggregation of exposures

Economic Interdependence (EI)

17. To capture the risk of multiple connected exposures experiencing default at the same time, the DFSA's current rules require firms to aggregate their exposures to Closely

⁶ The Financial Stability Board (FSB) designates G-SIBs around the world using a consistent methodology.

Related counterparties.⁷ Under PIB A4.11.5, persons are considered Closely Related for LE purposes if:⁸

- 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.
18. The BCBS LE standard uses more expansive and granular assessment criteria based on the real economic relationship between the parties, i.e., "Economic Interdependence (EI)", to determine Closely Related counterparties for aggregation of their exposures for the purpose of LE. EI between two entities is assessed using the following criteria:
- a) 50% or more of annual gross receipts/expenditures of one party is derived from transactions with the other party;
 - b) a guarantee in favour of the other party exists that is likely to result in the provider default if called;
 - c) significant output is sold to the other party and an alternative buyer is difficult to find;
 - d) single source of funds to repay loans for both parties with no alternative;
 - e) a default of one counterparty is likely to result in the default of the other;
 - f) reliance on the same funding provider that is hard to replace; or
 - g) financial problems at one party will make it difficult for the other to make full and timely repayment of liabilities.
19. The DFSA recognises the potential burden on firms in conducting EI assessments of immaterial exposures that are unlikely to impact LE. In line with the BCBS standard, we propose not to require firms to conduct an EI assessment for exposures that represent less than 5% of the firm's T1 capital.
20. Also in line with the BCBS position, the DFSA considers that - in limited cases - it might not be appropriate to aggregate exposures that meet some of the EI criteria in paragraph 18. The DFSA proposes to exempt a firm from having to aggregate exposures where it can be clearly demonstrated, to the satisfaction of the DFSA, that the borrowers are unlikely to default at the same time.

Proposal 4

21. The DFSA proposes to:
- a) adopt the BCBS EI criteria to determine when a Counterparty is to be considered as related to the Firm for the purpose of measuring LE;
 - b) apply the 5% of T1 Capital as a *de minimis* threshold for exposures for which Firms are required to conduct EI assessment of counterparties in line with the BCBS standard; and

⁷ See DFSA rules at PIB 4.15.3(h).

⁸ See DFSA rule PIB A4.11.5.

- c) exercise its exemption power in the circumstances noted in paragraph 20.

See draft PIB Rules A4.11.5(2)(3) and (5)

Question 4

Do you agree with the DFSA proposals in relation to applying Economic Interdependence for the purpose of LE aggregation? If not, why not?

Effective Control (EC)

22. In addition to using EI criteria, as set out above, for determining when exposures should be aggregated for LE purposes, the BCBS standard also requires aggregation of two exposures where one borrower exercises Effective Control (EC) over the other. EC is assumed where one borrower has:
- 50% or more ownership of voting rights in the other party, including through voting rights under agreements; or
 - influence over appointment or dismissal of the majority of board members and senior management of the other party; or
 - effective control based on IFRS (accounting) criteria.
23. The existing DFSA rules provide the conditions for treating two borrowers as Connected Counterparties.⁹ The rules imply that parties are connected if one has influence or control over the other. However, these rules are not as detailed as the BCBS LE Standard.
24. As with the EI criteria, aggregation for the purposes of LE may not be appropriate based purely on EC in the circumstances listed in paragraph 22. Therefore, where it can be clearly demonstrated, to the satisfaction of the DFSA, that there are effective corporate governance and other controls that negate risks arising from EC, the DFSA proposes to allow Connected Exposures to be treated as separate for LE purposes. This is in line with the supervisory discretion under the BCBS LE standard.

Proposal 5

25. The DFSA is proposing to adopt the EC criteria to determine Connected Counterparties that require exposures to be aggregated, whilst also exempting firms from having to take into account Connected Exposures for LE purposes in limited circumstances.

See draft PIB Rules A4.11.7(1) and (2)

Questions

- Do you agree with the DFSA proposal to adopt the BCBS Effective Control criteria? If not, why not?**
- Should the DFSA provide an exemption to Effective Control as outlined in paragraph 24? If not, why not?**

⁹ See DFSA rules under PIB A4.11.7.

Part II Removal of some Large Exposure exemptions

Should the DFSA remove some of the existing exemptions from Large Exposures to align with the BCBS LE standard?

Removal of the current higher LE Limit applicable to Financial Institutions (FIs) in Prudential CAT 1 and 5

26. The current PIB 4.15.10 provides an "Institutional Exemption" from LE limits to certain firms, which allows them to have exposures of up to 100% or USD 100 million (whichever is lower) to an investment grade financial institution. Similarly, PIB A4.11.9 provides an exemption from the LE limits, the "Connected Counterparty Exemption", which allows a Firm to hold exposures of up to 50% of its Capital Resources to Connected Counterparties subject to a number of conditions.
27. We believe that the Institutional and the Connected Counterparty Exemptions are not in line with the BCBS LE standard and do not support protecting financial stability and reducing the interconnectivity of financial institutions, particularly for deposit taking institutions. However, we are of the view that non-deposit taking institutions to whom these rules apply (i.e. credit providers, proprietary dealers and firms dealing as agent on a matched principal basis) could incur a disproportionate cost and administrative burden if these exemptions were no longer available to them, as this would require such Firms to maintain multiple bank accounts and change their intra-group liquidity management.

Proposal 6

28. In view of the considerations noted above, the DFSA proposes to:
- remove the "Institutional Exemption" and the "Connected Counterparty Exemption" for deposit-taking firms; and
 - retain these exemptions for other firms who are subject to the LE regime.

See draft PIB Rules 4.15.10 and A4.11.9

Questions

7. Do you agree with the DFSA's proposals to remove, or retain, the Institutional Exemption? If not, why not?

8. Do you agree with the DFSA's proposals to remove, or retain, the Connected Counterparty Exemption? If not, why not?

Treatment of Parental support for LE Limits

29. The current PIB 4.15.18(a) allows a Firm to exclude from its LE limits an exposure that is covered by a legally binding capital support agreement between the Firm and its Parent, where the Parent commits to remedy any capital shortfall that may arise if the exposure defaults in the future. This exemption is permitted regardless of the ability of the Parent entity to meet the capital shortfall.

30. The DFSA believes that it is prudent only to rely on parental guarantees that meet the conditions set out in PIB Rule 4.15.18(b)¹⁰ to reduce LEs. The concentration risk, which the LE rules are designed to address, will then be more likely to be properly mitigated if the Firm has to call on the support of its Parent to cover losses arising from a LE default.

Proposal 7

31. The DFSA proposes to remove the option under PIB 4.15.18(a) that allows a Firm to rely on a Parental capital support agreement to exclude an exposure from the LE limits.

See draft PIB Rule 4.15.18

Question 9

Do you agree that the DFSA should remove the Parental support exemption under PIB Rule 4.15.18(a)? If not, why not?

Proposal 8

Undrawn credit facilities and mortgages

32. Under current PIB Rule PIB A4.11.1(e), an undrawn credit facility is exempt from LE where the facility can only be drawn if it does not breach LE limits. The DFSA expects regulated firms to adhere to the highest standards of transparency. This exemption gives the impression that a Firm is able to provide a service while, in practice, it is constrained from doing so by the LE limits. The exemption is also not allowed under the BCBS standard and is not adopted by other regulators the DFSA benchmarked against.
33. Under current PIB Rule A4.11.1(f), another exemption is given to exposures secured by mortgages on residential properties and leasing transactions. This Rule allows for exposure reduction of up to 50% of the exposure value. This type of Credit Risk Mitigation (CRM), is not part of the CRM permitted under the BCBS standardised approach for credit risk (SA-CR) and is, therefore, not permitted under the BCBS LE standard. The DFSA sees no reason to deviate from the BCBS standard and, therefore, proposes to remove this exemption.
34. For the reasons set out in paragraphs 32 and 33, the DFSA proposes to align with the BCBS LE standard and remove LE exemptions relating to undrawn credit facilities and mortgages as currently allowed in PIB Rules A4.11.1(e) and (f).

See draft PIB Rule A4.11.1

Question 10

Do you agree with the DFSA's proposals to remove exemptions? If not, why not?

¹⁰ Allows reliance on a formal guarantee that meets a number of stringent conditions including the parent being an investment grade regulated bank, no objection from the parent home state regulator, and the guarantee amount not exceeding 10% of the parent capital base.

Part III – The measurement of Large Exposures

Should the DFSA align its Large Exposures measurement approach with the BCBS standard?

Credit Conversion Factors (CCFs) floor

35. Under the current PIB A4.2.1, CCFs are applied to convert an off balance sheet, unfunded, exposure to an on-balance sheet amount in order to facilitate the measurement of the exposure for capital and LE purposes. The CCFs are based on the likelihood of an off balance sheet exposure moving on-balance sheet.
36. The BCBS LE standard introduces a minimum CCF floor of 10% for LE measurement purposes, the current DFSA Rules do not have a minimum CCF floor. The vast majority of regulators we benchmarked against adopt the 10% BCBS floor. The DFSA proposes to apply the 10% CCF floor in line with the BCBS standard.

Proposal 9

See draft PIB Rule A4.11.14

Question 11

Do you agree that the DFSA should set a minimum floor of 10% for CCFs for LE purposes? If not, why not?

Eligible Credit Risk Mitigation (CRM)

37. CRM techniques are used under BCBS standards to reduce the risk weight applied to an asset, as well as the amount of the credit exposure, by shifting the exposure to the CRM provider. The reduction can be achieved using instruments such as credit guarantees, Credit Default Swaps (CDS), cross-exposure netting agreements and certain types of high quality collateral. The BCBS LE standard restricts CRM techniques to those permitted under the BCBS SA-CR¹¹ (i.e. no modelling) and requires the same CRM technique used for capital to be used for LE, if so permitted.
38. PIB section 4.13 requires the use of the SA-CR for capital purposes. However, there is presently no requirement to use the same CRM technique for both capital and LE calculation. This could potentially create arbitrage opportunities and would allow cherry picking of CRM techniques for capital and LE. The DFSA proposes to require the use of the same CRM techniques used for capital calculations to also be used for LE reduction, where permitted under the LE rules.
39. Similar to CCF and CRM, the BCBS LE standard does not allow modelling for collateral haircuts when using the Financial Collateral Comprehensive Approach (FCCA). Firms are required to apply only those haircuts provided by the supervisor. The existing DFSA LE rules do not prohibit the use of modelled haircuts for LE measurement purposes.

¹¹ CRM that is allowed under the Internal Rating Based Approach (IRB) such as Commercial and Residential Real Estate, Receivables and other collateral are not allowed for LE purposes.

Proposal 10

40. The DFSA proposes to align the use of CRM techniques for capital and LE purposes and to require firms using FCCA to apply supervisory haircuts only, thereby removing modelling risk from the measurement of LE in line with the BCBS LE standard.

See draft PIB Rules 4.13.1 (3) and 4.15.12 (1)

Questions

12. Do you agree that the DFSA should align the use of CRM techniques for capital and modelling purposes? If not, why not?
13. Do you agree that, for Large Exposure measurement purposes, the DFSA should require supervisory haircuts to be used under the Financial Collateral Comprehensive Approach? If not, why not?

Mandatory Exposure shifting

41. When using CRM, a requirement under the BCBS LE standard is for the firm to reduce the value of the original exposure and recognise an equal exposure to the CRM provider (exposure shifting), except where the CRM is a Credit Default Swap (CDS) and neither the reference entity, nor the CDS provider, is a Financial Institution.
42. The BCBS LE standard requires a firm to use the same CRM technique it used for capital calculation for LE measurement (except where the technique is not allowed under SA-CR) and shift the reduction in the exposure to the CRM provider. The amount subject to exposure shifting is as follows:
- the value of the protected portion for unfunded credit protection;
 - where the Financial Collateral Simple Approach is used, the market value of the collateral; and
 - where the FCCA is used, the market value of the collateral adjusted by applying the standard supervisory haircuts to the FCCA.

Proposal 11

43. The DFSA proposes:
- where a CDS is used as CRM, and neither the reference entity, nor the CDS provider, is a Financial Institution, then the exposure is reduced by the amount of credit protection bought, but the exposure recognised on the protection seller is the Counterparty Credit Risk (CCR);¹² and
 - all other credit derivative hedges follows the same exposure shifting as set out in paragraph 42.

¹² If both the provider and the reference entity of the CDS are not Financial Institutions, the amount of the exposure recognised against the CRM provider is the value of the CCR and not the actual reduction in the exposure.

See draft Rule in PIB 4.15.12 (2) and (3)

Question 14

Do you agree that the DFSA should require compulsory "exposure shifting", except from some CDS CRM? If not, why not?

Trading book exposures

44. The current PIB Rule A4.11.17 allows for an exposure to an issuer of securities to be calculated as the excess of all long positions over short positions in all securities issued by that issuer. Unlike the BCBS LE standard, this Rule doesn't differentiate between securities based on their seniority in liquidation.

Proposal 12

45. The DFSA agrees with the BCBS that effective offset of short and long positions needs to take into account seniority in liquidation. Therefore, the DFSA proposes to amend PIB Rule A4.11.17 to allow different issues of securities or credit derivatives used as a hedge from the same counterparty, to be offset in the trading book only if the short position or the underlying hedge, in the case of credit derivatives, is junior to, or equal in seniority to, the long position.

See draft DFSA rule in PIB A4.11.17

Question 15

Do you agree with the DFSA proposal on trading book exposures? If not, why not?

46. Exposures to Options are covered under current PIB Rules A.4.11.22 and A4.11.23. The approach uses the book value of the notional principal underlying the option to determine the exposure value of an option for LE measurement purposes. The BCBS LE standard requires the exposure value to be based on the change in the option price that will result from the default of the underlying instrument. The exposure values under the BCBS LE standard are set to the market value for a call option and the strike price minus the market value for a put option.
47. The DFSA proposes to align its Rules with the BCBS LE standard, so that Firms would need to aggregate the resulting option exposures to each underlying counterparty based on the exposure values set out in paragraph 46. As a result, if there were a negative net exposure after aggregation, the option exposure would need to be set to nil.

Proposal 13

See draft Rules in PIB A4.11.22 and A4.11.23

Question 16

Do you agree with the DFSA proposal on option exposures? If not, why not?

Part III Considerations for specific types of exposures

Should the DFSA adopt the special treatment for Sovereigns, Covered Bonds, Investment Structures, and Central Clearing Counterparties?

Exposure to Sovereigns and Connected Entities

48. The current PIB Rule A4.11.1 (a) provides an exemption from LE limits for sovereigns and Central Banks that receive a Credit Quality Grade rating of 1 or 2. This exemption does not extend to Public Sector Entities (PSEs) or clarify the aggregation of multiple PSE exposures based on their connection with a sovereign entity.
49. The BCBS LE standard provides more clarity over a number of issues in relation to PSEs and sovereign exposures, as follows:
 - a) by providing an exemption from LE limits to PSEs subject to the same capital treatment as the exempt sovereign;
 - b) by allowing two or more exposures outside the sovereign definition not to be treated as connected/related if the sole reason for linking them is being controlled or economically dependent on the sovereign (including eligible PSEs);
 - c) by requiring LE to PSE and sovereigns to be reported for monitoring purposes; and
 - d) if credit protection is bought on the exempt PSE or sovereign exposure, by applying the LE limits to the exposure shifted to the provider, notwithstanding that the original exposure is exempt.

Proposal 14

50. The DFSA proposes to:
 - a) extend the LE exemption provided to sovereigns to cover PSEs that benefit from the same capital treatment;
 - b) have the power to determine the level of aggregation of sovereign and government related entities;
 - c) require Firms to continue to report LE-exempt PSE and sovereign exposures for monitoring purposes; and
 - d) require Firms to recognise an exposure to the providers of credit protection, notwithstanding that the original exposure on which the credit protection is held is exempt.

See draft PIB Rules A4.11.1 and Guidance item no. 4

Question 17

Do you agree with the DFSA proposals on sovereigns and connected entities? If not, why not?

Covered Bonds

51. The BCBS standard provides for a special LE treatment of Covered Bonds,¹³ which are defined as follows:

"Bonds issued by a bank or mortgage institution and are subject by law to special public supervision designed to protect bond holders. Proceeds deriving from the issue of these bonds must be invested in conformity with the law in assets which, during the whole period of the validity of the bonds, are capable of covering claims attached to the bonds and which, in the event of the failure of the issuer, would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest"

52. The DIFC does not have a specific law or framework for the issuance and supervision of Covered Bonds in line with the BCBS standard. Nevertheless, it is possible that firms in the DIFC could potentially purchase Covered Bonds issued elsewhere that are eligible for preferential LE treatment under the BCBS standard. If no special treatment is afforded, Covered Bonds will continue to be measured at 100% of their market value.
53. The DFSA believes that introducing a special treatment for Covered Bonds is not warranted because:
- it has very limited use given the unlikely situation that DIFC firms end up holding Covered Bonds that meet the definition in paragraph 51; and
 - in the unlikely situation where a DIFC firm holds a substantial amount of qualifying Covered Bonds, and the exposure is pushing against its LE limit, the DFSA could deal with the situation on a case-by-case basis using the DFSA's waiver and modification powers.

Question 18

Do you agree with the DFSA proposal on Covered Bonds? If not, why not.

Collective Investment Undertakings, Securitisation Vehicles and other structures

54. When measuring LE, current PIB Rule A4.11.8 requires "a look through approach" to the underlying assets for exposures to undertakings, securitisation vehicles and other structures. The BCBS LE standard provides more details as to when a look through approach should be applied to a structure, as follows:
- a Firm does not have to look through a structure if it can demonstrate that its exposure to each asset in the structure is less than 0.25% of its Tier 1 Capital base (T1);¹⁴
 - if individual assets in a structure are equal to or exceed 0.25% of the Firm's T1 Capital base, then each underlying asset should be identified and the exposure added to other exposures to the same counterparty; and
 - if one or more assets in b) cannot be identified, then the exposure should be aggregated and assigned to a single client "unknown customer" to which the LE limits apply.

¹³ 20% or 100% of the nominal value, depending on a number of strict conditions.

¹⁴ The exposure, in this case, is the nominal exposure to the structure (provided it is not designed to circumvent LE).

55. The exposure amount to the underlying assets in a structure will depend on the hierarchy of loss distribution to investors in the winding-up of the structure. Where all investors rank equally, the exposure is the *pro rata* share of the Firm in the structure multiplied by the value of the underlying asset. If seniority differs, then the exposure is 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.
56. The BCBS standard also requires a firm to determine additional risks that are inherent in the structure itself and not only in the underlying assets. These include risks imposed by the fund manager, liquidity provider and credit protection provider. This means that if the structures result in exposure to 3rd party additional risk, the Firm should consider if such exposures should be aggregated and then added to other exposures to that same 3rd party to arrive at the total exposure that should be monitored and subject to LE limits.

Proposal 15

57. The DFSA proposes to align with the BCBS LE standard relating to the measurement of Exposures to Collective Investment Undertakings (CIUs), Securitisation Vehicles, and other structures.

See draft DFSA rules in PIB A4.11.8

Question 19

Do you agree with the DFSA proposal on exposures to CIUs, Securitisations and other structures? If not, why not?

Exposure to Central Counterparties (CCPs)

58. Clearing exposures to "Qualifying¹⁵ CCPs" are exempt from LE limits under the BCBS LE Standard. This is unchanged from our present regime, as exposures to CCPs are already measured as "nil", which excludes such exposures from LE. However, the definition of a "Qualifying CCP" under current PIB Rule A4.9.1¹⁶ is not fully aligned with the BCBS definition, which requires the CCP, *inter alia*, to be covered by rules consistent with the CPSS - IOSCO principles for Financial Markets Infrastructures. The DFSA proposes to align our definition of a Qualifying CCP with the BCBS definition.
59. Under the BCBS standard, for non-qualifying CCPs, a Firm needs to measure both its clearing and non-clearing¹⁷ exposures. Exposures to non-clearing activities are treated, under the BCBS standard, the same as an exposure to any other counterparty. However, Clearing Exposures are measured using the values in the table below, which we propose to adopt:

¹⁵ BCBS LE definition of Qualifying CCP is the same as per the Capital Framework and requires the CCP to be covered by IOSCO equivalent regulation. The current DFSA definition in PIB A4.9.1 requires daily collateralisation only and does not address being a regulated CCP.

¹⁶ PIB A4.9.1 allows the firm to apply 0% value for the exposure provided that the CCP's Counterparty Credit Risk Exposure with all participants in its arrangements are fully collateralised on a daily basis.

¹⁷ Examples include loans and guarantees to the CCP.

Type of Clearing Exposure	Exposure amount
Segregated initial margin	Nil
Non-segregated initial margin	The nominal amount of initial margin posted.
Pre-funded default fund contributions	Nominal amount of the funded contribution.
Unfunded default fund contributions	Nil
Equity stakes	The nominal amount.

Proposal 16

60. The DFSA proposes to align its Rules to the BCBS LE standard as noted in paragraphs 58 and 59.

See draft DFSA rules in A4.9.1 and A4.9.5

Questions

20. Do you agree that the DFSA should adopt the BCBS definition of qualifying CCPs? If not, why not?
21. Do you agree that the DFSA should adopt the BCBS Large Exposure treatment for non-qualifying CCPs? If not, why not?

Appendix 4 Questions in this Consultation Paper

1. Do you agree with our amendments to the definition of a Large Exposure? If not, why not?
2. Do you agree with our proposals to introduce a lower LE limit of 15% for interbank exposures between DIFC G-SIBs and to give the DFSA the power in relation to application of this LE rule to subsidiaries of G-SIBs? If not, why not?
3. Do you agree that the DFSA should have the power to set lower LE limits for a DIFC D-SIB (or its subsidiaries) exposures to each other, as well as to a non-DIFC D-SIB (or its subsidiaries)? If not, why not?
4. Do you agree with the DFSA proposals in relation to applying Economic Interdependence for the purpose of LE aggregation? If not, why not?
5. Do you agree with the DFSA proposal to adopt the BCBS Effective Control criteria? If not, why not?
6. Should the DFSA provide an exemption to Effective Control as outlined in paragraph 24? If not, why not?
7. Do you agree with the DFSA's proposals to remove, or retain, the Institutional Exemption? If not, why not?
8. Do you agree with the DFSA's proposals to remove, or retain, the Connected Counterparty Exemption? If not, why not?
9. Do you agree that the DFSA should remove the Parental support exemption under PIB Rule 4.15.18(a)? If not, why not?
10. Do you agree with the DFSA's proposals to remove exemptions? If not, why not?
11. Do you agree that the DFSA should set a minimum floor of 10% for CCFs for LE purposes? If not, why not?
12. Do you agree that the DFSA should align the use of CRM techniques for capital and modelling purposes? If not, why not?
13. Do you agree that, for Large Exposure measurement purposes, the DFSA should require supervisory haircuts to be used under the Financial Collateral Comprehensive Approach? If not, why not?
14. Do you agree that the DFSA should require compulsory "exposure shifting", except from some CDS CRM? If not, why not?
15. Do you agree with the DFSA proposal on trading book exposures? If not, why not?

16. Do you agree with the DFSA proposal on option exposures? If not, why not?
17. Do you agree with the DFSA proposals on sovereigns and connected entities? If not, why not?
18. Do you agree with the DFSA proposal on Covered Bonds? If not, why not.
19. Do you agree with the DFSA proposal on exposures to CIUs, Securitisations and other structures? If not, why not?
20. Do you agree that the DFSA should adopt the BCBS definition of qualifying CCPs? If not, why not?
21. Do you agree that the DFSA should adopt the BCBS Large Exposure treatment for non-qualifying CCPs? If not, why not?