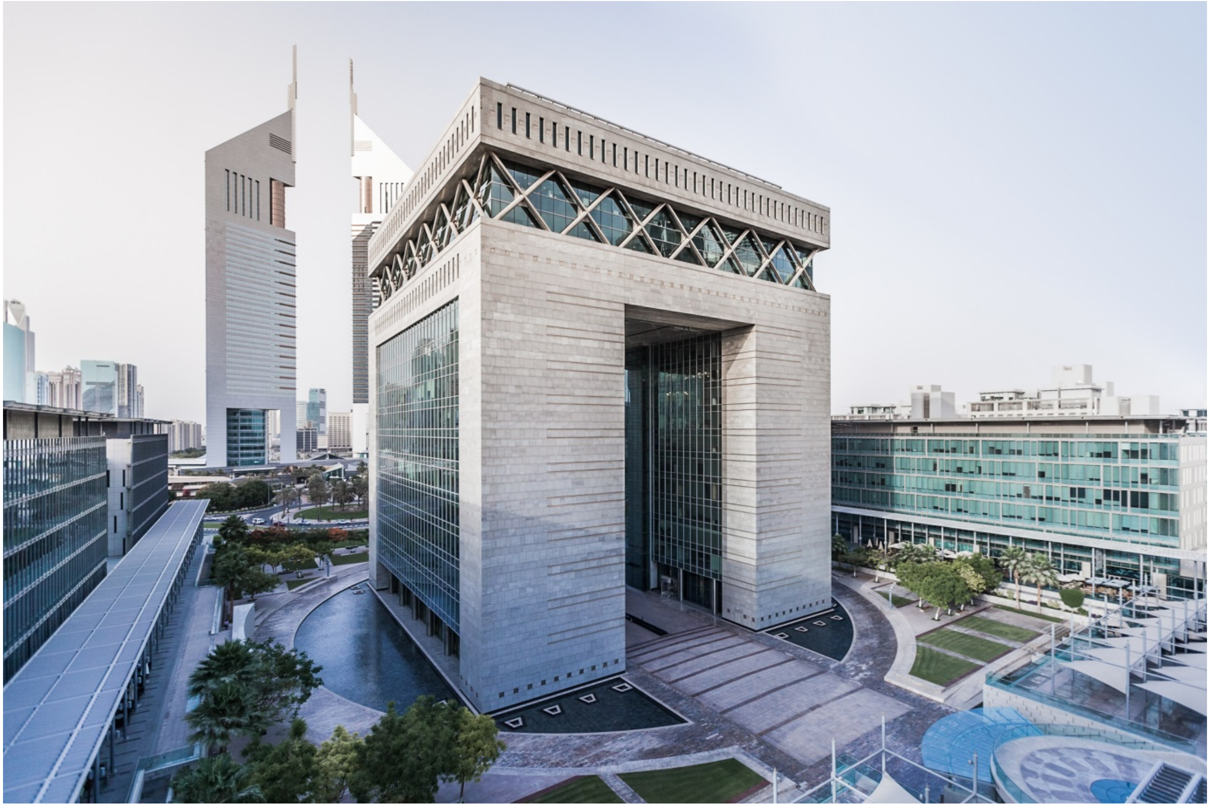
CONSULTATION PAPER NO.113



CAPITAL REQUIREMENTS REVIEW

22 JUNE 2017

PREFACE

Why are we issuing this consultation paper (CP)?

The DFSA proposes to amend the PIB Module of the DFSA Rulebook in order to bring it, where deemed necessary and appropriate, in line with the standards published by the Basel Committee for Banking Supervision. In addition, a small number of other changes are proposed. We are seeking stakeholders' views on these proposals.

Who should read this CP?

The proposals in this paper would be of particular interest to:

a) Authorised Firms carrying out any of the following financial services:

   i. Accepting Deposits;

   ii. Providing Credit;

   iii. Dealing in Investments as Principal;

   iv. Dealing in Investments as Agent;

   v. Dealing as Principal (Matched Principal basis); or

   vi. Managing a profit sharing investment account (unrestricted) (PSIAu);

b) applicants to be any of the above; and

c) advisers to any of the above.

Terminology

In this paper, 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.

What are the next steps?

All comments should be emailed to **consultation@dfsa.ae** using the Table provided in Appendix 1. Please refer to the consultation paper number in the subject line. You may identify the organisation you represent in providing your comments. The DFSA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise at the time of making comments.

The deadline for providing comments is **21 August 2017**.

Once we receive comments, we shall consider whether any changes are required to these proposals and then seek approval from the DFSA Board for the finalised proposals. Once the proposals are approved, we shall issue a notice on our website to this effect.

Structure of this CP

INTRODUCTION

1. The proposals in this paper are designed to implement, where deemed necessary and in the manner appropriate to the DIFC, further aspects of the capital standards developed by the Basel Committee on Banking Supervision (BCBS). The scope of our work has covered the Basel III capital framework[1] (the Basel III framework) as well as the specific guidance on global systemically important banks[2] (G-SIBs) and domestic systemically important banks[3] (D-SIBs). The relevant standards developed by the Financial Stability Board (FSB) were also considered.

2. When formulating the proposals, the DFSA carried out benchmarking against rules of authorities in Australia (APRA), Hong Kong SAR (HKMA), Singapore (MAS) and the United Kingdom (UK PRA). The joint approach adopted by the regulators in Jersey (FSC), Guernsey (FSC) and Isle of Man (FSC) was also considered, as was the recently amended capital framework of the UAE Central Bank (UAECB).

[1] Basel III: A global regulatory framework for more resilient banks and banking systems of June 2011.
[2] Global systemically important banks of July 2013.
[3] A framework for dealing with domestic systemically important banks of October 2012.

3. The proposed changes, which would be expected to take effect from 1 January 2018, are put forward taking into account the implementation solutions adopted in these jurisdictions and after careful consideration of the impact of the proposed changes on the DIFC. The draft proposed changes to the PIB Module of the DFSA Rulebook are attached at Appendix 2.

PROPOSED CHANGES TO THE EXISTING REGIME

I. Changes to the Capital adequacy representation

Please see proposed changes in PIB Chapter 3 and in other relevant Rules at Appendix 2.

4. The Basel III framework and, consequently, the rules implemented by the benchmarked jurisdictions express regulatory capital as a percentage of Risk Weighted Assets (RWA). The capital requirements and limits are represented with reference to RWAs (e.g. CET1 Capital should be at least 6% of the firm's RWA).

5. The PIB Module currently sets the capital requirements and monitors capital adequacy in absolute figure terms, referred to as a Risk Capital Requirement. The capital component requirements and capital buffers set out in the PIB Module are expressed as a percentage of the Risk Capital Requirement (PIB 3.8). For example, CET1 Capital should be equal to at least 60% of the firm's Risk Capital Requirement.

6. As a result, this difference in presentation of capital requirements limits direct comparability of capital adequacy ratios of the DFSA entities with those used by entities reporting under the Basel III framework. In addition, due to the current drafting of the PIB Rulebook and the applicable conversion rates among the various risk classes, there are also implications for the actual capital charges for the DIFC entities, which are effectively lower by several basis points compared to the Basel III requirements related to the Capital Conservation Buffer.

7. We propose a change in the PIB Module introducing the notion of RWAs in relation to capital requirements, capital component limits and buffers. This will align the DFSA regime with the Basel III framework. It will also facilitate for firms the calculation of capital charges by streamlining the process whilst allowing for direct comparability of capital metrics with firms in other jurisdictions, which have implemented the Basel III framework.

II. Adjustments to the provisions on the Capital Requirement

Please see proposed

8. The current provisions in PIB 3.3 and 3.4 are out of line with the Basel III framework in that they do not apply the principle that a

changes in PIB 3.3.2, 3.4.2 and 3.9.2 at Appendix 2.

bank's capital requirement should at all times include the minimum total capital and the applicable capital buffers. The capital buffers include the Capital Conservation Buffer, the Countercyclical Capital Buffer and the HLA Capital Buffer (Capital Buffers). In particular, under PIB 3.3 and 3.4, the Capital Requirement is not calculated as the sum of the Risk Capital Requirement and the Capital Buffers.

9. This may lead to scenarios where the amount of the Capital Requirement applicable to an Authorised Firm is significantly lower than what should be required under the Basel III framework, which is indeed required to cover both the Risk Capital Requirement and the Capital Buffers.

10. To address this, we propose to amend PIB 3.3.2, 3.4.2 and 3.9.2 so that, for the purpose of the calculation of the Capital Requirement, the sum of any Capital Buffers applies at all times on top of the Risk Capital Requirement.

III. Change to the provisions on the Capital Conservation Buffer

Please see proposed changes in PIB 3.9.1 at Appendix 2.

11. PIB 3.9 currently applies to Firms who are in Prudential Categories 1, 2, 3A and 5. Given the objective of the proposed changes is to align with the Basel III framework, which applies to banks, it is proposed not to apply the CCB requirement to Authorised Firms in Prudential Category 3A going forward. The DFSA may revisit the prudential treatment of firms in prudential Category 3A at a later stage.

NEW PROPOSALS

IV. New provisions on Countercyclical Capital Buffer

Please refer to the proposed provisions in PIB 3.9A and 3.9C at Appendix 2.

12. The BCBS Guidance on the Countercyclical Capital Buffer (CCyB) published in 2010[4] is designed to serve a broader macroprudential policy goal of protecting the banking sector in times of economic downturn. It gives national authorities the power to impose additional capital buffers during periods of excessive credit growth to the private non-financial sector.

13. By imposing the CCyB, the domestic authorities seek to ensure that the banking sector is sufficiently capitalised to maintain credit supply to the economy during any period of systemic stress. The

[4] Basel III: A global regulatory framework for more resilient banks and banking systems (para. 137) and Guidance for national authorities operating the countercyclical capital buffer of December 2010.

CCyB also has a moderating effect against the build-up of excessive credit growth by imposing higher credit costs.

14. The CCyB is intended for jurisdictions which are economies and which have at their disposal a set of macroeconomic indicators that enable determination of excessive credit growth to the private non-financial sector. The DIFC is not an economy *per se*, there are no DIFC-specific relevant economic indicators (the data on the DIFC being part of the macroeconomic statistics for the Emirate of Dubai and the UAE). The DIFC private non-financial sector is negligible and there is no noted credit exposure growth to the sector from DIFC-incorporated Authorised Firms.

15. For this reason, the DFSA considers that the power to impose a CCyB on Authorised Firms in relation to their exposures to the DIFC *economy* is not relevant at present.

16. However, the DFSA considers that the second strand to the CCyB contained in the Basel III framework, that of cross-border cooperation based on the principle of jurisdictional reciprocity, is relevant and should be introduced to the DFSA regime. The BCBS considers that failing to reciprocate the CCyB imposed by other jurisdictions would lead to an unlevel playing field and would undermine the idea behind the CCyB.

17. Jurisdictional reciprocity is recognised in all of the benchmarked jurisdictions (e.g. HKMA, MAS, UK PRA and APRA) and applies to all locally incorporated banks.

18. The principle means that jurisdictions should acknowledge and adopt the CCyBs published by each other in order to ensure that the buffer achieves its macroprudential objectives. The domestic authorities in the reciprocating jurisdictions are expected to require banks in their jurisdictions to:

    a) identify their credit exposures to the jurisdiction which imposed the CCyB;

    b) apply the same level of CCyB to these exposures (up to 2.5% of RWA, and beyond this level at the reciprocating jurisdiction's discretion); and

    c) put in place the CCyB within the same time-frame as imposed in the first jurisdiction, which the BCBS recommends to be 12 months (with shorter timelines possible).

19. On this basis, the DFSA proposes to introduce the power to impose the CCyB on DIFC-incorporated Authorised Firms on the basis of jurisdictional reciprocity. The proposed power would have the following parameters:

a) relevant entities would be obliged to apply the CCyBs imposed by the relevant authorities in other jurisdictions, in relation to their exposures to these jurisdictions;

b) the CCyB is a capital buffer on top of, and works in the same way as, the Capital Conservation Buffer (CCB) (i.e. distribution restrictions are imposed to achieve compliance) if the buffer falls below the required CET1 level. In extreme cases the distribution restrictions can affect the entire amount of available earnings;

c) the DFSA will reciprocate the CCyB imposed by other jurisdictions up to 2.5% of RWA, as recommended by the Basel III framework;

d) Authorised Firms should monitor the CCyBs applicable in jurisdictions in which they have credit exposures, for example, based on the lists published by the BCBS on the website of the Bank for International Settlements, and apply them accordingly;

e) entities in the DIFC would have 12 months to put in place the CCyB announced by other jurisdictions from the date it is made public, without the need for any action from the DFSA. We may, however, notify Authorised Firms of a different implementation timeline, if we consider it justified. This approach is recommended by the BCBS and adopted in several jurisdictions against which we benchmarked;

f) any CCyB imposed by the UAECB will apply in the DIFC to the exposures to the DIFC and the UAE at the rate specified by the UAECB; and

g) the DFSA reserves the right to impose a higher level of CCyB than announced by other jurisdictions outside of the UAE, if we consider that those levels are insufficient or where these jurisdictions do not operate, publish or for other reasons not impose the CCyB requirements. In such a case, we would issue a notice to Authorised Firms including a specified CCyB rate that we consider appropriate in the circumstances and the timeline for its implementation. This approach is supported by the BCBS CCyB Guidance and examples from other jurisdictions (e.g. APRA, HKMA).

20. The power is proposed to be implemented without transitional provisions, on the basis that other jurisdictions – who would be the ones putting a CCyB in place - would apply the transitional arrangements. This is similar to the approach the DFSA took when implementing the CCB.

V. New provisions on Global Systemically Important Banks

HLA buffer

Please refer to the proposed provisions in PIB 1.4, 3.9B and 3.9C at Appendix 2.

21. The BCBS framework on Global Systemically Important Banks (G-SIBs), based on the FSB recommendations[5], was published in 2013[6]. It aims to reduce the moral hazard to the global financial system posed by these entities. G-SIBs are identified annually by the FSB, based on an assessment methodology. They are placed in risk buckets based on a number of parameters, with each bucket attracting a specified additional capital buffer known as higher loss absorbency (HLA). The additional HLA buffers are currently set by the FSB at between 1% - 3.5% of RWA (with the top bucket remaining empty, i.e., no G-SIB faces a 3.5% HLA requirement)[7]. All the benchmarked jurisdictions have implemented these provisions.

22. In order to bring the DFSA regime in line with the Basel III framework, the DFSA proposes to introduce the power to impose the HLA buffer, at the rates prescribed by the FSB, applicable to firms in Prudential Categories 1 and 5 (i.e. banks) which are:

a) G-SIBs headquartered in the DIFC for which the DFSA is a consolidated prudential supervisor (automatic application of the HLA buffer); and

b) the subsidiaries of G-SIBs located in the DIFC (subject to DFSA discretion).

23. Whilst the requirement to hold an additional HLA buffer under a) would be automatic, and not subject to the decision-making procedure under Schedule 3 of the Regulatory Law, the situation under b) would be discretionary and the DFSA would follow the

[5] Reducing the moral hazard posed by systemically important financial institutions (FSB, October 2012)
[6] Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement (BCBS, July 2013)
[7] http://www.fsb.org/wp-content/uploads/2016-list-of-global-systemically-important-banks-G-SIBs.pdf

procedure in Schedule 3. In the latter case, an HLA buffer located in the DIFC could be a necessary and useful tool in the context of crisis preparedness and resolution. Both proposals set out in the preceding paragraph are consistent with the BCBS framework.

Disclosures

Please refer to the proposed provisions in PIB 11.1.3 and App 11 at Appendix 2.

24. Under the G-SIB framework, any bank with a total exposure greater than USD200bn (calculated under the Basel Leverage Ratio) is required to disclose in its financial statements a number of quantitative indicators. These provisions are implemented by all jurisdictions where the currently identified G-SIBs are located.

25. On the basis that we propose to introduce the power to impose an HLA requirement on any DIFC-headquartered G-SIBs, which are subject to our consolidated supervision, the DFSA also considers that the corresponding disclosures required by the Basel III framework are necessary. Therefore, we propose to introduce the requirement that any banking group headquartered in the DIFC, identified as a G-SIB and subject to our consolidated supervision, should publish a number of quantitative indicators in their financial statements.

Other measures applicable to G-SIBs

26. In addition to higher supervisory expectations, G-SIBs are also subject to the requirements improving their resolvability such as additional Total Loss Absorbing Capacity (TLAC) and recovery and resolution planning. The DFSA is currently considering, as part of another project, the international standards related to recovery and resolution and how they apply in the DIFC context and will consult on any potential proposals in due course.

VI. New provisions on Domestic Systemically Important Banks

Please refer to the proposed provisions in PIB 1.4, 3.9B and 3.9C at Appendix 2.

27. The DFSA also considered the BCBS framework for dealing with Domestic Systemically Important Banks (D-SIBs) published in 2012[8], which consists of 12 principles. The D-SIB framework is structurally similar to the framework on G-SIBs in that it requires a methodology for designating D-SIBs to which the HLA buffer is applied in line with a number of parameters. It is, however, more principle-based compared to the framework for G-SIBs to ensure

[8] A framework for dealing with domestic systemically important banks (BCBS, October 2012)

that the national authorities can capture adequately any domestic and regional features.

28. After careful consideration of the D-SIB framework, and its implementation in the jurisdictions against which we benchmarked, the DFSA proposes to:

  a) introduce the power to designate as a D-SIB any Authorised Firm in Prudential Categories 1, 2 and 5 incorporated in the DIFC. Please note that, as a result, the D-SIB provisions would cover a larger number of firms than those for G-SIBs. Foreign bank branches, which are not domestic firms, could also be designated by the DFSA as D-SIBs but it is expected that applicable measures would be limited to more intense supervision;

  b) apply to the designated entities an appropriately calibrated HLA buffer, commensurate with an entity's systemic importance in the domestic or regional context, at a rate between 1% and 3.5% of RWA, with the top bucket intended to remain empty in the normal course of events;

  c) the RWA for the purpose of the HLA bucket would be calculated with reference to RWA in the jurisdictions where the entity poses systemic risks. This is to avoid applying higher capital charges to operations in jurisdictions where the Authorised Firm is not systemically important;

  d) if the DIFC D-SIB is also included in the FSB G-SIB list and the entity is classified in a higher HLA bucket, then the DFSA would apply the higher HLA requirement;

  e) treat the HLA buffer as an add-on to the CCB, which must be met by CET1 Capital. Breaching the buffer would result in earnings distribution restrictions (similar to the mechanisms for the CCB and CCyB); and

  f) the designation as a D-SIB and the application of the HLA buffer would be subject to the procedure set out in Schedule 3 of the Regulatory Law.

29. The DFSA will make publicly available, in due course, the assessment methodology for identifying which Authorised Firms would be considered systemically important in the domestic or regional context, and a methodology for calculating the HLA buffer applicable to these entities. The methodologies will take due account of the Principles of the BCBS D-SIB framework.

Questions for your consideration

1. **Do you have any comments on, or concerns related to, the proposed rule changes? If so, what are they and how should they be addressed?**

2. **Please could you comment on the expected impact of the proposed changes on your DIFC activities?**

3. **Do you have any comments on the proposed timing of the changes?**

Appendix 1: Table of Comments

Name of commentator:		
Name of entity (if applicable)		
Is your response confidential?	☐ Yes	☐ No
If your response to the previous question is Yes, please state your reasons for such a request:		

Notes:

- 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. You must also provide an explanation of why you wish your comments be kept confidential.
- Your answers may require explanations. Please include those in the second column.
- If you do not wish to comment on any issue, please select the “no comments” box.

Ref.	Response	Comments on proposal	
Q1:	**Do you have any comments on, or concerns related to, the proposed rule changes? If so, what are they and how should they be addressed?**		
	☐ Yes ☐ No	Click here to enter text.	☐ No comments
Q2:	**Please could you comment on the expected impact of the proposed changes on your DIFC activities?**		
	Click here to enter text.		☐ No comments
Q3:	**Do you have any comments on the proposed timing of the changes?**		
	☐ Yes ☐ No	Click here to enter text.	☐ No comments