CONSULTATION PAPER NO.114

LIQUIDITY REQUIREMENTS REVIEW

22 JUNE 2017

PREFACE

Why are we issuing this consultation paper (CP)?

The DFSA proposes to amend the provisions on Liquidity Risk contained in the PIB Module of the DFSA Rulebook in order to align them with the standards published by the Basel Committee for Banking Supervision. We are seeking stakeholders' views on these proposals.

Who should read this CP?

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

a) Authorised Firms carrying out any of the following Financial Services:

   i. Accepting Deposits;

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

   iii. Providing Credit; or

   iv. Dealing in Investments as Principal;

b) applicants to be any of the above; and

c) advisers to any of the above.

Terminology

In this CP, 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 CP 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 to these proposals are required 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 CP are designed to implement, in the manner appropriate to the DIFC, the remaining elements of the Basel III liquidity framework[1] (the Basel liquidity framework) developed by the Basel Committee on Banking Supervision (BCBS). The Basel liquidity framework, which introduced the global liquidity standard, covers three essential elements: the Liquidity Coverage Ratio (LCR), the Net Stable Funding Ratio (NSFR), and monitoring tools.

2. The proposals set out in this CP constitute the second part of the implementation process undertaken by the DFSA and keep in line with the BCBS implementation deadlines. They follow and complement the changes brought in to the DFSA liquidity regime by the rules on the LCR consulted on in CP99 and introduced in 2015.

3. The scope of the current review covered both the qualitative and quantitative aspects of the Basel liquidity framework and, in particular, the following standards:

   a) Principles for Sound Liquidity Risk Management and Supervision, September 2008;

   b) Core principles for effective banking supervision, September 2012;

   c) The Liquidity Coverage Ratio and liquidity risk monitoring tools, January 2013;

   d) Monitoring tools for intraday liquidity management, April 2013;

   e) Liquidity coverage ratio disclosure standards, January 2014;

[1] Basel III: A global regulatory framework for more resilient banks and banking systems of June 2011.

f) Basel III: the Net Stable Funding Ratio, October 2014; and

g) Net Stable Funding Ratio disclosure standards, June 2015.

4. In addition, we have taken into account the Guidance Note on Quantitative Measures for Liquidity Risk Management in Institutions Offering Islamic Financial Services published by the Islamic Financial Services Board in April 2015[2] (the IFSB Guidance).

5. 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).

6. The proposed changes 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. The proposed changes are intended to take effect from 1 January 2018.

I. Changes to the management of Liquidity Risk

Please see proposed changes in PIB 9.2 and 9.2.A.

7. We have reviewed the existing provisions on qualitative requirements for Liquidity Risk policy, systems and controls set out in PIB 9.2 against the BCBS Sound Principles referred to in paragraph 3a) above. Several gaps were identified, which the proposed changes seek to address.

8. In particular, the following new requirements are proposed in PIB 9.2 (with the first two being elevated from the Guidance to the Rule level and expanded):

   a) a requirement to manage collateralised and encumbered assets actively through appropriate systems;

   b) a requirement to manage intra-day liquidity positions in a prudent manner, including a range of sub-requirements as to how this should be achieved; and

   c) a requirement to allocate liquidity costs, benefits and risks to products and business lines.

8. In addition, it is proposed to clarify the existing DFSA power to require an Authorised Firm to revoke the delegation to another Group entity of its liquidity risk management, which is currently possible under PIB 9.2.3. This clarification improves our regime overall and remains in line with the Basel liquidity framework.

[2] Guidance Note on Quantitative Measures for Liquidity Risk Management in Institutions Offering Islamic Financial Services

9. Lastly, we have added a few small textual improvements and enhanced the Guidance to some rules with a view to assisting Authorised Firms in their application of the rules.

II. Implementation of the Net Stable Funding Ratio

Please see proposed changes in PIB 9.3 and App9 at Appendix 2.

10. The DFSA proposes to implement the Basel III NSFR standard in the DIFC as a necessary tool of addressing bank liquidity risk management at the long end (i.e. out to one year), complementing the LCR which was implemented in the DIFC in 2015, which covers the short end (i.e. 30-day horizon). The objective of the standard is to ensure that banks fund their activities with sufficiently stable sources of funding over a one-year horizon.

NSFR in the DIFC

11. We are proposing to implement the NSFR standard with very limited changes compared to the BCBS text. The implementation also incorporates, where relevant, the elements of the IFSB Guidance applicable to Islamic financial institutions (IFIs). In this context, IFIs are firms authorised to manage unrestricted profit sharing investment accounts (PSIAu).

12. The proposed provisions would have the following parameters:

a) stable funding is considered in relation to the composition of a bank’s assets and off-balance sheet activities by dividing “Available Stable Funding (ASF)” by the amount of “Required Stable Funding (RSF)”. The ratio should be at least 100% at all times and can be depicted as follows:

$$\frac{\text{Available Amount of Stable Funding (ASF)}}{\text{Required Amount of Stable Funding (RSF)}} \geq 100\%$$

b) the ASF amount is determined by assigning stability factors ranging from 100% to 0% to capital and liabilities, assuming a degree of stability. The stability factors are based on two dimensions:

i. the term of the liability (i.e. the longer the maturity the more stable the funding); and

ii. the type of funding and counterparty (e.g. funding from retail and SME[3] customers is deemed to be more stable than wholesale funding);

c) there are five liability categories to which specific ASF factors are assigned. To determine the total ASF, banks must multiply the value of the funding in each of the five categories by the related ASF factor and add the resulting amounts. The categories of funding sources, presented in abbreviated form, are as follows:

Liability/Capital Instrument	ASF
➢ All capital instruments and liabilities with a residual maturity in excess of 1 year	100%
➢ Stable[4] SME and retail deposits (including at call) and/or PSIAus maturing in less than 1 year	95%
➢ Less Stable[5] SME and retail deposits (including at call) and/or PSIAus maturing in less than 1 year	90%
➢ Non-financial corporates' funding maturing in less than 1 year ➢ Operational deposits or operational accounts of financial institutions ➢ PSE, sovereign, and Multilateral Development Banks funding ➢ All other funding (secured and unsecured) maturing between 6 months & 1 year	50%
➢ All other liabilities (funding from central banks with residual maturity of less than a year, interbank funding <6m, trade date payables)	0%

d) the RSF is determined by assigning RSF factors to the bank's on- and off-balance sheet assets based on both the

3 The SME definition is set out in paragraphs 273-274 of the Basel II framework; see BCBS, International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version.

4 As defined in the LCR guidance (4) under APP9.2.15. It refers to the deposits that are fully insured by an effective deposit insurance scheme or by a public guarantee.

5 As defined in the LCR guidance (5) under APP 9.2.15. All other deposits not covered under "stable deposits" definition.

residual maturity and the liquidity value of these assets (i.e. the ease with which they can be liquidated). The factors range from 100% for the most illiquid exposures, which need to be entirely financed by stable funding, to 0% applied to the most liquid unencumbered assets[6]. Banks must multiply the value of their exposures in each of the eight RSF unencumbered asset categories by the related RSF factor and add the resulting amounts. The RSF categories and factors, presented in abbreviated form, are as follows:

Type of Unencumbered Asset	RSF %
➢ Cash, claim & reserves at the Central Bank less than 6 Months ➢ Sold Financial Instruments expected to settle	0%
➢ Level 1 LCR HQLA excluding those with 0% RSF assigned. ➢ Off-balance sheet exposures - undrawn portion of irrevocable or conditionally revocable liquidity and credit facilities to any client	5%
➢ Repos with Financial Institutions secured with level 1 LCR HQLA and that have residual maturity less than 6 months	10%
➢ All other loans to FIs less than 6 months ➢ LCR HQLA Level 2(A)	15%
➢ LCR HQLA Level 2 (B) ➢ All loans to FIs and CB with maturity between 6 months and 1 year ➢ All other loans with maturity less than 1 year	50%
➢ Unencumbered residential mortgages and loans with 35% risk weight (excluding those to financial institutions)	65%

[6] In the context of the ASF and the RSF calculations, the NSFR standard also provides for rules on encumbered assets, treatment of special short-term central bank operations, securities financing transactions and derivatives.

➢ Margins and contribution to default funds posted with CCPs against derivative contracts or Shari'a compliant hedging contracts ➢ All other loans (not mortgages) with risk weight over 35% (excluding FI loans)	85%
➢ Net NSFR derivative assets or 20% of NSFR Net derivative liabilities or Shari'a compliant hedging liabilities ➢ All other assets (NPLs, FI loans >1 year, fixed assets, items deducted from capital, non-exchange traded equities).	100%
➢ Unconditionally revocable credit and liquidity facilities ➢ Trade related LCs and LGs ➢ Non contractual obligations such as: buy back of own debt securities, redemption of managed funds, structured products	National Discretion

Scope of application

13. The NSFR standard is intended to apply to all internationally active banks on a consolidated basis. National supervisors may, however, also choose to apply it to sub-groups (i.e. specific parts of a banking group) or to non-internationally active banks.

14. On this basis, we are proposing to apply the NSFR rules to DIFC-incorporated Authorised Firms who are Accepting Deposits or Managing PSIAus.

15. We are not proposing to apply these rules to DIFC-based branches of international banks, on the assumption that they will be subject to the NSFR on a consolidated basis in their home jurisdictions. Having said that, we intend to reserve the right to cover these entities, if deemed appropriate, if their home jurisdiction decides not to implement the NSFR rules or delays implementing them.

National discretion

16. Under the NSFR framework, only one area of national discretion can be exercised by domestic regulators. It relates to the RSF

factors for specific off-balance sheet contingent funding obligations.

17. After consideration, and bearing in mind that no examples from other jurisdictions exist so far, we propose adopting similar factors to those currently used under the LCR regime (PIB Rule A9.2.15). This approach would ensure consistent implementation of the quantitative requirements on liquidity. The RSF factors would include:

Off-Balance Sheet Contingent Funding Obligations	RSF Factor
Unconditionally revocable credit and liquidity facilities	5%
Trade finance related obligations (including guarantees and letters of credit)	3%
Guarantees and letters of credit unrelated to trade finance obligations	10%
Non contractual obligation:	
• Debt-buy back requests (including related conduits)	100%
• Structured products (such as adjustable rate notes and variable rate notes)	10%
• Managed funds (with the objective of maintaining a stable value)	10%
• Other non-contractual obligations	100%

Benchmarking and application

18. The above proposals could not be benchmarked against other jurisdictions since the standard is not yet applicable. A high degree of compliance by BCBS members can be expected in advance of the agreed implementation deadline on 1 January 2018. The DFSA is also proposing to apply the NSFR provisions from that date.

III. Adjustments to the provisions on the LCR

Please see proposed changes in PIB A9.2.15 and A9.2.18

19. As noted above, as part of the present review we have considered the IFSB Guidance, which was published after the introduction of the LCR regime in the DIFC. Based on this we propose to supplement the provisions in PIB A9.2.15 and

at Appendix 2.

A9.2.18 with the relevant elements related to Shari'a compliant financing for firms in prudential Category 5.

20. That said, bearing in mind the DFSA's power under A9.2.9 to approve other types of assets as HQLA, including specifically Shari'a compliant financial products, we are not proposing to supplement the provisions related to HQLA with specific references.

IV. Disclosure and reporting requirements for the LCR and the NSFR

Please see proposed changes in PIB 11.3, App2 and App11 at Appendix 2.

21. The Basel III LCR and NSFR standards require firms to disclose publicly qualitative and quantitative aspects in relation to these ratios. The BCBS has developed and published common disclosure templates (and accompanying completion instructions) to be used for this purpose and implemented without changes in order to ensure consistency across firms globally. Since the IFSB supplemented the BCBS tables with elements related to Islamic financial institutions, we have also taken these into account.

22. The disclosures must be made through the firms' published financial statements or, at a minimum, a direct link should be provided to the publicly available disclosures. The frequency of publication should be the same as that of the financial statements (including unaudited) and based on quarterly data.

23. In order to bring the provisions of PIB 11.3 in line with these requirements, we are proposing that the disclosure of the NSFR be added to the list of quarterly disclosures. This requirement is complemented by the detailed disclosure templates for both the NSFR and the LCR in Appendix 11 to the PIB Module. Although the disclosure requirement related to the LCR existed in PIB 11.3, the detailed template is proposed to be added to PIB only now.

24. In addition, the LCR and the NSFR standards require ongoing monitoring and supervisory review to ensure appropriate implementation and compliance by banks. For the NSFR, in particular, it should be calculated and reported by the firms subject to this requirement at least quarterly and no later than the reports on capital adequacy.

25. In order to facilitate the reporting of the NSFR, we propose to introduce a new reporting form - B95 - which firms will be formally required to use from Q1 2018.

V. Adjustments to the provisions on the Maturity Mismatch Ratio

Please refer to the proposed provisions in PIB 9.3.10 at Appendix 2.

26. As mentioned at paragraph 2, the DFSA introduced the Basel III framework on LCR for relevant firms from 1 January 2015. The LCR aims to enhance the ability of a bank to survive an idiosyncratic and system wide severe stress period of 30 days by requiring the bank to hold HQLA to cover its net cash outflows within the stress period.

27. Prior to the introduction of the LCR, the DFSA relied on the Maturity Mismatch Ratio ('MMR'), set out in PIB 9.3.10 and 9.3.11, to measure and control liquidity risk. The provisions on the MMR were retained when the LCR was introduced. Since, in substance, the MMR is similar to the LCR, this has led to duplication of requirements.

28. Specifically, the LCR requires banks to hold HQLA to cover the cumulative net cash outflow during a 30-days stress scenario, which is equivalent, to a large extent, to the "Sight – 1 month" ratio under the MMR. For this reason, we are proposing to abolish the "Sight – 1 month" ratio on the basis that is has been replaced by the LCR. Form B80 would be revised to reflect this.

29. That said, if the provisions of the MMR were to be abolished entirely, certain gaps and risks might arise that were not previously present. In particular, although the LCR standard requires the firm to hold HQLA to cover the cumulative net cash outflow for a 30-day stress scenario, it does not address the issue of the timing of outflows within that period. The risk that liquidity mismatch may arise within the 30-day period is not inconceivable and may be significant. The BCBS LCR standard recognises this issue and leaves it to national supervisors and banks' own discretion to ensure that mismatches are properly addressed.

30. For this reason, we are not proposing to remove the "Sight - 8 days" ratio under the MMR, which we consider is working well so that short-term liquidity mismatches are adequately controlled. This approach is in line with the practices adopted by other regulators (e.g. the UK PRA, the EU's Single Supervisory Mechanism) to address risks within the 30-day period.

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