Dubai Financial Services Authority

CONSULTATION PAPER NO. 58

29 JULY 2008

IMPLEMENTATION OF PILLARS 2 & 3 OF BASEL II

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Why are we issuing this paper?

1. This Consultation Paper seeks public comments on the DFSA's proposals to implement Pillars 2 and 3 of Basel II. The proposals involve changes to the following modules of the DFSA Rulebook:

GEN	(see Appendix 1)
GLO	(see Appendix 2)
SUP	(see Appendix 3)
PIB	(see Appendix 4)
PIN	(see Appendix 5)

Who should read this paper?

2. The proposals in this paper would be of particular interest to Authorised Firms within Categories 1, 2, 3 or 5, and Insurers (other than PCCs, Captive Insurers and Authorised ISPVs). The proposals may also be of interest to Registered Auditors and Ancillary Service Providers operating in the realm of accounting and audit.

How is this paper structured?

3. In this paper, we set out:

   (a) the background and overview of the proposals (paragraphs 7-30); and

   (b) proposed Rule amendments (paragraphs 31-39).

How to provide comments?

4. All comments should be forwarded to the person specified below. You may, if relevant, 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.

What happens next?

5. The deadline for providing comments on the proposals is by close of business on **1 November 2008**. Once we receive your comments, we will consider if any further refinements are required to these proposals. We will then proceed to enact the changes to the DFSA's Rulebook. You should not act on these proposals until the relevant changes to the DFSA Rulebook are made. We will issue a notice on our website telling you when this happens.

Comments to be addressed to:

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Definitions

6. Defined terms are identified throughout this paper by the capitalisation of the initial letter of a word or of each word in a phrase and are defined in the Glossary (GLO) module. Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning. Some proposed changes to GLO are in Appendix 2.

Background

7. While most acknowledge that Basel II is an improvement over Basel I in terms of risk management standards and overall granularity of risk profiles, many financial professionals are debating whether Basel II could have prevented or lessened the impact of the recent crisis. These questions and arguments appear to be targeted at the capital calculation component of Basel II, rather than the supervisory review or market discipline components. Given this background, we believe implementation of Pillar 1 of Basel II is best reserved for a future date; however, we are minded to move ahead with implementation of Pillars 2 and 3. The following text outlines the background of the capital adequacy accords and provides the logic behind our recommendations. We encourage and welcome your considered feedback on this initiative.

8. In 1988, the Basel Committee on Banking Supervision (BCBS) published a framework for determining the capital adequacy for banks, commonly referred to as Basel I. Basel I was designed to strengthen the soundness and stability of the international financial system and to achieve a consistent framework for capital adequacy measurement globally. Basel I has been successful in achieving its objectives and has been adopted as a standard for prudential regulation in almost all countries of the world. A decade after Basel I, BCBS started work on an enhanced version of the framework with the primary objective of making the framework more risk-sensitive.

9. The BCBS published the revised framework of capital adequacy, commonly referred to as Basel II, in November 2005. The fundamental objectives of Basel II are to:

- strengthen the stability and soundness of financial services firms; and
- promote the adoption of stronger risk management practices.

The framework aims at significantly higher levels of risk sensitivity in calculating capital requirements and greater consistency in capital adequacy regulation across jurisdictions. Basel II involves greater use of internal risk assessments by firms and the consequent use of such risk assessments as inputs in their own assessment of risk and capital adequacy.

10. Basel II includes three main components, commonly referred to as three pillars:

- Pillar 1 - Minimum Capital Requirements;
- Pillar 2 - Supervisory Review Process; and
- Pillar 3 - Market Discipline.

Pillar 1 specifies the approaches allowable for arriving at minimum capital requirements. Pillar 2 deals with the supervisory review process which is intended to encourage better risk management practices and to ensure that firms hold adequate capital to address all risks, including any risks not covered in their Pillar 1 calculations. Pillar 3 aims to encourage market discipline, as a complement to the other two pillars, by specifying a set of disclosure requirements which will allow market participants to assess the soundness and risk levels of an institution.

11. The DFSA considers that it is essential to implement Basel II, though in a manner appropriate and proportionate to DIFC Authorised Firms, to be in line with the latest international prudential supervision standards and to ensure compliance with the revised Basel Core Principles. This is also consistent with the DFSA's philosophy of ensuring that DIFC is at the forefront of international standards and best practices. Our benchmarking indicates that most of the DFSA's peer regulators have either implemented or are in the process of implementing Basel II in their jurisdictions.

12. The DFSA proposes to proceed with implementing Pillars 2 and 3 now, and to implement the Pillar 1 provisions later. Given the current situation in the financial sector around the globe, we believe the elements of Pillar 1 are best adopted at a later date. This strategy remains consistent with the guidance offered by BCBS for implementation of Basel II, wherein BCBS has suggested that supervisors of certain markets may retain their current capital adequacy regime (Pillar 1) and concentrate on building a robust supervisory review framework (Pillar 2) and on enhancing market discipline (Pillar 3). The proposed implementation will therefore not include any aspect of Pillar 1 and consequently there will be no changes to the Rules for measuring Capital Requirements and Capital Resources specified in the PIB module of the DFSA Rulebook.

13. The DFSA's decision to delay implementing Pillar 1 is based on the relatively early stage of development of the DIFC financial market, and of firms within it, and that the PIB and PIN Rules currently provide an appropriate risk-sensitive capital adequacy regime.

14. Effective implementation of Basel II also requires that implementation suit the requirements of the jurisdiction and be accomplished in a proportionate and flexible manner, suitable for all regulated firms in a market. The DFSA believes that the proposed implementation approach suits the market in the DIFC and the nature and complexity of Authorised Firms operating within it.

Overview of the proposals

15. The proposed implementation and consequent Rule changes apply only to Domestic Firms which are in Categories 1, 2, 3 and 5, or are Insurers. In relation to Insurers, it is proposed that they will not apply to Protected Cell Companies (PCCs), ISPVs or Captive Insurers. The scope of application of the proposed Rules varies across the types of firm with less complex firms being subject to simpler requirements.

16. Domestic Firms in Categories 1 and 5, and Domestic Insurers (not PCCs, ISPVs or Captives), will be covered by the full scope of the Basel II implementation because of the relatively higher levels of risk posed by these Authorised Firms to the DFSA's objectives, given the nature and complexity of

their businesses. Implementation of the proposals is expected to help the firms in enhancing their risk management processes and to ensure that these Domestic Firms maintain adequate capital to address all risks faced by them.

17. Domestic Firms in Categories 2 and 3 will be covered by a reduced scope of implementation, which will require them to make a regular assessment of their risks, but not to perform their own assessments of capital adequacy, or to make enhanced disclosures to the market.

18. Although Basel II is primarily aimed at banks and deposit takers, the DFSA believes that this scope of implementation will encourage all relevant Domestic Firms to enhance their risk management standards. In addition, the implementation of Basel II will ensure that the DFSA's regulatory framework continues to reflect best regulatory practices. In this context we note that within Europe the Capital Requirements Directive applies a Basel II based approach to investment firms corresponding largely to our own Categories 2 and 3.

19. Pillars 2 and 3 are aimed at strengthening the management of all types of risks and enhancing market discipline. Many financial services firms face risks which are not covered by current prudential rules and cannot be readily addressed by availability of capital. The proposed Pillar 2 processes will require such firms to assess their risks and document their risk management processes. While certain questions are being raised with regard to the effectiveness of Pillar 1, given the large losses in the financial sector over the past year, relatively few questions have arisen with regard to the scope and application of Pillars 2 and 3. The overall approach to implementation, described below is broadly consistent with the approach taken by the Committee of European Banking Supervisors (CEBS), and is in line with guidance produced by the BCBS.

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Issues for consideration

Is it appropriate to implement Basel II Pillars 2 and 3 in the financial services industry of the DIFC, and at this time? If not, why not?

Is the scope of application appropriate?

Are there additional types of firm that should be included, or excluded?

Pillar 2

20. All Domestic Firms to whom the proposals apply (i.e. firms in Category 1, 2, 3 or 5 and firms which are Insurers other than PCCs, Captive Insurers or Authorised ISPVs) will be required to establish, maintain and operate adequate processes for completing robust internal risk assessments on an annual basis. An Internal Risk Assessment Process (IRAP) is an internal process of a Domestic Firm which should enable its senior management and Governing Body to adequately identify, assess, aggregate and monitor all the risks faced by the firm. The results of these assessments are required to be documented and submitted to the DFSA. The proposed Rules also require Authorised Firms to ensure a robust level of corporate governance over their IRAP so that the results are meaningful and contribute towards the objective of improving the internal risk management of the firm.

21. Additionally, Domestic Firms in Category 1 or 5, and those Insurers to whom the proposals apply, will be required to establish, maintain and operate adequate processes for completing robust internal capital adequacy assessment on an annual basis, using the results of their IRAP assessments. An Internal Capital Adequacy Assessment Process (ICAAP) is an internal process of a firm which enables the firm to identify risk elements which can be addressed with capital and aggregate them to determine the level of capital it needs to address all such risks and ensure that it holds adequate capital commensurate with the firm's risk profile. The results of these assessments are required to be documented and submitted to the DFSA. The proposed Rules would also require Domestic Firms in the relevant Categories to ensure a robust level of corporate governance and adequate oversight by senior management over their ICAAP processes so that the objective of ensuring adequate capital to address all risks is effectively achieved.

22. Both IRAP and ICAAP where applicable should form an integral part of the management and decision-making processes of the firm. They need to be comprehensive, forward-looking and covered by adequate oversight and governance.

23. The DFSA will review the results of the IRAP and, where applicable, the ICAAP as part of its Supervisory Review and Evaluation Process (SREP). The results of the SREP will enable the DFSA to determine the required level of supervisory oversight and identify the appropriate mix of supervisory tools.

24. The SREP review of a firm's ICAAP assessment may lead to the conclusion that the firm needs to maintain higher capital requirements than those determined using the applicable prudential rules. In such cases, the DFSA will specify an Individual Capital Requirement (ICR) for that firm, which will be in excess of the Capital Requirement (or, for an Insurer, Minimum Capital Requirement) calculated using applicable prudential rules. The DFSA will determine the ICR after considering the results of the SREP taking into account all the risks identified as part of the ICAAP and subsequent discussions with the firm, if need be. The DFSA will also consider other appropriate remedial measures which can help in achieving the desired supervisory objectives before resorting to issuing an ICR.

25. The DFSA may also specify an ICR for a firm in Category 2 or 3, which does not have to submit an ICAAP. This will again be done following the SREP, and after a similar process of consideration and discussion with the firm.

26. At present, GEN Rule 5.3.4 requires all Authorised Firms to establish and maintain risk management systems and controls to enable them to identify, assess, mitigate, control and monitor their risks. In requiring IRAP assessments the proposed Rules seek to give a structured framework to meet this current rule requirement. However, the DFSA will expect a firm to meet the IRAP requirements in a flexible manner proportionate to the scale and complexity of its activities.

Pillar 3

27. The primary objective of Pillar 3 is to complement the minimum capital requirements and the supervisory review process, by bringing market discipline to bear on firms. The BCBS has prescribed a set of minimum disclosure requirements which will enable market participants to take their own view of the risks and long-term soundness of an institution.

28. The prescribed set of disclosure requirements will require a firm to provide key information on the financial group structure, if applicable, capital, risk exposures, risk assessment processes. The risks to which firms are exposed and the techniques that those firms use to identify, assess, monitor and control those risks are important factors market participants consider in their assessment of a firm.

29. As regards Insurers, the International Association of Insurance Supervisors has recommended enhanced disclosures, and an enhanced disclosure regime is also being proposed by the European Commission as part of the Solvency II proposals.

30. The proposed Rules apply the disclosure requirements to Domestic Firms in Categories 1 and 5 and Insurers (except those excluded in paragraph 14). In the case of Financial Groups, the disclosure requirements are placed on the Parent entity of the Financial Group.

Issues for consideration

Do the Pillar 3 proposals apply to the appropriate sectors and categories of Authorised Firm? If not, what additional types of firm should be included or excluded?

Should the DFSA include Liquidity Risk as a separate risk element, even though guidance and discussion of this critical risk element by BCBS remains mostly in consultative and draft form?

Are the proposed disclosures appropriate? If not, what changes should be made?

Detailed description of the drafting (Pillar 2)

31. Proposed Rules in new chapter 6 in SUP, section 2.11 of PIB and section 4.5 of PIN incorporate key aspects of Pillar 2. The DFSA will consider a waiver request in relation to the requirements described below, if the Authorised Firm is a member of a Group and is consequently subject to similar or more stringent regulatory requirements at the Group level.

IRAP

32. Proposed section 6.3 of SUP requires a Domestic Firm which is in Category 1, 2, 3 or 5 or which is an Insurer (other than a PCC, Captive Insurer or Authorised ISPV) to establish and maintain an IRAP. The IRAP must identify, assess, aggregate and monitor the risks faced by the firm. Proposed App2 provides guidance on the types of risks that should be considered when a firm undertakes its IRAP.

ICAAP

33. Proposed section 6.4 of SUP stipulates the requirement for a Domestic Firm in Category 1 or 5 or which is an Insurer (other than a PCC, Captive Insurer or Authorised ISPV) to carry out an ICAAP on the basis of the results of its IRAP. Proposed App3 provides Guidance on the ICAAP process.

SREP

34. Proposed section 6.5 of SUP incorporates a process for the DFSA to review and evaluate an Authorised Firm's IRAP and ICAAP assessments. The SREP will include review and assessment of all the material risks borne by the firm as well as its internal controls and governance to manage those risks. Proposed App4 provides Guidance on the supervisory process of reviewing and assessing the IRAP and ICAAP.

ICR

35. Proposed sections 2.11 of PIB and 4.5 of PIN incorporate provisions to enable the DFSA to impose an ICR or a Financial Group ICR on an Authorised Firm on the basis of the results of the SREP. Currently, the DFSA has the means to impose capital requirements which are higher than those determined using PIB Rules for a specific Authorised Firm, by imposing a condition on that firm's licence. The proposed approach includes incorporating explicit rules which would enable the DFSA to impose higher capital requirements. It is expected that such powers would be used only in cases where other risk mitigants and/or supervisory tools are inadequate to address the risks identified in the IRAP or ICAAP or SREP.

36. Consequential changes relating to the ICR have also been made to relevant sections in the PIB and PIN module as marked in Appendix 4 and 5.

Issues for consideration

Are the proposed amendments clear and unambiguous?

Are the proposed SREP and its relationship with the IRAP and ICAAP clearly understandable? Would further Guidance be helpful?

Detailed description of the drafting (Pillar 3)

37. Proposed Rules in sections 9 of PIB and 11 of PIN incorporate disclosure requirements for a Domestic Firm which is in Category 1 or 5, or which is an Insurer (other than a PCC, Captive Insurer or Authorised ISPV), as applicable.

38. In the case of a Domestic Firm within Category 1 or 5, the proposed section 9 of PIB and App8 together generally set out the disclosure policy and the type of qualitative and quantitative disclosures that a firm is required to make. The disclosures generally relate to group information, business of the firm, the types of risks faced by the firm and capital adequacy. These disclosures are modelled on those recommended by CEBS.

39. Similarly, in the case of an Insurer, the proposed section 11 of PIN and App 11 set out the disclosure policy and the type of qualitative and quantitative disclosures that an Insurer is required to make. The disclosures also generally relate to group information, business of the firm, the types of risks faced by the firm and capital adequacy. The disclosures for Insurers are modelled on those in the EU Solvency II proposals.

Issues for consideration

Are the proposed amendments clear and unambiguous?

Do Authorised Firms see any practical difficulties with the proposed Guidance and Rules?